

Chapter 3: Small Business Issues

Issue 1: Tax Credits	123	Issue 6: Like-Kind Exchanges Under I.R.C. §1031	175
Issue 2: Fringe Benefits	143	Issue 7: Tax Aspects of Telecommuting	186
Issue 3: Vehicles	149	Issue 8: Independent Contractors	187
Issue 4: Installment Sales	156	Issue 9: Cash Accounting Method	191
Issue 5: Internet Business	173		

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

ISSUE 1: TAX CREDITS

INTRODUCTION

Congress has introduced many different tax credits into the tax code. These credits are designed to stimulate a segment of the economy or to compensate a particular industry for performing various services. For example, the orphan drug credit is designed to encourage drug manufacturers to research cures for diseases that only affect a small segment of the population. Without these credits, the companies might abandon their research because of low profit potential. The amount a particular credit is calculated on its own form and is then entered on Form 3800, General Business Credit. Once on Form 3800, the credit is used to reduce taxes in a specific order. Any credits not used are carried forward to the next tax year.

Tax credits have various effective dates and many have expiration dates as well. This chapter is designed to make tax practitioners aware of some of the most widely used credits.

DISABLED ACCESS CREDIT — FORM 8826

Amount Of Credit. I.R.C. §44 allows a qualifying small business to claim a nonrefundable credit for 50% of its eligible disabled-access expenditures for the year. The amount must exceed \$250, but cannot exceed \$10,250. The maximum credit is \$5,000 per tax year.

Qualifying Small Business. A qualifying small business must have:

- gross receipts not exceeding \$1 million during the preceding tax year; or
- no more than 30 full time employees during the preceding tax year. A full time employee is one who worked at least 30 hours per week for 20 or more weeks during the year.

Eligible Expenditures. Eligible access expenditures are amounts spent by a qualifying small business to enable it to comply with the Americans with Disabilities Act of 1990. Eligible access expenditures are expenses:

1. Incurred for the purpose of removing architectural, communication, physical, or transportation barriers which prevent a business from being accessible to, or usable by, individuals with disabilities. In addition, the expense must be in conjunction with a facility **first placed in service on or before November 5, 1990.**
2. To provide qualified interpreters, or other effective resources for making aurally delivered materials available to hearing-impaired individuals.

3. To provide qualified readers, taped texts, and other effective resources for making visually delivered materials available to visually impaired individuals.
4. To acquire or modify equipment or devices for individuals with disabilities.
5. To provide other similar services, modifications, materials, or equipment.

Amounts included must be reasonable and cannot include expenditures that are unnecessary to provide access for the disabled.

Expenses **not** eligible for the credit are:

1. Amounts spent for **new construction** of any facility placed in service after November 5, 1990; and
2. Amounts spent for purchase of equipment acquired in the normal course of business, and that has incidental benefits to disabled individuals.

Example 1. A dentist purchased an intra-oral camera system for his practice. In *Fan vs. Commissioner*, 117 T.C. No. 3 (2001), the tax court held that the system did not qualify because it was not purchased to comply with ADA and did not substitute the dentist's existing form of communication with these patients. The credit was denied even though the system was helpful for the dentist, in working with hearing impaired patients.

A taxpayer may claim the disabled access credit and take a deduction or capitalize the remaining expenditure. Taxpayers are **not** entitled to take a double deduction.

The disabled access credit is a part of the general business credit (GBC). Therefore it is subject to the same limitations as GBC.

Example 2. Dr. Sue Thomas moved her medical practice to a building built in 1948. She installed a \$13,000 ramp in 2002 to make the building wheelchair-accessible for her patients. In addition to claiming the \$5,000 credit, she can depreciate the \$8,000 remaining cost of the ramp.

A completed Form 8826 follows:

For Example 2

Form **8826**

Disabled Access Credit

OMB No. 1545-1205

2002

Attachment
Sequence No. **86**

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return.

Name(s) shown on return

Identifying number

Sue Thomas

Part I Current Year Credit

1 Total eligible access expenditures (see instructions)		1	13,000
2 Minimum amount		2	250
3 Subtract line 2 from line 1. If zero or less, enter -0-		3	12,750
4 Maximum amount		4	10,000
5 Enter the smaller of line 3 or line 4.		5	10,000
6 Multiply line 5 by 50% (.50)		6	5,000
7 Disabled access credits from pass-through entities:			
If you are a—	Then enter the total of the current year disabled access credits from—		
a Shareholder	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13	7	
b Partner	Schedule K-1 (Form 1065), lines 12c, 12d, or 13		
8 Current year disabled access credit. Add lines 6 and 7, but do not enter more than \$5,000.		8	5,000

Part II Allowable Credit (See Who must file Form 3800 to find out if you complete Part II or file Form 3800.)

9 Regular tax before credits:			
• Individuals. Enter the amount from Form 1040, line 42	}	9	37,596
• Corporations. Enter the amount from Form 1120, Schedule J, line 3; Form 1120-A, Part I, line 1; or the amount from the applicable line of your return			
• Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b, or the amount from the applicable line of your return			
10 Alternative minimum tax:		10	
• Individuals. Enter the amount from Form 6251, line 35	}	11	37,596
• Corporations. Enter the amount from Form 4626, line 15			
• Estates and trusts. Enter the amount from Form 1041, Schedule I, line 56			
11 Add lines 9 and 10		11	37,596
12a Foreign tax credit	12a		
b Credit for child and dependent care expenses (Form 2441, line 11)	12b		
c Credit for the elderly or the disabled (Schedule R (Form 1040), line 24)	12c		
d Education credits (Form 8863, line 18)	12d		
e Credit for qualified retirement savings contributions (Form 8880, line 14)	12e		
f Child tax credit (Form 1040, line 50)	12f		
g Mortgage interest credit (Form 8396, line 11)	12g		
h Adoption credit (Form 8839, line 18)	12h		
i District of Columbia first-time homebuyer credit (Form 8859, line 11)	12i		
j Possessions tax credit (Form 5735, line 17 or 27)	12j		
k Credit for fuel from a nonconventional source	12k		
l Qualified electric vehicle credit (Form 8834, line 20)	12l		
m Add lines 12a through 12l		12m	
13 Net income tax. Subtract line 12m from line 11. If zero, skip lines 14 through 17 and enter -0- on line 18		13	37,596
14 Net regular tax. Subtract line 12m from line 9. If zero or less, enter -0-	14		
15 Enter 25% (.25) of the excess, if any, of line 14 over \$25,000 (see instructions)	15	37,596	
16 Tentative minimum tax (see instructions):		16	3,149
• Individuals. Enter the amount from Form 6251, line 33	}	17	3,149
• Corporations. Enter the amount from Form 4626, line 13			
• Estates and trusts. Enter the amount from Form 1041, Schedule I, line 54			
17 Enter the greater of line 15 or line 16		17	3,149
18 Subtract line 17 from line 13. If zero or less, enter -0-		18	34,447
19 Credit allowed for the current year. Enter the smaller of line 8 or line 18 here and on Form 1040, line 53; Form 1120, Schedule J, line 6d; Form 1120-A, Part I, line 2a; Form 1041, Schedule G, line 2c; or the applicable line of your return. If line 18 is smaller than line 8, see instructions.		19	5,000

For Paperwork Reduction Act Notice, see back of form.

Cat. No. 12774N

Form **8826** (2002)

3

Limitation. All members of the same controlled group of corporations [I.R.C. §52(a)] and all taxpayers under common control [I.R.C. §52(b)] are treated as one taxpayer. The dollar limitations under I.R.C. §44 are apportioned among the members of any group. For partnerships and S corporations, the limits are applied **both** at the partnership and S corporation levels and to **each** partner or shareholder.

Election. The taxpayer must elect to use I.R.C. §44. It is not automatic. In addition, a business may not claim any other deduction, credit, or an increase in basis in connection with any expense associated with the credit.

Caution. IRS News Release 2002-17 warns taxpayers to beware of a **fraudulent investment scheme** that entices taxpayers to improperly use the disabled access credit. Unscrupulous promoters have been selling expensive pay telephones and falsely claiming that the purchase of the phone qualifies for the disabled access credit.

WORK OPPORTUNITY CREDIT — FORM 5884

Amount of Credit. Employers who hire members of specific groups are entitled to a credit against their tax liability. The maximum credit is 40% of \$6,000 of qualified **first-year** wages paid to each eligible employee. In certain circumstances, the credit is limited to 25%. For specific summer labor, the credit is limited to \$3,000 of wages per eligible employee. The credit is available for qualifying individuals who begin work after November 30, 1996 and before January 1, 2004. The employer's deduction for wages must be reduced by the current year credit. The first year is defined as the period beginning on the day the employee begins work and ending one year later.

Excerpted from IRS Pub. 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.

Rate and Maximum Credit Each Tax Year for Each Targeted Group Employee

Hours Worked	Rate	Maximum Qualified First-Year Wages	Credit
At least 400	40%	\$6,000 ¹	\$2,400
Fewer than 400, at least 120	25%	6,000 ¹	1,500

¹\$3,000 for a summer youth employee.

Qualifying Individuals. An individual from one of the following targeted groups must be **certified by the designated local agency**. An employee is not considered a targeted group employee without certification. Certification is obtained by submitting Form 8850 (Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits) to the designated local agency.

Note. A “designated local agency” means a state employment security agency. In Illinois, the **Illinois Department of Employment Security** (IDES) is the authorized agency for certification. A state or local probation officer is also authorized.

- 1. Qualified IV-A Recipient.** A member of a family receiving assistance under an IV-A program. This assistance must have been received for any nine months during the 18 months prior to the hiring date.
- 2. Qualified Veteran.** A veteran who is a member of a family receiving food stamps under a program associated with the Food Stamp Act of 1977. The food stamps must have been received for at least three months during the 12 months prior to hire date.
- 3. Qualified Ex-felon.** A convicted felon under federal or state law, who has a hiring date which is not more than one year after the last date on which the individual was convicted or released from prison, and is a member of

a family which had income during the previous six months that would be 70% or less of the Bureau of Labor Statistics living standard.

4. **High-Risk Youth.** A youth between the ages of 18 and 24 on the hiring date who lives within an empowerment zone, enterprise community, or renewal community.
5. **Vocational Rehabilitation Referral.** A person with a physical or mental disability which substantially handicaps employability. This individual will have been referred to the employer after having completed rehabilitative services under a plan approved by the Rehabilitation Act of 1973 or a program carried out under Chapter 31 of Title 38, U.S. Code.
6. **Qualified Summer Youth Employee.** Between the ages of 16 and 18, who performs services between May 1 and September 15, and has not been a prior employee of the employer. The credit limit on this type of employee is 40% of the first \$3,000 of wages.
7. **Qualified Food Stamp Recipient.** Between the ages of 18 and 25 and is a member of a family receiving food stamps under a program associated with the Food Stamp Act of 1977. The food stamps must have been provided for either the previous six months or for three out of five months prior to hiring date.
8. **Qualified SSI Recipient.** Receiving supplemental security income benefits under Title VI of the Social Security Act for any month ending within the 60-day period prior to the hiring date.

The employer may **not** claim the credit for first-year wages paid to:

- any individual related to the employer; or
- any employee that has been employed previously by the employer.

Example 3. Take-A-Chance Grocery, Inc. hired Frank Gordon, a qualified ex-felon, on November 1, 2001. The corporation is a calendar-year 1120S owned by two shareholders. Form 8850 was submitted and certification was received. In **2001**, the corporation paid Frank \$2,800. He worked a total of 360 hours in **2001**.

The completed 2001 Form 5884 is shown below. The Form 5884 was filed with the **2001** Form 1120S. The **2001** Schedule K-1 for each shareholder reported \$350 of allocated Work Opportunity Credit.

Frank continued to work full time for the corporation in **2002**, being paid \$18,000 in wages. The corporation's completed **2002** Form 5884 is also shown below. \$3,200 of Frank's **2002** wages qualifies as first-year wages (\$6,000 maximum less the \$2,800 qualified 2001 first-year wages).

2002 Workbook

For Example 3

Form 5884 (Rev. May 2002) Department of the Treasury Internal Revenue Service	<h3 style="margin: 0;">Work Opportunity Credit</h3> <p style="margin: 0;">▶ Attach to your return.</p>	OMB No. 1545-0219 <div style="border: 1px solid black; padding: 5px; display: inline-block;"> <b style="font-size: 2em;">2001 Attachment Sequence No. 77 </div>
Name(s) shown on return Take-A-Chance Grocery, Inc.		Identifying number 36-1111111

Part I Current Year Credit (Members of a controlled group, see instructions.)

1 Enter the total qualified first-year wages paid or incurred during the tax year, and multiply by the percentage shown, for services of employees who are certified as members of a targeted group and:															
a Worked at least 120 hours but fewer than 400 hours . . . \$ 2,800 × 25% (.25)	1a	700													
b Worked at least 400 hours . . . \$ × 40% (.40)	1b														
2 Current year credit. Add lines 1a and 1b. You must subtract this amount from your deduction for salaries and wages	2	700													
3 Work opportunity credits from pass-through entities <table border="0" style="width: 100%; margin-left: 20px;"> <tr> <td style="width: 15%;">If you are a—</td> <td style="width: 15%;">Then enter total of current year work opportunity credit(s) from—</td> <td style="width: 10%;"></td> </tr> <tr> <td>a Shareholder . . .</td> <td>Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.</td> <td rowspan="4" style="font-size: 3em; vertical-align: middle;">}</td> </tr> <tr> <td>b Partner . . .</td> <td>Schedule K-1 (Form 1065), lines 12c, 12d, or 13 . . .</td> </tr> <tr> <td>c Beneficiary . . .</td> <td>Schedule K-1 (Form 1041), line 14 . . .</td> </tr> <tr> <td>d Patron . . .</td> <td>Written statement from cooperative</td> </tr> </table>	If you are a—	Then enter total of current year work opportunity credit(s) from—		a Shareholder . . .	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.	}	b Partner . . .	Schedule K-1 (Form 1065), lines 12c, 12d, or 13 . . .	c Beneficiary . . .	Schedule K-1 (Form 1041), line 14 . . .	d Patron . . .	Written statement from cooperative	3		
If you are a—	Then enter total of current year work opportunity credit(s) from—														
a Shareholder . . .	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.	}													
b Partner . . .	Schedule K-1 (Form 1065), lines 12c, 12d, or 13 . . .														
c Beneficiary . . .	Schedule K-1 (Form 1041), line 14 . . .														
d Patron . . .	Written statement from cooperative														
4 Total current year work opportunity credit. Add lines 2 and 3. (S corporations, partnerships, estates, trusts, cooperatives, regulated investment companies, and real estate investment trusts, see instructions.)	4	700													

Part II Tax Liability Limit (See Who Must File Form 3800 to find out if you complete Part II or file Form 3800.)

5 Regular tax before credits: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 1040, line 40 • Corporations. Enter the amount from Form 1120, Schedule J, line 3; Form 1120-A, Part I, line 1; or the applicable line of your return • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b, or the amount from the applicable line of your return 			
6 Alternative minimum tax: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 28 • Corporations. Enter the amount from Form 4626, line 15 • Estates and trusts. Enter the amount from Form 1041, Schedule I, line 39 	6	0	
7 Add lines 5 and 6.	7	15,317	
8a Foreign tax credit	8a		
b Credit for child and dependent care expenses (Form 2441, line 9)	8b		
c Credit for the elderly or the disabled (Schedule R (Form 1040), line 20)	8c		
d Education credits (Form 8863, line 18).	8d		
e Rate reduction credit (Form 1040, line 47)	8e		
f Child tax credit (Form 1040, line 48)	8f		
g Mortgage interest credit (Form 8396, line 11)	8g		
h Adoption credit (Form 8839, line 14)	8h		
i District of Columbia first-time homebuyer credit (Form 8859, line 11)	8i		
j Possessions tax credit (Form 5735, line 17 or 27)	8j		
k Credit for fuel from a nonconventional source	8k		
l Qualified electric vehicle credit (Form 8834, line 20)	8l		
m Add lines 8a through 8l.	8m	0	
9 Net income tax. Subtract line 8m from line 7. If zero, skip lines 10 through 13 and enter -0- on line 14.	9	15,317	
10 Tentative minimum tax (see instructions)	10	0	
11 Net regular tax. Subtract line 8m from line 5. If zero or less, enter -0-	11	15,317	
12 Enter 25% (.25) of the excess, if any, of line 11 over \$25,000 (see instructions)	12	0	
13 Enter the greater of line 10 or line 12	13	0	
14 Subtract line 13 from line 9. If zero or less, enter -0-	14	15,317	
15 Work opportunity credit allowed for the current year. Enter the smaller of line 4 or line 14 here and on Form 1040, line 50; Form 1120, Schedule J, line 6d; Form 1120-A, Part I, line 4a; Form 1041, Schedule G, line 2c; or the applicable line of your return	15	700	

For Example 3

Form 5884 Department of the Treasury Internal Revenue Service	<h3 style="margin: 0;">Work Opportunity Credit</h3> <p style="text-align: center; margin: 0;">▶ Attach to your tax return.</p>	OMB No. 1545-0219 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2002</div> Attachment Sequence No. 77												
Name(s) shown on return Take-A-Chance Grocery, Inc.		Identifying number 36-1111111												
Part I Current Year Credit (Members of a controlled group, see instructions.)														
1 Enter the total qualified first-year wages paid or incurred during the tax year, and multiply by the percentage shown, for services of employees who are certified as members of a targeted group and:		<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 style="text-align: center;">1a</td> <td></td> <td></td> </tr> <tr> <td style="text-align: center;">1b</td> <td style="text-align: right;">3,200 × 40% (.40)</td> <td style="text-align: right;">1,280</td> </tr> <tr> <td style="text-align: center;">2</td> <td></td> <td style="text-align: right;">1,280</td> </tr> </table>				1a			1b	3,200 × 40% (.40)	1,280	2		1,280
1a														
1b	3,200 × 40% (.40)	1,280												
2		1,280												
a Worked for you at least 120 hours but fewer than 400 hours \$ × 25% (.25)														
b Worked for you at least 400 hours \$ 3,200 × 40% (.40)														
2 Add lines 1a and 1b. You must subtract this amount from your deduction for salaries and wages														
3 Work opportunity credits from pass-through entities:														
If you are a—	Then enter the total of the current year credits from—													
a Shareholder	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.	} 3												
b Partner	Schedule K-1 (Form 1065), lines 12c, 12d, or 13													
c Beneficiary	Schedule K-1 (Form 1041), line 14													
d Patron	Written statement from cooperative													
4 Current year credit. Add lines 2 and 3. (S corporations, partnerships, estates, trusts, cooperatives, regulated investment companies, and real estate investment trusts, see instructions.)		4 1,280												
Part II Allowable Credit (See Who must file Form 3800 to find out if you complete Part II or file Form 3800.)														
5 Regular tax before credits:														
• Individuals. Enter the amount from Form 1040, line 42		} 5 13,208												
• Corporations. Enter the amount from Form 1120, Schedule J, line 3; Form 1120-A, Part I, line 1; or the applicable line of your return														
• Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b, or the amount from the applicable line of your return														
6 Alternative minimum tax:														
• Individuals. Enter the amount from Form 6251, line 35		} 6 0												
• Corporations. Enter the amount from Form 4626, line 15														
• Estates and trusts. Enter the amount from Form 1041, Schedule I, line 56														
7 Add lines 5 and 6		7 13,208												
8a Foreign tax credit														
b Credit for child and dependent care expenses (Form 2441, line 11)		8b												
c Credit for the elderly or the disabled (Schedule R (Form 1040), line 24)		8c												
d Education credits (Form 8863, line 18)		8d												
e Credit for qualified retirement savings contributions (Form 8880, line 14)		8e												
f Child tax credit (Form 1040, line 50)		8f												
g Mortgage interest credit (Form 8396, line 11)		8g												
h Adoption credit (Form 8839, line 18)		8h												
i District of Columbia first-time homebuyer credit (Form 8859, line 11)		8i												
j Possessions tax credit (Form 5735, line 17 or 27)		8j												
k Credit for fuel from a nonconventional source		8k												
l Qualified electric vehicle credit (Form 8834, line 20)		8l												
m Add lines 8a through 8l		8m 0												
9 Net income tax. Subtract line 8m from line 7. If zero, skip lines 10 through 13 and enter -0- on line 14		9 13,208												
10 Net regular tax. Subtract line 8m from line 5. If zero or less, enter -0-		10 13,208												
11 Enter 25% (.25) of the excess, if any, of line 10 over \$25,000 (see instructions)		11 0												
12 Tentative minimum tax (see instructions)		12 0												
13 Enter the greater of line 11 or line 12		13 0												
14 Subtract line 13 from line 9. If zero or less, enter -0-		14 13,208												
15 Credit allowed for the current year. Enter the smaller of line 4 or line 14 here and on Form 1040, line 53; Form 1120, Schedule J, line 6d; Form 1120-A, Part I, line 2a; Form 1041, Schedule G, line 2c; or the applicable line of your return. If line 14 is smaller than line 4, see instructions		15 1,280												

For Paperwork Reduction Act Notice, see page 3.

