Chapter 1: New Tax Legislation

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Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

INTRODUCTION

The major 2002 tax bill is the Job Creation and Worker Assistance Act of 2002. However there are several tax provisions from prior bills that become effective for 2002 which merit discussion. The bills listed below will be covered within the chapter, but not in entirety. The following codes will be used to identify the bills that contain the provisions covered in this chapter.

- Economic Growth and Tax Relief Reconciliation Act of 2001 — EGTRRA
- Victims of Terrorism Tax Relief Act — VTTRA
- Extraterritorial Exclusion Act of 2000 — EEA
- Job Creation and Worker Assistance Act of 2002 — JCWA
- Farm Security and Rural Investment Act of 2002 — FSRIA

This chapter is not designed to be all-inclusive. It covers topics that will likely be important to the majority of tax practitioners. For provisions covered in other chapters within this workbook, only brief summaries are provided in this chapter. When this occurs, information referring to the chapter and page numbers where detailed information can be found is provided.

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

Background

The Economic Recovery and Tax Relief Reconciliation Act of 2001 was signed into law on June 7, 2001. This is a very comprehensive tax bill and provides changes to many sections of the Internal Revenue Code. This bill is discussed in detail in Chapter 9 of the *2001 Farm Income Tax Workbook*. Since many provisions of the bill did not become effective until 2002 or later, only those with a 2002 effective date are included here.

CREDIT FOR EMPLOYER-PROVIDED CHILD-CARE EXPENSES

EGTRRA
Act §205
[New I.R.C. §45F]
Effective Date: Tax years beginning after December 31, 2001.

Employers may receive a tax credit of up to $150,000 for qualified child-care expenses.

- A 25% credit applies to costs of building or operating a facility.
- A 10% credit applies to resource and referral services.
- The credit reduces deductions.
- The credit is subject to recapture.

Amount of Credit

The 2001 Act creates a new tax credit for child-care expenses paid for by businesses on behalf of their employees. These business taxpayers will receive a tax credit equal to **25%** of qualified expenses for "employee child-care" plus **10%** of "child-care resource and referral services." An expense is considered a qualified child-care resource and referral expense if it is incurred under a contract to provide child-care resource and referral services. The maximum total credit that may be claimed by a business taxpayer cannot exceed $150,000 per taxable year.

Example 1. Central Paper Co. is a calendar year 1120 Corporation. In 2002, Central establishes a child-care facility for dependents of its employees with children age six weeks to four years. It is located in a previously vacant portion of its headquarters building. It incurs $87,000 in qualified child-care expenditures. It also decides to initiate a child-care referral service for employees with children who are five years and older. The company hires KidCare, Inc. to provide this service for $10,000.

Summary of 2002 Expenses Paid by Corporation:

- $75,000 is used to rehabilitate space for the child-care facility
- $12,000 is used for operating expenses (utilities, repairs, insurance, etc.)
- $10,000 paid under contract to KidCare, Inc. for resource and referral services

Central's 2002 employer-provided child-care credit would be **$22,750** (($87,000 × 25%) + ($10,000 × 10%)) on **Form 8882**. The $22,750 credit is carried to Part I, line O on Central's Form 3800, General Business Credit.

Qualified Child-Care Expenses

Qualified child-care expenses include costs paid or incurred:

1. To acquire, construct, rehabilitate, or expand property that is to be used as part of the taxpayer's qualified child-care facility;
2. For the operation of the taxpayer's qualified child-care facility;
3. Under a contract with a qualified child-care facility to provide child-care services for employees of the taxpayer.

However, the law cautions that qualified child-care expenses cannot include expenses in excess of the fair market value (FMV) of this type of care.

Qualified Child-Care Facility

To be a "qualified child-care facility," the facility must:

- be used principally for child-care (unless it is the principal residence of the taxpayer);
- meet all applicable state and local laws and regulations;
- have open enrollment to the taxpayer's employees;
- not be located in a portion of the employer's or an employee's personal residence; and
- not discriminate in favor of highly-compensated employees as defined in I.R.C. §414(q).

If the facility is the principal trade or business of the taxpayer, at least 30% of the children enrolled in the facility must be dependents of the taxpayer's employees.

Basis reduced. The amount of the 25% credit to acquire, construct, rehabilitate or expand a child-care facility **must reduce the depreciable basis** of the facility.

Operating expenses reduced. The amount of the 25% credit for operating expenses of the facility **must reduce any otherwise deductible expenses.**

Reporting. The credit is a part of the General Business Credit and will be reported on Form 8882.

Recapture of Acquisition and Construction Credit

Credits taken by a taxpayer for the expenses for acquiring, constructing, rehabilitating, or expanding a qualified facility are subject to recapture during the first 10 years after the qualified child-care facility is placed in service.

Note. Year one begins on the first day of the tax year in which the qualified child-care facility is placed in service by the taxpayer.

If there is a recapture amount for any property whose basis was previously reduced by the credit, the basis of the property is increased by the recapture amount. For purposes of this provision, the term "recapture event" means a:

- cessation of the operation of the facility as a qualified child-care facility, or
- change in ownership, unless the person or business acquiring the facility agrees in writing to assume the potential recapture liability.

In the case of the assumption of the recapture liability, the amount would be computed as if there had been no change in ownership. Recapture of the credit does not apply to a cessation of operation of the child-care facility as a result of a casualty loss if that loss is restored "within a reasonable period of time."

Note. The recapture provision applies only to the 25% credit used for acquiring, constructing, rehabilitating or expanding the facility. It does not apply to the 25% credit for operating expenses of the facility.

Example 2. Central Paper Co. opened its child-care facility to its employees on December 1, 2002. If Central ceases to operate its child-care facility on November 1, 2007, it will be required to recapture 55% of the construction and acquisition credit.

Recapture Percentages

Year of Recapture Event	Applicable Recapture Percentage
1–3	100%
4	85%
5	70%
6	55%
7	40%
8	25%
9 and 10	10%
11 or more	0%

> **Note.** In planning for employer provided child-care, the taxpayer needs to be aware of the recapture penalty due to the severity of the recapture amount, especially during the early years of operation.

General Business Credit

The employer-provided child-care credit is part of the general business credit (I.R.C. §38), and therefore, is also subject to the I.R.C. §38 limitations and carryovers.

E.I.C. MARRIAGE PENALTY RELIEF AND SIMPLIFICATION

EGTRRA
Act §303
Effective Date: For tax years beginning after December 31. 2001.

- Marriage penalty is reduced by increasing the phase-out range for MFJ.
- Earned income and AGI calculations are simplified.
- Requirements for qualifying children are relaxed.
- Tiebreaker rules are changed for children.

Marriage Penalty Relief

The tax bill increased the beginning and ending of the Earned Income Credit (EIC) phase-out range for married individuals filing a joint return by the following amounts:

- $1,000 for tax years 2002, 2003, and 2004
- $2,000 for tax years 2005, 2006, and 2007
- $3,000 for tax years 2008, 2009, and 2010

> **Note.** The EIC is denied under I.R.C. §32(i) if the aggregate amount of certain investment income exceeds $2,400.

Year 2001 Earned Income Credit Phase-out Amounts

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Threshold Phase-out Amount	Completed Phase-out Amount
None	$364	$4,760	$5,950	$10,710
1	2,428	7,140	13,090	28,281
2 or more	4,008	10,020	13,090	32,121

Year 2002 Earned Income Credit Phase-out Amounts

Number of Children	Maximum Amount of the Credit	Earned Income Amount	Threshold Phase-out Amount	Completed Phase-out Amount
Single, Head of Household, Surviving Spouse, and Married Filing Separate				
None	$376	$4,910	$6,150	$11,060
1	2,506	7,370	13,520	29,201
2 or more	4,140	10,350	13,520	33,178
Married Filing Jointly				
None	$376	$4,910	$7,150	$12,060
1	2,506	7,370	14,520	30,201
2 or more	4,140	10,350	14,520	34,178

Maximum Marriage Penalty Reduction

Since the phase-out percentages are 7.65% for couples with no children, 15.98% for couples with one child, and 21.06% for couples with two or more children, the maximum benefit couples will get from the increases in the phase-out amounts are as follows:

	Increase in Threshold Phase-out	Number of Qualifying Children		
Years	Amount	None	One	Two or More
2002, 2003, & 2004	$1,000	$76.50	$159.80	$210.60
2005, 2006, & 2007	2,000	153.00	319.60	421.20
2008, 2009, & 2010	3,000	229.50	479.40	631.80

Example 3. Tonya has two qualifying children and $13,000 of earned income for 2001. Zach has no qualifying children and $18,000 of earned income for 2001.

EFFECT OF OLD LAW

For 2001, Tonya qualifies for the maximum $4,008 earned income credit if she is unmarried. Zach does not qualify for any earned income credit if he is unmarried. If Tonya and Zach are married in 2001, they must file a joint tax return to claim the earned income credit. Their joint income is in excess of the threshold phase-out amount, so the maximum credit is reduced as follows:

Maximum Credit	$4,008
Phaseout ($31,000 – $13,090) × 21.06%	(3,772)
Credit Allowed	**$236**

Example 4. Effect of New Law Without Inflation-Adjusted Numbers. Using the same facts as **Example 3**, Tonya is allowed to claim the maximum $4,008 earned income credit in 2002 if she is unmarried. Zach does not qualify for any earned income credit if he is unmarried. However, if Tonya and Zach are married in 2002, the maximum credit is reduced as follows:

Maximum credit	$4,008
Phaseout ($31,000 – $14,090) × 21.06%	(3,561)
Credit allowed	**$447**

Assuming no inflation adjustment for 2002, the new law reduces the marriage penalty for Tonya and Zach by $211 ($3,772 – $3,561). However, there is still a penalty resulting from Tonya being married.

Example 5. Effect of New Law With Inflation-Adjusted Numbers. Using the inflation-adjusted numbers listed above, the actual EITC amount for 2002 would be calculated as follows:

Maximum credit	$4,140
Phaseout ($31,000– $14,520) × 21.06%	(3,471)
Credit allowed	**$669**

Earned Income

Since the EITC is computed as a percentage of earned income, a taxpayer must have earned income in order to claim the credit. Earned income eligible for the credit includes wages, salaries, tips, and other employee compensation, but only to the extent that it is actually included in gross income for tax years after 2001 [I.R.C. §32(c)(2)(A)(i)]. It also includes net earnings from self-employment, determined after taking into account the deduction for 1/2 of the taxpayer's self-employment tax [I.R.C. §164(f)]. However, if the individual has a net loss in earnings from self-employment, it would reduce earned income [Reg. §1.32-2(c)(2)]. Finally, pursuant to Rev. Rul. 98-56, I.R.C. §1231 gains are not considered to be "earned income."

> **Note.** The IRS is becoming increasingly suspicious of taxpayers who claim the EITC but report net earnings from self-employment with little or no reported corresponding expenses. If the IRS subsequently discovers otherwise allowable expenses, especially those the taxpayer knows they would be getting anyway, like mortgage interest and taxes on Schedule A, the IRS will subtract the additional expenses from the reported earnings for purposes of computing the EITC. Also, if the IRS is unable to determine the amount of the additional expenses because of the taxpayer's failure to substantiate them, the government, at its discretion, may choose to completely disregard the claimed earnings when determining the taxpayer's eligibility for the EITC [CCA 200022051].

Nontaxable Employee Compensation

The definition of "earned income" now excludes nontaxable employee compensation previously included in the earned income credit calculation. Taxpayers will no longer include nontaxable employee compensation such as:

- employer contributions for nontaxable fringe benefits (I.R.C. §105(h) medical reimbursement plans, I.R.C. §117 scholarships and awards, I.R.C. §132 working condition fringes, I.R.C. §107 parsonage allowances, etc.);
- salary reduction contributions under a cafeteria plan (I.R.C. §125);
- elective deferrals such as contributions to an I.R.C. §401(k) plan;
- meals and lodging provided for the convenience of the employer (I.R.C. §119); or
- military housing subsistence allowances in earned income.

> **Note.** This change may increase or decrease a taxpayer's earned income credit depending on whether the taxpayer's earned income falls in the phase-in or phase-out range for the earned income credit.

Example 6. Debbie has $8,000 of taxable earned income and $1,000 of nontaxable earned income in 2001. She has two qualifying children. Her earned income credit for 2001 is $9,000 × 40% = $3,600. Assuming the same earned income in 2002, her earned income credit would be $8,000 × 40% = $3,200. Therefore, the new law actually reduces her earned income credit by $400.

Example 7. Greg has $16,000 of taxable earned income and $2,000 of nontaxable earned income in 2002. He has two qualifying children. Assuming no inflation adjustment in the threshold phase-out amount, the following table shows the effect of the new law on Greg's earned income credit.

	Old Law	New Law	Difference
Maximum Credit	$4,008	$4,008	
Phase-out	($18,000 – $14,090) × 21.06% =	($16,000 – $14,090) × 21.06% =	
	823	402	($421)
Credit allowed	$3,185	$3,606	$421

Alternative Minimum Tax (AMT)

The earned income credit is no longer reduced for taxpayers subject to the alternative minimum tax. The same credit amount may be used to offset both regular tax and AMT.

Adjusted Gross Income (AGI)

The 2001 Act replaced "modified adjusted gross income" with "adjusted gross income" for purposes of the earned income credit. This change was made to simplify the earned income calculation, but the change will also affect the amount of earned income credit some taxpayers can claim. This change affects:

1. The determination of who can claim a child as a "qualifying child" when AGI is the tiebreaker (A discussion of the tie-breaking test appears later in this section);
2. The phase-out of the earned income credit.

Example 8. Jenny has $18,000 of earned income in 2002. Her AGI is $20,000 and her modified AGI is $24,000. She has two qualifying children. Assuming no inflation adjustment in the threshold phase-out amount, the following table shows the effect of the new law on Jenny's earned income credit.

	Old Law	New Law	Difference
Maximum Credit	$4,008	$4,008	
Phase-out	($24,000 – $14,090) × 21.06% =	($20,000 – $14,090) × 21.06% =	
	2,087	1,245	($842)
Credit allowed	$1,921	$2,763	$842

Note. If "modified adjusted gross income" is less than "adjusted gross income," the new law could actually decrease the earned income credit for a taxpayer.

Relationship Test

The relationship test has been expanded to include descendants of stepchildren. "Qualifying children" now include the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, and a descendant of any of these individuals. An eligible foster child would also satisfy the relationship test.

Example 9. Mindy's stepdaughter, Beth (age 18), and Beth's son, Jake (age 1), lived with Mindy for 10 months during the year. Both Beth and Jake would be considered "qualifying children" for purposes of calculating Mindy's earned income credit. Under the prior definition of qualifying children, Jake would not have been a "qualifying child."

Foster Child Residency Requirement

An eligible foster child no longer has to reside with a taxpayer for a full year in order to be a "qualifying child." Instead, an eligible foster child is now only required to live with the taxpayer for more than half the year. This is also true for all other qualifying children.

Example 10. Tim, a foster child, resides with Barb for eight months during the year. Under the new law, Tim would now be considered an eligible child for purposes of Barb's earned income credit. Previously, Tim would not have been a qualifying child because he resided with Barb for less than one year.

Tie-Breaking Test

Under the old law, if a child qualified with respect to more than one person, the child was treated as a qualifying child of the person with the highest modified AGI. Under the new law:

1. If one of the individuals is the child's parent, then the child is considered the qualifying child of that parent.
2. If both parents claim the child and are not filing a joint return, then the child is considered the qualifying child of the parent with whom the child resided for the longer period of time during the year.
3. If this period of time is the same for both parents, then the parent with the higher AGI will be eligible to claim the child.
4. If none of the taxpayers claiming the child is the child's parent, then the taxpayer with the highest AGI will be eligible to claim the child.

Example 11. For purposes of the earned income credit, Jerry is a qualifying child to both Jerry's grandmother and Jerry's mother. Under the new tie-breaking test, Jerry's mother is eligible to claim the child without regard to adjusted gross income.

Disqualification of Non Custodial Parents

Beginning in 2004, the IRS will be allowed to use "math error authority" to deny the earned income credit to non custodial parents, as indicated by the Federal Case Registry of Child Support Orders.

MODIFICATIONS TO CHILD TAX CREDIT

EGTRRA
Act §201
[I.R.C. §24]
Effective Date: The credit increase and refund provision are effective for tax years beginning after December 31, 2000. The offset of AMT is effective in tax years beginning after December 31, 2001.

- Credit is increased to $1,000 over 10 years ($600 for 2001–2004).
- Credit is refundable to the extent that 10% (15% for 2005 and after) of taxable earned income exceeds $10,350.
- Credit can offset both regular tax and AMT.

