

# Chapter 2: Individual Taxpayer Problems

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

## PROBLEM 1: RATE REDUCTION CREDIT ON 2001 RETURNS

Even though the 2002 filing season for 2001 timely filed Form 1040s is over, the rate reduction credit could remain an issue for practitioners. The areas of concern are:

- filing amended 2001 returns for dependents if the Tax Computation Worksheet for Certain Dependents was ignored and if the IRS did not correct the tax computation error;
- claiming the credit on delinquent 2001 Forms 1040.

**Note.** The IRS Service Center computer software is programmed to detect and correct tax computation errors on 2001 tax returns of dependents. However, there is no guarantee that all such errors will be corrected via the IRS Service Center notices.

### Background Information

The IRS issued News Release IR-2002-06 in February 2002. In it, the IRS announced that it had found over one million errors when processing 2001 individual returns. The main reasons for the errors were:

- taxpayers mistakenly claimed the credit on line 47 of their 2001 Form 1040 even though they had previously received the maximum \$300 (single), \$500 (head of household), or \$600 (joint) advance payment;
- persons claimed as a **dependent** on another taxpayer's 2001 tax return claimed the credit in error on line 47 of their 2001 Form 1040;
- persons claimed as a **dependent** on another taxpayer's 2001 tax return failed to consider the **Tax Computation Worksheet for Certain Dependents** in computing tax on their 2001 tax returns.

# 2002 Workbook

The last reason for errors relating to dependents is illustrated by the following two examples:


**Example 1.** Laurie is a 16-year old high school student who was claimed as a dependent on her parents' 2001 Form 1040. Laurie's 2001 Form 1040 information is shown below.

Wages (line 7)	\$4,660
Ordinary dividends (line 9)	1,343
Adjusted gross income (lines 33 & 34)	\$6,003
Less: Standard Deduction (line 36)	(4,550)
Less: Exemption (line 38)	(0)
<b>Taxable Income (line 39)</b>	<b>\$1,453</b>

The tax listed in the Tax Table is \$219. However, since Laurie is claimed as a dependent on her parents' 2001 Form 1040, she is entitled to use the 10% tax bracket to compute her 2001 tax. She should have used the worksheet on page 33 of the 2001 Form 1040 instructions to compute her tax. The completed worksheet is shown below.

## Tax Computation Worksheet for Certain Dependents—Line 40

*Keep for Your Records*

<b>Before you begin:</b>		<input checked="" type="checkbox"/> Be sure you can use this worksheet (see <b>Tax Computation Worksheet for Certain Dependents</b> above). <input checked="" type="checkbox"/> <b>Do not</b> use this worksheet if you, or your spouse if filing jointly, received (before offset) an advance payment of your 2001 taxes. <input checked="" type="checkbox"/> Be sure you read the <b>Special Rules</b> below.	
1. Figure the tax on the amount on Form 1040, line 39 (or the applicable line of the worksheet, schedule, or form listed below). Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .		1. _____	<b>219</b>
2. Is the amount on line 1 more than the amount shown below for your filing status?			
<ul style="list-style-type: none"> <li>• Single or married filing separately—\$900</li> <li>• Married filing jointly or qualifying widow(er)—\$1,800</li> <li>• Head of household—\$1,500</li> </ul>			
<input type="checkbox"/> <b>Yes.</b> Enter: \$300 if single or married filing separately; \$500 if head of household; \$600 if married filing jointly or qualifying widow(er).		} . . . . .	2. _____
<input checked="" type="checkbox"/> <b>No.</b> Divide the amount on line 1 by 3.0.			
3. Subtract line 2 from line 1. Enter the result here and on Form 1040, line 40 (or the applicable line of the worksheet, schedule, or form listed below) . . . . .		3. _____	<b>146</b>
<b>Special Rules.</b> If you use: <ul style="list-style-type: none"> <li>• The <b>Capital Gain Tax Worksheet</b> on page 34, use the worksheet above to figure the tax on lines 4 and 14 of the Capital Gain Tax Worksheet.</li> <li>• <b>Schedule D, Part IV</b>, use the worksheet above to figure the tax on lines 25 and 39 of Part IV. If you use the <b>Schedule D Tax Worksheet</b> on page D-9, use the worksheet above to figure the tax on lines 15 and 36 of the Schedule D Tax Worksheet.</li> <li>• <b>Schedule J</b>, use the worksheet above to figure the tax on line 4 of Schedule J.</li> <li>• <b>Form 8615</b>, use the worksheet above to figure the tax on lines 15 and 17 of Form 8615 (and line 9 if the parent used this worksheet).</li> <li>• <b>Other forms or worksheets</b> that require you to figure the tax using the 2001 Tax Table or Tax Rate Schedules, use the worksheet above to figure the tax on any line that would otherwise be figured using the 2001 Tax Table or Tax Rate Schedules.</li> </ul>			

**Conclusion.** Laurie's tax on line 40 on her 2001 Form 1040 is \$146, or 10% of her \$1,453 taxable income. Even though she was not entitled to claim the rate reduction credit on line 47 of her 2001 Form 1040, she is entitled to a similar tax benefit by using the Worksheet shown above.

**Example 2.** Even though the preparer used reliable software to prepare the 2001 Form 1040 of a dependent child, an input error resulted in a correction notice from IRS. The following forms, schedules, and documents are shown for **Example 2**:

- 2001 Form 1040 of the dependent child (age 16) as filed with IRS (**with the tax calculation error**)
- A correction notice (CP12) from the Service Center
- Two completed **Tax Computation Worksheets for Certain Dependents** (page 33 of the 2001 Form 1040 Instructions)
- A recalculated page 2 of Schedule D showing the corrections determined by the two completed worksheets
- A recalculated page 2 of Form 1040 showing the corrected total tax of \$1,085 (lines 52 & 58)

**Notes for Example 2.**

1. Example 2 has the same facts as Example 1 except Laurie, the dependent child, has \$9,561 of capital gains on Schedule D.
2. Two worksheets are necessary, one for line 25, Schedule D and another for line 39, Schedule D.

**Conclusion.** Failure to use the worksheets resulted in a \$73 tax overpayment on Laurie's 2001 return.

# 2002 Workbook

## For Example 2

Form	1040	Department of the Treasury—Internal Revenue Service <b>U.S. Individual Income Tax Return</b>	2001	(99) IRS Use Only—Do not write or staple in this space.																												
<b>Label</b> (See instructions on page 19.)  <b>Use the IRS label.</b> Otherwise, please print or type.  <b>Presidential Election Campaign</b> (See page 19.)		For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20																														
		OMB No. 1545-0074																														
		Your first name and initial <b>Laurie B.</b>																														
		Last name <b>McNeile</b>																														
<b>Label HERE</b>		Your social security number <b>222 22 2222</b>																														
		If a joint return, spouse's first name and initial Last name																														
		Spouse's social security number																														
		Home address (number and street). If you have a P.O. box, see page 19. <b>420 Oak St.</b>																														
<b>Important!</b> You must enter your SSN(s) above.		Apt. no.																														
		City, town or post office, state, and ZIP code. If you have a foreign address, see page 19. <b>Cave In Rock, IL 62919</b>																														
		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? . . . . . <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No																														
		You Spouse <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No																														
<b>Filing Status</b>  Check only one box.		1 <input checked="" type="checkbox"/> Single																														
		2 <input type="checkbox"/> Married filing joint return (even if only one had income)																														
		3 <input type="checkbox"/> Married filing separate return. Enter spouse's social security no. above and full name here. ▶																														
		4 <input type="checkbox"/> Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶																														
		5 <input type="checkbox"/> Qualifying widow(er) with dependent child (year spouse died ▶ ). (See page 19.)																														
<b>Exemptions</b>  If more than six dependents, see page 20.		6a <input type="checkbox"/> Yourself. If your parent (or someone else) can claim you as a dependent on his or her tax return, <b>do not</b> check box 6a . . . . .																														
		b <input type="checkbox"/> Spouse . . . . .																														
		c Dependents:																														
		<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 40%;">(1) First name Last name</th> <th style="width: 20%;">(2) Dependent's social security number</th> <th style="width: 20%;">(3) Dependent's relationship to you</th> <th style="width: 20%;">(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 20)</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> </tbody> </table>			(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 20)				<input type="checkbox"/>				<input type="checkbox"/>				<input type="checkbox"/>				<input type="checkbox"/>				<input type="checkbox"/>				<input type="checkbox"/>
		(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if qualifying child for child tax credit (see page 20)																											
			<input type="checkbox"/>																													
			<input type="checkbox"/>																													
			<input type="checkbox"/>																													
			<input type="checkbox"/>																													
			<input type="checkbox"/>																													
			<input type="checkbox"/>																													
d Total number of exemptions claimed . . . . .																																
<b>Income</b>  Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.  If you did not get a W-2, see page 21.  Enclose, but do not attach, any payment. Also, please use Form 1040-V.		7 Wages, salaries, tips, etc. Attach Form(s) W-2 . . . . .																														
		8a Taxable interest. Attach Schedule B if required . . . . .																														
		b Tax-exempt interest. Do not include on line 8a . . . . .																														
		9 Ordinary dividends. Attach Schedule B if required . . . . .																														
		10 Taxable refunds, credits, or offsets of state and local income taxes (see page 22) . . . . .																														
		11 Alimony received . . . . .																														
		12 Business income or (loss). Attach Schedule C or C-EZ . . . . .																														
		13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>																														
		14 Other gains or (losses). Attach Form 4797 . . . . .																														
		15a Total IRA distributions . 15a																														
		b Taxable amount (see page 23)																														
		16a Total pensions and annuities . 16a																														
		b Taxable amount (see page 23)																														
		17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E																														
		18 Farm income or (loss). Attach Schedule F . . . . .																														
19 Unemployment compensation . . . . .																																
20a Social security benefits . 20a																																
b Taxable amount (see page 25)																																
21 Other income. List type and amount (see page 27) . . . . .																																
22 Add the amounts in the far right column for lines 7 through 21. This is your <b>total income</b> ▶																																
<b>Adjusted Gross Income</b>		23 IRA deduction (see page 27) . . . . .																														
		24 Student loan interest deduction (see page 28) . . . . .																														
		25 Archer MSA deduction. Attach Form 8853 . . . . .																														
		26 Moving expenses. Attach Form 3903 . . . . .																														
		27 One-half of self-employment tax. Attach Schedule SE . . . . .																														
		28 Self-employed health insurance deduction (see page 30) . . . . .																														
		29 Self-employed SEP, SIMPLE, and qualified plans . . . . .																														
		30 Penalty on early withdrawal of savings . . . . .																														
		31a Alimony paid b Recipient's SSN ▶																														
		32 Add lines 23 through 31a . . . . .																														
33 Subtract line 32 from line 22. This is your <b>adjusted gross income</b> ▶																																

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form 1040 (2001)

## For Example 2

Form 1040 (2001)

Page 2

## Tax and Credits

## Standard Deduction for—

• People who checked any box on line 35a or 35b or who can be claimed as a dependent, see page 31.

• All others:

Single,  
\$4,550

Head of household,  
\$6,650

Married filing jointly or  
Qualifying widow(er),  
\$7,600

Married filing separately,  
\$3,800

34	Amount from line 33 (adjusted gross income)	34	15,564
35a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here	35a	
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here	35b	<input type="checkbox"/>
36	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	36	4,550
37	Subtract line 36 from line 34	37	11,014
38	If line 34 is \$99,725 or less, multiply \$2,900 by the total number of exemptions claimed on line 6d. If line 34 is over \$99,725, see the worksheet on page 32	38	0
39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	11,014
40	Tax (see page 33). Check if any tax is from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	40	1,168
41	Alternative minimum tax (see page 34). Attach Form 6251	41	
42	Add lines 40 and 41	42	1,168
43	Foreign tax credit. Attach Form 1116 if required	43	10
44	Credit for child and dependent care expenses. Attach Form 2441	44	
45	Credit for the elderly or the disabled. Attach Schedule R	45	
46	Education credits. Attach Form 8863	46	
47	Rate reduction credit. See the worksheet on page 36	47	
48	Child tax credit (see page 37)	48	
49	Adoption credit. Attach Form 8839	49	
50	Other credits from: a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	50	
51	Add lines 43 through 50. These are your total credits	51	10
52	Subtract line 51 from line 42. If line 51 is more than line 42, enter -0-	52	1,158

## Other Taxes

53	Self-employment tax. Attach Schedule SE	53	
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54	
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55	
56	Advance earned income credit payments from Form(s) W-2	56	
57	Household employment taxes. Attach Schedule H	57	
58	Add lines 52 through 57. This is your total tax	58	1,158

## Payments

If you have a qualifying child, attach Schedule EIC.

59	Federal income tax withheld from Forms W-2 and 1099	59	322
60	2001 estimated tax payments and amount applied from 2000 return	60	2,000
61a	Earned income credit (EIC)	61a	
b	Nontaxable earned income	61b	
62	Excess social security and RRTA tax withheld (see page 51)	62	
63	Additional child tax credit. Attach Form 8812	63	
64	Amount paid with request for extension to file (see page 51)	64	
65	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136	65	
66	Add lines 59, 60, 61a, and 62 through 65. These are your total payments	66	2,322

## Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

67	If line 66 is more than line 58, subtract line 58 from line 66. This is the amount you overpaid	67	1,164
68a	Amount of line 67 you want refunded to you	68a	324
b	Routing number	c	Type: <input checked="" type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
69	Amount of line 67 you want applied to your 2002 estimated tax	69	840

## Amount You Owe

70	Amount you owe. Subtract line 66 from line 58. For details on how to pay, see page 52	70	
71	Estimated tax penalty. Also include on line 70	71	

## Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? ☒ Yes. Complete the following. ☐ No

Designee's name **Preparer** Phone no. ( ) Personal identification number (PIN) ( )

## Sign Here

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

Joint return? See page 19.	Your signature	Date	Your occupation	Daytime phone number
Keep a copy for your records.	Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	( )

## Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code	3/19/02		
	EIN		
	Phone no. ( )		

Form 1040 (2001)

## For Example 2

### SCHEDULE D (Form 1040)

Department of the Treasury  
Internal Revenue Service (99)

### Capital Gains and Losses

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

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **12**

Name(s) shown on Form 1040

**Laurie B. McNeile**

Your social security number

**222 22 2222**

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

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

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8 <b>See statement 2</b>			<b>30,000</b>	<b>21,507</b>	<b>8,493</b>	
9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .	9					
10 <b>Total long-term sales price amounts.</b> Add lines 8 and 9 in column (d) . . . . .	10		<b>30,000</b>			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .	11					
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .	12					
13 Capital gain distributions. See page D-1 of the instructions <b>See Statement 3</b>	13				<b>1,068</b>	
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 Capital Loss Carryover Worksheet . . . . .	14				( )	( )
15 Combine lines 8 through 14 in column (g) . . . . .	15					
16 <b>Net long-term capital gain or (loss).</b> Combine lines 8 through 14 in column (f) <b>Next:</b> Go to Part III on the back.	16				<b>9,561</b>	

\* **28% rate gain or loss** includes all "collectibles gains and losses" (as defined on page D-6 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page D-4 of the instructions).

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2001

## For Example 2

Schedule D (Form 1040) 2001

Page 2

**Part III Taxable Gain or Deductible Loss**

- 17 Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39 . . . . .

17	9,561
----	-------

**Next:** • If both lines 16 and 17 are gains and Form 1040, line 39, is more than zero, complete Part IV below.  
• Otherwise, skip the rest of Schedule D and complete Form 1040.

- 18 If line 17 is a loss, enter here and on Form 1040, line 13, the **smaller** of (a) that loss or (b) (\$3,000) (or, if married filing separately, (\$1,500)). Then complete Form 1040 through line 37 . . . . .

18	( )
----	-----

**Next:** • If the loss on line 17 is more than the loss on line 18 or if Form 1040, line 37, is less than zero, skip **Part IV** below and complete the **Capital Loss Carryover Worksheet** on page D-6 of the instructions before completing the rest of Form 1040.  
• Otherwise, skip **Part IV** below and complete the rest of Form 1040.

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

- 19 Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions . . . . .

19	
----	--

If line 15 or line 19 is more than zero, complete the worksheet on page D-9 of the instructions to figure the amount to enter on lines 22, 29, and 40 below, and skip all other lines below. Otherwise, go to line 20.

- 20 Enter your taxable income from Form 1040, line 39 . . . . .

20	11,014
----	--------

- 21 Enter the **smaller** of line 16 or line 17 of Schedule D . . . . .

21	9,561
----	-------

- 22 If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0- . . . . .

22	0
----	---

- 23 Subtract line 22 from line 21. If zero or less, enter -0- . . . . .

23	9,561
----	-------

- 24 Subtract line 23 from line 20. If zero or less, enter -0- . . . . .

24	1,453
----	-------

- 25 Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .

25	219
----	-----

- 26 Enter the **smaller** of:

- The amount on line 20 or
- \$45,200 if married filing jointly or qualifying widow(er);  
\$27,050 if single;  
\$36,250 if head of household; or  
\$22,600 if married filing separately

26	11,014
----	--------

If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.

- 27 Enter the amount from line 24 . . . . .

27	1,453
----	-------

- 28 Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34 . . . . .

28	9,561
----	-------

- 29 Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8 . . . . .

29	339
----	-----

- 30 Enter the **smaller** of line 28 or line 29 . . . . .

30	339
----	-----

- 31 Multiply line 30 by 8% (.08) . . . . .

31	27
----	----

- 32 Subtract line 30 from line 28 . . . . .

32	9,222
----	-------

- 33 Multiply line 32 by 10% (.10) . . . . .

33	922
----	-----

If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.

- 34 Enter the **smaller** of line 20 or line 23 . . . . .

34	
----	--

- 35 Enter the amount from line 28 (if line 28 is blank, enter -0-) . . . . .

35	
----	--

- 36 Subtract line 35 from line 34 . . . . .

36	
----	--

- 37 Multiply line 36 by 20% (.20) . . . . .

37	
----	--

- 38 Add lines 25, 31, 33, and 37 . . . . .

38	1,168
----	-------

- 39 Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .

39	1,654
----	-------

- 40 **Tax on all taxable income (including capital gains).** Enter the **smaller** of line 38 or line 39 here and on Form 1040, line 40 . . . . .

40	1,168
----	-------

Schedule D (Form 1040) 2001





## For Example 2



Department of the Treasury  
Internal Revenue Service

KANSAS CITY, MO 64999-0025

LAURIE B. MCNEILE  
420 OAK STREET  
CAVE IN ROCK IL 62919

## Customer Service

1-800-829-8815  
Caller ID: 524071

If you call us refer to this information:

Number of this Notice: CP12  
Date of this Notice: APR. 22, 2002  
Taxpayer Identification Number:  
222-22-2222  
Tax Form: 1040  
Tax Period: DEC. 31, 2001

**Amount of your refund: \$396.68**

We changed the figures on your 2001 tax return because we found one or more mistakes which changed the amount of your refund. These mistakes could change other areas of your tax return. You may have expected a different refund amount or no refund at all. We have listed the explanations on the page(s) following the tax statement.

## 2001 TAX STATEMENT

Please compare your return with the tax statement shown.



**If you agree** with our figures, *do not contact us.*

**If you disagree** with our figures or the way we processed your return, you may call the **Customer Service** number.

If you owe no other amounts the law requires us to collect, we'll refund any overpayment of \$1.00 or more to you in approximately six weeks.

Line Item On Return	Your Figures	IRS Figures
<b>Adjusted Gross Income</b>	\$15,564.00	\$15,564.00
<b>Taxable Income</b>	\$11,014.00	\$11,014.00
<b>Total Tax</b>	\$ 1,158.00	\$ 1,085.32
<b>Total Payments</b>		\$ 2,322.00
<b>Overpayment</b>		\$ 1,236.68
Less:		
*Interest		\$ .00
Amount applied to next year's estimated tax		\$ 840.00
<b>TOTAL SUBTRACTED</b>		\$ 840.00
<b>Amount Of Refund Per This Notice</b> (Interest added, if any)		<b>\$ 396.68</b>

*\*See the following pages of this notice for penalty and interest explanations.*

## CHANGE EXPLANATION(S)

We adjusted your tax return, because you reported that you could be claimed as a dependent on another person's return. When you're a dependent on another person's return, you are eligible to use the 10% tax bracket to compute the Tentative Tax on your 2001 return. We recomputed your tax using the 10% tax bracket.