Cat. No. 13570D

Form 5884 (2002)



WELFARE-TO-WORK CREDIT — FORM 8861

Amount of Credit. The welfare-to-work credit is limited to:

- 35% of the qualified **first-year** wages for each qualified employee; and
- 50% of the qualified **second-year** wages for each qualified employee.

The **maximum** yearly wages taken into account for each qualified employee is **\$10,000**. This credit is available for employees who begin work before January 1, 2004.

IRS Pub. 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.

Rate and Maximum Credit Each Tax Year for Each Long-Term Family Assistance Recipient

Hours Worked	Rate	Maximum Qualified First-Year Wages	Credit
Qualified first-year wages	35%	\$10,000	\$3,500
Qualified second-year wages	50%	10,000	5,000

Qualified Employees. An individual who is certified by the designated local agency as a “long-term family assistance recipient” is considered qualified. This individual is a member of a family receiving assistance under an IV-A program for at least 18 months prior to the hiring date. If the family ceased being eligible for assistance, the hire date for the qualified employee must be less than two years after the assistance stopped.

Observation. In Illinois, the Illinois Department of Employment Security (IDES) is the authorized agency for certification.

Each state has its own policies.

Example 4. In Illinois, the employer is required to pre-screen potential employees to determine eligibility. Before making a job offer, the employer must complete both a Pre-Screening Notice (Form 8850) and an Individual Characteristics Form ETA 9061.

These forms must be received by IDES, no later than the 21st day after the individual begins work for the employer. In cases where IDES has pre-determined that the prospective employee is eligible, the employee is given a conditional certification form. The employer is responsible for completing this form and returning it to the IDES office.

The following blank forms are shown below:

- Form 8850
- Individual Characteristics Form ETA 9601
- 2002 Form 8861 (Welfare-to-Credit)

Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits

OMB No. 1545-1500

▶ See separate instructions.

Job applicant: Fill in the lines below and check any boxes that apply. Complete only this side.

Your name _____ Social security number ▶ _____

Street address where you live _____

City or town, state, and ZIP code _____

Telephone no. (____) _____ - _____

If you are under age 25, enter your date of birth (month, day, year) ____/____/____

Work Opportunity Credit

- 1 Check here if you received a conditional certification from the state employment security agency (SESA) or a participating local agency for the work opportunity credit.
- 2 Check here if **any** of the following statements apply to you.
- I am a member of a family that has received assistance from Aid to Families with Dependent Children (AFDC) or its successor program, Temporary Assistance for Needy Families (TANF), for any 9 months during the last 18 months.
 - I am a veteran and a member of a family that received food stamps for at least a 3-month period within the last 15 months.
 - I was referred here by a rehabilitation agency approved by the state or the Department of Veterans Affairs.
 - I am at least age 18 but **not** over age 24 and I am a member of a family that:
 - a Received food stamps for the last 6 months, OR
 - b Received food stamps for at least 3 of the last 5 months, BUT is no longer eligible to receive them.
 - Within the past year, I was convicted of a felony or released from prison for a felony AND during the last 6 months I was a member of a low-income family.
 - I received supplemental security income (SSI) benefits for any month ending within the last 60 days.

Welfare-to-Work Credit

- 3 Check here if you received a conditional certification from the SESA or a participating local agency for the welfare-to-work credit.
- 4 Check here if you are a member of a family that:
- Received AFDC or TANF payments for at least the last 18 months, OR
 - Received AFDC or TANF payments for any 18 months beginning after August 5, 1997, OR
 - Stopped being eligible for AFDC or TANF payments after August 5, 1997, because Federal or state law limited the maximum time those payments could be made.

All Applicants

Under penalties of perjury, I declare that I gave the above information to the employer on or before the day I was offered a job, and it is, to the best of my knowledge, true, correct, and complete.

Job applicant's signature ▶ _____

Date ____/____/____

For Privacy Act and Paperwork Reduction Act Notice, see page 2.

Cat. No. 22851L

Form **8850** (Rev. 11-98)

For Employer's Use Only

Employer's name _____ Telephone no. () - EIN ▶ _____

Street address _____

City or town, state, and ZIP code _____

Person to contact, if different from above _____ Telephone no. () - _____

Street address _____

City or town, state, and ZIP code _____

If, based on the individual's age and home address, he or she is a member of group 4 or 6 (as described under **Members of Targeted Groups** in the separate instructions), enter that group number (4 or 6) ▶ _____

DATE APPLICANT:	Gave information	/ /	Was offered job	/ /	Was hired	/ /	Started job	/ /
-----------------	------------------	-----	-----------------	-----	-----------	-----	-------------	-----

Under penalties of perjury, I declare that I completed this form on or before the day a job was offered to the applicant and that the information I have furnished is, to the best of my knowledge, true, correct, and complete. Based on the information the job applicant furnished on page 1, I believe the individual is a member of a targeted group or a long-term family assistance recipient. I hereby request a certification that the individual is a member of a targeted group or a long-term family assistance recipient.

Employer's signature ▶	Title	Date / /
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Privacy Act and Paperwork Reduction Act Notice

Section references are to the Internal Revenue Code.

Section 51(d)(12) permits a prospective employer to request the applicant to complete this form and give it to the prospective employer. The information will be used by the employer to complete the employer's Federal tax return. Completion of this form is voluntary and may assist members of targeted groups and long-term family assistance recipients in securing employment. Routine uses of this form include giving it to the state employment security agency (SESA), which will contact appropriate sources to confirm that the applicant is a member of a targeted group or a long-term family

assistance recipient. This form may also be given to the Internal Revenue Service for administration of the Internal Revenue laws, to the Department of Justice for civil and criminal litigation, to the Department of Labor for oversight of the certifications performed by the SESA, and to cities, states, and the District of Columbia for use in administering their tax laws.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 2 hr., 47 min.
Learning about the law or the form 28 min.
Preparing and sending this form to the SESA 36 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001.

DO NOT send this form to this address. Instead, see **When and Where To File** in the separate instructions.



**Individual Characteristics Form
Work Opportunity Tax Credit and
Welfare-to-Work Tax Credit**

U.S. Department of Labor
Employment and Training Administration
U.S. Employment Service



1. CONTROL NO. (For Agency Use Only)	Individual Information (Instructions on the Back)	OMB Control No.: 1205-0371 Expires: 06/30/2001
		2. DATE RECEIVED (For Agency Use Only)

3. EMPLOYER NAME/ADDRESS	4. EMPLOYER ID NUMBER	5. EMPLOYMENT START DATE
	6. Have you worked for the above employer before? Yes _____ No _____	Starting Wage: \$ _____ per hour POSITION:

7. NAME OF INDIVIDUAL (Last, First, Middle)	8. SOCIAL SECURITY NUMBER:
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The above named individual is determined to have the following characteristics for WOTC Target Group Certification:

9. Age between 16 - 25? Yes _____ No _____ If YES, indicate your "Date of Birth" below: Date of Birth _____	10. A veteran and a member of a family that received Food Stamps for a period of at least 3 months in the last 15 months. Yes _____ No _____ If YES, also complete Box 17.	11. Is a member of a family that received AFDC (TANF) benefits for any 9 months in the last 18 months. Yes _____ No _____ If YES, also complete Box 17.
12. Is a member of a family that received Food Stamps for the last 6 months. Yes _____ No _____ or _____ for at least a 3-month period within the last 5 months, BUT is no longer receiving them? Yes _____ No _____ If YES to either, also complete Box 17.	13. In the past year has been convicted of a felony or released from prison after a felony conviction. Yes _____ No _____ If YES, complete below: Date of Conviction _____ Date of Release _____ Total income for the past 6 months for all family members living in the same household? Total Income: _____ (If No Income, Enter 0 above) No. of family members living in the same household for the past 6 months, including yourself: _____	14. Lives and plans to continue living in a Federal Empowerment Zone or Enterprise Community. Yes _____ No _____ 16. Received Supplemental Security Income (SSI) benefits for any month ending within the last 60 days. Yes _____ No _____
15. Is receiving or has received Rehabilitation Services through a State Rehabilitation Services program or the Veterans' Administration. Yes _____ No _____	17. If individual is not a primary recipient of benefits, please provide the following: Name of Primary Recipient _____ City/State of Benefits _____	

This section is to be completed by individuals starting work after December 31, 1997, under the Welfare-to-Work Tax Credit only.

18. Is a member of a family that:

- Has received AFDC or TANF payments for at least the last 18 consecutive months: Yes _____ No _____ or _____
- Has received/is receiving AFDC or TANF payments for any 18 months starting after August 5, 1997: Yes _____ No _____ or _____
- Stopped being eligible for AFDC or TANF payments after Aug. 5, 1997 because Federal or state law limited the maximum time such assistance is payable: Yes _____ No _____

19. SOURCES USED TO DOCUMENT ELIGIBILITY:

Note: I certify that the information is true and correct to the best of my knowledge. I understand that the information above may be subject to verification. The signature of the party completing this form is required below.

20. SIGNATURE:	21. DATE:
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2002 Workbook

INSTRUCTIONS FOR COMPLETING THE INDIVIDUAL CHARACTERISTICS FORM (ICF) ETA 9061: Work Opportunity and Welfare-to-Work Tax Credits. This form is used in conjunction with IRS Form 8850 to determine eligibility for the Work Opportunity Tax Credit (WOTC) and/or Welfare-to-Work (WtW) Tax Credit. The form may be completed by the applicant, the employer or employer representative, the SESA or the Participating Agency (PA) and signed by the person or agency filling out the form. Note. This form is required to be used, with modification, by all employers or third parties serving under contract as an agent or representative of the employer.

Box 1: Control Number (for agency use only). The SESA or PA determines the Control Number. It may be a Social Security Number, case number, or other appropriate designation which permits easy filing, identification and retrieval of forms. Enter this number here.

Box 2: Date (for agency use only). Enter the month, day, and year when the form is received.

Box 3: Employer Name/Address. Enter the name and address including zip code and telephone number of the employer applying for a WOTC and/or WtW Certification.

Box 4: Employer ID No. Enter employer's federal taxpayer identification number.

Box 5: Employment Start Date/Wage/Position or Title. Enter the employment start date, the hourly wage, which the employee will be paid. If not known, enter an estimated wage. Also, enter the job or position title, which the individual will be performing for the employer.

Box 6: Previous Employment for This Employer. This requires a YES or NO answer. Enter a check mark (✓) in the blank space that corresponds to your answer.

Box 7: Name of Individual. Enter full name of prospective employee.

Box 8: Social Security Number. Enter individual's social security number here.

Boxes 9 through 18: Enter a check mark (✓) to indicate if your answer is a YES or a NO. Provide additional information where requested for either the WOTC or the WtW target group eligibility.

Box 19. Sources to Document Eligibility. List and/or describe the documents or sources of collateral contacts that are attached to this form or that will be provided. Indicate in parentheses, next to each document listed whether it is attached or forthcoming. Some examples are provided below. The asterisk (*) indicates documents that may be obtained by the employer. Employers may also obtain a letter from the agency that administers a relevant program, stating that the individual or a member of his-her household meets one of the eligibility requirements.

AGE/BIRTHDATE:

(Required for high-Risk Summer Youth & Food Stamp)

- Birth Certificate
- Driver's License
- School I.D. Card/School Records
- Work Permit
- Federal/State/Local Government I.D.*
- Hospital Record of Birth

FAMILY INCOME:

(Required for Ex-Felon)

- Pay Stubs
- Employer Contacts
- W-2 Forms
- UI Documents
- Public Assistance Records
- Family Members' Statements
- Parole Officer Statements

EX-FELON STATUS:

- Parole Officer's Name/Statement
- Correction Institution Records
- Court Record, Extract, Contact

FOOD STAMP RECIPIENT:

- Food Stamp Benefit History
- Signed statement from authorized individual with specific description of months benefits were received.
- Case Number/Identifier

SSI RECIPIENT:

- SSI Record or Authorization SSI Contact
- Evidence of SSI Issuance

NUMBER IN FAMILY:

- Public Assistance
- Social Services Agencies
- Family Members' Statements
- Parole Officer's Statements

VETERANS STATUS:

- DD-214
- Reserve Unit Contacts
- Discharge Papers

VOCATIONAL REHABILITATION

REFERRAL:

- Voc. Rehab. Agency Contact
- Social Services Agency
- Veteran's Administration Contact

AFDC/TANF & Long-Term Assistance Recipient

- AFDC Benefits History
- Signed statement from authorized individual with specific description of months benefits were received.
- Case Number/Identifier

EMPOWERMENT ZONE/ENTERPRISE

COMMUNITY

- Driver's License
- Work Permit
- Utility Bills
- Lease Document
- Voter Registration Card
- Computer Printout From Foodstamp Award Letter
- Housing Authority Verification
- Landlord's Statement
- Letter From Social Service Agency or School
- Library Card**
- Medicaid/Medicare Card
- Property Tax Record
- Postmarked Envelope Addressed to Applicant
- Public Assistance Records
- Rent Receipt
- School I.D. Card
- Selective Service Registration Card
- W-4

* Where any item of documentation such as a Federal I.D. Card does not contain age or birthdate the SESA must obtain another documentary source to verify the individual's age.

** Where any form of documentary evidence, such as a Library Card does not contain the holder's address, the SESA must obtain documentary evidence issued in the jurisdiction where the EZ/EC is located showing the holder's address.

Box 20. Signature. If applicant completes this form, he or she must enter signature here. If applicant is a minor (under age 18), the parent or guardian should sign this box. If form is completed by the employer or his/her representative/agent, enter corresponding signature here. If form was completed by the intake staff of a SESA or participating agency, enter signature of intake staff in this box.

Box 21. Date. Enter the month, day and year in which the form was completed.

Persons are not required to respond to this collection of information unless it displays a currently valid OMB control number. Respondent's obligation to reply to these requirements are mandatory as required by P.L. 105-34. Public reporting burden for this collection of information is estimated to average 20 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to the U.S. Department of Labor, U.S. Employment Service, Room 4470, Washington, D.C. 20210 (Paperwork Reduction Project 1205-0371).

(Cut along dotted line and keep in your files)

TO THE JOB APPLICANT OR EMPLOYEE:

THE INFORMATION AND THE SUPPORTING DOCUMENTATION YOU HAVE PROVIDED IN COMPLETING THIS FORM OR IN SOME CASES OTHER INFORMATION THAT COULD HELP VERIFY THE RESPONSES YOU HAVE GIVEN TO THE ITEMS/QUESTIONS IN THIS FORM WILL BE DISCLOSED BY YOUR EMPLOYER TO THE STATE EMPLOYMENT SECURITY AGENCY (Enter corresponding State Employment Security Agency here)

IN ORDER TO QUALIFY FOR A FEDERAL EMPLOYER TAX CREDIT. PROVISION OF THIS INFORMATION IS VOLUNTARY. HOWEVER, THE INFORMATION IS REQUIRED FOR YOUR EMPLOYER TO RECEIVE THE FEDERAL TAX CREDIT. IF THE INFORMATION YOU PROVIDE IS ON A MEMBER OF YOUR FAMILY, YOU SHOULD PROVIDE HIM/HER A COPY OF THIS NOTICE.

2002 Workbook

Form **8861**

Welfare-to-Work Credit

OMB No. 1545-1569

2002

Attachment
Sequence No. **107**

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return.

Name(s) shown on return

Identifying number

Part I Current Year Credit

<p>1 Enter on the applicable line below the qualified first- or second-year wages paid or incurred during the tax year and multiply by the percentage shown for services of employees who are certified as long-term family assistance recipients. Members of a controlled group, see instructions.</p> <p>a Qualified first-year wages \$ × 35% (.35)</p> <p>b Qualified second-year wages \$ × 50% (.50)</p> <p>2 Add lines 1a and 1b. You must subtract this amount from your deduction for salaries and wages</p> <p>3 Welfare-to-work credits from pass-through entities:</p> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 20%;"></td> <td style="width: 20%; border-bottom: 1px solid black;">If you are a—</td> <td style="width: 60%; border-bottom: 1px solid black;">Then enter the total of the welfare-to-work credits from—</td> </tr> <tr> <td style="border: none;"> a Shareholder</td> <td style="border: none;"> b Partner</td> <td style="border: none;"> Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.</td> </tr> <tr> <td style="border: none;"> c Beneficiary</td> <td style="border: none;"> d Patron</td> <td style="border: none;"> Schedule K-1 (Form 1065), lines 12c, 12d, or 13</td> </tr> <tr> <td style="border: none;"></td> <td style="border: none;"></td> <td style="border: none;"> Schedule K-1 (Form 1041), line 14</td> </tr> <tr> <td style="border: none;"></td> <td style="border: none;"></td> <td style="border: none;"> Written statement from cooperative</td> </tr> </table> <p>4 Current year welfare-to-work credit. Add lines 2 and 3. (S corporations, partnerships, estates, trusts, cooperatives, regulated investment companies, and real estate investment trusts, see instructions.)</p>		If you are a—	Then enter the total of the welfare-to-work credits from—	a Shareholder	b Partner	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.	c Beneficiary	d Patron	Schedule K-1 (Form 1065), lines 12c, 12d, or 13			Schedule K-1 (Form 1041), line 14			Written statement from cooperative	<p>1a</p> <p>1b</p> <p>2</p> <p>3</p> <p>4</p>	
	If you are a—	Then enter the total of the welfare-to-work credits from—															
a Shareholder	b Partner	Schedule K-1 (Form 1120S), lines 12d, 12e, or 13.															
c Beneficiary	d Patron	Schedule K-1 (Form 1065), lines 12c, 12d, or 13															
		Schedule K-1 (Form 1041), line 14															
		Written statement from cooperative															

Part II Allowable Credit (See Who must file Form 3800 to find out if you complete Part II or file Form 3800.)

<p>5 Regular tax before credits:</p> <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 1040, line 42 • Corporations. Enter the amount from Form 1120, Schedule J, line 3; Form 1120-A, Part I, line 1; or the applicable line of your return • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b, or the amount from the applicable line of your return <p>6 Alternative minimum tax:</p> <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 35 • Corporations. Enter the amount from Form 4626, line 15 • Estates and trusts. Enter the amount from Form 1041, Schedule I, line 56 <p>7 Add lines 5 and 6</p> <p>8a Foreign tax credit</p> <p>b Credit for child and dependent care expenses (Form 2441, line 11)</p> <p>c Credit for the elderly or the disabled (Schedule R (Form 1040), line 24)</p> <p>d Education credits (Form 8863, line 18)</p> <p>e Credit for qualified retirement savings contributions (Form 8880, line 14)</p> <p>f Child tax credit (Form 1040, line 50)</p> <p>g Mortgage interest credit (Form 8396, line 11)</p> <p>h Adoption credit (Form 8839, line 18)</p> <p>i District of Columbia first-time homebuyer credit (Form 8859, line 11)</p> <p>j Possessions tax credit (Form 5735, line 17 or 27)</p> <p>k Credit for fuel from a nonconventional source</p> <p>l Qualified electric vehicle credit (Form 8834, line 20)</p> <p>m Add lines 8a through 8l</p> <p>9 Net income tax. Subtract line 8m from line 7. If zero, skip lines 10 through 13 and enter -0- on line 14</p> <p>10 Net regular tax. Subtract line 8m from line 5. If zero or less, enter -0-</p> <p>11 Enter 25% (.25) of the excess, if any, of line 10 over \$25,000 (see instructions)</p> <p>12 Tentative minimum tax (see instructions):</p> <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 33 • Corporations. Enter the amount from Form 4626, line 13 • Estates and trusts. Enter the amount from Form 1041, Schedule I, line 54 <p>13 Enter the greater of line 11 or line 12</p> <p>14 Subtract line 13 from line 9. If zero or less, enter -0-</p> <p>15 Credit allowed for the current year. Enter the smaller of line 4 or line 14 here and on Form 1040, line 53; Form 1120, Schedule J, line 6c; Form 1120-A, Part I, line 2a; Form 1041, Schedule G, line 2c; or the applicable line of your return. If line 14 is smaller than line 4, see instructions</p>	<p>5</p> <p>6</p> <p>7</p> <p>8a</p> <p>8b</p> <p>8c</p> <p>8d</p> <p>8e</p> <p>8f</p> <p>8g</p> <p>8h</p> <p>8i</p> <p>8j</p> <p>8k</p> <p>8l</p> <p>8m</p> <p>9</p> <p>10</p> <p>11</p> <p>12</p> <p>13</p> <p>14</p> <p>15</p>	
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For Paperwork Reduction Act Notice, see page 3.

Cat. No. 24858E

Form **8861** (2002)

INCREASING RESEARCH ACTIVITIES CREDIT — FORM 6765

Taxpayers may be eligible for a research credit for qualified research expenditures.

Qualified Research Expenditures. Qualified research expenses include in-house expenses such as, employees wages, supplies, and amounts paid to another person for the right to use computers for research. Contract research expenses are limited to 65% of the actual cost, unless the research is performed by certain qualified research consortia, then the percentage rises to 75% of the contract.

To be considered a qualified expense, the research must be undertaken for the purpose of:

- discovering information that is technological in nature; and
- useful for the development of a new or improved business component.