Before 2001, a taxpayer could claim a $500 tax credit for each qualifying child under the age of 17. A "qualifying child" was defined as:

- an individual who can be claimed as a dependent by a taxpayer; or
- the taxpayer's son or daughter (or descendant of either), stepson or stepdaughter, or eligible foster child.

In 2002, the child tax credit is phased out by $50 for each $1,000 of modified AGI over $75,000 for single filers and heads of household, $110,000 for joint filers, and $55,000 for married individuals filing separate returns. "Modified Adjusted Gross Income" (MAGI) is defined as the taxpayer's adjusted gross income plus the excluded income of:

- U.S. citizens or residents living abroad (I.R.C. §911),
- residents of Guam, American Samoa, and the Northern Mariana Islands (I.R.C. §931), and
- residents of Puerto Rico (I.R.C. §933)

The 2001 Act increased the child tax credit to $1,000 per child, phased in over a 10-year period.

Taxable Year	Credit Amount Per Child
2001–2004	$600
2005–2008	700
2009	800
2010	1,000

Example 12. Jarvis and Mavis Hughes are married. They file a joint return for 2002, and have MAGI of $120,000. They have two qualifying children under the age of 17. Since their MAGI of $120,000 exceeds the phase-out threshold of $110,000, they must reduce their tentative child tax credit of $1,200 by $500 (($10,000 ÷ $1,000) × $50). Their child tax credit for 2002 is $700 ($1,200 – $500). See the completed 2002 forms and worksheet which follow:

- Form 1040 for Jarvis and Mavis Hughes
- Child Tax Credit Worksheet from IRS Pub. 972, *Child Tax Credit*

For Example 12

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2002** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2002, or other tax year beginning , 2002, ending , 20 OMB No. 1545-0074

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

Your first name and initial: **Jarvis L.**	Last name: **Hughes**	Your social security number: **111 11 1111**
If a joint return, spouse's first name and initial: **Mavis V.**	Last name: **Hughes**	Spouse's social security number: **222 22 2222**
Home address (number and street). If you have a P.O. box, see page 19.	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.		

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

Filing Status
Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶). (See page 19.)

Exemptions

6a ☒ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a
b ☒ **Spouse**
No. of boxes checked on 6a and 6b: **2**

c **Dependents:**

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 20)
Sandra A.	Hughes	333 33 3333		☑
Timothy L.	Hughes	444 44 4444		☑
				☐
				☐
				☐

If more than five dependents, see page 20.

No. of children on 6c who:
• lived with you: **2**
• did not live with you due to divorce or separation (see page 20)
Dependents on 6c not entered above
d Total number of exemptions claimed — Add numbers on lines above ▶ **4**

Income

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

If you did not get a W-2, 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	7	120,000
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9	Ordinary dividends. Attach Schedule B if required	9	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions — 15a — **b** Taxable amount (see page 23)	15b	
16a	Pensions and annuities — 16a — **b** Taxable amount (see page 23)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits — 20a — **b** Taxable amount (see page 25)	20b	
21	Other income. List type and amount (see page 27)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	120,000

Adjusted Gross Income

23	Educator expenses (see page xx)	23	
24	IRA deduction (see page 27)	24	
25	Student loan interest deduction (see page 28)	25	
26	Tuition and fees deduction (see page XX)	26	
27	Archer MSA deduction. Attach Form 8853	27	
28	Moving expenses. Attach Form 3903	28	
29	One-half of self-employment tax. Attach Schedule SE	29	
30	Self-employed health insurance deduction (see page 30)	30	
31	Self-employed SEP, SIMPLE, and qualified plans	31	
32	Penalty on early withdrawal of savings	32	
33a	Alimony paid **b** Recipient's SSN ▶	33a	
34	Add lines 23 through 33a	34	
35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶	35	120,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2002)

Summary of Jarvis and Mavis Hughes' **2002** tax liability is shown below:

AGI (line 36)	$120,000
Standard deduction (line 38)	(7,850)
Exemption (4 × $3,000) (line 40)	(12,000)
Taxable income (line 41)	$100,150
Tax (line 42)	$20,837
Less: Education credit (line 48, Lifetime learning credit for Mavis)	(1,000)
Less: Child tax credit (line 50, see details below)	(700)
Total tax (line 61)	**$19,137**

For Example 12

Publication 972

Child Tax Credit Worksheet *Keep for Your Records*

Before you begin: If you are a Form 1040 filer, you will need the following forms if you are filing them.
- √ Form 2555, Foreign Earned Income
- √ Form 2555-EZ, Foreign Earned Income Exclusion
- √ Form 4563, Exclusion of Income for Bona Fide Residents of American Samoa

Part 1

1. Number of qualifying children: 2 × $600. Enter the result. **1** 1,200

2. Enter the amount from Form 1040, line 36, or Form 1040A, line 22. **2** 120,000

3. **1040 Filers.** Enter the total of any—
- Exclusion of income from Puerto Rico, and
- Amounts from Form 2555, lines 43 and 48; Form 2555-EZ, line 18; and Form 4563, line 15.

1040A Filers. Enter -0-. **3** 0

4. Add lines 2 and 3. Enter the total. **4** 120,000

5. Enter the amount shown below for your filing status.
- Married filing jointly - $110,000
- Single, head of household, or qualifying widow(er) - $75,000
- Married filing separately - $55,000

5 110,000

6. Is the amount on line 4 more than the amount on line 5?

☐ **No.** Leave line 6 blank. Enter -0- on line 7.

☒ **Yes.** Subtract line 5 from line 4. If the result is not a multiple of $1,000, increase it to the next multiple of $1,000 (for example, increase $425 to $1,000, increase $1,025 to $2,000, etc.). **6** 10,000

7. Multiply the amount on line 6 by 5% (.05). Enter the result. **7** 500

8. Is the amount on line 1 more than the amount on line 7?

☐ **No.** STOP You cannot take the child tax credit on Form 1040, line 50, or Form 1040A, line 33. You also cannot take the additional child tax credit on Form 1040, line 66, or Form 1040A, line 42. Complete the rest of your Form 1040 or 1040A.

☒ **Yes.** Subtract line 7 from line 1. Enter the result. *Go to Part 2 on the next page.* **8** 700

For Example 12

Child Tax Credit Worksheet—*Continued from page 3*

Keep for Your Records

Part 2

9. Enter the amount from Form 1040, line 44, or Form 1040A, line 28. **9** **20,837**

10. Add the amounts from—

Form 1040	**or** **Form 1040A**		
Line 45			
Line 46	Line 29	+	
Line 47	Line 30	+	
Line 48	Line 31	+	1,000
Line 49	Line 32	+	

Enter the total. **10** **1,000**

11. Are you claiming any of the following credits?

- Adoption credit, Form 8839
- Mortgage interest credit, Form 8396
- District of Columbia first-time homebuyer credit, Form 8859

☒ **No.** Enter the amount from line 10.

☐ **Yes.** Complete the *Line 11 Worksheet* on the next page to figure the amount to enter here.

11 **1,000**

12. Subtract line 11 from line 9. Enter the result. **12** **19,837**

13. Is the amount on line 8 of this worksheet more than the amount on line 12?

☒ **No.** Enter the amount from line 8.

☐ **Yes.** Enter the amount from line 12. See the **TIP** below.

This is your child tax credit.

13 **700**

Enter this amount on Form 1040, line 50, or Form 1040A, line 33.

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 66, **or** Form 1040A, line 42, only if you answered “Yes” on line 13.

- First, complete your Form 1040 through line 65, or Form 1040A through line 41.
- Then, use Form 8812 to figure any additional child tax credit.

> **Note.** Because their modified AGI exceeded the married filing jointly phase-out threshold of $110,000, the Child Tax Credit Worksheet from the 2002 Form 1040 Instructions **cannot** be used.

Refundability

Prior to 2001, the child tax credit was a nonrefundable credit with a limited exception. For families with three or more qualifying children, the child tax credit was refundable up to the amount their social security taxes exceeded their earned income credit.

The 2001 Act made the child tax credit **refundable** to the extent of 10% of the taxpayer's earned income in excess of $10,000 for the years 2001 to 2004. The $10,000 amount will be adjusted for inflation beginning in 2002.

> **Note.** The inflation adjusted floor amount for 2002 is $10,350. [Rev. Proc. 2001-59]

If the full amount of the child tax credit is reduced by the tax liability limitation, certain taxpayers are entitled to an **Additional Child Tax Credit. Form 8812** is used to compute this additional credit which may be refunded even if the regular tax is zero. See **Example 13**, which follows.

Example 13. Randy Smith has two qualifying children and 2002 wages of $20,000. He qualifies for the Head of household filing status. He has no other income and is entitled to no other nonrefundable personal credits. His tax liability for **2002** is calculated below.

AGI	$20,000
Standard deduction (Head of Household)	(6,900)
Personal exemptions (3 × $3,000)	(9,000)
Taxable income	$4,100
Tax from Tax Table	413

Randy's completed 2002 worksheet and form are shown next:

- Child Tax Credit Worksheet from the 2002 Form 1040 Instructions
- Form 8812

> **Note.** The Child Tax Credit was modified from the worksheet shown on page 38 in the 2001 Form 1040 Instructions.

For Example 13

Form 1040Ñ Line 50

Child Tax Credit Worksheet—Line 50

Keep for Your Records

CAUTION

Do not use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 37. Instead, use Pub. 972.

1. Number of qualifying children: 2 × $600. Enter the result. | 1 | 1,200

2. Enter the amount from Form 1040, line 44. | 2 | 413

3. Add the amounts from Form 1040:

Line 45 ______

Line 46 + ______

Line 47 + ______

Line 48 + ______

Line 49 + ______ Enter the total. | 3 | 0

Draft

4. Are the amounts on lines 2 and 3 the same?

☐ **Yes.** STOP
You cannot take this credit because there is no tax to reduce. However, see the **TIP** below before completing the rest of your Form 1040.

☒ **No.** Subtract line 3 from line 2. | 4 | 413

5. Is the amount on line 1 more than the amount on line 4?

☒ **Yes.** Enter the amount from line 4. Also, see the **TIP** below.

☐ **No.** Enter the amount from line 1.

This is your child tax credit. | 5 | 413

Enter this amount on Form 1040, line 50.

1040

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 66, if you answered "Yes" on line 4 **or** line 5 above.

- First, complete your Form 1040 through line 65.
- Then, use Form 8812 to figure any additional child tax credit.

For Example 13

Form **8812** — Department of the Treasury, Internal Revenue Service

Additional Child Tax Credit

Complete and attach to Form 1040 or Form 1040A.

OMB No. 1545-1620 — 2002 — Attachment Sequence No. 47

Name(s) shown on return: Randy Smith — Your social security number: 777 77 7777

Part I All Filers

1	Enter the amount from line 1 of your Child Tax Credit Worksheet on page 38 of the Form 1040 instructions or page 37 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication		1,200
2	Enter the amount from Form 1040, line 50, or Form 1040A, line 33		413
3	Subtract line 2 from line 1. If zero, **stop**; you cannot take this credit		787
4	Enter your total taxable earned income. See the instructions on back	20,000	
5	Is the amount on line 4 more than $10,350? ☐ **No.** Leave line 5 blank and enter -0- on line 6. ☒ **Yes.** Subtract $10,350 from the amount on line 4. Enter the result	9,650	
6	Multiply the amount on line 5 by 10% (.10) and enter the result		965

Next. Do you have three or more qualifying children?

☒ **No.** If line 6 is zero, **stop;** you cannot take this credit. Otherwise, skip Part II and enter the **smaller** of line 3 or line 6 on line 13.

☐ **Yes.** If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.

Part II Certain Filers Who Have Three or More Qualifying Children

7	Enter the total of the withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see the instructions on back		
8	**1040 filers:** Enter the total of the amounts from Form 1040, lines 29 and 57, plus any uncollected social security and Medicare or tier 1 RRTA taxes included on line 61. **1040A filers:** Enter -0-.		
9	Add lines 7 and 8		
10	**1040 filers:** Enter the total of the amounts from Form 1040, lines 64 and 65. **1040A filers:** Enter the total of the amount from Form 1040A, line 41, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 43 (see the instructions on back).		
11	Subtract line 10 from line 9. If zero or less, enter -0-		
12	Enter the **larger** of line 6 or line 11 here		

Next, enter the **smaller** of line 3 or line 12 on line 13.

Part III Your Additional Child Tax Credit

13	**This is your additional child tax credit**	787

Enter this amount on Form 1040, line 66, or Form 1040A, line 42.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10644E Form **8812** (2002)

Conclusion for Example 13. Randy's full child tax credit of $1,200 is limited to $413 (the amount of his tax liability on the worksheet). $413 is the nonrefundable portion of the credit. However, he is allowed a refundable Additional Child Tax Credit of $787 on Form 8812. Randy's total 2002 child tax credit is $1,200 as shown in the summary below.

1. Nonrefundable credit from worksheet (line 50, Form 1040)	$413
2. Refundable credit from Form 8812 (line 66, Form 1040)	787
Total child tax credit for 2002	**$1,200**

The **Additional Child Tax Credit** is refundable to the extent that 10% of 2002 taxable earned income exceeds $10,350. If 2002 taxable earned income **does not exceed $10,350**, a refundable credit may still be available to taxpayers who have **three** of more qualifying children. See **Example 14**, which follows.

Example 14. Assume the same facts as in **Example 13**, except Mr. Smith has **three** children. His tax liability for **2002** is calculated in the following table.

AGI	$20,000
Standard deduction (Head of Household)	(6,900)
Exemptions (4 × $3,000)	(12,000)
Taxable income	$1,100
Tax from Tax Table	$111
Earned income credit	$2,770
Employee-paid FICA (7.65%)	$1,530

Randy's completed 2002 worksheet and form are shown next:

- Child Tax Credit Worksheet from the 2002 Form 1040 Instructions
- Form 8812

Note. This worksheet was modified from the worksheet shown on page 38 in the 2001 Form 1040 Instructions.

For Example 14

Form 1040Ñ Line 50

Child Tax Credit Worksheet—Line 50

Keep for Your Records

CAUTION

Do not use this worksheet if you answered "Yes" to question 1, 2, or 3 on page 37. Instead, use Pub. 972.

1. Number of qualifying children: 3 × $600. Enter the result.	1	1,800
2. Enter the amount from Form 1040, line 44.	2	111
3. Add the amounts from Form 1040: Line 45 ____ Line 46 + ____ Line 47 + ____ Line 48 + ____ Line 49 + ____ Enter the total.	3	0
4. Are the amounts on lines 2 and 3 the same? ☐ **Yes.** STOP You cannot take this credit because there is no tax to reduce. However, see the **TIP** below before completing the rest of your Form 1040. ☒ **No.** Subtract line 3 from line 2.	4	111
5. Is the amount on line 1 more than the amount on line 4? ☒ **Yes.** Enter the amount from line 4. Also, see the **TIP** below. ☐ **No.** Enter the amount from line 1. } **This is your child tax credit.**	5	111

Enter this amount on Form 1040, line 50.

1040

Draft

TIP

You may be able to take the **additional child tax credit** on Form 1040, line 66, if you answered "Yes" on line 4 **or** line 5 above.

- First, complete your Form 1040 through line 65.
- Then, use Form 8812 to figure any additional child tax credit.

For Example 14

Form **8812**

Department of the Treasury
Internal Revenue Service

Additional Child Tax Credit

Complete and attach to Form 1040 or Form 1040A.

OMB No. 1545-1620

2002

Attachment Sequence No. **47**

Name(s) shown on return	Your social security number
Randy Smith	777 77 7777

Part I **All Filers**

1	Enter the amount from line 1 of your Child Tax Credit Worksheet on page 38 of the Form 1040 instructions or page 37 of the Form 1040A instructions. If you used Pub. 972, enter the amount from line 8 of the worksheet on page 3 of the publication			1	1,800
2	Enter the amount from Form 1040, line 50, or Form 1040A, line 33			2	111
3	Subtract line 2 from line 1. If zero, **stop**; you cannot take this credit			3	1,689
4	Enter your total taxable earned income. See the instructions on back	4	20,000		
5	Is the amount on line 4 more than $10,350? ☐ **No.** Leave line 5 blank and enter -0- on line 6. ☒ **Yes.** Subtract $10,350 from the amount on line 4. Enter the result	5	9,650		
6	Multiply the amount on line 5 by 10% (.10) and enter the result			6	965
	Next. Do you have three or more qualifying children? ☐ **No.** If line 6 is zero, **stop;** you cannot take this credit. Otherwise, skip Part II and enter the **smaller** of line 3 or line 6 on line 13. ☒ **Yes.** If line 6 is equal to or more than line 3, skip Part II and enter the amount from line 3 on line 13. Otherwise, go to line 7.				

