Chapter 13: Practitioner Q and A

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

ADOPTION CREDIT

Question 1. My clients went to Russia and completed all the requirements there to allow an unadopted Russian child to leave the country with them. This occurred in 2001. The adoption was finalized in the U.S. in August 2002 when the county circuit court approved the adoption decree. Can all of the adoption expenses paid in 2001 and 2002 be reported on the 2002 Form 8839 (Qualified Adoption Expenses)?

Answer 1. Yes. The adoption expenses are not "qualified adoption expenses" until the adoption becomes final. (I.R.C. §§23(e) and 137(e)). The adoption is finalized when it is approved by a U.S. court or other appropriate U.S. authority.

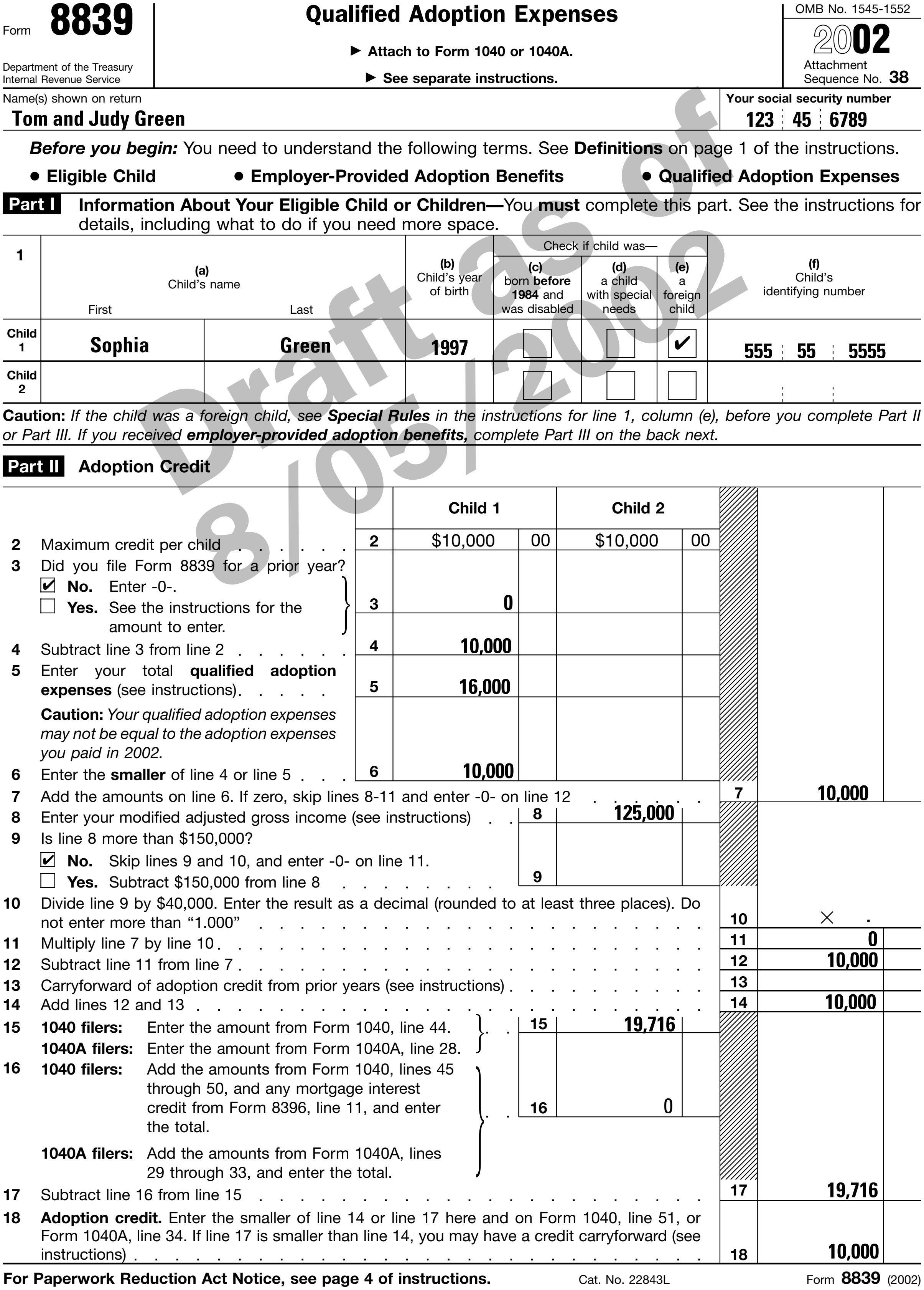
Example. Tom and Judy Green adopted a Russian child, Sophia. The adoption process began in April 2001. They made two trips to Russia in 2001 and satisfied all Russian laws and requirements in order to take Sophia out of Russia. They brought Sophia to their home in December 2001.

The county circuit court approved the adoption in August 2002 following the mandatory 6-month waiting period. Tom and Judy paid the following qualified adoption expenses:

Year Paid	Amount of Qualified Adoption Expenses Paid
2001	$13,000
2002	3,000
Total	$16,000

Note. The adoption credit limit is $10,000 for 2002.

Their completed Form 8839 is shown below:



Form **8839**

Department of the Treasury
Internal Revenue Service

Qualified Adoption Expenses

▶ **Attach to Form 1040 or 1040A.**

▶ **See separate instructions.**

OMB No. 1545-1552

2002

Attachment
Sequence No. **38**

Name(s) shown on return: **Tom and Judy Green**

Your social security number: **123 45 6789**

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

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

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

1	(a) Child's name First	(a) Child's name Last	(b) Child's year of birth	Check if child was— (c) born **before 1984** and was disabled	(d) a child with special needs	(e) a foreign child	(f) Child's identifying number
Child 1	**Sophia**	**Green**	**1997**	☐	☐	☑	**555 55 5555**
Child 2				☐	☐	☐	

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

Part II **Adoption Credit**

			Child 1	**Child 2**		
2	Maximum credit per child	2	$10,000 00	$10,000 00		
3	Did you file Form 8839 for a prior year? ☑ **No.** Enter -0-. ☐ **Yes.** See the instructions for the amount to enter.	3	**0**			
4	Subtract line 3 from line 2	4	**10,000**			
5	Enter your total **qualified adoption expenses** (see instructions).	5	**16,000**			
	Caution: *Your qualified adoption expenses may not be equal to the adoption expenses you paid in 2002.*					
6	Enter the **smaller** of line 4 or line 5	6	**10,000**			
7	Add the amounts on line 6. If zero, skip lines 8-11 and enter -0- on line 12				7	**10,000**
8	Enter your modified adjusted gross income (see instructions)		8	**125,000**		
9	Is line 8 more than $150,000? ☑ **No.** Skip lines 9 and 10, and enter -0- on line 11. ☐ **Yes.** Subtract $150,000 from line 8		9			
10	Divide line 9 by $40,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than "1.000"				10	× .
11	Multiply line 7 by line 10				11	**0**
12	Subtract line 11 from line 7				12	**10,000**
13	Carryforward of adoption credit from prior years (see instructions)				13	
14	Add lines 12 and 13				14	**10,000**
15	**1040 filers:** Enter the amount from Form 1040, line 44. **1040A filers:** Enter the amount from Form 1040A, line 28.		15	**19,716**		
16	**1040 filers:** Add the amounts from Form 1040, lines 45 through 50, and any mortgage interest credit from Form 8396, line 11, and enter the total. **1040A filers:** Add the amounts from Form 1040A, lines 29 through 33, and enter the total.		16	0		
17	Subtract line 16 from line 15				17	**19,716**
18	**Adoption credit.** Enter the smaller of line 14 or line 17 here and on Form 1040, line 51, or Form 1040A, line 34. If line 17 is smaller than line 14, you may have a credit carryforward (see instructions)				18	**10,000**

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

BUSINESS GIFTS

Question 2. One of my business clients, a self-employed sales representative, gives Christmas gifts of English biscuits and chocolates to her best customers. Is the cost limited to 50% as business-related entertainment or is it considered a gift subject to the $25 per person per year limitation?

Answer 2. It is a gift, subject to the $25 per person limit, not a business-related entertainment item. The 50% limitation does not apply.

8% CAPITAL GAINS TAX RATE

Question 3. Regarding the 8% capital gains tax rate on 5-year gains: Does all other income use up taxable income before considering qualified 5-year gains?