It must also qualify as an expense under I.R.C. §174. Substantially all of the research activities must constitute elements of a process of experimentation relating to a new or improved function, performance, reliability or quality.

Research conducted for a purpose related to style, taste, cosmetic, or seasonal design factors is not eligible for the credit.

Computer software is generally not eligible for the research credit. However, research costs qualify for the credit if the software is:

- innovative;
- developed with significant economic risk; and
- not commercially available.

Amount of Credit. Generally, the research credit is 20% of the amount the qualified research expenses for the tax year exceeds the base amount for that year.

Computation of Credit. The base amount equals a “fixed-base percentage” multiplied by the average amount of the taxpayer’s gross receipts for the four preceding years. The base amount cannot be less than 50% of the qualified research expenses for the current year.

“Fixed-base percentage” is computed differently for long-term companies, as opposed to start up companies. For companies that had gross receipts for at least three years during 1984 through 1988, the fixed-base percentage is arrived at by the ratio of total qualified expenses as it bears to total gross receipts for that period, subject to a maximum rate of 16%.

Example 5. Chemikel, Inc. incurred research expenses in 2001. The following factors and computations are used to determine their research credit.

2001 qualified research expenditures (wages and supplies)	\$75,000
1984–1988 aggregate qualified research expenses	200,000
1984–1988 aggregate gross receipts	4,000,000
1997–2000 average annual gross receipts	\$950,000

$$\text{Fixed base percentage} = \frac{\text{1984–1988 research expenses}}{\text{1984–1988 gross receipts}} = \frac{\$200,000}{\$4,000,000} = 5\%$$

Base amount equals:	
Average annual gross receipts for 1997–2000	\$950,000
Fixed base percentage	× .05
Base amount	\$47,500

2002 Workbook

Increased 2001 qualified research expenses computation:	
2001 qualified research expenditures	\$75,000
Less base amount	<u>(47,500)</u>
Increased 2001 research expenses	\$27,500
Research activities credit computation:	
Increased 2001 qualified research expenses	\$27,500
× 20% credit rate	<u>× .20</u>
2001 credit for increasing research activities	\$5,500

The 2001 partially completed Form 6765 for Chemikel, Inc. is shown on following page. Page 2 of Form 6765, which computes the Tax Liability Limit, is not shown.

2002 Workbook

Form **6765**

Credit for Increasing Research Activities

OMB No. 1545-0619

Department of the Treasury
Internal Revenue Service

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

2001

Attachment
Sequence No. **81**

Name(s) shown on return

Chemikel, Inc.

Identifying number
41-0000000

Part I Current Year Credit (Members of controlled groups or businesses under common control, see instructions.)

Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected the alternative incremental credit.

1	Basic research payments paid or incurred to qualified organizations (see instructions)	1		
2	Qualified organization base period amount	2		
3	Subtract line 2 from line 1. If zero or less, enter -0-	3		
4	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	4	73,000	
5	Cost of supplies	5	2,000	
6	Rental or lease costs of computers (see instructions)	6		
7	Enter the applicable percentage of contract research expenses (see instructions)	7		
8	Total qualified research expenses. Add lines 4 through 7	8	75,000	
9	Enter fixed-base percentage, but not more than 16% (see instructions)	9		5 %
10	Enter average annual gross receipts (see instructions)	10	950,000	
11	Multiply line 10 by the percentage on line 9	11	47,500	
12	Subtract line 11 from line 8. If zero or less, enter -0-	12	27,500	
13	Multiply line 8 by 50% (.50)	13	37,500	
14	Enter the smaller of line 12 or line 13	14	27,500	
15	Add lines 3 and 14	15	27,500	
16	Regular credit. If you are not electing the reduced credit under section 280C(c), multiply line 15 by 20% (.20), enter the result, and see the instructions for the schedule that must be attached. If you are electing the reduced credit, multiply line 15 by 13% (.13) and enter the result. Also, write "Sec. 280C" on the dotted line to the left of the entry space. Go to Section C	16	5,500	

Section B—Alternative Incremental Credit. Skip this section if you completed Section A.

17	Basic research payments paid or incurred to qualified organizations (see the line 1 instructions)	17		
18	Qualified organization base period amount	18		
19	Subtract line 18 from line 17. If zero or less, enter -0-	19		
20	Multiply line 19 by 20% (.20)	20		
21	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	21		
22	Cost of supplies	22		
23	Rental or lease costs of computers (see the line 6 instructions)	23		
24	Enter the applicable percentage of contract research expenses (see the line 7 instructions)	24		
25	Total qualified research expenses. Add lines 21 through 24	25		
26	Enter average annual gross receipts (see the line 10 instructions)	26		
27	Multiply line 26 by 1% (.01)	27		
28	Subtract line 27 from line 25. If zero or less, enter -0-	28		
29	Multiply line 26 by 1.5% (.015)	29		
30	Subtract line 29 from line 25. If zero or less, enter -0-	30		
31	Subtract line 30 from line 28	31		
32	Multiply line 26 by 2% (.02)	32		
33	Subtract line 32 from line 25. If zero or less, enter -0-	33		
34	Subtract line 33 from line 30	34		
35	Multiply line 31 by 2.65% (.0265)	35		
36	Multiply line 34 by 3.2% (.032)	36		
37	Multiply line 33 by 3.75% (.0375)	37		
38	Add lines 20, 35, 36, and 37	38		
39	Alternative incremental credit. If you are not electing the reduced credit under section 280C(c), enter the amount from line 38, and see the line 16 instructions for the schedule that must be attached. If you are electing the reduced credit, multiply line 38 by 65% (.65) and enter the result. Also, write "Sec. 280C" on the dotted line to the left of the entry space	39		

Section C—Total Current Year Credit for Increasing Research Activities

40	Pass-through research credit(s) from a partnership, S corporation, estate, or trust	40	0	
41	Total current year credit. Add line 16 or line 39 to line 40, and go to Part II on the back	41	5,500	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 13700H

Form **6765** (2001)

Start-up firms are allowed a lower fixed-base percentage in earlier years, which results in a higher research credit. A start-up firm is one which began business after December 31, 1983 or had both gross receipts and qualified research expenses fewer than three years between December 31, 1983 and January 1, 1989. Start-up companies with qualified research expenses are allowed a fixed-base percentage of 3% for each of the company's first five tax years. The fixed-base percentage for the sixth through the 10th years, where qualified research expenses were incurred, is a portion of the percentage that the qualified expenses bear to the gross receipts for the specified preceding years.

Alternative Incremental Method. Taxpayers may elect to use an alternative incremental method to determine the amount of research credit allowed for expenses other than payments to qualified research organizations such as universities. This alternative method is the sum of the following three amounts:

1. 2.65% of qualified research expenses for the tax year in excess of an amount that is 1% of the taxpayer's average gross receipts for the four preceding years, but not more than 1.5% of such average; plus
2. 3.2% of qualified research expenses for the tax year in excess of an amount that is 1.5% of the taxpayer's average gross receipts for the four preceding years but not more than 2% of such average; plus
3. 3.75% of qualified research expenses for the tax year in excess of an amount that is 2% of the taxpayer's average gross receipts for the four preceding years.

Once this election is made, it applies to all subsequent tax years. The IRS's consent is needed to revoke this election.

ALCOHOL USED AS FUEL CREDIT — FORM 6478

Amount of Credit. The alcohol fuel credit consists of an alcohol mixture credit, an alcohol credit, and a small ethanol producer credit.

Alcohol Mixture Credit. This credit is **60¢** for each gallon of **at least 190 proof alcohol** used by the taxpayer in the **production of a qualified mixture**. A "qualified mixture" is a blend of alcohol and gasoline, or alcohol and a special fuel that the taxpayer **uses** as fuel or **sells** to another person for use as fuel. The use or sale must occur in connection with the taxpayer's trade or business. If the alcohol is **at least 150 but less than 190 proof**, then the credit is **45¢** for each gallon.

Alcohol Credit. This credit is **60¢** for each gallon of **at least 190 proof alcohol** if it is **not blended with gasoline or special fuel**, and is **used as fuel in the taxpayer's trade or business**. This credit applies to alcohol that the taxpayer sells at retail to another person and places it in the fuel tank of that person's vehicle. If the alcohol is **at least 150 but less than 190 proof**, the credit is **45¢** per gallon.

Small Ethanol Producer Credit. This credit is **10¢** per gallon, for **up to 15 million gallons of qualified ethanol fuel** produced by a small ethanol producer. Qualified ethanol production is any ethanol that is produced and sold:

- for use in the production of a qualified mixture in the buyer's trade or business;
- for use as a fuel in the buyer's trade or business; or
- at retail to a buyer who places it in another person's tank.

Qualified ethanol production can also include any ethanol that is produced for the taxpayer's use or sold and placed into another person's tank. A qualified small ethanol producer is someone who has a productive capacity that does not exceed 30 million gallons.

Special Rules. The credit is applied at the entity levels for partnerships, S corporations, trusts and other pass through entities, as well as at the partner, shareholder, and beneficiary level.

This credit is coordinated with any excise tax exemption under I.R.C. §§4041, 4081(c), or 4091(c).

The alcohol mixture credit and the alcohol credit are reduced for ethanol blenders. For **2001 and 2002** the 60¢ credit is reduced to **53¢ and the 45¢** credit for ethanol is reduced to **39.26¢**.

For **2003 and 2004**, the amounts are reduced to **52¢ and 38.52¢** per gallon, respectively.

This credit expires for any sale after December 31, 2007. There is no credit for any period prior to January 1, 2008 when the manufacturer's gasoline excise is 4.3¢ per gallon.

REHABILITATION CREDIT — FORM 3468

Amount of Credit. The credit equals the sum of 10% of certain qualified rehabilitation expenses for qualified rehabilitated buildings other than certified historic structures and 20% of the qualified rehabilitation expenses for certified historic structures.

Qualified Rehabilitated Building. This is a building and its structural components, which have been substantially rehabilitated and placed in service before 1936, for which depreciation is allowed. It must satisfy a wall retention test:

- 50% or more of the existing external walls must be kept in place as external walls;
- 75% or more of the existing external walls must be kept in place as external or internal walls; and
- 75% or more of the existing internal structural framework must be kept in place.

Certified Historic Structure. A building and its structural components are considered a certified historic structure if it is:

- listed on the National Register; or
- located in a registered historic district; and
- certified by the Secretary of the Interior as being of historic significance to the district.

Rehabilitation Expenses. A building is considered as being substantially rehabilitated only if qualified rehabilitation expenses during a 24-month period, selected by the taxpayer, exceed the greater of the adjusted basis of the building and its components, or \$5,000.

Qualified expenses are amounts properly chargeable to a capital account for depreciable property. They include non-residential real property, residential real property, real property that has a class life of more than 12.5 years, or an addition or improvement to these types of property.

Expenses that do not qualify are those attributable to work done to facilities relating to the building, such as sidewalks, parking lots, and landscaping.

GENERAL BUSINESS CREDIT — SMALL EMPLOYER PENSION PLAN START-UP COSTS

Beginning after December 31, 2001, a qualifying employer may take up to 50% of the first \$1,000 in administrative and retirement education expenses for a newly established plan, for the first three years of the plan. A qualified small employer is one that employs fewer than 100 employees who earn \$5,000 or more during a past year.

Qualified costs are ordinary and necessary expenses incurred to establish or administer a retirement plan such as a SEP, SIMPLE, or 401(k) plan. Examples of these types of expenses are payroll set up costs, investment seminars, set up fees, investment fees, or consulting fees. If the taxpayer takes this credit, then he/she must reduce the amount of the expense by the amount of the credit.

At least one employee, who is not considered a highly compensated employee, must be eligible to participate.

ELECTRIC VEHICLE CREDIT

A taxpayer may take a non-refundable credit of 10% of the cost of a qualified electric vehicle placed in service prior to January 1, 2004 with a maximum credit of \$4,000. For vehicles placed in service during 2004, the credit is 25% of the

cost and for 2005 it is 50% of the cost and for 2006 it rises to 75% of the cost. There is no credit for vehicles placed in service after 2006.

This credit is claimed on Form 8834. **It is limited to the taxpayer's regular tax liability minus other credits exceeds the alternative minimum tax for that year.** If the taxpayer is unable to use the credit, it cannot be carried forward or back. It is simply lost.

LIMITATIONS AND CARRYBACKS AND CARRYFORWARDS

The general business credits listed under I.R.C. §38(b) are used in the order they are listed in the code section which is:

- the former regular investment credit;
- the rehabilitation investment credit;
- employee plan investment credit carryforward;
- former energy investment credit;
- reforestation investment credit;
- work opportunity credit (including any jobs credit carryforward);
- welfare-to-work credit;
- alcohol fuel credit;
- research credit;
- low income housing credit;
- enhanced oil recovery credit;
- disabled access credit;
- renewable electricity production credit;
- empowerment zone employment credit;
- indian employment credit;
- employer social security credit;
- orphan drug credit;
- new markets tax credit;
- small employer pension plan start-up cost credit;
- employer provided child care credit;
- credit for contributions to CDC;
- former work incentive (WIN) credit carryforward;
- former employee stock ownership credit carryforward;
- trans-Alaska pipeline liability fund credit;
- general credits from an electing large partnership.

The amount of the credit may not exceed the taxpayer's net income tax, less the greater of:

- taxpayer's tentative minimum tax; or
- 25% of the taxpayer's regular tax over \$25,000.

For the empowerment zone credit and the renewal community employment credit, the general business credit cannot exceed the taxpayer's net income tax less the greater of:

- 75% of the taxpayer's tentative minimum tax; or
- 25% of the taxpayer's regular tax over \$25,000.

If the total of the carryforward credits and the current year credits exceed the above limitations, then the excess credit is carried back one year and forward for 20 years. The entire amount of the unused credit must be carried back one year and the amount carried forward each year is then determined by the amount that has been used. A credit cannot be carried back to a year when that credit was not applicable. For instance, the small employer pension plan start up credit cannot be carried to a year prior to January 1, 2002 because it was not allowable in any years prior to that.

ISSUE 2: FRINGE BENEFITS

Employers may provide certain deductible fringe benefits that are tax-free to employees. The regulations provide that the definition of "employee" includes an individual who is self employed. I.R.C. §401(c)(1) provides that a self-employed individual is one who has earned income within the meaning of I.R.C. §1402(a), which specifically includes income from a partnership.

HEALTH INSURANCE

Contributions by an employer to an accident and health plan are not included in the income of the employee. Thus, payments of health insurance premiums by an S corporation for an employee are excluded by the employee. IRS has ruled that health insurance premiums paid by an S corporation for a shareholder/employee who owns **more than 2%** of company stock may not be excluded by the employee. In that case, the cost of the premiums must be included as wages on the Form W-2 of the shareholder/employee. However, the premiums are not wages for FICA (Social Security and Medicare).

Payments of health insurance premiums by a partnership for a partner are considered **guaranteed payments**. They are deductible by the partnership as compensation for services. Similar to the rule for a more than 2% S corporation shareholder/employee, the payments are not excluded by the partner.

Note. Premiums paid for shareholders and employees of C corporations are fully deductible.

However, **both** more than 2% shareholder/employees of S corporations and partners are entitled to the **self-employed health insurance deduction**. This deduction is taken on **line 30** on the **2002 Form 1040**. The deductible percentage for 2002 is 70%. A worksheet in the 2002 Form 1040 Instructions can be used to calculate the deduction. No deduction is allowed for any month in which the taxpayer is eligible to participate in any subsidized health plan of an employer of either the taxpayer or the taxpayer's spouse.

MEDICAL REIMBURSEMENT PLANS

A medical reimbursement plan is a self-insured plan under I.R.C. §105. It is a plan designed to reimburse **employees** for medical expenses as defined under I.R.C. §213 and not covered by medical insurance.

Limitations. A self-insured medical reimbursement plan may not discriminate in favor of highly compensated employees. The plan must cover 70% or more of all eligible employees, or 80% or more of all eligible employees if 70% or more of all employees are eligible.

An employer may exclude the following employees from the plan.

- Employees who have not completed three years of service
- Employees who have not attained age 25

- Part-time (less than 35 hours per week) or seasonal employees (less than nine months per year)
- Employees covered under a collective bargaining agreement
- Non resident alien employees with no U.S. source income

The plan may establish a maximum limit for the amount of reimbursement. The limit must be uniform for all employees and may not be modified based upon an employee's age or years of service.

Partners and S corporation shareholders. Self-employed individuals are **not** treated as employees. Therefore, partners and S corporation shareholders who own more than 2% of company stock are **not** allowed to participate in an I.R.C. §105 plan.

Note. Due to the attribution rules of I.R.C. §318(a) a more than 2% shareholder may not provide a medical reimbursement plan to a spouse.

VEHICLE EXPENSES

The expenses of vehicles provided to employees are deductible by the employer if there is a valid business purpose. The value of the personal use portion of the vehicle is a taxable fringe benefit to the employee.

Determination of Taxable Benefit

Annual Lease Valuation (ALV) Method. Under this method, an employee is taxed on the **annual lease value** of the auto shown in the ALV table in Reg. §1.61-2T(d)(2)(iii) and in IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*. The ALV table includes maintenance and insurance. Employer provided fuel may be valued 5.5¢ per mile.

New IRS Pub. 15-B (dated January 2002) is an excellent source of information. The section on the ALV method is highly recommended. The following items are shown below:

- The ALV table from IRS Pub. 15-B
- Worksheet for Determining Value of Personal Use of Employer-Provided Vehicles

Note.

1. For the ALV rules, an automobile is any four-wheeled vehicle (car, pickup truck, or van) manufactured primarily for use on public streets, roads and highways. The weight of the vehicle is irrelevant.
2. The worksheet is very useful for computing the total value of personal use of the vehicle. This amount must be included as wages on the employee's Form W-2 and is subject to employment taxes.
3. Employees who use employer-provided autos must keep an accurate record of personal miles driven and report the mileage amounts to their employers. It is recommended that employees report the personal miles on a monthly basis.

Annual Lease Value

Generally, you figure the annual lease value of an automobile as follows.

- 1) Determine the fair market value of the automobile on the first date it is available to any employee for personal use.
- 2) Using the following **Annual Lease Value Table**, read down column (1) until you come to the dollar range within which the fair market value of the automobile falls. Then read across to column (2) to find the annual lease value.

Annual Lease Value Table

(1)	(2)
<u>Automobile Fair Market Value</u>	<u>Annual Lease Value</u>
\$0 to 999	\$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

For automobiles with a fair market value of more than \$59,999, the annual lease value equals $(.25 \times \text{the fair market value of the automobile}) + \500 .

Worksheet For Determining Value of Personal Use of Employer-Provided Vehicles

1. Vehicle make, model and year _____

2. Later of January 1, 1985, or the date the vehicle was first available to the employee _____

3. Use of the N.A.D.A. Blue Book covering the period specified in #2 to determine the fair market value of the vehicle described in #1

Fair Market Value _____

4. Use the FMV determined in #3 to find the corresponding annual value in the ALV Table

Annual Value of Use _____

5. Compute the fraction of the year available

$\frac{\# \text{ Days Available}}{365 \text{ Days}} = \text{Fraction of Year Available}$

6. Compute the prorated annual value of use

Annual Value of Use \times Fraction of Year = Prorated Annual Value of Use

Prorated Annual Value of Use _____

7. Compute personal use percentage

$\frac{\# \text{ Personal Miles}}{\# \text{ Total Miles}} = \text{Personal Use Percentage}$

Personal Use Percentage _____

8. Compute value of personal use

Prorated Annual Value of Use \times Personal Use Percentage = Value of Personal Use

Value of Personal Use _____

9. Compute value of employer-provided fuel

Personal Miles \times \$0.055 = Value of Employer-Provided Fuel

Value of Employer-Provided Fuel _____

10. Compute total value of personal use of vehicle

Value of Personal Use + Value of Employer-Provided Fuel

Total Value of Personal Use of Vehicle _____

Vehicle Cents-Per-Mile Method. An employer may use this method to value the personal use by employees of employer-provided vehicles if either of the following two tests are met:

1. The employer reasonably expects the vehicle will be used regularly by the employee throughout the year.
2. The vehicle is actually driven at least 10,000 miles during the year by employees. This test is met even if all of the miles driven by the employee(s) are for personal use.

The valuation rate for **2002** is 36.5¢ per mile. This valuation method may **not** be used if the employee is a “**control employee,**” defined as follows;

- A board- or shareholder-appointed, confirmed or elected **officer** of the employer whose compensation equals or exceeds \$50,000 (adjusted for inflation)
- A **director** of the employer
- Any employee who receives \$100,000 or more in compensation (adjusted for inflation)
- A 1% or greater owner of an equity, capital or profit interest in the employer

Caution. There is **another severe restriction** in using the vehicle-cents-per-mile valuation method. For employer-provided vehicles first made available to employees for personal use in 2002, the **maximum fair market value (FMV)** of the vehicle may not exceed **\$15,300** (Rev. Proc. 2002-14, I.R.V. 2002-5, page 450). This restriction is based on the **luxury vehicle** restrictions for MACRS under I.R.C. §280F. For vehicles first made available in 2001, the FMV limit was \$15,400.