Part II **Certain Filers Who Have Three or More Qualifying Children**

7	Enter the total of the withheld social security and Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If you worked for a railroad, see the instructions on back	7	1,530		
8	**1040 filers:** Enter the total of the amounts from Form 1040, lines 29 and 57, plus any uncollected social security and Medicare or tier 1 RRTA taxes included on line 61. **1040A filers:** Enter -0-.	8	0		
9	Add lines 7 and 8	9	1,530		
10	**1040 filers:** Enter the total of the amounts from Form 1040, lines 64 and 65. **1040A filers:** Enter the total of the amount from Form 1040A, line 41, plus any excess social security and tier 1 RRTA taxes withheld that you entered to the left of line 43 (see the instructions on back).	10	2,770		
11	Subtract line 10 from line 9. If zero or less, enter -0-			11	0
12	Enter the **larger** of line 6 or line 11 here			12	965
	Next, enter the **smaller** of line 3 or line 12 on line 13.				

Part III **Your Additional Child Tax Credit**

13	**This is your additional child tax credit**	13	965

Enter this amount on Form 1040, line 66, or Form 1040A, line 42.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10644E Form **8812** (2002)

Conclusion for Example 14. Randy's full child tax credit of $1,800 (3 × $600) is limited to $111 (the amount of his tax liability on the worksheet). $111 is the nonrefundable portion of the credit. However, he is allowed a refundable Additional Child Tax Credit of $965 on Form 8812. Randy's total 2002 child tax credit is $1,076 as shown in the summary below.

1. Nonrefundable credit from worksheet (line 50, Form 1040)	$111
2. Refundable credit from Form 8812 (line 66, Form 1040)	965
Total child tax credit for 2002	**$1,076**

Note. In **Example 14**, Randy's withheld FICA and Medicare taxes of $1,530 was less than his refundable earned income credit of $2,770. Therefore, his refundable additional child tax credit is limited to $20,000 (earned income) less $10,350 (the 2002 floor) × 10%.

($20,000 – 10,350) × 10% = **$965**, which is computed on lines 4-6 of Form 8812.

Alternative Minimum Tax

The refundable portion of the child tax credit will no longer be reduced by the amount of the alternative minimum tax. In addition, the 2001 Act allows the child tax credit to the extent of the full amount of the individual's regular income tax and alternative minimum tax.

EXTENSION AND EXPANSION OF ADOPTION TAX BENEFITS

EGTRRA
Act §202
[I.R.C. §23 and I.R.C. §137]
Effective Date: Tax years beginning after December 31, 2001 except as noted.

- Credit and exclusion limits are increased to $10,000 per child.
- The income phase-out range is increased to $150,000–$190,000.
- Credit is allowed against AMT.

Old Law

Dollar and Income Limitations. Before 2002, a tax credit was allowed for qualified adoption expenses paid or incurred by a taxpayer. The maximum credit was $5,000 per eligible child ($6,000 for a special needs child). The credit was phased out ratably for taxpayers with modified AGI between $75,000 and $115,000.

Eligible Child

An eligible child was defined as an individual who:

- was under age 18, or
- was physically or mentally incapable of caring for himself or herself.

Special Needs Child

A "special needs child" was an eligible child who:

- was a citizen or resident of the United States, and
- a state determined could or should not be returned to the home of the birth parents, or
- had a specific factor or condition which makes the child difficult to adopt without adoption assistance. These factors might include things such as the child's ethnic background, age, or being part of a sibling group. A condition might include things such as medical conditions, or physical, mental, or emotional handicaps.

Qualified Adoption Expenses

Qualified adoption expenses included reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that were directly related to the legal adoption of an eligible child. These expenses did not include expenses that were:

- incurred in violation of State or Federal law,
- incurred for the adoption of a spouse's child,
- incurred for carrying out any surrogate parenting arrangement, or
- reimbursed by the taxpayer's employer or any other person or organization.

Note. In light of the numerous second (and, subsequent) marriages taking place today, take note of the above prohibition of the credit for costs incurred for the adoption of a spouse's child (or, children) from a previous marriage. This continues to be the case even under the new law.

Timing of Credit

Qualified adoption expenses could have been incurred in one or more taxable years.

1. The credit for expenses incurred or paid before the tax year in which the adoption becomes final was allowed the next tax year.
2. The credit for expenses incurred or paid during the year the adoption actually becomes final was allowed in year the expenses are incurred or paid.
3. The credit for expenses incurred or paid after the year in which the adoption becomes final was allowed in the year the expenses are incurred or paid.
4. In the case of a foreign child, the adoption credit was not allowed until the year in which the adoption becomes final.

Note. Thus, if the adoption of a foreign child was never finalized, no credit will be allowed.

Carryforward of Unused Credit

The adoption credit was a nonrefundable credit. But, any excess credit from a particular tax year may be carried forward five taxable years.

Adoption Assistance Programs

In addition to the adoption credit, an employee was allowed to exclude from gross income a maximum of $5,000 for qualified adoption expenses ($6,000 for a special needs child) paid or reimbursed by an employer under an adoption assistance program. A taxpayer could be eligible for both the adoption credit and the exclusion provided that these are not the same qualified adoption expenses. Unlike the credit, this exclusion from gross income for amounts received from an adoption assistance program cannot occur until the tax year in which the adoption becomes final.

Note. An employee who receives $3,000 from his/her employer for qualified adoption expenses in year one, a year in which the adoption was not yet final, must include the $3,000 in his gross income for year one. However, he/she could reduce his/her gross income in the tax year in which the adoption becomes final.

New Law

In 2002, the following changes are made to the adoption credit and employer provided assistance exclusion:

1. The maximum credit is increased to $10,000 per eligible child, including "special needs children."
2. The exclusion from income for employer provided adoption assistance is also increased to $10,000 per eligible child, including special needs children.
3. For tax years beginning after December 31, 2002, a $10,000 credit will be allowed in the year a special needs adoption is finalized, regardless of the actual amount of qualified adoption expenses. In 2003, a $10,000 exclusion will be allowed for assistance for a special needs adoption provided under an employer's adoption assistance program in the year the adoption is finalized, regardless of the amount of qualified adoption expenses.
4. The phase-out range is increased to between $150,000 and $190,000 of modified AGI.
5. The adoption credit will be allowed permanently against the alternative minimum tax.
6. The maximum credit amount, the maximum exclusion amount, and the phase-out range will be adjusted annually for inflation beginning in 2003.

Example 15. Les and Tammy Hayes began the process to adopt a child (not a "special needs child") in 2000. They paid qualified adoption fees of $2,000. During 2001, the year in which the adoption became final, the Hayes paid additional qualified adoption fees of $7,000. During both years, their modified AGI is $105,000. Their credit is calculated as follows:

- **Old Law.** (Effective for 2001) The adoption fees paid in 2000 were allowed as a credit in 2001. Since the adoption became final in 2001, the Hayes were also allowed a credit for the adoption expenses paid in 2001. Their credit amount was subject to a 75% reduction under the income limitation rule ($105,000 – $75,000 = $30,000 ÷ $40,000 = 75%). The Hayes' allowable credit for 2001 was $1,250 ($5,000 maximum credit – (75% × $5,000)).
- **New Law.** (Effective for 2002 through 2010) The facts are the same, except the adoption process started in 2001 rather than in 2000. The new law would apply to the credit calculation in 2002. The Hayes' total qualified adoption expenses of $9,000 are less than the maximum allowed of $10,000. Their modified AGI of $105,000 is less than the initial phase-out range amount of $150,000. Therefore, the Hayes' allowable credit for 2002 will be the full $9,000.

For Example 15 – Old Law

Form **8839** Department of the Treasury Internal Revenue Service

Qualified Adoption Expenses

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

OMB No. 1545-1552
2001
Attachment Sequence No. 38

Name(s) shown on return: Les and Tammy Hayes
Your social security number: 123 45 6789

Before you begin: You need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Eligible Child**
- **Employer-Provided Adoption Benefits**
- **Qualified Adoption Expenses**

Part I Information About Your Eligible Child or Children—You **must** complete this part. See the instructions for details, including what to do if you need more space.

1	(a) Child's name First	(a) Child's name Last	(b) Child's year of birth	Check if child was— (c) born **before** **1983** and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	Jerry	Hayes	1996	☐	☐	☐	987 65 4321
Child 2				☐	☐	☐	

Caution: *If the child was a foreign child, see **Special Rules** in the instructions for line 1, column (e), before you complete Part II or Part III. If you received **employer-provided adoption benefits,** complete Part III on the back next.*

Part II Adoption Credit

			Child 1	Child 2		
2	Enter $5,000 ($6,000 for a child with special needs)	2	5,000			
3	Did you file Form 8839 for a prior year? ☐ **No.** Enter -0-. ☐ **Yes.** See the instructions for the amount to enter.	3				
4	Subtract line 3 from line 2	4	5,000			
5	Enter the total **qualified adoption expenses** you paid in: • 2000 if the adoption was not final by the end of 2001. • 2000 and 2001 if the adoption was final in 2001. • 2001 if the adoption was final before 2001.	5	9,000			
6	Enter the **smaller** of line 4 or line 5	6	5,000			
7	Add the amounts on line 6. If zero, skip lines 8-11 and enter -0- on line 12				7	5,000
8	Enter your modified adjusted gross income (see instructions)		8	105,000		
9	Is line 8 more than $75,000? ☐ **No.** Skip lines 9 and 10, and enter -0- on line 11. ☐ **Yes.** Subtract $75,000 from line 8.		9	30.000		
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000"				10	× .750
11	Multiply line 7 by line 10				11	3,750
12	Subtract line 11 from line 7				12	1,250
13	Carryforward of adoption credit from prior years (see instructions)				13	0
14	Add lines 12 and 13. Then, see the instructions for the amount of credit to enter on Form 1040, line 49, or Form 1040A, line 32				14	1,250

For Paperwork Reduction Act Notice, see page 4 of instructions. Cat. No. 22843L Form **8839** (2001)

For Example 15 – New Law

Form **8839** | **Qualified Adoption Expenses** | OMB No. 1545-1552
Department of the Treasury Internal Revenue Service | ▶ Attach to Form 1040 or 1040A. ▶ See separate instructions. | 2002 Attachment Sequence No. 38

Name(s) shown on return: **Les and Tammy Hayes** | Your social security number: **123 45 6789**

Before you begin: You need to understand the following terms. See **Definitions** on page 1 of the instructions.

- **Eligible Child**
- **Employer-Provided Adoption Benefits**
- **Qualified Adoption Expenses**

Part I **Information About Your Eligible Child or Children—**You **must** complete this part. See the instructions for details, including what to do if you need more space.

1	(a) Child's name First	Last	(b) Child's year of birth	Check if child was— (c) born before 1984 and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	Jerry	Hayes	1996	☐	☐	☐	987 65 4321
Child 2				☐	☐	☐	

Caution: *If the child was a foreign child, see* ***Special Rules*** *in the instructions for line 1, column (e), before you complete Part II or Part III. If you received* ***employer-provided adoption benefits,*** *complete Part III on the back next.*

Part II **Adoption Credit**

			Child 1	Child 2		
2	Maximum credit per child	2	$10,000 00	$10,000 00		
3	Did you file Form 8839 for a prior year? ☐ **No.** Enter -0-. ☐ **Yes.** See the instructions for the amount to enter.	3	0			
4	Subtract line 3 from line 2	4	10,000			
5	Enter your total **qualified adoption expenses** (see instructions). **Caution:** *Your qualified adoption expenses may not be equal to the adoption expenses you paid in 2002.*	5	9,000			
6	Enter the **smaller** of line 4 or line 5	6	9,000			
7	Add the amounts on line 6. If zero, skip lines 8-11 and enter -0- on line 12				7	9,000
8	Enter your modified adjusted gross income (see instructions)			8 105,000		
9	Is line 8 more than $150,000? ☐ **No.** Skip lines 9 and 10, and enter -0- on line 11. ☐ **Yes.** Subtract $150,000 from line 8			9		
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than “1.000”				10	× .
11	Multiply line 7 by line 10				11	0
12	Subtract line 11 from line 7				12	9,000
13	Carryforward of adoption credit from prior years (see instructions)				13	0
14	Add lines 12 and 13				14	9,000
15	**1040 filers:** Enter the amount from Form 1040, line 44. **1040A filers:** Enter the amount from Form 1040A, line 28.			15 15,666		
16	**1040 filers:** Add the amounts from Form 1040, lines 45 through 50, and any mortgage interest credit from Form 8396, line 11, and enter the total. **1040A filers:** Add the amounts from Form 1040A, lines 29 through 33, and enter the total.			16 600		
17	Subtract line 16 from line 15				17	15,066
18	**Adoption credit.** Enter the smaller of line 14 or line 17 here and on Form 1040, line 51, or Form 1040A, line 34. If line 17 is smaller than line 14, you may have a credit carryforward (see instructions)				18	9,000

For Paperwork Reduction Act Notice, see page 4 of instructions. Cat. No. 22843L Form **8839** (2002)

Note. If a taxpayer has only paid or incurred $5,000 (or, any amount under $10,000) in qualified adoption expenses in a "special needs child" adoption, he/she will still be eligible for the full $10,000 allowable credit in the year that the adoption becomes final.

Comparison of Old Law and New Law

	Old Law (2001)	New Law (2002-2010)
Maximum Credit	$5,000 ($6,000 for a special needs child)	$10,000[1]
Maximum exclusion	$5,000 ($6,000 for a special needs child)	$10,000[2]
Phase-out range	$75,000 to $115,000	$150,000 to $190,000
Allowed against AMT?	Yes	Yes
Adjusted for inflation?	No	Yes

[1]Beginning in 2003, the taxpayer can claim a $10,000 credit in the year a special needs adoption is finalized regardless of whether the taxpayer has qualified adoption expenses.

[2]Beginning in 2003, the taxpayer can claim a $10,000 exclusion in the case of a special needs adoption regardless of whether the taxpayer has qualified adoption expenses.

Note. If after an unsuccessful effort to adopt a child, the taxpayer then succeeds in adopting another child, the unsuccessful and successful efforts are treated as one effort for the purposes of applying the dollar limit.

"Qualified expenses" do not include any expenses:

- that violate any law;
- for any surrogate parenting arrangement;
- for adopting a spouse's child; or
- reimbursed under an employer program or otherwise.

In addition, the credit is not allowed if it will result in a double benefit. No credit is allowed for any expense for a credit or deduction which is also available under another provision, or for any expense funded under any federal, state, or local program.

Individual Tax Rates

EGTRRA
Act §101
Effective Date: For tax years beginning after December 31, 2000.

The new 10% tax bracket is included in the tax tables.

Income tax rates for individuals are going down slightly. A new 10% tax rate has been created. Income tax rates have declined across the board over the past year.. The new rates can be found in Chapter 14: Tax Rates & Useful Tables.

Withholding Rates

EGTRRA
Act §101
Effective Date: For tax years beginning after December 31, 2001.

Witholding tax rates are modified to reflect the tax rate change.

Income tax withholding tables have been revised to reflect lower rates. Withholding on bonuses paid this year is 27%, and backup withholding on interest and dividends has decreased to 30%.

ESTATES, GIFTS AND TRUSTS

EGTRRA
Act §521
[I.R.C. §2010(c)]
Effective Date: Estates of decedents dying and gifts made after December 31, 2001.

The applicable exclusion amount is increased for gift and estate taxes.

Highlights of Changes Effective for 2002

- Increase in unified credit!n¤§Yvalent
- Compression of tax rates
- Decoupling the estate and gift taxes
- Conservation easement amount increased
- Increase in amount of special use valuation
- Change in tax rates for estates and trusts
- State death tax credit phased out
- Relaxed requirements for installment payment of gift taxes

Increased Unified Credit Equivalent

Fewer transfers will be taxed, since the estate and gift tax exemption jumps from $675,000 to $1 million in 2002. This amount is not scheduled to change again until 2004 when it increases to $1.5 million. Eventually, it will rise to $3.5 million in 2009.

Gift tax is "decoupled" from the estate tax applicable exclusion amount so only $1 million will be exempt from the gift tax, and it will remain at $1 million. Complete details are shown in the table below.