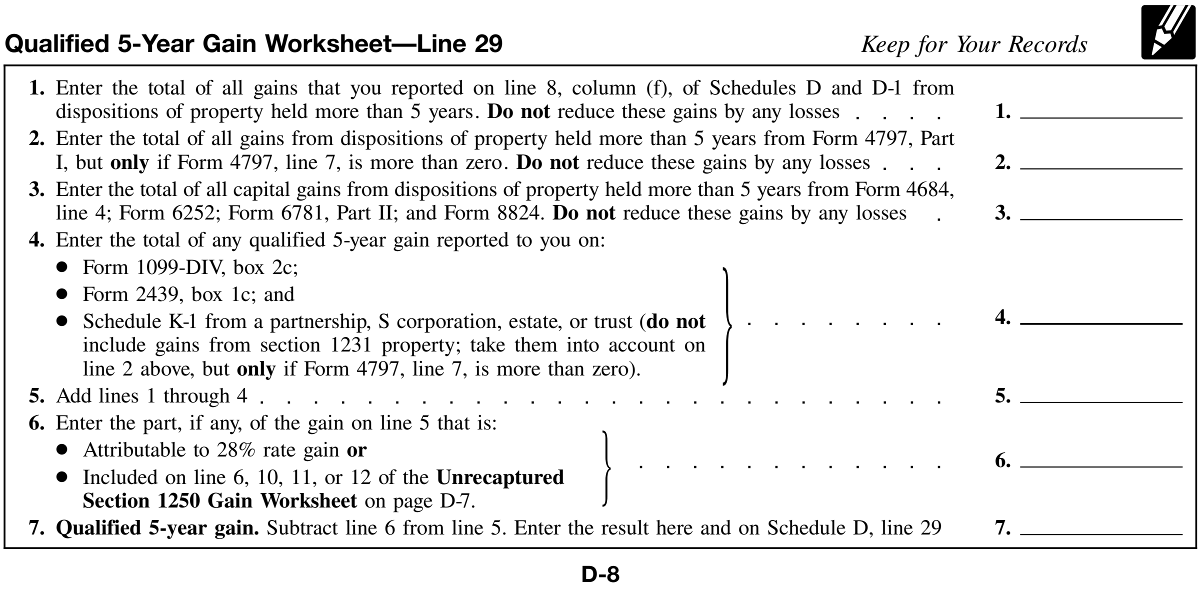
Answer 3. Yes. If a taxpayer's taxable income **excluding** 5-year gains is in excess of the ceiling for the 15% bracket, none of the 5-year gains will be taxed at 8%. Instead, they will be taxed at 20%.

Only 5-year gains that are **within the 15% tax bracket** (including other income) in 2001 and later years are eligible for the favorable 8% tax rate. Once the 15% tax bracket is used up (taxable income exceeds the ceiling for the 15% bracket), any remaining 5-year gains will be taxed at 20%.

The key to taking advantage of the 8% capital gains tax rate is to determine the correct amount of 5-year gains for 2002. Use the worksheet in the 2002 Form 1040 Instructions to determine the correct amount of qualified 5-year gains. Then, enter that amount on line 29 of the 2002 Schedule D. The computation in part IV of Schedule D will produce the correct tax.

Note. Don't forget the 5-year gains reported in Box 2c of the 2002 Form 1099-DIV (from mutual funds) and on Schedule K-1s from partnerships, S corporations, estates, and trusts. Completing the worksheet can be time consuming on a complex individual return. However, only lower-income taxpayers will be able to benefit from the 8% rate.

The worksheet from the 2001 Form 1040 Instructions is shown below.



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:
- 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.** ________

5. Add lines 1 through 4 . . . . **5.** ________

6. Enter the part, if any, of the gain on line 5 that is:
- 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.** ________

7. Qualified 5-year gain. Subtract line 6 from line 5. Enter the result here and on Schedule D, line 29 **7.** ________

D-8

Caution. Notice the important instruction for lines 1, 2 and 3 on the worksheet. **Do not reduce these (5-year gains) by any losses.** Enter only 5-year gains from line 8, column (f), of Schedule D. 5-year gains and 5-year losses **are not netted** in arriving at the figure to enter on lines 1, 2 and 3 of the worksheet. 5-year gains are included. 5-year losses are omitted.

See the **Example** for line 29, Schedule D in the 2002 Form 1040 Instructions for guidance in completing the worksheet. This **Example** was shown on page D-8 in the 2001 Form 1040 Instructions. It provides a thorough analysis for a complex individual return.

Question 4. My client sold an apartment building in 1998 on the installment method. The building had been purchased in 1990. The installment payments are to be paid over a 15-year period. They received a $17,000 payment in 2001. The gross profit percentage is 52.049%.

They use Form 6252 to report the gain each year. Will the 2001 taxable portion of the gain be eligible for the lower 8% capital gain rate as computed in Part IV of the 2001 Schedule D?

Note. The following example demonstrates a somewhat common situation of an existing installment sale of real property which could qualify for 8% treatment.

Answer 4. Yes. See the qualified 5-year gain worksheet shown previously in **Answer 3**. Line 3 of the worksheet states, "enter the total of all capital gains from dispositions of property **held more than five years** from............Form 6252." Since the apartment building was purchased in 1990 and sold in 1998, it met the more than 5-year test.

However, it is unlikely that any of the taxable installment sale amount will be a **capital gain** in 2001. The reason is that the amount of I.R.C. §1231 gain on each installment payment must be treated as **unrecaptured I.R.C. §1250 gain** until the total I.R.C. §1250 gain has been recaptured.

Example. The following example illustrates **Answer 4**.

- **A.** The owners of the apartment building are a husband and wife (Earl and Janet) who filed a joint 2001 return. Their 2001 taxable income was $75,000, which gives them a top tax bracket of 27.5%.
- **B.** The taxable amount of the installment sale, $8,848 (line 26, Form 6252) is taxed at a 25% rate in 2001 as unrecaptured I.R.C. §1250 gain. This is the maximum tax rate allowed for unrecaptured I.R.C. §1250 gain.
- **C.** The total unrecaptured I.R.C. §1250 gain on the sale of the apartment building is $81,660, the total MACRS deductions on it from 1990 through the date of sale in 1998.
- **D.** The amount of unrecaptured I.R.C. §1250 gain remaining to be reported in 2001 is $57,197 computed as follows:

Total unrecaptured I.R.C. §1250 gain (due to MACRS)	$81,660
Less: Unrecaptured I.R.C. §1250 gain reported in years 1998–2000 ($47,000 × 52.049%)	(24,463)
Amount remaining to be reported in 2001	$57,197

- **E.** Earl and Janet had $2,400 of capital gain distributions in 2001, $850 of which was identified as 5-year gain in box 2c of their 2001 Forms 1099-DIV.
- **F.** If Earl and Janet's 2001 taxable income had been within the 15% tax bracket, the $8,848 unrecaptured I.R.C. §1250 gain would have been taxed at 15% rather than at the maximum 25% rate.

G. The completed forms and schedules follow:

1. The 2001 Form 6252. **Note that even though the installment sale of the apartment building occurred in 1998, Part I of Form 6252 is completed to give the necessary facts.**
2. Part I of the 2001 Form 4797.
3. The Unrecaptured I.R.C. §1250 Gain Worksheet from the 2001 Form 1040 Instructions (shown on page D-7).
4. The 2001 Schedule D.
5. The Schedule D Tax Worksheet from the 2001 Form 1040 Instructions (shown on page D-9).

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: **Earl and Janet**
Identifying number:

1 Description of property ▶ **Apartment building**
2a Date acquired (month, day, year) ▶ **1 / 14 / 90** b Date sold (month, day, year) ▶ **3 / 10 / 98**
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	
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			
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			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	
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	52.049%
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	17,000
22	Add lines 20 and 21			22	17,000
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	47,000		
24	**Installment sale income.** Multiply line 22 by line 19			24	8,848
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	8,848

For Answer 4

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: **Earl and Janet**
Identifying number

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	8,848
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	8,848

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):	9	

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

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

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.** 8,848
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.** 8,848
7. Enter the **smaller** of line 6 or the gain from Form 4797, line 7	**7.**	8,848	
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.** 8,848
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.** 8,848
14. Enter the gain or (loss) from Schedule D, line 15	**14.**	0	
15. Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	**15.**	0	
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.** 0
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.** 8,848

D-7

For Answer 4, continued.

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: Earl and Janet

Your social security number

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
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	8,848	
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	2,400	
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	11,248	

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

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**

For Answer 4, continued.