Commuting Use Valuation Method. An employer may provide an automobile to an employee under a written policy allowing only commuting use of the vehicle. This method permits a \$3 per round trip commute value to be added to the employee’s Form W-2 wages for the year. There are five requirements that must be met for this rule to be applicable:

1. The employer owns or leases the vehicle and provides it to one or more employees for use in a trade or business.
2. The employer requires the employee to commute to and/or from work in the vehicle for bona fide non-compensatory reasons.
3. The employer establishes a **written policy** under which the employee is **not** allowed to use the vehicle for personal purposes.
4. Except for de minimis personal use, the employee does **not** use the vehicle for personal purposes other than commuting.
5. The employee required to use it for commuting is **not a control employee** (previously defined).

TRAVEL EXPENSES AND QUALIFIED TRANSPORTATION

Qualified transportation fringe benefits defined in I.R.C. §132(f) allow employers to provide this benefit tax free to employees provided they meet certain guidelines.

Qualified Transportation Fringe Benefits. Transportation in a commuter vehicle is considered qualified transportation. A commuter vehicle is defined as one that has a capacity for six or more adults, and for which 80% of the mileage is reasonably expected to be used for employee commuting. The transportation must be between the employee’s home and work place in order to qualify as a tax-free benefit.

A transit pass costing up to \$65 per month may be excluded from the employee’s income.

Qualified parking costing up to \$175 per month is also a tax-free fringe benefit.

Reimbursement Methods

High Low Substantiation Method. Rev. Proc. 2001-47 lists the locations that are considered to be high cost localities beginning October 1, 2001.

Under this method, an employer may reimburse an employee up to \$204 per day for lodging, meals, and incidentals with \$42 per day designated as meal allowance for travel to a high cost locality. For travel to all other localities, the maximum reimbursement is \$125 per day with \$34 per designated as a meal allowance.

Per Diem Substantiation Method. The federal per diem rates for meals and incidentals only can be found in IRS Pub. 1542. This method is allowed for use by any taxpayer including self-employed individuals as well as 10% or greater shareholders of corporations. This method may be used as reimbursement or as a deduction computation.

DEPENDENT CARE ASSISTANCE PROGRAMS

I.R.C. §129 allows employers to provide dependent care assistance to their employees as a tax-free fringe benefit. The maximum amount that can be excluded by employees is **\$5,000** (\$2,500 for a married person filing a separate return). The plan must be written and it must be non-discriminatory. Not more than 25% of the amount paid or incurred by the employer may be for the benefit of individuals who are shareholders or owners (or spouses or dependents) each of whom (on any day of the year) own more than 5% of the stock.

LIFE INSURANCE

Deductibility of Premiums. An employer may deduct the premium paid on any life insurance policy, or endowment or annuity contract, which covers an employee **if the employer is not directly or indirectly a beneficiary** of the policy or contract. This deduction is only available if the premiums represent **additional compensation** for services rendered by the employee.

An employer who is not named as the beneficiary is still considered a beneficiary if the employer can borrow on the policy, surrender it for cash, use the policy for credit, or if a creditor of the employer is a beneficiary. In addition, an employer is considered the beneficiary if the employee is required to assign his right, title, and interest in the policy to the employer, and if the employer has the right to terminate the policy and receive its cash value.

Buy-Sell Arrangements. Life insurance is often used to provide a source of funds for the purchase of a business interest owned by a shareholder or partner who dies. Under buy-sell arrangements, the life of the person whose interest will be purchased is insured for the benefit of those who will buy the decedent's interest. Therefore, premium payments under are **not deductible** because the taxpayer paying the premium is a direct or indirect beneficiary of the policy.

Example 5. Perkins Clothing, a partnership, purchases a life insurance policy on the life of the 60-year old 50% partner, James Perkins. The partnership is the named beneficiary of the policy. There is a written partnership agreement that the other 50% partner, Carol Black, will use the life insurance proceeds to purchase the partnership interest of James on his death.

Conclusion. The premiums paid by the partnership are not deductible.

EDUCATIONAL BENEFITS

I.R.C. §127 provides that expenses for educational assistance may be excluded from the income of any employee. See Chapter 8: Education Provisions for more details on this fringe benefit.

NO ADDITIONAL COST SERVICES

No additional cost services provided under I.R.C. §132(b) are generally deductible by the employer and non-taxable to the employee. These are services provided in the ordinary course of the employer's business if the employer does not incur any substantial additional costs to furnish them. Examples include:

- free standby flights to airline employees, and
- free phone service to telephone company employees.

Example 6. TravelCo, Inc. owns an airline and several hotels. It offers its employees use of hotel rooms and free air travel as a fringe benefit. The air travel is on a stand-by basis and the hotel rooms are only available if

they are not needed by guests. Only airline employees may treat the free air travel as a tax-free fringe benefit. They are taxed on the use of free hotel rooms. Conversely, only hotel employees receive the use of hotel rooms tax-free. They are taxed on the value of any free airline tickets.

WORKING CONDITION FRINGE BENEFITS

Working condition fringe benefits allowed under I.R.C. §132(d) are defined as property or services provided to any employee to the extent that they would be deductible as ordinary and necessary business expenses if the employee paid for them. Reg. §1.132-1T(b)(2) defines employees that are eligible to be covered under I.R.C. §132 as:

- current employees;
- partners who perform services for partnerships;
- directors of the employer; and
- independent contractors who perform services for the employer.

Examples of working condition fringe benefits include:

- the cost of business periodicals provided to the employee;
- the use of a company car while on company business; and
- business travel expenses.

CAFETERIA PLANS

Cafeteria plans allowed under I.R.C. §125 allow employees to select among cash and qualified tax-free benefits. This allows the employer to exclude from the employee's gross income any non-taxable fringe benefits they choose. Qualified benefits under I.R.C. §125 are not subject to FICA, Medicare, or federal unemployment taxes. If the employee elects to choose cash, then that amount is treated as taxable wages subject to all employment and income taxes.

Benefits Excludable. Reg. §1.125-2T allows the following qualified benefits to be excludable under I.R.C. §125:

- Group term life insurance up to \$50,000 [I.R.C. §79]
- Accident or health plans [I.R.C. §§105 and 106]
- Dependent care assistance programs [I.R.C. §129]
- Qualified group legal services [I.R.C. §120]
- Qualified cash or deferred arrangement that is part of a profit sharing or stock bonus plan [I.R.C. §401(k)]
- Vacation days program, provided vacation days are not redeemable for cash at a later date

Non-Discrimination Requirements. A cafeteria plan may not discriminate in favor of highly compensated employees. The safe harbor test for applying the non-discrimination rules can be found in I.R.C. §401(k)(12). Prop. Reg. §1.125-1, Q & A No. 4 specifically eliminates the self-employed taxpayer as a qualified employee for the purposes of participating in a cafeteria plan. Therefore, a partner or a more than 2% shareholder of an S corporation may not participate in the plan.

ISSUE 3: VEHICLES

LISTED PROPERTY

A passenger automobile is any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways, and that is rated as having **6,000 pounds or less** of unloaded gross vehicle weight. These do not include ambulances, hearses, or any vehicle used in a trade or business in the business of transporting persons or property for compensation.

Although heavy trucks and vans do not meet the passenger automobile definition, they are still a means of transportation. Therefore, they are within the definition of “listed property” in I.R.C. §280F(d)(4) and are subject to the business usage rules. **If qualified business use is 50% or less, depreciation is limited to straight-line and I.R.C. §179 expensing may not be used.**

The taxpayer must maintain records to substantiate the business use of a vehicle. To meet the adequate record requirement, a taxpayer must maintain an account book, diary, log, statement of expense, trip sheet or similar record that is sufficient to establish each element of an expenditure. An adequate record must generally be written. However, a record of the business use prepared in a computer memory device with the aid of a logging program will constitute an adequate record. If a taxpayer can establish that the failure to produce adequate records is due to the loss of records through circumstances beyond the taxpayer’s control (i.e. fire, flood, earthquake), the taxpayer has the right to reconstruct the expenses and use by any reasonable method [Reg. §1.274-5T(c)(5)].

A taxpayer may maintain an adequate record for portions of a taxable year and use that record to substantiate the amount of business use for the entire tax year, provided that the taxpayer can demonstrate by other evidence that the periods for which the adequate record is maintained is representative of the use throughout the year [Reg. §1.274-5T(c)(3)(ii)].

DEPRECIATION LIMITATIONS FOR “LUXURY AUTOS”

For passenger automobiles placed in service during 2000, 2001, and 2002, the **maximum** amount of depreciation (including the I.R.C. §179 deduction) allowable for the first year is limited to \$3,060, \$4,900 for the second year, \$2,950 for the third year and \$1,775 for each succeeding taxable year until the depreciable basis is recovered. These maximum limitation amounts assume 100% business use.

Note. The \$3,060 first-year maximum limitation for automobiles placed in service after September 10, 2001 but before 2003 is increased by \$4,600. Therefore, the **combined** MACRS, I.R.C. §179 deduction, plus the special 30% depreciation allowance first-year limitation for such autos is **\$7,660**.

The depreciation limits are increased for qualified clean burning vehicles and certain electric vehicles. For passenger vehicles designed to be propelled primarily by electricity, the depreciation limits are tripled. The maximum first year depreciation for 2002 is \$9,180, \$14,700 for the second year, \$8,750 for the 3rd year and \$5,325 for each succeeding year.

The same first year increase applies for electric automobiles placed in service after September 10, 2001 and before September 11, 2004 as for gasoline powered vehicles.

For those vehicles that are modified to use clean burning fuel, the I.R.C. §280F limits apply only to that portion of the vehicle cost not represented by the installed qualified clean burning fuel property. In other words, the taxpayer is allowed a depreciation deduction without regard to I.R.C. §280F on the installed clean burning fuel property.

The depreciation deduction is reduced for personal use after the I.R.C. §280F limits are applied.

BASIS OF VEHICLE USED IN TRADE OR BUSINESS

Basis Computation For Vehicles

Any depreciation attributable to personal use is treated as business or investment use for purposes of computing the unadjusted basis for future depreciation.

Example 7. Sam, a self-employed consultant, bought and placed in service a **new** \$20,000 passenger auto on June 1, 2001. He used it **60%** for business purposes in 2001. He did not elect an I.R.C. §179 deduction. His regular MACRS deduction for 2001, without considering the “luxury auto” depreciation limitation, is \$2,400 as shown in the computation on the next page.

MACRS Computation Without Considering Depreciation Limitation

Cost of automobile (acquired June 1, 2001)	\$20,000
First-year MACRS percentage for 5-year property	× 20%
Allowable MACRS for 2001 assuming 100% business use	<u>\$4,000</u>
Business use limitation (\$4,000 × 60% business use)	\$2,400

However, due to the “luxury auto” depreciation limitation, Sam’s 2001 MACRS deduction is limited to \$1,836 computed as follows:

First-year limitation	\$3,060
Business use percentage for 2001	× 60%
Allowable 2001 MACRS deduction	<u>\$1,836</u>

For 2002, Sam’s unrecovered cost basis for computing MACRS is \$16,940 (\$20,000 total cost basis less the first-year maximum limitation amount of \$3,060). If Sam’s business use increases to 80% in 2002, his 2002 MACRS deduction will be \$3,920 computed as follows:

Second-year limitation	\$4,900
Business use percentage for 2002	× 80%
Allowable 2002 MACRS deduction	<u>\$3,920</u>

Example 8. Assume the same facts as **Example 7**, except Sam bought the **new** auto on June 1, 2002. His business use percentage for 2002 is **60%**. He does not elect the I.R.C. §179 deduction. However, due to his high net profit from his consulting business, Sam takes the **30% special depreciation allowance**. Sam computes his **maximum 2002 depreciation of \$4,596** as follows:

Step 1.	Cost × 2002 business use percentage \$20,000 × 60% =	\$12,000
Step 2.	Step 1 × 30% \$12,000 × 30% =	\$3,600
Step 3.	Step 1 – Step 2 \$12,000 – \$3,600 =	\$8,400
Step 4.	Step 3 × first-year MACRS percentage \$8,400 × 20% =	\$1,680
Step 5.	Step 4 + Step 2 \$1,680 + \$3,600 =	\$5,280
Step 6.	\$7,660 × 2002 business use percentage \$7,660 × 60% =	\$4,596
Step 7	Maximum deduction is lesser of Steps 5 or 6	\$4,596

Standard Mileage Rate

A taxpayer may use the business standard mileage rate for computing his/her vehicle expense for either an owned vehicle or a leased vehicle. For 2002, the rate is 36.5¢ per mile. This deduction is claimed in lieu of the actual operating and fixed costs of the automobile. This includes depreciation, repairs, gasoline, tires, insurance, license registration or fees, and lease payments. Parking fees and tolls are not included in the standard mileage rate and therefore are allowed as a separate deduction. Interest paid on a car loan is also a separate deduction for self-employed individuals. However, I.R.C. §163(h)(2)(A) states that the business portion of interest paid on a auto loan by an **employee** is considered to be a **non-deductible personal interest**.

If the standard mileage rate is used, depreciation is considered to have been allowed at the rate of 15¢ per mile for 2001 and 2002. For 2000, the depreciation factor was 14¢ per mile. For 1998 and 1999 the factor was 12¢ per mile. This depreciation reduces basis (but not below zero) in determining the adjusted basis for computation of gain or loss on the sale of the vehicle.

The standard mileage rate may **not** be used for vehicles for hire, or for two or more vehicles used simultaneously (such as a fleet operation). Ltr. Rul. 8343005 allows each spouse to use the standard mileage rate for their separately owned vehicles in their separate businesses. Also, the standard mileage rate may not be used if the automobile was previously depreciated under the actual cost method using a depreciation schedule other than straight line, if an I.R.C. §179 deduction was claimed, or if the taxpayer had used ACRS or MACRS depreciation.

By using the standard mileage rate, the taxpayer has chosen to exclude the automobile from MACRS depreciation. If after using the standard mileage rate, the taxpayer uses actual cost, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life.

Leased Vehicles

Lease payments for a vehicle are deductible as an ordinary and necessary business expenses to the extent the vehicle is used in the taxpayer's trade or business or for the production of income. A taxpayer must spread any advance payments over the entire lease period.

A taxpayer must include a lease inclusion amount in income each year if the value of the vehicle is more than the luxury automobile limit. For vehicles first leased in 2002, the amount is **more than \$15,500**. The inclusion amount is prorated for the number of days of the lease term in the tax year. A partial **2002** lease inclusion table is shown below.

Dollar Amounts for Automobiles (Other than Electric Automobiles) With a Lease Term Beginning in Calendar Year 2002

Fair Market Value of Automobile		Tax Year During Lease				
Over	Not Over	1st	2nd	3rd	4th	5th and later
30,000	31,000	71	155	230	275	318
31,000	32,000	75	165	245	294	338
32,000	33,000	80	175	260	312	360
33,000	34,000	85	185	276	329	381
34,000	35,000	89	196	290	348	402
35,000	36,000	94	206	305	367	422
36,000	37,000	99	216	321	384	443
37,000	38,000	103	226	336	403	464
38,000	39,000	108	236	351	421	485
39,000	40,000	112	247	366	439	506
40,000	41,000	117	257	381	457	527

Example 9. Karen, a self-employed photographer, began to lease a new SUV with a fair market value of **\$34,750** on June 1, 2002. The term of the lease is 36 months. She uses the vehicle **75%** for business purposes in 2002. On line 6 (Other income) on her **2002 Schedule C**, Karen must report a **\$39** inclusion amount. The computation and a portion of Karen's schedule C is shown below.

First-year Dollar Amount from table shown above.	\$89
$\$89 \times \text{prorated amount of } (214 \text{ days} \div 365 \text{ days})$	52
$\$52 \times 75\% \text{ (business use percentage)}$	39

SCHEDULE C (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>	Profit or Loss From Business (Sole Proprietorship) ▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. ▶ Attach to Form 1040 or 1041. ▶ See Instructions for Schedule C (Form 1040).	<small>OMB No. 1545-0074</small> <div style="font-size: 2em; font-weight: bold;">2002</div> <small>Attachment Sequence No. 09</small>
Name of proprietor Karen		Social security number (SSN)
A Principal business or profession, including product or service (see page C-1 of the instructions) Photographer		B Enter code from pages C-7 & 8
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN), if any
E Business address (including suite or room no.) ▶ City, town or post office, state, and ZIP code		
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶		
G Did you "materially participate" in the operation of this business during 2002? If "No," see page C-2 for limit on losses <input type="checkbox"/> Yes <input type="checkbox"/> No		
H If you started or acquired this business during 2002, check here <input type="checkbox"/>		
Part I Income		
1	Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here <input type="checkbox"/>	
2	Returns and allowances	
3	Subtract line 2 from line 1	
4	Cost of goods sold (from line 42 on page 2)	
5	Gross profit. Subtract line 4 from line 3	
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	39
7	Gross income. Add lines 5 and 6	

Assume Karen's business use percentage remains at 75% for the entire lease term, which ends on May 31, 2005. Her inclusion amounts for **2003**, **2004** and **2005** are shown in the chart below:

Year	\$ Amount		Proration		Business Use		Inclusion Amount
2003	\$196	×	(365 ÷ 365)	×	75%	=	\$147
2004	290	×	(366 ÷ 366)	×	75%	=	218
2005	290	×	(151 ÷ 365)	×	75%	=	90

Note. For the last year of the lease, which is 2005 for Karen, use the dollar amount from the table for the preceding year.

Lease vs. Buy

There are several items to consider when deciding to lease versus buy a vehicle. The most important considerations are:

- How many miles are put on a vehicle in a year?
- How often are vehicles traded?
- What cost is involved in the lease price compared to the purchase price?

2002 Workbook

Additional considerations include whether the vehicle is modified with items such as speakers, alarms and hitches, or whether the lease is extended over longer periods, such as five years. These options may not be practical or available with a lease.

In most states, sales tax is charged on leased vehicles. Some leasing companies will require the lessee to pay sales tax up front, or they may add it into the lease payment. Some states require that sales tax be paid each month on the lease payment, and be added onto the lease payment and paid by the lessee.

The costs associated with a lease are:

- the cost of the vehicle;
- the interest factor if the vehicle was purchased instead of being leased;
- sales tax;
- operating expenses or mileage costs; and
- the resale value when the lease is terminated.

A higher resale normally results in a lower lease payment.

Most leasing companies build an 8–10¢ per mile operating cost factor into the lease payment. If the lessee exceeds the mileage allowed in the lease contract, a penalty is charged at the end of the lease. Generally, the penalty is computed at 12–15¢ per each excessive mile.

Example 10. Sam leases a \$21,000 vehicle for 36 months at \$350 per month. The lease payment includes sales tax, which is paid by the leasing company. The lease allows Sam to drive 15,000 miles annually before an excessive mileage penalty is assessed. Sam’s total lease payments will be **\$12,600** for the 36-month lease term.

Sam must compare his **\$12,600 lease cost** to his ownership cost if he buys the vehicle instead. **The ownership cost is \$13,152**, as calculated below.

Purchase price	\$21,000
6% Sales tax ($\$21,000 \times 6\%$)	1,260
Interest on a 4% 36-month loan	1,392
Less resale value after 36 months (estimate)	(10,500)
Sam’s ownership cost	\$13,152

Note. These calculations do not consider the tax effect of depreciation or the time value of money.

Observation. The cost of leasing in **Example 10** is slightly less than purchasing. However, buying the vehicle would be less assuming zero percent financing, a fairly common sales incentive.

Sale of a Business Vehicle

For a business vehicle that has been used 100% for business, the adjusted basis is calculated by subtracting the depreciation claimed from the cost basis. Due to the I.R.C. §280F “luxury auto” limitations, the sale may result in a loss rather than a gain.

Example 11. Sam purchased a \$35,000 vehicle in June 2001 and uses it 100% for business for three years. His depreciation deductions on the vehicle are limited by I.R.C. §280F. His total depreciation deduction for the 3-year period is \$11,798 as shown below.

For 2001 (first-year limitation)	\$3,060
For 2002 (second-year limitation)	4,900
For 2003 (third-year limitation)	2,950
For the first 6 months of 2004 (half of fourth-year limitation)	888
Total depreciation claimed during the lease period	\$11,798

Sam's adjusted basis for computing gain or loss is \$23,202 (\$35,000 less \$11,798) as of July 1, 2004. If the estimated sales price then is **greater than \$23,202**, Sam would probably be wise to **trade** the vehicle rather than sell it. However, if the estimated sales price is **less than \$23,202**, the sale would result in an ordinary loss on his 2004 Form 4797.

Note. Since the car is used 100% for business, the depreciation limit in the year of sale is not reduced.

For a vehicle used partially for personal purposes and partially for business, the analysis is more complicated. Gain or loss on the business portion is recognized, but only gain is recognized on the personal portion. Losses on the sale of personal assets are not allowed.

Example 12. Same facts as **Example 11**, except Sam uses the vehicle **80% for business** use each year of the lease. His total depreciation claimed during the 3-year lease period is **\$10,148** (\$12,685 × 80%). Assume Sam sells the vehicle for its fair market value of **\$18,000** on July 1, 2004.

Sam actually had two sales in 2004. The sale of a **business** auto and the sale of a **personal** auto are shown below.