	Estate Tax		Gift Tax	
Year of Death or Gift	Applicable Exclusion Amount	Applicable Credit Amount	Applicable Exclusion Amount	Applicable Credit Amount
2001	$675,000	$220,550	$675,000	$220,550
2002	1,000,000	345,800	1,000,000	345,800
2003	1,000,000	345,800	1,000,000	345,800
2004	1,500,000	555,800	1,000,000	345,800
2005	1,500,000	555,800	1,000,000	345,800
2006	2,000,000	780,000	1,000,000	345,800
2007	2,000,000	780,000	1,000,000	345,800
2008	2,000,000	780,000	1,000,000	345,800
2009	3,500,000	1,455,800	1,000,000	345,800
2010	Repealed	Repealed	1,000,000	345,800
2011 and after	1,000,000	345,800	1,000,000	345,800

The 2001 Act reduces tax rates over a 9-year period by reducing rates for the highest estate and gift tax brackets. In addition, the 5% surcharge is repealed for gifts made and for decedents dying after 2001. For 2002, the top estate and gift tax rate is dropping to 50%. In 2011, the 2001 Act is repealed and rates will return to 2001 rates. These changes are summarized below.

Calendar Year	Highest Estate Tax Bracket	Highest Gift Tax Bracket
2001	60%[1]	60%[1]
2002	50%	50%
2003	49%	49%
2004	48%	48%
2005	47%	47%
2006	46%	46%
2007	45%	45%
2008	45%	45%
2009	45%	45%
2010	Repealed	35%
2011 and after	60%[1]	60%[1]

[1] A 5% surtax is imposed, in addition to the unified tax rates, on amounts in excess of $10 million to phase out the benefit of the graduated tax rates. The surtax is imposed only until the average tax rate on the estate reaches 55%. Consequently, the highest marginal tax rate is 60% for amounts over $10 million but not more than $17,184,000. The marginal tax rate drops back to 55% for amounts over $17,184,000.

Effect of the Estate and Gift Tax Changes

Compression of Tax Rates

The phase-in of the increased exemption and the rate reductions reduce the number of effective estate and gift tax brackets. Beginning in 2002, there will be only five effective estate and gift tax brackets as shown below:

Estate Tax Bracket	Marginal Tax Rate
$1,000,001 to $1,250,000	41%
$1,250,001 to $1,500,000	43%
$1,500,001 to $2,000,000	45%
$2,000,001 to $2,500,000	49%
$2,500,001 and up	50%

Beginning in 2003, there will be only four effective gift and estate tax brackets as shown below:

Estate Tax Bracket	Marginal Tax Rate
$1,000,001 to $1,250,000	41%
$1,250,001 to $1,500,000	43%
$1,500,001 to $2,000,000	45%
$2,000,001 and up	49%

In 2004 and 2005, there will be only two effective estate tax brackets as shown below:

Estate Tax Bracket	Marginal Tax Rate
$1,500,001 to $2,000,000	45%
$2,000,001 and up	47% (2004) 48% (2005)

In 2007 through 2009, there will be an effective flat estate tax rate for the larger estates as shown below:

Year	Estate Tax Bracket	Flat Tax Rate
2007 and 2008	$2,000,001 and up	45%
2009	$3,500,000 and up	45%

In 2004 through 2009 there will be four effective gift tax brackets as shown below:

Gift Tax Bracket	Marginal Tax Rate
$1,000,001 to $1,250,000	41%
$1,250,001 to $1,500,000	43%
$1,500,001 to $2,000,000	45%
$2,000,001 and up	48% (2004)
	47% (2005)
	46% (2006)
	45% (2007–2009)

Beginning in 2010, there will be an effective 35% flat gift tax rate for taxable gifts over $1,000,000.

Decoupling the Estate and Gift Taxes

Under prior law, the estate and gift taxes were "unified" so that just one rate schedule applied to accumulated gifts during a taxpayer's life and to accumulated lifetime gifts plus the taxable estate at the time of death. Beginning in 2004, the gift tax applicable exclusion amount is less than the estate tax applicable exclusion amount. This difference affects the dynamics of planning lifetime gifts and death transfers.

Under prior law, there were three estate and gift tax advantages to giving assets away during life rather than transferring them at death:

1. The annual exclusion exempts the first $10,000 of lifetime gifts of present interests to each donee each year.

> **Note.** The $10,000 annual exclusion is indexed after 1998 in $1,000 increments. For 2001, the indexed amount remained at $10,000. However, starting in 2002, it was increased to $11,000.

Example 16. Selma Nash gives $11,000 to each of her 10 grandchildren each year. Those gifts reduce her estate by $110,000 without using any of her applicable exclusion amount. There is no equivalent deduction under the estate tax.

2. Any appreciation in the value of the asset between the date of the gift and the date of death escaped the gift and estate taxes.

Example 17. Jeffrey Smith owns a tract of land that is worth $260,000 on August 1, 2006. Prior to 2006, he made taxable gifts totaling $1,000,000. If Jeffrey gives the land to his daughter on August 1, 2006, under prior law, he will owe $102,090 of federal gift taxes on the $249,000 taxable gift ($260,000 – $11,000 annual exclusion). If the land increased in value to $500,000 by the time of his death in 2013, Jeffrey will owe no further gift or estate taxes on the land, since the land is no longer an asset of his estate.

3. The gift taxes paid on lifetime gifts could possibly reduce the taxable estate.

Example 18. Riley Mason had an estate worth $10 million in 2000, before he made a $1.25 million taxable gift. The gift reduced his estate by not only the $1.25 million gift, but also by the $227,750 gift tax on that gift.

Therefore, if Riley died without any changes in the value of his estate and his death occurred more than 3 years after the date of this initial transfer, his taxable estate would have been

$10,000,000 – $1,250,000 – $227,750 = $8,522,250.

The total of his transfers that would be subject to the gift or estate tax would be

$8,522,250 + $1,250,000 = $9,772,250.

Under the "gross-up" provision" of I.R.C. §2035(b), the value of the gross estate includes the amount of any gift tax paid by the decedent or her estate on any gift (made by the decedent or her spouse) within the three years prior to her death.

By contrast, if Riley waited until death to transfer all of his $10,000,000 estate, the full $10,000,000 would be subject to the estate tax.

Lifetime Gifts vs. Testamentary Transfers

The three advantages, described above, remain under the 2001 Act. However, there is a disadvantage to lifetime gifts over transfers at death. Accumulated lifetime taxable gifts over the $1 million applicable exclusion amount will create a gift tax liability, while the same amount transferred at death may be tax-free. The amount transferred at death may be tax-free because the amount is below the estate tax applicable credit amount, or death occurs when there is no estate tax at all.

Note. For purposes of gift and estate tax planning, taxpayers will now rarely want to make taxable gifts that trigger gift tax liability. This will be true until there is more certainty about where the estate provisions are heading after 2010.

Example 19. If Riley from **Example 18** dies in 2010, and the new law has not changed, there will be no estate tax on his estate whether he made the gift in 2000 or not. Consequently, making the gift caused him to pay unnecessary gift taxes.

Note. Lifetime gifts that trigger gift tax liability may be warranted for gift and estate tax planning purposes. This may be true for taxpayers who are not expected to live until the repeal of the estate tax in 2010, and who have an estate that exceeds the applicable exclusion amount in the year of expected death.

Example 20. Meg Platt has a $4 million estate. She is elderly, and in poor health. Meg has an interest in a family business that is now worth $500,000, but is expected to be worth $1 million in a few years. She wants her grandson, Grant, to have the business interest. Meg made taxable gifts that accumulate to $675,000 prior to 2001. Meg is likely to live until 2002, but not many years beyond.

For gift and estate tax purposes, Meg should give the business interest to Grant in 2002, when the applicable exclusion amount increases to $1 million. That will cause her to pay $67,512 of gift taxes on the $489,000 taxable gift ($500,000 – $11,000 annual exclusion). It will reduce her estate by the potential $1 million value of the business interest, and the $67,512 of gift taxes, assuming she lives at least three years after the date of the gift. Assuming no other changes in the value of her estate, the reduction in value would reduce her estate tax by approximately $323,092 if she dies in 2007 or 2008.

Form 706

The following form is the revised Form 706, page 1. The IRS has made substantial changes to reflect the new law.

Form **706** (Rev. August 2002)
Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see separate instructions).
To be filed for decedents dying after December 31, 2001, and before January 1, 2003.
For Paperwork Reduction Act Notice, see page 25 of the separate instructions.

OMB No. 1545-0015

Part 1.—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)	**1b** Decedent's last name		**2** Decedent's Social Security No.
3a Legal residence (domicile) at time of death (county, state, and ZIP code, or foreign country)	**3b** Year domicile established	**4** Date of birth	**5** Date of death
6a Name of executor (see page 4 of the instructions)	**6b** Executor's address (number and street including apartment or suite no. or rural route; city, town, or post office; state; and ZIP code)		
6c Executor's social security number (see page 4 of the instructions)			
7a Name and location of court where will was probated or estate administered			**7b** Case number
8 If decedent died testate, check here ▶ ☐ and attach a certified copy of the will.	**9** If Form 4768 is attached, check here ▶ ☐		
10 If Schedule R-1 is attached, check here ▶ ☐			

Part 2.—Tax Computation

1	Total gross estate less exclusion (from Part 5, Recapitulation, page 3, item 12)		1
2	Total allowable deductions (from Part 5, Recapitulation, page 3, item 23)		2
3	Taxable estate (subtract line 2 from line 1)		3
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))		4
5	Add lines 3 and 4		5
6	Tentative tax on the amount on line 5 from Table A on page 12 of the instructions		6
7	Total gift tax payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)		7
8	Gross estate tax (subtract line 7 from line 6)		8
9	Maximum unified credit (applicable credit amount) against estate tax	9	
10	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See page 4 of the instructions.)	10	
11	Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)		11
12	Subtract line 11 from line 8 (but do not enter less than zero)		12
13	Credit for state death taxes. **Attach credit evidence** (see instructions). Do not enter more than line 12. Figure the credit by using the amount on line 3 less $60,000. See Table B in the instructions. Enter the amount here from Table B ▶ .... x .75 ▶		13
14	Subtract line 13 from line 12		14
15	Credit for Federal gift taxes on pre-1977 gifts (section 2012) (attach computation)	15	
16	Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)	16	
17	Credit for tax on prior transfers (from Schedule Q)	17	
18	Total (add lines 15, 16, and 17)		18
19	Net estate tax (subtract line 18 from line 14)		19
20	Generation-skipping transfer taxes (from Schedule R, Part 2, line 10)		20
21	Total transfer taxes (add lines 19 and 20)		21
22	Prior payments. Explain in an attached statement	22	
23	United States Treasury bonds redeemed in payment of estate tax	23	
24	Total (add lines 22 and 23)		24
25	Balance due (or overpayment) (subtract line 24 from line 21)		25

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Signature(s) of executor(s) — Date

Signature of preparer other than executor — Address (and ZIP code) — Date

Cat. No. 20548R

State Death Tax Credit

EGTRRA
Act §§531 and 523
[I.R.C. §§2011 and 2058]
Effective Date: Estates of descendents dying after December 31, 2001.

The state death tax credit is phased out over four years and is replaced with a state death tax deduction.

Old Law

A credit was allowed against the federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia for any property included in the decedent's gross estate. The maximum amount of credit allowable for state death taxes was determined under a graduated rate table, the top rate was 16%, based on the size of the decedent's adjusted taxable estate. Most states would impose a "pick-up" or "soak-up" estate tax, which serves to impose a state tax equal to the maximum federal credit allowed.

New Law

Under the new law, from 2002 through 2004, the state death tax credit allowable under present law is reduced as shown below:

Year	State Death Tax Credit Reduced from Prior Law Amounts by
2002	25%
2003	50%
2004	75%

In 2005, the state death tax credit is completely repealed, after which there will only be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any state or the District of Columbia, in respect of property included in the gross estate of the decedent. State taxes must be paid and claimed before the latter of the following applies:

1. Four years after the filing of the estate tax return.
2. 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, if a timely petition for re-determination of a deficiency has been filed with the Tax Court.
3. The expiration of the period of extension to pay estate taxes over time under I.R.C. §6166.
4. If a timely claim for a claim for refund or credit of an overpayment of tax has been filed, the later of:
   - **a.** 60 days from the date of mailing by certified mail or registered mail by the Secretary of the Treasury to the taxpayer of a notice of the disallowance of any part of such claim;
   - **b.** 60 days after a decision by any court of competent jurisdiction becomes final with respect to a timely suit instituted upon such claim;
   - **c.** Two years after a notice of the waiver of disallowance is filed under I.R.C. §6532(a)(3).

Observation. States that have an estate tax equal to the federal estate tax credit for death taxes will have to amend their estate tax law in order to collect any revenue from it after 2004.

Effect of the Change in Law

Under the law prior to repeal in 2005, the effect of a state "pick up" tax and the federal estate tax credit for state death taxes is to simply "shift" the tax liability from the federal government to the state government. However, the total liability is not changed.

Example 21. (Effective for 2001). Mary Peters died in 2001 with a $1million taxable estate. She made no taxable gifts during her lifetime. Her state imposes an estate tax equal to the maximum credit for state death taxes. Her federal and state estate tax liability is calculated as shown below:

	Computation Without State Death Tax	Computation With State Death Tax
Taxable estate	$1,000,000	$1,000,000
Tentative tax	345,800	345,800
Applicable credit amount	220,550	220,550
Tax before credit	125,250	125,250
State death tax credit	0	33,200
Federal estate tax due	125,250	92,050
Total federal and state	125,250[1]	125,250[1]

[1]Note that the total of the federal and state estate taxes is the same as the federal estate tax that would be due if there were no state death tax.

Loss of Revenue to States

The deduction will not provide the same tax benefit as the credit that it replaced. The deduction will reduce federal estate taxes by only the marginal federal estate tax rate rather than by 100% of the state death taxes.

Example 22. (Effective for 2002-2010). Assume Mary's state imposes a flat 4% estate tax when she dies in 2005. Her gross estate is worth $2 million. Mary made no taxable gifts during her lifetime. Mary's state estate tax is $80,000, but the deduction for that tax reduces her federal estate tax by only $36,000. Consequently, her total taxes are increased by $44,000.

	Computation Without State Death Tax	Computation With State Death Tax
Gross estate	$2,000,000	$2,000,000
State death tax deduction	0	80,000
Taxable estate	$2,000,000	$1,920,000
Tentative tax	780,800	744,800
Applicable credit amount	555,800	555,800
Federal estate tax due	225,000	189,000
Total federal and state	225,000	269,000

Installment Payment of Estate Tax

EGTRRA
Act §§571 and 572
[I.R.C. §6166]
Effective Date: Estates of descendents dying after December 31, 2001.

> The requirements for installment payments of estate taxes are relaxed so more estates will qualify.

Background

The estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely-held business exceeds 35% of the decedent's adjusted gross estate. The adjusted gross estate is equal to the gross estate minus certain deductions. If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.

Special Interest Rate

A special 2% interest rate applies to the amount of deferred estate tax attributable to the first $1 million in taxable value of a closely held business. The inflation adjusted amount for 2001 was $1.06 million and is $1.1 million in 2002 The interest rate applicable to the amount of estate tax, attributable to the taxable value of the closely-held business in excess of **$1.1 million**, is equal to 45% of the rate applicable to underpayments of tax under I.R.C. §6621. Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Example 23. At the time of her death on December 1, 2000, Michele owned a baking business that was worth $800,000. Assuming that she otherwise had a $1 million taxable estate, the estate tax due on September 1, 2001, was $345,800 – $220,550 = $125,250. The executor of Michele's estate elected to pay the $100,200 (($125,250 × $800,000) ÷ $1 million) estate tax due on Michele's $800,000 business in installments under I.R.C. §6166. Furthermore, the executor elected to pay interest only for the first five years (at a rate of 2%) and to pay the $100,200 of tax in 10 equal installments beginning five years after the due date of the estate tax return. The payments are shown below:

Date	Interest	Principal	Total
September 1, 2002	$2,004.00	$0	$2,004.00
September 1, 2003	2,004.00	0	2,004.00
September 1, 2004	2,004.00	0	2,004.00
September 1, 2005	2,004.00	0	2,004.00
September 1, 2006	2,004.00	10,020.00	12,024.00
September 1, 2007	1,803.60	10,020.00	11,823.60
September 1, 2008	1,603.20	10,020.00	11,623.20
September 1, 2009	1,402.80	10,020.00	11,422.80
September 1, 2010	1,202.40	10,020.00	11,222.40
September 1, 2011	1,002.00	10,020.00	11,022.00
September 1, 2012	801.60	10,020.00	10,821.60
September 1, 2013	601.20	10,020.00	10,621.20
September 1, 2014	400.80	10,020.00	10,420.80
September 1, 2015	200.40	10,020.00	10,220.40
Total	**$19,038.00**	**$100,200.00**	**$119,238.00**

For purposes of these rules, an interest in a "closely-held business" is:

1. An interest as a proprietor in a sole proprietorship;
2. An interest as a partner in a partnership carrying on a trade or business if 20% or more of the total capital interest of such partnership is included in the decedent's gross estate, or the partnership had 15 or fewer partners; or
3. Stock in a corporation carrying on a trade or business, if 20% or more of the value of the voting stock of the corporation is included in the decedent's gross estate, or such corporation had 15 or fewer shareholders. The decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding

company. If ownership is through a holding company, the stock must be non readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the 5-year deferral for principal and the 2% interest rate do not apply. The value of any interest in a closely-held business does not include the value of that portion of such interest attributable to passive assets held by such business.

