Chapter 2: Small Business Issues

Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

ISSUE 1 — FORM 4797

INTRODUCTION

When taxpayers sell assets used in their trade or business, they record the sale on Form 4797, *Sales of Business Property*. The form is designed to sort assets by type and to allow the recapture of depreciation and IRC §179 deductions. Ultimately, the sales are sorted into capital gains and losses, and ordinary income. The capital gains and losses transfer to Schedule D, and the ordinary income from depreciation recapture is reported on line 14 of Form 1040.

There are **three advantages** to reporting sales on Form 4797:

1. Normally, the gains avoid being taxed for self-employment tax.
2. A portion of the gain may be eligible for capital gain treatment and taxed at a lower rate.
3. Losses from the sale of the business assets are fully deductible as ordinary losses.

Form 4797 is used to report the sale or exchange of:

1. Depreciable or amortizable property;
2. Oil, gas, geothermal, or other mineral property; and
3. IRC §126 property.

Other transactions reported on Form 4797 include:

1. Involuntary conversion (from other than a casualty or theft) of property used in a trade or business,
2. Disposition of noncapital assets (other than inventory or property held for resale in a trade or business),
3. Disposition of capital assets not reported on Schedule D, and
4. Recapture of amounts under IRC §§179 and 280F(b)(2) when the business use of IRC §179 or listed property decreases to 50% or less.

Classification of Assets

In order to understand how Form 4797 works, it is necessary to understand how capital assets are classified. Capital assets are defined in IRC §1221. The term **capital asset** refers to property held by a taxpayer, whether or not it is used in his trade or business. It includes everything **except:**

1. Inventory;

2. Depreciable property and real property used in the taxpayer's trade or business;
3. A copyright; a literary, musical, or artistic composition; a letter, memorandum, or similar property[1] held by:
    - **a.** A taxpayer whose personal efforts created the property,
    - **b.** In the case of a letter, memorandum, or similar property, a taxpayer for whom the property was prepared or produced, or
    - **c.** A taxpayer who acquired the property from a taxpayer described in items **3a** or **3b** in a transaction that gave him a carryover basis in the property;
4. Accounts receivable acquired in a business;
5. A publication of the U.S. government that is received from the U.S. government or any agency of it other than by purchase at the price at which it is offered for sale to the public,[2] and that is held by:
    - **a.** A taxpayer who received the publication from the U.S. government or
    - **b.** A taxpayer who acquired the property from a taxpayer described in **5a** in a transaction that gave him a carryover basis in the property;
6. Most commodities-derivative financial instruments;
7. Hedging transactions; and
8. Supplies regularly used in the business.

SPECIAL RULES FOR DETERMINING CAPITAL GAIN TREATMENT

The Internal Revenue Code has rules for determining capital gain treatment. For example, IRC §1231 deals with property used in a trade or business and IRC §1245 covers gains from dispositions of certain depreciable property. There are also special rules for IRC §§1250, 1252, 1254, and 1255 property.

IRC §1231 Treatment

Property used in the taxpayer's trade or business is classified as §1231 property. Involuntary conversions also fall under §1231.

> **Note.** Although **IRC §1231** assets are often referred to as **capital assets,** they receive different tax treatment than normal **IRC §1221** assets.[3] Section §1231 assets include equipment, land, and buildings used in a business.

Form 4797 aggregates gains and losses from IRC §1231 transactions. If there is a **net gain** from these transactions, all of the gains and losses are treated as **long-term capital gains or losses.** If there is a **net loss,** all of the gains and losses are treated as **ordinary gains and losses.**

There are **two requirements** to qualify for IRC §1231 treatment.[4] The property must be either:

1. Property used in a **trade or business** (i.e. equipment, buildings, or land) or
2. Property subject to an **involuntary conversion,** which is either:
    - **a.** Property used in a trade of business or
    - **b.** A capital asset held for more than one year in connection with a trade or business or a transaction entered into for profit.

Property Used in a Trade or Business: General Definition

The phrase **used in a trade or business** within the context of IRC §1231 has a very special meaning. Property must meet **three** requirements to be "used in a trade or business:"

1. It must be **held more than one year.**
2. It must be **used in a trade or business** (in the normal meaning under IRC §162) and be either:
   a. **Subject to the allowance for depreciation** or
   b. **Real property.**
3. It cannot be inventory or property that is held for sale in the ordinary course of business.

Note. Generally, case law indicates that rental real property is an IRC §1231 asset and not IRC §1221 investment property.

Other Included Property

Property that is specifically **included** in IRC §1231 includes:

1. **Timber,** if the owner has made an IRC §631(a) election to treat the cutting as a sale or exchange;[5]
2. **Timber, coal, or domestic iron ore** sold under a contract that retains an economic interest for the taxpayer;[6]
3. **Cattle and horses** held for breeding, dairy, or sporting purposes and **held for 24 months or more;**[7]
4. Other livestock **held for draft, breeding, or sporting purposes and** held for 12 months or more;[8] and
5. **Unharvested crops** that are:
   a. On land sold in the trade or business and held for more than one year **and**
   b. Sold or exchanged at the same time and to the same person as the land.

Note. Livestock does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, and so on.

Involuntary Conversions

Certain involuntary conversions are included in IRC §1231 transactions. They include:

1. Destruction by fire, storm, shipwreck, or other casualty, but **only if** the recognized **gains** from such conversions **exceed** the recognized **losses** from such conversions;
2. Theft or seizure, but **only if** the recognized **gains** from such conversions **exceed** the recognized **losses** from such conversions; and
3. Condemnation, or the threat or imminence of condemnation.

Example 1. The city notified Kaye that it plans to condemn two acres of vacant land that fronts her business in order to enlarge the highway. Kaye purchased the land on November 5, 2000, for $10,000. She incurred $3,000 of legal expense for representation in the condemnation proceedings. On July 6, 2003, the city paid Kaye $8,000 for the land. Kaye does not intend to reinvest the proceeds in replacement property. Kaye's Form 4797 follows:

For Example 1

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

2003

Attachment Sequence No. **27**

Name(s) shown on return	**Identifying number**
Kaye	789-45-1235

1 Enter the gross proceeds from sales or exchanges reported to you for 2003 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) for entire year Subtract (f) from the sum of (d) and (e)	**(h)** Post-May 5, 2003, gain or (loss)* (see below)
2							
Land	11/5/2000	7/6/2003	8,000		13,000		(5,000)

			(g)	**(h)**
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**		
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 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:	**7**		(5,000)

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.

All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) 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 or (loss) in each column as a long-term capital gain or (loss) 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 line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)	**9**		

*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain **and** the amount, if any, on line 8, column (g), does **not** exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) **after** May 5, 2003. However, do **not** include gain attributable to unrecaptured section 1250 gain.

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, column (g)	**11**	(5,000)
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g), if applicable . . .	**12**	
13	Gain, if any, from line 31	**13**	
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**	(5,000)

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)**	(5,000)

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Nonrecaptured IRC §1231 Losses from Prior Years (Form 4797, line 8)

IRC §1231(c) requires that **net IRC §1231 gains** in a given year be reported as **ordinary income** to the extent that IRC §1231 **losses** were deducted against ordinary income in the previous **five years** and have **not yet been recaptured.** Taxpayers must keep a running balance of unrecaptured IRC §1231 losses so they can calculate the net IRC §1231 gain to report as ordinary income.

The unrecaptured losses for a given year are computed by starting with the fifth year prior to the current year. If that year has an IRC §1231 loss, that loss is included in the balance. If that year has a gain, nothing is included in the balance. For each of the next four years, the balance is **increased** by any IRC §1231 **losses** that are reported and **decreased** by any IRC §1231 gains that are reported as ordinary income.

The losses that are recaptured in the current year (the lesser of line 7 or line 8 on Part I of Form 4797) are reported in Part II of Form 4797 on line 12. Therefore, the gains receive **ordinary income** treatment rather than the more favorable long-term capital gain treatment.

Example 2. Jess reported the following IRC §1231 gains and losses:

Year	Gain (Loss)
1998	$(10,000)
1999	(10,000)
2000	15,000
2001	10,000
2002	(7,000)

In 2003, Jess has a $10,000 net IRC §1231 gain. She calculates her recapture as follows:

Year	Gain (Loss)	Loss Recaptured	Unrecaptured Loss Remaining
1998	$(10,000)	$ 0	$(10,000)
1999	(10,000)	0	(20,000)
2000	15,000	15,000	(5,000)
2001	10,000	5,000	0
2002	(7,000)	0	(7,000)
2003		7,000	0

The five-year look-back rule is applied by comparing the net IRC §1231 gain with the nonrecaptured IRC §1231 losses from the **previous five years.**

Jess's $15,000 net gains from 2000 and $10,000 in 2001 cause her to recapture all of the $20,000 net losses from 1998 and 1999. Therefore, the net loss of $7,000 from 2002 is her only nonrecaptured loss, and it is carried forward to 2003.

The nonrecaptured loss causes Jess to **recognize $7,000 of her $10,000 net IRC §1231 gain in 2003 as ordinary income and the remaining $3,000 as long-term capital gain.**

Observation. For 2004, Jess has recaptured all of her IRC §1231 losses. Therefore, a net IRC §1231 gain in 2004 will be reported as a capital gain. Jess will report her 2003 recapture as shown on the following Form 4797.

For Example 2

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

2003

Attachment Sequence No. **27**

Name(s) shown on return: **Jess**

Identifying number: **999-55-2222**

1	Enter the gross proceeds from sales or exchanges reported to you for 2003 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	**40,000**

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) for entire year Subtract (f) from the sum of (d) and (e)	**(h)** Post-May 5, 2003, gain or (loss)* (see below)
2								
	10 acres of Farmland	**6/30/78**	**4/25/03**	**40,000**		**30,000**	**10,000**	

			(g)	(h)
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		
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 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:	7	**10,000**	

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.

All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) 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 or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.

			(g)	(h)
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	**7,000**	
9	Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)	9	**3,000**	

*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain **and** the amount, if any, on line 8, column (g), does **not** exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) **after** May 5, 2003. However, do **not** include gain attributable to unrecaptured section 1250 gain.

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, column (g)	11	( )
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g), if applicable	12	**7,000**
13	Gain, if any, from line 31	13	
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	**7,000**

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)	**7,000**

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Casualty Losses

A casualty is the damage, destruction, or loss of property resulting from an unforeseen event that is sudden, unexpected, or unusual. Fires, thefts, storms, floods, tornadoes, vandalism, earthquakes, and other accidents are examples of casualties.

> **Example 3.** Fred, a 70-year-old carpenter, lost his tools when they were stolen from his shop on July 4, 2003. These tools were acquired between 1989 and 1992 and were fully depreciated. He received $18,000 from his insurance company for the loss of the tools. The original cost of the tools was in excess of $25,000.
>
> He decides to retire and therefore does not replace the tools. As a result, he has a recognized 2003 gain of $18,000 from the casualty. Fred reports the $18,000 gain as shown on the following Forms 4684 and 4797.

For Example 3

Form 4684 (2003) Attachment Sequence No. **26** Page **2**

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side.	**Identifying number**
Fred	**111-22-4444**

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** Tools 1989-1992

Property **B**

Property **C**

Property **D**

		Properties A	Properties B	Properties C	Properties D
20 Cost or adjusted basis of each property	20	0			
21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3 **Note:** *If line 20 is **more** than line 21, skip line 22.*	21	18,000			
22 Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year	22	18,000			
23 Fair market value **before** casualty or theft	23				
24 Fair market value **after** casualty or theft	24				
25 Subtract line 24 from line 23	25				
26 Enter the **smaller** of line 20 or line 25 **Note:** *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.*	26				
27 Subtract line 21 from line 26. If zero or less, enter -0-	27				

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions).	28	

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft		**(b)** Losses from casualties or thefts: *(i)* Trade, business, rental or royalty property	**(b)** Losses from casualties or thefts: *(ii)* Income-producing and employee property	**(c)** Gains from casualties or thefts includible in income
Casualty or Theft of Property Held One Year or Less				
29		( )	( )	
		( )	( )	
30 Totals. Add the amounts on line 29	30	( )	( )	

31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	31	
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, partnerships, and S corporations, see instructions	32	

Casualty or Theft of Property Held More Than One Year

		(b)(i)	(b)(ii)	(c)
33 Casualty or theft gains from Form 4797, line 32	33			0
34		( )	( )	
		( )	( )	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii)	35	( )	( )	▨

36 Total gains. Add lines 33 and 34, column (c)	36	
37 Add amounts on line 35, columns (b)(i) and (b)(ii)	37	
38 If the loss on line 37 is **more** than the gain on line 36:		
a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions	38a	
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11	38b	
39 If the loss on line 37 is **less** than or **equal** to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3, column (g) and the net post-May 5 gain or loss, if applicable, in column (h)	39	

Note: *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 7. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 6.*

Form **4684** (2003)

For Example 3

Form 4797 (2003) Page **2**

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

		(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:		
A	Tools	1989-92	7/4/2003
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	18,000			
21	Cost or other basis plus expense of sale	21	25,000			
22	Depreciation (or depletion) allowed or allowable	22	25,000			
23	Adjusted basis. Subtract line 22 from line 21	23	0			
24	Total gain. Subtract line 23 from line 20	24	18,000			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	25,000			
b	Enter the **smaller** of line 24 or 25a	25b	18,000			
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				
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	18,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	18,000
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, column (g), and if applicable, column (h)	32	0

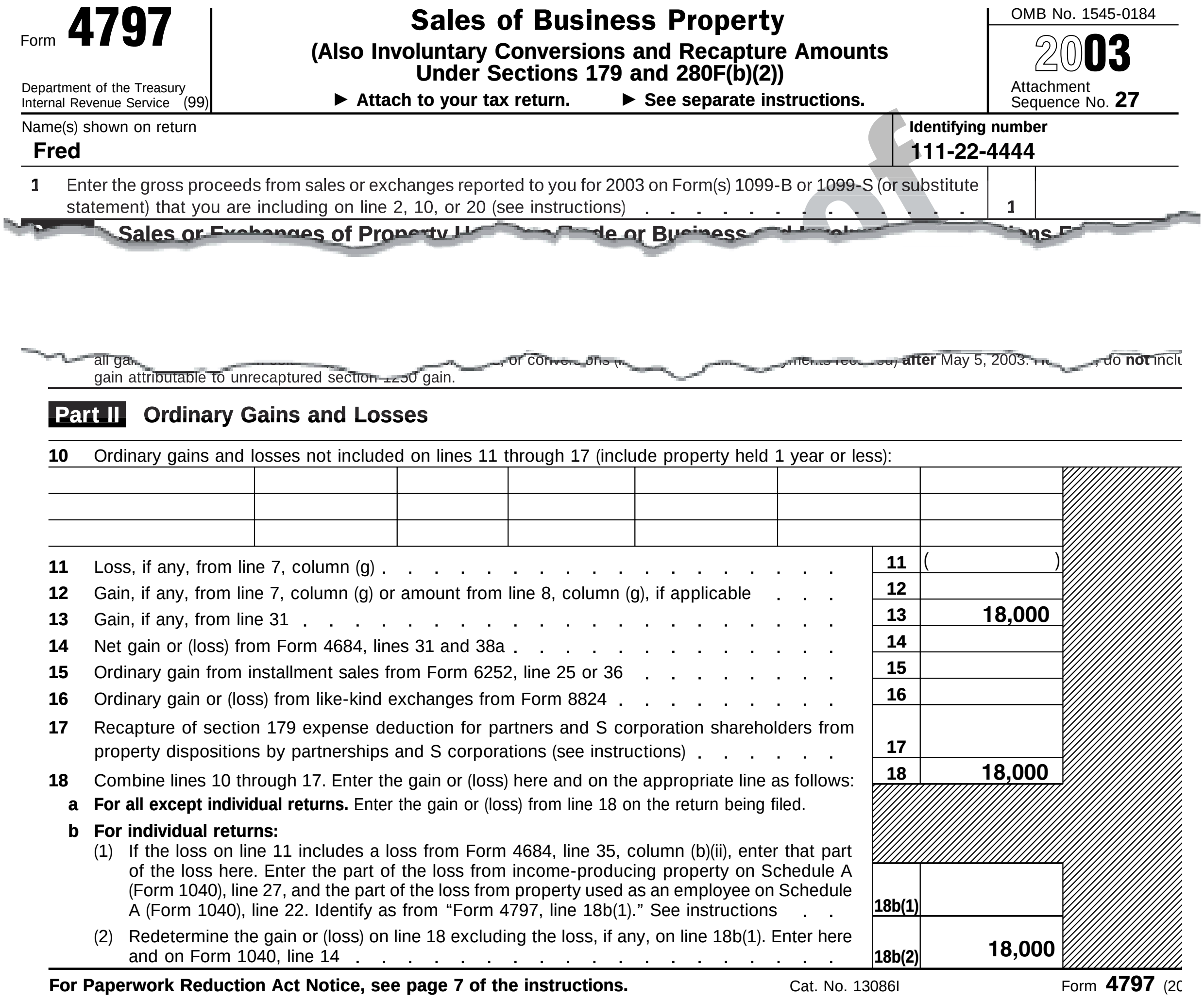
Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less

(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		

Form **4797** (2003)

For Example 3



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
2003
Attachment Sequence No. **27**

Name(s) shown on return: **Fred**
Identifying number: **111-22-4444**

1 Enter the gross proceeds from sales or exchanges reported to you for 2003 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

Sales or Exchanges of Property U… Trade or Business …

all ga… or conver…ons … after May 5, 2003. … do **not** inclu
gain attributable to unrecaptured section 1250 gain.