## For Example 2

2

### Tax Computation Worksheet for Certain Dependents—Line 40

Keep for Your Records

**Before you begin:**

- ✓ Be sure you can use this worksheet (see **Tax Computation Worksheet for Certain Dependents** above).
- ✓ **Do not** use this worksheet if you, or your spouse if filing jointly, received (before offset) an advance payment of your 2001 taxes.
- ✓ Be sure you read the **Special Rules** below.

**Worksheet 1**  
For line 25, Sch. D - Tax on \$1,435

1. Figure the tax on the amount on Form 1040, line 39 (or the applicable line of the worksheet, schedule, or form listed below). Use the Tax Table or Tax Rate Schedules, whichever applies . . . . . **1. 219**

2. Is the amount on line 1 more than the amount shown below for your filing status?

- Single or married filing separately—\$900
- Married filing jointly or qualifying widow(er)—\$1,800
- Head of household—\$1,500

☐ **Yes.** Enter: \$300 if single or married filing separately; \$500 if head of household; \$600 if married filing jointly or qualifying widow(er). . . . . **2. 73**

☒ **No.** Divide the amount on line 1 by 3.0.

3. Subtract line 2 from line 1. Enter the result here and on Form 1040, line 40 (or the applicable line of the worksheet, schedule, or form listed below) **(Line 25, Sch. D as corrected)** **3. 146**

**Special Rules.** If you use:

- The **Capital Gain Tax Worksheet** on page 34, use the worksheet above to figure the tax on lines 4 and 14 of the Capital Gain Tax Worksheet.
- **Schedule D, Part IV**, use the worksheet above to figure the tax on lines 25 and 39 of Part IV. If you use the **Schedule D Tax Worksheet** on page D-9, use the worksheet above to figure the tax on lines 15 and 36 of the Schedule D Tax Worksheet.
- **Schedule J**, use the worksheet above to figure the tax on line 4 of Schedule J.
- **Form 8615**, use the worksheet above to figure the tax on lines 15 and 17 of Form 8615 (and line 9 if the parent used this worksheet).
- **Other forms or worksheets** that require you to figure the tax using the 2001 Tax Table or Tax Rate Schedules, use the worksheet above to figure the tax on any line that would otherwise be figured using the 2001 Tax Table or Tax Rate Schedules.

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Need more information or forms? See page 7.

### Tax Computation Worksheet for Certain Dependents—Line 40

Keep for Your Records

**Before you begin:**

- ✓ Be sure you can use this worksheet (see **Tax Computation Worksheet for Certain Dependents** above).
- ✓ **Do not** use this worksheet if you, or your spouse if filing jointly, received (before offset) an advance payment of your 2001 taxes.
- ✓ Be sure you read the **Special Rules** below.

**Worksheet 2**  
For line 39, Sch. D - Tax on \$11,014

1. Figure the tax on the amount on Form 1040, line 39 (or the applicable line of the worksheet, schedule, or form listed below). Use the Tax Table or Tax Rate Schedules, whichever applies . . . . . **1. 1,654**

2. Is the amount on line 1 more than the amount shown below for your filing status?

- Single or married filing separately—\$900
- Married filing jointly or qualifying widow(er)—\$1,800
- Head of household—\$1,500

☐ **Yes.** Enter: \$300 if single or married filing separately; \$500 if head of household; \$600 if married filing jointly or qualifying widow(er). . . . . **2. 300**

☒ **No.** Divide the amount on line 1 by 3.0.

3. Subtract line 2 from line 1. Enter the result here and on Form 1040, line 40 (or the applicable line of the worksheet, schedule, or form listed below) **(Line 39, Sch. D as corrected)** **3. 1,354**

**Special Rules.** If you use:

- The **Capital Gain Tax Worksheet** on page 34, use the worksheet above to figure the tax on lines 4 and 14 of the Capital Gain Tax Worksheet.
- **Schedule D, Part IV**, use the worksheet above to figure the tax on lines 25 and 39 of Part IV. If you use the **Schedule D Tax Worksheet** on page D-9, use the worksheet above to figure the tax on lines 15 and 36 of the Schedule D Tax Worksheet.
- **Schedule J**, use the worksheet above to figure the tax on line 4 of Schedule J.
- **Form 8615**, use the worksheet above to figure the tax on lines 15 and 17 of Form 8615 (and line 9 if the parent used this worksheet).
- **Other forms or worksheets** that require you to figure the tax using the 2001 Tax Table or Tax Rate Schedules, use the worksheet above to figure the tax on any line that would otherwise be figured using the 2001 Tax Table or Tax Rate Schedules.

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Need more information or forms? See page 7.

## For Example 2 (Recalculated Per Worksheets)

Schedule D (Form 1040) 2001

Page **2**

### Part III Taxable Gain or Deductible Loss

<p><b>17</b> Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39 . . . . .</p> <p><b>Next:</b> • If both lines 16 and 17 are gains <b>and</b> Form 1040, line 39, is more than zero, complete Part IV below. • Otherwise, skip the rest of Schedule D and complete Form 1040.</p>	<b>17</b>	<b>9,561</b>	
<p><b>18</b> If line 17 is a loss, enter here and on Form 1040, line 13, the <b>smaller</b> of (a) that loss or (b) (\$3,000) (or, if married filing separately, (\$1,500)). Then complete Form 1040 through line 37</p> <p><b>Next:</b> • If the loss on line 17 is more than the loss on line 18 <b>or</b> if Form 1040, line 37, is less than zero, skip <b>Part IV</b> below and complete the <b>Capital Loss Carryover Worksheet</b> on page D-6 of the instructions before completing the rest of Form 1040. • Otherwise, skip <b>Part IV</b> below and complete the rest of Form 1040.</p>	<b>18</b> (		)

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

<p><b>19</b> Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions . . . . .</p> <p><b>If line 15 or line 19 is more than zero, complete the worksheet on page D-9 of the instructions to figure the amount to enter on lines 22, 29, and 40 below, and skip all other lines below. Otherwise, go to line 20.</b></p>	<b>19</b>				
<p><b>20</b> Enter your taxable income from Form 1040, line 39 . . . . .</p>	<b>20</b>	<b>11,014</b>			
<p><b>21</b> Enter the <b>smaller</b> of line 16 or line 17 of Schedule D . . . . .</p>	<b>21</b>	<b>9,561</b>			
<p><b>22</b> If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0- . . . . .</p>	<b>22</b>	<b>0</b>			
<p><b>23</b> Subtract line 22 from line 21. If zero or less, enter -0- . . . . .</p>	<b>23</b>	<b>9,561</b>			
<p><b>24</b> Subtract line 23 from line 20. If zero or less, enter -0- . . . . .</p>	<b>24</b>	<b>1,453</b>			
<p><b>25</b> Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .</p>	<b>25</b>	<b>146</b>	<b>-219</b>		
<p><b>26</b> Enter the <b>smaller</b> of:</p> <ul style="list-style-type: none"> <li>• The amount on line 20 <b>or</b></li> <li>• \$45,200 if married filing jointly or qualifying widow(er);</li> <li>  \$27,050 if single;</li> <li>  \$36,250 if head of household; or</li> <li>  \$22,600 if married filing separately</li> </ul> <p><b>If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.</b></p>	<b>26</b>	<b>11,014</b>			
<p><b>27</b> Enter the amount from line 24 . . . . .</p>	<b>27</b>	<b>1,453</b>			
<p><b>28</b> Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34 . . . . .</p>	<b>28</b>	<b>9,561</b>			
<p><b>29</b> Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8 . . . . .</p>	<b>29</b>	<b>339</b>			
<p><b>30</b> Enter the <b>smaller</b> of line 28 or line 29 . . . . .</p>	<b>30</b>	<b>339</b>			
<p><b>31</b> Multiply line 30 by 8% (.08) . . . . .</p>	<b>31</b>		<b>27</b>		
<p><b>32</b> Subtract line 30 from line 28 . . . . .</p>	<b>32</b>	<b>9,222</b>			
<p><b>33</b> Multiply line 32 by 10% (.10) . . . . .</p> <p><b>If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.</b></p>	<b>33</b>		<b>922</b>		
<p><b>34</b> Enter the <b>smaller</b> of line 20 or line 23 . . . . .</p>	<b>34</b>				
<p><b>35</b> Enter the amount from line 28 (if line 28 is blank, enter -0-) . . . . .</p>	<b>35</b>				
<p><b>36</b> Subtract line 35 from line 34 . . . . .</p>	<b>36</b>				
<p><b>37</b> Multiply line 36 by 20% (.20) . . . . .</p>	<b>37</b>				
<p><b>38</b> Add lines 25, 31, 33, and 37 . . . . .</p>	<b>38</b>	<b>1,095</b>	<b>1,168</b>		
<p><b>39</b> Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .</p>	<b>39</b>	<b>*1,354</b>	<b>1,654</b>		
<p><b>40</b> <b>Tax on all taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 38 or line 39 here and on Form 1040, line 40 . . . . .</p>	<b>40</b>	<b>1,095</b>	<b>1,168</b>		



**\*Worksheet 2**

Schedule D (Form 1040) 2001

## Example 2 (Recalculated Per Service Center Notice CP12)

Form 1040 (2001)

Page 2

## Tax and Credits

## Standard Deduction for—

• People who checked any box on line 35a or 35b or who can be claimed as a dependent, see page 31.

• All others:

Single, \$4,550

Head of household, \$6,650

Married filing jointly or Qualifying widow(er), \$7,600

Married filing separately, \$3,800

34	Amount from line 33 (adjusted gross income)	34	15,564
35a	Check if: <input type="checkbox"/> You were 65 or older, <input type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here . . . ▶ 35a		
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here . . . ▶ 35b <input type="checkbox"/>		
36	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	36	4,550
37	Subtract line 36 from line 34	37	11,014
38	If line 34 is \$99,725 or less, multiply \$2,900 by the total number of exemptions claimed on line 6d. If line 34 is over \$99,725, see the worksheet on page 32	38	0
39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	11,014
40	Tax (see page 33). Check if any tax is from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	40	1,095 1,168
41	Alternative minimum tax (see page 34). Attach Form 6251	41	1,095 1,168
42	Add lines 40 and 41	42	
43	Foreign tax credit. Attach Form 1116 if required	43	10
44	Credit for child and dependent care expenses. Attach Form 2441	44	
45	Credit for the elderly or the disabled. Attach Schedule R	45	
46	Education credits. Attach Form 8863	46	
47	Rate reduction credit. See the worksheet on page 36	47	
48	Child tax credit (see page 37)	48	
49	Adoption credit. Attach Form 8839	49	
50	Other credits from: a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	50	
51	Add lines 43 through 50. These are your total credits	51	10
52	Subtract line 51 from line 42. If line 51 is more than line 42, enter -0-	52	1,085 1,158
53	Self-employment tax. Attach Schedule SE	53	
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54	
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55	
56	Advance earned income credit payments from Form(s) W-2	56	
57	Household employment taxes. Attach Schedule H	57	
58	Add lines 52 through 57. This is your total tax	58	1,085 1,158

## Payments

If you have a qualifying child, attach Schedule EIC.

59	Federal income tax withheld from Forms W-2 and 1099	59	322
60	2001 estimated tax payments and amount applied from 2000 return	60	2,000
61a	Earned income credit (EIC)	61a	
b	Nontaxable earned income	61b	
62	Excess social security and RRTA tax withheld (see page 51)	62	
63	Additional child tax credit. Attach Form 8812	63	
64	Amount paid with request for extension to file (see page 51)	64	
65	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136	65	
66	Add lines 59, 60, 61a, and 62 through 65. These are your total payments	66	2,322

## Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

67	If line 66 is more than line 58, subtract line 58 from line 66. This is the amount you overpaid	67	1,237 1,164
68a	Amount of line 67 you want refunded to you	68a	397 324
b	Routing number	c	Type: <input checked="" type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
69	Amount of line 67 you want applied to your 2002 estimated tax	69	840

## Amount You Owe

70	Amount you owe. Subtract line 66 from line 58. For details on how to pay, see page 52	70	
71	Estimated tax penalty. Also include on line 70	71	

## Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? ☒ Yes. Complete the following. ☐ No

Designee's name ▶ **Preparer** Phone no. ▶ ( ) Personal identification number (PIN) ▶

## Sign Here

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

Your signature	Date	Your occupation	Daytime phone number
		<b>Student</b>	( )
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	

## Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
	3/19/02		
Firm's name (or yours if self-employed), address, and ZIP code ▶	EIN	Phone no.	( )

Form 1040 (2001)

## PROBLEM 2: TAXATION OF CLERGY

Most of the following information is taken from three IRS sources:

- The MSSP (Market Segment Specialization Program) training guide prepared for use by the IRS examiners when examining tax returns of clergy members
- IRS Pub. 517, *Social Security and Other Information for Members of the Clergy*
- IRS Pub. 1828, *Tax Guide for Churches* (newly revised and available on the IRS web site)

### Self-Employed or Common-Law Employee of Congregation?

A duly ordained, commissioned, or licensed member of the clergy, who is employed by a congregation on a salaried basis, **is a common-law employee and not a self-employed individual for income tax purposes**. This issue was settled, in the opinion of the IRS, by the *Weber Appeals Court* case (4<sup>th</sup> Circuit) (95-2 USTC, ¶50,409. See pages 255-56 in the *1995 Farm Income Tax Workbook*.) **However, special rules apply.**

A clergy member's salary is subject to federal income tax **but not** federal income tax withholding. The clergy member can enter into a voluntary withholding agreement with the congregation under I.R.C. §3402(p)(1). To do so, the clergy member must furnish the congregation a completed Form W-4. The income tax withheld is reported in Box 2 on the clergy member's Form W-2.

**The employer congregation is required to issue a Form W-2 whether income tax was withheld or not.** The amount of wages shown in Box 1 of the Form W-2 must be reported on line 7 (Wages, salaries, and tips) of the clergy member's Form 1040.

### Different Rules for Social Security Coverage

Clergy members are hybrid employees as they are treated differently for social security coverage than they are for income tax purposes. The wages they receive from their employer congregation are **not** subject to FICA taxes. Instead, the wages are treated as earnings from self-employment. There are **two exceptions**. The wages are **not** considered earnings from self-employment if:

1. The clergy member is a member of a religious order who has taken a vow of poverty, or
2. The clergy member has requested and received from the IRS an exemption from self-employment tax by filing Form 4361.

#### Section A—Short Schedule SE. **Caution.** Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a . . . . .	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report . . . . .	2		
3	Combine lines 1 and 2 . . . . .	3		
4	<b>Net earnings from self-employment.</b> Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax . . . . . ▶	4		
5	<b>Self-employment tax.</b> If the amount on line 4 is: <div style="display: flex; align-items: center;"> <div style="margin-right: 10px;"> <p>• \$80,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on <b>Form 1040, line 53.</b></p> <p>• More than \$80,400, multiply line 4 by 2.9% (.029). Then, add \$9,969.60 to the result. Enter the total here and on <b>Form 1040, line 53.</b></p> </div> <div style="font-size: 3em; margin-left: 10px;">}</div> </div>	5		
6	<b>Deduction for one-half of self-employment tax.</b> Multiply line 5 by 50% (.5). Enter the result here and on <b>Form 1040, line 27</b> . . . . .	6		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2001

It is recommended that a statement be attached to explain the amount of self-employment earnings that must be reported on line 2, Section A of Schedule SE. **The following list shows income and expense items to be included in arriving at the amount to enter on line 2, Schedule SE for clergy members:**

**A. W-2 Wages (Box 1, Form W-2)**

The following amounts should be included in Box 1 (Wages) of the clergy member's Form W-2:

1. Regular salary
2. Non-accountable auto allowance
3. Social security (self-employment tax) allowance paid by the congregation, if applicable
4. Any other non-accountable allowances paid to the clergy member for professional expenses (Example. Continuing education expenses allowance)

**B. All professional expenses**

**Note.** These may be deducted in full for SE tax purposes even if they were not deducted for income tax purposes.

**Examples of Professional Expenses to Deduct in arriving at the line 2, Schedule SE figure:**

- Cost of robes (unreimbursed) even if not deducted on Schedule A due to 2% AGI limitation or because the standard deduction was used.
- Unreimbursed business auto expenses can be explained by the following example.

**Example 3.** Pastor Ann drove her auto 5,220 miles for church business in 2002. She was paid a **non-accountable auto allowance** of \$3,000 in 2002. This \$3,000 must be included in Box 1 (Wages) on Ann's 2002 Form W-2.

She uses the 2002 standard mileage rate of 36.5¢.  $5,220 \text{ miles} \times 36.5¢ = \$1,905$ . **The \$1,905 will be deducted in arriving at the line 2, Schedule SE figure.**

**Note.** If the \$3,000 allowance is **not** included as wages in Box 1 on Ann's 2002 Form W-2, it must be included in arriving at the line 2, Schedule SE figure.

**C. Fair rental value of parsonage provided by the congregation**

**Note.** An estimate from a local realtor is usually the best evidence of fair rental value. The estimate should not include the value of utilities or furniture.

- D.** Cost of utilities paid by the congregation for the parsonage
- E.** Rental (parsonage) allowance paid in lieu of providing a parsonage (including separate utility allowance paid, if applicable)
- F.** Social Security (self-employment tax) allowance paid by the congregation if not included in Box 1 of Form W-2
- G.** Net profit from Schedules C or C-EZ for income and expenses related to weddings, funerals, etc.

**Note.** All expenses are deducted in arriving at the line 2, Schedule SE figure, **even if reduced on Schedules C or C-EZ by the "expenses allocable to tax-free income" rule** (discussed later).

## Rental (Parsonage) and Utilities Allowances

The amount clergy members receive that is officially designated in congregation records as a rental allowance (includes payment of utilities) is excluded from gross income under I.R.C. §107 if:

1. The amount is used to provide or rent a home; and
2. The amount is not more than reasonable pay for services performed by the clergy member.

This exclusion applies **only for income tax purposes**. It is **not** excluded in computing self-employment tax. The exclusion is limited to the **lower** of the following amounts:

- The amount actually used to provide a home
- The amount officially designated as a rental allowance
- The fair market value of the home, including furnishings, utilities, garage, etc.

**Note.** The Clergy Housing Allowance Clarification Act of 2002 (May 2002) amends I.R.C. §107. It clarifies that the rental allowance (parsonage) cannot exceed the fair rental value of the home, including furnishings and appurtenances such as garage, plus the cost of utilities. This was created to prevent the Ninth Circuit Court of Appeals from eliminating the tax-free status of the rental allowance. This was a secondary issue addressed by the Ninth Circuit in the *R.D. Warren* Tax Court case. See page 628 in the *2000 Farm Income Tax Workbook* for details on this case.

The IRS recommends that the amounts and identification of the allowances be shown in Box 14 (Other) of the Form W-2. This information is very helpful when preparing the tax return of the clergy member.

**Caution.** The tax court has held in three cases that if a clergy member receives **tax-free income** such as a rental (parsonage) allowance, a portion of the otherwise “deductible unreimbursed professional expenses” on Form 2106 is **not deductible** (I.R.C. §265).

**Note.** IRS examiners will likely raise this issue in an exam if the proper allocation is ignored. **See page 9 in IRS Pub 517 for details on this “tax trap.”** See also the *Robert H. McFarland* Tax Court case (64 TCM 374, TC Memo 1992-440). This issue is illustrated by the following Example.

**Example 4.** Pastor White receives a \$30,000 cash salary and a \$10,000 rental (parsonage) allowance in 2002. This is his only ministry income. He used the entire \$10,000 rental allowance to pay expenses for his personally owned home. He has \$4,000 of unreimbursed professional expenses in 2002.

He would be entitled to deduct only **75%** of the \$4,000 of such expenses on his 2002 Form 2106 (Unreimbursed Employee Business Expenses). The computation of the **75%** deductible ratio is shown below.

Taxable ministry income (\$30,000 salary) = 75%

Total ministry income of \$40,000 (\$30,000 + \$10,000)

**Planning Pointer.** This problem can be eliminated if the congregation and the clergy member would agree that all professional expenses are to be reimbursed, preferably through a monthly voucher arrangement supported by receipts and records.



## Employee Business Expenses of Clergy Members

Clergy members who are employees may deduct the following professional expenses on Form 2106 (subject to the “tax-free income limitation rule” explained above):

- Professional expenses for which the clergy member is not reimbursed under an I.R.C. §62(c) **accountable plan**
- “Non-accountable” professional expenses for which the clergy member receives an **allowance** rather than reimbursement

Generally, **reimbursements** made to a clergy member by a congregation under an **accountable plan** are **not** included in either the clergy member’s gross income or on the Form W-2. In addition, they are excluded in computing self-employment tax.