Sale of the 80% business use portion of the vehicle in 2004	
Sales price (80% of \$18,000)	\$14,400
Less: Unadjusted cost basis (80% of \$35,000)	(28,000)
Plus: Depreciation claimed during the lease period	12,685
Loss on sale of business portion on 2004 Form 4797	(\$915)
Sale of the 20% personal use portion of the vehicle in 2004	
Sales price (20% of \$18,000)	\$3,600
Less: Unadjusted cost basis (20% of \$35,000)	(7,000)
Nondeductible loss in 2004 on sale of personal asset	(\$3,400)

Reg. §1.280F-2T(g)(2)(ii) requires a special computation in determining the depreciable basis of a new vehicle when a part business/part personal use vehicle has been traded for a new vehicle. The basis is computed under the normal trade-in rules and then is reduced by the difference between what depreciation would have been allowable if the old car had been used 100% for business and the depreciation actually claimed as business use.

2002 Workbook

Example 13. Assume the same facts as **Example 12**, except Sam **trades** the vehicle for a new vehicle on July 1, 2004. His boot paid to the dealer is \$10,000. Sam's depreciable basis in the new vehicle is \$32,315 as shown below.

Unadjusted cost basis of trade-in vehicle	\$35,000
Less: Depreciation assuming 100% business use	(12,685)
Plus: Boot paid on trade	<u>10,000</u>
Depreciable basis in new vehicle acquired July 1, 2004	\$32,315

Note. This special basis calculation shown in **Example 13** is for depreciation purposes only. For gain or loss purposes on a future sale of Sam's new vehicle, his basis is \$25,315 (\$28,000 less \$12,685, plus \$10,000).

ISSUE 4: INSTALLMENT SALES

DEFINITIONS

Installment Sale. An installment sale is a disposition of property where at least 1 payment is to be received in a year after which the sale occurs.

Installment Method. The installment method is a method under which income is recognized in a year where payments are received in proportion to which the gross profit bears to the total contract price.

Selling Price. The selling price is the total of any money, FMV of any installment obligation, and FMV of any property received by the seller. The selling price is the gross sales price without any reduction for mortgages or encumbrances on the property.

Contract Price. The contract price is equal to the selling price less that portion of any indebtedness assumed by the buyer which does not exceed the seller's basis in the property.

Qualifying Indebtedness. Qualifying indebtedness is a mortgage encumbering the property or any other indebtedness assumed by the buyer incident to the acquisition of the property.

Installment Sale Basis. The installment sale basis is the adjusted basis of the property plus selling expenses and income from depreciation recapture that is required to be reported in the year of sale.

Gross Profit. The gross profit is the selling price less the installment sale basis in the property. This is the gain the taxpayer will report using the installment method.

Gross Profit Percentage. The gross profit percentage is arrived at by dividing the gross profit by the contract price. This percentage is multiplied by the principal payments received each year.

ELECTIONS

If a sale qualifies as an installment sale, it must be reported on Form 6252 unless the taxpayer elects out of the installment method of reporting.

The taxpayer must elect out of the installment method before the due date (including extensions) of his/her tax return for the year the installment sale occurs. This election is irrevocable without permission from the IRS. A revocation will not be allowed if the primary reason is to avoid federal income tax or if the tax year is closed.

Rev. Proc. 92-58 provides for an automatic 6-month extension from the due date of the return for making certain elections prescribed by statute as required to be made by the due date of the return. If a return was timely filed without

an extension and the taxpayer did not elect out of the installment method, the taxpayer could elect to amend the return within 6 months and make the election to report the sale in full in the year of disposition.

The election out of the installment method of reporting is made by reporting the entire sale on Schedule D or Form 4797, whichever is applicable.

COMPONENTS OF AN INSTALLMENT OBLIGATION

Each installment obligation will consist of the following three components:

1. Return of the taxpayer's basis in the property
2. Gain on the sale
3. Interest

The taxpayer's basis in the property is the adjusted basis of the property plus selling expenses plus any depreciation required to be recaptured in the year of sale.

Gain on the sale is the difference between the taxpayer's basis in the property and the amount realized. Gross profit is the gain to be reported each year over the life of the installment contract. If a mortgage is assumed by the buyer, the gross profit may not be the actual amount of cash the seller receives. If the mortgage assumed is less than the installment basis, then the assumption of the mortgage is subtracted from the selling price to arrive at the contract price. If the mortgage assumed is greater than the installment basis, then the excess is treated as a payment received in the year of sale. In addition to the portion of the mortgage assumption equal to basis, being subtracted from the sales price, this excess is added to the selling price to arrive at the contract price. The gross profit percentage is derived from dividing the gross profit by the contract price.

Interest is generally the amount of **stated interest** in the contract. If there is no stated interest or insufficient interest rates (less than AFR) stated, the taxpayer must allocate an amount of each payment as **unstated interest** under I.R.C. §483.

DEPRECIATION RECAPTURE INCOME

If depreciable personal property (I.R.C. §1245 property) is reported on the installment method, any depreciation recapture income must be reported in the year of sale. This is true whether or not an installment payment was received that year.

Example 14. Backroad Auto Salvage, Inc. sells its fully depreciated car crusher for \$50,000 in 2002. It was purchased in 1990 for \$105,000. The sale is on the installment basis. Backroad receives an installment payment of \$20,000 in 2002. The entire \$50,000 gain must be reported in 2002 because the gain is attributable to the recapture of depreciation.

Sellers of commercial real property which was depreciated under an ACRS accelerated method, must also report any recapture income depreciation in the year of sale. Such depreciation is treated as if it were on I.R.C. §1245 property instead of I.R.C. §1250 property.

Sellers of residential real property which was depreciated under an ACRS accelerated method, must report the excess of the accelerated depreciation over straight-line depreciation in the year of sale. If the property is completely depreciated out, there will be no recapture income.

The portion of the gain due to depreciation on I.R.C. §1250 property may be reported on the installment method. This portion of the gain will be taxed at a maximum rate of 25%. It does not qualify for any of the preferential capital gain rates.

Note. See Chapter 13: Practitioner Q and A for a complete discussion of this issue. Completed forms and schedules are shown.

RELATED PARTY SALES

If a taxpayer reports a sale on the installment method to a related party and the related party sells the property **within two years of the date of the first sale**, the first seller must report the amount realized by the related party as if he/she had received it from the first sale.

The recognition of gain on the second disposition will not be required if there is an involuntary conversion or a disposition occurring because of death of the related party. Similarly, the gain is not recognized if it is established to the satisfaction of the IRS that neither the first disposition (to the related person), nor the second disposition had as one of its primary purposes the avoidance of income tax.

It is the responsibility of the original seller to notify the IRS if the related party has disposed of the property.

Comprehensive Installment Sale Example

The sale of a business is not usually a sale of a single asset. Instead, all the assets of the business are sold. The result is each asset is treated as if it were sold separately. Assets can include real property, personal property, inventory, goodwill, going concern value, accounts receivable, or cash. The computation of gain for some assets involve the depreciation recapture rules. Some qualify for the installment method of reporting and some, including those sold at a loss, do not.

Sam Smith sold his retail business on the installment basis on December 15, 2001. The sales contract allocated the \$250,000 sales price to the six assets sold as shown below.

NOTE	Asset Sold	Sales Price	Expense of Sale	Down Payment
	Inventory	\$4,000	\$200	\$400
	Equipment	2,000	100	200
	Building	160,000	8,000	16,000
	Land	40,000	2,000	4,000
	Covenant not to Compete	10,000	500	1,000
	Goodwill	34,000	1,700	3,400
	Totals	\$250,000	\$12,500	\$25,000

The seller assumes Sam's mortgage on the land and building of \$75,000. \$15,000 of the mortgage is allocated to land and \$60,000 to building based on the sales price ratio.

Sam received a \$25,000 down payment in 2001. He will receive 10 annual payments of \$15,000 plus 6% interest beginning in 2002.

The gain/loss computations are shown below.

Assets	Sales Price	Cost Basis	Accumulated Depr.	Gain/Loss ¹
Inventory	\$4,000	\$5,000	(\$1,200)	
Equipment (bought in 1995)	2,000	24,000	24,000	\$1,900
Building (bought in 1992)	160,000	90,000	28,451(MACRS)	90,451
Land (bought in 1992)	40,000	10,000		28,000
Covenant not to Compete	10,000	0		9,500
Goodwill	34,000	0		32,300
Totals	\$250,000	\$129,000	\$52,451	\$160,951

¹ The gain or loss includes the expense of sale amount shown in the first chart

Answer

Sam must report the \$4,000 sale of inventory on his 2001 Schedule C. He reports the equipment, building, land, covenant not to compete and goodwill on separate Form 6252s.

Note regarding the mortgage assumption of \$15,000 on the land. In the year mortgage is assumed (2001), it reduces basis dollar for dollar, until basis has been consumed. Any excess is taxable in the year of assumption, and all future principal payments are 100% taxable.

Sam must report the entire \$1,900 gain on the sale of the office equipment on Form 4797 because it is an I.R.C. §1245 gain. This gain is reported in full in 2001. All principal payments received in future years for the equipment are return of basis and therefore **not taxable**.

Note. Sam's 2001 Form 4797 should be prepared before preparing the 2001 Form 6252 for the equipment.

Sam's 2001 Forms and Schedules for the installment sale follow.

2002 Workbook

For Comprehensive Example

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or Form 1065-B.
▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2001

Attachment
Sequence No. **09**

Name of proprietor Sam Smith		Social security number (SSN) 333 33 3333
A Principal business or profession, including product or service (see page C-1 of the instructions) Retail Sales	B Enter code from pages C-7 & 8 ▶ 9 9 9 9 9	
C Business name. If no separate business name, leave blank.	D Employer ID number (EIN), if any	
E Business address (including suite or room no.) ▶ City, town or post office, state, and ZIP code		
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶		
G Did you "materially participate" in the operation of this business during 2001? If "No," see page C-2 for limit on losses . <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
H If you started or acquired this business during 2001, check here . <input type="checkbox"/>		

Part I Income

1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here <input type="checkbox"/>	1	4,000	
2 Returns and allowances	2		
3 Subtract line 2 from line 1	3	4,000	
4 Cost of goods sold (from line 42 on page 2)	4	5,000	
5 Gross profit. Subtract line 4 from line 3	5	-1,000	
6 Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6		
7 Gross income. Add lines 5 and 6 ▶	7	-1,000	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8			19 Pension and profit-sharing plans	19	
9 Bad debts from sales or services (see page C-3)	9			20 Rent or lease (see page C-4):	20a	
10 Car and truck expenses (see page C-3)	10			a Vehicles, machinery, and equipment	20b	
11 Commissions and fees	11	200		b Other business property	21	
12 Depletion	12			21 Repairs and maintenance	22	
13 Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	2,738		22 Supplies (not included in Part III)	23	
14 Employee benefit programs (other than on line 19)	14			23 Taxes and licenses	24	
15 Insurance (other than health)	15			24 Travel, meals, and entertainment:	24a	
16 Interest:	16a			a Travel	24b	
a Mortgage (paid to banks, etc.)	16b			b Meals and entertainment	24c	
b Other				c Enter nondeductible amount included on line 24b (see page C-5)	24d	
17 Legal and professional services	17			d Subtract line 24c from line 24b		
18 Office expense	18			25 Utilities	25	
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	2,938		26 Wages (less employment credits)	26	
29 Tentative profit (loss). Subtract line 28 from line 7	29	-3,938		27 Other expenses (from line 48 on page 2)	27	
30 Expenses for business use of your home. Attach Form 8829	30					
31 Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.	31	-3,938				
32 If you have a loss, check the box that describes your investment in this activity (see page C-6). • If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198 .				32a <input checked="" type="checkbox"/> All investment is at risk.		
				32b <input type="checkbox"/> Some investment is not at risk.		

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2001

For Comprehensive Example

Part III Cost of Goods Sold (see page C-6)

33 Method(s) used to value closing inventory: **a** Cost **b** Lower of cost or market **c** Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation Yes No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	5,000	
36 Purchases less cost of items withdrawn for personal use	36		
37 Cost of labor. Do not include any amounts paid to yourself	37		
38 Materials and supplies	38		
39 Other costs	39		
40 Add lines 35 through 39	40	5,000	
41 Inventory at end of year	41		
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	5,000	



2002 Workbook

Form **4797**
 Department of the Treasury
 Internal Revenue Service (99)

Sales of Business Property

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

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

OMB No. 1545-0184
2001
 Attachment
 Sequence No. 27

Name(s) shown on return: **Sam Smith** Identifying number: **333-33-3333**

1 Enter the gross proceeds from sales or exchanges reported to you for 2001 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

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

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

3 Gain, if any, from Form 4684, line 39	3	
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	21,472
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6 Gain, if any, from line 32, from other than casualty or theft	6	
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	21,472
Partnerships (except electing large partnerships). Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below. S corporations. Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax. All others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on Schedule D and skip lines 8, 9, 11, and 12 below.		
8 Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): S corporations. Enter any gain from line 9 on Schedule D (Form 1120S), line 15, and skip lines 11 and 12 below. All others. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the gain from line 9 as a long-term capital gain on Schedule D.	9	

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11 Loss, if any, from line 7	11	()
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	
13 Gain, if any, from line 31	13	1,900
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17 Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	17	
18 Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows:	18	1,900
a For all except individual returns. Enter the gain or (loss) from line 18 on the return being filed. b For individual returns:		
(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions		
	18b(1)	
(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14		
	18b(2)	1,900

2002 Workbook

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

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Land	1/01/92	12/15/01
B Building	1/01/92	12/15/01
C Office Equipment	1/01/95	12/15/01
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1 before completing.)	20	40,000	160,000	2,000
21	Cost or other basis plus expense of sale	21	12,000	98,000	24,100
22	Depreciation (or depletion) allowed or allowable	22		28,451	24,100
23	Adjusted basis. Subtract line 22 from line 21	23	12,000	69,549	100
24	Total gain. Subtract line 23 from line 20	24	28,000	90,451	1,900
25 If section 1245 property:					
a	Depreciation allowed or allowable from line 22	25a		24,000	
b	Enter the smaller of line 24 or 25a	25b		1,900	
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a			
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b			
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c			
d	Additional depreciation after 1969 and before 1976	26d			
e	Enter the smaller of line 26c or 26d	26e			
f	Section 291 amount (corporations only)	26f			
g	Add lines 26b, 26e, and 26f	26g	0	0	
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a	Soil, water, and land clearing expenses	27a			
b	Line 27a multiplied by applicable percentage (see instructions)	27b			
c	Enter the smaller of line 24 or 27b	27c			
28 If section 1254 property:					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a			
b	Enter the smaller of line 24 or 28a	28b			
29 If section 1255 property:					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a			
b	Enter the smaller of line 24 or 29a (see instructions)	29b			

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

30	Total gains for all properties. Add property columns A through D, line 24	30	120,351
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	1,900
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6 *	32	0

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

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

* Excludes installment sale again ☒

2002 Workbook

Form **6252**

Installment Sale Income

OMB No. 1545-0228

Department of the Treasury
Internal Revenue Service

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

2001
Attachment
Sequence No. **79**

Name(s) shown on return

Sam Smith

Identifying number

333-33-3333

- 1** Description of property ▶ **Office Equipment**
- 2a** Date acquired (month, day, year) ▶ **1 / 01 / 95** **b** Date sold (month, day, year) ▶ **12 / 15 / 01**
- 3** Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 Yes No
- 4** Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale Yes No

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

5 Selling price including mortgages and other debts. Do not include interest whether stated or unstated	5	2,000	
6 Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6		
7 Subtract line 6 from line 5	7	2,000	
8 Cost or other basis of property sold	8	24,000	
9 Depreciation allowed or allowable	9	24,000	
10 Adjusted basis. Subtract line 9 from line 8	10	0	
11 Commissions and other expenses of sale	11	100	
12 Income recapture from Form 4797, Part III (see instructions)	12	1,900	
13 Add lines 10, 11, and 12	13	2,000	
14 Subtract line 13 from line 5. If zero or less, do not complete the rest of this form (see instructions)	14	0	
15 If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-	15		
16 Gross profit. Subtract line 15 from line 14	16		
17 Subtract line 13 from line 6. If zero or less, enter -0-	17		
18 Contract price. Add line 7 and line 17	18		

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

19 Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions	19		
20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20		
21 Payments received during year (see instructions). Do not include interest, whether stated or unstated	21		
22 Add lines 20 and 21	22		
23 Payments received in prior years (see instructions). Do not include interest, whether stated or unstated	23		
24 Installment sale income. Multiply line 22 by line 19	24		
25 Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25		
26 Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26		

Form **6252**

Installment Sale Income

OMB No. 1545-0228

Department of the Treasury
Internal Revenue Service

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

2001
Attachment
Sequence No. **79**

Name(s) shown on return

Sam Smith

Identifying number

333-33-3333

- 1** Description of property ▶ **Building**
- 2a** Date acquired (month, day, year) ▶ **01 / 01 / 92** **b** Date sold (month, day, year) ▶ **12 / 15 / 01**
- 3** Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 Yes No
- 4** Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale Yes No

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

5 Selling price including mortgages and other debts. Do not include interest whether stated or unstated	5	160,000	
6 Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	60,000	
7 Subtract line 6 from line 5	7	100,000	
8 Cost or other basis of property sold	8	90,000	
9 Depreciation allowed or allowable	9	28,451	
10 Adjusted basis. Subtract line 9 from line 8	10	61,549	
11 Commissions and other expenses of sale	11	8,000	
12 Income recapture from Form 4797, Part III (see instructions)	12		
13 Add lines 10, 11, and 12	13	69,549	
14 Subtract line 13 from line 5. If zero or less, do not complete the rest of this form (see instructions)	14	90,451	
15 If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-	15	0	
16 Gross profit. Subtract line 15 from line 14	16	90,451	
17 Subtract line 13 from line 6. If zero or less, enter -0-	17	0	
18 Contract price. Add line 7 and line 17	18	100,000	

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

19 Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions	19	90.4510	
20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0	
21 Payments received during year (see instructions). Do not include interest, whether stated or unstated	21	16,000	
22 Add lines 20 and 21	22	16,000	
23 Payments received in prior years (see instructions). Do not include interest, whether stated or unstated	23		
24 Installment sale income. Multiply line 22 by line 19	24	14,472	
25 Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25	0	
26 Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26	14,472	

Explanation of the \$90,451 gain on the sale of the building.

The building was purchased in 1992 for \$90,000. Its sale price was \$160,000. The total gain was \$90,451, **\$28,451 of which was due to MACRS depreciation.**

The portion of the \$160,000 sales price Sam received in 2001 was **\$16,000** ((\$25,000 down payment received × \$160,000) ÷ \$250,000). The **\$16,000** is shown on line 21 on the Form 6252 for the building. Using the gross profit percentage of 90.451, **\$14,472** of the \$16,000 is taxable in 2001. The **\$14,472** is shown on line 24 on the Form 6252 for the building.

The entire **\$14,472** installment sale income is unrecaptured I.R.C. §1250 gain as shown on the worksheet on this page. If Sam had been in the 27.5% tax bracket or higher in 2001, the unrecaptured I.R.C. §1250 gain of **\$14,472** would have been taxed at a **maximum 25%** rate.

Since Sam's 2001 taxable income was only \$16,164, his entire, his entire 2001 taxable income was within the 15% tax bracket. Therefore, the taxable portion of the unrecaptured I.R.C. §1250 gain is taxed at only a **15% rate**. See the Schedule D Tax Worksheet on page 169 for the complicated tax computation.