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, column (g)	**11**	( )
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g), if applicable	**12**	
13	Gain, if any, from line 31	**13**	18,000
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**	18,000
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)**	18,000

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CONSTRUCTION OF FORM 4797

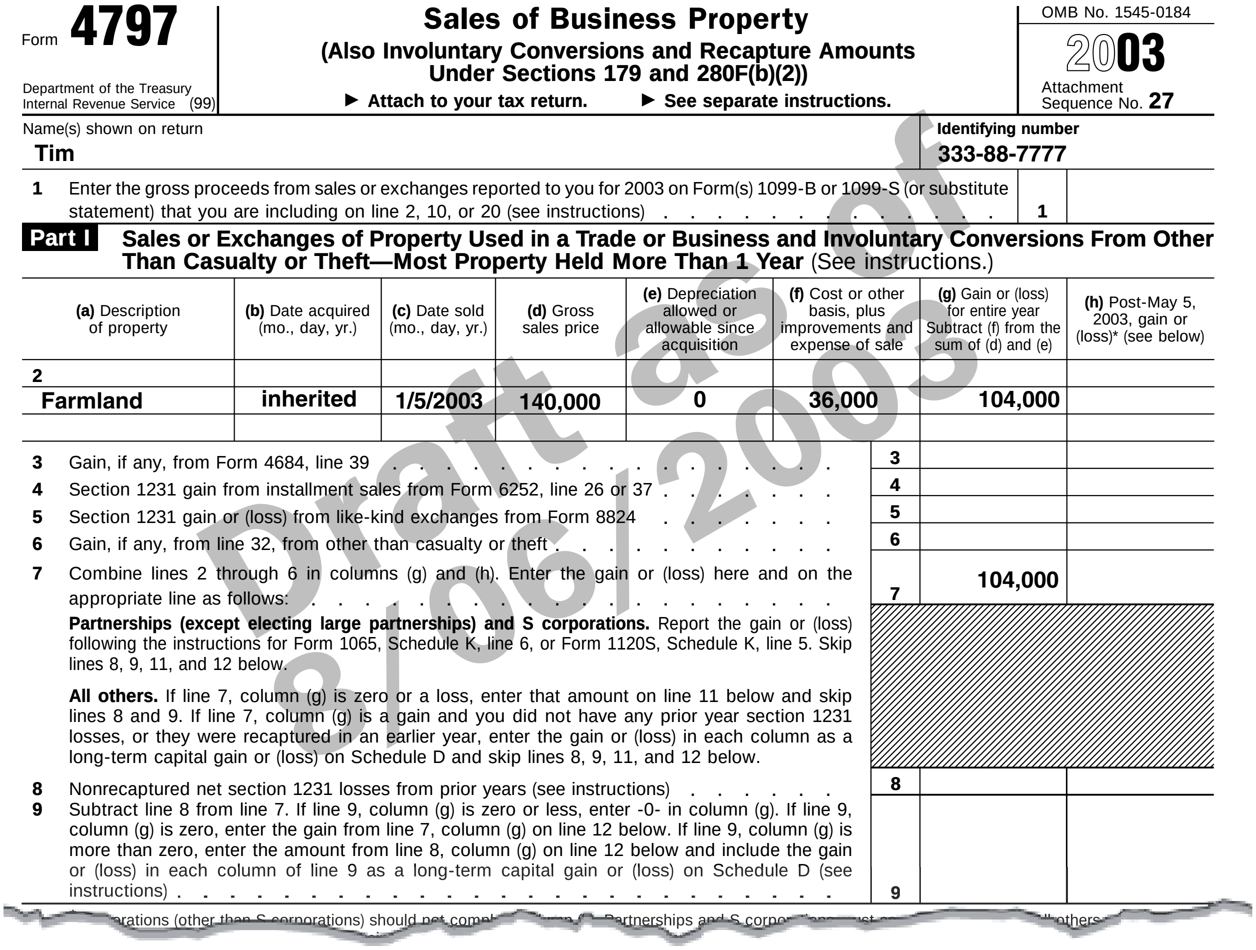
Form 4797 is divided into four parts. Each part is intended for specific transactions. Failure to include a transaction on the appropriate part can result in an erroneous tax computation.

Part I

Part I is used to report transactions that are **not required** to be reported in **Part III.** Typically, these are gains or losses from **nondepreciable assets held more than one year. Examples:** Unimproved land, raised breeding livestock.

Example 4. Tim's only IRC §1231 transaction in 2003 was the sale of farmland used in his farming business. He inherited the land in November 1967 from his father's estate when its FMV was $30,000. He sold the land on January 5, 2003, for $140,000 and paid a broker commission of $6,000. Tim will report his $104,000 gain on Form 4797 as follows:

For Example 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
2003
Attachment Sequence No. **27**

Name(s) shown on return: **Tim**
Identifying number: **333-88-7777**

1 Enter the gross proceeds from sales or exchanges reported to you for 2003 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) for entire year Subtract (f) from the sum of (d) and (e)	**(h)** Post-May 5, 2003, gain or (loss)* (see below)
2								
	Farmland	inherited	1/5/2003	140,000	0	36,000	104,000	

			(g)	(h)
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		
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 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:	7	104,000	
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8		
9	Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)	9		

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.

All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) 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 or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.

rations (other than S corporations) should not compl Partnerships and S corpo others

Part II

If transactions are not reportable in Part I or Part III or the property sold is not a capital asset reportable on Schedule D, the transactions are reported in Part II.

They include gains and losses from:

1. Property held one year or less, for example, breeding hogs held less than one year.
2. Securities and commodities held by a trader who makes a mark-to-market election.
3. Ordinary losses from the sale or exchange (including worthlessness) of stock in a small business investment company.
4. Losses from the sale or exchange of IRC §1244 small business stock.
5. Recapture of IRC §179 deductions included on Form K-1 if it is due to a disposition. It is included only to the extent it was deducted in a prior year.

Part III

Part III is used primarily to report gains on the disposition of property subject to recapture of depreciation. Generally, property held for less than one year is not included in Part III.

IRC §1245 Recapture. IRC §1245 requires the lesser of the gain realized or the depreciation previously claimed to be reported as ordinary income upon sale or transfer of an asset that is defined as IRC §1245 property. Basically, this includes personal property for which depreciation was allowed and certain real property, such as single-purpose agricultural and horticultural structures and property used as an integral part of production.

This gain is reported on Part III of Form 4797. Since all of the gain is ordinary, it flows to Part II, line 13, on page 1 of Form 4797.

In addition to regular depreciation, the following are treated as depreciation:

- Any amount claimed as depreciation under IRC §179
- Any amount claimed as a 30%/50% special depreciation allowance
- Any basis reduction as a result of discharge of indebtedness under IRC §108
- The basis reduction from claiming the investment credit [9]
- The deduction for qualified clean-fuel vehicle property or refueling property

Note. See pages 565–566 in the *2002 University of Illinois Income Tax Workbook* for details on the deduction for qualified clean-fuel vehicle property.

- Deductions claimed under IRC §190 (removal of architectural and transportation barriers to the handicapped and elderly), IRC §193 (deduction for tertiary injection expenses), or IRC §1253(d)(2) or (3) (transfers of franchises, trademarks, and trade names) (as in effect before the Omnibus Reconciliation Act of 1993).

Example 5. Sandy, an incorporated attorney, sold her personally owned business building on March 3, 2003. The following chart shows the facts regarding the building and its sale.

		Expense of Sale	Cost
Date of sale	March 3, 2003		
Price of building	$140,000	$ 7,778*	$75,000
Price of lot	40,000	2,222**	10,000
Sale price of building and lot	$180,000	$10,000	$85,000
Expense of sale	10,000		
Date building contruction was completed	July 3, 1984		
Construction cost	$75,000		
Cost of purchased lot	10,000		
ACRS accelerated depreciation	75,000		

* Allocation of the expense of the sale to the building [(140,000 ÷ 180,000) × 10,000]

** Allocation of the expense of the sale to the lot [(40,000 ÷ 180,000) × 10,000]

Note. Since the building was placed in service after March 15, 1984, and before May 9, 1985, it is 18-year real property under ACRS. The building is subject to IRC §1245 recapture since it is **nonresidential real property** depreciated using ACRS.

For Example 5

Form 4797 (2003) Page **2**

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	Building	7/3/1984	3/3/2003
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	140,000			
21	Cost or other basis plus expense of sale	21	82,778			
22	Depreciation (or depletion) allowed or allowable	22	75,000			
23	Adjusted basis. Subtract line 22 from line 21	23	7,778			
24	Total gain. Subtract line 23 from line 20	24	132,222			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	75,000			
b	Enter the **smaller** of line 24 or 25a	25b	75,000			
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				
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	132,222
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	75,000
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, column (g), and if applicable, column (h)	32	57,222

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

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

Form **4797** (2003)

For Example 5

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
2003
Attachment Sequence No. **27**

Name(s) shown on return: **Sandy**

Identifying number: **666-55-6666**

1	Enter the gross proceeds from sales or exchanges reported to you for 2003 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) for entire year Subtract (f) from the sum of (d) and (e)	**(h)** Post-May 5, 2003, gain or (loss)* (see below)
2								
	Lot	7/3/1984	3/3/2003	40,000		12,222	27,778	

			(g)	(h)
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		
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	57,222	
7	Combine lines 2 through 6 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:	7	85,000	

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.

All others. If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) 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 or (loss) in each column as a long-term capital gain or (loss) 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 line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)	9		

*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain **and** the amount, if any, on line 8, column (g), does **not** exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) **after** May 5, 2003. However, do **not** include gain attributable to unrecaptured section 1250 gain.

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, column (g)	11	( )
12	Gain, if any, from line 7, column (g) or amount from line 8, column (g), if applicable . . .	12	
13	Gain, if any, from line 31	13	75,000
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	75,000

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)	75,000

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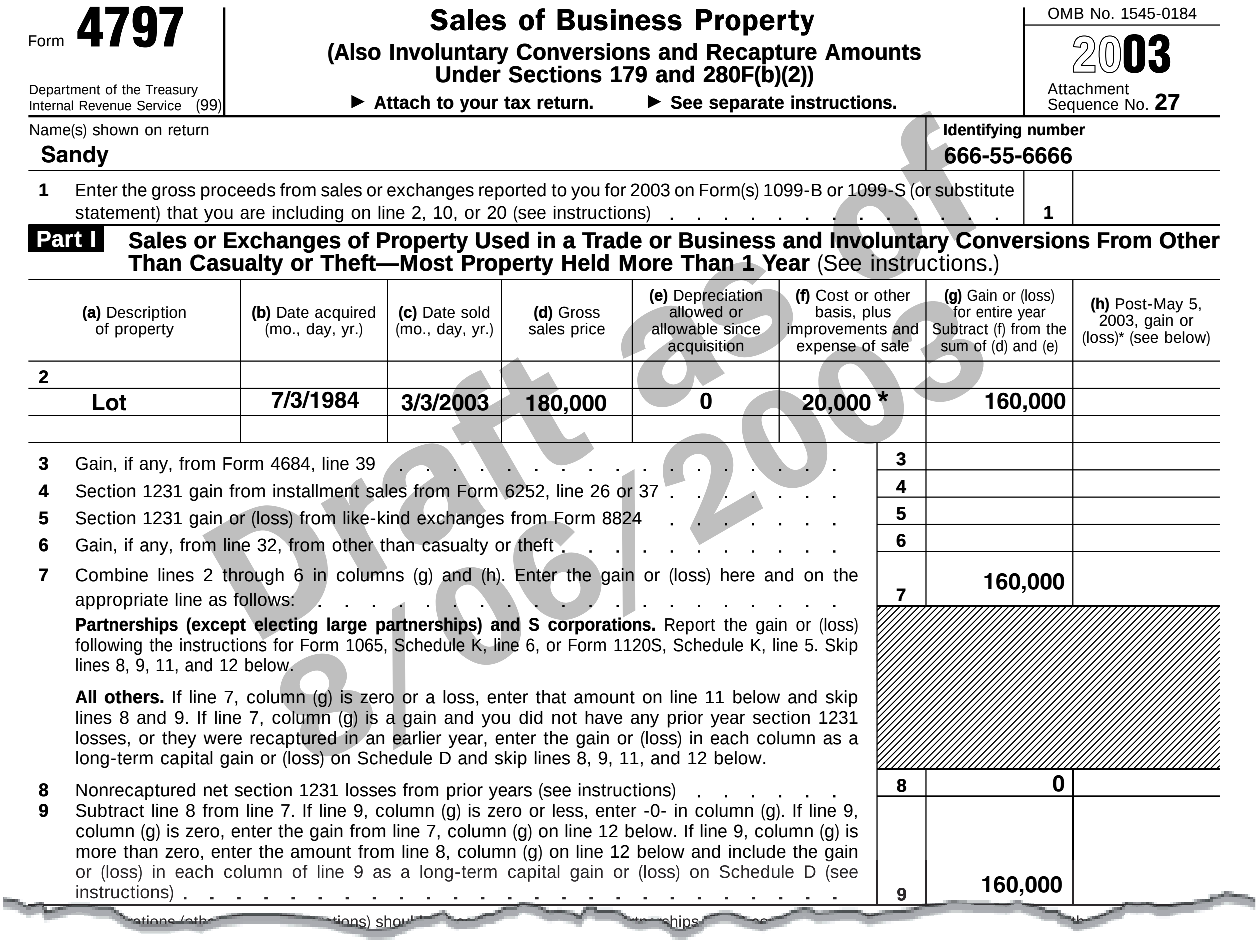
In certain situations it is possible for the value of the building to have decreased or have no value in the sale, for example, a property that is being purchased for redevelopment. The existing structure will be destroyed and a new building erected. In this case the entire sale price is for the underlying land.

> **Note.** If this argument is being made, the seller may want to have an appraisal conducted to validate the building has no value.

Example 6. Assume the same facts as **Example 5,** except Sandy's building is in a redevelopment area and has been vacant for the past three years. The building will be demolished for the construction of a new parking garage. Using this set of facts, the entire gain is a capital gain and the sale will be reported on Part I of Form 4797.



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
2003
Attachment Sequence No. **27**

Name(s) shown on return: **Sandy**

Identifying number: **666-55-6666**

1 Enter the gross proceeds from sales or exchanges reported to you for 2003 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) for entire year Subtract (f) from the sum of (d) and (e)	**(h)** Post-May 5, 2003, gain or (loss)* (see below)
2								
	Lot	7/3/1984	3/3/2003	180,000	0	20,000 *	160,000	

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		
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 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:	7	160,000	
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below. **All others.** If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) 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 or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.			
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	0	
9	Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)	9	160,000	

* $10,000 basis in land and $10,000 selling cost

> **Planning Tip.** If the sales price of the building is **greater** than the original cost, the allocation of the sales price between the land and the building makes no tax difference. However, if the sales price of the building is **less** than the original cost, the allocation of the sales price may have significant tax consequences.

Part IV

The recapture amounts under IRC §§179 and 280F(b)(2) when business use drops to 50% or less is reported in Part IV.

Recapture of IRC §179 Deductions. An IRC §179 recapture is triggered when the business use of property placed in service in an earlier year is reduced to 50% or less during the recapture period. The recapture period is the entire recovery period of the qualifying IRC §179 property.[10]

The recapture amount (reported on Form 4797) equals the IRC §179 expense deduction minus the MACRS depreciation amount that would have been allowed on the expense amount. This is calculated from the time the property was placed in service up to and including the year of recapture.[11]

Listed Property. If an IRC §179 deduction is claimed on listed property, and the business use of the property later falls to 50% or less, the IRC §179 recapture is included with the recapture of the excess depreciation.[12] The IRC §280F(b)(2) recapture rule requires the taxpayer to report as income the difference between:

1. The depreciation and IRC §179 deduction that has been claimed and
2. The depreciation that would have been allowed using the alternative MACRS depreciation rules.

Listed property is any of the following:

1. Any passenger automobile.
2. Any other property used for transportation.
3. Any property of a type generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video recording equipment).
4. Any computer and related peripheral equipment, unless it is used only at a regular business establishment and is owned or leased by the person operating the establishment. A regular business establishment includes a portion of a dwelling unit if and only if that portion is used **both regularly and exclusively** for business.
5. Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

Example 7. Tammy paid $12,000 for a previously owned car she used in her photography business in 2000. She used the car 80% in the business and 20% for personal use. Therefore, her basis in the portion used for business was $9,600. She claimed an IRC §179 deduction of $1,000 for the car on her 2000 income tax return. She depreciated the remaining $8,600 business basis using MACRS. She deducted the following depreciation.

Year	Depreciation Rate	Depreciation Basis	Depreciation Amount
2000 (§179)			$1,000
2000	15.00%	$8,600	1,290
2001	25.50%	8,600	2,193
2002	17.85%	8,600	1,535
			$6,018

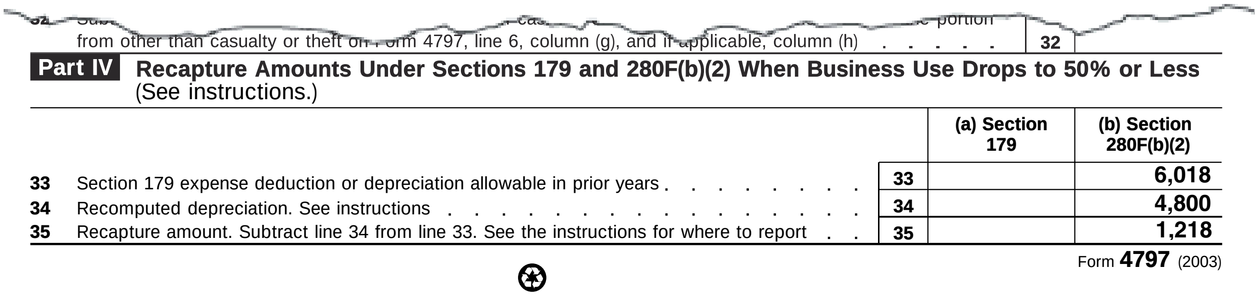
The total depreciation and IRC §179 deduction through 2002 is $6,018.

In 2003, Tammy used the car only 40% for business. Therefore, she must recapture the IRC §179 deduction and depreciation claimed to the extent they exceed the depreciation that is allowed under alternative MACRS. The recapture is calculated as follows.

Alternative MACRS Depreciation Allowable (Straight-Line Method)

Year	Depreciation Rate	Depreciation Basis	Depreciation Amount
2000	10.00%	$9,600	$ 960
2001	20.00%	9,600	1,920
2002	20.00%	9,600	1,920
			$4,800
Total taken			$6,018
Total allowable			(4,800)
Excess depreciation recapture			$1,218

Tammy reports the recapture on Form 4797. She also reports the $1,218 recapture amount on her 2003 Schedule C. The $6,018 reduced her self-employment income in 2000–2002, but the $1,218 recapture amount in 2003 will also be subject to self-employment tax.



from other than casualty or theft on Form 4797, line 6, column (g), and if applicable, column (h) 32

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		6,018
34	Recomputed depreciation. See instructions	34		4,800
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		1,218

Form **4797** (2003)

Note. Tammy's depreciation for 2003 is zero. The $12,000 cost × 40% business use results in a $4,800 business basis. When the $4,800 of depreciation claimed in prior years is subtracted, there is no remaining business basis to be depreciated.

Observation. If the property is disposed of in a fully taxable event, this recapture provision does not apply.[13]

Guidelines

The following table from the instructions for Form 4797 is helpful in determining where to enter a disposition of the 4797.

Where To Make First Entry for Certain Items Reported on This Form

	(a) Type of property	**(b) Held 1 year or less**	**(c) Held more than 1 year**
1	Depreciable trade or business property:		
a	Sold or exchanged at a gain	Part II	Part III (1245, 1250)
b	Sold or exchanged at a loss	Part II	Part I
2	Depreciable residential rental property:		
a	Sold or exchanged at a gain	Part II	Part III (1250)
b	Sold or exchanged at a loss	Part II	Part I
3	Farmland held less than 10 years upon which soil, water, or land clearing expenses were deducted:		
a	Sold at a gain	Part II	Part III (1252)
b	Sold at a loss	Part II	Part I
4	Disposition of cost-sharing payment property described in section 126	Part II	Part III (1255)
5	Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:	**Held less than 24 months**	**Held 24 months or more**
a	Sold at a gain	Part II	Part III (1245)
b	Sold at a loss	Part II	Part I
c	Raised cattle and horses sold at a gain	Part II	Part I
6	Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:	**Held less than 12 months**	**Held 12 months or more**
a	Sold at a gain	Part II	Part III (1245)
b	Sold at a loss	Part II	Part I
c	Raised livestock sold at a gain	Part II	Part I

Note. Additional information on Form 4797 can be found in Chapter 8 of the *1999* and Chapter 4 of the *1995 University of Illinois Farm Income Tax Workbooks.*

ISSUE 2 — CONSTRUCTION INDUSTRY ISSUES

ACCOUNTING FOR LONG-TERM CONTRACTS

Allowable tax accounting methods for the construction industry vary significantly based on the size of the company, the type of contract, and the timing of the contract.

A short-term contract is one started and completed within the taxpayer's taxable year. The related construction costs are treated as current period costs under all methods of accounting.

A long-term contract is any contract that is not completed within the taxable year into which it is entered, for example, a contract that begins in November 2003 and is not finished until January 2004. This is considered a long-term contract although it lasts three months. The accounting methods permissible for long-term contracts are defined in Treas. Reg. §§1.460-1 through 5.