If the congregation uses a **non-accountable** arrangement, the **allowances** must be included in the clergy member’s gross income and must be reported as Wages in Box 1 of Form W-2. However, the clergy member may deduct all professional expenses paid in computing self-employment tax. This is true even if the standard deduction is claimed or if the 2% AGI limitation negates Form 2106 expenses.

## Comprehensive Example

The following example involves a Lutheran minister who does not itemize. For a more complex example, including the “tax-free income limitation rule” for Form 2106 expenses, see IRS Pub. 517.

**Example 5.** Kathryn is an ordained Lutheran minister. Her church, St. John’s, pays rent and utilities for her apartment. Her **2001** ministry income consists of the following:

W-2 wages from St. John’s	\$15,888
Lenten service fees from another church (see note below)	200
Total ministry income	<u>\$16,088</u>

**Note.** This congregation did not issue a Form W-2 to Kathryn. She was assigned by the bishop to provide ministerial services to this congregation during the lenten season. A 2002 substitute Form W-2 was prepared by the tax preparer; however, it is not shown.

She made a 2001 contribution of \$2,000 to her Roth IRA. The following forms, schedules, and statements are shown.

- Form W-2 from St. John’s
- Form 1040
- Schedule SE
- Statement explaining the amount on line 2, Schedule SE



# 2002 Workbook

## For Example 5

a Control number		22222		Void <input type="checkbox"/>		For Official Use Only ▶ OMB No. 1545-0008	
b Employer identification number 777777				1 Wages, tips, other compensation \$ 15,888		2 Federal income tax withheld \$ 0.00	
c Employer's name, address, and ZIP code <b>St. John's Ev. Lutheran Church</b> <b>P.O. Box 185</b> <b>Cherry Valley, IL 61016</b>				3 Social security wages \$		4 Social security tax withheld \$	
				5 Medicare wages and tips \$		6 Medicare tax withheld \$	
				7 Social security tips \$		8 Allocated tips \$	
				9 Advance EIC payment \$		10 Dependent care benefits \$	
d Employee's social security number 111-11-1111				11 Nonqualified plans \$		12a See instructions for box 12 \$	
e Employee's first name and initial <b>Kathryn D.</b>		Last name <b>Kohl</b>		13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12b <input type="checkbox"/> \$	
1026 School Street Apartment 2 Cherry Valley, IL 61016				14 Other <b>Rent \$3,000.00</b> <b>Utilities \$2,048.00</b> <b>paid by church</b>		12c <input type="checkbox"/> \$	
						12d <input type="checkbox"/> \$	
f Employee's address and ZIP code				15 State Employer's state ID number <b>IL 1234-5678</b>		16 State wages, tips, etc. \$	
				17 State income tax \$ 0.00		18 Local wages, tips, etc. \$	
				19 Local income tax \$		20 Locality name	

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

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

2001

Cat. No. 10134D

Department of the Treasury—Internal Revenue Service

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

## 2

Cat. No. 11320B Form **1040** (2001)

# 2002 Workbook

## For Example 5

Form 1040 (2001)

Page **2**

### Tax and Credits

#### Standard Deduction for—

- People who checked any box on line 35a or 35b or who can be claimed as a dependent, see page 31.
- All others:
  - Single, \$4,550
  - Head of household, \$6,650
  - Married filing jointly or Qualifying widow(er), \$7,600
  - Married filing separately, \$3,800

34	Amount from line 33 (adjusted gross income)	34	<b>44,105</b>
35a	Check if: <input type="checkbox"/> You were 65 or older, <input checked="" type="checkbox"/> Blind; <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> Blind. Add the number of boxes checked above and enter the total here	<b>1</b>	
36	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	36	<b>5,650</b>
37	Subtract line 36 from line 34	37	<b>38,455</b>
38	If line 34 is \$99,725 or less, multiply \$2,900 by the total number of exemptions claimed on line 6d. If line 34 is over \$99,725, see the worksheet on page 32	38	<b>2,900</b>
39	Taxable income. Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	<b>35,555</b>
40	Tax (see page 33). Check if any tax is from a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972	40	<b>5,616</b>
41	Alternative minimum tax (see page 34). Attach Form 6251	41	
42	Add lines 40 and 41	42	<b>5,616</b>
43	Foreign tax credit. Attach Form 1116 if required	43	
44	Credit for child and dependent care expenses. Attach Form 2441	44	
45	Credit for the elderly or the disabled. Attach Schedule R	45	
46	Education credits. Attach Form 8863	46	
47	Rate reduction credit. See the worksheet on page 36	47	
48	Child tax credit (see page 37)	48	
49	Adoption credit. Attach Form 8839	49	
50	Other credits from: a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8396 c <input type="checkbox"/> Form 8801 d <input type="checkbox"/> Form (specify)	50	
51	Add lines 43 through 50. These are your total credits	51	<b>0</b>
52	Subtract line 51 from line 42. If line 51 is more than line 42, enter -0-	52	<b>5,616</b>

### Other Taxes

53	Self-employment tax. Attach Schedule SE	53	<b>2,863</b>
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54	
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55	
56	Advance earned income credit payments from Form(s) W-2	56	
57	Household employment taxes. Attach Schedule H	57	
58	Add lines 52 through 57. This is your total tax	58	<b>8,479</b>

### Payments

If you have a qualifying child, attach Schedule EIC.

59	Federal income tax withheld from Forms W-2 and 1099	59	
60	2001 estimated tax payments and amount applied from 2000 return	60	<b>6,600 00</b>
61a	Earned income credit (EIC)	61a	
62	Nontaxable earned income	62	
63	Excess social security and RRTA tax withheld (see page 51)	63	
64	Additional child tax credit. Attach Form 8812	64	
65	Amount paid with request for extension to file (see page 51)	65	
66	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136	66	<b>6,600</b>
67	Add lines 59, 60, 61a, and 62 through 65. These are your total payments	67	

### Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

68a	Amount of line 67 you want refunded to you	68a	
69	Amount of line 67 you want applied to your 2002 estimated tax	69	
70	Amount you owe. Subtract line 66 from line 58. For details on how to pay, see page 52	70	<b>1,879</b>
71	Estimated tax penalty. Also include on line 70	71	

### Amount You Owe

### Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? ☐ Yes. Complete the following. ☒ No

Designee's name	Phone no.	Personal identification number (PIN)
-----------------	-----------	--------------------------------------

### Sign Here

Joint return? See page 19. Keep a copy for your records.

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

Your signature	Date	Your occupation	Daytime phone number
		<b>Ordained Minister</b>	( )
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	

### Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code	EIN	Phone no.	( )

Form **1040** (2001)

## For Example 5

SCHEDULE SE  
(Form 1040)Department of the Treasury  
Internal Revenue Service (99)

## Self-Employment Tax

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

OMB No. 1545-0074

2001

Attachment  
Sequence No. 17

Name of person with self-employment income (as shown on Form 1040)

Kathryn D. Kohl

Social security number of person  
with self-employment income ▶

111 : 11 : 1111

## Who Must File Schedule SE

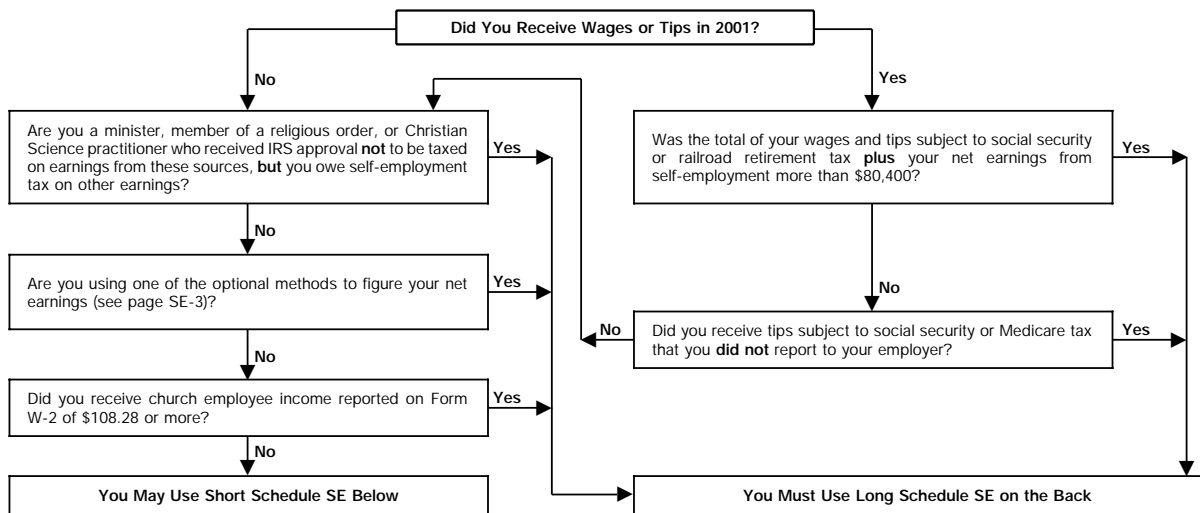
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is **not** church employee income. See page SE-1.

**Note.** Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

**Exception.** If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 53.

## May I Use Short Schedule SE or Must I Use Long Schedule SE?



## Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a . . . . .	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. <b>Ministers</b> and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report . . . <b>see attached statement</b> . . . . .	2	20,263	
3	Combine lines 1 and 2 . . . . .	3	20,263	
4	<b>Net earnings from self-employment.</b> Multiply line 3 by 92.35% (.9235). If less than \$400, <b>do not</b> file this schedule; you do not owe self-employment tax . . . . . ▶	4	18,713	
5	<b>Self-employment tax.</b> If the amount on line 4 is: <ul style="list-style-type: none"> <li>• \$80,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on <b>Form 1040, line 53.</b></li> <li>• More than \$80,400, multiply line 4 by 2.9% (.029). Then, add \$9,969.60 to the result. Enter the total here and on <b>Form 1040, line 53.</b></li> </ul>	5	2,863	
6	<b>Deduction for one-half of self-employment tax.</b> Multiply line 5 by 50% (.5). Enter the result here and on <b>Form 1040, line 27</b> . . . . .	6	1,432	

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2001

## For Example 5

Kathryn D. Kohl SSN 111-11-1111

Statement to show computation for line 2, section A, Schedule SE (Net self-employment earnings as an ordained Lutheran minister)

1)	Cash wages per W-2 Form from St. John's Church	\$15,888.00
2)	Wages from another church (no W-2 furnished)	200.00
3)	Rent and utilities paid by employer church for apartment furnished to me without cost (See Box 14 of the Form W-2 from St. John's)	5,048.90
4)	Less: Unreimbursed professional expenses	(873.45)
Line 2, Section A, Schedule SE		<u>\$20,263.45</u>

## PROBLEM 3: MARITAL STATUS

**Scenario 1 Facts.** Rick and Camille are single and have been cohabitating in Illinois since April 2000. They remain unmarried as of December 31, 2002. Rick is 26 and Camille is 21. Camille gave birth to a son, Arturo, in August 2001. Arturo lives the entire year of 2002 with Rick and Camille in their rented home. The 2002 income of Rick and Camille is shown below.

Individual	2002 Wages (per Form W-2)	2002 Total Income
Rick	\$20,000	\$20,000
Camille	\$15,000	\$15,000

Both will use the standard deduction on their 2002 tax returns.

**Question 1A.** What are their filing options for 2002?

**Answer 1A.** One may be entitled to Head of Household status and the other must file as a single filer.

**Question 1B.** Who should claim Arturo's exemption?

**Answer 1B.** The technical answer is the person who furnished more than half of Arturo's support for 2002. A comparison of Rick and Camille's 2002 take-home pay is needed to determine the support issue. Assume Rick meets the support test and Camille does not.

**Question 1C.** Who is entitled to the \$600 child tax credit?

**Answer 1C.** Rick, since he is claiming Arturo's exemption.

The numbers from Rick's 2002 Form 1040 using **Head of Household** filing status are shown below.

AGI	\$20,000
Less: Exemptions (2 × \$3,000)	(6,000)
Less: Standard deduction (Head of Household)	(6,900)
Taxable income	<u>\$7,100</u>
Tax from Tax Table	713
Less: Child tax credit (1 child)	(600)
Total tax (before considering Earned Income Credit)	<u>\$113</u>

**Question 1D.** Who is entitled to claim the Earned Income Credit for 2002?

**Answer 1D.** Rick. According to the **new 2002 rules** for persons with the same qualifying child, if two persons may be able to claim the same qualifying child for earned income credit purposes, **the qualifying child can be claimed only by the:**

1. Parents, if they file a joint return;
2. Parent, if only one of the two persons is the child's parent;
3. Parent with whom the child lived the longest during 2002, if the two persons are the child's parents;
4. Parent with the highest AGI, if the child lives with each parent for the same amount of time during 2002; or
5. Person with the highest AGI, if neither of the persons is the child's parent.

Test 4 applies to Rick and Camille. Since Rick's 2002 AGI is higher than Camille's, **he only** would be entitled to claim the earned income credit for Arturo. Rick's 2002 earned income credit is \$1,466.

**Question 1E.** What is the tax result for Camille?

**Answer 1E.** Camille must file as a single individual. She is entitled to no child tax or earned income credits. The numbers from Camille's 2002 Form 1040 using single filing status are show below.

AGI	\$15,000
Less: Personal exemption	(3,000)
Less: Standard deduction (Single)	(4,700)
Taxable income	\$7,300
Tax from Tax Table	799

**Scenario 2 Facts.** The facts are the same as shown previously for Scenario 1 **except the couple got married in December 2002.**

**Question 2A.** What is their best filing option for 2002?

**Answer 2A.** They have two options, file a **joint** 2002 return or file **married filing separately**. Earned income credit is a non-factor in their decision because:

- individuals who are **married filing separately** are entitled to no earned income credit; and
- by filing a **joint** return, their 2002 AGI of \$35,000 is **more than the phase-out ceiling of \$30,200 for couples with one qualifying child.**

Therefore, their best option is to file a joint 2002 return.

The numbers from Rick and Camille's 2002 Form 1040 using **joint** filing status are shown below.

AGI (Rick's \$20,000 wages and Camille's \$15,000 wages)	\$35,000
Less: Exemptions (3 × \$3,000)	(9,000)
Less: Standard deduction (Joint)	(7,850)
Taxable income	\$18,150
Tax from Tax Table	2,126
Less: Child tax credit (1 child)	(600)
Total tax	\$1,526

**Question 2B.** How much additional tax will they pay due to their decision to get married in December?

**Answer 2B.** \$2,149. The comparison is shown below.

**Scenario 1 Tax Computation (Unmarried)**

Rick's total tax before considering Earned Income Credit	\$113
Camille's total tax	799
Less: Rick's Earned Income Credit	(1,466)
Total Tax (Negative with Earned Income Credit)	(\$554)

**Scenario 2 Tax Computation (Married Filing Jointly)**

Total Tax (no Earned Income Credit allowed)	\$1,526
---	---------

**Note.** Even though there is a slight marriage penalty relief for 2002 for married taxpayers who file jointly, it does not help Rick and Camille. See Chapter 1: New Tax Legislation for details about the marriage penalty relief in computing 2002 Earned Income Credit.

## Information from IRS Compliance Estimates regarding Earned Income Credit.

In February 2002, IRS released a lengthy document entitled *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns*. Following is some information from that source.

- Approximately \$31 billion of EITC was claimed on 1999 returns.
- Approximately \$11 billion of the \$31 billion was claimed in error, some due to fraud.
- About 18%, or approximately \$2 billion, of the \$11 billion of erroneous EITC for 1999, was attributable to married taxpayers who filed as Single or Head of Household rather than as Married Filing Separately as required.
- Of the \$11 billion of over-claimed EITC, the IRS has been able to recover only about \$1.8 billion as of February, 2002.

## PROBLEM 4: DEATH OF A SPOUSE

**Facts.** Patti Ogden was married to John Ogden. He died in June 2002. Patti remarries Anthony Johnson in December 2002. Patti's **only income** in 2002 is a nontaxable injury settlement under I.R.C. §104(a)(2) of \$2,000. John Ogden's 2002 income consisted of \$28,000 of wages. Anthony Johnson's 2002 income is \$40,000 consisting of wages, interest, and dividends.

**Question A.** If Patti and Anthony file a joint 2002 return, can Patti's \$3,000 exemption be claimed on the final return of the decedent, John Ogden?

**Answer A. No.** In that case, John Ogden's final 2002 return must use the **married filing separate** filing status, and no exemption is allowed for Patti.

**Question B.** If Patti and Anthony do not file jointly for 2002, may Patti's \$3,000 exemption be claimed on Anthony's separate 2002 return?

**Answer B. Yes.** Since Patti has no gross income in 2002, Anthony may claim her exemption on his separate return. And Patti's \$3,000 exemption may also be claimed on John's final 2002 separate return (Rev. Rul. 71-159).

**Question C.** Would Answer 2 change if Patti had gross income in 2002?

**Answer C. Yes.** Assume that Patti's only 2002 income is \$10 of interest income. Since she has gross income, even though very small, her exemption cannot be claimed on either Anthony's or John's 2002 separate returns. However, with these facts, Anthony can and should claim Patti's \$3,000 exemption by filing a joint 2002 return with her.



**PROBLEM 5: TAXATION ISSUES FOR MEMBERS OF ARMED FORCES****ISSUE 1: COMBAT PAY**

All of the pay received during **any part of a month** while serving in a combat zone or hazardous duty area is **excludable** for:

- enlisted personnel;
- warrant officers; and
- commissioned warrant officers.

This **full exclusion also applies** to military pay received during any part of a month the taxpayer **was hospitalized** as a result of wounds, disease, or injury incurred in a combat zone or hazardous duty area.

The combat pay exclusion rules for **commissioned officers** (other than a commissioned warrant officer) is limited to the **highest rate of enlisted pay** (plus any imminent danger or hostile fire pay received) for any month served in a combat zone or hazardous duty area.

The current combat zones (3) and hazardous duty area (1) are shown below:

- Afghanistan area
- Kosovo (Balkan) area
- Persian Gulf area
- former areas of Yugoslavia (Bosnia and Herzegovina, Croatia, and Macedonia)

The combat pay exclusion generally poses no tax reporting problems for preparers. **Excludable combat pay is not included in Box 1 of Form W-2.**

**Note.** After discussions with various military personnel, it is the opinion of the author that incorrect Form W-2s from the Armed Forces are rare. In the very unusual situation where excludable combat pay is incorrectly included in Box 1 of the W-2, a corrected W-2 must be obtained from the finance office. **A taxpayer cannot exclude as combat pay any wages shown in Box 1 of Form W-2.**

**Extension of IRS Deadlines for Armed Forces Members**

Taxpayers who served in a combat zone or hazardous duty area have a **minimum 180-day extension** for taking actions with IRS. These include:

- filing tax returns;
- paying balances due or other deficiencies;
- filing refund claims or amended returns; and
- making IRA contributions.

In addition to the 180 days, deadlines are also extended by the number of days left to file when combat zone duty began.

**Example 6.** Sergeant Octavio Cruz entered Afghanistan on September 28, 2001. He served in the combat zone through May 23, 2002. He then returned to the U.S.A. The deadlines for filing his 2001 and 2002 returns are figured as follows.

**The 2001 tax return.** The filing deadline is **March 4, 2003. He has 285 days after leaving the combat zone on May 24, 2002 to file his 2001 tax return.** The computation of the deadline extension period is shown below.

1.	180 days from the date he left the combat zone	180
2.	The number of days remaining to file his 2001 tax return (as of the date he entered the combat zone - January 1 through April 15, 2002)	105
	Total number of days in extension period	285

**The 2002 tax return.** The filing deadline is not extended because the 180-day extension period after May 23, 2002 ends on Nov. 19, 2002. This is before the start of the filing season for 2002 returns (January 1 through April 15, 2003). Therefore, his 2002 tax return must be filed by April 15, 2003, unless he applies for the normal filing extensions.

When Octavio files his 2001 tax return, he should write in red at the top of it: ENDURING FREEDOM. This is not necessary for his 2002 return as it is subject to the normal filing deadline.

**Planning Pointer.** When preparing the **2001 tax returns** for military personal, pay close attention to **Box 12 of the 2001 Form W-2**. Box 12 reports **nontaxable earned income** such as:

- combat pay
- basic allowance for subsistence (BAS)
- basic allowance for housing (BAH)

The total of these items, although excluded from gross income, must be shown on line 61b on the 2001 Form 1040 (Nontaxable earned income). This amount is added to taxable earned income reported in Box 1 of the W-2 (Wages) to arrive at total earned income in computing the 2001 earned income credit.

However, when preparing **2002 tax returns**, the amount of nontaxable earned income **is not** a factor in computing **2002 Earned Income Credit**. See Chapter 1: New Tax Legislation for the new rules for computing 2002 earned income credit.