3

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

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

OMB No. 1545-0228

2001
Attachment
Sequence No. **79**

Name(s) shown on return

Sam Smith

Identifying number

333-33-3333

- 1 Description of property ▶ **Covenant not to compete**
- 2a Date acquired (month, day, year) ▶ **01 / 01 / 92** b Date sold (month, day, year) ▶ **12 / 15 / 01**
- 3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 Yes No
- 4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale Yes No

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

5 Selling price including mortgages and other debts. Do not include interest whether stated or unstated	5	10,000	
6 Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6		
7 Subtract line 6 from line 5	7	10,000	
8 Cost or other basis of property sold	8		
9 Depreciation allowed or allowable	9		
10 Adjusted basis. Subtract line 9 from line 8	10		
11 Commissions and other expenses of sale	11	500	
12 Income recapture from Form 4797, Part III (see instructions)	12		
13 Add lines 10, 11, and 12	13	500	
14 Subtract line 13 from line 5. If zero or less, do not complete the rest of this form (see instructions)	14	9,500	
15 If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-	15	0	
16 Gross profit. Subtract line 15 from line 14	16	9,500	
17 Subtract line 13 from line 6. If zero or less, enter -0-	17	0	
18 Contract price. Add line 7 and line 17	18	10,000	

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

19 Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions	19	95.0000	
20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0	
21 Payments received during year (see instructions). Do not include interest, whether stated or unstated	21	1,000	
22 Add lines 20 and 21	22	1,000	
23 Payments received in prior years (see instructions). Do not include interest, whether stated or unstated	23		
24 Installment sale income. Multiply line 22 by line 19	24	950	
25 Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25		
26 Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26	950	

3

2002 Workbook

Form **6252**

Installment Sale Income

OMB No. 1545-0228

Department of the Treasury
Internal Revenue Service

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

2001
Attachment
Sequence No. **79**

Name(s) shown on return

Sam Smith

Identifying number

333-33-3333

- 1** Description of property ▶ **Goodwill**
- 2a** Date acquired (month, day, year) ▶ **01 / 01 / 92** **b** Date sold (month, day, year) ▶ **12 / 15 / 01**
- 3** Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 Yes No
- 4** Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale Yes No

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

5 Selling price including mortgages and other debts. Do not include interest whether stated or unstated	5		34,000
6 Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6		
7 Subtract line 6 from line 5	7	34,000	
8 Cost or other basis of property sold	8		
9 Depreciation allowed or allowable	9		
10 Adjusted basis. Subtract line 9 from line 8	10		
11 Commissions and other expenses of sale	11	1,700	
12 Income recapture from Form 4797, Part III (see instructions)	12		
13 Add lines 10, 11, and 12	13		1,700
14 Subtract line 13 from line 5. If zero or less, do not complete the rest of this form (see instructions)	14		32,300
15 If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-	15		0
16 Gross profit. Subtract line 15 from line 14	16		32,300
17 Subtract line 13 from line 6. If zero or less, enter -0-	17		0
18 Contract price. Add line 7 and line 17	18		34,000

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

19 Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions	19		95.0000
20 If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20		0
21 Payments received during year (see instructions). Do not include interest, whether stated or unstated	21		3,400
22 Add lines 20 and 21	22		3,400
23 Payments received in prior years (see instructions). Do not include interest, whether stated or unstated	23		
24 Installment sale income. Multiply line 22 by line 19	24		3,230
25 Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)	25		
26 Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)	26		3,230

**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

Sam Smith

Your social security number

333 : 33 : 3333

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 Total short-term sales price amounts. 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 Net short-term capital gain or (loss). 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						
9 Enter your long-term totals, if any, from Schedule D-1, line 9			9			
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)			10			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					11	25,652
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					13	
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 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f) Next: Go to Part III on the back.					16	25,652

* **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).

2002 Workbook

Part III Taxable Gain or Deductible Loss

<p>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</p> <p>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.</p>	17	25,652	
<p>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</p> <p>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.</p>	18 ()		

Part IV Tax Computation Using Maximum Capital Gains Rates

<p>19 Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions</p> <p>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.</p>	19	14,472	
<p>20 Enter your taxable income from Form 1040, line 39</p>	20		
<p>21 Enter the smaller of line 16 or line 17 of Schedule D</p>	21		
<p>22 If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-</p>	22	0	
<p>23 Subtract line 22 from line 21. If zero or less, enter -0-</p>	23		
<p>24 Subtract line 23 from line 20. If zero or less, enter -0-</p>	24		
<p>25 Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies</p>	25		
<p>26 Enter the smaller of:</p> <ul style="list-style-type: none"> • 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 <p>If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.</p>	26		
<p>27 Enter the amount from line 24</p>	27		
<p>28 Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34</p>	28		
<p>29 Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8</p>	29	11,180	
<p>30 Enter the smaller of line 28 or line 29</p>	30		
<p>31 Multiply line 30 by 8% (.08)</p>	31		
<p>32 Subtract line 30 from line 28</p>	32		
<p>33 Multiply line 32 by 10% (.10)</p> <p>If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.</p>	33		
<p>34 Enter the smaller of line 20 or line 23</p>	34		
<p>35 Enter the amount from line 28 (if line 28 is blank, enter -0-)</p>	35		
<p>36 Subtract line 35 from line 34</p>	36		
<p>37 Multiply line 36 by 20% (.20)</p>	37		
<p>38 Add lines 25, 31, 33, and 37</p>	38		
<p>39 Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies</p>	39		
<p>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</p>	40	1,640	



Unrecaptured Section 1250 Gain Worksheet—Line 19

Keep for Your Records



If you are not reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.	
1. If you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252), enter the smaller of line 22 or line 24 of Form 4797 for that property. If you did not have any such property, go to line 4. If you had more than one such property, see instructions	1. _____
2. Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1	2. _____
3. Subtract line 2 from line 1	3. _____
4. Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year (see instructions)	4. <u>14,472</u>
5. Enter the total of any amounts reported to you on a Schedule K-1 from a partnership or an S corporation as "unrecaptured section 1250 gain"	5. _____
6. Add lines 3 through 5	6. <u>14,472</u>
7. Enter the smaller of line 6 or the gain from Form 4797, line 7	7. <u>14,472</u>
8. Enter the amount, if any, from Form 4797, line 8	8. _____
9. Subtract line 8 from line 7. If zero or less, enter -0-	9. <u>14,472</u>
10. Enter the amount of any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain (see instructions)	10. _____
11. Enter the total of any amounts reported to you on a Schedule K-1, Form 1099-DIV, or Form 2439 as "unrecaptured section 1250 gain" from an estate, trust, real estate investment trust, or mutual fund (or other regulated investment company)	11. _____
12. Enter the total of any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you did not make an entry in Part I of Form 4797 for the year of sale (see instructions)	12. _____
13. Add lines 9 through 12	13. <u>14,472</u>
14. Enter the gain or (loss) from Schedule D, line 15	14. _____
15. Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	15. <u>0</u>
16. Combine lines 14 and 15. If the result is zero or a gain, enter -0-. If the result is a (loss), enter it as a positive amount	16. <u>0</u>
17. Unrecaptured section 1250 gain. Subtract line 16 from line 13. If zero or less, enter -0-. Enter the result here and on Schedule D, line 19	17. <u>14,472</u>

D-7

Qualified 5-Year Gain Worksheet—Line 29

Keep for Your Records



1. Enter the total of all gains that you reported on line 8, column (f), of Schedules D and D-1 from dispositions of property held more than 5 years. Do not reduce these gains by any losses	1. _____			
2. Enter the total of all gains from dispositions of property held more than 5 years from Form 4797, Part I, but only if Form 4797, line 7, is more than zero. Do not reduce these gains by any losses	2. _____			
3. Enter the total of all capital gains from dispositions of property held more than 5 years from Form 4684, line 4; Form 6252; Form 6781, Part II; and Form 8824. Do not reduce these gains by any losses	3. _____			
4. Enter the total of any qualified 5-year gain reported to you on: <table style="margin-left: 20px; border: none;"> <tr> <td style="vertical-align: top;"> <ul style="list-style-type: none"> ● Form 1099-DIV, box 2c; ● Form 2439, box 1c; and ● Schedule K-1 from a partnership, S corporation, estate, or trust (do not include gains from section 1231 property; take them into account on line 2 above, but only if Form 4797, line 7, is more than zero). </td> <td style="font-size: 3em; vertical-align: middle; padding: 0 10px;">}</td> <td style="vertical-align: middle;">.</td> </tr> </table>	<ul style="list-style-type: none"> ● Form 1099-DIV, box 2c; ● Form 2439, box 1c; and ● Schedule K-1 from a partnership, S corporation, estate, or trust (do not include gains from section 1231 property; take them into account on line 2 above, but only if Form 4797, line 7, is more than zero). 	}	4. _____
<ul style="list-style-type: none"> ● Form 1099-DIV, box 2c; ● Form 2439, box 1c; and ● Schedule K-1 from a partnership, S corporation, estate, or trust (do not include gains from section 1231 property; take them into account on line 2 above, but only if Form 4797, line 7, is more than zero). 	}		
5. Add lines 1 through 4	5. _____			
6. Enter the part, if any, of the gain on line 5 that is: <table style="margin-left: 20px; border: none;"> <tr> <td style="vertical-align: top;"> <ul style="list-style-type: none"> ● Attributable to 28% rate gain or ● Included on line 6, 10, 11, or 12 of the Unrecaptured Section 1250 Gain Worksheet on page D-7. </td> <td style="font-size: 3em; vertical-align: middle; padding: 0 10px;">}</td> <td style="vertical-align: middle;">.</td> </tr> </table>	<ul style="list-style-type: none"> ● Attributable to 28% rate gain or ● Included on line 6, 10, 11, or 12 of the Unrecaptured Section 1250 Gain Worksheet on page D-7. 	}	6. _____
<ul style="list-style-type: none"> ● Attributable to 28% rate gain or ● Included on line 6, 10, 11, or 12 of the Unrecaptured Section 1250 Gain Worksheet on page D-7. 	}		
7. Qualified 5-year gain. Subtract line 6 from line 5. Enter the result here and on Schedule D, line 29	7. _____			

D-8

Schedule D Tax Worksheet—Line 40

Keep for Your Records



Complete this worksheet only if line 15 or line 19 of Schedule D is more than zero. Otherwise, complete Part IV of Schedule D to figure your tax. **Exception: Do not** use Schedule D, Part IV, or this worksheet to figure your tax if line 16 or line 17 of Schedule D or Form 1040, line 39, is zero or less; instead, see the instructions for Form 1040, line 40.

1. Enter your taxable income from Form 1040, line 39		1. <u>16,164</u>
2. Enter the smaller of line 16 or line 17 of Schedule D	2. <u>25,652</u>	
3. If you are filing Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-. Also enter this amount on Schedule D, line 22	3. <u>0</u>	
4. Subtract line 3 from line 2. If zero or less, enter -0-		4. <u>25,652</u>
5. Combine lines 7 and 15 of Schedule D. If zero or less, enter -0-	5. <u>0</u>	
6. Enter the smaller of line 5 above or Schedule D, line 15, but not less than zero	6. _____	
7. Enter the amount from Schedule D, line 19	7. <u>14,472</u>	
8. Add lines 6 and 7		8. <u>14,472</u>
9. Subtract line 8 from line 4. If zero or less, enter -0-		9. <u>11,180</u>
10. Subtract line 9 from line 1. If zero or less, enter -0-		10. <u>4,984</u>
11. Enter the smaller of:		
<ul style="list-style-type: none"> • The amount on line 1 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 	}	11. <u>16,164</u>
12. Enter the smaller of line 10 or line 11	12. <u>4,984</u>	
13. Subtract line 4 from line 1. If zero or less, enter -0-	13. <u>0</u>	
14. Enter the larger of line 12 or line 13	▶ 14. <u>4,984</u>	
15. Figure the tax on the amount on line 14. Use the Tax Table or Tax Rate Schedules, whichever applies		▶ 15. <u>746</u>
If lines 11 and 12 are the same, skip lines 16 through 21 and go to line 22. Otherwise, go to line 16.		
16. Subtract line 12 from line 11		▶ 16. <u>11,180</u>
17. Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8. Also enter this amount on Schedule D, line 29	17. <u>11,180</u>	
18. Enter the smaller of line 16 above or line 17 above		18. <u>11,180</u>
19. Multiply line 18 by 8% (.08)		19. <u>894</u>
20. Subtract line 18 from line 16	20. _____	
21. Multiply line 20 by 10% (.10)	21. _____	
If lines 1 and 11 are the same, skip lines 22 through 34 and go to line 35. Otherwise, go to line 22.		
22. Enter the smaller of line 1 or line 9	22. _____	
23. Enter the amount from line 16 (if line 16 is blank, enter -0-)	23. _____	
24. Subtract line 23 from line 22	▶ 24. _____	
25. Multiply line 24 by 20% (.20)	25. _____	
If line 7 is zero or blank, skip lines 26 through 31 and go to line 32. Otherwise, go to line 26.		
26. Enter the smaller of line 4 or line 7	26. _____	
27. Add lines 4 and 14	27. _____	
28. Enter the amount from line 1 above	28. _____	
29. Subtract line 28 from line 27. If zero or less, enter -0-	29. _____	
30. Subtract line 29 from line 26. If zero or less, enter -0-	▶ 30. _____	
31. Multiply line 30 by 25% (.25)	31. _____	
If line 6 is zero, skip lines 32 through 34 and go to line 35. Otherwise, go to line 32.		
32. Add lines 14, 16, 24, and 30	32. _____	
33. Subtract line 32 from line 1	33. _____	
34. Multiply line 33 by 28% (.28)	34. _____	
35. Add lines 15, 19, 21, 25, 31, and 34		35. <u>1,640</u>
36. Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies		36. <u>2,426</u>
37. Tax on all taxable income (including capital gains). Enter the smaller of line 35 or line 36. Also enter this amount on Schedule D, line 40, and Form 1040, line 40		37. <u>1,640</u>

ISSUE 5: INTERNET BUSINESS

WEB SITE PREPARATION

A web site is used to transmit information, education or advertising. The IRS has offered very little tax guidance pertaining to web site preparation costs.

Domain Name

A domain name is also called the web address. A domain name is not part of the actual web site program or software. The tax treatment of domain name costs is unclear. If a domain name is registered for two years, it appears that the costs should be capitalized and amortized over a 2-year period. At the end of the period, the registration must be renewed. Therefore, the cost might be viewed as a lease expense instead. If the business is already in existence, the taxpayer could view the expenses as ordinary and necessary business expense per I.R.C. §162. The rationale is that a domain name expands to way a company conducts its business. If the registration cost is incurred prior to start up, or as a spin-off of an existing business, then the costs should be amortized over five years as a start-up expense under I.R.C. §195.

A domain name does not clearly fit into the definition of intangible assets under I.R.C. §197. If purchased from a third party, its cost appears to meet the definition of going concern value under Treas. Reg. §1.197-2(b). If a domain name is considered a trademark, then its cost would amortized over a 15-year period.

Web Site Creation and Development Expenses

One position on deducting costs associated with creating a web site is similar to self-created software. Therefore, the costs of writing and creating the content on the site should be capitalized. This would include the cost of writing the code for the web site, hiring authors and marketing consultants, and creating graphics and pictures for the web site. These costs would be amortized over a 5-year period unless the taxpayer could establish a shorter life [Rev. Proc. 69-21 and Rev Rul. 89-23].

A second position is that the costs of the web site development be split between **web software** and **content**. If the **content** was designed and created primarily for **advertising** purposes, or for an online magazine, newspaper, etc. then those costs should be **currently deductible** [Rev. Rul. 92-80]. The company creating the web site must have a comprehensive advertising campaign in place to show why the company created the content and graphics [*RJR Nabisco Inc.*, TC Memo 1998-252]. However, costs such as creating search engines, writing the web program, bulletin boards, or software to assist in writing the program must be capitalized.

A web site is developed through the use of **software** which may be purchased or self-developed. Purchased software is amortized using the straight-line method over a 36-month period if it is not considered an I.R.C. §197 intangible. If it is considered I.R.C. §197 property, then it must be amortized over 15 years. Software that meets the definition of research and experimental expenses under I.R.C. §174 may be a current expense deductible in full or a capital expense amortized over five years [I.R.C. §§174(a) and (b)].

Some costs associated with maintaining a web site are considered to be currently deductible, such as:

- the annual fee for a domain name;
- the monthly fee to host the web site;
- wages to maintain the web site.

The cost of changing web content or graphics should be considered normal maintenance and therefore deducted currently.

SALES TAX ISSUE

The same issue of physical presence test also applies to the state level concerning the collection of sales tax. In Illinois, the State issued a GIL-00-0104 (general information letter) dated 6-8-00 referencing 2 Ill. Adm. Code 1200.120(b)

and (c). The GIL states that an Illinois retailer is one who either accepts purchase orders or maintains inventory in Illinois and fills Illinois orders from that inventory. The definition of a “retailer maintaining a place of business in Illinois” is set forth at 86 Ill. Adm. Code 150.201(i).

An out-of-state retailer maintaining a place of business in Illinois is required to register with the State as an Illinois Use Tax collector. The retailer must collect and remit Use Tax to the State on behalf of its Illinois customers even though the retailer does not incur any Retailers’ Occupation Tax liability.

The final type of retailer is simply the out-of-State retailer that does not have sufficient contacts (or “nexus”) with Illinois to be required to submit to Illinois tax law. A retailer in this situation does not incur Retailers’ Occupation tax on sales into Illinois and is not required to collect Use Tax on behalf of its Illinois customers. However, the retailer’s Illinois customers still incur Use Tax on the purchase of the out-of-state goods and have a duty to self-assess their Use Tax liability and remit the amount directly to the State.

The United States Supreme Court in the case of *Quill Corp v. North Dakota*, 112 S.Ct. 1904 (1992), set forth the current guidelines for determining what nexus requirements must be met before a person is properly subject to a state’s sales tax laws. The Supreme Court set out a two-prong test for nexus. The first prong is whether the Due Process Clause is satisfied. Due Process will be satisfied if the person or entity purposely avails himself or itself of the benefits of an economic market in a forum state. The second prong of the Supreme Court’s nexus test requires that, if due process requirements have been satisfied, the person or entity must have a physical presence in the forum state to satisfy the Commerce Clause.

A physical presence does not mean simply an office or other physical building. Under Illinois tax law, it also includes the presence of any representative or agent of the seller. The representative need not be a sales representative and it is immaterial for tax purposes that the representative’s presence is temporary.

HOBBY VS. BUSINESS VENTURE

While starting an internet business is relatively simple, there is no assurance it will become a successful business. It must be engaged in for a profit or the IRS could classify it as a hobby under I.R.C. §183.

In order to constitute the carrying on of a trade or business, the activity “must be carried on in good faith, with the dominant hope and intent of making a profit.” [*Maurice C Dreicer*; 78 TC 642(1982)] There are nine factors in determining whether an activity is engaged in for profit. All facts and circumstances with respect to the activity are taken into account.

- 1. Manner in which activity is conducted.** The taxpayer should prepare a business plan, including a break-even analysis, determining the amount of income necessary for the activity to be profitable in projecting the anticipated costs of the business. Detailed and accurate records should be kept, as well as a separate checking account for each activity. The taxpayer should advertise and promote the activity in a business-like manner. He/she should be willing to make changes to the operation if the activity is initially unsuccessful. He/she should also be prepared to demonstrate that circumstances beyond the control of the taxpayer prevented a profit from being realized. And finally, that the taxpayer does not allow losses to grow without making an effort to change operations or consult experts.
- 2. Expertise of the taxpayer.** The taxpayer should consult with experts before beginning the activity and on an “as needed basis” after starting. He/she should also do research and study to increase expertise regarding the business.
- 3. Time and effort expended in carrying on the activity.** The IRS considers the fact of significant personal time and effort spent on the activity, especially if it does not have recreational aspects. Does the taxpayer employ competent and qualified personnel, if there is limited time? Does the taxpayer make major decisions based upon personal enjoyment instead of business prospects?

4. **Expectation that assets used in activity may appreciate in value.** The IRS will also take into account, that the assets increase in value could produce income as well as day to day operations. However, don't expect that the activity will become profitable solely due to anticipated appreciation.
5. **Taxpayer's success in other activities.** The taxpayer should be prepared to show a history of converting activities from unprofitable to profitable businesses. They will also look at the expertise acquired in different businesses to attempt to make this activity profitable.
6. **History of income or loss with respect to the activity.** The taxpayer should be conscious of the length of the start-up period customarily required to make similar activities profitable. The taxpayer may keep tract of business circumstances and personal setbacks beyond the taxpayer's control that may result in losses for a longer period than usual. Also, the taxpayer should not incur losses out of proportion to the expected gains from the activity.
7. **Amount of occasional profits, if any.** The taxpayer should report any profits from the activity, no matter how small they are or how often they occur. If losses in one year are relatively small, the taxpayer may consider foregoing the loss deduction for that year in order to strengthen the case for a profit motive that will permit the deduction of losses in other years, when they might be greater. Also consider business or economic cycles which might make it unrealistic to expect profits on a regular basis.
8. **Financial status of the taxpayer.** The taxpayer should be prepared to invest substantial resources in the activity to demonstrate a serious intent to create a success. The taxpayer should also not be willing to sustain continued losses because of the existence of other financial resources, where it would be a prudent business decision to end the activity.
9. **Elements of personal pleasure or recreation.** The taxpayer should be prepared to show that any personal pleasure or recreation derived from the activity is insignificant or merely incidental in comparison to business motives. You should not attempt to claim deductions from an activity where the possibility for profit is small in comparison to the substantial possibility for personal gratification.

Presumption of Profit

An activity is presumed carried on for profit if it produced a profit in at least three of the last five tax years, including the current year. If a business activity passes this 3-out-of-5-year test, it is presumed to be engaged in for profit. Therefore, the I.R.C. §183 limitation on deducting business expenses does not apply. The result is that all business deductions related to the activity can be deducted, even for the years that report a new loss. Taxpayers can rely on this presumption test unless the IRS shows it is not valid.

ISSUE 6: LIKE-KIND EXCHANGES UNDER I.R.C. §1031

There can be significant tax consequences at the time of sale of both real and personal property. While reduced capital gain tax rates will lessen the impact, I.R.C. §§1245 and 1250 may apply and the recapture of depreciation rules can add substantial unforeseen income that will be taxed at higher marginal rates. With the use of ACRS and MACRS depreciation, basis in assets can decrease very rapidly. In some instances, the only remaining basis is in the land.