The **percentage of completion method (PCM)** is required for long-term contracts, except when the taxpayer qualifies as a **small contractor** or is a home builder. Qualifying small contractors may elect to use **any** allowable accounting method, provided the method is applied consistently. A home builder that does not qualify as a small contractor is allowed to use the cost capitalization rules of IRC §263A or the PCM.

A taxpayer's method of accounting for contracts may not be changed without IRS consent.

INTEREST CAPITALIZATION

All contractors must capitalize interest when required. Interest expense is required to be capitalized for **any** contract that is **expected to last more than either:**

- Two years **or**
- One year **and** cost more than $1 million.

The production period for the contract **begins** on the first date any allocable costs are incurred (except bidding and negotiating) **or** when 5% or more of the total estimated costs have been incurred, whichever date is **later.**

The production period **ends** when the contract is completed and accepted, **or** the customer starts using the property for its intended purpose **and** at least 95% of the total estimated costs have been incurred, whichever is **earlier.**

SEVERING AND AGGREGATING CONTRACTS

Contractors must evaluate if any contracts need to be severed or aggregated. Deciding to sever or aggregate contracts should be based on the facts and circumstances of each case and should only be done when necessary to clearly reflect income. Severing by a taxpayer who is required to use the PCM requires the Commissioner's prior written consent.

Aggregation of contracts is only allowed if a reasonable businessperson would not have agreed to the terms of one contract without also receiving the terms of the other. An agreement that changes the number of units to be constructed and provides for separate acceptance of the additional units must be accounted for separately.

If a long-term contract calls for both production activities and nonproduction activities, accounting for the contract should be separated by activity. Nonproduction activities include any activities that are not incident to or necessary for the construction project, such as providing architectural, design, engineering, and construction management services. In addition, performance under a guaranty, warranty, or maintenance agreement may not be accounted for under the long-term contract method. The production activities should be accounted for under the long-term contract rules, and the nonproduction activities should be accounted for under another permissible method.

A statement must be attached to any return that includes severed or aggregated contracts. The statement must contain the taxpayer's tax ID number, name, and the legend "NOTIFICATION OF SEVERANCE OR AGGREGATION UNDER SEC 1.460-1(e)."

SMALL CONTRACTORS

Definition

To be exempt from using PCM under the small contractor provision, there are two requirements:

1. At the time the contract is executed, it is expected to be completed within a 24-month period **and**
2. For the three taxable years **preceding** the year in which the contract was executed, the contractor's average annual gross receipts did not exceed $10 million.

Gross receipts include income from:

- All trades or businesses under common control of the taxpayer,
- All members of any controlled group of corporations or partnerships of which the taxpayer is a member,
- Any predecessor to any of the above, and
- A proportionate share of the construction-related income of any entity not already included which owns more than 5% of the taxpayer or which is owned by more than 5% by the taxpayer.

Note. The first test is applied on a contract-by-contract basis. For example, a small contractor might have several contracts expected to last less than two years and one contract expected to last three years. In this case, the shorter contracts **could** be accounted for using any allowable method, but the three-year contract **must** be accounted for using PCM.

ACCOUNTING METHODS FOR SMALL CONTRACTORS

Small contractors may account for long-term contracts under any permissible accounting method, including PCM. However, the method must **clearly reflect income,** and must be **applied consistently** for all similarly classified long-term contracts.

CASH METHOD

Contractors using the cash method report revenue when it is actually received or constructively received. Revenue includes advance payments received.

Contract job costs are deductible in the year paid. However, materials kept on hand that are not incidental should be capitalized **or** accounted for using the "nonincidental" materials rule. **These rules allow the cost of nonincidental materials to be deducted in the year they are consumed or paid for, whichever is later.**[14] Materials that become part of real property owned by the taxpayer must be capitalized.

Example 8. Greg, a self-employed roofing contractor, uses the cash method and accounts for materials and supplies under the nonincidental materials rule. He entered into a contract with a homeowner in December 2003 to replace a roof. Greg bought the roofing shingles from a local supplier and had them delivered to the customer's residence. He paid the supplier $5,000 when the shingles were delivered.

Greg completed the job in December 2003 and gave the homeowner a bill for $15,000 at that time. In March 2004, the customer paid Greg.

Since the shingles were consumed and purchased in 2003, the **cost of the shingles can be deducted in 2003.** However, the $15,000 **income will be reported on Greg's 2004 Schedule C.**

Example 9. Assume the same facts as **Example 8,** except Greg does not install the shingles until January 2004. Although the shingles were paid for in 2003, they were not used until 2004. Therefore, their $5,000 cost cannot be deducted until 2004.

Example 10. Maury is a speculative builder of houses that are built on land he owns. The costs of materials for the houses are not inventory because the house is real property held for sale by Maury. Therefore, construction costs must be capitalized.

Example 11. Louise, a cash basis small contractor, builds houses on land her customers own. Because she does not own the house, the materials are inventoriable items, not real property held for sale. Louise may deduct the cost of materials when used or purchased, whichever is later, and may report the income when received.

Note. The cash accounting method was covered in depth in Chapter 3, pages 191–194 in the *2002 University of Illinois Income Tax Workbook.*

CASH VERSUS ACCRUAL

To use the cash method of accounting, the contractor's average gross receipts from the last three years cannot exceed $10 million ($5 million for C Corporations).

> **Note.** Practitioners should consult Rev. Proc. 2002-28 for contractors whose businesses encompass multiple types of activities (like construction and retailing). For taxpayers wishing to change to the cash method of accounting, refer to Section 7 of Rev. Proc. 2002-28. See page 286 in the *2002 University of Illinois Income Tax Workbook* for a brief analysis of this revenue procedure.

ACCRUAL METHODS

Accrual method contractors recognize income when all events have occurred which fix the right to receive such income and the amount of income can be determined with reasonable accuracy.

Accrual method contractors are entitled to treat expenses as incurred when all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.

The completed contract method and the exempt percentage of completion method are two of the accrual methods allowed for small contractors in addition to the PCM.

Completed Contract Method

Under the completed contract method (CCM), profit or loss is reported on a contract-by-contract basis in the year in which the contract is completed and accepted. Any item of income or deduction that is in dispute is taken into account in the taxable year in which the dispute is resolved. In addition to all direct costs, the following **indirect costs must be allocated** to the contract:

1. Indirect supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan
2. Officers' compensation, other than incidental services
3. Indirect materials and supplies
4. Depreciation and amortization **as calculated for financial statement purposes not to exceed the amount reported for tax purposes**
5. Depletion
6. Rent
7. Taxes attributable to labor, materials, supplies, equipment, or facilities
8. Insurance on equipment, facilities, materials, and so forth
9. Utilities
10. Repairs and maintenance of equipment or facilities
11. Tools and equipment not capitalized
12. Cost of quality control and inspection
13. Administrative costs for contracts other than costs of selling

The following costs are **not required** to be allocated to the contract when using the CCM:

1. Marketing, selling, and advertising expenses, **including** bidding expenses.
2. Research and experimental expenses.
3. Casualty, theft, and capital losses.

4. Depreciation and amortization on temporarily idle equipment and facilities. An asset used in construction is considered to be idle when it is **not** en route to or located at a job site.
5. Depreciation and amortization used for tax purposes in excess of the amounts used for financial statement purposes.
6. Income taxes.
7. Costs attributable to strikes, rework labor, scrap, and spoilage.
8. Percentage of depletion in excess of cost depletion.
9. General and administrative expenses for the organization.
10. Other distribution expenses.
11. Deferred compensation plan expenses.
12. Employee benefit expenses.
13. Officer compensation.

See **Example 14** at the end of this section for an example of the CCM.

Exempt-Contract Percentage of Completion Method

Under the exempt-contract percentage of completion method (EPCM) expenses are reported in the year incurred and revenues are reported in proportion to the amount of the contract completed. The degree of completion is calculated by multiplying the estimated total contract price times the percentage of completion at the end of the tax year less any income recognized in the prior tax years of the contract.

$$\begin{array}{c}\text{Estimated}\\\text{total contract}\\\text{price}\end{array} \times \begin{array}{c}\text{Percentage}\\\text{of}\\\text{completion}\end{array} - \begin{array}{c}\text{Prior}\\\text{year's}\\\text{income}\end{array} = \begin{array}{c}\text{Current}\\\text{year's}\\\text{revenue}\end{array}$$

The EPCM allows the contractor flexibility in choosing how to calculate the percentage of completion, provided the method clearly reflects income.

The percentage of completion on a contract may be calculated using either of the following methods:

- **Cost Comparison Method.** The cost comparison method uses the ratio of the costs incurred as of the end of the tax year to the estimated total contract costs for each contract. Any type of cost comparison can be used, provided the method is used consistently for that contract. The most common types of cost comparison include:
  1. Contract costs compared to total estimated contract costs,
  2. Direct labor costs compared to total estimated direct labor costs, and
  3. Direct labor hours compared to total estimated direct labor hours.
- **Work Comparison Method.** The work comparison method compares, as of the end of the taxable year, the work performed on the contract with the estimated total work to be performed. Examples of this method include measuring output based upon units produced, units delivered, phases completed, or value added.

The EPCM is included in **Example 14** at the end of this section.

Note. Practitioners should be sure to include change orders in the EPCM calculation and to exclude nondeductible expenses and allowances for contingencies.

ALTERNATIVE MINIMUM TAX

Many small contractors, other than those involved in home construction, must compute alternative minimum taxable income (AMTI) using the PCM. This adjustment for AMT is also subject to look-back rules (defined under large contractors) for long-term contracts, which is reported on line 21 on Form 6251, *Alternative Minimum Tax*.

HOME CONSTRUCTION CONTRACTORS

Home construction contractors not qualifying as small contractors are required to capitalize the cost of construction under the UNICAP rules or use PCM to report revenues.

A "home" is defined as a building with **four or fewer dwelling units.** A contract is a **home construction contract** if 80% or more of the estimated total contract costs are attributable to the construction or improvement of real property directly related to and located on the site of a "home." The costs of common improvements (such as sewers, roads, and clubhouses) that benefit the dwelling units are included in the costs of the "homes."

If a contract involves the construction of both commercial units and dwelling units within the same building, to test the 80% rule, the contractor may allocate the costs using any reasonable method, such as specific identification, square footage, or fair market value (FMV).

> **Example 12.** Jamie is a home contractor whose three-year average gross receipts are $12 million. Jamie does not qualify as a small contractor and, therefore, must capitalize home construction costs for all of her contracts or use PCM to report revenues.
>
> **Example 13.** Seth is a home builder who is eligible to use the cash method of accounting. For the past three years his gross receipts have averaged less than $10 million each year. Historically, all of his contracts have been completed in less than one year and he uses the nonincidental materials method of accounting for contract expenses.
>
> In 2003, Seth accepts a contract that is expected to take 28 months to complete. Because the contract is expected to last longer than 24 months, the new contract does not qualify for accounting under the methods allowed for small contractors. Therefore, the direct and indirect costs of this contract must be capitalized or the income must be reported using PCM. However, all other contracts may still be reported using the cash method.

Note. The costs in **Examples 12 and 13** must be capitalized regardless of who owns the land, unlike **Examples 10 and 11** for small home builders who use the cash method.

The UNICAP method is included in **Example 14** at the end of this section.

RESIDENTIAL CONSTRUCTION CONTRACTORS

A residential construction contract is a home construction contract, except the buildings being constructed contain **more than four dwelling units each.**

A taxpayer may report income for this type of long-term contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM). Under the PCCM, 70% of the reportable income is calculated using PCM and 30% of the reportable income is calculated using any other permissible method.

LARGE CONTRACTORS

IRC §460 generally requires the use of the PCM to account for long-term contracts. This code section also introduces the **look-back method,** which requires certain taxpayers to calculate interest due/receivable for underpayment/overpayment of related annual income taxes when a long-term contract is completed.

Exceptions to the PCM Requirements

1. Small contractors.
2. Home construction contracts.
3. Residential construction contracts.
4. Contracts for services, construction management, maintenance, and warranty work.
5. The taxpayer must allocate to cost-plus and federal long-term contracts any cost that is identified under the terms of the contract or law.
6. A taxpayer using the PCM may elect to defer reporting income and expenses from contracts that are less than 10% complete. This election applies to all long-term contracts entered into during and after the taxable year of the election.

PERCENTAGE OF COMPLETION METHOD

Revenue Earned Allocation Rules

The amount of revenue earned each year by a contract is determined by multiplying the estimated total contract price times the percentage of completion at the end of the tax year less any income recognized in the prior tax years of the contract.

Large contractors **must** use the **cost-to-cost percentage of completion method** to determine the degree of completion. Engineering estimates or other approaches to determine the degree of completion may not be used.

The **cost-to-cost method** of determining the degree of contract completion is computed by dividing the total cumulative costs incurred by the estimated total contract costs.

$$\frac{\text{Total cumulative costs incurred to date}}{\text{Estimated total contract costs}} = \text{Percent complete}$$

Specially ordered materials and supplies for a project must be included in the costs incurred to measure the percentage of completion. Total costs cannot include contingency reserves.

Allocation of Costs to Long-Term Contracts

Direct Material Costs. All direct material costs which become an integral part of the finished project and all materials that are consumed in the ordinary course of completing the project must be allocated to the contract.

Direct material costs include the invoice price less discounts, plus transportation or other necessary charges incurred to acquire possession of the goods. They also include materials provided by subcontractors.

The costs of direct materials and supplies that are purchased specifically for a particular long-term contract are allocable to the contract in the taxable year in which such costs are incurred. The costs of other direct materials and supplies (such as those previously held by the taxpayer) are allocable to the contract in the taxable year in which such materials and supplies are dedicated to the contract.

Materials and supplies on hand (at the job site) at the beginning and end of the taxable year are job costs. They are not included in inventory.

Direct Labor Costs. All direct labor costs that are identified or associated with a long-term contract must be allocated to the contract. The elements of direct labor costs include items such as basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. The cost of labor supplied by subcontractors is also a direct labor cost.

Cost-Plus and Federal Contracts. All costs which are specifically identified by the terms of a cost-plus contract and by federal, state, or local laws and regulations must also be allocated to cost-plus and federal contracts, respectively. These costs can include the time value of money if the contract includes a charge for it.

Indirect Costs. Indirect costs include all costs other than direct material costs and direct labor costs.

Some indirect costs may benefit both the long-term contract activity of the taxpayer and other business activities of the taxpayer. Accordingly, these costs require a reasonable allocation between the portion that is attributable to each long-term contract and the portion attributable to the other business activities of the taxpayer.

Indirect costs must be allocated to a long-term contract by either the specific identification method or a method using burden rates such as ratios based on direct cost or hours.

The indirect costs that **must be allocated to long-term contracts of large contractors** include:

1. Indirect supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan.
2. Officers' compensation.
3. Stock bonus, pension, profit-sharing, or annuity plan contributions or other plans deferring the receipt of compensation.
4. Employee benefit expenses paid or accrued on behalf of labor.
5. Indirect materials and supplies.
6. Purchasing and handling costs.
7. Storage costs.
8. Depreciation and amortization on equipment and facilities.
9. Depletion, whether or not in excess of cost.
10. Rent.
11. Taxes attributable to labor, materials, supplies, equipment, or facilities.
12. Insurance on equipment, facilities, materials, and so forth.
13. Utilities.
14. Repairs and maintenance of equipment or facilities.
15. Engineering and design costs, including preproduction costs, excluding experimental costs.
16. Experimental expenses that are directly attributable to a long-term contract in existence at the time the expenses are incurred.
17. Rework labor, scrap, and spoilage.
18. Tools and equipment not capitalized.
19. Cost of quality control and inspection.
20. Bidding expenses incurred in the solicitation of a long-term contract awarded to the taxpayer. If the contract is not awarded to the taxpayer, bidding costs are deductible when there is hard evidence that the taxpayer's bid is not accepted.

21. Licensing and franchise costs.
22. Administrative costs directly attributable to the long-term contract.
23. Direct and indirect costs incurred by any service, administrative, or support function to the extent such costs are allocable to a long-term contract.

Costs that are **not required to be allocated to long-term contracts** include:

1. Marketing, selling, and advertising expenses.
2. Research and experimental expenses that are not directly attributable to an agreement in existence at the time the expenses are incurred.
3. The cost of assets deducted under IRC §179.
4. Casualty, theft, and capital losses.
5. Depreciation and amortization on temporarily idle equipment and facilities. An asset used in construction is considered to be idle when it is **not** en route to or located at a job site.
6. Income taxes.
7. Costs attributable to strikes.
8. Warranty and product liability costs.
9. Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.

The PCM is included in **Example 14** at the end of this section.

Simplified Cost-to-Cost Method

Contractors using the PCM for all long-term contracts may use a simplified cost-to-cost method. However, the simplified method cannot be used by taxpayers who elect not to report contracts less than 10% complete. It also cannot be used by those using the PCCM for residential construction contracts.

Under the simplified cost-to-cost method, only the following costs are used in determining the percentage of completion:

1. Direct material costs and direct labor costs (including subcontractors)
2. Depreciation and amortization on equipment and facilities directly related to the construction project

A taxpayer using the simplified cost-to-cost method must use the same costs in determining the costs allocated to the contract, the costs incurred before the close of the taxable year, and the estimated total contract cost.

Once this method is elected, it must be used for all subsequent long-term contracts. It will also be used for AMT and the look-back method calculations.

The simplified form of PCM is included in **Example 14** at the end of this section.

THE LOOK-BACK METHOD

In the taxable year the contract is completed, the amount of taxes paid in each year of the contract must be compared to the amount of taxes that would have been paid if the actual costs and actual contract price were used in the PCM calculation instead of the anticipated amounts. Interest must be paid by the taxpayer if there is an underpayment for a taxable year under this **look-back method,** and interest is paid to the taxpayer if there is an overpayment.

The **look-back method does not apply** to:

- Small contractors.
- Home construction contracts.
- A contract taking less than 24 months to complete, if the gross price does not exceed the **lesser** of $1 million or 1% of the average annual gross receipts of the taxpayer. This exception to the look-back rules applies for both regular and AMT purposes.

Note. The look-back method is complex and should not be used without a clear understanding of Treas. Reg. §1.460 and Form 8697, *Interest Computation under the Look-Back Method for Long-Term Contracts*

OTHER CONSTRUCTION INDUSTRY ISSUES

Subcontractor versus Employee

Misclassification of labor is one of the most common accounting and tax issues within the construction industry. Many persons who should be classified as employees are treated as subcontractors because of the high costs of workers' compensation insurance and payroll taxes.

There are **three factors** to consider when determining who is a subcontractor and who is an employee:

- Behavioral control
- Financial control
- Relationship between the parties

Note. For a more detailed explanation of these factors, see pages 187–191 of the *2002 University of Illinois Income Tax Workbook* and IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

Other Compensation Income

A contractor may receive an ownership interest in a project for his services. The value of this interest should be included in income.[15]

Abandonment Losses

If a taxpayer abandons an asset, the loss is generally deductible to the extent of the taxpayer's adjusted basis in the abandoned property. To support an abandonment loss, the taxpayer must establish intent to abandon the asset and make some affirmative act of abandonment. The loss is deductible in the year the abandonment is sustained for nondepreciable property.

In general, abandonment losses occur with "spec" home builders, real estate developers, and related party entities more frequently than with other types of contractors. Some legitimate reasons for abandonment losses are due to lack of financing, bonding, disapproval of zoning changes, or cost overruns.

Intercompany Transactions

Treas. Reg. §1.460-1(g) covers special rules for activities benefiting long-term contracts of a related party.