## ISSUE 2: TRAVEL AND TRANSPORTATION EXPENSES FOR RESERVISTS

**Scenario 1 Facts.** Otto is employed full-time as an auto mechanic in Mt. Zion, IL in 2002. He and his family reside in Mt. Zion. He also is a member of the Air National Guard unit in Springfield, IL. In 2002, he makes the following round trips to Springfield to attend reserve meetings. He receives no mileage reimbursement.

Number of Round Trips Made in 2002	Round Trip Mileage
24 (one Saturday and one Sunday each month)	104

**Question 1A.** May Otto deduct auto expenses on his 2002 Form 2106 (Employee Business Expenses)?

**Answer 1A. Yes.** Mt. Zion is his tax home since that is where he earned the majority of his income.

Because the Springfield reserve unit is located outside the metropolitan area of Mt. Zion, Otto is entitled to deduct the mileage. (Rev. Rulings 55-109 and 90-23).

**Question 1B.** What is the deduction on the 2002 Form 2106?

**Answer 1B.** \$911, computed as follows:

24 round trips @ 104 miles = 2,496 business miles

2,496 miles  $\times$  36.5¢ = \$911 (subject to the 2% AGI limitation)

**Scenario 2 Facts.** Same facts as Scenario 1, except Otto works and lives in Riverton, IL which is 12 miles from the Springfield Air National Guard headquarters at Capital Airport.

**Question 2A.** May Otto deduct auto expenses on his 2002 Form 2106?

**Answer 2A. No.** The location of the reserve unit is in the same metropolitan area (Sangamon County) where Otto lives and works.

**Scenario 3 Facts.** Ed and Nancy live in Normal, IL. Nancy is an elementary teacher and Ed is a full-time student at Illinois State University. Ed's only employment income in 2002 is his reserve pay from the Air National Guard unit located in Springfield, IL.

**Question 3A.** May Ed deduct auto expenses on his 2002 Form 2106 for the round trip mileage to attend monthly reserve meetings in Springfield?

**Answer 3A. No.** His auto expenses are considered nondeductible commuting expenses from his home to his sole place of employment.

## ISSUE 3: DEPENDENCY EXEMPTIONS FOR ARMED FORCES PERSONNEL

There are numerous court cases dealing with parents who attempted to claim dependency exemptions for children who entered military service during the year.

**Example 7.** Brenda, age 18, entered the Army on June 7, 2002. She was a high school student through May and lived with her parents until reporting for active duty. However, the support test must be met by her parents. It will probably be difficult for the parents to prove that they furnished more support for Brenda in 2002 than she and the U.S. Army did.

## PROBLEM 6: DIVORCE TAXATION ISSUES

### ISSUE 1: COURT AWARDED ATTORNEY FEES

It is fairly common in divorces for one spouse to pay the other spouse's attorney fees. The amount of the fees is usually determined by the judge and is court ordered at the time the divorce is finalized and the decree is signed by the judge.

The tax question to be resolved is whether the attorney fees constitute alimony deductible by the payor spouse and taxable to the recipient spouse. In most cases, the answer is no.

**Example 8.** Lloyd and Melba, residents of Illinois, were divorced in July 2002. Lloyd was 67 and Melba was 63 on the date of the divorce. Both were wealthy. Lloyd owns a successful business and Melba inherited 2000 acres of farmland from her father on his death in 1980.

There was a property settlement. In addition, Lloyd agreed to pay Melba's attorney fees as he initiated the divorce proceedings. The judge ordered Lloyd to pay \$30,000 to Melba's attorney. He paid the \$30,000 by check five days after the judge granted the divorce. The decree was silent as to whether Lloyd's liability for Melba's attorney fees was to cease upon her death.

**Question 8A.** Is the \$30,000 paid by Lloyd considered deductible alimony by him and taxable to Melba?

**Answer 8A.** No. In order to be considered alimony, **the decree should have explicitly stated that Lloyd's obligation to pay the attorney fees would terminate at Melba's death.** Since it didn't, state (Illinois) law applies. Under Illinois law, Lloyd would have remained liable for the \$30,000, either to Melba's estate or to her attorney directly.

**Conclusion.** In order to constitute deductible alimony to Lloyd, his attorney should have insisted on a clause in the decree similar to the following:

In this hypothetical situation, it is unlikely the parties would agree that Lloyd's liability to pay Melba's attorney fees will terminate in the event of her death prior to the payment of the fees.

**Caution.** If Lloyd's payment of Melba's \$30,000 attorney fees does constitute deductible alimony for him in 2002, both Lloyd and Melba will be subject to the **recapture of alimony** rules in 2005. The reason is that Lloyd paid more than \$15,000 of alimony in 2002 and paid no alimony in 2003 and 2004. **The alimony recapture amount in 2005 will be \$15,000.** See pages 326-328 in the *2000 Farm Income Tax Workbook* for a thorough explanation of the alimony recapture rules.

**Note.** Some of the court cases and IRS Letter Rulings pertaining to Issue 1 are shown below.

## Analysis of the Law For Divorce Instruments Executed After 1984

Under I.R.C §71(b), alimony must meet the five tests shown below:

1. The payment must be in cash.
2. The divorce decree does not state that the payment is not to be considered alimony.
3. The spouses are not members of the same household at the time the payment is made.
4. There is no liability to make the payment after the death of the payee spouse.
5. The payment is not treated as child support.

Listing of Applicable Court Cases and IRS Rulings:

- *Thomas D. Berry*, 80 TCM 825 (2000-CCH), TC Memo 2000-373. (See pages 389-90 in the *2001 Farm Income Tax Workbook*. Involves Oklahoma law. Tax Court decision affirmed by 10th Circuit Court of Appeals in June 2002 [CA-10, 2002-1 USTC ¶ 50, 453])
- IRS Letter Ruling 9542001, July 10, 1995 (Involves Illinois law.)
- *R. Lawrence Smith III*, 75 TCM 2251 (1998-CCH), TC Memo 1998-166 (Involves Georgia law.)

## ISSUE 2: PROPERTY SETTLEMENTS — TRANSFERS BETWEEN SPOUSES

There is no recognized gain or loss on the transfer of property between spouses under I.R.C. §1041. This rule applies to transfers after July 18, 1984. **The recipient spouse takes the transferor spouse's basis, similar to the basis rules for gifted property.** This rule, though convenient, can pose delayed tax problems to the recipient spouse as explained in the following example.

**Example 9.** Tom and Judy were divorced in 2002. They jointly owned two apartment buildings. The information relating to the two buildings as of the date of divorce is shown below.

Property	Date Purchased	Purchase Price	Prior Depreciation	Adjusted Basis
1) 8 unit apartment	1992	\$300,000	\$88,002	\$211,998
2) 5 unit apartment	1970	90,000	75,000	15,000

The 5-unit apartment building bought in 1970 is completely depreciated as of the date of the divorce in 2002. The building was assigned a 30-year life in 1970 and the straight line method was used. The \$15,000 adjusted basis is the value assigned to the lot when the building was purchased.

The fair market values and outstanding debt as of the date of divorce for the two apartment buildings are shown below.

Property	Fair Market Value	Mortgage Balance
1) 8 unit apartment	\$400,000	\$170,000
2) 5 unit apartment	\$270,000	None

In the property settlement, Judy received the 5-unit apartment building and Tom received the 8-unit apartment building.

**Question 9A.** What is Judy's basis in the 5-unit apartment building following the divorce?

**Answer 9A.** She already owned half of the building prior to the divorce since it was owned in joint tenancy. She acquired Tom's half of the building in the property settlement. Due to I.R.C. §1041, she acquires his adjusted basis in his half of the property. Therefore, after the divorce, she owns 100% of the building. Her basis is the \$15,000 adjusted basis (cost of lot) shown above.

**Question 9B.** What are the tax consequences to Judy if she sells the 5-unit apartment building in 2005 for \$275,000 after subtracting expenses of sale?

**Answer 9B.** Judy will have a \$260,000 gain computed as follows:

Sales price in 2005	\$290,000
Less: Expense of sale	( 15,000)
Less: Adjusted basis (cost of lot)	(15,000)
Gain recognized (Part III, Form 4797)	\$260,000

**Question 9C.** How much tax will Judy owe in 2005 on her \$260,000 gain? Assume no further change in tax law and that Judy is in the 29% tax bracket in 2005.

**Answer 9C.** \$55,750 as shown in the following computation:

- There is no I.R.C. §1250 ordinary income recapture since straight line depreciation was used.
  - The unrecaptured I.R.C. §1250 gain is \$75,000, the amount of the straight line depreciation.  
It is taxed at a 25% rate.  $75,000 \times 25\% = 18,750$
  - The remaining gain of \$185,000 (total gain of \$260,000 – \$75,000) is I.R.C. §1231 gain.  
It is taxed at a 20% rate.  $185,000 \times 20\% = 37,000$
- Total 2005 tax on the \$260,000 gain \$55,750

**Question 9D.** What could Judy have done to prevent or reduce this large tax liability in 2005?

**Answer 9D.** She could have negotiated to receive high basis property in the property settlement rather than the 5-unit apartment building. This is especially important if she anticipates cash flow problems after the divorce.

**Examples of high basis property Judy could have received.** Stocks or mutual funds which had declined or slightly increased in value.

In addition, Judy could have received the personal residence and a vacation home. The gain on the sale of these could be excluded under I.R.C. §121 with proper tax planning.

**Question 9E.** What other tax planning advice might help Judy prevent or reduce this large 2005 tax liability from the sale of the apartment building?

**Answer 9E.** If Judy didn't need the cash, she could trade the apartment building for other property in an I.R.C. §1031 tax-free exchange, or Judy could borrow money, preferably via a home equity loan, in 2005 to meet her cash flow needs. That might be a tax-wise alternative to selling the apartment building.

If a sale was the only alternative, she could have used the installment sale method. The tax result might have been a lower 2005 tax bracket for Judy.

**Caution.** Another substantial delayed tax problem in divorce is retirement plans. If one spouse is awarded a portion of or all of the other spouse's 401(k) plan, any distributions received would be taxable as ordinary income in the year received.

**Conclusion.** The tax rules of I.R.C. §1041 are advantageous to both spouses at the time of the divorce. However, there may be eventual tax consequences if transferred property is later disposed. Those consequences can be substantial, especially for low basis property received. This potential tax trap should be considered in negotiating a divorce property settlement.

**Note.** See pages 301-307 in the *2001 Farm Income Tax Workbook* for information regarding unrecaptured I.R.C. §1250 gain.

## Other Tax Considerations Regarding Property Transferred in Divorce After July 18, 1984 (Table 4 from IRS Pub. 504, *Divorced or Separated Individuals*)

### Property Transferred Pursuant to Divorce

The tax treatment of items of property transferred from you to your spouse or former spouse pursuant to your divorce is shown below.

IF You Transfer:	THEN You:	AND Your Spouse or Former Spouse:	FOR more Information, See:
Income producing property (such as an interest in a business rental property, stocks, or bonds)	Include on your tax return any profit or loss, rental income or loss, dividends, or interest generated or derived from the property during the year until the property is transferred	Reports any income or loss generated or derived after the property is transferred.	
Interest in a passive activity with unused passive activity losses	Cannot deduct your accumulated unused passive activity losses allocable to the interest.	Increases the adjusted basis of the transferred interest by the amount of the unused losses.	Publication 925, <i>Passive Activity and At-Risk Rules</i>
Investment credit property with recapture potential	Do not have to recapture any part of the credit.	May have to recapture part of the credit if he or she disposes of the property or changes its use before the end of the recapture period.	Form 4255, <i>Recapture of Investment Credit</i>

### ISSUE 3: ESTIMATED TAX PAYMENTS

The proper crediting of estimated tax payments by divorced spouses can be a problem area.

**Example 10.** Leon and Marsha Williams filed a **joint 2001 tax return**. The \$4,000 overpayment on it was credited to their 2002 joint return. They made one 2002 joint estimated tax payment of \$3,000 on June 15, 2002. However, they were divorced in November 2002. The divorce decree contained this clause:

It is agreed that Leon will be entitled to claim \$5,000 of the \$7,000 total 2002 estimated tax payments made to IRS on his 2002 federal tax return. It is also agreed that Marsha will be entitled to claim the remaining \$2,000 of 2002 estimated tax payments on her 2002 federal tax return.

Leon did not remarry in 2002. Marsha remarried Trevor Short on December 31, 2002.

Individual	Social Security Number
Leon Q. Williams	333-33-3333
Marsha A. Short	444-44-4444
Trevor T. Short	555-55-5555



# 2002 Workbook

**Question 10A.** Will this agreement in the divorce decree be honored by the IRS?

**Answer 10A.** Yes, according to IRS Pub. 504 which states:

*If you and your spouse made joint estimated tax payments for 2002 but file separate returns, either of you can claim all of your payments, or **you can divide them in any way on which you both agree.***

If Leon claims \$5,000 estimated tax payments on his 2002 single return and Marsha and Trevor claim \$2,000 on their 2002 joint return, there should be no ultimate IRS objections. Leon and Marsha must follow these instructions shown in IRS Pub 504:

*If you claim any of the payments on your tax return, enter your spouse's or former spouse's social security number in the space provided on the front of Form 1040 or Form 1040A.*

*If you were divorced and remarried in 2002, enter your present spouse's social security number in that space. Also enter your former spouse's social security number, followed by "DIV" to the left of line 60, Form 1040, or line 38, Form 1040A.*

## Excerpts from Leon's 2002 Form 1040

Form <b>1040</b>		Department of the Treasury—Internal Revenue Service		<b>2002</b>		(99) IRS Use Only—Do not write or staple in this space.	
<b>Label</b> (See instructions on page 19.)  <b>Use the IRS label.</b> Otherwise, please print or type.  <b>Presidential Election Campaign</b> (See page 19.)	<b>L A B E L  H E R E</b>	For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2002, ending , 20		OMB No. 1545-0074			
		Your first name and initial <b>Leon Q.</b>		Last name <b>Williams</b>		Your social security number <b>333 33 3333</b>	
		If a joint return, spouse's first name and initial		Last name		Spouse's social security number <b>444 44 4444</b>	
		Home address (number and street). If you have a P.O. box, see page 19.		Apt. no.		<b>▲ Important! ▲</b> You <b>must</b> enter your SSN(s) above.	
		City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.					
<b>Note.</b> Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want \$3 to go to this fund? . . . ▶				You      Spouse		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> Yes <input type="checkbox"/> No	
<b>Filing Status</b>  Check only one box.	1	<input checked="" type="checkbox"/>	Single				
	2	<input type="checkbox"/>	Married filing joint return (even if only one had income)				
	3	<input type="checkbox"/>	Married filing separate return. Enter spouse's social security no. above and full name here. ▶				
	4	<input type="checkbox"/>	Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶				
	5	<input type="checkbox"/>	Qualifying widow(er) with dependent child (year spouse died ▶ ). (See page 19.)				
<b>Payments</b>  If you have a qualifying child, attach Schedule EIC.	59	Federal income tax withheld from Forms W-2 and 1099 . . .		59			
	60	2002 estimated tax payments and amount applied from 2001 return . . .		60	<b>5,000</b>	<b>00</b>	
	61a	Earned income credit (EIC) . . . . .		61a			
	b	Nontaxable earned income . . . . . 61b					
	62	Excess social security and RRTA tax withheld (see page 51)		62			
	63	Additional child tax credit. Attach Form 8812 . . . . .		63			
	64	Amount paid with request for extension to file (see page 51)		64			
	65	Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136		65			
66	Add lines 59, 60, 61a, and 62 through 65. These are your <b>total payments</b> . . . ▶		66		<b>5,000</b>	<b>00</b>	

## Excerpts from Trevor and Marsha's Joint 2002 Form 1040

<b>Form 1040</b> Department of the Treasury—Internal Revenue Service <b>2002</b> (99) IRS Use Only—Do not write or staple in this space.																																																																																				
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**Question 10B.** What will be the likely result if Leon and Marsha do not have an agreement regarding the 2002 joint estimated tax payments of \$7,000? Assume each claims the entire \$7,000 on their respective 2002 tax returns.

**Answer 10B.** The likely outcome is numerous notices from the IRS Service Center. IRS Pub. 504 states the policy Service Centers use when an agreement is not reached:

*If you cannot agree, you must divide the estimated tax payments in proportion to your individual tax amounts as shown on your separate returns for 2002.*

Similar to other unagreed tax issues between divorcing spouses, the resolution of the unresolved estimated tax dispute is unpredictable. In many cases, without an agreement, the estimated tax payments are initially credited to the primary taxpayer whose social security number appears first on the Form 1040-ES.

See page 405 in the *2001 Farm Income Tax Workbook* for an example of that detrimental result to the wife (IRS Chief Counsel Advice 200130036 dated May 25, 2001). The rationale of this ruling is that **an agreement was made** because the **husband claimed all** of the estimated taxes on his separate return and the **wife claimed none** on her separate return. The wife subsequently asked to have part of the estimated taxes credited to her. **The IRS's answer was no, since filing the returns constituted an agreement to allocate all of the estimated taxes to the husband.**

**Note.** For more guidance in this troublesome area, see *IRS Letter Ruling 200011047* (Service Center Advice Memo) dated January 19, 2000.

**Conclusion.** Experienced divorce attorneys recognize that joint estimated tax payments are an item to resolve in property settlement negotiations. If your client is in the divorce process, try to ensure that an estimated tax agreement is part of the divorce decree.

Another potential issue in divorce is what portion of an income tax refund, if any, each ex-spouse will receive. This is another issue which should be resolved in the divorce decree.

## PROBLEM 7: DISTRIBUTIONS FROM COMMERCIAL ANNUITIES

With an increasingly aging population, many older taxpayers are now beginning to receive distributions from commercial annuities they purchased from life insurance companies. Commercial annuities are often referred to as nonqualified plans. Most taxpayers who own commercial annuities do not choose to annuitize distributions over their life expectancy. Instead they receive distributions as they need them for cash flow purposes.

**Example 11** involves a commercial annuity with these facts:

1. The variable annuity was purchased **after** August 13, 1982.
2. The annuity starting date is June 14, 2020.
3. The investment in the contract (premiums paid) by the owner is \$110,000. The premiums were paid in 1990-1992.
4. The owner never received any loans from the annuity.
5. The owner and annuitant, Sandra Theobald, reached age 59½ in 2001.
6. Sandra received her first nonperiodic annuity distribution on October 10, 2002. The amount of the gross distribution was \$15,000 which she used for vacation purposes.
7. The cash value of the variable annuity contract (figured without regard to any surrender charge) was \$326,000 on October 9, 2002.

**Example 11.** Assume the facts shown above. Sandra will receive a \$13,500 check from the life insurance company in October 2002.

**Question 11A.** How much of the gross distribution of \$15,000 is taxable?

**Answer 11A.** All of it is taxable. Sandra will receive a 2002 Form 1099-R from the payer. It is shown on the following page.

## For Example 11

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code  <b>Santa Fe Life Insurance Company</b>		1 Gross distribution <b>\$ 15000.00</b>		OMB No. 1545-0119  <b>2002</b> Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
		2a Taxable amount <b>\$ 15000.00</b>			
		2b Taxable amount not determined <input type="checkbox"/>		Total distribution <input type="checkbox"/>	<b>Copy B</b> Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.
PAYER'S Federal identification number  <b>49-0000000</b>	RECIPIENT'S identification number  <b>999-99-9999</b>	3 Capital gain (included in box 2a)  \$		4 Federal income tax withheld  <b>\$ 15000.00</b>	
RECIPIENT'S name  <b>Sandra L. Theobald</b>  Street address (including apt. no.)  City, state, and ZIP code		5 Employee contributions or insurance premiums  \$		6 Net unrealized appreciation in employer's securities  \$	
		7 Distribution code  <b>7</b>	IRA/SEP/SIMPLE <input type="checkbox"/>	8 Other  \$ %	This information is being furnished to the Internal Revenue Service.
		9a Your percentage of total distribution %		9b Total employee contributions \$	
Account number (optional)  <b>14-20514904</b>		10 State tax withheld  \$		11 State/Payer's state no.	12 State distribution  \$
		13 Local tax withheld  \$		14 Name of locality	15 Local distribution  \$

Form 1099-R

Department of the Treasury - Internal Revenue Service

## Computation of the Taxable Portion of the Distribution

Sandra must include in her 2002 gross income the smaller of:

- the nonperiodic distribution of \$15,000, or
- the amount by which:
  1. the cash value of \$326,000 immediately before the distribution exceeds;
  2. Sandra's \$110,000 investment in the contract.