Schedule D (Form 1040) 2001 Page **2**

Part III **Taxable Gain or Deductible Loss**

17 Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39 . . . . **17** 11,248

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

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

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

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

19 Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions **19** 8,848

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

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

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

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

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

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

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

26 Enter the **smaller** of:
- The amount on line 20 **or**
- $45,200 if married filing jointly or qualifying widow(er);
  $27,050 if single;
  $36,250 if head of household; or
  $22,600 if married filing separately } . . . **26**

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

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

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

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

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

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

32 Subtract line 30 from line 28 . . . . **32**

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

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

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

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

36 Subtract line 35 from line 34 . . . . **36**

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

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

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

40 **Tax on all taxable income (including capital gains).** Enter the **smaller** of line 38 or line 39 here and on Form 1040, line 40 . . . . **40** 14,580*

Schedule D (Form 1040) 2001

*** To be left blank per Worksheet**

Note. This number originates from the Schedule D worksheet, line 37.

For Answer 4, continued.

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. 75,000
2. Enter the **smaller** of line 16 or line 17 of Schedule D . . . 2. 11,248
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. 0
4. Subtract line 3 from line 2. If zero or less, enter -0- . . . 4. 11,248
5. Combine lines 7 and 15 of Schedule D. If zero or less, enter -0- 5. 0
6. Enter the **smaller** of line 5 above or Schedule D, line 15, but not less than zero . . . 6. 0
7. Enter the amount from Schedule D, line 19 . . . 7. 8,848
8. Add lines 6 and 7 . . . 8. 8,848
9. Subtract line 8 from line 4. If zero or less, enter -0- . . . 9. 2,400
10. Subtract line 9 from line 1. If zero or less, enter -0- . . . 10. 72,600
11. Enter the **smaller** of:
    - 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. 45,200
12. Enter the **smaller** of line 10 or line 11 . . . 12. 45,200
13. Subtract line 4 from line 1. If zero or less, enter -0- . . . 13. 63,752
14. Enter the **larger** of line 12 or line 13 . . . ▶ 14. 63,752
15. Figure the tax on the amount on line 14. Use the Tax Table or Tax Rate Schedules, whichever applies ▶ 15. 11,888

    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. ______
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. ______
18. Enter the **smaller** of line 16 above or line 17 above . . . 18. ______
19. Multiply line 18 by 8% (.08) . . . 19. ______
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. 2,400
23. Enter the amount from line 16 (if line 16 is blank, enter -0-) . 23. 0
24. Subtract line 23 from line 22 . . . ▶ 24. 2,400
25. Multiply line 24 by 20% (.20) . . . 25. 480

    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. 8,848
27. Add lines 4 and 14 . . . 27. 75,000
28. Enter the amount from line 1 above . . 28. 75,000
29. Subtract line 28 from line 27. If zero or less, enter -0- . . . 29. 0
30. Subtract line 29 from line 26. If zero or less, enter -0- . . . ▶ 30. 8,848
31. Multiply line 30 by 25% (.25) . . . 31. 2,212

    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. 14,580
36. Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies . . 36. 14,982
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. 14,580

D-9

CHARITABLE DONATIONS

Question 5. I have a client who regularly donates appreciated stock to her church. She owns a lot of EE bonds. Can she give the EE bonds to the church and claim a contribution deduction equal to the value of the bonds at the date of the gift?

Answer 5. Yes, but there is a big tax trap involved. Your client **cannot** avoid taxation on the accrued interest on the EE bonds when she donates them. Also, tax may not be deferred by first converting the EE bonds to HH bonds and then donating them to the church. **When E, EE, HH, or I bonds are donated to a charity, the donor should generally include all of the previously unreported accrued interest as taxable income.** This assumes that the accrued interest has not been reported annually. In summary, our recommendation is that your client continues to give appreciated stock held more than one year to her church rather than EE bonds.

Note. The taxable interest will increase AGI and may cause Social Security benefits to be taxable and could create phase-out issues.

DEDUCTING STUDENT LOAN INTEREST

Facts. My client, Marsha, is a divorced mother of a college student (daughter Sarah) who she is entitled to claim as a dependent. In **2000**, Marsha established an education loan in her own name to help pay for Sarah's college expenses. In **2001**, Marsha's AGI will be about $50,000. She will not be able to deduct much of the $3,000 of **2001** student loan interest she pays on line 24, Form 1040 due to the AGI phase-out rules. Marsha does not itemize deductions.

Question 6. It appears that with similar facts in **2002**, Marsha will be able to deduct most of her student loan interest on her 2002 single return. Am I interpreting this correctly? (Shown on page 503 in the *2001 Farm Income Tax Workbook*).

Answer 6. Yes. The 2001 Act significantly increased the modified AGI phase-out ranges for deducting student loan interest beginning in 2002. **If Marsha's 2002 modified AGI is under the phase-out ceiling of $50,000 for single taxpayers, she will be entitled to deduct up to $2,500 of student loan interest on line 24 of her 2002 Form 1040**. See Chapter 8: Education Provisions for more details on the expansion of the deduction for student loan interest.

Regarding the New Student Loan Interest Rules Beginning in 2002 and Miscellaneous Information

1. The new modified AGI phase-out ranges for 2002 are:

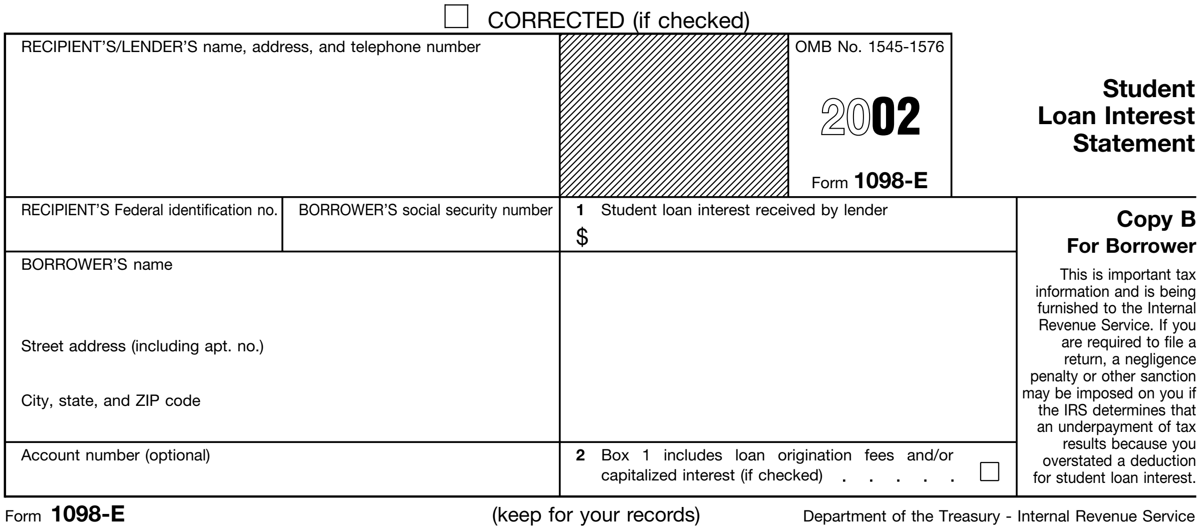
Filing Status	2002 Modified AGI Phase-out Range
a) Single	Begins at $50,000. Fully effective at $65,000.
b) Joint	Begins at $100,000. Fully effective at $130,000.

2. Many taxpayers who previously received qualified student loans for their college dependents have used home equity loans. That tax planning is logical, provided the taxpayer itemizes deductions. But for taxpayers with facts similar to Marsha, the new student loan deductions rules beginning in 2002 may provide a better option.

3. Form W-9S is used to certify to a lender that all the proceeds of a loan are to be used for qualified education expenses. The lender will report interest of $600 or more on Form 1098-E. A taxpayer may make a binding election for the current year and all future years to treat a home equity loan as unsecured debt that does not qualify as home mortgage interest under Reg. 1.163-10T(o)(5).

4. Student loan interest rates were adjusted July 1, 2002. They are now at their lowest level in history. The rates fell to 3.46% – 4.06% depending on the type and date of the loan.

5. Approximately 64% of all students borrow to finance their college costs. The average loan balance as of July 1, 2002 was $16,928 for graduates.



☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, address, and telephone number

OMB No. 1545-1576

2002

Form **1098-E**

Student Loan Interest Statement

RECIPIENT'S Federal identification no.

BORROWER'S social security number

1 Student loan interest received by lender
$

Copy B
For Borrower

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for student loan interest.