ALLOCATION OF COSTS TO CONTRACTS
UNDER DIFFERENT METHODS OF ACCOUNTING FOR LONG-TERM CONTRACTS

	PCM	PCM Simplified	UNICAP	CCM	EPCM
	Reg. 1.460-5	Reg. 1.460-5	IRC 263A	Reg. 1.460-5	Reg. 1.460-4
WHO MAY USE	Anyone	A	H	S	S
DIRECT COSTS					
Materials	Yes	Yes	Yes	Yes	Electable
Labor	Yes	Yes	Yes	Yes	Electable
Subcontracts	Yes	Yes	Yes	Yes	Electable
INDIRECT COSTS					
1. Indirect Supervisory Wages (& related costs)	Yes	No	Yes	Yes	Electable
2. Officers' Compensation	Yes	No	Yes	Yes	Electable
3. Deferred Compensation Plans	Yes	No	Yes	No	Electable
4. Employee Benefits	Yes	No	Yes	No	Electable
5. Indirect Materials & Supplies	Yes	No	Yes	Yes	Electable
6. Purchasing & Handling	Yes	No	Yes	No	Electable
7. Storage	Yes	No	Yes	No	Electable
8. Depreciation & Amortization on Production Assets	Tax	Tax	Tax	Financial	Electable
9. Depletion (whether or not in excess of cost)	Yes	No		Cost Only	Electable
10. Rent	Yes	No	Yes	Yes	Electable
11. Taxes	Yes	No	Yes	Yes	Electable
12. Insurance	Yes	No	Yes	Yes	Electable
13. Utilities	Yes	No	Yes	Yes	Electable
14. Repairs & Maintenance on Production Assets	Yes	No	Yes	Yes	Electable
15. Engineering & Design	Yes	No	Yes	No	Electable
16. Contract-related Research	Yes	No	Yes	No	Electable
17. Rework Labor, Scrap, & Spoilage	Yes	No	Yes	No	Electable
18. Tools & Equipment (not capitalized)	Yes	No	Yes	Yes	Electable
19. Quality Control & Inspection	Yes	No	Yes	Yes	Electable
20. Successful Bidding	Yes	No	Yes	No	Electable
21. Unsuccessful Bidding	No	No	No	No	Electable
22. Licensing & Franchises	Yes	No	Yes	No	Electable
23. Admin. Costs (attributable to the long-term contracts)	Yes	No	Yes	No	Electable
24. Marketing, selling, & advertising expenses	No	No	No	No	Electable
25. Research (not contract related)	No	No	No	No	Electable
26. The Cost of Assets Deducted under IRC §179	No	No	No	No	Electable
27. Casualty, Theft, & Capital Losses	No	No	No	No	Electable
28. Depreciation & Amortization on Idle Assets	No	No	No	No	Electable
29. Income Taxes	No	No	No	No	Electable
30. Costs Attributable to Strikes	No	No	No	No	Electable
31. Warranty & Product Liability Costs	No	No	No	No	Electable
32. Interest	*	*	*	*	*
33. Costs Identified in Contract or in Law	Yes	No	Yes	No	Electable

* Depends on length & total cost of contract

A Anyone who uses PCM for all long-term contracts and who has not elected to defer contracts less than 10% complete. Excludes residential developers using PCCM under which 70% of revenue is calculated using PCM + 30% another method.

H Home Builders: Contractors who do not qualify as small contractors, but who are building residences containing four or less units.

S Small Contractors: Contracts less than 24 months & Contractors with average annual gross receipts under $10 Million.

Example 14. Phillips Construction, Inc., enters into a long-term contract on October 4, 2002. The contract is expected to be completed by August 31, 2004.

At the end of 2002, the estimated total costs were $780,000 and the contract was 4.5% complete.

At the end of 2003, the estimated total costs increased to $854,000 and the project was 51% complete.

In 2004, upon completion, the actual costs were $857,000.

The following pages show the income and loss to be reported in each of the three years using three different allowable PCM methods.

For Example 14

COMPREHENSIVE COMPARATIVE EXAMPLE
ACCOUNTING FOR LONG-TERM CONTRACTS

23 MONTH CONTRACT, BEGINNING OCTOBER 2002 ENDING AUGUST 2004
The contract is **not** a "cost-plus contract" nor a federal government contract.

			PERCENTAGE OF COMPLETION METHODS					
2002	Costs Incurred During Year	Expected Total @ End of Contract	PCM		PCM (Simplified)		EPCM (Labor Method)	
			Incurred	Estimated	Incurred	Estimated	Incurred	Estimated
DIRECT COSTS								
Materials	$ 21,000	$ 250,000	$ 21,000	$ 250,000	$ 21,000	$ 250,000	$ 0	$ 0
Labor	7,000	350,000	7,000	350,000	7,000	350,000	7,000	350,000
INDIRECT COSTS								
Indirect Wages (& related costs)	500	25,000	500	25,000	0	0	0	0
Employee Benefits	1,000	100,000	1,000	100,000	0	0	0	0
Indirect Materials and Supplies	1,000	20,000	1,000	20,000	0	0	0	0
Depreciation	3,000	20,000	3,000	20,000	3,000	20,000	0	0
Rent	1,000	23,000	1,000	23,000	0	0	0	0
Successful Bidding	1,000	1,000	1,000	1,000	0	0	0	0
TOTAL COSTS	35,500	789,000	35,500	789,000	31,000	620,000	7,000	350,000
Percentage Complete (Incurred divided by Estimated)			4.50%		5.00%		2.00%	
Contract Price			1,200,000		1,200,000		1,200,000	
Revenue Recognized in 2002 (Percentage Complete x Price)			54,000		60,000		24,000	
Expenses Deducted in 2002			A 35,500		A 35,500		A 35,500	
NET INCOME (LOSS) REPORTED IN 2002			18,500		24,500		(11,500)	

A: For percentage of completion methods, all expenses are deducted currently. The allocation is done only for the purpose of determining the percentage complete.

For Example 14

			PERCENTAGE OF COMPLETION METHODS					
2003	Costs Incurred During Year	Expected Total @ End of Contract	PCM		PCM (Simplified)		EPCM (Labor Method)	
			Incurred	Estimated	Incurred	Estimated	Incurred	Estimated
DIRECT COSTS								
Materials	150,000	315,000*	150,000	315,000	150,000	315,000	0	0
Labor	150,500	350,000	150,500	350,000	150,500	350,000	150,500	350,000
INDIRECT COSTS								
Indirect Wages (& related costs)	16,500	25,000	16,500	25,000	0	0	0	0
Employee Benefits	50,000	100,000	50,000	100,000	0	0	0	0
Indirect Materials and Supplies	10,000	20,000	10,000	20,000	0	0	0	0
Depreciation	11,000	20,000	11,000	20,000	11,000	20,000	0	0
Rent	12,000	23,000	12,000	23,000	0	0	0	0
Successful Bidding	0	1,000	0	1,000	0	0	0	0
TOTALS	400,000	854,000	400,000	854,000	311,500	685,000	150,500	350,000
Prior Year Costs	35,500		35,500		31,000		7,000	
Total Costs Incurred by End of Year	435,500		435,500		342,500		157,500	
Percentage Complete			51.00%		50.00%		45.00%	
Contract Price			1,200,000		1,200,000		1,200,000	
Revenue Earned by End of Year (Percentage x Price)			612,000		600,000		540,000	
less Revenue Recognized In Prior Year			54,000		60,000		24,000	
Revenue Recognized in 2003			558,000		540,000		516,000	
Expenses Deducted in 2003			400,000		400,000		400,000	
NET INCOME (LOSS) REPORTED IN 2003			158,000		140,000		116,000	

***Mangement Revised the Estimated Total Materials Costs**

For Example 14

2004	Costs Incurred During Year	Actual Total @ End of Contract	PERCENTAGE OF COMPLETION METHODS					
			PCM		PCM (Simplified)		EPCM (Labor Method)	
			Incurred	Actual	Incurred	Actual	Incurred	Actual
DIRECT COSTS								
Materials	179,500	350,500	179,500	350,500	179,500	350,500	0	0
Labor	150,000	307,500	150,000	307,500	150,000	307,500	150,000	307,500
INDIRECT COSTS								
Indirect Wages (& related costs)	12,000	29,000	12,000	29,000	0	0	0	0
Employee Benefits	50,000	101,000	50,000	101,000	0	0	0	0
Indirect Materials and Supplies	10,000	21,000	10,000	21,000	0	0	0	0
Depreciation	12,000	26,000	12,000	26,000	0	26,000	0	0
Rent	8,000	21,000	8,000	21,000	0	0	0	0
Successful Bidding	0	1,000	0	1,000	0	0	0	0
TOTALS	421,500	857,000	421,500	857,000	341,500	684,000	150,000	307,500
Prior Years Costs	435,500		435,500		342,500		157,500	
Total Costs Incurred by End of Year	857,000		857,000		684,000		307,500	
Percentage Complete			100.00%		100.00%		100.00%	
Contract Price			1,200,000		1,200,000		1,200,000	
Revenue Earned by End of Year			1,200,000		1,200,000		1,200,000	
less Revenue Recognized In Prior Years			612,000		600,000		540,000	
Revenue Recognized in 2004			588,000		600,000		660,000	
Expenses Deducted in 2004			421,500		421,500		421,500	
NET INCOME (LOSS) REPORTED IN 2004			166,500		178,500		238,500	
TOTAL JOB PROFITABILITY @ COMPLETION			343,000		343,000		343,000	

For Example 14

COMPREHENSIVE COMPARATIVE EXAMPLE
ACCOUNTING FOR LONG-TERM CONTRACTS

	CAPITALIZED COST METHODS					
	2002		**2003**		**2004**	
	UNICAP	CCM	UNICAP	CCM	UNICAP	CCM
DIRECT COSTS						
Materials	$ 21,000	$ 21,000	150,000	150,000	179,500	179,500
Labor	7,000	7,000	150,500	150,500	150,000	150,000
INDIRECT COSTS						
Indirect Wages (& related costs)	500	500	16,500	16,500	12,000	12,000
Employee Benefits	1,000	0	50,000	0	50,000	0
Indirect Materials and Supplies	1,000	1,000	10,000	10,000	10,000	10,000
Depreciation	3,000	3,000	11,000	11,000	12,000	12,000
Rent	1,000	1,000	12,000	12,000	8,000	8,000
Successful Bidding	1,000	0	0	0	0	0
TOTAL COSTS	35,500	33,500	400,000	350,000	421,500	371,500
Revenue Recognized	0	0	0	0	1,200,000	1,200,000
Uncapitalized Expenses Deducted	0	2,000	0	50,000	857,000	805,000
NET INCOME (LOSS) REPORTED	0	(2,000)	0	(50,000)	343,000	395,000
TOTAL JOB PROFITABILITY @ COMPLETION					343,000	343,000

ISSUE 3 — PURCHASE OF A BUSINESS

When a business is sold, the buyer and seller are required by IRC §1060 to file Form 8594, *Asset Acquisition Statement Under IRC §1060*, with their income tax returns. This form summarizes the purchase price by allocating the values of the purchased assets between categories. The underlying goal of this reporting requirement is to create identical allocations between the buyer and seller.

New regulations, effective for allocations of assets acquired or deemed acquired after March 15, 2001, added two new classes to the allocation:

- Class VI assets (all IRC §197 intangibles **except** goodwill and going concern value)
- Class VII assets (goodwill and going concern value)

The allocation and reporting rules apply only in the case of an "applicable asset acquisition." This is defined as any transfer of a group of assets that constitute a trade or business in the hands of the buyer **or** seller, if the buyer's basis in the assets is determined wholly by the consideration paid for the assets. As a practical matter, this term encompasses most routine sales of a business.

Form 8594 is treated as an information return, and failure to file this form when required may trigger a penalty. The penalty for failure to file an information return is generally $50 per return, but in the case of intentional disregard, the penalty becomes the greater of $100 or 10% of the "aggregate amount of items required to be reported."[16]

These reporting requirements include transactions with any person who owns at least 10% (including those covered by the attribution rules of IRC §318) of a selling corporation's stock. For example, the stockholder might enter into an employment contract, covenant not to compete, royalty, lease, or other agreement with the buyer contingent with the sale of assets.

Form 8594 is **not required** if any of the following apply:

- A group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which IRC §1031 applies. However, Form 8594 is still required for any part of the group to which IRC §1031 does not apply.
- A partnership interest is transferred (see Temp. Reg. §1.755-2T for special reporting requirements).

TRADE OR BUSINESS DEFINED

A group of assets constitutes a trade or business if goodwill or going concern value could attach to such assets under any circumstances. A group of assets can also qualify as a trade or business if it qualifies as an active trade or business under IRC §355 (relating to distributions of stock in controlled corporations). Factors to consider in determining whether goodwill or going concern value could attach include:

1. The presence of any IRC §197 or other intangible assets (but the transfer of such an asset in the absence of other assets will not be a trade or business),
2. Any excess of the total paid for the assets over the aggregate book value of the assets (other than goodwill or going concern value) as shown in the purchaser's financial accounting books and records, and
3. A license, a lease agreement, a covenant not to compete, a management contract, an employment contract, or other similar agreements between purchaser and seller (or managers, directors, owners, or employees of the seller).

ALLOCATION OF CONSIDERATION

The purchaser's consideration is the cost of the assets. The seller's consideration is the amount realized. Because the amount realized might be reduced by selling costs, consideration is not always the same for both parties.

An allocation of the consideration must be made to determine the purchaser's basis in each acquired asset and the seller's gain or loss on the transfer of each asset. **The amount allocated to an asset cannot exceed its FMV on the purchase date (except for a Class VII asset—see the following list).** The amount allocated to an asset is also subject to any applicable limits under the Internal Revenue Code or general principles of tax law.[17]

The **residual method** must be used for the allocation of the sales price among the assets transferred. Under the residual method, consideration is allocated first to Class I, then to each class in proportion to its FMV on the purchase date. If an asset in one of the classes can be included in more than one class, the lower numbered class must be used (e.g., if an asset could be included in Class III or IV, choose Class III).

Note. Ideally the parties have agreed upon the allocation of the purchase price within the purchase documents. **The code provides that a written agreement governing the allocation shall be binding on both parties unless the IRS determines that the allocation is not appropriate.** If the purchase documents are not clear, then it is in the best interest of the parties to agree to the allocation prior to filing their tax returns for the year of purchase/sale.

CLASSES OF ASSETS DEFINED

Class I assets are savings and checking accounts held in banks, savings and loan associations, and other depository institutions (but not certificates of deposit).

Class II assets are actively traded personal property (any personal property which has an established financial market), certificates of deposit, and foreign currency. Class II assets do not include stock of target affiliates, whether or not actively traded, other than actively traded "preferred" stock. Examples of Class II assets include U.S. government securities and publicly traded stock.

Class III assets are accounts receivable, debt instruments, and assets that the taxpayer marks-to-market at least annually for federal income tax purposes. **However, Class III assets do not include:**

1. Debt instruments issued by persons related to the purchased business as of the day following the acquisition date,
2. Most contingent debt instruments, and
3. Debt instruments convertible into the stock or other property of the issuer.

Class IV assets are property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business (inventory).

Class V assets are all assets not included in Classes I, II, III, IV, VI, and VII.

Class VI assets are all IRC §197 intangibles, **except** goodwill and going concern value.[18]

IRC §197 intangibles include the following:

- Workforce in place
- Business books and records, operating systems, or any other information base, process, design, pattern, know-how, formula, or similar item
- Any customer-based intangible
- Any supplier-based intangible
- Any license, permit, or other right granted by a governmental unit

- Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business
- Any franchise (other than a sports franchise), trademark, or trade name

IRC §197 intangibles do **not include** any of the following:

- An interest in a corporation, partnership, trust, or estate
- Interests under certain financial contracts
- Interests in land
- Certain computer software
- Certain separately acquired interests in films, sound recordings, videotapes, books, or other similar property
- Interest under leases of tangible property
- Certain separately acquired rights to receive tangible property or services
- Certain separately acquired interests in patents or copyrights
- Interests under indebtedness
- Professional sports franchises
- Certain transaction costs

Class VII assets are goodwill and going concern value (even if they otherwise qualify as a IRC §197 intangibles).

Example 15. Seller Accounting, Inc., and Buyer Tax Services, Inc., enter into an agreement on June 30, 2003, for Buyer Tax Services, Inc., to purchase all the assets of Seller Accounting, Inc., for $85,000. In addition, Buyer pays the 100% stockholder (Peg Owner) and her husband (Joe Owner) to enter into noncompete agreements totaling $15,000. Seller pays $1,000 to its attorney for legal services relating to the sale. The parties agree to the following amounts:

		Class
Noncompete		
Noncompete agreement with Ms. Owner	$10,000	VI
Noncompete agreement with Mr. Owner	5,000	VI
Total	$15,000	
Market Value of Assets of Seller Accounting, Inc.		
Cash in bank	2,000	I
Mutual funds	3,000	II
Accounts receivable	10,000	III
Accounting software for sale	1,000	IV
Furniture and fixtures	5,000	V
Noncompete agreement with SA, Inc.	10,000	VI
Franchise license	12,000	VI
Goodwill	42,000	VII
Total Market Value of Seller	$85,000	

Buyer Tax Services, Inc., has not incurred any additional costs related to the purchase and therefore will report this transaction on Form 8594 as follows:

For Example 15

Form **8594** (Rev. October 2002)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060
▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021
Attachment Sequence No. **61**

Name as shown on return: **BUYER TAX SERVICES, INC.**
Identifying number as shown on return: **36-3456789**

Check the box that identifies you:
☑ Purchaser ☐ Seller

Part I **General Information**

1 Name of other party to the transaction: **SELLER ACCOUNTING, INC., JOE OWNER, PEG OWNER**
Other party's identifying number: **37-5555555, 333-22-3333, 555-44-5555**

Address (number, street, and room or suite no.): **315 ANYWHERE AVE**

City or town, state, and ZIP code: **PEKIN, IL 61554**

2 Date of sale: **6/30/2003**
3 Total sales price (consideration): **$100,000**

Part II **Assets Transferred—**All filers of an original statement must complete.

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$ **2,000**	$ **2,000**
Class II	$ **3,000**	$ **3,000**
Class III	$ **10,000**	$ **10,000**
Class IV	$ **1,000**	$ **1,000**
Class V	$ **5,000**	$ **5,000**
Class VI and VII	$ **79,000**	$ **79,000**
Total	$ **100,000**	$ **100,000**

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . . ☑ Yes ☐ No
If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document?. . . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . ☑ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 10-2002)

Note. By checking "Yes" for line 6, the taxpayer is required to attach a schedule reporting the additional information required on that line. Line 6 applies to both the purchaser and the seller. To determine the maximum consideration to be paid, any contingencies specified in the agreement are assumed to be met. If the maximum consideration cannot be determined at the time the form is filed, the schedule should show how the consideration will be computed and the payment period.

Seller Accounting, Inc., must adjust the consideration for the amount of costs incurred in the sale. Rather than realizing $85,000, it realized $84,000 after selling expenses. Using the residual method, the market value of each class is subtracted from the sales price, until the remaining balance of the consideration is less than the market value of the class.

Compare the Form 8594 for Seller to the Form 8594 for Buyer. Under the column labeled "Allocation of sales price," the amount allocated to Class VI and VII has been reduced by the $1,000 selling costs. Like Buyer, Seller is required to attach a schedule for line 6.