In other words, Sandra's nonperiodic annuity distributions **are allocated first to earnings (the taxable part) and then to her cost in the contract (the tax-free part)**. Her earnings immediately before the \$15,000 distribution were \$216,000 (\$326,000 cash value – \$110,000 premiums paid).

**Example 11** is straightforward. The facts are fairly typical. Most variable annuities sold in the last twenty years were invested in mutual funds. Many owners of these annuities benefited from the unprecedented bull stock market of the 1990s.

Since the insurance company has all of the necessary facts input in its computer system, the 1099-R should be correct and complete. The 1099-R which follows shows federal income tax withheld of \$1,500, or 10% of the taxable distribution. Sandra's distribution was subject to the normal withholding rules. However, she could have completed Form W-4P to elect to have either:

- more than 10% withheld, or
- no income tax withheld.

# 2002 Workbook

Since Sandra was over 59½ in 2002, she does not owe the 10% early distribution penalty on her 2002 Form 1040.

**Example 12.** Assume similar facts as **Example 11** except, the annuity was purchased before August 14, 1982. Further assume that:

- all of the \$110,000 of premiums (investment on contract) were paid **before August 14, 1982**; and
- the cash value of the annuity was \$326,000 immediately before the \$15,000 distribution on October 10, 2002.

**Question 12A.** How much of the gross distribution of \$15,000 is taxable?

**Answer 12A.** None of the \$15,000 is taxable. In **Example 12**, the \$15,000 distribution is taxable **only to the extent that it exceeds the \$110,000 cost of the contract** (the premiums paid prior to August 14, 1982.).

The 2002 Form 1099-R for **Example 12** is shown below.

## For Example 12

PAYER'S name, street address, city, state, and ZIP code <b>Santa Fe Life Insurance Company</b>		1 Gross distribution <b>\$ 15000.00</b>		OMB No. 1545-0119 <b>2002</b> Form 1099-R		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.  <b>Copy A</b> For Internal Revenue Service Center  File with Form 1096.  For Privacy Act and Paperwork Reduction Act Notice, see the <b>2001 General          Instructions for          Forms 1099,          1098, 5498,          and W-2G.</b>
		2a Taxable amount \$				
		2b Taxable amount not determined <input type="checkbox"/>		Total distribution <input type="checkbox"/>		
PAYER'S Federal identification number <b>49-0000000</b>	RECIPIENT'S identification number <b>999-99-9999</b>	3 Capital gain (included in box 2a) \$		4 Federal income tax withheld \$		
RECIPIENT'S name <b>Sandra L. Theobald</b>		5 Employee contributions or insurance premiums <b>\$ 15000.00</b>		6 Net unrealized appreciation in employer's securities \$		
Street address (including apt. no.)		7 Distribution code <b>7</b>	IRA/ SEP/ SIMPLE <input type="checkbox"/>	8 Other \$		
City, state, and ZIP code		9a Your percentage of total distribution %		9b Total employee contributions \$		
Account number (optional) <b>14-20514904</b>		10 State tax withheld \$		11 State/Payer's state no. \$		12 State distribution \$
		13 Local tax withheld \$		14 Name of locality \$		15 Local distribution \$

Form 1099-R

Cat. No. 14436Q

Department of the Treasury - Internal Revenue Service

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## Observations for Example 12.

1. Box 5 of the Form 1099-R above for **Example 12** shows \$15,000. This represents the insurance premiums (investment in contract) recovered tax free during 2002. Sandra recovered \$15,000 of her \$110,000 investment in 2002.
2. Box 2a, Taxable amount, is zero.

**Example 13.** Due to the very competitive marketing of commercial annuities, many taxpayers are exchanging old annuity products for new ones with better features. An annuity contract with one company can be exchanged for another annuity with a different company in a **nontaxable transaction** under I.R.C. §1035.

The 2002 Form 1099-R for **Example 13** is shown below.

### For Example 13

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code <b>West Virginia Mutual Life Insurance Company</b>		1 Gross distribution \$ <b>293278.21</b>		OMB No. 1545-0119 <b>2002</b> Form <b>1099-R</b>		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
		2a Taxable amount \$ <b>0</b>		2b Taxable amount not determined <input type="checkbox"/> Total distribution <input checked="" type="checkbox"/>		
PAYER'S Federal identification number <b>52-0000000</b>	RECIPIENT'S identification number <b>888-88-8888</b>	3 Capital gain (included in box 2a) \$		4 Federal income tax withheld \$		Copy B Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.
RECIPIENT'S name <b>Gerald T. West</b>		5 Employee contributions or insurance premiums \$ <b>110000.00</b>		6 Net unrealized appreciation in employer's securities \$		
Street address (including apt. no.)		7 Distribution code <b>6</b>	IRA/SEP/SIMPLE <input type="checkbox"/>	8 Other \$	%	This information is being furnished to the Internal Revenue Service.
City, state, and ZIP code		9a Your percentage of total distribution %		9b Total employee contributions \$		
Account number (optional) <b>14-20514904</b>		10 State tax withheld \$		11 State/Payer's state no.		12 State distribution \$
		13 Local tax withheld \$		14 Name of locality		15 Local distribution \$

Form **1099-R**

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### Observations for Example 13.

- Box 2a, Taxable amount, shows zero. The Instructions for form 1099-R state, "For a nontaxable I.R.C. §1035 exchange of life insurance, annuity, or endowment contracts, enter 0 (zero) in Box 2a."
- Box 5 shows the total premiums paid by Gerald.
- Box 7 shows a Distribution code 6, I.R.C. §1035 exchange.

**Conclusion.** Reporting nonperiodic distributions from commercial annuities is generally not difficult due to accurate and complete Forms 1099-R from the insurance company. The same is true for a complete surrender of an annuity contract at maturity, or for one that is annuitized.

IRS Pub. 575, *Pension and Annuity Income*, is a good reference source for annuity payments. IRS Pub. 571, *Tax-Sheltered Annuity Plans I.R.C. §403(b) Plans*, is also helpful. Help is also available from the Employee Plans Taxpayer Assistance telephone service. A special toll-free number has been established for this assistance. It is (877)829-5500 and is available during regular business hours.

**Note.** See pages 297-300 in the *2001 Farm Income Tax Workbook* for information relating to Civil Service annuities of retired federal employees.

## PROBLEM 8 : TEMPORARY VS. INDEFINITE ASSIGNMENT FOR CONSTRUCTION WORKERS

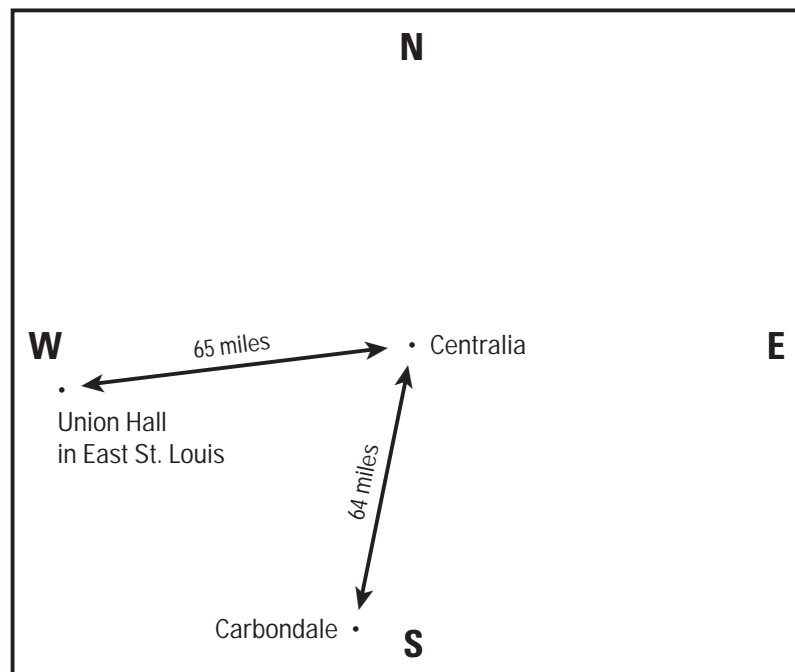
With the downturn in the economy, the issue of deducting travel and transportation expenses for **temporary** job locations may be more prevalent in 2002. A union construction job, in general, constitutes high income employment. Union and nonunion construction employees often must work away from their residence. The issue of deducting travel and transportation expenses is a contentious one as evidenced by the many court cases in this area. This issue can also be a difficult one for preparers due to an unintentional misunderstanding of the facts and lack of records.

Under I.R.C. 162(a)(2), deductible travel expenses (meals and lodging) must meet three tests:

1. They must be ordinary and necessary.
2. They must be incurred while away from home.
3. They must be incurred for a trade or business.

The first problem facing preparers is to determine the **tax home** of the client. The **tax home** for construction workers often is somewhere other than where their personal residence is located.

**Example 14.** Floyd, Linda, and their children live in Centralia, IL. He is a member of the United Steelworkers local with headquarters in East St. Louis, IL. The distance from Lloyd's personal residence to the union hall is 65 miles. Linda is an elementary teacher in Centralia. See the diagram below.



Floyd rarely works in Centralia. In **2002**, Lloyd had 10 temporary construction jobs. All but one of the 10 jobs was in the general area (30 mile radius) surrounding his East St. Louis union hall. He drove back and forth



between Centralia and these nine jobs in his pick-up truck in 2002, incurring no lodging. However, for approximately half of these round trips, he rode with another steelworker from Centralia in his vehicle.

He also worked for 12 weeks during the summer in Carbondale, IL on a construction job at Southern Illinois University. He drove back and forth from Centralia to Carbondale in his truck for **57 days** for this job, **a round trip of 128 miles**.

Floyd has been a member of the Steelworkers local in East St. Louis for 20 years. The majority of his union jobs during this period have been within a 30 mile radius of the union hall.

**Question 14A.** Where is Floyd's tax home in 2002?

**Answer 14A.** With the given facts for **Example 14**, the most likely answer is his **union headquarters** in East St. Louis. The fact that he did not have any job within a 30 mile radius of Centralia in 2002 is not helpful to him in trying to establish that Centralia is his tax home.

Excerpt from IRS Pub. 463, *Travel, Entertainment, Gift and Car Expenses*:

*To determine whether you are traveling away from home, you must first determine the location of your tax home. Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the entire city or general area in which your work is located. (Rev. Rul. 56-49)*

**Conclusion.** Trying to determine Floyd's tax home in 2002 poses a problem for a preparer. But it would appear that Floyd does have a **regular or principal place of business**, both historically, in general, and in 2002, in particular. It is **the entire city or general area** of his East St. Louis union headquarters which assigns him his jobs.

**Question 14B.** Assuming that Floyd's 2002 tax home is his union hall, what employee business expenses can Floyd deduct on his 2002 Form 2106?

**Answer 14B.** The mileage to the **temporary job** in Carbondale is deductible. There is no doubt as to this conclusion. The issue of determining **temporary vs. indefinite** is discussed later.

57 round trips to Carbondale  $\times$  128 miles = 7,296 miles

7,296 business miles  $\times$  36.5¢ = **\$2,663**

Floyd's completed 2002 Form 2106 is shown on the next page:

# 2002 Workbook

## For Example 14

Form <b>2106</b> (Rev. March 2002) Department of the Treasury Internal Revenue Service (99)	<b>Employee Business Expenses</b> ▶ See separate instructions. ▶ Attach to Form 1040.	OMB No. 1545-0139 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2002</div> Attachment Sequence No. <b>54</b>
Your name <b>Floyd</b>	Occupation in which you incurred expenses <b>Union steelworker</b>	Social security number <b>777 77 7777</b>

### Part I Employee Business Expenses and Reimbursements

Step 1 Enter Your Expenses	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.) . . . . .	1 <b>2,663</b>	
2 Parking fees, tolls, and transportation, including train, bus, etc., that <b>did not</b> involve overnight travel or commuting to and from work . .	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. <b>Do not</b> include meals and entertainment	3	
4 Business expenses not included on lines 1 through 3. <b>Do not</b> include meals and entertainment . . . . .	4	
5 Meals and entertainment expenses (see instructions) . . . . .	5	
6 <b>Total expenses.</b> In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5 . . . . .	6 <b>2,663</b>	

**Note:** If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.

### Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1

7 Enter reimbursements received from your employer that were <b>not</b> reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions) . . . . .	7 <b>0</b>	
--	------------	--

### Step 3 Figure Expenses To Deduct on Schedule A (Form 1040)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 . . . . .	8 <b>2,663</b>	
<b>Note:</b> If <b>both columns</b> of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 60% (.60) instead of 50%. For details, see instructions.) . . . . .	9 <b>2,663</b>	
10 Add the amounts on line 9 of both columns and enter the total here. <b>Also, enter the total on Schedule A (Form 1040), line 20.</b> (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter the total.) . . . . . ▶	10 <b>2,663</b>	

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11700N

Form **2106** (2002) (Rev. 3-2002)

## For Example 14

Form 2106 (2002) (Rev. 3-2002)

Page 2

**Part II Vehicle Expenses****Section A—General Information** (You must complete this section if you are claiming vehicle expenses.)

	(a) Vehicle 1	(b) Vehicle 2
11 Enter the date the vehicle was placed in service . . . . .	11 05 / 23 / 00	/ /
12 Total miles the vehicle was driven during 2001 . . . . .	12 22,496 miles	miles
13 Business miles included on line 12 . . . . .	13 7,296 miles	miles
14 Percent of business use. Divide line 13 by line 12 . . . . .	14 32 %	%
15 Average daily roundtrip commuting distance . . . . .	15 130 miles	miles
16 Commuting miles included on line 12 . . . . .	16 10,200 miles	miles
17 Other miles. Add lines 13 and 16 and subtract the total from line 12 . . . . .	17 5,000 miles	miles
18 Do you (or your spouse) have another vehicle available for personal use? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
19 Was your vehicle available for personal use during off-duty hours? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
20 Do you have evidence to support your deduction? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No
21 If "Yes," is the evidence written? . . . . .	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	<input type="checkbox"/> Yes <input type="checkbox"/> No

**Section B—Standard Mileage Rate** (See the instructions for Part II to find out whether to complete this section or Section C.)

22 Multiply line 13 by 36½¢ (.365) . . . . .	22 2,663
--	----------

**Section C—Actual Expenses**

	(a) Vehicle 1	(b) Vehicle 2
23 Gasoline, oil, repairs, vehicle insurance, etc. . . . .	23	
24a Vehicle rentals . . . . .	24a	
b Inclusion amount (see instructions) . . . . .	24b	
c Subtract line 24b from line 24a . . . . .	24c	
25 Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions) . . . . .	25	
26 Add lines 23, 24c, and 25 . . . . .	26	
27 Multiply line 26 by the percentage on line 14 . . . . .	27	
28 Depreciation. Enter amount from line 38 below . . . . .	28	
29 Add lines 27 and 28. Enter total here and on line 1 . . . . .	29	

**Section D—Depreciation of Vehicles** (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)

	(a) Vehicle 1	(b) Vehicle 2
30 Enter cost or other basis (see instructions) . . . . .	30	
31 Enter section 179 deduction and special allowance (see instructions) . . . . .	31	
32 Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance). . . . .	32	
33 Enter depreciation method and percentage (see instructions) . . . . .	33	
34 Multiply line 32 by the percentage on line 33 (see instructions) . . . . .	34	
35 Add lines 31 and 34 . . . . .	35	
36 Enter the limit from the table in the line 36 instructions . . . . .	36	
37 Multiply line 36 by the percentage on line 14 . . . . .	37	
38 Enter the <b>smaller</b> of line 35 or line 37. Also enter this amount on line 28 above . . . . .	38	



Form 2106 (2002)(Rev. 3-2002)

Once the issue of determining the location of a client's tax home is resolved, the next step is to determine if the client has an **indefinite or a temporary assignment** in 2002. Determining whether a taxpayer is in fact away from his/her tax home has always been a difficult issue. Revenue Ruling 93-86 explains the confusing rules for making this determination. The main concern of preparers and taxpayers in interpreting the Revenue Ruling is that it requires an uncanny ability to predict the future. Its rationale is based mainly on foresight rather than hindsight.

**Excerpts from IRS Pub. 463, Travel, Entertainment, Gift and Car Expenses** (Rev. Rul. 93-86):

*Temporary Assignment vs. Indefinite assignment. If your job away from your main place of work is temporary, your tax home does not change. You are considered to be away from home for the whole period you are away from your main place of work. You can deduct your travel expenses. See Table 1 for a summary of deductible expenses which follows. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less.*

**Note.** In **Example 14**, it is easy to determine that Floyd's 12-week job in Carbondale was a **temporary** job. It lasted less than a year and it is not within his main place of work in the greater East St. Louis area where his union hall is located.

## Travel Expenses You Can Deduct

This chart summarizes expenses you can deduct when you travel away from home for business purposes.

IF You Have Expenses for:	THEN You Can Deduct the Costs of:
Transportation	Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program your cost is zero. If you travel by ship, see <i>Luxury Water Travel and Cruise ships</i> (under <i>Conventions</i> ) for additional rules and limits.
Taxi, commuter bus, and airport limousine	Fares for these and other types of transportation that take you between: 1) The airport or station and your hotel, and 2) The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
Baggage and shipping	Sending baggage and sample or display material between your regular and temporary work locations.
Car	Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
Lodging and meals	Your lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages taxes, and related tips. See <i>Meals</i> for additional rules and limits.
Cleaning	Dry cleaning and laundry.
Telephone	Business calls while on your business trip. This includes business communication by fax machine or other communication devices.
Tips	Tips you pay for any expenses in this chart.
Other	Other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

**Determining Temporary or Indefinite.** You must determine whether your assignment is temporary or indefinite **when you start work. If you expect a job to last for one year or less, it is temporary** unless there are facts or circumstances that indicate otherwise. **A job that is initially temporary may become indefinite due to changed circumstances.** A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

**Example 15.** Corey is a union electrician who lives in Peoria, IL and normally works in the general Peoria area. In 2002, he was assigned to a job in Bloomington, IL which was 43 miles from his residence. When he started the Bloomington job on March 11, 2002, he was told by his Peoria IBEW union that it would last approximately eight months. However, on November 20, 2002, the union asked him to remain on the job for another four months. He did so and the job terminated on April 16, 2003.

**Question 15A.** Is Corey's Bloomington, IL job temporary or indefinite?

**Answer 15A.** Per Rev. Rul. 93-86 and IRS Pub. 463, the answer is **both**. Since Corey realistically expected the job to last only 8 months **when he began the job**, it is **temporary from March 11 through November 20, 2002**. However, due to changed circumstances, it was no longer realistic for Corey to expect that the Bloomington job would last for **one year or less** after November 20, 2002. Therefore, the job became **indefinite from November 21, 2002 through the completion date on April 16, 2003**.

**Question 15B.** What expenses may Corey deduct on his 2002 Form 2106?

**Answer 15B.** His round trip mileage for the 176 round trips between his Peoria residence and the Bloomington job site from March 11, 2002 through November 20, 2002.

176 round trips to Bloomington  $\times$  86 miles = 15,136 miles

15,136 business miles  $\times$  36.5¢ = **\$5,525**

**Observation.** Even though the rationale of Rev. Rul. 93-86 seems difficult to follow, the application of it does place great reliance on what the union hall tells the worker when the job is assigned. Most construction projects last less than a year. But some do not. Examples of the latter would include:

- Construction of nuclear power plants (not a hot item now but it could be in the future)
- Construction of large corporate, commercial, governmental, or university buildings

**Question 15C.** Assume that Corey stayed in a Bloomington motel for two nights in March 2002 due to an ice storm instead of driving back to Peoria. What travel expenses could he deduct for meals and lodging on his 2002 Form 2106?

**Answer 15C.** He could deduct the standard meal allowance of **\$30 a day for the three days** he was away from his Peoria residence. Due to the 50% limitation, Corey could deduct **\$45 of meals** on his 2002 Form 2106. This standard meal allowance is revised every October 1. These are called the CONUS (continental United States) per diem rates. In addition, Corey could deduct his actual lodging expenses for the two nights.

**Note.** The standard \$30 per day meal allowance, which applies to most locations in the United States, could change on October 1, 2002. This allowance can be used by both employees and self-employed individuals whether or not reimbursement is received. Most major cities are designated as **high-cost areas** which qualify for higher standard meal allowances of \$34, \$38, \$42, or \$46 through September 30, 2002. These higher CONUS per diem rates, for the period October 1, 2002 through September 30, 2003 can be found at [www.policyworks.gov/perdiem](http://www.policyworks.gov/perdiem).