New Law

The new law expanded the definition of a "closely-held business" for purposes of installment payment of estate tax. It increases from **15** to **45** the maximum number of partners in a partnership and shareholders in a corporation that is considered a "closely-held business" in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

The new law also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is also eligible for installment payment of the estate tax. The new law also provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (i.e., which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

The term "qualifying lending and finance business" means a lending and finance business, if:

1. Based on all the facts and circumstances immediately before the date of the decedent's death, there was substantial activity with respect to the lending and finance business, or
2. During at least three of the five taxable years ending before the date of the decedent's death, such business had:
    a. At least one full-time employee substantially all of whose services were the active management of such business,
    b. 10 full-time, non owner employees substantially all of whose services were directly related to such business, and
    c. $5 million in gross receipts from activities that qualify as "lending and finance business" described below.

The term "lending and finance business" means a trade or business of:

- making loans;
- purchasing or discounting accounts receivable, notes, or installment obligations;
- engaging in rental and leasing of real and tangible personal property, including entering into leases and purchasing, servicing, and disposing of leases and leased assets;
- rendering services or making facilities available in the ordinary course of a lending or finance business; or
- rendering services or making facilities available in connection with activities described in 1 through 4 carried on by the corporation rendering services or making facilities available, or another corporation which is a member of the same affiliated group [I.R.C. §1504 without regard to I.R.C. §1504(b)(3)].

The term "qualifying lending and finance business" does not include any interest in an entity, if the stock or debt of such entity or a controlled group [I.R.C. §267(f)(1)] of which such entity was a member was readily tradable on an established securities market or secondary market (as defined by the Secretary of the Treasury) at any time within three years before the date of the decedent's death.

Example 24. Maxwell owned 60% of the shares in the local bank when he died on March 1, 2002. The shares were valued at $1 million and his taxable estate was $1.25 million. Therefore, the shares constitute 80% of the taxable estate. Marvin's estate can elect the 5-year installment payment of estate taxes under I.R.C. §6166. Of the $102,500 of estate tax due on December 1, 2002, $82,000 is attributable to the shares of stock. That amount can be paid in five equal installments with interest at 2%. The payments will be as follows:

Date	Interest	Principal	Total
December 1, 2003	$1,640	$16,400	$18,040
December 1, 2004	1,312	16,400	17,712
December 1, 2005	984	16,400	17,384
December 1, 2006	656	16,400	17,056
December 1, 2007	328	16,400	16,728
Total	**$4,920**	**$82,000**	**$86,920**

The 2001 Act clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be non readily tradable in order to qualify for installment payment of the estate tax. The new law also provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

Note. No inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a "trade or business" eligible for installment payment of estate tax under present law.

The estate tax exclusion for conservation easements increased in 2002. It will be allowed to reduce the taxable estate by up to $500,000, an increase of $100,000.

A detailed analysis of this Act is not included in this workbook.

Education and Retirement Provisions

More detailed information regarding provisions of the Economic Growth Tax Reform Relief Act of 2001 may be found in Chapter 8: Education Provisions and Chapter 7: Retirement. The following contains only a brief summary of these provisions.

Employer-Provided Educational Assistance

EGTRRA
Act §411
[I.R.C. §127]
Effective date: Years beginning after December 31, 2001

The $5,250 company-paid tuition exclusion expanded to include graduate school courses. (Covered in more detail in Chapter 8: Education Provisions.)

Coverdell Educational Savings Accounts

EGTRRA
Act §401
[I.R.C. §530]
Effective Date: For years beginning after December 31, 2001.

The annual contribution has been increased to $2,000.

Starting in 2002, Coverdell education savings accounts are significantly more tax-advantaged. Withdrawals are excluded from gross income if used for education related costs incurred in connection with primary, secondary or post-secondary schooling. The annual contribution limit has been increased from $500 to $2,000 with AGI phase-out caps being raised as well. Unlike in past years, contributions for 2002 can be made by April 15, 2003 (Covered in more detail in Chapter 8: Education Provisions.)

State Sponsored Prepaid Educational Programs

EGTRRA
Act §402
[I.R.C. §529]
Effective Date: For taxable years beginning after December 31. 2001, except that the exclusion for distributions from a program established by a private institution is effective for taxable years beginning after December 31, 2003.

- Provision is expanded to include private educational institutions.
- First cousins are eligible family members.
- Nonqualified withdrawals are subject to a 10% additional tax.

Distributions from state prepaid plans are tax-free, but only if distributions are used for post-secondary educational costs. (Covered in more detail in Chapter 8: Education Provisions.)

Deduction for Higher Education Expenses

EGTRRA
Act §431
[I.R.C. §222]
Effective Date: For payments made in taxable years beginning after December 31, 2001 and before January 1, 2006.

A deduction is allowed for qualified higher education expenses.

A new $3,000 above-the-line deduction for college costs commences in 2002. It will start to phase out for joint filers with AGI's over $130,000, and for single filers with AGI over $65,000. (Covered in more detail in Chapter 8: Education Provisions.)

Student Loan Interest Deduction

EGTRRA
Act §412
[I.R.C. §221]
Effective Date: For interest paid on qualified education loans after December 31. 2001.

- Income phase-out ranges are increased.
- The 60-month limit is eliminated.
- Voluntary interest payments are deductible.

The 60-month time limit has been eliminated. Consequently, more student loan interest will now be deductible More importantly, the phase-out limits for married taxpayers are now double those for single taxpayers. (Covered in more detail in Chapter 8: Education Provisions.)

Employer-Provided Retirement Advice

EGTRRA
Act §665
[I.R.C. §132(a)(7) and (m)]
Effective Date: Years beginning after December 31, 2001.

Qualified retirement planning services provided by an employer are excluded from income. (Covered in more detail in Chapter 7: Retirement.)

Faster Vesting for Matching Contributions

EGTRRA
Act § 632
[I.R.C. § 411]
Effective Date: Years beginning after December 31, 2001.

Beginning in 2002, more rapid vesting schedules apply to employer matching contributions. For one type of plan, vesting is 100% after 3 years of service. In the other type of plan, vesting is increased in 2-year increments by 20%, with vesting at 100% after 6 years of service. (Covered in more detail in Chapter 7: Retirement.)

Credit for Pension Plan Startup Costs for Small Employers

EGTRRA
Act §619
[I.R.C. §45E]
Effective Date: Years beginning after December 31, 2001.

A nonrefundable tax credit is allowed for administrative and retirement-education expenses incurred by a small business that adopts a qualified retirement plan. The credit is equal to 50% of the first $1,000 of qualified expenses. (Covered in more detail in Chapter 7: Retirement.)

Increase in Pension and IRA Contribution Limits

EGTRRA
Act §§611, 616 and 631
[I.R.C. §§219, 404, 408 and 415]
Effective Date: For tax years beginning after December 31. 2001.

Limits on contributions to pension plans and IRAs are increased.

Contribution limits for pension plans and IRAs have increased. In 2002, the limit for IRAs is $3,000, the limit for I.R.C. §§401(k) and 403(b) plans is $11,000. A detailed listing of increases for the next eight years, is found in Chapter 7: Retirement.

Additional Catch-Up Contributions

EGTRRA
Act §601
[I.R.C. §219(b)(2)(B)]
Effective Date: For tax years beginning after December 31. 2001.

Individuals age 50 and older can make catch-up contributions to retirement plans. (Covered in more detail in Chapter 7: Retirement.)

Credit for Elective deferrals and IRA Contributions

EGTRRA
Act §618
[New I.R.C §25B]
Effective Date: Tax years beginning after December 31, 2001 and before January 1, 2007.

A nonrefundable credit is allowed for contributions to a qualified retirement plan. The maximum credit is 50% of up to $2,000 of contributions. The credit is reduced to zero as AGI increases.

Low and middle-income taxpayers who contribute to their retirement plans are allowed a tax credit of up to $1,000 for contributions made to IRAs. They are also allowed a tax credit for contributions to tax qualified employer plans. This special tax break is phased-out gradually and is completely eliminated for joint filers when their AGI reaches $50,000...$25,000 for single filers. (See Chapter 7: Retirement.)

Elective Deferrals Not Taken Into Account for Purposes of Deduction Limits

EGTRRA
Act §614
[I.R.C. § 404(n)]
Effective Date: For years beginning after December 31. 2001.

Elective deferral contributions are not subject to the deduction limits and are not taken into account for any other employer contribution limits. (Covered in more detail in Chapter 7: Retirement.)

Employee Contributions to Defined Contribution Plans Limited to 100% of Compensation

EGTRRA
Act §632
[I.R.C. § 415(c)(1)]
Effective Date: For years beginning after December 31. 2001, except as noted.

- Contribution limit for defined contribution plan increased to 100% of compensation.
- Contribution limit for I.R.C. §457 plans increased to 50% of compensation for 2002-2009 and to 100% for 2010. (Covered in more detail in Chapter 7: Retirement.)

Rollovers Among Various Plans

EGTRRA
Act §§641, 642 and 643
[I.R.C. §§402, 403(b), 408, and 457]
Effective Date: For distributions made after December 31. 2001, except as noted.

Rollovers are allowed among various retirement plans. (Covered in more detail in Chapter 7: Retirement.)

Plan Loans for S Corporation Owners, Partners, Members of LLCs and Sole Proprietors

EGTRRA
Act §612
[I.R.C. §4957(f)(6)]
Effective Date: For tax years beginning after December 31. 2001.

Owner-employees are allowed to receive loans from retirement plans. (Covered in more detail in Chapter 7: Retirement.)

LEGISLATIVE RELIEF FOR VICTIMS OF TERRORISM ATTACKS

On January 23, 2002, the Victims of Terrorism Tax Relief Act was enacted. It provides tax relief for those who died or were injured in the September 11, 2001 terrorist attacks, the anthrax bio-terrorism attacks, or the 1995 Oklahoma City bombing. Significant highlights of the Act include:

1. Income tax relief for victims in the year of death and the year prior to death;
2. Exemption of the first $8.5 million of an estate from federal estate tax and the first $3 million from state estate tax;
3. Tax-free treatment for certain death benefits paid by employers to their employees;

4. Charitable organizations can make pro-rata payments prospectively to victims' families without financial need being demonstrated;

5. Expansion of IRS, DOL, and PBGC authority to postpone tax-related and pension-related deadlines;

6. Allowing IRS to share taxpayer information with other federal law enforcement agencies investigating terrorist attacks.

EXTRATERRITORIAL INCOME EXCLUSION

EEA

[I.R.C. §114]
Effective Date: Enacted to be retroactively available to transactions occurring on and after October 1, 2000.

Act allows smaller businesses to gain tax benefits from exporting.

Summary

Permits a portion of income from export products to be excluded based on the proportion of depreciation claimed domestically and abroad.

Background

The Extra-Territorial Exclusion Act of 2000, permits a portion of income from export products to be excluded based on the proportion of depreciation claimed domestically and abroad (See I.R.C. §865(c)).

Note. The World Trade Organization (WTO) ruled on January 14, 2002, the legislation is "inconsistent with international trade agreements."

Introduction

The taxation of Foreign Sales Corporations (FSC) are described in I.R.C. §§921 through 927.

New Income Tax Exclusion

New law provides for the use of an income exclusion.

In response to a decision of the World Trade Organization, Congress repealed the Foreign Sales Corporation (FSC) provisions in I.R.C. §§921-927 and substituted a new income exclusion for taxpayers involved in foreign sales activities [P.L. 106-519, enacted November 15, 2000].

The exclusion, enacted in I.R.C. §114, applies to extraterritorial income, with the related definitions enacted in I.R.C. §§941-943.

The income exclusion applies to individuals, corporations, partnerships and other pass-through entities that have foreign sales activity, and was enacted to be retroactively available to transactions occurring on and after October 1, 2000.

Existing FSCs can delay implementation of the exclusion until January 1, 2002.

In general, the exclusion from income is the greatest of:

- 1.2% of foreign trading gross receipts,
- 15% of foreign trade income, or
- 30% of foreign sale and leasing income.

"Foreign trading gross receipts" are defined as arising from:

- the sale, exchange or other disposition of qualifying foreign trade property;
- the lease or rental of qualifying foreign trade property for use by the lessee outside the U.S.;
- services that are related and subsidiary to any sale, exchange, or other disposition of qualifying foreign trade property by the taxpayer or any lease or rental of qualifying foreign trade property for use by the tenant outside the U.S.;
- engineering or architectural services for construction projects outside the U.S.; or
- the performance of managerial services in connection with the production of foreign trading gross receipts [I.R.C. §942(a)(1)].

If foreign trading gross receipts for the tax year exceed $5 million, the taxpayer must also substantiate that certain economic processes take place outside the U.S. to qualify for the exclusion (i.e., either foreign direct costs attributable to the transactions must equal or exceed 50% of the total direct costs attributable to the transaction, or foreign direct costs must equal or exceed 85% of total direct costs in any two specified activities, such as advertising, transportation, etc.).

Foreign sale and leasing income is calculated by taking into account only directly allocable expenses to determine income that is:

- properly allocable to activities that constitute foreign economic processes;
- derived from the lessee or rental of qualifying foreign trade property for use outside the U.S.;
- derived from the sale of qualifying foreign trade property formerly leased or rented by a lessee outside the U.S. [I.R.C. §942(c)].

IRS Form 8873 is used to calculate the amount of exempt income. A blank form is on the following page.

> **Note.** In the past, smaller businesses, particularly a proprietorship, received no privileges for foreign sales activities. The costs associated with establishment of a Foreign Sales Corporation (FSC) often prohibited small businesses from gaining any tax advantage from exporting. However, this new income exclusion applies to all businesses that are involved in foreign sales activities, and may simply be claimed by the use of Form 8873, without the need to create any separate business entity or additional compliance obstacles.

Form **8873**

Department of the Treasury
Internal Revenue Service

Extraterritorial Income Exclusion

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

OMB No. 1545-1722
2002
Attachment Sequence No. 126

Name(s) as shown on return | Identifying number

Part I Elections and Other Information

1 Check the box if you are electing under section 942(a)(3) to exclude a portion of your gross receipts from foreign trading gross receipts on line 15. Attach a schedule indicating which receipts are being excluded . . . ▶ ☐

2 Check the box if you are electing to apply the extraterritorial income exclusion provisions to certain transactions involving a FSC (see instructions). Attach a schedule listing the affected transactions (see instructions) . . . ▶ ☐

3 Check the box if the taxpayer is a foreign corporation electing to be treated as a domestic corporation (see instructions) . . ▶ ☐

4a Are you excepted from the foreign economic process requirements because your foreign trading gross receipts are $5 million or less? . . . ▶ ☐ Yes ☐ No

b If "No," check the applicable box to indicate how you met the foreign economic process requirements:
(1) ☐ You met the 50% foreign direct cost test (see instructions).
(2) ☐ You met the alternative 85% foreign direct cost test (see instructions).