For Example 15

Form **8594**
(Rev. October 2002)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060
► **Attach to your income tax return.** ► **See separate instructions.**

OMB No. 1545-1021
Attachment Sequence No. **61**

Name as shown on return: **SELLER ACCOUNTING, INC.**

Identifying number as shown on return: **37-5555555**

Check the box that identifies you:
☐ Purchaser ☑ Seller

Part I **General Information**

1 Name of other party to the transaction: **BUYER TAX SERVICES, INC.**

Other party's identifying number: **36-3456789**

Address (number, street, and room or suite no.): **295 SOMEWHERE AVE**

City or town, state, and ZIP code: **PEKIN, IL 61554**

2 Date of sale: **6/30/2003**

3 Total sales price (consideration): **$84,000**

Part II **Assets Transferred**—All filers of an original statement must complete.

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$ 2,000	$ 2,000
Class II	$ 3,000	$ 3,000
Class III	$ 10,000	$ 10,000
Class IV	$ 1,000	$ 1,000
Class V	$ 5,000	$ 5,000
Class VI and VII	$ 64,000	$ 63,000
Total	$ 84,000	$ 84,000

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☑ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document?. . . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . . ☑ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 10-2002)

In addition to attaching Form 8594 to the corporation's return, Peg and Joe will also have to attach Form 8594 to their Form 1040. They will include a detailed schedule for line 6. Their form follows:

For Example 15

Form **8594**
(Rev. October 2002)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060
▶ **Attach to your income tax return.** ▶ **See separate instructions.**

OMB No. 1545-1021
Attachment Sequence No. **61**

Name as shown on return: **JOE & PEG OWNER**

Identifying number as shown on return: **333-22-3333**

Check the box that identifies you:
☐ Purchaser ☑ Seller

Part I **General Information**

1 Name of other party to the transaction: **BUYER TAX SERVICES, INC.**

Other party's identifying number: **36-3456789**

Address (number, street, and room or suite no.): **295 SOMEWHERE AVE**

City or town, state, and ZIP code: **PEKIN, IL 61554**

2 Date of sale: **6/30/2003**

3 Total sales price (consideration): **$15,000**

Part II **Assets Transferred—**All filers of an original statement must complete.

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$ **15,000**	$ **15,000**
Total	$ **15,000**	$ **15,000**

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☑ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document?. . . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . ☑ Yes ☐ No

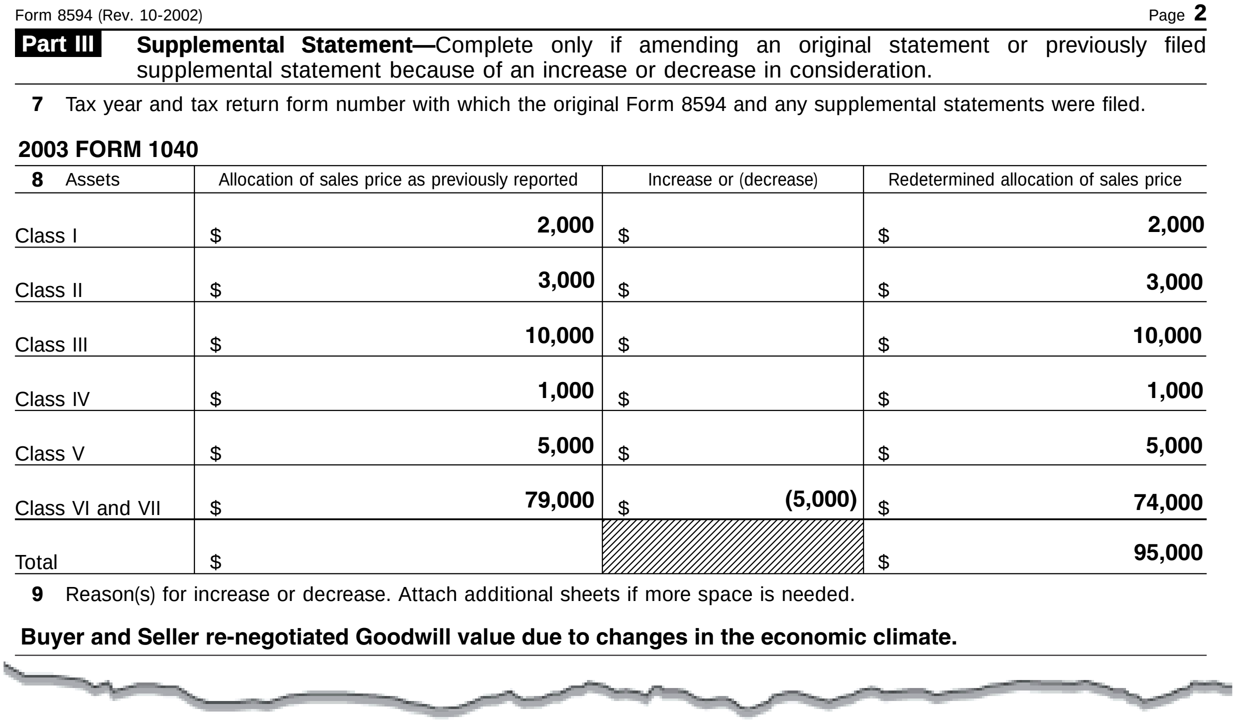
If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 10-2002)

REALLOCATION AFTER AN INCREASE/DECREASE IN CONSIDERATION

If an increase or decrease in consideration occurs after the purchase date, the seller and/or the purchaser must allocate the increase or decrease among the assets. If the increase or decrease occurs in the same tax year as the purchase date, the increase or decrease is considered to have occurred on the purchase date. If the increase or decrease occurs **after the tax year of the purchase date,** it is considered in the tax year in which it occurs. The instructions for Form 8594 contain specific guidelines for changing the allocation and reporting the revised amounts in Part III of the form. **Parts II and III should never be completed on the same Form 8594.**

Example 16. Assume the same facts as **Example 15,** except due to economic difficulties in 2004, Buyer and Seller agree to reduce the selling price by $5,000. Each party files a new Form 8594 with its 2004 return showing the new allocation of the purchase price. Per the instructions, the last class is reduced first for most decreases. Buyer also reduces the tax basis of the asset. Part III for Buyer for 2004 follows:



Form 8594 (Rev. 10-2002) Page **2**

Part III **Supplemental Statement—**Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

2003 FORM 1040

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$ **2,000**	$	$ **2,000**
Class II	$ **3,000**	$	$ **3,000**
Class III	$ **10,000**	$	$ **10,000**
Class IV	$ **1,000**	$	$ **1,000**
Class V	$ **5,000**	$	$ **5,000**
Class VI and VII	$ **79,000**	$ **(5,000)**	$ **74,000**
Total	$	▨	$ **95,000**

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Buyer and Seller re-negotiated Goodwill value due to changes in the economic climate.

Note. For more information, Chapter 8, Sale of a Business, in the *2000 University of Illinois Farm Income Tax Workbook* contains extensive coverage on buying and selling a business. Although classes have expanded, the remainder of the information in the chapter is current as of this publication.

ISSUE 4 — GAIN/LOSS ON REPOSSESSED PROPERTY

DEFINITIONS

A **repossession** is the taking back of something that was originally sold. A repossession has the same tax treatment whether it is a voluntary act on the part of the buyer or is court ordered and enforced.

A **foreclosure** is the taking of the property used as collateral for a loan.

An **installment sale (contract)** is any sale that calls for the taxpayer to receive at least one payment after the end of the tax year in which the sale took place.[19]

The **installment method** is reporting the income from the installment sale as the payments are received instead of reporting the full amount in the year of the sale.

Fair market value is defined as what a willing buyer will pay a willing seller. If the property is sold at a lawful public auction or judicial sale, the sales price is presumed to be the property's FMV unless there is clear evidence showing otherwise.

AFFECTED TAXPAYERS

Both the taxpayer who lost the property and the taxpayer who repossessed the property have potential tax consequences.

Timing of Repossession. Repossession is normally deemed to have taken place at the time the property is taken from the debtor. If the property was abandoned and the creditor expects to commence a foreclosure, execution, or similar sale within three months of the date he believes the property was abandoned, the reporting date for the debtor's sale is the date of the foreclosure, execution, or similar sale. If the creditor anticipates such a sale, but it does not take place within the three-month period, the sale date is the date the three-month period ends.

1. Taxpayer Who Lost Property

The taxpayer who lost the property in a repossession or a foreclosure is deemed to have sold the property. The sale will be reported on the form or schedule that a sale of that particular property would normally be reported on, for example, Schedule D or Form 4797.

Sales Price. The sales price depends on whether the taxpayer was personally liable for the debt (recourse debt) or not (nonrecourse debt). The taxpayer will commonly receive a Form 1099-A showing the repossession or foreclosure of the property. Box 5, Form 1099-A, asks if the taxpayer is personally responsible for repayment of the debt.

Not Liable. If the taxpayer was not personally liable for the debt, the sales price of the property is the amount remaining on the debt at the time of the repossession or foreclosure.

Liable. If the taxpayer was personally liable for the debt, the "sales price" of the property is the **smaller** of:

- The amount remaining on the debt at the time of the repossession (Box 2 of Form 1099-A) or
- The property's FMV at the time of the repossession (Box 4 of Form 1099-A).

Example 17. Hugo is a former self-employed trucker. He bought a new International semitractor in 2001. In May 2003, Navistar Credit Co. repossessed the truck in full satisfaction of the loan. Following are the facts regarding the truck and its repossession:

Date purchased	April 20, 2001
Cost (purchased outright with no trade-in)	$86,000
Amount of original loan from Navistar Credit Co.	$75,000
Date of repossession by the lender	May 10, 2003
Remaining loan principal on repossession date	$61,750

The 2003 Form 1099-A from Navistar Credit Co. follows:

For Example 17

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no.

Navistar Credit Company
1060 W. Belmont
Chicago, IL 60613

OMB No. 1545-0877

2003

Form **1099-A**

Acquisition or Abandonment of Secured Property

LENDER'S Federal identification number: **36-0000000**

BORROWER'S identification number: **888-88-8888**

1 Date of lender's acquisition or knowledge of abandonment: **May 10, 2003**

2 Balance of principal outstanding: $ **61750.00**

BORROWER'S name: **Hugo M. Trucker**

3

4 Fair market value of property: $ **60000.00**

Street address (including apt. no.): **142 Paradise Lane**

5 Was borrower personally liable for repayment of the debt? ☒ Yes ☐ No

City, state, and ZIP code: **Chillicothe, IL 61523**

6 Description of property:
2001 International Semitractor
SN:C1103T778XL427

Account number (optional): **51963704-1**

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 taxable income results from this transaction and the IRS determines that it has not been reported.

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

Instructions for Borrower

Certain lenders who acquire an interest in property that was security for a loan or who have reason to know that such property has been abandoned must provide you with this statement. You may have reportable income or loss because of such acquisition or abandonment. Gain or loss from an acquisition generally is measured by the difference between your adjusted basis in the property and the amount of your debt canceled in exchange for the property, or, if greater, the sale proceeds. If you abandoned the property, you may have income from the discharge of indebtedness in the amount of the unpaid balance of your canceled debt. You also may have a loss from abandonment up to the adjusted basis of the property at the time of abandonment. Losses on acquisitions or abandonments of property held for personal use are not deductible. See **Pub. 544,** Sales and Other Dispositions of Assets, for information about foreclosures and abandonments.

Property means any real property (such as a personal residence); any intangible property; and tangible personal property that is held for investment or used in a trade or business.

If you borrowed money on this property with someone else, each of you should receive this statement.

Box 1. For a lender's acquisition of property that was security for a loan, the date shown is generally the earlier of the date title was transferred to the lender or the date possession and the burdens and benefits of ownership were transferred to the lender. This may be the date of a foreclosure or execution sale or the date your right of redemption or objection expired. For an abandonment, the date shown is the date on which the lender first knew or had reason to know that the property was abandoned or the date of a foreclosure, execution, or similar sale.

Box 2. Shows the debt (principal only) owed to the lender on the loan when the interest in the property was acquired by the lender or on the date the lender first knew or had reason to know that the property was abandoned.

Box 4. Shows the fair market value of the property. If the amount in box 4 is less than the amount in box 2, and your debt is canceled, you may have cancellation of debt income.

Box 5. Shows whether you were personally liable for repayment of the loan when the debt was created or, if modified, when it was last modified.

Box 6. Shows the description of the property acquired by the lender or abandoned by you. If "CCC" is shown, the form indicates the amount of any Commodity Credit Corporation loan outstanding when you forfeited your commodity.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code

Navistar Credit Company
1060 W. Belmont
Chicago, IL 60613

OMB No. 1545-1424

2003

Form **1099-C**

Cancellation of Debt

CREDITOR'S Federal identification number: **36-0000000**

DEBTOR'S identification number: **888-88-8888**

1 Date canceled: **May 10, 2003**

2 Amount of debt canceled: $ **1750.00**

DEBTOR'S name: **Hugo M. Trucker**

3 Interest if included in box 2: $

4

Street address (including apt. no.): **142 Paradise Lane**

5 Debt description:
2001 International Semitractor
SN: C1103T778XL427

City, state, and ZIP code: **Chillicothe, IL 61523**

Account number (optional): **51963704-1**

6 Bankruptcy (if checked) ☐

7 Fair market value of property: $ **60000.00**

Copy B
For Debtor

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 taxable income results from this transaction and the IRS determines that it has not been reported.

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

Hugo's MACRS deductions for the repossessed truck on his Schedule Cs while he was in business are:

Year	MACRS Deducted on Schedule C	
2001	$28,664	($86,000 × 33.33%) (Table A-1, IRS Pub. 946)
2002	38,227	($86,000 × 44.45%)
2003	6,368	($86,000 × 14.81%)(disposed of in 2003)
	$73,259	(Total MACRS deducted by Hugo)

Hugo's adjusted basis in the repossessed truck is $12,741 ($86,000 – $73,259).

Question A. Does Hugo have a taxable event in 2003?

Answer A. Yes. The repossession of his truck by the lender will produce two types of income on Hugo's 2003 tax return. See the completed worksheet from IRS Pub. 544, *Sales and Other Dispositions of Assets* and information regarding cancellation of debt income.

For Example 17

Table 1-2. Worksheet for Foreclosures and Repossessions
(Keep for your records)

Part 1. Figure your income from cancellation of debt. (Note: *If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Part 1 and go to Part 2.)*	
1. Enter the amount of debt canceled by the transfer of property	**61,750**
2. Enter the fair market value of the transferred property	**60,000**
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero	**1,750**
Part 2. Figure your gain or loss from foreclosure or repossession.	
4. Enter the smaller of line 1 or line 2. Also include any proceeds you received from the foreclosure sale. (If you are not personally liable for the debt, enter the amount of debt canceled by the transfer of property.)	**60,000**
5. Enter the adjusted basis of the transferred property	**12,741**
6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4	**47,259**

* The income may not be taxable. See *Cancellation of debt.*

> Income from cancellation of debt is not taxed if any of the following conditions apply.
>
> - The cancellation is intended as a gift.
> - The debt is qualified farm debt (see chapter 4 of Publication 225, *Farmer's Tax Guide).*
> - The debt is qualified real property business debt (see chapter 5 of Publication 334, *Tax Guide for Small Business).*
> - You are insolvent or bankrupt (see Publication 908).

Note. Hugo was not insolvent or bankrupt on the repossession date. The debt does not qualify as farm debt under IRC §108(g).

Question B. Where should Hugo report the $1,750 income from cancellation of debt?

Answer B. Since the debt to Navistar Credit Co. originated from his Schedule C trucking business, Hugo will report the $1,750 as other income on line 6 on his 2003 Schedule C.[20] IRS Pub. 544 states: "Report the income from cancellation of a debt related to a business or rental activity as business or rental income."

Question C. Where should Hugo report the $47,259 gain from the repossession?

Answer C. In Part III of his 2003 Form 4797. The entire gain is IRC §1245 recapture income. The completed Form 4797 follows.

For Example 17

Form 4797 (2003) Page **2**

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	2001 International Semi-Tractor (repossessed by lender)	4/20/2001	5/10/2003
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	60,000			
21	Cost or other basis plus expense of sale	21	86,000			
22	Depreciation (or depletion) allowed or allowable	22	73,259			
23	Adjusted basis. Subtract line 22 from line 21	23	12,741			
24	Total gain. Subtract line 23 from line 20	24	47,259			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	73,259			
b	Enter the **smaller** of line 24 or 25a	25b	47,259			
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				
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	47,259
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	47,259
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, column (g), and if applicable, column (h)	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		

Form **4797** (2003)

2. Taxpayer Who Foreclosed on the Property

In these cases, the taxpayer is deemed to receive a payment on the outstanding loan equal to the FMV of the property. If the FMV is larger than the outstanding debt plus foreclosure costs, the taxpayer has income equal to the difference. The taxpayer has a basis in the property equal to its FMV on the date of the foreclosure.

If the FMV is smaller than the outstanding debt plus foreclosure costs **and** the debt is a **recourse debt,** then the **debtor owes the difference** and the taxpayer merely has a payment to apply to the debt (at the property's FMV). If the debt is **nonrecourse debt,** then the **debtor does not owe the difference** and the taxpayer has a loss equal to the difference between the property's FMV and the debt outstanding plus the foreclosure costs. The taxpayer has a basis in the property equal to its FMV on the date of the foreclosure.

3. Taxpayer Who Repossessed the Property

In most cases, the seller has a gain to report when property is repossessed. This occurs because the taxpayer who sold the property normally receives some principal payments prior to the repossession and also has possession of the property available for resale.

The amount included as income upon repossession depends on the type of property repossessed (personal property or real property) and the method used to report the original sale (installment method or full reporting method).

REPOSSESSION OF PERSONAL PROPERTY

The **seller's** gain or loss on the repossession of personal property is calculated by comparing:

- The FMV of the property at the time of the repossession and
- The taxpayer's basis in the installment contract plus repossession costs.

Not Reported on Installment Method

If the gain or loss from the installment contract is reported **in full** in the year of the original sale, the taxpayer's basis in the contract is the remaining principal owed on the contract at the time of the repossession.

> **Note.** An installment sale that results in a loss is not allowed to use the installment method of reporting and must be reported in full in the year of the sale.

If the property's FMV at the time of the repossession is more than the taxpayer's basis in the contract (plus repossession costs), the taxpayer has a gain equal to the difference. The character of the gain is discussed later.

If the property's FMV at the time of the repossession is less than the taxpayer's basis in the contract (plus repossession costs), the taxpayer has a loss equal to the difference. The character of the loss is discussed later.

The new basis in the property is its FMV at the time of the repossession.

Example 18. Tanya sold her antique auto on contract in 2000 and reported the entire profit on her 2000 Schedule D. The sale price was $12,000 and her basis was $5,000, resulting in a profit of $7,000. Tanya repossessed the antique auto in 2003 when the remaining balance owed by the buyer was $6,000. Following are the tax consequences of Tanya's repossession.

FMV of auto on repossession date	$7,500
Tanya's gain on the repossession ($7,500 FMV − $6,000)	1,500
Tanya's basis in the repossessed auto (FMV)	7,500

Example 19. Barry sold his beer can collection on eBay in 2000 on contract and reported the entire profit on his 2000 Schedule D. The sale price was $15,000 and his basis was $10,000, resulting in a profit of $5,000. Barry repossessed most of his beer cans in 2003 when the remaining balance owed by the buyer was $9,000. Following are the tax consequences Barry's repossession.

FMV of beer cans on repossession date	$6,000
Barry's loss on the repossession ($6,000 – $9,000)	(3,000)
Barry's basis in the repossessed beer cans (FMV)	6,000

Reported on Installment Method

If the gain from the installment contract is being reported on the installment method, the taxpayer's basis in the contract is the amount owed on the contract at the time of the repossession, reduced by the untaxed profit (balance in the contract multiplied by the gross profit percentage).