## PROBLEM 9: FORM 4835 (FARM RENTAL INCOME AND EXPENSES) TAXATION ISSUES

Form 4835 is used by many Illinois landowners to report farm rental income based on crops and livestock shares produced by the tenant. Listed below are the important tax aspects of Form 4835.

**The form is to be used by those landowners who do not materially participate (for self-employment tax purposes) in the operation or management of the farm.**

**Example 16.** Edna is an 85-year old widow. Her husband, Elmer, who was an operating farmer, died in 1990. Edna inherited 300 acres from Elmer. She has crop share rented the 300 acres to Mark, an unrelated tenant farmer, since 1990. She receives 50% of the crops as rental income. She lives in Macomb, IL and rarely visits the farm which is located 40 miles from her residence.

Her tenant farmer makes all of the farm management decisions without consulting Edna. Edna and her tenant have an oral agreement that when Mark sells his grain to the elevator, he also sells an equal portion of Edna's crop share grain.

**Question 16A.** With the facts in **Example 16**, what form should Edna use for 2002 to report her farm rental income and expenses, Schedule F or Form 4835?

**Answer 16A.** This is an easy decision. Edna does **not meet any of the four material participation tests** shown below in 2002. Therefore she should file a Form 4835 to report her 2002 farm rental income and expenses.

Excerpt from the *Farmer's Tax Guide* (IRS Pub. 225):

*Rent paid in the form of crop shares is included in earnings subject to SE tax for the year you sell, exchange, give away, or use the crop shares **if you meet one of the four material participation tests** discussed next at the time the crop shares are produced.*

*You do any three of the following:*

1. *Pay at least half the direct costs of producing the crop or livestock.*
  - a. *Furnish at least half the tools, equipment, and livestock used in the production activities.*
  - b. *Advise or consult with your tenant.*
  - c. *Inspect the production activities periodically.*
2. *You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.*
3. *You work 100 hour or more spread over a period of 5 weeks or more in activities connected with agricultural production.*
4. *You do things that, considered in their totality, show that you are materially and significantly involved in the production of the farm commodities.*

**Example 17.** Howard, who is 64 years old in 2002, declared his retirement after harvesting his 2001 crops. He became eligible for Social Security benefits on December 1, 2001. He owns 550 acres of farmland. He and his wife, Donna, received \$24,000 of Social Security benefits in 2002.

- Howard's Social Security benefit — \$14,000
- Donna's Social Security benefit — \$10,000

He began to crop share rent his 550 acres to his son Mike in the spring of 2002. Howard and Donna live in a residence located on the 550 acres. Howard is in good health and is extremely active in making farm management decisions. In fact, in Mike's opinion, he makes too many of these decisions. Howard worked over 500 hours in May, June, July, September, and October of 2002 in agricultural production activities. He insisted on operating the combine for all of the 2002 harvest on his 550 acres.

**Question 17A.** With the facts in **Example 17**, which form should Howard use for 2002 to report his farm rental income and expenses, Schedule F or Form 4835?

**Answer 17A.** The correct answer is Schedule F as he certainly meets tests 2, 3, and 4 shown above.



**Question 17B.** If Howard is your tax client, which form will you use to report his 2002 farm rental income and expenses?

**Answer 17B.** (Intentionally left blank to protect both the innocent and the guilty!)

**Observation.** From a practical standpoint, this issue is rarely raised in an IRS exam of landlords. Factual situations similar to Howard's in **Example 17** are very common in Illinois. This issue is one that poses ethical problems for preparers. In some cases, ascertaining the facts are difficult, both for preparers and IRS examiners.

A reverse factual situation explained in **Example 18** can pose identical problems.

**Example 18.** Marsha, who is 55 years old in 2002, has been an elementary teacher employed by the same public school system since she graduated from college in 1978. She is single and has never contributed to FICA or Medicare. She plans to retire in 10 years and would like to qualify for Medicare when she does without payment of a large premium.

Marsha inherited 260 acres of farmland from her mother in January 2002. The farmland is located in the central part of the state and she lives in a northern metropolitan area in the same state. She will continue the 50/50 crop share arrangement that her mother had with the tenant farmer, T.J., in 2002. She knows very little about farming but she trusts T.J. to make the correct farm management decisions.

**Question 18A.** With the facts in **Example 18**, what form should Marsha use for 2002 to report her farm rental income and expenses?

**Answer 18A.** If she can meet even 1 of the 4 material participation tests shown previously, she should use Schedule F. To qualify for Medicare, she needs 40 quarters (also called credits) of self-employment earnings prior to her retirement from teaching. By reporting her farm rental income and expenses on Schedule F for 10 years beginning in 2002, she should accomplish her goal, assuming she meets the minimum income requirements.

**Note.** A taxpayer does not pay a monthly Part A (hospital insurance) Medicare premium if he/she or his/her spouse have 40 or more quarters of Medicare-covered employment. A \$319 per month (for 2002) premium is paid by individuals who are not otherwise eligible for premium-free hospital insurance and have less than 30 quarters of Medicare covered employment. The Part A premium is \$175 for individuals with 30 to 39 quarters of Medicare-covered employment. The Part B (medical insurance) premium is \$54 for everyone.

**If an operating farmer retires from farming and begins to crop share lease his farmland to a tenant farmer, the initial Form 4835 could show very little or no income.**

**Example 19.** Assume the same facts as in **Example 17** for Howard. He retired from farming after harvesting his 2001 crops and began to crop share his farmland to his son in the spring of 2002. The rental agreement between Howard and his son was the typical 50/50 crop share lease in which Howard was to receive half of the crops raised on his 550 acres as rental income.

After you explain the law, Howard insists that you file a 2002 Form 4835 for his farm rental activities. He states: "I worked hard all my life and now we are getting Social Security. I sure don't want to pay anymore Social Security taxes on my farm rental income!"

**Question 19A.** If Howard does not sell any of his 2002 crop share grain until 2003, what will be the likely 2002 tax result for Howard and Donna?

Assume these facts for **2002** for Howard's farming and farm rental operations:

- He sold \$140,000 of **carryover grain he raised in 2001** when he was an operating farmer in **2002**.
- He did not sell any **2002** crop share grain until **2003**.
- He paid his half of the **2002** crop input costs (fertilizer, seed, etc.) in **2002**. These costs were related to his initial year of the 50/50 crop share arrangement with his son.

**Answer 19A.** Howard will file both a Schedule F and a Form 4835 for 2002. **The 2002 Form 4835 will show the following:**

Crop income, line 1 (no 2002 crops sold in 2002)	None
Ag subsidy income, lines 3a and 3b (for 2002 crops)	\$18,000
Other income, line 6 (fertilizer rebate)	1,000
<b>Gross farm rental income, line 7</b>	<b>\$19,000</b>
Chemicals, line 9 (for 2002 crops)	(\$5,000)
Depreciation, line 12 (on farm buildings and drainage tile)	(2,000)
Fertilizer, line 15 (for 2002 crops)	(13,000)
Insurance, line 18 (on farm buildings)	(1,000)
Interest, line 19a (on loans for grain bins)	(500)
Repairs, line 23 (on farm buildings and tile)	(2,000)
Seed, line 24 (for 2002 crops)	(8,000)
Farm organization dues, line 30a	(75)
Farm magazines, line 30b	(80)
<b>Total expenses, line 31</b>	<b>(\$31,655)</b>
<b>Net farm rental loss, line 32</b>	<b>(\$12,655)</b>

Howard's completed 2002 Form 4835 is shown below. His 2002 Schedule F is shown later. Remember that his rental activities are by definition passive activities.

# 2002 Workbook

## For Example 19

Form <b>4835</b> Department of the Treasury Internal Revenue Service (99)	<b>Farm Rental Income and Expenses</b> (Crop and Livestock Shares (Not Cash) Received by Landowner (or Sub-Lessor)) (Income not subject to self-employment tax) ▶ Attach to Form 1040. ▶ See instructions on back.	OMB No. 1545-0187 <b>2002</b> Attachment Sequence No. <b>37</b>
Name(s) shown on Form 1040 <b>Howard and Donna</b>		Your social security number  Employer ID number (EIN), if any  
<b>A</b> Did you actively participate in the operation of this farm during 2002? See instructions . . . . . <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
<b>Part I Gross Farm Rental Income—Based on Production.</b> Include amounts converted to cash or the equivalent.		
<b>1</b> Income from production of livestock, produce, grains, and other crops . . . . .	<b>1</b>	
<b>2a</b> Total cooperative distributions (Form(s) 1099-PATR) <b>2a</b>	<b>2b</b> Taxable amount	
<b>3a</b> Agricultural program payments. See instructions <b>3a</b> <b>18,000</b>	<b>3b</b> Taxable amount	<b>18,000</b>
<b>4</b> Commodity Credit Corporation (CCC) loans. See instructions: <b>a</b> CCC loans reported under election . . . . . <b>4a</b> <b>b</b> CCC loans forfeited . . . . . <b>4b</b>	<b>4c</b> Taxable amount	
<b>5</b> Crop insurance proceeds and certain disaster payments. See instructions: <b>a</b> Amount received in 2001 . . . . . <b>5a</b> <b>c</b> If election to defer to 2002 is attached, check here <input type="checkbox"/> <b>5d</b> Amount deferred from 2000 . . . . . <b>5d</b>	<b>5b</b> Taxable amount	
<b>6</b> Other income, including Federal and state gasoline or fuel tax credit or refund. See instructions	<b>6</b>	<b>1,000</b>
<b>7</b> <b>Gross farm rental income.</b> Add amounts in the right column for lines 1 through 6. Enter the total here and on Schedule E (Form 1040), line 41 . . . . . ▶	<b>7</b>	<b>19,000</b>
<b>Part II Expenses—Farm Rental Property.</b> Do not include personal or living expenses.		
<b>8</b> Car and truck expenses. See Schedule F instructions—also attach <b>Form 4562</b> . . . . . <b>8</b>		
<b>9</b> Chemicals . . . . . <b>9</b> <b>5,000</b>		
<b>10</b> Conservation expenses (see instructions) . . . . . <b>10</b>		
<b>11</b> Custom hire (machine work) . . . . . <b>11</b>		
<b>12</b> Depreciation and section 179 expense deduction not claimed elsewhere . . . . . <b>12</b> <b>2,000</b>		
<b>13</b> Employee benefit programs other than on line 21. See Schedule F instructions . . . . . <b>13</b>		
<b>14</b> Feed purchased . . . . . <b>14</b>		
<b>15</b> Fertilizers and lime . . . . . <b>15</b> <b>13,000</b>		
<b>16</b> Freight and trucking . . . . . <b>16</b>		
<b>17</b> Gasoline, fuel, and oil . . . . . <b>17</b>		
<b>18</b> Insurance (other than health) . . . . . <b>18</b> <b>1,000</b>		
<b>19</b> Interest: <b>a</b> Mortgage (paid to banks, etc.) . . . . . <b>19a</b> <b>500</b> <b>b</b> Other . . . . . <b>19b</b>		
<b>20</b> Labor hired (less employment credits). See Schedule F instructions . . . . . <b>20</b>		
<b>21</b> Pension and profit-sharing plans . . . . . <b>21</b>		
<b>22</b> Rent or lease. See instructions: <b>a</b> Vehicles, machinery, and equipment . . . . . <b>22a</b> <b>b</b> Other (land, animals, etc.) . . . . . <b>22b</b>		
<b>23</b> Repairs and maintenance . . . . . <b>23</b> <b>2,000</b>		
<b>24</b> Seeds and plants purchased . . . . . <b>24</b> <b>8,000</b>		
<b>25</b> Storage and warehousing . . . . . <b>25</b>		
<b>26</b> Supplies purchased . . . . . <b>26</b>		
<b>27</b> Taxes . . . . . <b>27</b>		
<b>28</b> Utilities . . . . . <b>28</b>		
<b>29</b> Veterinary, breeding, and medicine . . . . . <b>29</b>		
<b>30</b> Other expenses (specify): <b>a</b> <b>Farm Bureau Dues</b> . . . . . <b>30a</b> <b>75</b> <b>b</b> <b>Farm Magazines</b> . . . . . <b>30b</b> <b>80</b> <b>c</b> . . . . . <b>30c</b> <b>d</b> . . . . . <b>30d</b> <b>e</b> . . . . . <b>30e</b> <b>f</b> . . . . . <b>30f</b> <b>g</b> . . . . . <b>30g</b>		
<b>31</b> <b>Total expenses.</b> Add lines 8 through 30g . . . . . ▶	<b>31</b>	<b>(31,655)</b>
<b>32</b> <b>Net farm rental income or (loss).</b> Subtract line 31 from line 7. If the result is income, enter it here and on Schedule E, line 39. If the result is a loss, you <b>must</b> go on to line 33 . . . . .	<b>32</b>	<b>(12,655)</b>
<b>33</b> If line 32 is a loss, you <b>must</b> check the box that describes your investment in this activity. See instructions . . . . . You may need to complete <b>Form 8582</b> to determine your deductible loss, regardless of which box you check (see instructions). However, if you checked 33b, you <b>must</b> complete <b>Form 6198</b> before going to Form 8582. In either case, enter the deductible loss here and on Schedule E, line 39 . . . . . <b>PAL</b>	<b>33a</b> <input checked="" type="checkbox"/> All investment is at risk. <b>33b</b> <input type="checkbox"/> Some investment is not at risk.	<b>33c</b> <b>(6,100)</b>

For Paperwork Reduction Act Notice, see instructions on back.

Cat. No. 13117W

Form **4835** (2002)

**Question 19B.** Why is Question A at the top of Howard's Form 4835, "Did you actively participate in the operation of this farm in 2002?" answered yes?

**Answer 19B.** Question A relates to the "active participation in a rental real estate activity" rules for the passive activity loss limitations of I.R.C. §469. Howard easily met this active participation test for his farm rental activity in 2002. **The active participation test for the passive loss limitation rules is different from the material participation test for self-employment tax purposes.**

Excerpt from Instructions for Form 8582 (*Passive Activity Loss Limitations*):

*If you actively participated in a passive rental real estate activity, you may be able to deduct from nonpassive income up to \$25,000 of loss from the activity. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities.*

*You may be treated as actively participating if, for example, you participated in making management decisions or arranged for others to provide services (such as repairs) in a significant sense. Management decisions that may count as active participation include:*

- *Approving new tenants*
- *Deciding on rental terms*
- *Approving capital or repair expenditures*
- *Other similar decisions*

**Question 19C.** What type of loss is the \$12,655 net farm rental loss shown on Form 4835, passive or nonpassive?

**Answer 19C.** It is a passive rental activity. The instructions on the reverse of Form 4835 state:

*Use this form only if the activity is a rental activity for purposes of the passive activity loss limitations. See the instructions for Form 8582, Passive Activity Loss Limitations, for the definition of "rental activity."*

**Note.** The instructions for Form 4835 are clear and unambiguous. If a taxpayer uses Form 4835 to report a crop share rental activity, he/she is admitting that the activity is a passive activity subject to the passive activity loss limitations rules. If the taxpayer is engaged in a **trade or business**, the crop share rental activity must be reported on Schedule F and subjected to self-employment tax if applicable.

**Question 19D.** Assume that Howard and Donna's 2002 modified AGI exceeds \$100,000. Do they have to file a 2002 Form 8582?

**Answer 19D. Yes.** There are two exceptions shown in the Form 8582 instructions. If either exception is met, Form 8582 does not have to be filed with Howard and Donna's 2002 joint return. They do not meet **Exception 1** because they do not have an overall passive loss. They also fail to meet **Exception 2** because their 2002 modified AGI exceeds \$100,000.

### Computation of Line 6, Form 8582 (2002 Modified AGI)

1) Interest income, line 8a, Form 1040	\$13,000
2) Dividend income, line 9, Form 1040	4,000
3) Form 4794 gain on sale of machinery, line 14, Form 1040 (I.R.C. §1245 ordinary gain)	9,800
4) Schedule F net profit, line 18, Form 1040 (the completed 2002 Schedule F is shown after the Form 8582)	111,000
2002 Modified AGI (line 6, Form 8582)	<u>\$137,800</u>

**Note.** In computing Howard and Donna's 2002 modified AGI, the following items are omitted per the Form 8582 instructions:

- The \$12,655 passive loss shown on line 1b, Form 8582
- The \$20,400 taxable amount of the \$24,000 social security benefits received (85% of Howard and Donna's \$24,000 benefits are taxable on line 20b, Form 1040)
- One-half, or \$6,750, of Howard's \$13,501 self-employment tax on the \$111,000 Schedule F net profit (line 27, Form 1040)

The following completed 2002 forms and schedules are shown next:

- Howard and Donna's Form 8582 (only \$6,100 of the \$12,655 Form 4835 passive loss is allowed in 2002).
- Howard's Schedule F (to report the sale of the carryover grain he raised in 2001 as an operating farmer less the related expenses).

### Howard's 2002 Schedule F Information

Sale of 2001 carryover crops (line 4)	\$140,000
Hedging loss (line 10)	(14,000)
Gross income	\$126,000
Truck expense (line 12)	\$2,100
Repairs (line 27)	300
2001 real estate taxes paid in 2002 (line 31)	12,000
Tax preparation fee (line 34a)	290
Office expenses (line 34b)	310

## For Example 19

Form <b>8582</b> Department of the Treasury Internal Revenue Service (99)	<b>Passive Activity Loss Limitations</b> ▶ See separate instructions. ▶ Attach to Form 1040 or Form 1041.	OMB No. 1545-1008 <b>2002</b> Attachment Sequence No. <b>88</b> Identifying number																		
Name(s) shown on return <b>Howard and Donna</b>																				
<b>Part I 2002 Passive Activity Loss</b> Caution: See the instructions for Worksheets 1 and 2 on page 8 before completing Part I.																				
<b>Rental Real Estate Activities With Active Participation</b> (For the definition of active participation see <b>Active Participation in a Rental Real Estate Activity</b> on page 3 of the instructions.)																				
<b>1a</b> Activities with net income (enter the amount from Worksheet 1, column (a)). . . . . <b>b</b> Activities with net loss (enter the amount from Worksheet 1, column (b)). . . . . <b>(Form 4835, line 32)</b> . . . . . <b>c</b> Prior years unallowed losses (enter the amount from Worksheet 1, column (c)). . . . . <b>d</b> Combine lines 1a, 1b, and 1c . . . . .	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"><b>1a</b></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>1b</b></td><td>( <b>12,655</b> )</td><td></td></tr> <tr><td><b>1c</b></td><td>( )</td><td></td></tr> <tr><td><b>1d</b></td><td><b>(12,655)</b></td><td></td></tr> </table>	<b>1a</b>			<b>1b</b>	( <b>12,655</b> )		<b>1c</b>	( )		<b>1d</b>	<b>(12,655)</b>		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>1d</b></td><td><b>(12,655)</b></td><td></td></tr> </table>				<b>1d</b>	<b>(12,655)</b>	
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<b>1b</b>	( <b>12,655</b> )																			
<b>1c</b>	( )																			
<b>1d</b>	<b>(12,655)</b>																			
<b>1d</b>	<b>(12,655)</b>																			
<b>All Other Passive Activities</b>																				
<b>2a</b> Activities with net income (enter the amount from Worksheet 2, column (a)). . . . . <b>b</b> Activities with net loss (enter the amount from Worksheet 2, column (b)). . . . . <b>c</b> Prior years unallowed losses (enter the amount from Worksheet 2, column (c)). . . . . <b>d</b> Combine lines 2a, 2b, and 2c . . . . .	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"><b>2a</b></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>2b</b></td><td>( )</td><td></td></tr> <tr><td><b>2c</b></td><td>( )</td><td></td></tr> <tr><td><b>2d</b></td><td></td><td></td></tr> </table>	<b>2a</b>			<b>2b</b>	( )		<b>2c</b>	( )		<b>2d</b>			<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>2d</b></td><td></td><td></td></tr> </table>				<b>2d</b>		
<b>2a</b>																				
<b>2b</b>	( )																			
<b>2c</b>	( )																			
<b>2d</b>																				
<b>2d</b>																				
<b>3</b> Combine lines 1d and 2d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c or 2c. <b>Do not</b> complete Form 8582. Report the losses on the forms and schedules normally used. If this line and line 1d are losses, go to Part II. Otherwise, enter -0- on line 9 and go to line 10 . . . . .																				
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>3</b></td><td><b>(12,655)</b></td><td></td></tr> </table>						<b>3</b>	<b>(12,655)</b>													
<b>3</b>	<b>(12,655)</b>																			
<b>Part II Special Allowance for Rental Real Estate With Active Participation</b> Note: Enter all numbers in Part II as positive amounts. See page 8 for examples.																				
Note: If your filing status is married filing separately and you lived with your spouse at any time during the year, <b>do not</b> complete Part II. Instead, enter -0- on line 9 and go to line 10.																				
<b>4</b> Enter the <b>smaller</b> of the loss on line 1d or the loss on line 3 . . . . .																				
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>4</b></td><td><b>12,655</b></td><td></td></tr> </table>						<b>4</b>	<b>12,655</b>													
<b>4</b>	<b>12,655</b>																			
<b>5</b> Enter \$150,000. If married filing separately, see page 8 . . . . . <b>6</b> Enter modified adjusted gross income, but not less than zero (see page 8) . . . . . Note: If line 6 is greater than or equal to line 5, skip lines 7 and 8, enter -0- on line 9, and go to line 10. Otherwise, go to line 7. <b>7</b> Subtract line 6 from line 5 . . . . . <b>8</b> Multiply line 7 by 50% (.5). <b>Do not</b> enter more than \$25,000. If married filing separately, see page 9 . . . . . <b>9</b> Enter the <b>smaller</b> of line 4 or line 8 . . . . .	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"><b>5</b></td><td style="width: 80%;"><b>150,000</b></td><td style="width: 10%;"></td></tr> <tr><td><b>6</b></td><td><b>137,800</b></td><td></td></tr> <tr><td><b>7</b></td><td><b>12,200</b></td><td></td></tr> </table>	<b>5</b>	<b>150,000</b>		<b>6</b>	<b>137,800</b>		<b>7</b>	<b>12,200</b>		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>8</b></td><td><b>6,100</b></td><td></td></tr> <tr><td><b>9</b></td><td><b>6,100</b></td><td></td></tr> </table>				<b>8</b>	<b>6,100</b>		<b>9</b>	<b>6,100</b>	
<b>5</b>	<b>150,000</b>																			
<b>6</b>	<b>137,800</b>																			
<b>7</b>	<b>12,200</b>																			
<b>8</b>	<b>6,100</b>																			
<b>9</b>	<b>6,100</b>																			
<b>Part III Total Losses Allowed</b>																				
<b>10</b> Add the income, if any, on lines 1a and 2a and enter the total . . . . .																				
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>10</b></td><td><b>0</b></td><td></td></tr> </table>						<b>10</b>	<b>0</b>													
<b>10</b>	<b>0</b>																			
<b>11</b> <b>Total losses allowed from all passive activities for 2001.</b> Add lines 9 and 10. See page 11 to find out how to report the losses on your tax return . . . . . <b>(Form 4835, line 33c)</b>																				
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 10%;"></td><td style="width: 80%;"></td><td style="width: 10%;"></td></tr> <tr><td><b>11</b></td><td><b>6,100</b></td><td></td></tr> </table>						<b>11</b>	<b>6,100</b>													
<b>11</b>	<b>6,100</b>																			
For Paperwork Reduction Act Notice, see page 12 of the instructions.																				