5 Complete lines 5a through 5c. For foreign sale and leasing income transactions, complete only lines 5a and 5c(1).
a Business activity code ______ **b** Product or product line ______
c Check the applicable box to indicate the basis of your reporting:
(1) Transaction-by-transaction:
(a) ☐ Aggregate on Form 8873 **(b)** ☐ Aggregate on tabular schedule **(c)** ☐ Tabular schedule of transactions
(2) ☐ Group of transactions

Part II Foreign Trade Income and Foreign Sale and Leasing Income

Caution: *If a related person is also eligible for an extraterritorial income exclusion, see* ***Excluded property*** *on page 2 of the instructions.*

			(a) Foreign Trade Income	(b) Foreign Sale and Leasing Income
6	Sale, exchange, or other disposition of qualifying foreign trade property	6		
7	Enter the amount from line 6, column (a), attributable to the sale of property formerly leased or rented for use by the lessee outside the United States	7		
8	Lease or rental of qualifying foreign trade property for use by the lessee outside the United States. Enter the same amount in both columns . .	8		
9	Services related and subsidiary to the sale, exchange, or other disposition of qualifying foreign trade property . . .	9		
10	Enter the amount from line 9, column (a), attributable to the sale of property formerly leased or rented for use by the lessee outside the United States	10		
11	Services related and subsidiary to the lease of qualifying foreign trade property for use by the lessee outside the United States. Enter the same amount in both columns . . .	11		
12	Engineering or architectural services for construction projects outside the United States	12		
13	Managerial services provided to unrelated persons (see instructions) .	13		
14	Enter the sum of the amounts from lines 6, 9, 12, and 13 of column (a) attributable to foreign economic processes. **Do not** include any amounts already included on lines 7, 8, 10, or 11 in column (b) . . .	14		
15	**Foreign trading gross receipts.** Add lines 6 through 13 in column (a) .	15		
16	Add lines 7 through 14 in column (b) . . .	16		
17	**Cost of goods sold:**			
a	Inventory at beginning of year . . .	17a		
b	Purchases . . .	17b		
c	Cost of labor . . .	17c		
d	Additional section 263A costs (attach schedule) . . .	17d		
e	Other costs (attach schedule) . . .	17e		
f	Total. Add lines 17a through 17e . . .	17f		
g	Inventory at end of year . . .	17g		
h	Subtract line 17g from line 17f . . .	17h		
18	In column (a), subtract line 17h from line 15. In column (b), subtract line 17h from line 16 . . .	18		
19	Other expenses and deductions (see instructions) (attach schedule) .	19		
20	**Foreign trade income.** In column (a), subtract line 19 from line 18. If -0- or less, stop here. You do not qualify for the exclusion . . .	20		
21	**Foreign sale and leasing income.** In column (b), subtract line 19 from line 18	21		

For Paperwork Reduction Act Notice, see page 4 of the instructions. Cat. No. 30732F Form **8873** (2002)

Form 8873 (2002) Page **2**

Part III Marginal Costing (**Note:** *If you are **not** using Marginal Costing, skip Part III and go to Part IV.*)

Section A — Foreign Trade Income Using Marginal Costing Method

22	Foreign trading gross receipts. Enter the amount from line 15			**22**	
23	Costs and expenses allocable to the amount reported on line 22:				
a	Cost of direct material attributable to property sold	**23a**			
b	Cost of direct labor attributable to property sold	**23b**			
c	Add lines 23a and 23b			**23c**	
24	Subtract line 23c from line 22			**24**	
25	Worldwide gross receipts from sales of the product or product line			**25**	
26	Costs and expenses allocable to the amount reported on line 25:				
a	Cost of goods sold attributable to property sold	**26a**			
b	Expenses attributable to gross income	**26b**			
c	Add lines 26a and 26b			**26c**	
27	Subtract line 26c from line 25. (**Note:** *If -0- or less, stop here. You may not use Part III to determine your qualifying foreign trade income. Go to line 37.*)			**27**	
28	Overall profit percentage. Divide line 27 by line 25. Carry the result to at least three decimal places			**28**	
29	Overall profit percentage limitation. Multiply line 22 by line 28			**29**	
30	**Foreign trade income using marginal costing.** Enter the **smaller** of line 24 or line 29			**30**	

Section B — 15% of Foreign Trade Income Method

31	Multiply line 30 by 15% (.15)	**31**	
32	**Foreign trade income using full costing.** Enter the amount from line 20	**32**	
33	Enter the **smaller** of line 31 or line 32	**33**	

Section C — 1.2% of Foreign Trading Gross Receipts Method

34	Multiply line 22 by 1.2% (.012)	**34**	
35	Multiply line 30 by 30% (.30)	**35**	
36	Enter the **smallest** of lines 32, 34, or 35	**36**	

Part IV Extraterritorial Income Exclusion (Net of Disallowed Deductions)

37	Enter your foreign trade income from line 20			**37**	
38	Multiply line 37 by 15% (.15)			**38**	
39	Enter your foreign trading gross receipts from line 15	**39**			
40	Multiply line 39 by 1.2% (.012)	**40**			
41	Multiply line 38 by 2.0	**41**			
42	Enter the **smaller** of line 40 or line 41			**42**	
43	Enter your foreign sale and leasing income from line 21			**43**	
44	Multiply line 43 by 30% (.30)			**44**	
45	Enter the **greatest** of lines 33, 36, 38, 42, or 44. If you are using the alternative computation, see instructions for the amount to enter			**45**	
46	Divide the amount on line 45 by the amount on line 37. Carry the result to at least three decimal places. If the result is 1.0 or more, enter 1.0	**46**			
47	If line 44 equals line 45, enter the amount from line 19, column (b). Otherwise, enter the amount from line 19, column (a).	**47**			
48	Multiply line 46 by line 47			**48**	
49	Add lines 45 and 48			**49**	
50	Reduction for international boycott operations, illegal bribes, kickbacks, etc. (see instructions)			**50**	
51	**Qualifying foreign trade income.** Subtract line 50 from line 49. If -0- or less, stop here. You do not qualify for the exclusion			**51**	
52	Enter the amount from line 18, column (a)	**52**			
53	Divide line 51 by line 52. Carry the result to at least three decimal places	**53**			
54	Multiply line 47 by line 53			**54**	
55	**Extraterritorial income exclusion (net of disallowed deductions).** Subtract line 54 from line 51. Enter the result here and on the "Other deductions" or "Other Expenses" line of your return (see instructions)			**55**	

Form **8873** (2002)

JOB CREATION AND WORKER ASSISTANCE ACT 2002

Background

On March 9, 2002, just two days after Federal Reserve Chairman Alan Greenspan told Congress that the economy "was rebounding from recession," President Bush signed into law the Job Creation and Worker Assistance Act of 2002 (H.R. 3090; P.L. 107-147).

Overview of Various Provisions

The bill provides:

- a 3-year, 30% depreciation allowance for business assets, along with the requisite alternative minimum tax modification for the depreciation allowance (i.e., there will be no need to make any adjustment for AMT purposes);
- an increase in the carryback for net operating losses from two to five years and a waiver of the 90% limitation against the AMT;
- creation of an array of targeted tax breaks to spur investment in the New York areas damaged September 11;
- a 2-year extension for expired tax breaks known as the tax extenders;
- a 5-year extension of the subpart F exception for active financing income for insurance companies operating abroad;
- a handful of technical tax corrections; and
- a 13-week extension of unemployment insurance (UI) benefits that can be automatically renewed for an extra 13 weeks if states require additional resources.

The Joint Committee on Taxation (JCT) estimates that the bill will cost $51 billion in 2002, approximately $94 billion from 2002 to 2007, and about $42 billion through 2012.

State and local governments have expressed concern about the 30% depreciation allowance costing them billions of dollars in lost revenue. A number of states have decided not to adopt the special 30% depreciation allowance and the extended net operating loss (NOL) carryback rules. See page 50 for a list of states that are not conforming to federal law.

SPECIAL 30% DEPRECIATION ALLOWANCE FOR CERTAIN ASSETS

JCWA
Act §101
[I.R.C. §168]
Effective Date: For qualifying assets purchased after September 10, 2001 and before September 11, 2004 which are placed into service before January 1, 2005.

> The special 30% depreciation allowance is required. Taxpayers must make an election if they do not wish to claim the deduction.

Summary

- **Retroactive** effective date and its impact upon clients.
- Special 30% depreciation allowance amount **not** an adjustment for AMT.
- Remaining MACRS depreciation deductions **not** an adjustment for AMT.
- Any I.R.C. §179 amount must be taken **first.**

- As with I.R.C. §179, **entire** special 30% depreciation amount allowed regardless of when during tax year the asset is first placed into service (i.e., **short** tax years have no effect on special amount).
- Special 30% depreciation allowance is an "all or nothing" proposition for each MACRS class of assets.
- For returns filed before June 1, 2002, the taxpayer can either file an amended tax return or file Form 3115 for next year's return (i.e., "catch-up depreciation") to claim tax benefits of the special 30% depreciation allowance.

Introduction

Under the 2002 Act, certain business assets purchased after September 10, 2001 and before September 11, 2004 are allowed a special 30% depreciation allowance. This is determined **after** taking into account any I.R.C. §179 amount, but **before** computing the normal MACRS depreciation amount for the first tax year that the asset is placed into service.

Required Time Frame. "Original use" of property must commence with the taxpayer on or after September 11, 2001, and the property must be placed into service before January 1, 2005. A special rule applies to property that is sold and leased back. The rule applies to property that is originally placed in service after September 10, 2001 by a person, sold and then leased back. If the leaseback occurs within three months after the date the property was originally placed in service, the property is treated as if originally placed in service no earlier than the date it is first used under the leaseback.

Exception for Transportation, 15- & 20-Year Property. An extension of the placed-into-service date of one year (i.e., January 1, 2006) is provided for certain property with a recovery period of 10 years or longer and certain transportation property. "Transportation property" is defined as tangible personal property used in the trade or business of transporting persons or property.

> **Special Rule.** For property eligible for the "extended placed-into-service date," a special rule limits the amount of costs eligible for the additional first year depreciation. For such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") shall be eligible for the additional first year depreciation.

Transitional Rule. The law specifically states that "if a binding contract to acquire the property existed before September 11, 2001, the property does not qualify."

Self-Constructed Property. For property that is manufactured, constructed, or produced **and used** by the taxpayer, the manufacture, construction, or production of the property must have begun after September 10, 2001, and before September 11, 2004. The same is true for property that is constructed by another person for use by the taxpayer.

> **Note.** This "transitional rule" precludes any property that otherwise qualifies for the special 30% depreciation provisions from getting the tax break if the taxpayer was committed to buying the property before September 11, 2001. It will be important to examine the facts behind the purchase of property that occurred close to September 11, 2001 to see if the taxpayer might fall into this trap.

Original Use (New) Property

According to the JTC's explanation, the term "original use" means the first use to which the property is put. This is whether or not use corresponds to use of property by the taxpayer. When evaluating whether property qualifies as "original use," the same factors are used to determine whether property qualifies as "new I.R.C. §38 property" for purposes of the investment tax credit [Reg. §1.48-2]. Additional capital expenditures incurred to recondition or rebuild acquired property (or owned property) will satisfy the "original use" requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer will not satisfy the "original use" requirement.

Unlike the I.R.C. §179 immediate expensing rules [I.R.C. §179(d)(2)(A)], the special 30% depreciation allowance does not prohibit the purchase of otherwise qualifying property from a "disqualified person."

Example 25. On February 1, 2002, Jack buys a used machine from Jill for $20,000. Prior to September 11, 2004, Jack spends $5,000 for a new motor on the machine which is properly capitalized.

The $5,000 will be treated as satisfying the "original use" requirement and will therefore be "qualified property". Assuming all other conditions are met, this will be eligible for the special 30% depreciation. However, no part of the original $20,000 purchase price will qualify for the additional first year depreciation since the "original use" of the machine did not commence with Jack.

Note. The special 30% depreciation rules do not apply to "used property." Similar to the "old" ITC rules, the use of the property must have commenced with the taxpayer seeking the tax break. If the taxpayer makes capitalizable improvements to previously acquired "used" property, then the cost of the improvements could qualify for the special 30% deprecation.

Allowed for Both Regular and AMT Tax Purposes

The special 30% depreciation allowance amount is treated like an I.R.C. §179 immediate expensing amount since it is not considered an adjustment for AMT purposes for the tax year that the asset is placed into service.

Note. Taxpayers claiming the special 30% depreciation receive a double tax break. First, the amount of the special depreciation is not subject to the alternative minimum tax. Second, because they used the special 30% depreciation, the regular depreciation for the asset is also excluded from the AMT calculation.

Note. There is uncertainty whether the special 30% depreciation will affect the 40% rule when trying to determine whether the taxpayer must use the mid-quarter depreciation convention. One thought is since I.R.C. §179 immediate expensing amounts are not counted toward the 40% of the taxpayers assets, the special depreciation should not be counted either. An opposing argument is that under I.R.C. §168(d)(3)(A) the mid-quarter convention applies if the total bases of all I.R.C. §168 assets purchased in an asset class exceeds 40% of the aggregate bases of properties to which I.R.C. §168 applies. At the time this book was printed the IRS had not made a final decision. They are expected to make an announcement.

Property Qualifying for Special 30% Depreciation

Besides meeting the purchase and placed into service dates mentioned above, the property must:

1. Be eligible for general MACRS depreciation rules;
2. Have first use commence with the taxpayer seeking the special 30% depreciation allowance; and
3. Fall under one of the classes listed below:
   - **a.** Property with a recovery period of 20 years or less (like farm buildings and land improvements);
   - **b.** Water utility property;
   - **c.** Non-I.R.C. §197 computer software; or
   - **d.** Qualified leasehold improvements.

A special rule precludes the additional first-year depreciation allowance for property that is required to be depreciated under the alternative depreciation system of MACRS. An exception exists where the taxpayer has elected under I.R.C. §168(g)(7), so the special depreciation allowance could be claimed for that class.

"Non-I.R.C. §197 computer software" seems to include software assets governed by Rev. Proc. 2000-50. This procedure allows the taxpayer to amortize the cost over 36 months, starting with the month the asset is first placed into service. Many software packages, where updates are regularly released, have a useful life of one year or less. In this situation, the cost is often deducted within the existing tax year.

Note. The new special 30% depreciation rules give the practitioner more reason to carefully determine if a "fixture" in commercial buildings is either:

- 5- or 7-year MACRS property; or
- a "structural component" properly classified as 39-year property.

The special 30% depreciation allowance applies unless the taxpayer elects to not apply it to a class of property for the tax year in which it is otherwise available. If the election is made, it applies to all property in that class placed in service for that year. On March 19, 2002, the IRS released a newly-revised Form 4562 and instructions. On page 4 of the instructions, it directs that a statement be attached to Form 4562 affirmatively electing not to take any special 30% depreciation on a particular class of property that otherwise qualifies. If not made, the "allowed or allowable" rules relating to depreciation might be applied and the bases of such property would have to be reduced by the 30% allowance.

Qualified Leasehold Improvements

"Qualified leasehold improvement property" is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met:

- the improvement must be made under or pursuant to a lease either by the lessee (or sub-lessee) of that portion of the building, or by the lessor of that portion of the building;
- that portion of the building is to be occupied exclusively by the lessee (or any sub-lessee); and
- the improvement must be placed in service more than three years after the date the building was first placed in service.

Caution. Leasehold improvements are frequently made to new buildings, or ones that have not been in service for more than three years. A tenant in a new shopping mall might not be able to take advantage of this tax break, if the mall is less than three years old. Also, if a business owns the real property outright (i.e., it is not being used pursuant to a lease), then the question of an item being a "leasehold improvement" is rendered moot.

New I.R.C. §168(k)(3)(B) states that the following leasehold improvements are not eligible for the special 30% depreciation allowance:

- Any enlargement of the building
- Any elevator or escalator
- Any structural component benefiting a common area
- The internal structural framework of the building

Example 26. Roger began to lease one-half of a commercial building for his new Italian restaurant in 1990. Due to increased competition from a new restaurant, Roger asked the owner of the building to make some improvements, but the owner declined. The lease, which was renewed in 2000, states that "the lessee may make and pay for building improvements, subject to approval of the lessor."

In July 2002, Roger placed in service the following **leasehold improvements** to the building: (He paid for all of them.)

Asset	Cost
a) New wall to separate the smoking section from the non-smoking section (non-load-bearing)	$3,000
b) New central air conditioners (2 units)	12,000
c) New vent system for kitchen	3,000
Total Leasehold Improvements made in 2002	**$18,000**

Question A. Under the 2002 Act, which of the leasehold improvements qualify for the special 30% depreciation allowance?

Answer A. All three assets qualify for the special 30% depreciation allowance, since none of the improvements meets the provisions of I.R.C. §168(k)(3)(B).

Computation of the special 30% depreciation allowance for 2002:

$18,000 × 30% (Part II on the 2002 Form 4562) = **$5,400**

Question B. How is the MACRS deduction for these three assets computed?