BORROWER'S name

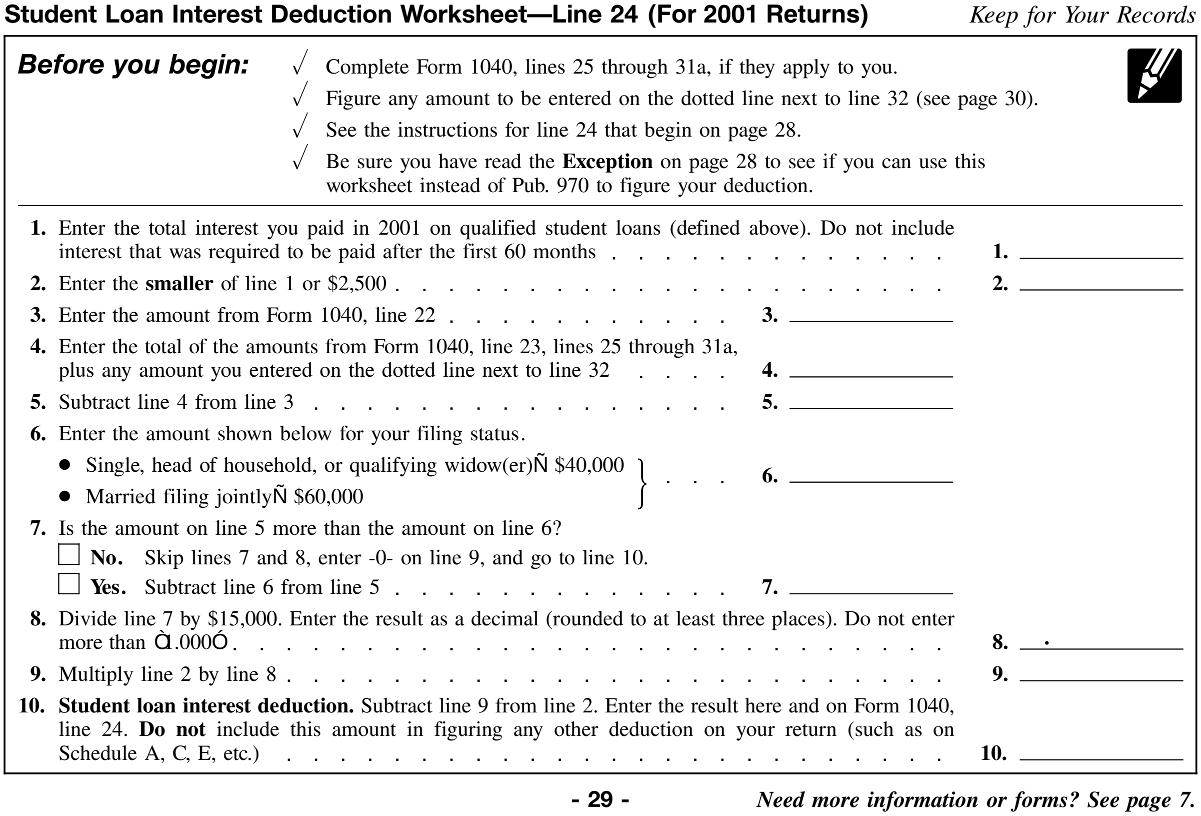
Street address (including apt. no.)

City, state, and ZIP code

Account number (optional)

2 Box 1 includes loan origination fees and/or capitalized interest (if checked) . . . . . ☐

Form **1098-E** (keep for your records) Department of the Treasury - Internal Revenue Service



Student Loan Interest Deduction Worksheet—Line 24 (For 2001 Returns) *Keep for Your Records*

Before you begin:

- √ Complete Form 1040, lines 25 through 31a, if they apply to you.
- √ Figure any amount to be entered on the dotted line next to line 32 (see page 30).
- √ See the instructions for line 24 that begin on page 28.
- √ Be sure you have read the **Exception** on page 28 to see if you can use this worksheet instead of Pub. 970 to figure your deduction.

1. Enter the total interest you paid in 2001 on qualified student loans (defined above). Do not include interest that was required to be paid after the first 60 months . . . . **1.** ______

2. Enter the **smaller** of line 1 or $2,500 . . . . **2.** ______

3. Enter the amount from Form 1040, line 22 . . . . **3.** ______

4. Enter the total of the amounts from Form 1040, line 23, lines 25 through 31a, plus any amount you entered on the dotted line next to line 32 . . . . **4.** ______

5. Subtract line 4 from line 3 . . . . **5.** ______

6. Enter the amount shown below for your filing status.

- Single, head of household, or qualifying widow(er)Ñ $40,000
- Married filing jointlyÑ $60,000

} . . . **6.** ______

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

☐ **No.** Skip lines 7 and 8, enter -0- on line 9, and go to line 10.

☐ **Yes.** Subtract line 6 from line 5 . . . . **7.** ______

8. Divide line 7 by $15,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than Ò1.000Ó . . . . **8.** __.______

9. Multiply line 2 by line 8 . . . . **9.** ______

10. **Student loan interest deduction.** Subtract line 9 from line 2. Enter the result here and on Form 1040, line 24. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.) . . . . **10.** ______

- 29 - *Need more information or forms? See page 7.*

DEEMED SALE ELECTION ON 2001 RETURNS

Question 7. My client has a large capital loss carryover to 2001. He owns several residential rental properties, which have appreciated. I know he can make the deemed sale election to report phantom paper gains on the rental buildings. My question is: Is the increase in basis resulting from this deemed sale election on January 1, 2001 eligible for MACRS depreciation?

Answer 7. This is another great question. Some may argue that because there is no cash outlay, no depreciation is allowable. However, I.R.C. §311(e) of the Taxpayer Relief Act of 1997 provides that when the election is made, the property is treated as sold for an amount equal to FMV and reacquired for an amount equal to FMV. If the deemed sale election is made for a residential rental property, a sale is reported on Form 4797, and gain (including any applicable depreciation recapture) is taxable. The deemed reacquisition establishes a new basis, and depreciation should begin again using the new basis. MACRS generally would apply. Even if the prior placed-in-service date was pre-1987, residential rental property is not excluded from MACRS under the related-party acquisition rules (page 8 of IRS Pub. 946).

Therefore, the unofficial answer to your question is **yes.**

DEPRECIATION OF SOFTWARE

Question 8. I bought a large computer system consisting of hardware and software for $30,000. The software cost $10,000 and came from a different vendor than the hardware company. The hardware company installed the software, paid the software company, and billed me for one total amount of $30,000. May I treat the $10,000 software cost as a separate item and depreciate it over three years?

Answer 8. **Yes,** as long as the $10,000 cost of the software is separately stated on the $30,000 invoice. Computer software is depreciated over a 36-month period using the straight-line method [Treas. Reg. §1.167(a)-14(b)(2)].

Note. Refer to Chapter 1: New Tax Legislation for details on the special 30% depreciation allowance.

DIVORCE

Question 9. I prepare the returns of a divorced mother and her two sons who live with her. She has not remarried and says she never will. When preparing Form 8615 (Tax for Children Under Age 14 Who Have Investment Income of More Than $1,500), what should be entered on line 6 (parent's taxable income)? The boys' father is very reluctant (putting it mildly!) to furnish me with a copy of his return.

Answer 9. Where parents are legally separated or divorced, use the return of the parent **who has custody of the child for the greater part of the year** for line 6 entry purposes. We assume, that with the facts given, you will enter the mother's taxable income on line 6 of Form 8615.

Note. The Instructions for Form 8615 are not very thorough. For a complete explanation of how to prepare the form, see IRS Pub. 929, *Tax Rules for Children and Dependents*. Also see pages 351-366 in the *1999 Farm Income Tax Workbook* for excellent coverage including completed forms, schedules, and worksheets. If the tax professional lacks computer software that prepares Form 8615, it will be a time consuming task. This is especially true if the children have capital gain income.