Cat. No. 63704F

Form 8582 (2002)

## For Example 19

### SCHEDULE F (Form 1040)

Department of the Treasury  
Internal Revenue Service (99)

### Profit or Loss From Farming

▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.

▶ See Instructions for Schedule F (Form 1040).

OMB No. 1545-0074

**2002**

Attachment  
Sequence No. **14**

Name of proprietor

**Howard**

Social security number (SSN)

A Principal product. Describe in one or two words your principal crop or activity for the current tax year.

**Corn and Soybeans**

B Enter code from Part IV

▶ **1 1 1 1 0 0**

D Employer ID number (EIN), if any

C Accounting method:

(1) ☒ Cash

(2) ☐ Accrual

E Did you "materially participate" in the operation of this business during 2002? If "No," see page F-2 for limit on passive losses. ☒ Yes ☐ No

### Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.) Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.

1	Sales of livestock and other items you bought for resale . . . . .	1		
2	Cost or other basis of livestock and other items reported on line 1 . . . . .	2		
3	Subtract line 2 from line 1 . . . . .	3		
4	Sales of livestock, produce, grains, and other products you raised . . . . .	4		<b>140,000</b>
5a	Total cooperative distributions (Form(s) 1099-PATR) . . . . .	5a		
5b	Taxable amount . . . . .	5b		
6a	Agricultural program payments (see page F-2) . . . . .	6a		
6b	Taxable amount . . . . .	6b		
7	Commodity Credit Corporation (CCC) loans (see page F-3):			
a	CCC loans reported under election . . . . .	7a		
b	CCC loans forfeited . . . . .	7b		
7c	Taxable amount . . . . .	7c		
8	Crop insurance proceeds and certain disaster payments (see page F-3):			
a	Amount received in 2002 . . . . .	8a		
8b	Taxable amount . . . . .	8b		
c	If election to defer to 2003 is attached, check here <input type="checkbox"/> 8d Amount deferred from 2001 . . . . .	8d		
9	Custom hire (machine work) income . . . . .	9		
10	Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) <b>Hedging Loss</b>	10		<b>(14,000)</b>
11	<b>Gross income.</b> Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . .	11		<b>126,000</b>

### Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses such as taxes, insurance, repairs, etc., on your home.

12	Car and truck expenses (see page F-4—also attach Form 4562) . . . . .	12		<b>2,100</b>
13	Chemicals . . . . .	13		
14	Conservation expenses (see page F-4) . . . . .	14		
15	Custom hire (machine work) . . . . .	15		
16	Depreciation and section 179 expense deduction not claimed elsewhere (see page F-4) . . . . .	16		
17	Employee benefit programs other than on line 25 . . . . .	17		
18	Feed purchased . . . . .	18		
19	Fertilizers and lime . . . . .	19		
20	Freight and trucking . . . . .	20		
21	Gasoline, fuel, and oil . . . . .	21		
22	Insurance (other than health) . . . . .	22		
23	Interest:			
a	Mortgage (paid to banks, etc.) . . . . .	23a		
b	Other . . . . .	23b		
24	Labor hired (less employment credits) . . . . .	24		
25	Pension and profit-sharing plans . . . . .	25		
26	Rent or lease (see page F-5):			
a	Vehicles, machinery, and equipment . . . . .	26a		
b	Other (land, animals, etc.) . . . . .	26b		
27	Repairs and maintenance . . . . .	27		<b>300</b>
28	Seeds and plants purchased . . . . .	28		
29	Storage and warehousing . . . . .	29		
30	Supplies purchased . . . . .	30		
31	Taxes . . . . .	31		<b>12,000</b>
32	Utilities . . . . .	32		
33	Veterinary, breeding, and medicine . . . . .	33		
34	Other expenses (specify):			
a	<b>Tax preparation fee</b> . . . . .	34a		<b>290</b>
b	<b>Office expenses</b> . . . . .	34b		<b>310</b>
c	. . . . .	34c		
d	. . . . .	34d		
e	. . . . .	34e		
f	. . . . .	34f		
35	<b>Total expenses.</b> Add lines 12 through 34f . . . . .	35		<b>15,000</b>
36	<b>Net farm profit or (loss).</b> Subtract line 35 from line 11. If a profit, enter on Form 1040, line 18, and also on Schedule SE, line 1. If a loss, you must go on to line 37 (estates, trusts, and partnerships, see page F-6) . . . . .	36		<b>111,000</b>
37	If you have a loss, you must check the box that describes your investment in this activity (see page F-6). • If you checked 37a, enter the loss on Form 1040, line 18, and also on Schedule SE, line 1. • If you checked 37b, you must attach Form 6198.			
37a	<input type="checkbox"/> All investment is at risk.			
37b	<input type="checkbox"/> Some investment is not at risk.			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11346H

Schedule F (Form 1040) 2002



## Observations Regarding Example 19

1. For many cash basis farmers, the year following their retirement from active farming can present unusually substantial income tax liabilities. Proper advance tax planning might lessen the tax burden. If the SSA became aware of the factional situation in 2002, SSA would force Howard to repay his 2002 Social Security benefits **since he has not retired from farming**, according to SSA rules.
2. Howard's 2002 Schedule F net farm profit of \$111,000 must be reported on his 2002 Schedule SE (not shown). **Howard's 2002 self-employment tax is \$13,501.** However, in the given solution for **Example 19**, Howard's 2002 \$11,633 self-employment tax liability will **not result in any reduction to Howard's 2002 Social Security benefits**. This is due to the **carryover crop exclusion** provision of the Social Security Regulations.
3. Since Howard worked at least 100 hours over a period of 5 weeks or more in agricultural production, both the IRS and SSA could challenge his use of Form 4835 for the 2002 crop-share rental arrangement. If the SSA became aware of the factional situation in 2002, SSA would force Howard to repay his 2002 Social Security benefits **since he has not retired from farming**, according to SSA rules.
4. Howard could reduce his 2002 SE tax by using only a 2002 Schedule F to report all farm-related income and expenses. However, the sale of his 2002 crops in 2003 would be subject to SE tax since Howard would be considered to have materially participated in their productions in 2002.
5. If Howard insists on use of Form 4835, he should be educated about the material participation rules and encouraged to reduce his participation in farming activities.
6. The \$12,000 of 2001 real estate taxes on Howard's improved 550 acres which he paid in 2002 are deducted on his Schedule F.

**Rationale to support a Schedule F deduction.** 2001 Illinois real estate taxes are assessed as of January 1, 2001 and are payable in 2002. Since Howard was an operating farmer in 2001, the 2001 taxes paid in 2002 are a carryover expense related to producing his 2001 crops. He sold the crops raised in 2001 in 2002 and the \$140,000 proceeds are reported on line 4 of Howard's 2002 Schedule F.

7. Howard's **2003 Form 4835** will probably show a significant net farm rental profit. This anticipated profit is passive income and will be entered on line 1a, Part I on the **2003 Form 8582** (Rental Real Estate Activities with net income).
8. The 2002 suspended **passive loss of \$6,555** will be entered on line 1c, Part I on the **2003 Form 8582** (Prior years unallowed losses). The computation of the suspended loss is shown below:

Total passive loss	\$12,655
Less: allowed passive loss	(6,100)
<b>2002 Suspended loss</b>	<b>\$6,555</b>

9. Even though there is considerable doubt about whether Howard is entitled to report his crop share farm rental activity on Form 4835, at least he is being consistent by filing both a 2002 and 2003 Form 4835 to report this activity.

The 2002 Form 4835 shows a loss and future Forms 4835 will likely show profits.

## PROBLEM 10: CHARITABLE REMAINDER TRUSTS

The Charitable Remainder Trust (CRT) has become a popular income and estate tax planning instrument. The grantor of a CRT receives: **a contribution deduction on Schedule A** in the year the trust is created equal to the present value of the remainder interest in the property transferred to the charity, and **annual income distributions**, usually for the remainder of the grantor's life.

By establishing a Charitable Remainder Trust, the grantor receives a guaranteed income stream and satisfies a charitable gifting need. In general, a CRT allows a donor to make a gift to charity while retaining a life interest in the property transferred to the trust.

The most effective Charitable Remainder Trust is one established during the donor's lifetime ("**inter vivos transfer**") rather than one created by operation of the will (testamentary transfer). The charitable deduction afforded the grantor of a **testamentary trust** obtains only an estate tax deduction for the remainder interest of the property earmarked for charity.

I.R.C. §664 provides strict rules for compliance of Charitable Remainder Trusts:

- Annual income must be paid to at least one non-charitable beneficiary over his or her lifetime, or joint lives for multiple beneficiaries, or over a fixed period of up to 20 years.
- The assets in the CRT pass irrevocably to the designated charity (or charities) when the non-charitable beneficiary's interest ends in the trust.
- The CRT is irrevocable and not a Grantor trust.
- The amounts paid to the non-charitable beneficiary (or beneficiaries) cannot be less than 5% of the fair market value of the property.

### ANNUAL TAX FILING REQUIREMENTS

The CRT is tax exempt, but annual tax returns are required on a calendar year basis. Form 5227 is used to reflect the financial activities for the year and to pay excise taxes, if any, on prohibited transactions. Tax on unrelated business income is calculated on Form 1041. The annual filing of Form 5227 includes Form 1041-K transmittals to the trust beneficiaries. In addition, Form 1041-A (Trust Accumulation of Charitable Amounts) must be filed on annual basis. The initial Form 5227 must include a true copy of the trust document.

**Note.** Financial planners often encourage donors to fund their Charitable Remainder Trust with appreciated property. Since the CRT is tax exempt, the property can be sold within the trust and capital gains taxes can be avoided. The result is the CRT has more principal to fund income payments to the non charitable beneficiary and to assist the charity.

Taxpayers who might be candidates for a Charitable Remainder Trust would include:

- older individuals or couples with a high net worth;
- individuals/couples needing additional current income;
- individuals with a low tax basis and a higher fair market value in their assets, combined with a desire to avoid capital gains taxes (see **Example 20**); or
- individuals with strong charitable inclinations.

The following uses can be made with the creation of a Charitable Remainder Trust:

- Portfolio Diversification,
- Fund a retirement plan without any restrictions,
- Minimize the detrimental tax results of the income in respect of decedent rules for IRA or qualified retirement plan distributions (see **Example 21**),
- Provide income for a disabled child,
- Provide for spendthrift provisions,
- Protect assets from nursing home expenses and other creditors,
- Fund college education for grandchildren,
- Provide for the payment of maintenance or fund payments under a prenuptial agreement,
- Ease of administration — as a separate trustee will oversee the CRT.

**Example 20.** John Mabry, age 65, and his wife, Sue, age 62, have a net worth in excess of \$3,000,000. John has successfully operated a tax practice all his adult life and wishes to retire. John is convinced that there will always be an estate tax in place regardless of current law provisions. He presently has an offer to sell his tax practice for \$500,000 (he has zero basis).

If John were to sell the business, he would pay the federal capital gain tax, applicable state income taxes, and he would also be liable for potential alternative minimum tax. A sale of his business would net him perhaps \$350,000 to invest at 6%, or \$21,000 a year. John and Sue have discussed the situation at length. They note that their children are financially secure and are poised to inherit most of their money eventually with or without changes to the federal estate tax law.

John and Sue have always been partial to Habitat for Humanity. They would like to see this charity receive a portion of their net worth. John could create a CRT and transfer his business interest into it. The business could then be sold by the trust to an unrelated party for \$500,000. John, Sue, and their children could expect annual income from the CRT of \$30,000 over the next 20 years (6% of \$500,000). **This is \$9,000 greater than he would have received if he had he sold the business and invested the net cash remainder.** In addition, John and Sue would be entitled to a charitable contribution deduction of \$105,215 on their income tax return for the year the CRT was created.

The charitable contribution deduction is arrived at by calculating the remainder interest using the actuarial tables in IRS Pub. 1457.

**Example 21.** Robert Bosworth, age 68, retired from Ameritech several years ago and rolled over his 401(k) proceeds into a self-directed IRA. This IRA is now valued at \$1,200,000 since Robert largely avoided tech stocks in his portfolio. Robert has other assets, including appreciated securities that total \$2,500,000. His daughter, Connie, is the beneficiary of his IRA. Robert recognizes that Connie's future inheritance of these other assets (excluding the IRA) will provide adequately for her since she is married and works as a school administrator.

Robert met with his estate planner to review his financial situation. He indicated that he would like to leave a portion of his estate to Coe College in Iowa. The estate planner shared his concerns about the retirement account being a part of his estate. The IRA, currently worth \$1,200,000, would

- be included in Robert's estate and subject to estate tax, and
- would be taxed at regular income tax rates to Connie when she received payments after his death.

The crafty estate tax planner suggests that Robert name a Charitable Remainder Trust as the beneficiary for the IRA and leave the balance of his estate to his daughter.

Further, the Charitable Remainder Trust would be created as a CRAT (Charitable Remainder Annuity Trust) which provides that fixed periodic payments will be made to a non-charitable beneficiary (Connie). Connie will receive an annual payment of \$72,000 (6% of \$1,200,000) for six years. The tax results are:

- Robert's estate tax is reduced;
- Robert is entitled to a charitable contribution deduction to Coe College in the year the CRAT is created; and
- the IRA proceeds are not taxed to the daughter.

Depending on Robert's year of death, and the applicable estate tax rates, the overall tax savings could be significant. It becomes a win-win situation as more overall wealth is transferred to both the charitable beneficiary (Coe College) and to the non-charitable beneficiary (Connie) since estate taxes are reduced and the income taxes on the IRA are eliminated.

**Note.** The non-charitable beneficiary's (Connie) periodic payments must at least equal 5% of the value of the IRA. The FMV is determined when the property is transferred to the trust for a charitable remainder annuity trust (CRAT), and annually for a charitable remainder unitrust (CRUT).

The following comparisons reflect the overall tax savings **if a CRT is set up as the beneficiary** for the IRA instead of having Connie named as beneficiary.

	Beneficiaries	
	Connie – IRA Coe College – Estate	CRT – IRA Connie – Estate
Gross Estate	\$3,700,000	\$3,700,000
Estate Tax Charitable Deduction	(1,200,000)	(863,076)
Taxable Estate	2,500,000	2,836,942
Estate Tax (2002 rates)	1,025,800	1,194,271
Income Tax on IRA (net of §691)	285,187	0
Net to Connie at Dad's death	1,189,013	1,305,729
Value of CRT annuity to Connie	0	336,924
<b>Total Value to Connie</b>	<b>\$1,189,013</b>	<b>\$1,642,653</b>

## CHARITABLE LEAD TRUSTS

Charitable Lead Trusts are a mirror image of Charitable Remainder Trusts. Charitable Lead Trusts (CLT) can provide an immediate benefit to a charity and a future benefit to the donor's family. CLTs are set up to provide an income interest to a charitable beneficiary for a period of time, after which the property reverts back to the grantor (or his non-charitable beneficiaries). The current prevailing low interest rates make a CLTs a desirable instrument for a taxpayer wanting to transfer assets to his children at a low transfer (gift tax) cost while meeting his own charitable goals.

**Example 22.** Uncle Jack transfers \$1,000,000 to a 15-year Charitable Lead Trust with an 8% charitable annuity in December 2002 when the I.R.C. §7520 rate is 5.4%. This means that Uncle Jack's favorite charities will reap \$80,000 cash a year for 15 years — then the amount is transferred to his children.

Annual Payout	\$80,000
Present Value of the Annuity	808,368
Remainder Interest	191,632
Charitable Deduction	808,368
Amount Subject to Gift Tax	191,632
Donor's Deduction as a Percentage of Amount Transferred	80.84%

**PROBLEM 11: RETAINED LIFE ESTATES**

A common estate tax planning strategy involves taxpayers gifting their personal residences, vacation homes, and business property such as a farm to their children while retaining the right to use the property for the rest of their lives. This transaction creates an immediate potential gift tax liability and a future estate tax inclusion item.

**Example 23.** On March 9, 1992, Steve Sands gave to his son, Bob, a remainder interest in his personal residence. Steve retained the right to live in the home for the rest of his life. At the time of this gift, the home was worth \$225,000 and Steve's tax basis (cost) was \$145,000. Steve was 72 years old on March 9, 1992, the date of the gift. Steve died in 2001. The appraised value of the home at the time of his death was \$290,000. In addition to the personal residence, Steve also had other assets that totaled \$1,400,000. Bob sold his father's home for \$315,000 in 2002.

**Question 23A.** What are the gift tax consequences of Steve's gift of the remainder interest in 1992?

**Answer 23A.** Since Steve made a gift of over \$10,000, a gift tax return should be filed by April 15, 1993. A transfer of the remainder interest without consideration is a gift for gift tax purposes.

The value of a remainder interest is determined using Table 5 from Treas. Reg. 20.2031-7 which is based on the age of the life tenant. The interest rate is 120% of the federal mid-term rate for the month of the gift, rounded to the nearest 0.2 of 1%. This is called the I.R.C. §7520 rate.

The full value of the property is multiplied by the factor from the table to determine the value of the remainder interest. For Steve, the value of the remainder interest is \$105,365 calculated as follows:

Fair market value of home at time of gift	\$225,000
Factor from table for 72 year old life tenant (7.6% interest rate March 1992)	× .46829
<b>Value of remainder interest</b>	<b>\$105,365</b>

Since the remainder interest is not a present interest (full gift will not be complete until Steve dies), the \$10,000 annual exclusion for 1992 did not apply. **The full \$105,365 represents a taxable 1992 gift, but no gift tax would be owed since Steve had made no prior taxable gifts during his lifetime.**

# 2002 Workbook

A copy of Steve's 1992 gift tax return (Form 709) is shown below.