Answer B. Assuming the three assets are "structural components" of Roger's one-half of the leased building rather than personal property, the 2002 MACRS deduction is calculated as follows:

Asset	Date Acquired	Adjusted Cost	Recovery Period
Leasehold Improvements	July 1, 2002	$12,600	39 years

Total cost of leasehold improvements	$18,000
Less: Special 30% depreciation allowance	(5,400)
Remaining cost eligible for MACRS	**$12,600**

The mid-month convention applies. The MACRS percentage for non-residential real property placed in service in July is 1.177%. The MACRS deduction is $148 as calculated below.

$12,600 × 1.177% (Part III, Form 4562) = **$148**

Note. If the central air conditioners and the vent system of the building benefited portions of the building other than Roger's leased portion, these assets would not qualify for the special allowance. If that were the case, the three assets would represent **"structural components benefiting a common area"** of the leased building.

> **Note.** The provision for "qualified leasehold improvements" encourages redevelopment projects on buildings which might otherwise remain empty. This provision provides incentive to improve older properties, where there might otherwise be hesitation if the costs would only be eligible for 39-year straight-line depreciation.

Qualified Leases. For purposes of the provision, a binding commitment to enter into a lease is treated as a "lease." The parties to the commitment are the lessor and lessee. However, a lease between related persons is not considered a lease for this provision (i.e., for purposes of the "binding commitment" exception).

Effect on Luxury Cars

In addition to the special 30% depreciation provision, $4,600 is added to the first year cap otherwise available. For 2001 and 2002, this is $3,060. Therefore, a total of $7,660 can be deducted (i.e., either through normal MACRS deductions and/or I.R.C. §179 immediate expensing election) for the year that the car is placed into service (i.e., as long as it qualifies by being purchased and placed into service after September 10, 2001).

Example 27. Eric, who is self-employed, purchased a luxury car for $55,000 in December, 2001. He used it as 100% for business. Because of the change created by the special 30% depreciation allowance, Eric can now deduct $7,660 on his 2001 amended tax return. The new $7,660 limitation replaces the former first-year "luxury auto" limit of $3,060 Eric deducted on his original 2001 Form 4562.

> **Note.** See Chapter 3: Small Business Issues for more details on how the special 30% depreciation allowance affects "luxury autos."

Adjustment to Basis

The basis of the property and the depreciation allowed for the first year that the asset is placed into service must be adjusted to reflect the special 30% depreciation (i.e., along with any I.R.C. §179 immediate expensing amount otherwise taken on the asset).

Example 28. John Moore purchases a $40,000 SUV with an unloaded gross curb weight of over 6,000 lbs. on December 31, 2002. After taking an allowable I.R.C. §179 immediate expensing amount of $24,000, he is left with a basis of $16,000. Under the special 30% depreciation provision, he elects to depreciate an additional 30% of the asset's basis, or $4,800 (30% × $16,000). Finally, on the remaining basis of $11,200 ($40,000 – ($24,000 + $4,800)), he takes his normal MACRS deduction of $2,240 (40% DDB × 1/2 × $11,200). As a result of this $40,000 purchase made late in the tax year, John receives a total deduction of $31,040 ($24,000 + $4,800 + $2,240), or nearly 78% of the asset's original cost in the first tax year.

Original Cost	$40,000	
I.R.C. §179 Deduction	(24,000)	
Basis after I.R.C. §179	$16,000	
30% Special depreciation	(4,800)	
Basis for regular depreciation	$11,200	
Regular MACRS depreciation	(2,240)	
Remaining basis to depreciation in 2002	$8,960	
Total 2002 deduction	$31,040	78% of original cost

John's completed 2002 Form 4562 follows.

For Example 28

Form **4562** Department of the Treasury Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

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

OMB No. 1545-0172 2002 Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
John Moore		111-11-1111

Part I Election To Expense Certain Tangible Property Under Section 179
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See page 2 of the instructions for a higher limit for certain businesses	1	$24,000
2	Total cost of section 179 property placed in service (see page 3 of the instructions)	2	40,000
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	24,000

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	Sport Utility Vehicle	40,000	24,000
7	Listed property. Enter the amount from line 29	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	24,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	24,000
10	Carryover of disallowed deduction from line 13 of your 2001 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	112,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	24,000
13	Carryover of disallowed deduction to 2003. Add lines 9 and 10, less line 12 ▶ 13	0	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.**)**

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see page 3 of the instructions)	14	4,800
15	Property subject to section 168(f)(1) election (see page 4 of the instructions)	15	
16	Other depreciation (including ACRS) (see page 4 of the instructions)	16	

Part III MACRS Depreciation (Do not include listed property.**)** (See page 4 of the instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2002	17	
18	If you are electing under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2002 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property		11,200	5	H4	200% MACRS	2,240
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2002 Tax Year Using the Alternative Depreciation System

(a) Classification of property	(b)	(c)	(d)	(e)	(f)	(g)
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (see page 6 of the instructions)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instr.	22	31,040
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562** (2002)

No Overall Cap on Special 30% Depreciation

Unlike I.R.C. §179, where there is a phase-out rule if more than $200,000 in property is put into service for a particular tax year, the new special 30% depreciation provision is void of any such requirement.

> **Example 29.** Huge, Inc. purchases and places into service new 5-year equipment costing $3 million on October 1, 2001. The company could elect special 30% depreciation of $900,000 for the first year in addition to the normal MACRS depreciation amount allowed on the remaining $2.1 million of basis in these assets. If elected, all other 5-year assets purchased and placed into service after September 10, 2001 for that tax year would have to be reduced for the appropriate special 30% depreciation amounts.

Rules Automatically Apply Unless "Election Out" Is Made

As stated previously, the special 30% depreciation rules apply to otherwise qualifying property unless the taxpayer attaches a statement to Form 4562 electing out of the provisions for each class of property. For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to I.R.C. §46(d)(3), as in effect prior to the Tax Reform Act of 1986, shall apply.

Since the new provision applies to property placed into service after September 10, 2001, in tax years ending after that date, many taxpayers will now qualify for a tax break on business returns already filed. As a result, amended returns should be considered, especially where the special 30% depreciation is desired for a certain class of otherwise qualifying property.

Even though the new rules require the taxpayer to "elect out" of the special 30% depreciation, the IRS has said that returns filed prior to June 1, 2002 need not contain the election to "elect out." Taxpayers filing on or after June 1, 2002 will need to make the election with the filing of Form 4562 with regard to property placed in service after September 10, 2001 and before September 11, 2004. Otherwise, the "allowed or allowable" language of the depreciation rules will require that the adjusted bases of such property be reduced even though the taxpayer did not claim the tax benefit associated with the special 30% depreciation provisions.

> **Comment.** A supplement to IRS Pub. 946, *How to Depreciate Property*, has now been released and explains the special 30% depreciation rules. A supplement to IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses,* deals with the changes specific to autos.

Guidance on Special 30% Depreciation Issued (Rev. Proc. 2002-33)

> **Comment.** When President Bush signed the new tax law on March 9th, this provision in particular took practitioners by surprise, especially with regard to its retroactive effective date (i.e., for qualifying assets placed into service after September 10, 2001). Client returns ready to be filed had to be redone or put on extension. And, those returns already filed had to be reviewed to ascertain if they should be amended. This revenue procedure outlines the major issues involved with this decision and sets a June 1, 2002 deadline the implementation of these rules.

The new provision allows for an additional 30% deduction for certain depreciable property acquired after September 10, 2001 and before September 11, 2004 and placed into service before January 1, 2005. The tax break is allowed for both regular tax and AMT purposes. In a fashion similar to the immediate expensing election, the entire amount of the special 30% depreciation is taken into account regardless of what point in the tax year that the property is first placed into service (i.e., there is no pro-ration required). The 30% calculation is taken on the adjusted basis of the property, which is its cost or other basis multiplied by the percentage of business/investment use, reduced first by any I.R.C. §179 immediate expense deduction. And, the normal MACRS depreciation deduction is determined after reducing the adjusted basis of the qualifying property by both the immediate expensing and special 30% depreciation amounts, if any.

When calculating the normal MACRS depreciation deduction for any property for which the special 30% depreciation deduction is claimed, there will be no adjustment for AMT purposes. Also, a taxpayer must decide to claim the special 30% depreciation for all qualifying property otherwise contained in a particular MACRS class, or for none of the assets in that class, for a given tax year. In other words, the special 30% depreciation election cannot be made on an asset-by-asset basis as is the case with the I.R.C. §179 immediate expensing provision.

If the taxpayer filed a 2001 tax return before June 1, 2002 on which qualifying property was listed on Form 4562, there are two options if the special 30% depreciation provision is desired. The taxpayer may claim the special 30% depreciation amount by either:

1. Filing an amended federal tax return (or, a qualified amended return pursuant to Rev. Proc. 94-69) on or before the due date (including extensions) of that federal tax return for the next succeeding tax year. If this alternative is utilized, the amended return (or, the qualified amended return) should include the statement "Filed Pursuant to Rev. Proc. 2002-33" at the top of the return; or

2. Filing a Form 3115, "Application for Change in Accounting Method" with the taxpayer's federal tax return for the next succeeding tax year. The Form 3115 should include the statement: "Automatic Change Filed Under Rev. Proc. 2002-33."

Note. If a taxpayer decides not to elect special 30% depreciation allowance for a particular class of property, the election is revocable only with the prior written consent of the Commissioner.

States Not Conforming With the Federal 30% Depreciation Adjustment

Due to the loss of substantial federal funding, several states have elected not to allow the special 30% depreciation. Other states have modified the federal law in some manner. The following list indicates states that are nonconforming for corporate taxes and individual taxes. It is important to check the taxpayer's state law. Some of these states are disallowing the deduction on 2001 returns while others will begin the disallowance in 2002. Still others have made a modification to the law, such as Ohio that only allows 5/6 of the federal amount. As of September 6, 2002 the nonconforming states are:

Arizona	Hawaii	Massachusetts	South Carolina
Arkansas	Idaho	Mississippi	Tennessee
California	Illinois	Missouri	Vermont
Connecticut	Indiana	New Hampshire	Virginia
District of Columbia	Iowa	New Jersey	Wisconsin
	Kentucky	Pennsylvania	
Georgia	Maryland	Rhode Island	

The states with special situations include:

Maine	Montana	Ohio	Texas
Michigan	Nebraska	Oklahoma	
Minnesota	North Carolina	South Dakota	

Net Operating Loss

JCWA
Act §102
[I.R.C. §170]
Effective Date: For tax years ending in either 2001 or 2002.

- Original election to forgo carryback period can be revoked and new 5-Year Rule used.
- Election to forgo new 5-year carryback period can also be made.

Introduction

Losses incurred in a tax year ending in either 2001 or 2002 may be carried back five years, instead of the normal 2 or 3-year period. If the taxpayer is subject to AMT, any alternative tax NOL (ATNOL) deduction attributable to an NOL carried back or, carried forward to a tax year ending either during 2001 or 2002 is allowed to offset up to 100% of their AMTI (i.e., determined without regard to the NOL deduction). Taxpayers may elect out of this extended carryback period. However, once elected, the choice is irrevocable and may not be changed without the permission of the IRS.

Casualty and PDDA Losses

The new 5-year carryback period also applies to casualty and **Presidentially Declared Disaster Area** (PDDA) losses.

Switch to 5-Year NOL Carryback Available Until October 31 (Rev. Proc. 2002-40)

The IRS has provided qualifying taxpayers a limited opportunity to take advantage of the new 5-year NOL carryback provision, if they already filed returns for tax years ending during 2001 or 2002. To apply for a tentative carryback adjustment, taxpayers must act **before November 1, 2002.** The revenue procedure allows taxpayers with a net operating loss in a tax year ending during 2001 or 2002 and who elected under I.R.C. §172(b)(3) to forgo the NOL carryback period, to revoke their elections and to apply the 5-year carryback period. The procedure also allows these taxpayers, and taxpayers who used a 2-year carryback period, to file an application for a tentative carryback adjustment under I.R.C. §6411(a) based on a 5-year NOL carryback period. This is the case even if the 12-month period for filing the application has expired. A revocation and/or application for tentative carryback adjustment under Rev. Proc. 2002-40 must be made before November 1, 2002. Finally, taxpayers who filed returns for a tax year ending in 2001 or 2002, and who did not elect to forgo the carryback period, and did not use the 2-year carryback period, may elect to relinquish the 5-year carryback period. This will allow them to retain the ability to use the 2-year carryback period, if they act before November 1, 2002.

A corporation that wants to use either the 5- or 2-year carryback period must file a Form 1139 or Form 1120X. Individuals must file a Form 1045 or Form 1040X. Estates or trusts must file a Form 1045, or amended Form 1041. Taxpayers should type or print across the top of the appropriate form "Revocation of NOL carryback waiver under Rev. Proc. 2002-40" or "Amended refund claims under Rev. Proc. 2002-40."

Note. The new rule that allows an NOL to offset up to 100% of AMTI is not advantageous for married taxpayers with AMT income under $490,000 and for corporations below $400,000 since it wastes some of their AMT exemption.

Discharge of S Corporation Indebtedness

JCWA
Act §402
[I.R.C. §1366]
Effective Date: For Cancellation of Indebtedness situations arising after October 11, 2001.

Cancellation of indebtedness in an S corporation does not increase the basis of the shareholder's stock.

Background

In 2001, the Supreme Court relied on the "plain language" of the Revenue Code to decide excluded cancellation of indebtedness income **could still serve to increase an S corporation shareholder's stock basis.** This could then be used for taking suspended K-1 losses [*Gitlitz v. Commr.,* No. 99-1295 (Supreme Ct. Jan. 9, 2001)].

Congress Reverses Supreme Court

Under the new law, Congress reversed this decision for all such situations arising after October 11, 2001.

Comment. The court's decision put S corporation shareholders at a decided advantage when compared to owners of partnership or LLC interests. When they experienced difficult financial circumstances they enjoyed not only the protection of the "insolvency exception" against recognizing cancellation of indebtedness income, but could also use this same amount to take previously denied flowthrough losses, due to the lack of sufficient stock basis.

Electronic Filing of Form 1099s

JCWA
Act §401
[I.R.C. §6050]
Effective Date: For any tax year ending after March 9, 2002.

Payers will be able to transmit 2002 Forms 1099 electronically, provided the recipient consents.

Background

Currently, some information returns must be presented to taxpayers either in person or in a statement sent by first-class mail in a specified format.

Information to Be Sent to Recipient's Web Address

Under the new law, this information may be sent to the taxpayer's web address as long as it is acceptable to the taxpayer. This provision could save 1099 filers considerable postage expense.

Extension of Expiring Tax Credits

JCWA
Act §§601-613
Effective Date: For tax years ending on or before December 31, 2003.

For the credits listed below, which were scheduled to expire December 31, 2001, the new law extends them until December 31, 2003.

2-Year Extension

The 2-year extension applies to:

- Work Opportunity Tax Credit (I.R.C. §51(a)),
- Welfare-to-Work Credit (I.R.C. §51A(d)(2)),
- Credit for Producing Electricity from Wind, Biomass and Poultry Litter (I.R.C. §45 regarding the tax credit for electricity production from alternative energy sources),
- Taxable Income Limit on Percentage Depletion from Marginal Wells (I.R.C. §613 with regard to the suspension of the 100-percent-of-net-income limitation on percentage depletion for oil and gas from marginal wells),
- Clean-fuel Vehicle Deduction,

Note. See Chapter 13: Practitioner Q and A for more details on this topic.

- Qualified Zone Academy Bonds (I.R.C. §1397E regarding the authority to continuing issuing them),
- Cover Over Payments of tax on distilled spirits (I.R.C. §7652(f)(1)),
- Tax on Failure to Comply with Mental Health Parity Requirements (I.R.C. §9812),
- Suspension of Reduction of Deductions for Mutual Life Insurance Companies (I.R.C. §809(j)),

- Tax Incentives for Investment in Native American Reservations and Other Energy Incentives (I.R.C. §168(j)), and
- Credit for qualified electric vehicles.

The Research & Development credit, which expires on June 30, 2004, was not addressed in the new law. The use of the adoption and child credits against AMT was made permanent.

New AGI Deduction for Teachers

JCWA
Act §406(a)
[I.R.C. §62]
Effective Date: For tax years 2002 and 2003.

> Teachers receive an above-line deduction of $250 for teaching supplies.

Elementary and secondary school teachers will receive an AGI deduction for qualifying education expenses (i.e., classroom supplies, book and equipment) equal to $250 for 2003 & 2003 (I.R.C. §62(a)(2)(D)). The deduction is available to "eligible educators", who are described as teachers of kindergarten through grade 12, instructors, counselors, principals, and aides in a school who work at least 900 hours during a school year (I.R.C. §62(d)).