If the seller is faced with a large tax liability on disposition of property and the intent is to purchase similar property, the provisions of I.R.C. §1031 can save substantial tax dollars. In addition to tax considerations, there may be **non-tax reasons** to consider an exchange. For example, the owner of a labor-intensive apartment complex might want to exchange it for a commercial building that uses triple net leases. Or, the owner of a commercial building may want to exchange it for a building in a different location. While these are both valid reasons for wanting to exchange properties, without the provisions of I.R.C. §1031, the owners may not be able to make the exchange due to cash erosion caused by significant income taxes on the disposition.

In this discussion, exchange and I.R.C. §1031 are used interchangeably. Property being sold is referred to as “**relinquished property**” and property to be acquired is “**replacement property.**”

The word “exchange” leaves the impression that both parties are interested in owning the other’s property. This is rarely the case. In reality, exchange is the sale of the relinquished property and the purchase of the replacement property. What makes this a qualified exchange is that the statutory and regulatory requirements of I.R.C. §1031 are strictly followed.

ADVANTAGES AND DISADVANTAGES

Advantages

- A property may be more marketable if the seller is willing to take another property in exchange as part of the sale. Since “boot” can be used as a part of the exchange, a seller can receive cash for a substantial part of the sale and property as a lesser part. Property can then be sold at a later date. **This could be an advantage over an installment sale if the seller questions financial capacity of the buyer.**
- An exchange can facilitate a seller’s change in investment strategy. Craig’s exchange in **Example 15** describes an investment strategy change.
- Since less cash is required with an exchange, the buyer may find it easier to get financing for the purchase.
- An exchange can provide for a consolidation of investments. For example, Mary owns 200 acres of land 20 miles from her main farming operation. Because of the death of her neighbor, 175 acres adjoining the home farm becomes available for sale. By participating in an exchange, Mary is able to purchase new property without additional financing.
- Without the tax burden of a sale, an investor is able to build and increase an asset base more rapidly.
- Since an exchange is handled as one transaction, the seller can keep his/her funds active over the transaction period which provides for a continuity of investment.

Disadvantages

- The replacement property must meet the like-kind test for the exchange to qualify for I.R.C. §1031 treatment. A description of what constitutes like-kind is shown below.
- While boot can be used in an exchange, relinquished property and replacement property should have similar values.
- Because the exchange results in a transfer of basis, the replacement property will likely have a lower depreciable basis which can be tax detrimental in future years.

WHAT IS LIKE-KIND PROPERTY?

As used in I.R.C. §1031, the words “**like-kind**” have reference to the nature or character of property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. Whether the real estate involved is improved or unimproved is not material.

No gain or loss is recognized if a taxpayer:

- exchanges property held for productive use in his/her trade or business, together with cash, or other property of like-kind for the same use. (For example, a used truck or passenger automobile for a new passenger automobile to be used for a like purpose.);
- (who is not a dealer in real estate) exchanges an urban apartment building for a farm or ranch;
- exchanges a leasehold of a fee with 30 years or more remaining for real estate;
- exchanges improved real estate for unimproved real estate (**Example.** A warehouse for a parcel of bare land);
- exchanges investment property and cash for investment property of a like-kind.

RULES FOR REAL PROPERTY

As shown above, unimproved real property can be exchanged for improved real property and qualify for non-recognition rules of I.R.C. §1031. However, not all apparent real property is classified as real property for I.R.C. §1231 purposes. Examples are single purpose livestock facilities and grain bins. These structures are I.R.C. §1245 property. To determine if land, with these structures attached, can be exchanged for unimproved land, refer to the provisions of I.R.C. §1245 rather than I.R.C. §1031.

Example 15. Craig owns an apartment complex valued at \$1,000,000 in Champaign, IL. He acquired it as a gift from his father in 1975. His father paid \$160,000 for the property in 1960. The remaining cost basis in 2002 is \$20,000, the land value. Craig wishes to sell the property and purchase an office building in Tampa, FL for \$1,000,000. This Tampa building will provide a steady cash flow for his retirement and will take little effort to manage. Closing costs and commissions on the apartment sale will approximate \$80,000.

After visiting his tax preparer, Craig discovers his state and federal tax liability will be \$235,690 for the apartment sale. Craig is convinced to use the tax-free provisions of I.R.C. §1031 to acquire the Tampa building. The basis in it will be \$100,000 (\$20,000 remaining basis in apartment + \$80,000 of exchange closing costs).

Note. I.R.C. §1031 does not provide for permanent tax-free benefits. It only defers gain that would be recognized until a later date when the replacement property is disposed.

Caution. The additional tax liability of an IRS examination determination that the exchange is not qualified under I.R.C. §1031 can be huge. Clients should be advised to use a team when making an exchange. The tax preparer's job is to make the tax calculations, the attorney will prepare the exchange agreements, the realtor will provide the buyers, sellers and sales contracts and the qualified intermediary will hold the escrowed funds, maintain escrow accounts and perform title/closing services.

RULES FOR PERSONAL PROPERTY

Depreciable tangible personal property qualifies for I.R.C. §1031 if it is of a **like-kind and like-class**. The property is considered like-class to other depreciable tangible properties if exchanged properties are either within the same **General Asset Class** or within the same **Product Class**. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. **A property's General Asset Class or Product Class is determined as of the date of exchange.**

Property within a General Asset Class consists of property described in one of the asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses. If the four-digit product class ends in a "9", for miscellaneous, it is not considered a product class for the determination of like-kind and therefore, the property does not qualify for like-kind treatment.

Property within a Product Class consists of depreciable tangible personal property that is listed in a four-digit product class within Division D of the Standard Industrial Classification codes.

General Asset Classes and Product Classes may be modified or updated from time to time. Exchanges occurring after a modification or update will relate to the modified or updated classes.

The general asset classes are:

Office furniture, fixtures, and equipment (asset class 00.11);

Information systems (computers and peripheral equipment) (asset class 00.12);

2002 Workbook

Data handling equipment, except computers (asset class 00.13);

Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21);

Automobiles, taxis (asset class 00.22);

Buses (asset class 00.23);

Light general purpose trucks (asset class 00.241);

Heavy general purpose trucks (asset class 00.242);

Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25);

Tractor units for use over-the-road (asset class 00.26);

Trailers and trailer-mounted containers (asset class 00.27);

Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28); and

Industrial steam and electric generation and/or distribution systems (asset class 00.4).

The product classes are:

SPECIFIC DEPRECIABLE ASSETS USED IN ALL BUSINESS ACTIVITIES, EXCEPT AS NOTED:

00.11 *Office Furniture, Fixtures, and Equipment: Includes furniture and fixtures that are not a structural component of a building. Includes assets such as desks, safes, and communications equipment. Does not include communications equipment that is included in other CLADR classes -*

00.12 *Information Systems: Includes computers and their peripheral equipment used in administering normal business transactions and the maintenance of business records, their retrieval and analysis. Information systems are defined as:*

Computers: A Computer is an electronically activated device capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention. It usually consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. Excluded from this category are adding machines, electronic desk calculators, etc.

Peripheral equipment consists of the auxiliary machines that may be placed under control of the central processing unit. Non limiting examples are: Card readers, card punches, magnetic tape feeds, high speed printers, optical character readers, tape cassettes, mass storage units, paper tape equipment, keypunches, data entry devices, teleprinters, terminals, tape drives, disc drives, disc files, disc packs, visual image projector tubes, card sorters, plotters, and collators. Peripheral equipment may be used on-line or off-line. Does not include equipment that is an integral part of other capital equipment that is included in other CLADR classes of economic activity, i.e., computers used primarily for process or production control, switching, channeling, and automating distributive trades and services such as point of (POS) computer systems -

00.13 *Data Handling Equipment, except Computers: Includes only typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment -*

00.21 *Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) -*

00.22 *Automobiles, Taxi -*

00.23 Buses -

00.24 Light General Purpose Trucks: Includes trucks for use over the road (actual unloaded weight less than 13,000 pounds) -

00.242 Heavy General Purpose Trucks: Includes heavy general purpose trucks, concrete ready mix-trucks, and ore trucks, for use over the road (actual unloaded weight 13,000 pounds or more) -

Railroad Cars and Locomotives, except those owned by railroad transportation companies -

Tractor Units for Use Over-the-Road -

Trailers and Trailer-Mounted Containers - Vessels, Barges, Tugs, and Similar Water Transportation Equipment, except those used in marine construction -

Note. See Appendix B in IRS Pub. 946, *How to Depreciate Property*, for more details on Asset Classes including complete tables.

Example 16. Ken trades a computer for a printer. Since both assets are in class 00.12 they are considered to be like-kind.

Example 17. Diana trades her airplane for a new Rolls Royce automobile. Since the airplane falls into asset class 00.21 and the automobile into asset class 00.22 they do not qualify for like-kind treatment in an exchange.

RECEIPT OR PAYMENT OF OTHER PROPERTY OR MONEY IN A TAX-FREE EXCHANGE

Receipt of "Boot"

If a taxpayer receives other property or cash for an I.R.C. §1031 exchange, any gain will be recognized to the extent of the cash and/or FMV of the other property. However, any loss is not recognized.

Example 18. In 2002, Jack exchanges real estate he purchased in 1965 for \$40,000 for replacement real estate valued at \$100,000 plus \$5,000 in cash. The recognized gain on Jack's 2002 return is limited to the \$5,000 cash he received.

Payment of "Boot"

If a taxpayer gives cash or other property in an I.R.C. §1031 exchange, the money or FMV of property given increases the basis of the replacement property.

Example 19. In 2002, Jack exchanges real estate he purchased in 1965 for \$40,000 for replacement real estate valued at \$100,000. In the exchange, Jack pays \$5,000 in cash. His basis in the replacement property will be \$45,000 including the \$5,000 cash he paid.

Assumption of Liabilities

The assumption of liabilities by either party to the exchange is treated either as cash received or cash paid, depending on the circumstances. Each party must compute the **net effect** of all liabilities assumed in the exchange. If one party **assumes more liabilities** than he/she is relieved of, that party is considered to have **paid cash** to the other party. Conversely, if one party is **relieved of more liabilities** than he/she assumes, that party is considered to have **received cash** from the other party.

2002 Workbook

Example 20. Jill owns an apartment building. Her adjusted basis in it is \$700,000 and it is subject to a \$200,000 mortgage. She transfers the property to Bill in an I.R.C. §1031 exchange and receives \$70,000 in cash and Bill's apartment building valued at \$800,000. Bill assumes Jill's \$200,000 mortgage. She realizes a gain of \$370,000 on the exchange, computed as follows:

Value of Bill's property received	\$800,000	
Cash received from Bill	70,000	
Net liabilities relieved of	200,000	
Total Jill received	\$1,070,000	
Less: Jill's adjusted basis	(700,000)	
Gain realized by Jill	\$370,000	

Under I.R.C. §1031(b), Jill will **recognize \$270,000** of gain (\$70,000 of cash received and her \$200,000 mortgage assumed by Bill). The basis of Jill's replacement apartment building is \$700,000 computed as follows:

Adjusted Basis of relinquished property		\$700,000
Less: Cash received	(70,000)	
Less: Mortgage assumed by Bill	(200,000)	
Jill's recognized gain		<u>(\$270,000)</u>
Difference		\$430,000
Plus the recognized gain		270,000
Basis of Jill's replacement property		<u>\$700,000</u>

Example 21. Larry owns an apartment building. On the date of I.R.C. §1031 exchange, it has an adjusted basis of \$400,000, a fair market value of \$520,000 and is subject to a \$380,000 mortgage. Jane also owns an apartment building. Her building has an adjusted basis of \$475,000, a fair market value of \$520,000, and is subject to a mortgage of \$450,000. When these properties are exchanged, Larry receives \$40,000 in cash and Jane's apartment, subject to her \$380,000 mortgage.

Larry realizes a gain of \$90,000 on the exchange, computed as follows:

Value of Jane's property received	\$520,000	
Cash received from Jane	40,000	
Larry's liability assumed by Jane	380,000	
Total Larry received		\$940,000
Less Larry's adjusted basis	(\$400,000)	
Less Jane's liability assumed by Larry	(450,000)	
		<u>(850,000)</u>
Gain realized by Larry		\$90,000

The amount of **cash or “other property”** received by Larry is \$40,000. His assumption of Jane’s mortgage of \$380,000 is offset by his \$450,000 mortgage which Jane assumed. Thus the cash or other property Larry received is \$40,000 according to I.R.C. §1031(b). Therefore, **\$40,000** of Larry’s \$90,000 realized gain is **recognized**. The basis of Larry’s replacement apartment is \$470,000 computed as follows:

Adjusted basis of relinquished property	\$400,000	
Jane’s liability assumed by Larry	450,000	
Total		\$850,000
Less: Cash Larry received	(40,000)	
Less: Larry’s liability assumed by Jane	(380,000)	
		(420,000)
Difference		\$430,000
Plus Larry’s recognized gain		40,000
Basis of Larry’s replacement property		\$470,000

Jane realizes a gain of **\$75,000** on the exchange, computed as follows:

Value of Larry’s property received		\$520,000
Cash received from Larry	\$0	
Jane’s liability assumed by Larry	450,000	
Total Jane received		970,000
Less Jane’s adjusted basis	(475,000)	
Less cash Jane paid	(40,000)	
Less Larry’s liability assumed by Jane	(380,000)	
		(895,000)
Gain realized by Jane		\$75,000

The amount of cash or other property received by Jane is \$30,000, computed as follows:

Value of Larry’s property received		\$520,000
Cash received from Larry	\$0	
Jane’s liability assumed by Larry	450,000	
Total Jane received		970,000
Less Jane’s adjusted basis	(475,000)	
Less cash Jane paid	(40,000)	
Less Larry’s liability assumed by Jane	(380,000)	
		(895,000)
Gain realized by Jane		\$75,000

Therefore, \$30,000 of Jane’s \$75,000 realized gain is recognized. The basis of Jane’s replacement property is \$475,000, computed as follows:

2002 Workbook

Adjusted basis of relinquished property	\$475,000	
Cash Jane paid to Larry	(40,000)	
Larry's liability assumed by Jane	380,000	
	<hr/>	
Total		\$895,000
Less: Cash Jane received	0	
Less: Jane's liability assumed by Larry	(450,000)	
	<hr/>	
Total Cash Equivalent		(450,000)
Difference		\$445,000
Plus: Jane's recognized gain		<u>30,000</u>
Basis of Jane's replacement property		\$475,000

Special Rules for Exchanges between Related Persons

A related person is defined as any person bearing a relationship to the taxpayer described in I.R.C. §§267(b) or 707(b)(1).

Special rules apply to like-kind exchanges between related persons. These rules affect both direct and indirect exchanges. Under these rules, if either related person disposes of the property **within two years** after the I.R.C. §1231 exchange, the exchange is **disqualified from nonrecognition treatment**. Instead, the **gain or loss on the original exchange must be recognized as of the date of the later disposition**.

Disposition will not trigger recognition if it occurs:

- because of death of either related person;
- as a result of an involuntary conversion; or
- if it is established to the satisfaction of the IRS that neither the exchange nor disposition has as one of its principal purposes the avoidance of federal income tax.

TREATMENT OF DEFERRED EXCHANGES

A deferred exchange occurs when replacement property is not transferred at the same time relinquished property is transferred. For a deferred exchange to qualify as a like-kind exchange, several requirements must be met.

IDENTIFICATION PERIOD AND EXCHANGE PERIOD

In general, any replacement property received by the taxpayer will be treated as not of a like-kind to the relinquished property if:

- the replacement property is not **"identified"** before the end of the **"identification period"**; or
- the identified replacement property is not received before the end of the **"exchange period."**

The **identification period** begins on the day the taxpayer transfers relinquished property and ends at midnight on the 45th day thereafter [Treas. Reg. §1.1031(k)-1(b)(2)(i)].

The **exchange period** begins on the date the taxpayer transfers relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return for the year of the transfer [Treas. Reg. §1.1031(k)-1(b)(2)(ii)].

Note. See pages 543-44 in the *2000 Farm Income Tax Workbook* for more information and planning tips regarding the strict provisions of the 45-day and 180-day rules.

In the case of multiple transfers both the identification period and the exchange period begin on the transfer date of the **earliest** property transferred [Treas. Reg. §1.1031(k)-1(b)(2)(iii)].

IDENTIFICATION METHOD

Replacement property is considered identified if it is designated as replacement property in a written document sent to either:

- the person obligated to transfer the replacement property (even if a disqualified person), or
- any other person involved in the exchange other than the taxpayer or a disqualified person.

Examples of persons involved in the exchange include qualified intermediaries, escrow agents and title companies, as well as parties directly involved in the exchange.

An identification of replacement property made in a written document and signed by all parties before the end of the exchange period will satisfy identification requirements.

The replacement property is identified only if it is **unambiguously described** in the written document. For real property this means a **legal description, street address or distinguishable name**. For personal property, it is a description of a particular type of property, such as a make, model and year.

ALTERNATIVE OR MULTIPLE PROPERTIES

There may be times when the seller does not know what property to use as replacement property or whether a specific property will be available. Regardless of the number of relinquished properties transferred by the taxpayer as a part of the exchange, the maximum number of replacement properties that may be identified is:

- three properties without regard to value of the properties (“3-Property rule”); or
- any number of properties as long as their combined value does not exceed 200% of the combined values of relinquished properties on the date of transfer (200% rule).

If the taxpayer violates either the “3-Property rule” or the “200% rule”, they are treated as if no replacement property had been identified. An exception to this and an identification satisfying the exchange requirements will be considered made if:

- replacement property is received before the end of the identification period; and
- identified before the end of the identification period and received before the end of the exchange period. This is true only if the taxpayer receives property before the end of the exchange period identified as replacement property with a FMV of at least 95% of the aggregate fair market value of all identified replacement properties (“95% rule”) [Reg. §1.1031(k)-1(c)(4)(ii)B].

For this purpose, FMV of each identified replacement property is determined as of the date the property is received by the taxpayer or the last day of the exchange period, whichever is earlier.

For purposes of applying the “3-Property rule”, the “200% rule”, and the “95% rule”, all identifications of replacement property that have been revoked are taken into account.

REVOCAION OF IDENTIFICATION

An identification of replacement property may be revoked at any time before the end of the 45-day identification period. To be valid, the revocation must be made in a written document signed by the taxpayer and sent to the person who received the original identification. The revocation must be received before the end of the 45-day identification period.

RECEIPT OF IDENTIFIED PROPERTY

The receipt requirement is met if the identified replacement property is received before the end of the 180-day exchange period only if:

- the taxpayer receives replacement property before the end of the 180-day exchange period; and
- the replacement property received is substantially the same property as identified.

If more than one replacement property is identified, each property is considered separately.

IDENTIFICATION/RECEIPT OF REPLACEMENT PROPERTY TO BE PRODUCED

The transfer of relinquished property for property under construction or to be produced will not destroy the non-recognition of gain under I.R.C. §1031 if certain conditions are met.

- If a part of the replacement property is to be produced, it must be identified in the same manner as existing property. For example, if the replacement property consists of land and a barn under construction, the land would be described by means of its legal description. The barn would be identified with as much description as practical.
- For purposes of the 200% rule, the value is the estimated value at time of completion.

In determining whether the property received is substantially similar to property identified variations caused by usual or typical construction changes are not taken into account. However, if substantial changes are made in the property produced, the replacement property received will not be considered substantially similar to the property identified [Reg. §1.1031(k)-1(e)(3)(i)].

If identified property is personal property, construction must be completed before the property is received by the taxpayer.

In the case of real property, where construction is not complete by the time it is transferred to the taxpayer, property will be considered as substantially similar to the property identified, if it will meet the substantially similar tests when it's complete. The property received must be construed as real property under local law.

RECEIPT OF CASH OR OTHER PROPERTY

In the case of a transfer or relinquished property, gain or loss may be recognized if the taxpayer actually or constructively receives cash or other property before receiving the like-kind property.

Caution. If the taxpayer receives cash or other property in full amount of consideration for relinquished property before receiving like-kind property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind property.

Actual or constructive receipt occurs when the taxpayer actually receives money or economic benefit of money or non-like-kind property or has it available if they wish to access money or property. If the taxpayer is not in constructive receipt because of limitations attached to money or property, they become constructively received when limitations expire or lapse.

Like-Kind Exchange Worksheet

Old Property	New Property
Description	Description
Date Disposed	Date Acquired
Value	Value
Notes/Mortgages ()	Notes/Mortgages ()
Equity	Equity

Realized Gain

Sales Price	_____
Less: Adjusted Basis	()
Less: Exchange Expenses	()
Gain/(Loss)	_____
(Loss cannot be recognized)	

Recognized Gain

Decrease in Equity or	_____
Increase in Equity	()
Decrease in Mortgage(s), if any	_____
Less: Exchange Expenses	()
Gain/(Loss)	_____
Recognized Gain, but only to extent of realized gain	_____
(Note, if result is negative, there is no recognized gain)	

Basis of New Property

Cost of Property	_____
Plus: Non-Recognized Loss, if any, or	_____
Less: Non-Recognized Gain, if any	()
Basis of New Property	_____

ISSUE 7: TAX ASPECTS OF TELECOMMUTING

INTRODUCTION

A 1998 study predicted an estimated 11 million employees would be working, at least partially, from their home by 2000. However, in 1999, almost 20 million people were telecommuting. These numbers increase dramatically each year. There are many advantages for both employees and employers. One advantage for an employee might be reduced child care expense. An advantage for an employer might be less expense for office rental space. With the increased electronic communication efficiency, workers are able to share work project data as fast as if they were in the same building.