For Answer 9

Form **8615**

Department of the Treasury
Internal Revenue Service (99)

Tax for Children Under Age 14 With Investment Income of More Than $1,500

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

OMB No. 1545-0998
2002
Attachment Sequence No. **33**

Child's name shown on return

Child's social security number

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

A Parent's name (first, initial, and last). **Caution:** *See instructions before completing.*

B Parent's social security number

C Parent's filing status (check one):
☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Part I Child's Net Investment Income

1 Enter the child's investment income (see instructions) 1

2 If the child **did not** itemize deductions on **Schedule A** (Form 1040 or Form 1040NR), enter $1,500. Otherwise, see instructions 2

3 Subtract line 2 from line 1. If zero or less, **stop;** do not complete the rest of this form but **do** attach it to the child's return 3

4 Enter the child's **taxable income** from Form 1040, line 41; Form 1040A, line 27; or Form 1040NR, line 39 4

5 Enter the **smaller** of line 3 or line 4 5

Part II Tentative Tax Based on the Tax Rate of the Parent

6 Enter the parent's **taxable income** from Form 1040, line 41; Form 1040A, line 27; Form 1040EZ, line 6; TeleFile Tax Record, line K; Form 1040NR, line 39; or Form 1040NR-EZ, line 14. If zero or less, enter -0- 6

7 Enter the total, if any, from Forms 8615, line 5, of **all other** children of the parent named above. **Do not** include the amount from line 5 above 7

8 Add lines 5, 6, and 7 8

9 Enter the tax on the amount on line 8 based on the **parent's** filing status above (see instructions). If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used, check here ▶ ☐ 9

10 Enter the parent's tax from Form 1040, line 42; Form 1040A, line 28, minus any alternative minimum tax; Form 1040EZ, line 10; TeleFile Tax Record, line K; Form 1040NR, line 40; or Form 1040NR-EZ, line 15. **Do not** include any tax from **Form 4972** or **8814.** If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) was used to figure the tax, check here . ▶ ☐ 10

11 Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to **Part III** 11

12a Add lines 5 and 7 . . . . 12a

b Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places) . . 12b × .

13 Multiply line 11 by line 12b 13

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

14 Subtract line 5 from line 4 14

15 Enter the tax on the amount on line 14 based on the **child's** filing status (see instructions). If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used to figure the tax, check here . . . . ▶ ☐ 15

16 Add lines 13 and 15 16

17 Enter the tax on the amount on line 4 based on the **child's** filing status (see instructions). If the Capital Gain Tax Worksheet or Schedule D or J (Form 1040) is used to figure the tax, check here . . . . ▶ ☐ 17

18 Enter the **larger** of line 16 or line 17 here and on the **child's** Form 1040, line 42; Form 1040A, line 28; or Form 1040NR, line 40 18

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 64113U Form **8615** (2002)

EXCLUSION OF SERIES EE BOND INTEREST

Facts. Grandparents bought a grandchild Series EE U.S. savings bonds in the early 1980s when interest rates were high. The bonds are in the name and social security number of the grandchild. The grandchild began college in August 2001 and some of the bonds were cashed to pay for college expenses.

Question 10. Can the grandchild use Form 8815 (Exclusion of Interest From Series EE and I Savings Bonds Issued After 1989) to exclude interest on his single 2001 tax return? The grandchild has about $15,000 of 2001 wages and quite a bit of investment income including the EE bond interest.

Answer 10. No. The exclusion on Form 8815 is not available for bonds bought in the name of a child or grandchild who is under age 24 by a parent or a grandparent. See the Instructions for Form 8815.

> **Note.** See pages 159-166 in the *2001 Farm Income Tax Workbook* for a thorough analysis of this interest exclusion provision.

FOSTER CARE

Question 11. An instructor mentioned that foster care payments received from the state are excludable. However, I have a client who received a Form 1099-MISC from the state of Illinois for a physically handicapped foster child. What should I do in this situation?

Answer 11. Based on the facts that your client cared for only one handicapped foster child, it appears the state of Illinois issued the Form 1099-MISC in error. If so, attach a statement to the return explaining that the 1099 amount should not be reported as income is not taxable. Following is an excerpt from IRS Pub. 525, *Taxable and Nontaxable Income*.

Foster-Care providers. Payments you receive from a state or tax-exempt child-placement agency for providing care to qualified foster individuals in your home generally are not included in your income. However, you must include in your income payments received for the care of:

- *More than five individuals age 19 or older, and*
- *Certain difficulty-of-care payments.*

Difficulty-of-care payments. These are additional payments that are designated by the payer as compensation for providing the extra care that is required for physically, mentally, or emotionally handicapped foster individuals.

You must include in your income difficulty-of-care payments received for more than:

- *10 qualified foster individuals under age 19, or*
- *Five qualified foster individuals age 19 or older.*

> **Note.** Some taxpayers care for more than five foster individuals. The result is that the foster-care payments for the **sixth qualified foster individual and up that are 19 or older** must be reported on Schedule C.

> **Note.** See Chapter 1: New Tax Legislation for some minor changes made to foster care payments for 2002 and later tax years.

HOME REFINANCING

Question 12. Regarding refinancing a home mortgage: If a lender charged a "refinancing fee" or "origination fee" that has no relation to the loan amount, can this fee be treated as "points" and amortized over the life of the loan?

Answer 12. No. This "refinancing fee" would be neither deductible nor amortizable on Schedule A. According to IRS Pub. 936, *Home Mortgage Interest Deduction*, "points" must meet these tests:

- The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- The points were computed as a percentage of the principal amount of the mortgage.
- The amount is clearly shown on the settlement statement (usually the Form HUD-1) as points charged for the mortgage.

Note. See pages 295-97 in the *2001 Farm Income Tax Workbook* for comprehensive coverage of home refinancing tax issues.

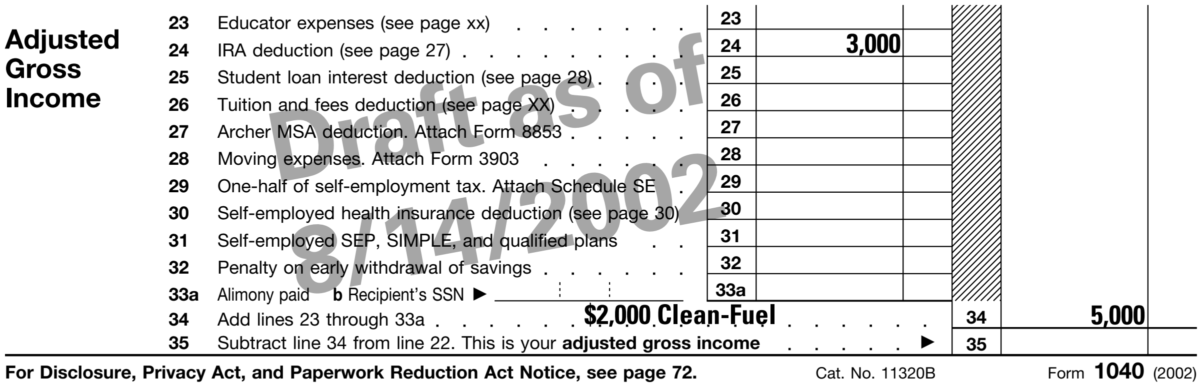
HYBRID ELECTRIC VEHICLE

Question 13. Your book (Example 1 on page 318 in the *2001 Farm Income Tax Workbook*) shows that a taxpayer who buys a new HEV (hybrid electric vehicle) is entitled to only a $1,000 "Clean-Fuel" deduction on line 32 on his/her 2001 Form 1040. I think the maximum $2,000 deduction is more appropriate. It would seem to me that the cost of the battery system in HEVs would easily be at least $2,000. Could you comment?

Answer 13. The IRS has certified the first hybrid gas-electric automobile as being eligible for the clean-burning fuel deduction under a procedure for automobile manufacturers, Rev. Proc. 2002-52, I.R.B. 2002-24. Purchasers of a new Toyota Prius for model years 2001, 2002 and 2003 will be able to claim a deduction of $2,000, the maximum amount of the one-time deduction, for the year that the vehicle was first put into use.

Individuals take the benefit as an adjustment to income and need not itemize deductions on tax returns to claim it. Taxpayers may claim the deduction for a past year by filing an amended return.

Example. Marsha bought a 2003 Honda Civic Hybrid sedan on July 30, 2002 for $21,300 (including state sales tax). The car is used 100% for personal use, including commuting. If Honda certifies that the cost of the electric power system in the vehicle is $3,700, Marsha will be entitled to a $2,000 "clean-fuel" deduction on line 34 on her 2002 Form 1040 as shown below.