Example 30. Charles, a 6th grade teacher, spends $30 for poster board for a classroom display. He also spends $75 for a classroom reference book and $250 for science equipment. His total expenditures for 2002 are $355. Because of the limitation, he can only deduct $250 on line 23 of 2002 Form 1040. The remaining $105 is an itemized deduction subject to the 2% AGI limitation.

Adjusted Gross Income	23	Educator expenses (see page xx)	23			
	24	IRA deduction (see page 27)	24			
	25	Student loan interest deduction (see page 28)	25			
	26	Tuition and fees deduction (see page XX)	26			
	27	Archer MSA deduction. Attach Form 8853	27			
	28	Moving expenses. Attach Form 3903	28			
	29	One-half of self-employment tax. Attach Schedule SE	29			
	30	Self-employed health insurance deduction (see page 30)	30			
	31	Self-employed SEP, SIMPLE, and qualified plans	31			
	32	Penalty on early withdrawal of savings	32			
	33a	Alimony paid **b** Recipient's SSN ▶	33a			
	34	Add lines 23 through 33a			34	
	35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶			35	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2002)

MSAs Extended for 2 More Years

JCWA
Act §612(a)
[I.R.C. §220(d)(1)]
Effective Date: Archer Medical Savings Accounts are extended until December 31, 2003.

> Archer Medical Savings Accounts are extended another year.

Definition of "Foster Care Payments" Expanded

JCWA
Act §404(a)
[I.R.C. §131]
Effective Date: For years beginning after December 31, 2001.

> The definition of "qualified foster care payments" has been expanded.

The definition of "foster care payments," which are excluded from gross income, has been expanded. Under the new definition, even if the payor is not a tax-exempt organization or the person being cared for is over age 18, the payment still qualifies for an exclusion from income.

Catch-up Contributions to Retirement Plans

JCWA
Act §411(o)(1)
[I.R.C. §414(v)(2)]
Effective Date: For years beginning after December 31, 2001.

Taxpayers who are at least age 50 by the end of the tax year may make additional payments to their retirement plans.

Taxpayers, who are at least age 50 by the end of the tax year, may make additional payments to their retirement plans.

Bad Debt Exclusion for Accrual Basis Taxpayers Limited

JCWA
Act § 403
[I.R.C. §448(d)(5)]
Effective Date: For years ending after March 9, 2002.

A limitation is placed on taxpayers that may use the non-accrual experience method of accounting.

The non-accrual experience method of accounting is available only for amounts to be received for the performance of qualified services and for services provided by certain small businesses.

For tax years ending after March 9, 2002, only accrual basis taxpayers with gross receipts under $5 million or Personal Service Corporations, will be able to exclude income that "experience indicates will not be collected."

Deemed 18% Election, Exclusion of Gain of Personal Residence and Suspended Passive Losses

JCWA
Act §414(a)
[I.R.C. §469(g)(1)(A)]
Effective Date: For years beginning after May 6, 1997.

Deemed sale election will not qualify sale for exclusion of gain of a personal residence or allow deduction of suspended passive losses.

A taxpayer may not exclude the gain on a personal residence if the gain was created by the deemed sale rules that were used to qualify the sale for the 18% capital gain rate. This discourages the taxpayer from attempting to increase the basis in their personal residence.

The Act clarified that gains attributable to the deemed sale of an asset with passive activity losses would not result in a deduction of the passive activity losses.

Note. For a more complete discussion of the deemed sale election, see page 197 and 199 of the *2001 Farm Income Tax Workbook*, or refer to Rev. Rul. 2001-57 The election must be made by October 15, 2002 for 2001 Form 1040 (original or extended).

THE FARM SECURITY AND RURAL INVESTMENT ACT (FSRIA) OF 2002

Inclusion of Price-Income Support Payments into Income

FSRIA
Act. §1601(d)
Effective Date: On an elective basis, the spring of 1999 federal farm program payments.

Addresses the problem of constructive receipt for payments under the 2002 Act.

Year of Inclusion

Under prior law, if payments were made available in a year prior to the time of regular payment with an option in the recipient to accept payment or to defer payment to the following year, the amount made available was includible in income in the earlier of the year of actual payment or the year made available to the taxpayer. Rev. Rul. 68-44, 1968-1 C.B. 191.

Legislation has been enacted making payments under the Federal Agriculture Improvement and Reform Act of 1996 not subject to constructive receipt. That legislation followed the enactment of legislation advancing, on an elective basis, the spring, 1999 federal farm program payment, to the fall of 1998.

The protection from constructive receipt was broadened in 1999, again for payments under the FAIR Act of 1996. The Farm Security and Rural Investment Act of 2002 incorporated the previous expansion of constructive receipt doctrine.

Excerpted from FSRIA: "The protection that was afforded producers that had an option to accelerate the receipt of any payment under a production flexibility contract payable under the Federal Agriculture Improvement and Reform Act of 1996...shall also apply to the option to receive the:

- advance payment of direct payments and countercyclical payments under subtitle A and C; and
- single payment of compensation for eligible peanut quota holders under I.R.C. §1310."

MOST RECENT 2002 TAX LEGISLATION

TRADE ACT OF 2002

[I.R.C. §35]

Health Care Tax Credit for Displaced Workers

Background Information. The **Trade Act of 2002** was signed into law on August 6, 2002. It includes a **new health care insurance credit which can be claimed on 2002 returns.** The new revenue code section for this legislation is I.R.C. §35. The purpose of the legislation is to provide a tax benefit to assist workers specified in certain provisions of the Trade Adjustment Assistance (TAA) program. This program was created by Congress to aid workers whose jobs are negatively impacted by imports.

Detailed information is shown below. However, the new 2002 Form 8885, which will be filed with 2002 Forms 1040 or 1040NR to claim the credit, was not available at the time this workbook went to press. The IRS is scheduled to have this **form published** in draft form by **December 2002**.

Taxpayers who are eligible for this new credit on 2002 Forms 1040. The credit is available to two classes of workers:

1. Workers who lose their jobs due to trade-related developments specified in the TAA program. These workers are eligible to receive trade readjustment allowances.

2. Workers over age 55 as of the first day of any month for which they receive a pension, and portion of which is paid by the Pension Benefit Guaranty Corporation (PBGC).

However, the credit cannot be claimed by an individual who may be claimed as a **dependent** on another person's tax return.

Amount of the credit. The credit equals 65% of the qualified health insurance premium paid by eligible workers. This new credit will be claimed on the **2002 Form 8885**.

Types of health insurance premiums that qualify for the 65% Credit. Generally, premiums paid on the following types of health insurance plans will be eligible:

- COBRA continuation plans
- Specific state plans
- Employer group plans in which the taxpayer's spouse is eligible to participate

Effective date. Due to the specific restriction of the new legislation, the **first eligible month for computing the credit is December 2002**. An eligible taxpayer will be entitled to claim a 2002 credit on Form 8885 equal to 65% of eligible premiums paid for the month of December.

Other features of the new credit. The credit is a refundable credit and is not phased out for high AGI taxpayers.

Note. Taxpayers who qualify for this new credit should receive certification of eligibility on Form 8887, Health Insurance Eligibility Certification. They should receive this certification prior to February 1, 2003. Clients who are potentially eligible for this credit should be alerted about this new certificate. If a client receives a Form 8887, the tax practitioner will want to explore the possibility of preparing a 2002 Form 8885 for the client.

CLERGY HOUSING ALLOWANCE CLARIFICATION ACT OF 2002

[I.R.C. §107]

Background

There has been confusion regarding the taxation of the housing allowance for clergy. While housing provided for services is generally taxed as compensation, there is an exception for parsonages. The exception allows the rental value of the housing unit provided or a rental allowance paid for rent or to provide a home for the clergy be excluded from gross income. The issue was what if the allowance exceeded the fair rental value? In the Warren case, 114 TC 343, the court ruled that, "the exclusion from gross income for a designated parsonage allowance is not limited to the lesser of the fair market value of the home or the amount used to provide a home."

New Law

The Clergy Housing Allowance Clarification Act of 2002, P.L. 107-181 has clarified the existing law. It has inserted the language, "and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."

For tax years prior to 2002, a minister can exclude a housing allowance even though it exceeds the fair rental value of the housing. However, for tax years beginning after December 31, 2001 and for years for which the taxpayer filed a return after April 16, 2002, the new law applies.

Note. Details of the *Warren* case are included in the *2000 Farm Income Tax Workbook* on pages 628-629. A thorough discussion of Taxation of Clergy occurs in Problem 2 of Chapter 2: Individual Taxpayer Issues.

REVENUE PROCEDURE 2001-59

Each year the IRS publishes a Revenue Procedure that identifies various revised rates, deductions and credits based on the annual inflation rate. The following list is not all inclusive, but contains the changed items that are most widely used.

Exemption Amounts

Revenue Procedure 2001-59
[I.R.C. §151]
Effective Date: For tax years beginning after December 31, 2001.

Exemption amounts are adjusted based on inflation rate.

Personal exemptions will be $3,000 with the phase-out of 2% for each $2,500 of AGI above $206,000 for joint returns, $137,300 for singles, and $171,650 for heads of household. As a result, exemptions are eliminated completely above $328,500, $259,800 and $294,150, respectively.

Standard Deduction Amounts

Revenue Procedure 2001-59
[I.R.C. §63]
Effective Date: For tax years beginning after December 31, 2001.

Standard deduction amount is adjusted for inflation.

Standard deductions have increased due to inflation adjustments. In the following table 2002 Standard Deductions are listed for each filing class. For dependents claimed on Form 1040, the standard deduction remains $750 for investment income. For a dependent with earned income, the standard deduction is the larger of $750 or earned income plus $250...with a maximum limitation of $4,700 for 2002. The phase-out for itemized deductions starts at a higher income level in 2002, decreased by 3% of AGI over $137,300, regardless of filing status.

Filing Status	2002 Standard Deduction
Married Filing Joint	$7,850
Married Filing Joint, one is 65	8,750
Married Filing Joint, both are 65	9,650
Single	4,700
Single, age 65	5,800
Head of Household	6,900
Head of Household, age 65	8,050

Special Use Valuation

Revenue Procedure 2001-59
Act §581
[I.R.C. §2032A]
Effective Date: For estates of decedents dying in 2002.

The special use valuation of real estate is higher with up to $820,000 of farm or business realty permitted to receive a discount valuation.

Income Tax Rates for Estates and Trusts

Revenue Procedure 2001-59
Act §511
[I.R.C. §2001(c)]
Effective Date: Estates of descendents dying and gifts made after December 31, 2001.

The tax rates have been adjusted for inflation.

Rate Reductions

The income tax brackets for trusts and estates filing Form 1041 has been changed.

Estates And Trusts

If Taxable Income Is	Then the Tax Is:
Not Over $1,850	15% of the taxable income
Over $1,850 but not over $4,400	$277.50 plus 27% of the excess over $1,850
Over $4,400 but not over $6,750	$966.00 plus 30% of the excess over $4,400
Over $6,750 but not over $9,200	$1,671.00 plus 35% of the excess over $6,750
Over $9,200	$2,528.50 plus 38.6% of the excess over $9,200

Note. Congress chose not to create a new 10% rate for Form 1041 fiduciary tax returns. As always, especially with these extremely high rates, it is critical to either make the necessary annual distributions to keep the taxable income down to a minimal amount, or invest in growth stocks or other tax-free investments, such as municipal bonds.

Employer-provided Parking and Transit Passes

Revenue Procedure 2001-59
[I.R.C. §132(a)(5)(f)]
Effective Date: For tax years beginning in 2002.

The amount for tax-free parking and transit passes increases in 2002.

Employers can provide more tax-free parking for 2002, up to $185 per month. Tax-free transit passes can be provided up to $100 per month.

Deduction for Health Insurance Premiums

Revenue Procedure 2001-59
[I.R.C. §162]
Effective Date: For tax years beginning in 2002.

The self-employed health insurance deduction is increased to 70%.

In 2002, self-employed taxpayers can deduct 70% of their medical premiums, an increase from 60% in 2001. The deduction remains available for owners of more than 2% of S corporations shares (i.e., per Rev. Rul. 91-26, premiums paid by the company are listed as "wages" not subject to employment taxes on Form W-2). The deduction will increase to 100% for years beginning in 2003.

Long-term Care Premiums

Revenue Procedure 2001-59
[I.R.C. §213(d)]
Effective Date: For tax years beginning after December 31, 2001.

Long-term health care deduction is inflation adjusted.

Long-term-care premiums are deductible as medical expenses in 2002, up to $2,990 for those age 70 and older, $2,390 for ages 60 to 70, $900 for ages 50 to 60, $450 for ages 40 to 50, $240 for ages 40 or younger. The limitation for payments under these policies increases to $210 per day.

Age of Taxpayer	Maximum Deduction
Age 70 and older	$2,990
Between 60 and 70	2,390
Between 50 and 60	900
Between 40 and 50	450
Under age 40	240

Medical Savings Accounts (MSAs)

Revenue Procedure 2001-59
[I.R.C. §220(c)(2)(A)]
Effective Date: For years beginning after December 31, 2001.

MSA deduction limit is increased due to inflation adjustment.

Higher deductibles apply for MSAs where "self only" policy deductibles must range from $1,650 to $2,500, with a $3,300 ceiling for out-of-pocket costs. Family policy deductibles must range from $3,300 to $4,950, with a $6,050 maximum on medical bills not covered by the policy.

Estimated Taxes

Revenue Procedure 2001-59
[I.R.C. §6654]
Effective Date: For tax year 2002.

The prepayments of estimated tax required to not subject a taxpayer to penalty is increased to 112% of the 2001 tax.

Rules on estimated taxes have changed for 2002. Taxpayers who had AGIs over $150,000 in the last tax year must prepay at least 112% of 2001 tax liability, or 90% of this year's tax to avoid Form 2210 underpayment penalties. Individuals with incomes of $150,000 or less in the last tax year must prepay either 100% of their 2001 tax or 90% of the current year's tax. The percentage drops to 110% for years after 2002.

Luxury Car Tax

Revenue Procedure 2001-59
[I.R.C. §§4001 and 4003]
Effective Date: For years beginning after December 31, 2001.

The luxury car tax is imposed on new luxury cars costing more than $40,000.

The luxury car tax is 3% for vehicles costing over $40,000.

Foreign Earned Income Exclusion

Revenue Procedure 2001-59
[I.R.C. §911]
Effective Date: For calendar year 2002 and thereafter.

Foreign earned income exclusion increased to $80,000.

The foreign earned income exclusion for U.S. employees working abroad is increased to $80,000.

Loans to Continuing Care Facilities

Revenue Procedure 2001-59
[I.R.C. §7702B(d)(4)]
Effective Date: For calendar year 2002.

Below market rate loans for qualified long-term-care facilities increased to $148,000.

Larger tax-free loans can be made to continuing care facilities in 2002, with lenders not being taxed on interest forgone on loans up to $148,800.

Note. Retirement and Education Provisions are covered in more detail in their respective chapters within this workbook. They are mentioned here, only briefly.

Savings Bonds Used for Educational Costs

Revenue Procedure 2001-59
[I.R.C. §135]
Effective Date: For years beginning after December 31, 2001.

Tax-free income from EE bonds used for higher education are adjusted for inflation.

Income limits are higher for tax-free EE bonds used for education purposes. Phase-out of the exclusion for interest on joint returns begins at modified AGI of $86,400. For single filers, the phase-out begins at $57,600. The exclusion is gone when income reaches $116,400 and $72,600, respectively. Married filing separately cannot use this exclusion. Remember, the limits apply when the bonds are cashed, not when they are purchased. (Covered in more detail in Chapter 8: Education Provisions.)

Phase-out Limits for Educational Credits

Revenue Procedure 2001-59
[I.R.C. §25A(a)]
Effective Date: For years beginning after December 31, 2001.

Phase-out limits for Hope and Lifetime Learning credits are inflation adjusted.

The income caps for the HOPE and Lifetime Learning credits have increased. The phase-out for joint filers starts at $82,000 and for single filers it starts at $41,000. (Covered in more detail in Chapter 8: Education Provisions.)

Standard Mileage Rate

Revenue Procedure 2001-59
[I.R.C. §§61, 62, 162, 170, 213, 217, 274 and 1016]
Effective Date: For tax years beginning after December 31, 2001.

The standard mileage rate is increased to 36.5¢ per mile.

Standard allowance for business driving for 2002 is 36.5¢ a mile. The rate for medical travel and moving expenses is 13¢ per mile. There is no change for charitable driving, which remains 14¢ per mile. As in the past, the cost of parking and tolls is added to these amounts.