Telecommuting is defined as working off-site for an outside employer at least one day per month. Over 80% of telecommuters do so part-time (1-3 days per week). One Energy Department study found telecommuting saves 1-2% of total annual gasoline consumption with the potential for more savings. Economists recognize that telecommuters avoid “congestion costs”, such as lost time and excess fuel usage in traffic jams. Atlanta’s congestion cost is estimated at \$3,500 per year for each additional driver. Telecommuting offers many interesting challenges to employers and creates unique tax issues for telecommuters.

DEDUCTIBILITY OF HOME OFFICE EXPENSE

Congress created I.R.C. §280A in 1976 to permit an office-in-home deduction. This allowed individuals to deduct a portion of their personal residence expenses if they used a space in it for business purposes. I.R.C. §280A was amended in 1997 which qualified more taxpayers to deduct office-in-home expenses.

Principal Place of Business

In order to deduct office-in-home expenses, a taxpayer is required to show that the office is used both **exclusively and regularly**.

Example 22. Sally has a home office that is only used for business. However, she uses the office only 26 weeks per year. She does not qualify for a home office deduction since her office does **not** meet the “regular use” test.

Whether the office is the **principal place of business** was defined by the Supreme Court in the *Soliman* case (*Commr. v. Soliman*, (1993, S Ct)). The court found that where a taxpayer had more than one location, it was necessary to compare the time at all locations to determine the principal location. It looked at the relative importance of the activities performed at each location and the amount of time spent at each. The Court noted that the home office does not become the principal place of business by default if the relative importance of the activities at each location can not be determined.

Beginning in 1998, due to a legislative change, if the office is used exclusively and regularly to conduct **administrative and management activities** and there is **no other fixed location** where the taxpayer conducts substantial or administrative or management activities, a home office will qualify for a deduction. However, this change applies mainly to self-employed taxpayers.

Example 23. Chuck is a self-employed electrician. He spends his days at customer homes and businesses performing his trade. In his home office, he uses his computer for billing and bookkeeping and a telephone to call clients. He has no other office. Chuck is entitled to an office-in-home deduction, provided it is used exclusively and regularly for his administrative and management business activities.

Convenience of the Employer Test

A telecommuter faces one other severe restriction. In order to qualify for the deduction, an employee must be required to furnish a home office. This is called the “**convenience of the employer**” test. This test **will be met only** if the **employer demands** the employee work from his/her home. If the **employee voluntarily** works from his/her home, the “convenience of the employer” test is **not met** and home office expense deductions will be **denied**.

Principal Place of Employment Test

The principal place of employment test will normally be met if the employee works **full time** from the home office. However, if he/she commutes to the employer-provided office part-time, an office-in-home deduction will likely be denied.

Example 24. Josh writes training manuals for his employer. He does all of his writing at home, but occasionally goes to his employer's office to meet with supervisors and other team members to discuss future projects. He spends more time at home than at the employer's office. Under these circumstances, it appears Josh will qualify for a home office deduction since he meet both the principal place of employment and convenience of employer tests.

Other Considerations

The gross income test should not be a problem for telecommuters. The gross income test requires that the income generated in the home office exceed the expenses allocated to the home office.

TRANSPORTATION EXPENSE

If a telecommuter qualifies to deduct home office expenses, transportation expenses between the home office and other work places are deductible. Therefore, the telecommuting employee can deduct the mileage costs for the trips from the home office to the employer's office for meetings, etc.

COMPUTER AND RELATED EQUIPMENT

If the employer furnishes the employee with a computer or other equipment, the costs can be deducted by the employer as if the equipment were located in the employer's office. The employee will treat the computer and related equipment as a working condition fringe benefit.

If the employee purchases work equipment (computer, fax, etc.), it can be depreciated only if the equipment is required as a **condition of employment**. If the employee's home office deductions do not qualify under I.R.C. §280A, the personal computer will be treated as **listed property**.

REIMBURSED EXPENSES RELATED TO TELECOMMUTING

The employer may supply the telecommuter with a high-speed telephone line, office supplies and other equipment. Or, the employee may be reimbursed for these expenses. The employee could also be reimbursed for utilities and maintenance expenses. The employer-provided property and services will normally qualify as tax-free working condition fringe benefits.

ISSUE 8: INDEPENDENT CONTRACTORS

It is critical to differentiate between individuals the Internal Revenue Code treats as employees and those who are regarded as independent contractors. An employer's definition of the provider of services as an employee or as an independent contractor does not determine the status. The critical question is the actual relationship that is established between the employer and the provider. If the employment relationship is treated as an employer-employee relationship by the Code, it makes no difference what that relationship is called by the parties, how payments are made, or whether the employment is full-time or part-time. If it is an employer-employee relationship, the employer is subject to certain obligations.

Common Law Principles

Usually, an employer-employee relationship exists under common law principles if the person for whom the services are performed has the right to control and direct the individual performing the services not only as to the result, but also as to the details and the means by which that result is accomplished. If the person performing the services is subject to the will and control of the person for whom the services are performed as to both what must be done and how it must be done, that person generally is an employee.

A very important factor that indicates an employer-employee relationship is the right of the employer to discharge the employee. Also, included is where the person for whom the work is being performed provides the tools and the place to work.

DISTINGUISHING EMPLOYEES AND INDEPENDENT CONTRACTORS

In the new IRS Pub. 15-A, *Employer's Supplemental Tax Guide* (Rev. January 2002), the IRS provides current information that must be considered when distinguishing between employees and independent contractors. This new IRS publication analyzes the three categories which determine whether a worker is an independent contractor or an employee.

- behavioral control
- financial control
- type of relationship

Behavioral Control

This relates to whether the business has a right to **direct and control** how a worker does the work. Factors to consider include **instructions** and **training** given to workers as shown below:

Instructions: If a worker receives extensive instructions on how work is to be done, this suggests the worker is an employee. Instructions can cover a wide range of topics, for example:

- how, when or where to do the work;
- what tools or equipment to use;
- what assistants to hire to help with the work; or
- where to purchase supplies and services.

If a worker receives less extensive instructions about what should be done, but not how it should be done, the worker may be an independent contractor. For instance, instructions about time and place may be less important than direction on how the work is performed.

Training: If the business provides a worker with training about required procedures and methods, this indicates the business wants the work done in a certain way, and this suggest the worker may be an employee.

Financial Control

This type of control related to whether the business has a right to control the business aspects of the worker's job, including:

- 1. The extent to which the worker has unreimbursed business expenses.** Independent contractors are more likely to have unreimbursed expenses than employees. Fixed on-going costs incurred regardless of whether work is being performed are especially important. Employees may also incur unreimbursed expenses in connections with the work they perform for their employer.
- 2. The extent of the worker's investment.** An independent contractor often has a significant investment in the facilities used in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- 3. The extent to which the worker makes services available to the relevant market.** An independent contractor is generally free to seek other business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.
- 4. How the business pays the worker.** An employee is generally guaranteed a regular wage amount for an hourly, weekly or another period of time. This usually indicates a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a set fee for a job. However, in some professions like law, it is common for independent contractors to be paid hourly.
- 5. The extent to which the worker can realize a profit or loss.** If the worker can realize a profit or loss, this indicates independent contractor status.

Type of Relationship

Factors that identify the type of relationship between the employer and worker are:

1. **Written contracts describing the relationship the parties intend to create.**
2. **Whether the business provides the worker with employee fringe benefits such as insurance, a pension plan, vacation or sick pay.** If these are received; there is an indication the worker is an employee.
3. **The permanency of the relationship.** If a worker is engaged with the expectation the relationship will continue indefinitely, rather than for a specified period of time, this is generally considered evidence the intent is to create an employer-employee relationship.
4. **The extent to which services performed by the worker are a key aspect of the regular business of the company.** If a worker provides services that are a key aspect of regular business activity, it is more likely the employer has the right to direct and control the employee's activities. For example, if a law firm hires an attorney, it is likely it will represent the attorney's work as its own and it has the right to control or direct the attorney's work. This would indicate an employer-employee relationship.

An employer or employee may request a determination from the IRS by filing **Form SS-8**, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

Following are several industry specific examples of distinguishing between employee and independent contractors.

Building and Construction Industry

Example 1. Tim, an experienced ceramic tiler, orally agrees to perform full time services at construction sites for a construction corporation. He uses his own tools and performs services in the order designated by the corporation, and according to its specifications. The corporation supplies all materials, and makes frequent inspections of his work. He is paid on a piecework basis, and the corporation carries worker's compensation insurance on him. He does not have a separate place of business and he does not perform similar services for others. Either party in this relationship can end the services at any time.

Tim is considered an employee.

Example 2. Bill contracted with Elm Corporation to complete roofing on an entire housing complex. A signed contract established a set fee for the services Bill renders. Bill is a licensed roofer and carries worker's compensation and liability insurance under his business name, Bill's Roofing. Bill hires roofers, who are treated as employees for Federal employment tax purposes. If there is a problem with the roofing work, Bill's Roofing is responsible for paying for any repairs.

Bill is an independent contractor, doing business as Bill's Roofing.

Trucking Industry

Example 3. Ross Trucking contracts to deliver material for Black, Inc. at \$140 per ton. Ross Trucking is not paid for any articles not delivered. At times, Ray Ross, the operator of Ross Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Ray Ross. All equipment is owned or rented by Ray, and he is responsible for all maintenance. None of the drivers are provided by Black, Inc.

Ray Ross is an independent contractor, operating as Ross Trucking.

Computer Industry

Example 4. Sue Smith, a computer programmer, was laid off when BigByte, Inc. downsized. BigByte, Inc. agrees to pay Sue a flat amount to complete a project to create a specific product. It is not clear how long it will take to complete the project, and Sue is not guaranteed any minimum payment for the hours she spends

on the project. BigByte, Inc. provides Sue with no instructions beyond the specifications of the product. Sue and BigByte, Inc. have a written contract, which indicates Sue is considered an independent contractor, she is required to pay her own federal and state taxes and she received no benefits from BigByte, Inc. BigByte will file a Form 1099-MISC. Sue does the work on a new computer which cost her \$7,000. She works at home and is not expected or allowed to attend meetings of the software development group.

Sue is an independent contractor.

Automobile Industry

Example 5. Don is a salesman employed on a full-time basis by Bob Green, and auto dealer. He works 6 days per week and is on duty in Bob's showroom on assigned days and times. He appraises trade-ins, but his appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. Don has to develop leads and report results to Bob. Because of his experience, he requires only minimal assistance in closing and financing sales and other phases of his work. Don is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group term life insurance for Don.

Don is an employee of Bob Green.

Example 6. An auto sales agency furnishes space for Hank to perform auto repair services. He provides his own tools, equipment and supplies. He seeks out business from insurance adjusters and other individuals and does all the body and repair work that comes to the agency. He hires and discharges his own helpers, determines his own and his helper's working hours, quotes prices for the repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts and receives as compensation, a large percentage of the gross collections from the auto repair shop.

Hank is an independent contractor and the helpers are his employees.

§530 OF THE REVENUE ACT OF 1978

§530 of the Revenue Act of 1978, provides that if, for purposes of the employment tax provisions, an employer did not treat an individual as an employee for any period, then the individual will be deemed not to be an employee for that period, unless the employer had no reasonable basis for not treating the individual as an employee. For periods after December 31, 1996, the IRS must provide written notice of the provisions of §530 of the Revenue Act of 1978 to the taxpayer at the beginning of any audit involving worker classification.

For an employer to obtain relief, the employer's basis for not treating the individual as an employee must be reasonable. A taxpayer may satisfy the reasonable basis requirements by showing that it reasonably relied on the advice of an attorney in making the decision to treat the worker as an independent contractor.

This relief is only available if all required federal tax returns, including Form 1099, has been filed for the worker for that period. The relief will not apply if the employer or any predecessor treated any individual holding a substantially similar position as an employee for any period beginning after December 31, 1977.

Revenue Procedure 85-18 identifies three specific safe harbors for providing a reasonable basis for not treating an individual as an employee. An employer may rely on:

1. Judicial precedent or published rulings, or technical advice, letter rulings, or a determination letter from the IRS pertaining to that employer.
2. The fact that a past IRS audit (whether or not pertaining to employment tax issues) did not question the employment tax treatment of individuals holding positions substantially similar to those whose status may be at issue. For periods after December 31, 1996, however, for this safe harbor to apply, the audit must involve an examination for employment tax purposes of whether the worker involved or workers holding a position substantially similar to that of the worker involved should be treated as an employee.

3. A long-standing recognized practice of a significant segment of the industry in which the employer is engaged, whether or not the practice is uniform throughout the entire industry. For periods after December 31, 1996, a significant segment of the industry includes any figure over 25% of the industry and may be established as a smaller percentage depending on facts and circumstances. A practice that has continued for at least 10 years will be considered long-standing, and a shorter period may be considered as such depending on facts and circumstances. Mere reliance on industry practice is not sufficient for this safe harbor; any such reliance must be reasonable.

An employer who fails to meet any of these three safe harbors may be entitled to relief if some other reasonable basis for not treating the individual as an employee can be demonstrated.

I.R.C. §3509 COMPUTATION

If an employer fails to deduct and withhold any tax for any employee, the amount of the employer's liability for withholding taxes will be determined as if the amount required to be deducted and withheld were equal to 1.5% of the wages paid. For purposes of employee Social Security tax, 20% will be imposed.

RECLASSIFICATION ISSUES

The employer will have to issue correct W-2s and corrected 1099s for the years of reclassification. One of the most potentially serious consequences of worker reclassification is disqualification of an employer's qualified retirement plan. This can occur in two ways:

1. The IRS can take the position that a plan is disqualified if it is not operated in accordance with its written terms. Therefore, if a plan states it provides benefits to all employees and benefits were not provided, the IRS could find the plan is not and has not been operated in accordance with its terms.
2. The treatment of additional workers as employees can cause the plan to fail any of a number of tests that depend on the number and ratio of highly compensated to non highly compensated employees, including non-discrimination, coverage, and participation tests.

In the past, the IRS has usually not followed up employment tax reclassifications with attacks on the qualified status of the plans, except in very abusive situations. However, employers can not rely upon this as a reason to ignore the effect of reclassification on plan qualifications.

In addition, employers will have to go through similar analysis for their other benefit plans, such as, group health insurance, cafeteria plans, educational assistance plans, or dependent care assistance programs. The same is true of self-insured accident and health plans, but not other medical plans which are not subject to non-discrimination requirements.

ISSUE 9: CASH ACCOUNTING METHOD

In a series of two Notices and a Revenue Procedure (listed below), the IRS has approved a new accounting safe harbor. It allows the cash basis of accounting to be used by service businesses which meet a 3-year average gross receipts test of \$10 million or less.

This important change in IRS policy liberalizes the previous \$1 million safe harbor provided by Rev. Proc. 2000-22 and 2001-10. Following is a listing of the Notices and Revenue Procedure mentioned above:

1. Notice 2001-76 (issued December 2001)
2. Notice 2002-14 (issued February 2002)
3. Revenue Procedure 2002-28 (issued April 2002)

The IRS issued the new \$10 million cash basis safe harbor in order to:

- reduce administrative and tax compliance burdens on small service businesses; and
- reduce disputes over which taxpayers must use the accrual method of accounting.

This liberalization will benefit small service businesses which would otherwise need to maintain inventories and use the accrual method. The IRS estimates that over 500,000 businesses will be able to utilize these new accounting rules. The IRS decided to adopt the new rules following numerous court defeats in cases where it tried to switch construction and service businesses to the accrual method.

The \$10 million gross receipt test. In order to qualify, a taxpayer's average annual gross receipts must be \$10 million or less for three tax years ending with each tax year ending on or after December 31, 2000.

Example 25. A-1 Home Remodeling, Inc. has been using the accrual method of accounting. However, due to the liberalization rules shown above, it would like to adopt the cash method for its 2002 calendar year Form 1120. Its average annual gross receipts for the 3-year period 1999-2001 was slightly less than \$10 million. However, its average annual gross receipts for the 3-year period 1998-2000 was slightly more than \$10 million.

Conclusion. A-1 is not eligible to switch to the cash method of accounting for 2002. 2000 and 2001 "prior years ending on or after December 31, 2000". The 3-year average annual gross receipts test must be met for each 3-year period. Since A-1 did not meet the 3-year test for 1998-2000, it is not eligible to switch to the cash method in 2002.

Businesses that Don't Qualify to Use the Liberalized Relief from Accrual Accounting

The following businesses are prohibited from using the new relief if their principal business activity is:

- mining;
- manufacturing;
- wholesale trade;
- retail trade;
- publishing; and
- sound recording.

The following entities are also prohibited by specific statute:

- C corporations or partnership with C corporation partners if their average annual 3-year gross receipts exceed \$5 million (I.R.C. §448).

Note. The prohibition shown above does not affect personal service corporations or farming businesses.

Planning Tip. This restriction is eliminated if the entity form is switched to an LLC, LLP or an S corporation.

Special Rules for Inventoriable Items

Any business that qualifies for the new relief from accrual accounting must treat "inventoriable items" in the same manner as specified for "nonincidental materials and supplies" under Treas. Reg. §1.162-3.

An “inventoriable item” includes:

- items purchased for resale to customers; and
- raw materials used to produce finished goods.

Example 26. Fairview Animal Hospital buys pet supplies and food for sale to customers at its business location. The cost of such “resale” merchandise cannot be deducted in the year purchased if the year of sale is later. Rather, such cost is deductible in the later tax year when sold.

Example 27. Joe’s Plumbing, Inc., a calendar year plumbing contractor, installs plumbing fixtures in customers’ homes and businesses. Joe reasonably determines his principal business activity is construction, which is an eligible activity under the new rules. The gross receipts of the corporation for the three preceding years were:

Year	Gross Receipts
1999	\$6,000,000
2000	\$7,000,000
2001	\$8,000,000

The corporation’s average annual gross receipts for the 3-year period 1999-2001 were \$7,000,000. The corporation may use the cash method of accounting for all of its trades or businesses for 2002.

Example 28. Jim, a self-employed plumbing contractor, installs plumbing fixtures in customers’ homes and businesses. He also has a store that sells plumbing equipment to homeowners and other plumbers. He receives **60%** of his total income from plumbing installation (including amounts charged for parts and fixtures used in the installation procedure). He receives **40%** of his total income from the sale of plumbing equipment through his store. He reasonably determines he is in the construction business. He is eligible to use the cash method of accounting under the new rules.

Example 29. Sue, a self-employed plumbing contractor, installs plumbing fixtures in customers’ homes and businesses. She receives **40%** of her gross receipts from installation (including amounts charged for parts and fixtures used in the installation procedure). She receives **60%** from the sale of plumbing equipment to retail customers in her store. Her principal business activity is retail trade. This is an ineligible activity for the cash method of accounting unless she keeps **separate** books and records for the installation business and the retail business. If these records are maintained separately, she may use the cash method for the installation part of her business. However, she must use the accrual method for the retail part of her business. If separate records are not maintained, she must use the accrual method for both businesses.

Example 30. Jose is a self-employed roofing contractor. He is eligible to use the cash method of accounting because his average annual gross receipts are less than \$10 million. He entered into a contract with a homeowner in December 2001 to replace the homeowner’s roof. Jose bought the roofing shingles from a local supplier and had them delivered to the homeowner’s residence. He paid the supplier \$5,000 when the shingles were delivered in December 2001. Jose completed the job in December 2001 and gave the homeowner a bill for \$15,000 at that time. Jose received the check from the customer in March 2002.

Jose is permitted to deduct the \$5,000 for the shingles on his 2001 Schedule C the year he bought them and provided the service. He will report the \$15,000 on his 2002 Schedule C, the year he receives the check from the customer.

Example 31. Same facts as **Example 30**, except Jose did not perform the work until January 2002 and received payment from the customer in May 2002. Because the shingles were not provided to the customer until 2002, their \$5,000 cost is not deducted until 2002, even though Jose paid for them in 2001.

Requesting relief from accrual accounting under the new rules

If a taxpayer wants to switch to the cash method, the new guidelines contained in Section 7 of Rev. Proc. 2002-28 must be followed. In general, this change requires completion of Form 3115, Application for Change in Accounting Method. However, this is an automatic consent and requires no user fee.

Effective Date. Eligible business taxpayers may use these new rules for the tax years ending on or after December 31, 2001. Also, the IRS stated it would not challenge the use of the cash method in earlier years by eligible business taxpayers.

To make the switch to the cash method, an original Form 3115 must be attached to a timely filed original return (including extensions) or to an amended return filed within six months of the original due date of the return. In addition, a copy of Form 3115 must be sent to the IRS National Office no later than when the original return is filed.

Note. See Chapter 6: Rulings and Cases for an analysis of the following Notice and three Revenue Procedures relating to Issue 9, Cash Accounting Method:

- Notice 2001-76
- Revenue Procedure 2002-9
- Revenue Procedure 2002-19
- Revenue Procedure 2002-28