Adjusted Gross Income

23	Educator expenses (see page xx)	23			
24	IRA deduction (see page 27)	24	3,000		
25	Student loan interest deduction (see page 28)	25			
26	Tuition and fees deduction (see page XX)	26			
27	Archer MSA deduction. Attach Form 8853	27			
28	Moving expenses. Attach Form 3903	28			
29	One-half of self-employment tax. Attach Schedule SE	29			
30	Self-employed health insurance deduction (see page 30)	30			
31	Self-employed SEP, SIMPLE, and qualified plans	31			
32	Penalty on early withdrawal of savings	32			
33a	Alimony paid **b** Recipient's SSN ▶	33a			
34	Add lines 23 through 33a **$2,000 Clean-Fuel**			34	5,000
35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶			35	

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

Facts regarding H.E.V.s:

1. Toyota received IRS certification in late July 2002 that the 2001, 2002 and 2003 models of its Prius autos qualify for the $2,000 clean-fuel deduction.
2. The Honda Insight (all models) and the 2003 Honda Civic Hybrid sedan also qualify for the $2,000 clean-fuel deduction.
3. Sole proprietors must claim the clean-fuel deduction on business use vehicles on the Other Expenses line on Schedules C or F. If the vehicle is used partly for personal use, the $2,000 deduction is split between either Schedules C or F and line 34 on the 2002 Form 1040 (as shown above).
4. Other individuals, including employees who use the vehicle partly for business purposes, claim the entire $2,000 clean-fuel on line 34 on the 2002 Form 1040 (as shown above).
5. Only initial purchasers are entitled to the $,2000 clean-fuel deduction. The deduction is not allowed for the cost of used vehicles.

INHERITED IRA

Question 14. Is there any time limit on when a surviving spouse can elect to treat her deceased husband's IRA as her own? For example, assume the wife has already received distributions from her late husband's IRA based on his age. Is it too late for her to roll over the balance in his IRA into an IRA in her own name?

Answer 14. The answer to your last question is **no, it is not too late** [Treas. Reg. §1.408-8(A5)]. The only restriction on making the election to treat an inherited IRA as his/her own is that **the surviving spouse must be the sole beneficiary of the deceased spouse's IRA.**

The election by a surviving spouse to treat an inherited IRA as his/her own is generally a good idea if:

- the surviving spouse is younger than the deceased spouse who owned the IRA, and
- deferral of income is an objective.

Even if the surviving spouse is over 70$^1/_2$ when the IRA owner dies, treating the inherited IRA as his/her own may be a good idea. The surviving spouse can do this and name his/her own beneficiary. The result is smaller distributions from the new IRA compared to taking distributions from the deceased's IRA as beneficiary.

> **Note.** See Chapter 7: Retirement for more details on this strategy.

INHERITED STOCK

Question 15. Do inherited stocks sold at a gain by the heir automatically qualify as 5-year gains?

Answer 15. This is a great question. The answer is **no**. I.R.C. §1223 governs holding periods. Under I.R.C. §1223, the basis of inherited property is **not** a transferred basis. Instead, it is adjusted to the FMV as of the valuation date. Because the basis does not transfer, the decedent's holding period does not transfer. **Therefore, the heir would need to hold the inherited stock for more than five years from the decedent's death in order to qualify any gain on its sale as a 5-year gain.**

INTEREST DEDUCTION

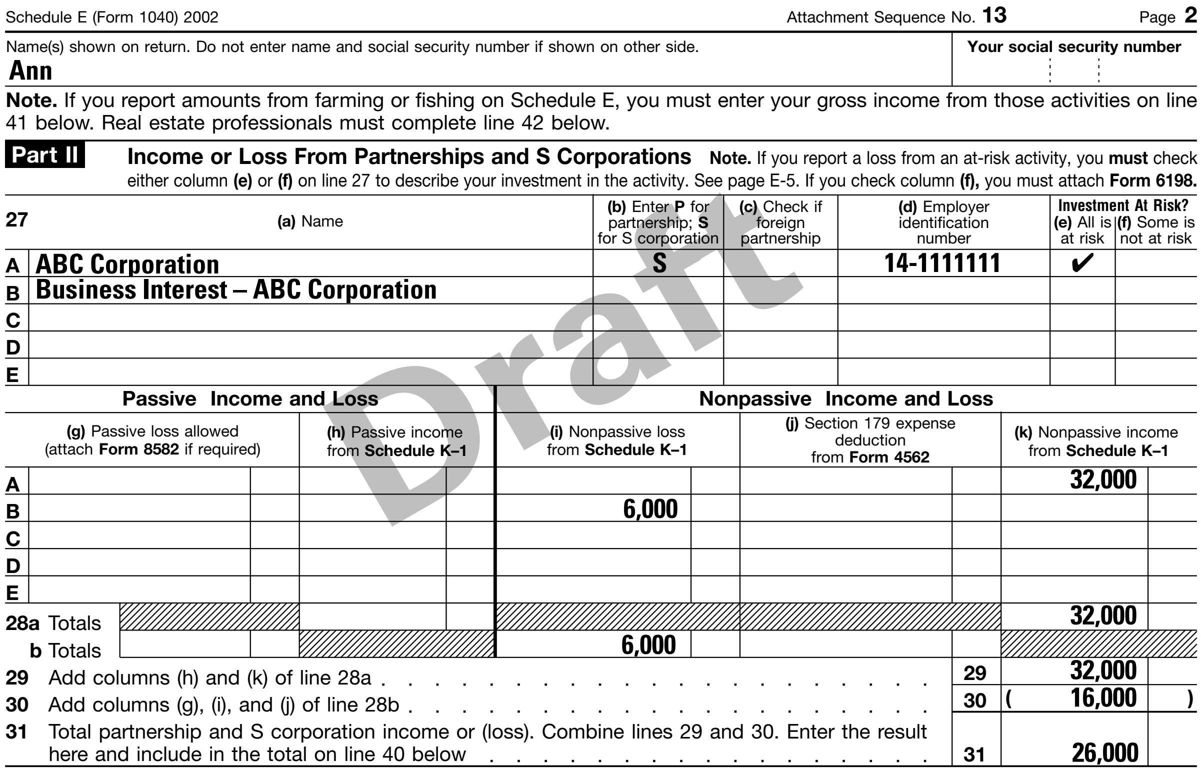
Question 16. My client borrowed $100,000 to purchase S corporation common stock. Is the interest on the loan deductible on page 2 of Schedule E? Or is it considered investment interest reportable on Form 4952?

Answer 16. According to IRS Pub. 535, *Business Expenses*, it depends on the assets owned by the S corporation at the time the stock is purchased. If **all** of the assets of the S corporation are **business assets**, the loan interest is deductible in Part II, Schedule E as **business interest**. However, if some of the assets are investment assets like securities and some of the assets are business assets, an allocation must be made of the interest paid. The portion of the interest allocated to purchase of securities owned by the S corporation would be considered **investment interest.**

Example. Ann borrowed $100,000 from a bank in 2000 to buy 50% of the stock in ABC Corporation, an S corporation. At the time of the stock transaction, **all** of the corporation's assets were business-related assets, such as the following:

- Inventory
- Accounts receivable
- Equipment
- Goodwill
- Cash in an operating checking account

Ann paid $6,000 of interest to the bank in 2002 on the loan. The 2002 Schedule K-1 from ABC Corporation reported ordinary income from trade of business activities on line 1 of $32,000. She materially participated in the activities of the corporation in 2002. Ann's 2002 Part II, Schedule E is shown below.



Schedule E (Form 1040) 2002 Attachment Sequence No. **13** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.
Ann

Your social security number

Note. If you report amounts from farming or fishing on Schedule E, you must enter your gross income from those activities on line 41 below. Real estate professionals must complete line 42 below.

Part II **Income or Loss From Partnerships and S Corporations** **Note.** If you report a loss from an at-risk activity, you **must** check either column **(e)** or **(f)** on line 27 to describe your investment in the activity. See page E-5. If you check column **(f)**, you must attach **Form 6198.**

27	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**Investment At Risk?** **(e)** All is at risk	**(f)** Some is not at risk
A	**ABC Corporation**	**S**		**14-1111111**	✔	
B	**Business Interest – ABC Corporation**					
C						
D						
E						

	Passive Income and Loss		**Nonpassive Income and Loss**		
	(g) Passive loss allowed (attach **Form 8582** if required)	**(h)** Passive income from **Schedule K–1**	**(i)** Nonpassive loss from **Schedule K–1**	**(j)** Section 179 expense deduction from **Form 4562**	**(k)** Nonpassive income from **Schedule K–1**
A					**32,000**
B			**6,000**		
C					
D					
E					
28a Totals	▨		▨	▨	**32,000**
b Totals		▨	**6,000**		▨

29	Add columns (h) and (k) of line 28a	**29**	**32,000**
30	Add columns (g), (i), and (j) of line 28b	**30**	(**16,000**)
31	Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below	**31**	**26,000**

The format shown above is explained on page 17 of IRS Pub. 535, *Business Expenses* (For use in preparing 2001 returns). This rationale also applies to loans used to buy **partnership interests.** However, it does **not** apply to loans used to buy stock in a C corporation as explained in the Note on the following page.