If the property's FMV at the time of the repossession is more than the taxpayer's basis in the contract (plus repossession costs), the taxpayer has a gain equal to the difference. If the property's FMV at the time of the repossession is less than the taxpayer's basis in the contract (plus repossession costs), the taxpayer has a loss equal to the difference. The worksheet from IRS Pub. 537, *Installment Sales*, can be used to compute the gain or loss on repossession. The worksheet has been completed for **Example 20.**

Example 20. Randy sold his grand piano for $12,000 on the installment method in 2001. His basis in the piano was $8,000. Therefore, his gain was $4,000. However, the buyer ceased making payments on the installment sale in 2003 and Randy was forced to repossess his piano. Following are the facts regarding Randy's repossession in 2003.

FMV of piano when repossessed	$6,500
Unpaid principal balance owed to Randy	9,000
Randy's unrealized profit (unpaid balance $9,000 × 33.33% gross profit percentage) on his 2001 installment sale	3,000
Basis of obligation ($9,000 – $3,000)	6,000
Repossession costs paid by Randy (moving expense)	200

The completed worksheet (modified) from IRS Pub. 537 follows.

Use the following worksheet to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

1) FMV of property repossessed		6,500
2) Unpaid balance of installment obligation	9,000	
3) Unrealized profit (line 2 × gross profit %)	3,000	
4) Basis of obligation (line 2 – line 3)	6,000	
5) Plus: Repossession costs . . .	200	6,200
6) Gain or loss on repossession (line 1 – line 5)		300

Tax Solution for Example 20. Randy's gain on the 2003 repossession is $300. He will report the gain on the same form or schedule that he used to report the original 2001 installment sale (Schedule D or Form 4797). His basis in the repossessed piano is the FMV on the repossession date, or $6,500.

REPOSSESSION OF REAL PROPERTY

If the three conditions shown below are **not met,** the repossession of real property is **identical to the treatment of the repossession of personal property.** The property's FMV is compared to the taxpayer's basis in the installment obligation plus repossession costs to determine the taxpayer's gain or loss on the repossession.

If the three conditions shown below **are** met, the repossession of **real property has its own rules.** Under these rules the property's FMV does not have any effect on the taxpayer's gain. A loss is not allowed on the repossession of real property that meets these three conditions:[21]

1. The repossession takes place to protect the seller's security rights in the property.
2. The installment obligation must commence at the time of the original sale rather than as a result of a later sale.
3. The seller does not pay any additional compensation to get the property back. Additional compensation includes assuming debts that the buyer has put on the property, such as back real estate taxes, a second mortgage, etc. A seller can pay additional compensation if:
    - The original sales contract has a buy back clause or
    - The buyer defaulted or default is imminent.

The **realized gain** on the repossession of real property that meets these conditions is calculated by subtracting the amount the taxpayer already reported as income from the total principal payments collected.

The **recognized gain** is the smaller of:

- Realized gain or
- Amount of gain from the original sale less the amount already taxed, less repossession costs.

The worksheet from IRS Pub. 537 can be used to compute the gain on repossession. The worksheet has been completed for **Example 21** which follows.

Example 21. Victor sold an apartment building in 2000 for $100,000 on the installment method. His adjusted basis was $30,000, and his gross profit ratio was 70% ($70,000 profit ÷ $100,000 sale price). Victor received $20,000 of principal payments (including the down payment) prior to the repossession in 2003. He paid no repossession costs. Following is the computation of his real property repossession gain.

For Example 21

Untaxed Principal Received	
1. Total principal payments received	$20,000
2. Gross profit ratio	70%
3. Portion of principal previously taxed (line 1 × line 2)	$14,000
4. Untaxed portion (line 1 − line 3)	$6,000
Limitation	
5. Gain from original sale	$70,000
6. Less gain previously taxed, excluded, or deferred	(14,000)
7. Less repossession costs	0
8. Original gain not previously taxed (line 5 − lines 6 and 7)	$56,000
Taxable Gain on Repossession	
9. Smaller of line 4 and line 8	$ 6,000

Use the following worksheet to determine the taxable gain on a repossession of real property reported on the installment method.

1) Payments received before repossession		20,000
2) Minus: Gain reported		14,000
3) Gain on repossession		6,000
4) Gross profit on sale		70,000
5) Gain reported (line 2)	14,000	
6) Plus: Repossession costs	0	14,000
7) Subtract line 6 from line 4		56,000
8) Taxable gain (lesser of line 3 or 7)		6,000

Character of Gain or Loss

The character of the gain or loss is determined by the following rules, regardless of whether the property is personal property or real property.

A gain is treated as **ordinary income** if:

- Gain or loss from the original sale is reported in full the year of the sale,
- Repossession results in a **gain,**
- Taxpayer/seller transferred the title, and
- Repossession is voluntary on the part of the buyer.[22]

A loss is treated as a **bad debt** if:

- Gain or loss from the original sale is reported in full the year of the sale,
- Repossession results in the **loss,**
- Taxpayer/seller transferred the title, and
- Repossession is voluntary on the part of the buyer.[23]

If the original sale is reported on the installment method, then the gain or loss on repossession retains the **same character** as the gain/loss. For example, if the taxpayer has a long-term capital gain on the original sale, then the gain or loss on the repossession is a long-term capital gain.

Observation. Neither the code nor the regulations address the character of the gain or loss on the repossession when the above conditions are not met, such as the title not transferring, or the repossession not being voluntary on the part of the buyer. Since the regulations so clearly state the treatments given above, it appears repossessions that do not meet these conditions will retain the same character as the original sale.

New Basis of Repossessed Property

The taxpayer's basis in the real property repossessed under these rules is equal to the following:

- Original basis of the property at the time of the original sale
- Less principal payments received up to the time of the repossession
- Plus gain previously taxed, deferred, or excluded
- Plus amounts included in income as a result of the repossession
- Plus repossession costs

MISCELLANEOUS

Debts Assumed by Seller

If the taxpayer assumes debts attached to the property when repossession takes place, the taxpayer is considered to have paid the debt amounts to purchase the property. These amounts are added to the taxpayer's basis in the property. The reason these debts exist is not important for the seller. They are treated as basis adjustments and are not deductible. For example, if the buyer is delinquent on real estate taxes, the seller may have to pay those taxes in order to regain clear title to the property. The amount the seller pays is a basis adjustment, not a deductible real estate tax.

Worksheet for Practitioner Use

Gain on Repossession of Personal Property (and Nonqualifying Real Property)

Not Reported Using Installment Method

1. Balance due on the installment obligation ________
2. FMV of property at time of repossession ________
3. Loss on repossession.* Subtract line 2 from line 1, but do not enter less than zero. ________
4. Gain on repossession. Subtract line 1 from line 2, but do not enter less than zero. ________

Reported Using Installment Method

1. Balance due on the installment obligation ________
2. Gross profit percentage ________
3. Multiply line 1 by line 2 ________
4. Subtract line 3 from line 1 ________
5. FMV of property at time of repossession ________
6. Loss on repossession.* Subtract line 5 from line 4, but do not enter less than zero. ________
7. Gain on repossession. Subtract line 4 from line 5, but do not enter less than zero. ________

*A loss is allowed only if the taxpayer does not receive any other property and the debtor is not liable for repayment of the balance of the debt.

Worksheet for Practitioner Use

Gain on Repossession of Real Property

Untaxed Principal Received

1. Total principal payments received ______
2. Gross profit ratio ______
3. Portion of principal previously taxed (line 1 × line 2) ______
4. Untaxed portion (subtract line 3 from line 1) ______

Limitation

5. Gain from original sale ______
6. Less gain previously taxed, excluded, or deferred ______
7. Less repossession costs ______
8. Original gain not previously taxed (subtract lines 6 and 7 from line 5) ______

Taxable Gain on Repossession

9. Smaller of line 4 or line 8 ______

New Basis

10. Original basis of property at the time of original sale ______
11. Less principal payments received up to the time of repossession ______
12. Plus gain previously taxed, deferred, or excluded ______
13. Plus amounts included in income as a result of repossession ______
14. Plus repossession costs ______
15. Equals taxpayer's new basis ______

ISSUE 5 — CHANGE OF ACCOUNTING METHOD: IRC §481(A) ADJUSTMENTS

OVERVIEW AND INTRODUCTION

There have been several changes and clarifications regarding accounting methods over the past few years. Many of these allow taxpayers to change accounting method in order to take advantage of the changes or clarification. Recent changes include:

- Claiming and correcting missed or underclaimed depreciation.[24]
- Certain taxpayers with average annual gross receipts of $1 million or less can use cash method of accounting.[25]

- Certain taxpayers with average annual gross receipts of $10 million or less can use the cash method of accounting.[26]
- Restaurants and bars can deduct the cost of their smallwares replacements instead of having to depreciate them.[27]
- Replacement tires for certain vehicles can be deducted instead of depreciated.[28]
- Golf courses can depreciate the cost of creating "modern greens" instead of adding the costs to the land.[29]

AUTOMATIC CONSENT

The accounting changes listed above are changes that fall into the automatic consent status. This means the taxpayer is deemed to have automatically received the Commissioner's consent to make the change **provided** the taxpayer meets the conditions and follows the change of accounting method procedures. These procedures are updated periodically, with the most recent version contained in Rev. Proc. 2002-09 with modifications in Rev. Proc. 2002-19. No user fee is required for these changes although the taxpayer must file Form 3115, *Application for Change in Accounting Method.* The Form 3115 request is reviewed by the IRS for accuracy.

Rev. Proc. 2002-19 permits taxpayers to request an accounting change involving an issue that is under examination, in appeals, or in a federal court. In these situations, taxpayers must provide a copy of Form 3115 to the applicable IRS examiner, appeals officer, or other official in addition to noting "Issue Under Consideration" on the copy of the Form 3115 that is sent to the IRS National Office in Washington, DC.

Example 22. Tax Iz Us Inc. has been using the accrual method of accounting. However, due to the liberalization rules, it would like to adopt the cash method for its 2003 calendar year Form 1120. Its annual gross receipts for the 4-year period 1999–2002 were $9 million. Its gross receipts for 1998 were $13 million. Therefore, its average annual gross receipts for the 3-year period 1998–2000 were slightly more than $10 million. The corporation is not eligible to switch to the cash method of accounting for 2003 because the 3-year average must be less than $10 million for **each** of the 3-year periods ending in 2000, 2001, and 2002. Since the corporation did not meet the 3-year test for 1998–2000, it is not eligible to switch to the cash method in 2003.

	Gross Receipts in Millions		
1998	$ 13		
1999	9	$ 9	
2000	9	9	$ 9
2001		9	9
2002			9
Total	$ 31	$ 27	$ 27
Average	$10.33	$9.00	$9.00

Where to File

A copy of Form 3115 must be filed on or before the due date (plus extension) of the return for the year the taxpayer desires to make the change. The original Form 3115 must be attached to the tax return for which the accounting change applies. The copy of Form 3115 should be filed with the national office at:

Commissioner of Internal Revenue
Attention: CC:IT&A (Automatic Rulings Branch)
PO Box 7604
Benjamin Franklin Station
Washington, DC 20044

Separate addresses are available when a taxpayer uses a designated private delivery service, the application is for an exempt organization, or the application is hand delivered.

IRC §481(a) Adjustment Calculation

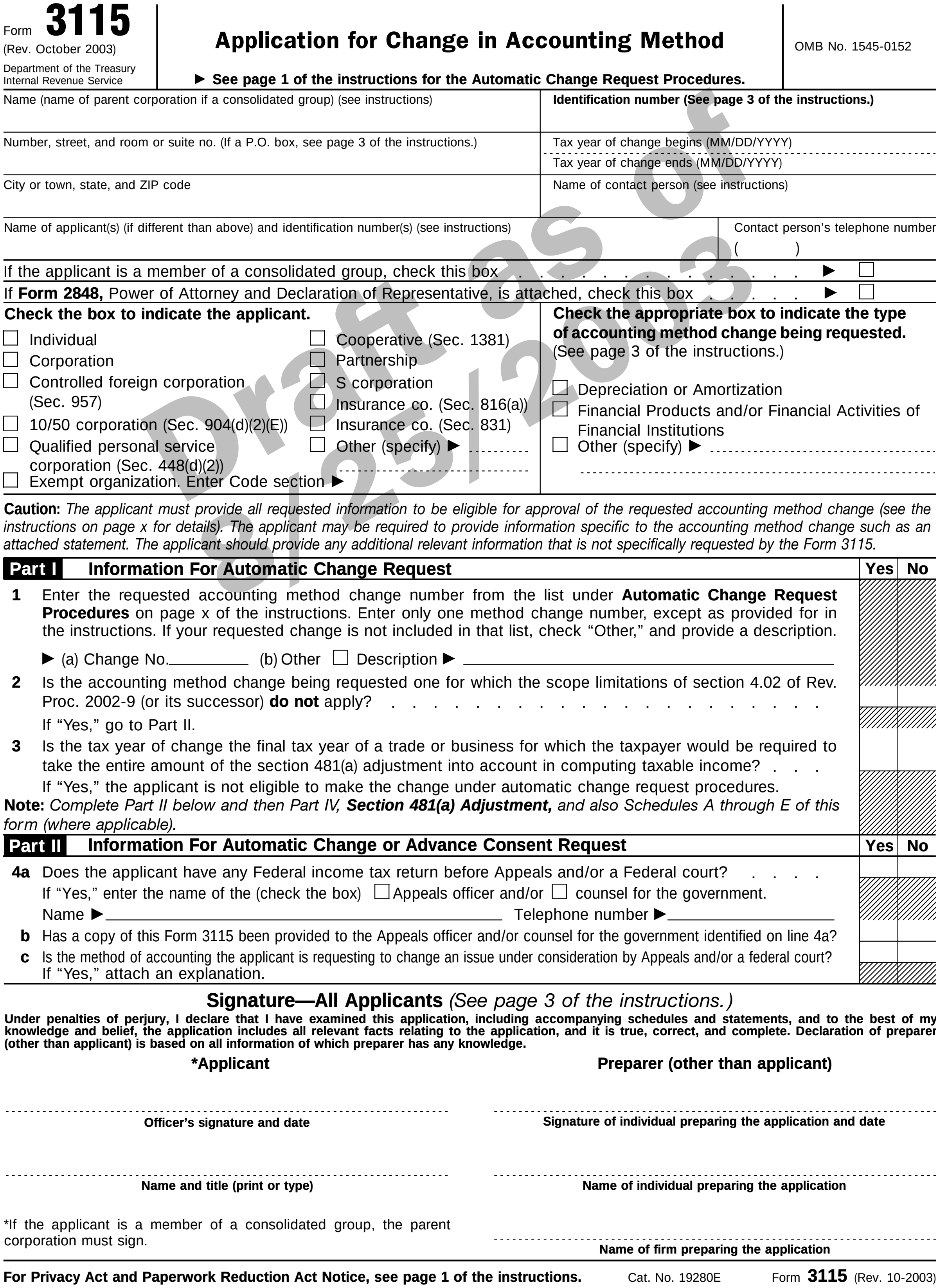
The IRC §481(a) adjustment takes into account items of income and expense to the extent necessary to make sure no item is being duplicated or omitted. The items considered are those that are affected by the accounting method changes. For example, a change in depreciation method will normally involve only the prior depreciation claimed on the property, while a change in overall accounting method from cash to accrual involves at least a taxpayer's accounts receivable, accounts payable, and inventory.

In addition to making the IRC §481(a) adjustment, the taxpayer also makes the applicable adjustment to the items used in the calculation. For example, if the change involves an amount of depreciation not previously claimed, the taxpayer will adjust the **accumulated depreciation** amounts on the business books to reflect the new amounts.

The regulations refer to calculating the IRC §481(a) adjustment by recalculating the taxpayer's income for all prior years using the accounting method to which the taxpayer is changing. Some adjustment calculations will require looking at many years of tax returns while other calculations may only require looking at the most recent year.

> **Example 23.** OfficePro wants to make a change in depreciation method to claim missed depreciation on several omitted assets. OfficePro claimed no depreciation on the omitted assets in prior years. The total amount of omitted depreciation on these assets for the tax years prior to the year of the IRC §481 adjustment is $10,000. Therefore, OfficePro's IRC §481(a) adjustment is a negative $10,000 for the year of the automatic change of accounting.
>
> See the blank 2003 Form 3115. Instructions were not released prior to the workbook publication deadline, so the form has not been completed for the example.

For Example 23



Form **3115**
(Rev. October 2003)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

▶ **See page 1 of the instructions for the Automatic Change Request Procedures.**

OMB No. 1545-0152

Name (name of parent corporation if a consolidated group) (see instructions)

Identification number (See page 3 of the instructions.)

Number, street, and room or suite no. (If a P.O. box, see page 3 of the instructions.)

Tax year of change begins (MM/DD/YYYY)

Tax year of change ends (MM/DD/YYYY)

City or town, state, and ZIP code

Name of contact person (see instructions)

Name of applicant(s) (if different than above) and identification number(s) (see instructions)

Contact person's telephone number ( )

If the applicant is a member of a consolidated group, check this box . . . . ▶ ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached, check this box . . . . . ▶ ☐

Check the box to indicate the applicant.

☐ Individual
☐ Corporation
☐ Controlled foreign corporation (Sec. 957)
☐ 10/50 corporation (Sec. 904(d)(2)(E))
☐ Qualified personal service corporation (Sec. 448(d)(2))
☐ Exempt organization. Enter Code section ▶
☐ Cooperative (Sec. 1381)
☐ Partnership
☐ S corporation
☐ Insurance co. (Sec. 816(a))
☐ Insurance co. (Sec. 831)
☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. (See page 3 of the instructions.)

☐ Depreciation or Amortization
☐ Financial Products and/or Financial Activities of Financial Institutions
☐ Other (specify) ▶

Caution: *The applicant must provide all requested information to be eligible for approval of the requested accounting method change (see the instructions on page x for details). The applicant may be required to provide information specific to the accounting method change such as an attached statement. The applicant should provide any additional relevant information that is not specifically requested by the Form 3115.*

Part I **Information For Automatic Change Request** — Yes No

1 Enter the requested accounting method change number from the list under **Automatic Change Request Procedures** on page x of the instructions. Enter only one method change number, except as provided for in the instructions. If your requested change is not included in that list, check "Other," and provide a description.

▶ (a) Change No.__________ (b) Other ☐ Description ▶ ____________

2 Is the accounting method change being requested one for which the scope limitations of section 4.02 of Rev. Proc. 2002-9 (or its successor) **do not** apply? . . . .

If "Yes," go to Part II.

3 Is the tax year of change the final tax year of a trade or business for which the taxpayer would be required to take the entire amount of the section 481(a) adjustment into account in computing taxable income? . . .

If "Yes," the applicant is not eligible to make the change under automatic change request procedures.

Note: *Complete Part II below and then Part IV,* ***Section 481(a) Adjustment,*** *and also Schedules A through E of this form (where applicable).*

Part II **Information For Automatic Change or Advance Consent Request** — Yes No

4a Does the applicant have any Federal income tax return before Appeals and/or a Federal court? . . . . .

If "Yes," enter the name of the (check the box) ☐ Appeals officer and/or ☐ counsel for the government.

Name ▶____________ Telephone number ▶____________

b Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 4a?

c Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a federal court? If "Yes," attach an explanation.