Form <b>709</b> (Rev. November 1991)		<b>United States Gift (and Generation-Skipping Transfer) Tax Return</b> (Section 6019 of the Internal Revenue Code) (For gifts made after October 8, 1990, and before January 1, 1993)		OMB No. 1545-0020 Expires 8-31-93	
Department of the Treasury Internal Revenue Service		Calendar year 19 <b>92</b> ▶ See separate instructions. For Privacy Act Notice, see the Instructions for Form 1040.			
1 Donor's first name and middle initial <b>STEVE S</b>		2 Donor's last name <b>SANDS</b>		3 Social security number <b>186 55 5555</b>	
4 Address (number, street, and apartment number) <b>1818 WEST MUMFORD</b>				5 Legal residence (Domicile) <b>USA</b>	
6 City, state, and ZIP code <b>ARLINGTON HEIGHTS, IL 62005</b>				7 Citizenship <b>USA</b>	
8 If the donor died during the year, check here <input type="checkbox"/> and enter date of death . . . . ., 19 . . . . .				Yes	No
9 If you received an extension of time to file this Form 709, check here <input type="checkbox"/> and attach the Form 4868, 2688, 2350, or extension letter					
10 Enter the total number of separate donees listed on Schedule A—count each person only once . . . . . <input type="checkbox"/>					
11a Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If the answer is "No," do not complete line 11b.					<b>X</b>
11b If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)? . . . . .					<b>X</b>
12 Gifts by husband or wife to third parties.—Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. If the answer is "No," skip lines 13–18 and go to Schedule A.)					
13 Name of consenting spouse				14 SSN	
15 Were you married to one another during the entire calendar year? (See instructions.)					
16 If the answer to 15 is "No," check whether <input type="checkbox"/> married <input type="checkbox"/> divorced or <input type="checkbox"/> widowed, and give date (see instructions) ▶					
17 Will a gift tax return for this calendar year be filed by your spouse?					
18 <b>Consent of Spouse</b> —I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.					
Consenting spouse's signature ▶				Date ▶	
1 Enter the amount from Schedule A, Part 3, line 15 . . . . .				1	<b>105,365</b>
2 Enter the amount from Schedule B, line 3 . . . . .				2	
3 Total taxable gifts (add lines 1 and 2) . . . . .				3	<b>105,365</b>
4 Tax computed on amount on line 3 (see Table for Computing Tax in separate instructions). . . . .				4	<b>25,410</b>
5 Tax computed on amount on line 2 (see Table for Computing Tax in separate instructions). . . . .				5	
6 Balance (subtract line 5 from line 4) . . . . .				6	<b>25,410</b>
7 Maximum unified credit (nonresident aliens, see instructions) . . . . .				7	<b>192,800 00</b>
8 Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C) . . . . .				8	
9 Balance (subtract line 8 from line 7) . . . . .				9	<b>192,800</b>
10 Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions) . . . . .				10	
11 Balance (subtract line 10 from line 9) . . . . .				11	<b>192,800</b>
12 Unified credit (enter the smaller of line 6 or line 11) . . . . .				12	<b>25,410</b>
13 Credit for foreign gift taxes (see instructions) . . . . .				13	
14 Total credits (add lines 12 and 13) . . . . .				14	<b>25,410</b>
15 Balance (subtract line 14 from line 6) (do not enter less than zero) . . . . .				15	<b>0</b>
16 Generation-skipping transfer taxes (from Schedule C, Part 3, col. H, total) . . . . .				16	<b>0</b>
17 Total tax (add lines 15 and 16) . . . . .				17	<b>0</b>
18 Gift and generation-skipping transfer taxes prepaid with extension of time to file . . . . .				18	<b>0</b>
19 If line 18 is less than line 17, enter BALANCE DUE (see instructions) . . . . .				19	<b>0</b>
20 If line 18 is greater than line 17, enter AMOUNT TO BE REFUNDED . . . . .				20	<b>0</b>
Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.					
Donor's signature ▶				Date ▶	
Preparer's signature (other than donor) ▶				Date ▶	
Preparer's address (other than donor) ▶					

For Paperwork Reduction Act Notice, see page 1 of the separate instructions for this form.

Cat. No. 16783M

Form **709** (Rev. 11-91)

## SCHEDULE A

 Computation of Taxable Gifts

**Part 1.—Gifts Subject Only to Gift Tax.** *Gifts less political organization, medical, and educational exclusions—see instructions*

A Item number	B Donee's name, relationship to donor (if any), and address and description of gift. If the gift was made by means of a trust, enter trust's identifying number below and attach a copy of the trust instrument. If the gift was securities, enter the CUSIP number(s), if available.	C Donor's adjusted basis of gift	D Date of gift	E Value at date of gift
1				

**Part 2.—Gifts Which are Direct Skips and are Subject to Both Gift Tax and Generation-Skipping Transfer Tax.** *You must list the gifts in chronological order. Gifts less political organization, medical, and educational exclusions—see instructions. (Also list here direct skips that are subject only to the GST tax at this time as the result of the termination of an "estate tax inclusion period." See instructions.)*

A Item number	B Donee's name, relationship to donor (if any), and address and description of gift. If the gift was made by means of a trust, enter trust's identifying number below and attach a copy of the trust instrument. If the gift was securities, enter the CUSIP number(s), if available.	C Donor's adjusted basis of gift	D Date of gift	E Value at date of gift
1				

**Part 3.—Gift Tax Reconciliation**

1	Total value of gifts of donor (add column E of Parts 1 and 2)	1	105,365	
2	One-half of items ..... attributable to spouse (see instructions)	2		
3	Balance (subtract line 2 from line 1)	3	105,365	
4	Gifts of spouse to be included (from Schedule A, Part 3, line 2 of spouse's return—see instructions)	4		
	If any of the gifts included on this line are also subject to the generation-skipping transfer tax, check here <input type="checkbox"/> and enter those gifts also on Schedule C, Part 1.			
5	Total gifts (add lines 3 and 4)	5	105,365	
6	Total annual exclusions for gifts listed on Schedule A (including line 4, above) (see instructions)	6		
7	Total included amount of gifts (subtract line 6 from line 5)	7	105,365	
<b>Deductions</b> (see instructions)				
8	Gifts of interests to spouse for which a marital deduction will be claimed, based on items ..... of Schedule A	8		
9	Exclusions attributable to gifts on line 8	9		
10	Marital deduction—subtract line 9 from line 8	10		
11	Charitable deduction, based on items ..... to ..... less exclusions	11		
12	Total deductions—add lines 10 and 11	12		
13	Subtract line 12 from line 7	13	105,365	
14	Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)	14		
15	Taxable gifts (add lines 13 and 14). Enter here and on line 1 of the Tax Computation on page 1	15	105,365	

*(If more space is needed, attach additional sheets of same size.)*



# 2002 Workbook

**Question 23B.** What if Steve Sands ignored the filing of the gift tax return (Form 709) for 1992?

**Answer 23B.** Since there was no gift tax liability for 1992, there would be no late filing penalty due. However, Steve should file, even if late, to insure the running of the three year statute of limitation for the valuation of gifts.

**Question 23C.** What are the estate tax consequences of the retained life estate?

**Answer 23C.** The retained life estate causes the full value of the home at Steve's death, which is \$290,000, to be included in his gross estate. Therefore, the full value of the home is included in the amount (\$1,690,000) reported on line 1 of Form 706.

**Note.** The amount included on line 1 of Form 706 includes **both** the retained life estate that was **not** taxed as a gift in 1992 and the remainder interest that was. However, to prevent double taxation of the \$105,365, this amount is **not** included in the adjusted taxable gifts that are reported on line 4 of Form 706. The exclusion amount used in 1992 to offset the gift tax on \$105,365 is restored on line 11 of Form 706.

Form <b>706</b> (Rev. July 1999) Department of the Treasury Internal Revenue Service	<b>United States Estate (and Generation-Skipping Transfer) Tax Return</b> Estate of a citizen or resident of the United States (see separate instructions). To be filed for decedents dying after December 31, 1998 For Paperwork Reduction Act Notice, see page 1 of the separate instructions.	OMB No. 1545-0015
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<b>1a</b> Decedent's first name and middle initial (and maiden name, if any) <b>STEVE S.</b>	<b>1b</b> Decedent's last name <b>SANDS</b>	<b>2</b> Decedent's Soc. Sec. No. <b>186-55-5555</b>
<b>3a</b> Legal residence (domicile) at time of death (county, state, and ZIP code, or foreign country) <b>COOK, IL 62005</b>	<b>3b</b> Year domicile established <b>1920</b>	<b>4</b> Date of birth <b>07/15/1920</b>
<b>5</b> Date of death <b>03/15/2001</b>		
<b>6a</b> Name of executor (see page 4 of the instructions) <b>BOBO SANDS</b>	<b>6b</b> Executor's address (number and street including apartment or suite no. or rural route; city, town, or post office; state; and ZIP code) <b>15 SHADY GROVE MOBILE HOME PARK          SPRINGFIELD, IL 62705</b>	
<b>6c</b> Executor's social security number (see page 4 of the instructions) <b>155-22-2222</b>		
<b>7a</b> Name and location of court where will was probated or estate administered <b>COOK COUNTY CHICAGO ILLINOIS</b>		<b>7b</b> Case number <b>01-P-141</b>
<b>8</b> If decedent died testate, check here <input type="checkbox"/> and attach a certified copy of the will.		<b>9</b> If Form 4788 is attached, check here <input type="checkbox"/>
<b>10</b> If Schedule R-1 is attached, check here <input type="checkbox"/>		

<b>1</b> Total gross estate less exclusion (from Part 5, Recapitulation, page 3, item 12) .....	<b>1</b>	<b>1,690,000.</b>
<b>2</b> Total allowable deductions (from Part 5, Recapitulation, page 3, item 23) .....	<b>2</b>	
<b>3</b> Taxable estate (subtract line 2 from line 1) .....	<b>3</b>	<b>1,690,000.</b>
<b>4</b> Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after Dec. 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b))) ...	<b>4</b>	
<b>5</b> Add lines 3 and 4 .....	<b>5</b>	<b>1,690,000.</b>
<b>6</b> Tentative tax on the amount on line 5 from Table A on page 12 of the instructions .....	<b>6</b>	<b>641,300.</b>
<b>7a</b> If line 5 exceeds \$10,000,000, enter lesser of line 5 or \$17,184,000. If line 5 is \$10,000,000 or less, skip lines 7a & 7b & enter -0- on line 7c	<b>7a</b>	
<b>b</b> Subtract \$10,000,000 from line 7a .....	<b>7b</b>	
<b>c</b> Enter 5% (.05) of line 7b .....		<b>0.</b>
<b>8</b> Total tentative tax (add lines 6 and 7c) .....	<b>8</b>	<b>641,300.</b>
<b>9</b> 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) ..	<b>9</b>	
<b>10</b> Gross estate tax (subtract line 9 from line 8) .....	<b>10</b>	<b>641,300.</b>
<b>11</b> Maximum unified credit (applicable credit amount) against estate tax ..	<b>11</b>	<b>* 220,550.</b>
<b>12</b> Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed \$6,000. See page 4 of the instructions.) .....	<b>12</b>	<b>0.</b>
<b>13</b> Allowable unified credit (applicable credit amount) (subtract line 12 from line 11) .....	<b>13</b>	<b>220,550.</b>
<b>14</b> Subtract line 13 from line 10 (but do not enter less than zero) .....	<b>14</b>	<b>420,750.</b>
<b>15</b> Credit for state death taxes. Do not enter more than line 14. Figure the credit by using the amount on line 3 less \$60,000. See Table B in the instructions and attach credit evidence (see instructions) .....	<b>15</b>	<b>77,280.</b>
<b>16</b> Subtract line 15 from line 14 .....	<b>16</b>	<b>343,470.</b>
<b>17</b> Credit for Fed. gift taxes on pre-1977 gifts (sec. 2012) (attach computation)	<b>17</b>	
<b>18</b> Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.) ..	<b>18</b>	
<b>19</b> Credit for tax on prior transfers (from Schedule Q) .....	<b>19</b>	
<b>20</b> Total (add lines 17, 18, and 19) .....	<b>20</b>	
<b>21</b> Net estate tax (subtract line 20 from line 16) .....	<b>21</b>	<b>343,470.</b>
<b>22</b> Generation-skipping transfer taxes (from Schedule R, Part 2, line 10) .....	<b>22</b>	
<b>23</b> Total transfer taxes (add lines 21 and 22) .....	<b>23</b>	<b>343,470.</b>
<b>24</b> Prior payments. Explain in an attached statement. ....	<b>24</b>	
<b>25</b> United States Treasury bonds redeemed in payment of estate tax ....	<b>25</b>	
<b>26</b> Total (add lines 24 and 25) .....	<b>26</b>	
<b>27</b> Balance due (or overpayment) (subtract line 26 from line 23) .....	<b>27</b>	<b>343,470.</b>

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 _____

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\* Tax on \$675,000 – the exemption amount for 2001.

# 2002 Workbook

Form 706 (Rev. 7-99) **STEVE S. SANDS**

**186-55-5555**

## Part 4. -- General Information (continued)

Please check the "Yes" or "No" box for each question.		Yes	No
<b>7a</b> Have Federal gift tax returns ever been filed? . . . . .			<b>X</b>
If "Yes," please attach copies of the returns, if available, and furnish the following information:			
<b>7b</b> Period(s) covered	<b>7c</b> Internal Revenue office(s) where filed		
If you answer "Yes" to any of questions 8-16, you must attach additional information as described in the instructions.			
<b>8a</b> Was there any insurance on the decedent's life that is not included on the return as part of the gross estate? . . . . .			<b>X</b>
<b>b</b> Did the decedent own any insurance on the life of another that is not included in the gross estate? . . . . .			<b>X</b>
<b>9</b> Did the decedent at the time of death own any property as a joint tenant with right of survivorship in which (a) one or more of the other joint tenants was someone other than the decedent's spouse, and (b) less than the full value of the property is included on the return as part of the gross estate? If "Yes," you must complete and attach Schedule E . . . . .			<b>X</b>
<b>10</b> Did the decedent, at the time of death, own any interest in a partnership or unincorporated business or any stock in an inactive or closely held corporation? . . . . .			<b>X</b>
<b>11</b> Did the decedent make any transfer described in section 2035, 2036, 2037, or 2038 (see the instructions for Schedule G beginning on page 11 of the separate instructions)? If "Yes," you must complete and attach Schedule G . . . . .			<b>X</b>
<b>12</b> Were there in existence at the time of the decedent's death:			
<b>a</b> Any trusts created by the decedent during his or her lifetime? . . . . .			<b>X</b>
<b>b</b> Any trusts not created by the decedent under which the decedent possessed any power, beneficial interest, or trusteeship? . . . . .			<b>X</b>
<b>13</b> Did the decedent ever possess, exercise, or release any general power of appointment? If "Yes," you must complete and attach Schedule H . . . . .			<b>X</b>
<b>14</b> Was the marital deduction computed under transitional rule of Public Law 97-34, sec. 403(e)(3) (Economic Recovery Tax Act of 1981)? If "Yes," attach a separate computation of the marital deduction, enter the amount on item 20 of the Recapitulation, and note on item 20 "computation attached." . . . . .			<b>X</b>
<b>15</b> Was the decedent, immediately before death, receiving an annuity described in the "General" paragraph of the instructions for Schedule I? If "Yes," you must complete and attach Schedule I . . . . .			<b>X</b>
<b>16</b> Was the decedent ever the beneficiary of a trust for which a deduction was claimed by the estate of a pre-deceased spouse under section 2056(b)(7) and which is not reported on this return? If "Yes," attach an explanation . . . . .			<b>X</b>

## Part 5. -- Recapitulation

Item no.	Gross estate	Alternate value	Value at date of death
<b>1</b>	Schedule A -- Real Estate . . . . .	<b>1</b>	<b>290,000 .</b>
<b>2</b>	Schedule B -- Stocks and Bonds . . . . .	<b>2</b>	<b>0 .</b>
<b>3</b>	Schedule C -- Mortgages, Notes, and Cash . . . . .	<b>3</b>	<b>1,400,000 .</b>
<b>4</b>	Schedule D -- Insurance on the Decedent's Life (attach Form(s) 712) . . . . .	<b>4</b>	<b>0 .</b>
<b>5</b>	Schedule E -- Jointly Owned Property (attach Form(s) 712 for life insurance) . . . . .	<b>5</b>	<b>0 .</b>
<b>6</b>	Schedule F -- Other Miscellaneous Property (attach Form(s) 712 for life ins.) . . . . .	<b>6</b>	<b>0 .</b>
<b>7</b>	Schedule G -- Transfers During Decedent's Life (att. Form(s) 712 for life ins.) . . . . .	<b>7</b>	<b>0 .</b>
<b>8</b>	Schedule H -- Powers of Appointment . . . . .	<b>8</b>	<b>0 .</b>
<b>9</b>	Schedule I -- Annuities . . . . .	<b>9</b>	<b>0 .</b>
<b>10</b>	Total gross estate (add items 1 through 9) . . . . .	<b>10</b>	<b>1,690,000 .</b>
<b>11</b>	Schedule U -- Qualified Conservation Easement Exclusion . . . . .	<b>11</b>	
<b>12</b>	Total gross estate less exclusion (subtract item 11 from item 10). Enter here and on line 1 of Part 2 -- Tax Computation . . . . .	<b>12</b>	<b>1,690,000 .</b>
Item no.	Deductions		Amount
<b>13</b>	Schedule J -- Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims . . . . .	<b>13</b>	
<b>14</b>	Schedule K -- Debts of the Decedent . . . . .	<b>14</b>	
<b>15</b>	Schedule K -- Mortgages and Liens . . . . .	<b>15</b>	
<b>16</b>	Total of items 13 through 15 . . . . .	<b>16</b>	
<b>17</b>	Allowable amount of deductions from item 16 (see the instructions for item 17 of the Recapitulation) . . . . .	<b>17</b>	
<b>18</b>	Schedule L -- Net Losses During Administration . . . . .	<b>18</b>	
<b>19</b>	Schedule L -- Expenses Incurred in Administering Property Not Subject to Claims . . . . .	<b>19</b>	
<b>20</b>	Schedule M -- Bequests, etc., to Surviving Spouse . . . . .	<b>20</b>	
<b>21</b>	Schedule O -- Charitable, Public, and Similar Gifts and Bequests . . . . .	<b>21</b>	
<b>22</b>	Schedule T -- Qualified Family-Owned Business Interest Deduction . . . . .	<b>22</b>	
<b>23</b>	Total allowable deductions (add items 17 through 22). Enter here and on line 2 of the Tax Computation . . . . .	<b>23</b>	

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**Question 23D.** What are the tax consequences when Bob, the remainderman, sells the home for \$315,000 in 2002, the year following Steve's death?

**Answer 23D.** The general rule for gift tax is that the donee (Bob) retains the carryover basis from the donor (Steve). However, that rule will not apply here since Bob's basis is the full fair market value of the home (\$290,000) determined by the date of death basis rather than the carry over basis rules. Since I.R.C. §2036(a) requires the full value of Steve's home to be included in his estate for estate tax purposes, Bob's basis is \$290,000. Bob has a \$25,000 long-term capital gain in 2002 since inherited property automatically receives long-term treatment. The computation of Bob's gain is shown below:

Amount realized on sale of home	\$315,000
Less: date of death value basis	(290,000)
Bob's long-term gain on his 2002 Schedule D	\$25,000

Taxpayers may want to consider the use of a Qualified Personal Residence Trust (QPRT) which offers far greater flexibility. A QPRT is an irrevocable trust to which the transferor (grantor) transfers his or her personal residence or vacation home. The Grantor retains exclusive use of the residence for a term of years specified by the trust instrument which also provides that the residence will be returned to the Grantor's estate if the Grantor dies prior to the expiration of the term of the trust. If the Grantor survives the term of the trust, the QPRT terminates and the residence is distributed to one or more third parties (children or grandchildren) selected by the Grantor. These third parties are known as remainderman beneficiaries.

The benefit of a QPRT is that a gift is deemed to have been made at the time the trust is established. But, the fair market of the home is discounted based on the age of the grantor and the term of the trust. And if the grantor survives the term of the trust, the residence goes to the named beneficiaries and is NOT included in the Grantor's estate. The beneficiaries receive no step up in basis but use the Grantor's tax basis increased by gift taxes paid, if any.

**Note.** The tax practitioner is reminded that an experienced attorney should be consulted when drafting a Qualified Personal Residence Trust (QPRT). The Grantor could continue to live in the residence when the trust terminates provided that the Grantor lease the property from the beneficiaries at fair rental value (Private Letter Ruling 9249014).

# 2002 Workbook