Note. If Ann had bought **C corporation stock** rather than S corporation stock in 2000, her $6,000 interest paid in 2002 would be **investment interest.** The $6,000 would be reported on line 1 of Part I on her 2002 Form 4952 (investment interest expense paid or accrued in 2002). In that case, Ann could have avoided the potential limitation of the investment interest rules if she had borrowed the $100,000 as a **home equity loan.** See page 244 in the *1997 Farm Income Tax Workbook* for more details.

INTERNET SALES

Question 17. I have a client who buys items on eBay with the intention of reselling them for profit. He has made several hundred purchases and sales to date (as November 30, 2001) in 2001. How should this activity be reported on his 2001 tax return?

Answer 17. Your client is in a unique retail Schedule C activity. An ending inventory for December 31, 2001 must be determined. Hopefully, your client keeps accurate records. If not, your tax preparation fee might not exactly please your eBay-minded client.

Note. In a news release dated June 2002, eBay announced that the company would offer group health insurance coverage to its "power sellers." eBay's CEO stated, "Many power sellers are self-employed eBay merchants. That leaves our family entrepreneurs at a serious disadvantage when it comes to acquiring healthcare coverage for their families." To qualify for this perk, an eBay merchant must be registered with the company's Power Seller program and sell between $2,000 and $25,000 per month on the web site. eBay estimates that 100,000 or more of its merchants currently qualify using these standards.

IRA ROLLOVERS

Question 18A. It appears that an IRA can be rolled over to a tax-sheltered annuity [I.R.C. §403(b)] plan for school teachers. Is this correct?

Question 18B. If so, can an individual contribute to an IRA, later roll it over to an I.R.C. §403(b) plan, and take advantage of the I.R.C §403(b) loan provisions?

Answer 18. The answer to both questions is **yes**, beginning in 2002. This is referred to as the **"portability feature"** for qualified retirement plans, a provision of the Economic Growth and Tax Relief Reconciliation Act of 2001. **There is one restriction:**

- After-tax contributions, including nondeductible IRA contributions, are **not** permitted to be rolled over from an IRA into a qualified plan, an I.R.C. §403(b) plan, or an I.R.C. §457 plan (for state and local government and certain tax-exempt organization employees). Also some state retirement plans have additional restrictions.

Note. See page 508 in the *2001 Farm Income Tax Workbook* for more details.

MINIMUM REQUIRED DISTRIBUTIONS

Question 19. Should a single taxpayer (80-year old surviving husband) who will potentially have significant estate tax liability take more than the minimum required distributions from his $500,000 plus IRA?

Answer 19. This strategy should certainly be considered. Retirement plan assets are **taxed twice**, once as an asset of the estate and again to the beneficiaries who inherit the plan and take distributions. The combined estate and income taxes could be astronomically high. For example, if the estate tax rate on the date of death value of the plan was **37%** and the beneficiary is in the **35%** income tax bracket when a plan distribution is received, **the combined tax rate would be 72%!**

Note. See Chapter 2: Individual Taxpayer Problems for an example of how this tax problem can be mitigated by creating a Charitable Remainder Trust (CRT).

S CORPORATION SHAREHOLDER LOANS

Question 20. An S corporation has a large loss in its initial year of business in 2001. An 80% shareholder borrowed $150,000 in his own name from a bank and then lent $110,000 to the S corporation. This occurred in 2001. Can he deduct his $90,000 portion of the S corporation's 2001 distributive loss on his 2001 Schedule E?

Answer 20. Yes. Direct loans from an S shareholder to the corporation increase the shareholder's basis. With the facts given, the shareholder's $110,000 direct loan to the S corporation in 2001 should permit a full deduction of the shareholder's 2001 $90,000 distributive loss.

Caution. The **guarantee** of an S corporation loan by a shareholder does not immediately increase shareholder basis. This issue has been litigated frequently, with IRS prevailing in the vast majority of court cases. See pages 239-44 in the *2000 Farm Income Tax Workbook* for more information on this topic.

SELF-RENTAL RULE AND PASSIVE LOSSES

Regarding the self-rental rule as it pertains to the passive loss limitation rules under I.R.C. §469:

Facts. An incorporated (C corporation) dentist owns his dental practice building individually and rents it to his corporation for an $80,000 profit. He materially participates in the dental C corporation.

He has one other passive loss, a $100,000 rental loss from a 50% ownership in an outlet mall building. According to the self-rental regulation [Treas. Reg.§1.469-2(f)(6)], the rental profit on the dental building is treated as nonpassive.

Question 21. Could he give the dental building to his wife and then take the position that future rental profits from it could be treated as passive?

Answer 21. No. There is a court case with similar facts. See the *Michael F. and Jane H. Connor* Appeals Court case (CA-7, 2002-2 USTC ¶50,560 reported July 5, 2000). A brief analysis of the initial Tax Court case can be found on page 607 of the *1999 Farm Income Tax Workbook.*

Excerpt from the 7th Circuit Appeals Court Opinion

Rental activities are expressly included as passive activities, but if a taxpayer participates materially in an entity involved in the rental of property, the proceeds from that rental may be deemed to arise from a non-passive activity. Passive activity rules apply to personal service corporations. ***For purposes of determining whether a taxpayer materially participates in an activity, participation of his spouse will be included as participation of the taxpayer.***

DID YOU KNOW?

1. A record number of Americans now own vacation homes. The number of second homes in the U.S. has increased dramatically from 1.7 million in 1980 to 4.1 million in 2001. This trend has been aided in 2002 by low mortgage interest rates and stock market gloom. Expect more vacation home tax issues when you prepare 2002 tax returns. See pages 92-97 in the *1997 Farm Income Tax Workbook* for information on this topic. The tax rules have not changed since 1997.
2. The interest rate on U.S. Series I savings bonds fell to 2.57% for bonds issued after April 30, 2002 and before November 1, 2002. For I Bonds issued between May 1, 2001 and October 31, 2001, the interest rate is 3.57% for the 6-month period ending October 31, 2002. A better current alternative for savings bond investors is the Series EE bond. The interest rate on EE bonds (renamed Patriot bonds) is 3.96% for bonds issued between May 1, 2002 and October 31, 2002.
3. High-income taxpayers pay a disproportionate share of the total tax burden. According to 1999 data from the IRS, the top 5% of 1999 tax filers paid 55.5% of total federal individual income taxes, up from 43.4% for 1991. Their share of total 1999 AGI was 34%. To rank in the top 5% for 1999, AGI was $120,846 or higher. The Tax Foundation attributes the trend to:
   - a strong economy in the 1990s;
   - new 36% and 39.6% tax rates approved in 1993; and
   - phase-out of exemptions, itemized deductions, and other targeted tax breaks for high income taxpayers.

Agriculture-Related Questions and Answers

8% CAPITAL GAIN TAX RATE

Question 22. Regarding 5-year gains (reported on line 29, Part IV of Schedule D) and the 8% capital gain rate:

For raised cows reported in Part I of Form 4797, how does a preparer determine whether they have been held for more than five years? If they have been and if the farmer's taxable income is within the 15% bracket, the gain on the raised cows would be entitled to the favorable 8% rate.

Answer 22. We assume that many, if not most, farmers who have a cow/calf herd keep records of each animal, perhaps by using ear tags. If not, we assume that in an IRS exam situation, the burden of proof would be on the taxpayer to prove the accuracy of the line 29, Schedule D qualified 5-year gain figure.

CHARITABLE DONATIONS OF GRAIN

Question 23. Is there any tax consequence to a farm C corporation that annually donates grain to the sole shareholder's church? The corporation is on the cash basis.

My analysis is that the answer to my question is **no** since:

- the donated raised grain has a zero basis to the corporation, and
- therefore, the corporation's charitable contribution deduction is zero.

Answer 23. You correctly answered your question and your analysis is correct provided that the gifted grain was produced in the corporation's **previous** taxable year.

The original authority for this conclusion is Rev. Rul. 55-531. However, if the raised grain is donated to the church in the **tax year in which the grain is produced**, the Rev. Rul. provides that:

- The costs applicable to producing the donated grain are not deductible by the donor as a business expense.

Rev. Rul. 55-531 provides an IRS examiner with authority to disallow all direct and indirect costs of producing gifted grain by an operating farmer **if the grain is donated in the same year it is produced.** The disallowed expenses become a cost basis of the gifted grain which can be deducted as a contribution on Schedule A if the operating farmer itemizes deductions.

Note. The rationale of Rev. Rul. 55-531 was recently incorporated in the Treasury Regulations. See Treas. Reg. §1.170-1(c)(4) and Example (5).