Signature—All Applicants *(See page 3 of the instructions.)*

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application includes all relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

***Applicant**

Officer's signature and date

Name and title (print or type)

*If the applicant is a member of a consolidated group, the parent corporation must sign.

Preparer (other than applicant)

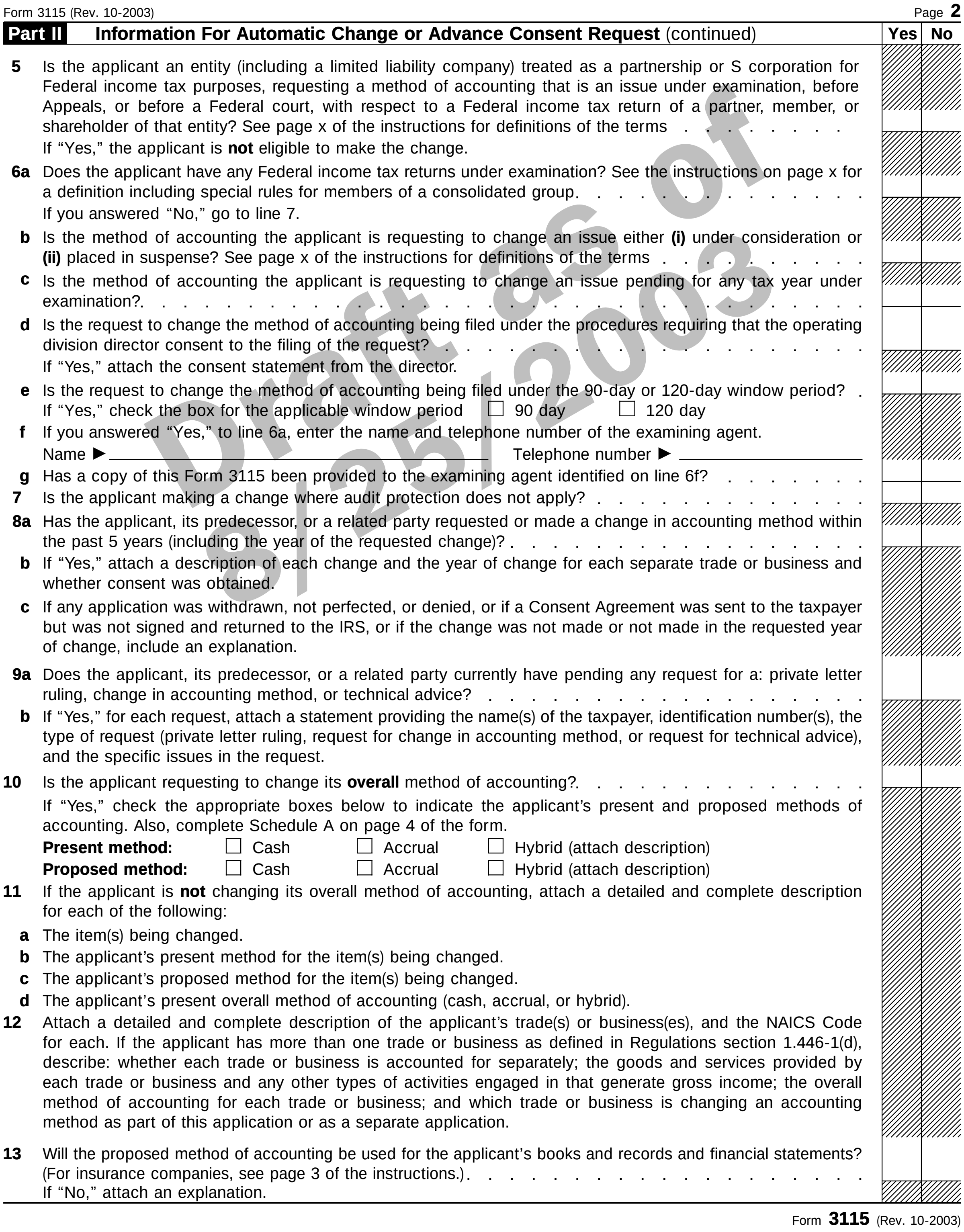
Signature of individual preparing the application and date

Name of individual preparing the application

Name of firm preparing the application

For Privacy Act and Paperwork Reduction Act Notice, see page 1 of the instructions. Cat. No. 19280E Form **3115** (Rev. 10-2003)

For Example 23



Form 3115 (Rev. 10-2003) Page **2**

Part II	Information For Automatic Change or Advance Consent Request (continued)	Yes	No
5	Is the applicant an entity (including a limited liability company) treated as a partnership or S corporation for Federal income tax purposes, requesting a method of accounting that is an issue under examination, before Appeals, or before a Federal court, with respect to a Federal income tax return of a partner, member, or shareholder of that entity? See page x of the instructions for definitions of the terms . . . . If “Yes,” the applicant is **not** eligible to make the change.		
6a	Does the applicant have any Federal income tax returns under examination? See the instructions on page x for a definition including special rules for members of a consolidated group. . . . . If you answered “No,” go to line 7.		
b	Is the method of accounting the applicant is requesting to change an issue either **(i)** under consideration or **(ii)** placed in suspense? See page x of the instructions for definitions of the terms		
c	Is the method of accounting the applicant is requesting to change an issue pending for any tax year under examination?.		
d	Is the request to change the method of accounting being filed under the procedures requiring that the operating division director consent to the filing of the request? . . . . If “Yes,” attach the consent statement from the director.		
e	Is the request to change the method of accounting being filed under the 90-day or 120-day window period? . If “Yes,” check the box for the applicable window period ☐ 90 day ☐ 120 day		
f	If you answered “Yes,” to line 6a, enter the name and telephone number of the examining agent. Name ▶ ______________ Telephone number ▶ ______________		
g	Has a copy of this Form 3115 been provided to the examining agent identified on line 6f?		
7	Is the applicant making a change where audit protection does not apply?		
8a	Has the applicant, its predecessor, or a related party requested or made a change in accounting method within the past 5 years (including the year of the requested change)?		
b	If “Yes,” attach a description of each change and the year of change for each separate trade or business and whether consent was obtained.		
c	If any application was withdrawn, not perfected, or denied, or if a Consent Agreement was sent to the taxpayer but was not signed and returned to the IRS, or if the change was not made or not made in the requested year of change, include an explanation.		
9a	Does the applicant, its predecessor, or a related party currently have pending any request for a: private letter ruling, change in accounting method, or technical advice?		
b	If “Yes,” for each request, attach a statement providing the name(s) of the taxpayer, identification number(s), the type of request (private letter ruling, request for change in accounting method, or request for technical advice), and the specific issues in the request.		
10	Is the applicant requesting to change its **overall** method of accounting?. . . . . If “Yes,” check the appropriate boxes below to indicate the applicant’s present and proposed methods of accounting. Also, complete Schedule A on page 4 of the form. **Present method:** ☐ Cash ☐ Accrual ☐ Hybrid (attach description) **Proposed method:** ☐ Cash ☐ Accrual ☐ Hybrid (attach description)		
11	If the applicant is **not** changing its overall method of accounting, attach a detailed and complete description for each of the following:		
a	The item(s) being changed.		
b	The applicant’s present method for the item(s) being changed.		
c	The applicant’s proposed method for the item(s) being changed.		
d	The applicant’s present overall method of accounting (cash, accrual, or hybrid).		
12	Attach a detailed and complete description of the applicant’s trade(s) or business(es), and the NAICS Code for each. If the applicant has more than one trade or business as defined in Regulations section 1.446-1(d), describe: whether each trade or business is accounted for separately; the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; the overall method of accounting for each trade or business; and which trade or business is changing an accounting method as part of this application or as a separate application.		
13	Will the proposed method of accounting be used for the applicant’s books and records and financial statements? (For insurance companies, see page 3 of the instructions.) . . . . If “No,” attach an explanation.		

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For Example 23

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Part II **Information For Automatic Change or Advance Consent Request** (continued) **Yes** **No**

14a Has the applicant engaged or will it engage in a transaction to which section 381(a) applies (e.g., a reorganization, merger, or liquidation) during the proposed taxable year of change determined without regard to any potential closing of the year under section 381(b)(1)? . . . .

b If "Yes," for the items of income and expense that are the subject of this application, attach a statement identifying the methods of accounting used by the parties to the section 381(a) transaction immediately before the date of distribution or transfer and the method(s) that would be required by section 381(c)(4) or (c)(5) absent consent to the change(s) requested in this application.

15 Does the applicant request a **conference of right** with the IRS National Office if the IRS proposes an adverse response?. . . . .

16 If the applicant is changing to the cash method or changing its method of accounting under sections 263A, 448, 460, or 471, enter the gross receipts of the 3 tax years preceding the year of change.

1st preceding year ended: mo. yr.	2nd preceding year ended: mo. yr.	3rd preceding year ended: mo. yr.
$	$	$

Part III **Information For Advance Consent Request** **Yes** **No**

17 Is the applicant's requested change described in any revenue procedure or regulation as an automatic change request? . . . .

If "Yes," attach an explanation describing why the applicant is submitting its request under advance consent procedures.

18 Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explain how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method. Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method. The applicant should include a discussion of any authorities that may be contrary to its use of the proposed method.

19 Attach a copy of all documents related to the proposed change. (See page 3 of the instructions.)

20 Attach a statement of the applicant's reasons for the proposed change.

21 If the applicant is a member of a consolidated group for the year of change, do all other members of the consolidated group use the proposed method of accounting for the item being changed? . . . .

If "No," attach an explanation.

22 Has the applicant ever been a member of a consolidated group other than the current group? . . . . . .

If "Yes," provide the former parent corporation's **(a)** name, **(b)** identification number, **(c)** address, and **(d)** tax years the applicant was a member.

23a Enter the amount of **user fee** attached to this application. ▶ $ ________________ (See page 2 of the instructions.)

b If the applicant qualifies for a reduced user fee, attach the necessary information or certification required by Rev. Proc. 2003-1 (or its successor). See the instructions.

Part IV **Section 481(a) Adjustment** **Yes** **No**

24 Do the procedures for the change being requested require the use of the cutoff method?

25 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ __________________ Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the same application, attach a list of the name, identification number, NAICS code (see page x of the instructions), and the amount of the section 481(a) adjustment attributable to each applicant.

26 If the section 481(a) adjustment is an increase to income of less than $25,000, does the applicant elect to take the entire amount of the adjustment into account in the year of change? . . . .

27 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a controlled group, or other related parties? . . . .

If "Yes," attach an explanation.

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For Example 23

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Schedule A—Change in Overall Method of Accounting (If Schedule A applies, Part I below must be completed.)

Part I **Change in Overall Method** (See page 3 of the instructions.)

1 Enter the following amounts as of the close of the tax year preceding the year of change. If none, state "None." Also attach a statement providing a breakdown of the amounts entered on lines 1a through 1g.

		Amount
a	Income accrued but not received	$
b	Income received or reported before it was earned. Attach a description of the income and the legal basis for the proposed method. (See page 3 of the instructions.)	
c	Expenses accrued but not paid	
d	Prepaid expense previously deducted	
e	Supplies on hand previously deducted and/or not previously reported	
f	Inventory on hand previously deducted and/or not previously reported. Complete Schedule D, Part II	
g	Other amounts (specify) ▶	
h	**Net section 481(a) adjustment** (Combine lines 1a–1g.) (See page 3 of the instructions.)	$

2 Is the applicant also requesting the recurring item exception under section 461(h)(3)? (See page 4 of the instructions.) ☐ **Yes** ☐ **No**

3 Attach copies of the profit and loss statement (Schedule F (Form 1040) for farmers) and the balance sheet, if applicable, as of the close of the tax year preceding the year of change. On a separate sheet, state the accounting method used when preparing the balance sheet. If books of account are not kept, attach a copy of the business schedules submitted with the Federal income tax return or other return (e.g., tax-exempt organization returns) for that period. If the amounts in Part I, lines 1a through 1g, do not agree with those shown on both the profit and loss statement and the balance sheet, explain the differences on a separate sheet.

Part II **Change to the Cash Method For Advance Consent Request** (See page 4 of the instructions.)

Applicants requesting a change to the cash method must attach the following information.

1 A description of inventory items (items whose production, purchase, or sale is an income producing factor) and materials and supplies used in carrying out the business.

2 An explanation as to whether the applicant is required to use the accrual method under any section of the Code or regulations.

Schedule B—Change in Reporting Advance Payments (See page 4 of the instructions.)

1 If the applicant is requesting to defer advance payment for services under Rev. Proc. 71-21, 1971-2 C.B. 549, attach the following information:

a Sample copies of all service agreements used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the service agreement that require the taxpayer to perform services.

b If any parts or materials are provided, explain whether the obligation to provide parts or materials is incidental (of minor or secondary importance) to an agreement providing for the performance of personal services.

c If the change relates to contingent service contracts, explain how the contracts relate to merchandise that is sold, leased, installed, or constructed by the applicant and whether the applicant offers to sell, lease, install, or construct without the service agreement.

d A description of the method the applicant will use to determine the amount of income earned each year on service contracts and why that method clearly reflects income earned and related expenses in each year.

e An explanation of how the method the applicant will use to determine the amount of gross receipts each year will be no less than the amount included in gross receipts for purposes of its books and records. See section 3.11 of Rev. Proc. 71-21.

2 If the applicant is requesting a deferral of advance payments for goods under Regulations section 1.451-5, attach the following information:

a Sample copies of all agreements for goods or items requiring advance payments used by the applicant that are subject to the requested change in accounting method. Indicate the particular parts of the agreement that require the applicant to provide goods or items.

b A statement providing that the entire advance payment is for goods or items. If not entirely for goods or items, a statement that an amount equal to 95% of the total contract price is properly allocable to the obligation to provide activities described in Regulations section 1.451-5(a)(1)(i) or (ii) (including services as an integral part of those activities).

c An explanation of how the method the applicant will use to determine the amount of gross receipts each year will be no less than the amount included in gross receipts for purposes of its books and records. See Regulations section 1.451-5(b)(1).

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For Example 23

Schedule C—Changes Within the LIFO Inventory Method (See page 4 of the instructions.)

Part I General LIFO Information

Complete this section if the requested change involves changes within the LIFO inventory method. Also, attach a copy of all **Forms 970,** Application To Use LIFO Inventory Method, filed to adopt or expand the use of the LIFO method.

1 Attach a description of the applicant's present and proposed LIFO methods and submethods for each of the following items.

a Valuing inventory (e.g., unit method or dollar-value method).

b Pooling (e.g., by line or type or class of goods, natural business unit, multiple pools, raw material content, simplified dollar-value method, inventory price index computation (IPIC) pools, etc.).

c Pricing dollar-value pools (e.g., double-extension, index, link-chain, link-chain index, IPIC method, etc.).

d Figuring the current year cost of goods in the ending inventory (e.g., most recent purchases, earliest acquisitions during the year, average cost of purchases during the year, etc.).

2 If any present method or submethod used by the applicant is not the same as indicated on Form(s) 970 filed to adopt or expand the use of the method, attach an explanation.

3 If the proposed change is not requested for all the LIFO inventory, specify the inventory to which the change is and is not applicable.

4 If the proposed change is not requested for all of the LIFO pools, specify the LIFO pool(s) to which the change is applicable.

5 Attach a statement addressing whether the applicant values any of its LIFO inventory on a method other than cost. For example, if the applicant values some of its LIFO inventory at retail and the remainder at cost, the applicant should identify which inventory items are valued under each method.

6 If changing to the IPIC method, attach a statement indicating the indexes, tables, and categories the applicant proposes to use.

Part II Change in Pooling Inventories

1 If the applicant is proposing to change its pooling method or the number of pools, attach a description of the contents of, and state the base year for, each dollar-value pool the applicant presently uses and proposes to use.

2 If the applicant is proposing to use natural business unit (NBU) pools or requesting to change the number of NBU pools, attach the following information (to the extent not already provided) in sufficient detail to show that each proposed NBU was determined under Regulations section 1.472-8(b)(1) and (2):

a A description of the types of products produced by the applicant. If possible, attach a brochure.

b A description of the types of processes and raw materials used to produce the products in each proposed pool.

c If all of the products to be included in the proposed NBU pool(s) are not produced at one facility, the applicant should explain the reasons for the separate facilities, indicate the location of each facility, and provide a description of the products each facility produces.

d A description of the natural business divisions adopted by the taxpayer. State whether separate cost centers are maintained and if separate profit and loss statements are prepared.

e A statement addressing whether the applicant has inventories of items purchased and held for resale that are not further processed by the applicant, including whether such items, if any, will be included in any proposed NBU pool.

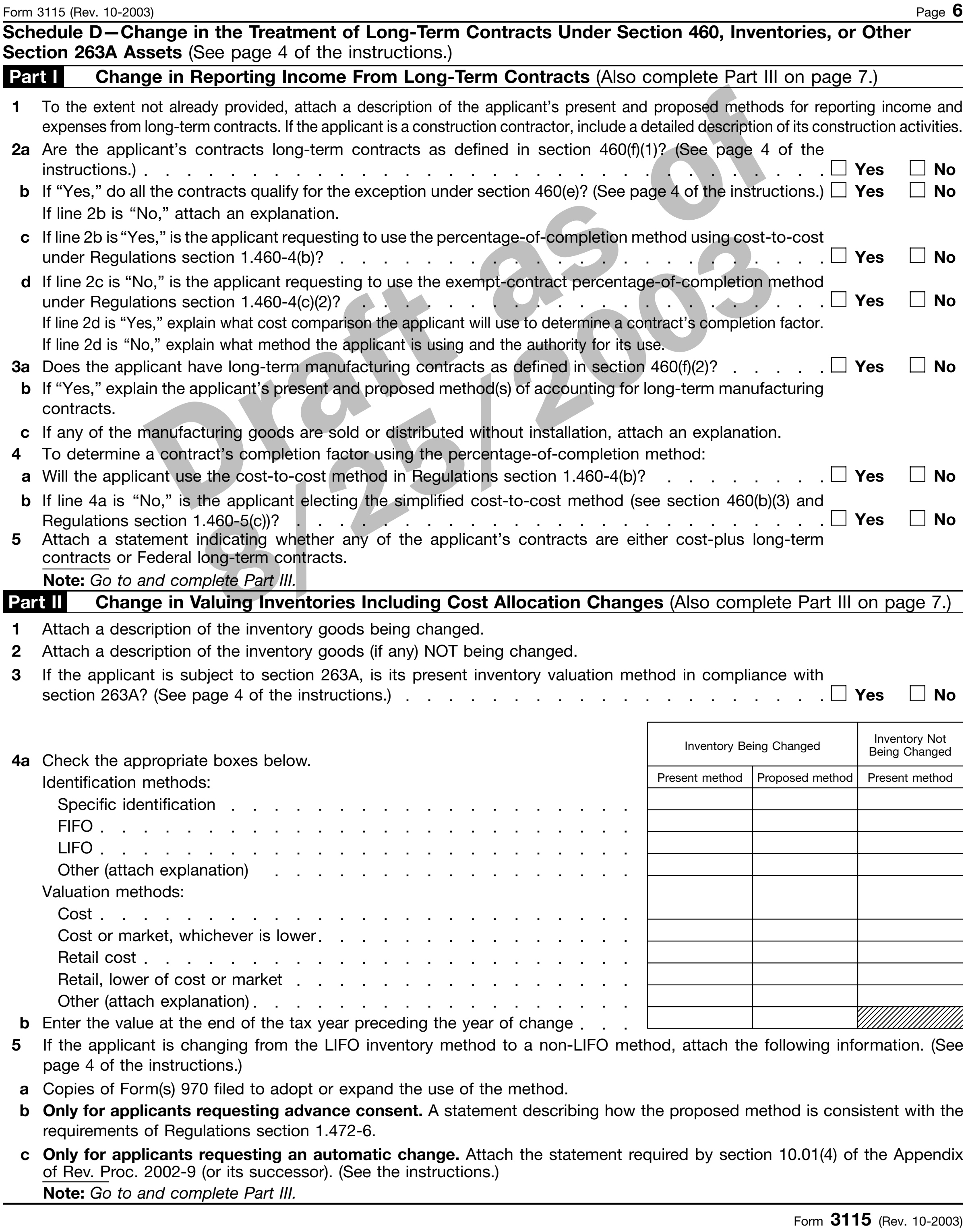
f A statement addressing whether all items including raw materials, goods-in-process, and finished goods entering into the entire inventory investment for each proposed NBU pool are presently valued under the LIFO method. Describe any items that are not presently valued under the LIFO method that are to be included in each proposed pool.

g A statement addressing whether, within the proposed NBU pool(s), there are items both sold to unrelated parties and transferred to a different unit of the applicant to be used as a component part of another product prior to final processing.