Caution. Different rules apply to farm landlords as opposed to operating farmers. Landlords receive **rental income** which **cannot** be assigned without income recognition. **Crop shares received by a landlord which are given to others are considered converted to money when the gift is made. Therefore, the fair market value of the donated crop shares on the date of the gift must be reported as income, even though someone else receives payment for the crop shares**. (*Farmer's Tax Guide For Use in Preparing 2001 Returns*, page 16. The authority is Rev. Rul. 75-11, 1975-1 CB 27). As a result, there is generally **no tax incentive** for a crop share landlord to donate crop shares either to a charity or to family members as rental income is immediately recognized.

FORCED SALE OF FARMLAND

Question 24. A court orders heirs of an estate to sell the farmland at auction. One of the heirs purchases the land at 150% of the estate tax return FMV. Which entity pays the tax on the capital gain?

Answer 24. The capital gain is taxable to the estate. We don't know why the estate tax value and the sales price are so different. There could be valid reasons why the two figures are so far apart. However, if there are no valid reasons and if the estate tax liability was small or zero, filing an amended Form 709 to increase the value of the land may be a wise move.

Question 25. Is there a capital gain on the purchaser's inherited land?

Answer 25. The following advice is given based on the limited facts presented. The buyer would want to structure the transaction so that he/she bought **only** the portion of the land not inherited. We are certain that is what would be done since the purchasing heir already owns his/her portion of the land. Thus, he/she would buy only the land inherited by the other heirs.

LIMESTONE ROYALTY PAYMENTS

Question 26. A farm landlord client inherited 120 acres of farmland on which limestone is located. The quarry company has already made over $80,000 of royalty payments to him in 2001. How should I report this income on the 2001 return?

Answer 26. Since your client is receiving royalty payments, he has retained an economic interest in the limestone. Therefore, the amount of his payments depends on the amount of limestone removed. The royalty payments are reported in Part I, Schedule E. Percentage depletion is allowed as follows:

1.	Depletion rate for limestone used as agricultural lime	**14%**
2.	Depletion rate of limestone used as road material (often called riprap)	**5%**

Example. Amber received the following limestone royalty payments in 2002 from Highview Stone Company:

1. $65,000 for limestone used for agricultural lime
2. $13,000 for limestone used for road riprap

Computation of Allowable Percentage Depletion for 2002

Category	Royalty Payment	Depletion Rate	Depletion
1) Ag lime	$65,000	14%	$9,100
2) Road riprap	13,000	5%	650
Total depletion allowance, line 20, Schedule E			$9,750

The following items are shown below and on the next pages:

- 2002 Form 1099-MISC from Highview Stone Company
- Information sheet sent by Highview Stone Company
- Amber's completed 2002 Schedule E

For Answer 26

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. **Highview Stone Company**		1 Rents $	OMB No. 1545-0115 2002 Form **1099-MISC**	**Miscellaneous Income**
		2 Royalties $ **78000.00**		
		3 Other income $	**4 Federal income tax withheld** $	**Copy B** **For Recipient**
PAYER'S Federal identification number	RECIPIENT'S identification number **111-11-1111**	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name **Amber**		7 Nonemployee compensation $	8 Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ► ☐	10 Crop insurance proceeds $	
City, state, and ZIP code		11	12	
Account number (optional)		13 Excess golden parachute payments $	14 Gross proceeds paid to an attorney $	
15		16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form **1099-MISC** (keep for your records) Department of the Treasury - Internal Revenue Service

For Answer 26

IMPORTANT INFORMATION — KEEP FOR YOUR 2002 INCOME TAX RECORDS

To: All landowners who received limestone royalty payments from Highview Stone Company in 2002
From: Highview Stone Company
Date: January 31, 2003
Topic: Tax treatment of limestone royalty payments

According to our records, you received a total of $78,000 of limestone royalty payments in 2002. This total is comprised of:

Payment for limestone used for agricultural purposes	**$65,000**
Payment for limestone used for highway construction	**$13,000**

According to IRS rules and regulations, it is our understanding that you are allowed a percentage depletion rate of 14% for ag limestone royalties and 5% for highway construction limestone royalties.

Please consult your tax advisor for more details on this topic. We suggest you give this information sheet along with the enclosed 2002 Form 1099-MISC to your tax preparer. If you have questions about this, please contact Jane Doe in our accounting office. Her phone number is (111) 111-1111. Her fax number is (111) 111-1110.

For Answer 26

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

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ **Attach to Form 1040 or Form 1041.** ▶ **See Instructions for Schedule E (Form 1040).**

OMB No. 1545-0074
2002
Attachment Sequence No. **13**

Name(s) shown on return: Amber

Your social security number: 111 11 1111

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-1). Report farm rental income or loss from **Form 4835** on page 2, line 39.

1	Show the kind and location of each **rental real estate property:**	**2** For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: ● 14 days **or** ● 10% of the total days rented at fair rental value? (See page E-1.)	**Yes**	**No**
A		**A**		
B		**B**		
C		**C**		

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3 Rents received	3				3	
4 Royalties received	4	78,000			4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-2)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9	1,500				
10 Legal and other professional fees	10	3,000				
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-2)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16	1,200				
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19				19	
20 Depreciation expense or depletion (see page E-3)	20	9,750			20	
21 Total expenses. Add lines 19 and 20	21	15,450				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file **Form 6198**	22	62,550				
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file **Form 8582.** Real estate professionals must complete line 42 on page 2	23	( )	( )	( )		

24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses	24	62,550
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2	26	62,550

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11344L **Schedule E (Form 1040) 2002**

Regarding Amber's Schedule E

A. Lines 1 and 2 are to be left blank for royalty property according to Schedule E Instructions.

B. The limestone deposit is located on approximately 40 acres of an 80 acre tract of land. The **real estate taxes of $2,400** on the 80 acre tract are allocated as follows:

1. 50%, or **$1,200**, to Schedule E.
2. 50%, or **$1,200** to Form 4835 (not shown).

C. Amber paid **$3,000 in legal fees** to defend a noise pollution suit filed by an adjoining landowner.

D. Amber paid **$1,500 for liability insurance** on the quarry site.

E. The depletion deduction of $9,750 is **limited to 50% of the taxable income** from the property figured without the depletion deduction. Amber is **not** affected by this limitation. The computation of her **taxable income limitation** is:

a) Royalties received	$78,000
b) Less: All allowable deductions except depletion	(5,700)
c) Balance	$72,300
	× 50%
d) Taxable income limitation on Amber's depletion	$36,150

F. Amber would use cost depletion **if** it exceeded the $9,750 of percentage depletion. However, in most cases, percentage depletion will exceed cost depletion for limestone royalties. See IRS Pub. 535, *Business Expenses*, for details regarding cost depletion computation.

STOCK BASIS

Question 27. My client bought stock for $10,000 in 1998. It was worth $12,000 on January 2, 2001. If the **deemed sale election** was made on the 2001 tax return and the stock is sold in 2005, is the basis for computing the 2005 long-term capital gain or loss $12,000?

Answer 27. Yes. If current law does not change, the 2005 tax result is shown below.

- The gain on the 2005 stock sale (if any) will be taxed at **20%** if your client is in the 26% tax bracket or higher in 2005.
- If your client's 2005 taxable income (including any gain on the stock sale is entirely within the 15% tax bracket, any gain will be taxed at **8%**.

If your client had waited and sold the stock on or after January 3, 2006, any gain would have been taxed at 18% if your client's tax bracket was 25% or higher.

TEMPORARY EASEMENT PAYMENTS

Facts. A farmer client received the following from the County Highway Department for granting a temporary 4-month easement on several frontage acres while a bridge replacement project was going on.

- $2,000 for damages to growing crops (reported as Other Income in Box 3, Form 1099-MISC)
- $1,500 for the temporary easement (reported as Rents in Box 1, Form 1099-MISC)

The county used my client's land to build a small temporary shed to store materials. Occasionally, the county parked some construction equipment on the land on the weekends.

Question 28. How should these payments be reported on his tax return?

Answer 28. Since your client did not grant a **permanent (perpetual)** easement, the arrangement is not treated as a sale of property. The $1,500 payment for the temporary easement is treated as **ordinary rental income**. It could be reported as either:

- other farm income on line 10, Schedule F, or
- real estate rental in part I of Schedule E.

The $2,000 crop damages should be reported on line 10, Schedule F (Other Income).

> **Note.** See Issue 13 in Chapter 4: Agricultural Issues for a complete analysis of how to report the granting of a permanent easement.