3 If the applicant is engaged in manufacturing and is proposing to use the multiple pooling method or raw material content pools, attach information to show that each proposed pool will consist of a group of items that are substantially similar. See Regulations section 1.472-8(b)(3).

4 If the applicant is engaged in the wholesaling or retailing of goods and is requesting to change the number of pools used, attach information to show that each of the proposed pools is based on customary business classifications of the applicant's trade or business. See Regulations section 1.472-8(c).

For Example 23



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Schedule D—Change in the Treatment of Long-Term Contracts Under Section 460, Inventories, or Other Section 263A Assets (See page 4 of the instructions.)

Part I Change in Reporting Income From Long-Term Contracts (Also complete Part III on page 7.)

1 To the extent not already provided, attach a description of the applicant's present and proposed methods for reporting income and expenses from long-term contracts. If the applicant is a construction contractor, include a detailed description of its construction activities.

2a Are the applicant's contracts long-term contracts as defined in section 460(f)(1)? (See page 4 of the instructions.) ☐ **Yes** ☐ **No**

b If "Yes," do all the contracts qualify for the exception under section 460(e)? (See page 4 of the instructions.) ☐ **Yes** ☐ **No**
If line 2b is "No," attach an explanation.

c If line 2b is "Yes," is the applicant requesting to use the percentage-of-completion method using cost-to-cost under Regulations section 1.460-4(b)? ☐ **Yes** ☐ **No**

d If line 2c is "No," is the applicant requesting to use the exempt-contract percentage-of-completion method under Regulations section 1.460-4(c)(2)? ☐ **Yes** ☐ **No**
If line 2d is "Yes," explain what cost comparison the applicant will use to determine a contract's completion factor.
If line 2d is "No," explain what method the applicant is using and the authority for its use.

3a Does the applicant have long-term manufacturing contracts as defined in section 460(f)(2)? ☐ **Yes** ☐ **No**

b If "Yes," explain the applicant's present and proposed method(s) of accounting for long-term manufacturing contracts.

c If any of the manufacturing goods are sold or distributed without installation, attach an explanation.

4 To determine a contract's completion factor using the percentage-of-completion method:

a Will the applicant use the cost-to-cost method in Regulations section 1.460-4(b)? ☐ **Yes** ☐ **No**

b If line 4a is "No," is the applicant electing the simplified cost-to-cost method (see section 460(b)(3) and Regulations section 1.460-5(c))? ☐ **Yes** ☐ **No**

5 Attach a statement indicating whether any of the applicant's contracts are either cost-plus long-term contracts or Federal long-term contracts.

Note: *Go to and complete Part III.*

Part II Change in Valuing Inventories Including Cost Allocation Changes (Also complete Part III on page 7.)

1 Attach a description of the inventory goods being changed.

2 Attach a description of the inventory goods (if any) NOT being changed.

3 If the applicant is subject to section 263A, is its present inventory valuation method in compliance with section 263A? (See page 4 of the instructions.) ☐ **Yes** ☐ **No**

	Inventory Being Changed		Inventory Not Being Changed
	Present method	Proposed method	Present method
4a Check the appropriate boxes below.			
Identification methods:			
Specific identification			
FIFO			
LIFO			
Other (attach explanation)			
Valuation methods:			
Cost			
Cost or market, whichever is lower			
Retail cost			
Retail, lower of cost or market			
Other (attach explanation)			
b Enter the value at the end of the tax year preceding the year of change			▨

5 If the applicant is changing from the LIFO inventory method to a non-LIFO method, attach the following information. (See page 4 of the instructions.)

a Copies of Form(s) 970 filed to adopt or expand the use of the method.

b **Only for applicants requesting advance consent.** A statement describing how the proposed method is consistent with the requirements of Regulations section 1.472-6.

c **Only for applicants requesting an automatic change.** Attach the statement required by section 10.01(4) of the Appendix of Rev. Proc. 2002-9 (or its successor). (See the instructions.)

Note: *Go to and complete Part III.*

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For Example 23

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Part III **Method of Cost Allocation** (Complete this part if the requested change involves either property subject to section 263A or long-term contracts as described in section 460. See the instructions on page 4.)

Section A—Allocation and Capitalization Methods

Attach a description (including sample computations) of the present and proposed method(s) the applicant uses to capitalize direct and indirect costs properly allocable to long-term contracts, real or tangible personal property produced, and property acquired for resale. Include a description of the method(s) used for allocating indirect costs to intermediate cost objectives such as departments or activities prior to the allocation of such costs to long-term contracts, real or tangible personal property produced, and property acquired for resale. The description must include the following:

1 The method of allocating direct and indirect costs (i.e., specific identification, burden rate, standard cost, or other reasonable allocation method).

2 The method of allocating mixed service costs (i.e., direct reallocation, step-allocation, simplified service cost using the labor-based allocation ratio, simplified service cost using the production cost allocation ratio, or other reasonable allocation method).

3 The method of capitalizing additional section 263A costs (i.e., simplified production with or without the historic absorption ratio election, simplified resale with or without the historic absorption ratio election including permissible variations, the U.S. ratio, or other reasonable allocation method).

Section B—Direct and Indirect Costs Required To Be Allocated (Check the appropriate boxes in Section B showing the costs that are or will be fully included, to the extent required, in the cost of real or tangible personal property produced or property acquired for resale under section 263A or allocated to long-term contracts under section 460. Mark "N/A" in a box if those costs are not incurred by the applicant. If a box is not checked, it is assumed that those costs are not fully included to the extent required. Attach an explanation for boxes that are not checked.)

		Present method	Proposed method
1	Direct material		
2	Direct labor		
3	Indirect labor		
4	Officers' compensation (not including selling activities)		
5	Pension and other related costs		
6	Employee benefits		
7	Indirect materials and supplies		
8	Purchasing costs		
9	Handling, processing, assembly, and repackaging costs		
10	Offsite storage and warehousing costs		
11	Depreciation, amortization, and cost recovery allowance for equipment and facilities placed in service and not temporarily idle		
12	Depletion		
13	Rent		
14	Taxes other than state, local, and foreign income taxes		
15	Insurance		
16	Utilities		
17	Maintenance and repairs that relate to a production, resale, or long-term contract activity		
18	Engineering and design costs (not including section 174 research and experimental expenses)		
19	Rework labor, scrap, and spoilage		
20	Tools and equipment		
21	Quality control and inspection		
22	Bidding expenses incurred in the solicitation of contracts awarded to the applicant		
23	Licensing and franchise costs		
24	Capitalizable service costs (including mixed service costs)		
25	Administrative costs (not including any costs of selling or any return on capital)		
26	Research and experimental expenses attributable to long-term contracts		
27	Interest		
28	Other costs (Attach a list of these costs.)		

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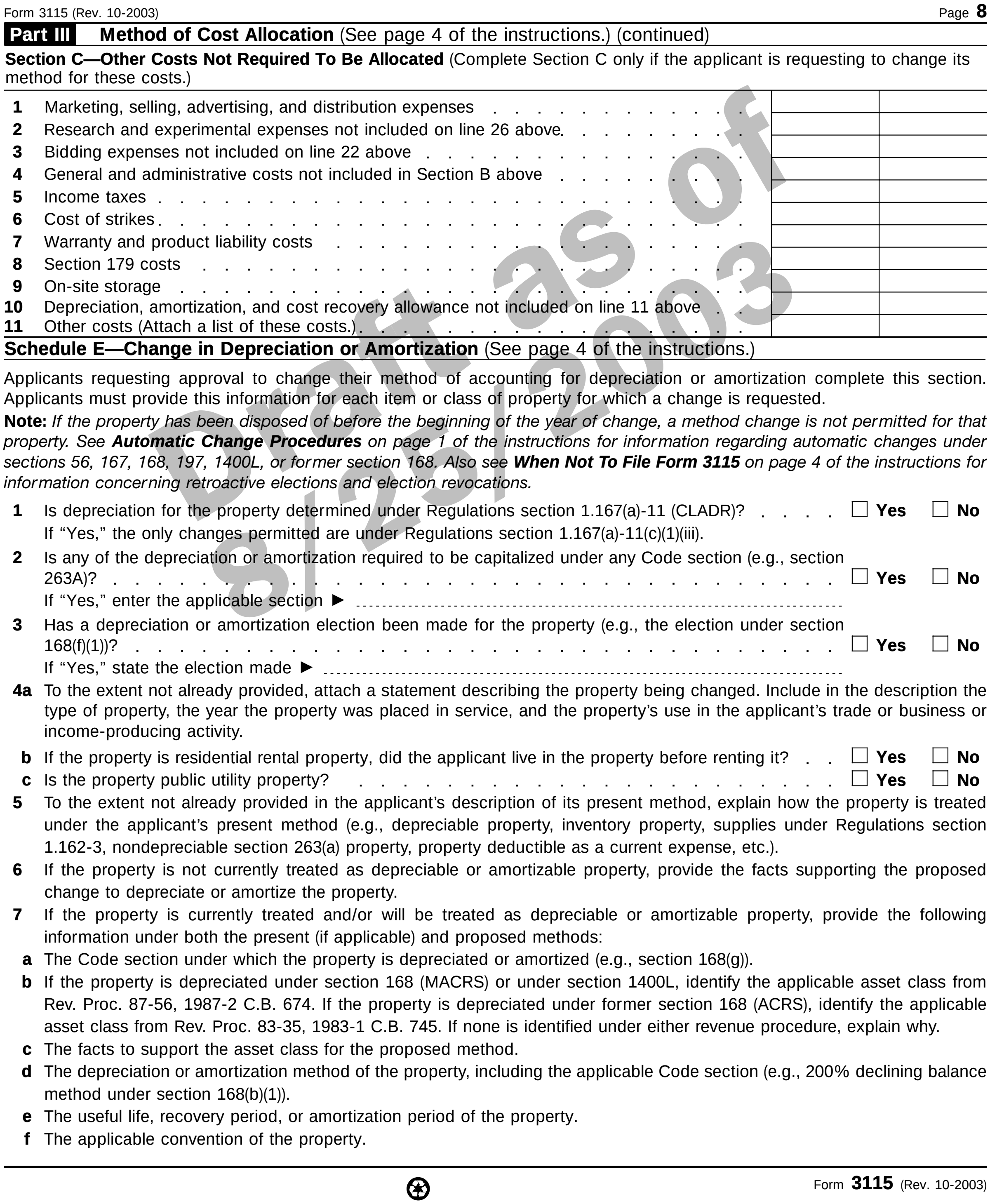
For Example 23



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Part III **Method of Cost Allocation** (See page 4 of the instructions.) (continued)

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

1	Marketing, selling, advertising, and distribution expenses		
2	Research and experimental expenses not included on line 26 above		
3	Bidding expenses not included on line 22 above		
4	General and administrative costs not included in Section B above		
5	Income taxes		
6	Cost of strikes		
7	Warranty and product liability costs		
8	Section 179 costs		
9	On-site storage		
10	Depreciation, amortization, and cost recovery allowance not included on line 11 above		
11	Other costs (Attach a list of these costs.)		

Schedule E—Change in Depreciation or Amortization (See page 4 of the instructions.)

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants must provide this information for each item or class of property for which a change is requested.

Note: *If the property has been disposed of before the beginning of the year of change, a method change is not permitted for that property. See **Automatic Change Procedures** on page 1 of the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400L, or former section 168. Also see **When Not To File Form 3115** on page 4 of the instructions for information concerning retroactive elections and election revocations.*

1 Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? ☐ **Yes** ☐ **No**
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section (e.g., section 263A)? ☐ **Yes** ☐ **No**
If "Yes," enter the applicable section ► ____________

3 Has a depreciation or amortization election been made for the property (e.g., the election under section 168(f)(1))? ☐ **Yes** ☐ **No**
If "Yes," state the election made ► ____________

4a To the extent not already provided, attach a statement describing the property being changed. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? ☐ **Yes** ☐ **No**

c Is the property public utility property? ☐ **Yes** ☐ **No**

5 To the extent not already provided in the applicant's description of its present method, explain how the property is treated under the applicant's present method (e.g., depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, provide the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information under both the present (if applicable) and proposed methods:

a The Code section under which the property is depreciated or amortized (e.g., section 168(g)).

b If the property is depreciated under section 168 (MACRS) or under section 1400L, identify the applicable asset class from Rev. Proc. 87-56, 1987-2 C.B. 674. If the property is depreciated under former section 168 (ACRS), identify the applicable asset class from Rev. Proc. 83-35, 1983-1 C.B. 745. If none is identified under either revenue procedure, explain why.

c The facts to support the asset class for the proposed method.

d The depreciation or amortization method of the property, including the applicable Code section (e.g., 200% declining balance method under section 168(b)(1)).

e The useful life, recovery period, or amortization period of the property.

f The applicable convention of the property.

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Example 24. Jane wants to make a change in her overall accounting method **from cash to accrual** effective January 1, 2003. Her records as of December 31, 2002, show:

- Accounts receivable of $400,000,
- Accounts payable of $310,000, and
- $60,000 of accrued wages and other expenses.

Since Jane was using the cash method of accounting, none of the accounts receivable, accounts payable, or accrued wages were reported on her prior tax returns. **Jane's IRC §481(a) adjustment is a positive $30,000 ($400,000 of income from the accounts receivables, less $310,000 of accounts payable and $60,000 of accrued expenses).**

Jane's **ending** balance sheet figures on her **2002** tax return showed no accounts receivable, accounts payable, or accrued expenses. After this accounting change, Jane's **beginning** balance sheet figures on her **2003** tax return will show accounts receivable of $400,000, accounts payable of $310,000, and accrued expenses of $60,000. When she pays or collects these items, they will be recorded as a payment or collection on the applicable account and not as an income or expense.

Example 25. Robin wants to make a change in her overall accounting method **from accrual to cash** effective January 1, 2003. Her records as of December 31, 2002, show:

- Accounts receivable of $40,000,
- Accounts payable of $31,000, and
- $6,000 of accrued wages and other expenses that were deducted in 2002 but weren't paid until 2003.

Robin must analyze tax years prior to 2002 to determine if other accruals are still outstanding. If proper accounting records were maintained in the prior tax years, all previous accruals should be reflected in the December 31, 2002, figures. **Therefore, Robin's 2003 tax year IRC §481(a) adjustment is a negative $3,000 ($31,000 + $6,000 – $40,000).**

Robin's ending balance sheet figures on her 2002 tax return shows accounts receivable of $40,000, accounts payable of $31,000, and accrued expenses of $6,000. After this accounting change, Robin's beginning balance sheet figures on her 2003 tax return will show no accounts receivable, accounts payable, or accrued expenses. When she pays or collects these items, they will be recorded as an expense or as income.

IRC §481(a) Adjustment Period

The adjustment required for making this change is taken into account according to IRC §481(a). Once the IRC §481(a) adjustment is calculated it is reported as either additional income or additional expense on the tax return(s).

Negative Adjustment

Rev. Proc. 2002-19 provides a change in the timing of claiming a **negative** IRC §481(a) adjustment. If the taxpayer has a **negative** IRC §481(a) adjustment (generally in the taxpayer's favor), then the adjustment is made **entirely** in the year of the accounting change (effective for tax years ending on or after December 31, 2001). Taxpayers who filed their applicable returns on or before April 15, 2002, and used the normal spreading of their IRC §481(a) adjustment had until September 10, 2002, to revise their Form 3115 to use the one-year provision. If they did nothing, then the normal spreading outlined in the original Form 3115 was required.

Note. See page 287 in the *2002 University of Illinois Income Tax Workbook* for a thorough analysis of Rev. Proc. 2002-19, including an example.

The default rule of Rev. Proc. 2002-09 requires a **positive** IRC §481(a) adjustment to be spread over a period of **four** years. If the IRC §481(a) is a **positive** adjustment of less than $25,000, the taxpayer can report the entire IRC §481(a) adjustment in the year of the change by making an election on Form 3115. This election is made on page 3, Part III, line 21a. Although this line refers to positive and negative IRC §481(a) adjustments of less than $25,000, **negative IRC §481(a) adjustments are required to be taken in full in the year of change as noted earlier** under Rev. Proc. 2002-19. When the IRS revises this form it will make the appropriate change to the wording and instructions.

The adjustment period under Rev. Proc. 2002-19 is reduced if the taxpayer used the former accounting method for **less than four years.** In that case, the IRC §481(a) adjustment is taken into account over the same number of years that the taxpayer used the former method of accounting. For example, a taxpayer used the cash method of accounting for three years and makes a change to the accrual method of accounting effective the beginning of the fourth year. Therefore, the IRC §481(a) adjustment will be spread over a period of **three** years rather than four.

ISSUE 6 — NEW BUSINESS CREDITS

SMALL EMPLOYER PENSION PLAN START-UP COST CREDIT

This IRC §45E nonrefundable credit was created by the Economic Growth and Tax Relief Reconciliation Act of 2001 to help offset some of the costs that an employer incurs in setting up a retirement plan. The credit is effective for tax years beginning after December 31, 2001, for plans established in 2002 or later years.

Eligible Employer

Taxpayers are eligible employers if, during the preceding year, they had 100 or fewer employees who earned at least $5,000 of compensation. The aggregation rules under IRC §§52(a), 52(b), 414(m), and 414(o) apply. These rules treat all members of a controlled group, all trades or businesses under common control, and all members of an affiliated service group as a single employer for purposes of this credit.

An eligible employer must not have established or maintained a qualified employer plan during the three-tax-year period prior to the first tax year in which the new plan is effective.

Qualified Start-Up Costs

These include all ordinary and necessary expenses paid or incurred in connection with:

- Establishing or administering an eligible employer plan or
- The retirement-related education of employees with respect to such plan.

A **qualified plan** includes a plan described in IRC §4972(d). This includes defined benefit plans; defined contribution plans, including IRC §401(k) plans; SIMPLEs; and SEPs.

There must be at least one employee eligible to participate in the plan who is not a highly compensated employee.

Computation

The nonrefundable credit is equal to **50% of the first $1,000** of qualified expenses **for each of the first three years of the plan,** resulting in a maximum annual credit of $500. The taxpayer can claim a deduction for the qualified start-up expenses after reducing them by the amount of the credit.

A taxpayer can elect to claim the deduction for the costs instead of claiming the credit. There is not an election form or statement required for this election. This election is made by not claiming the credit and not completing Form 8881.

Using the Credit

The first credit year is typically the taxable year which includes the date that the new qualified plan is established. The taxpayer can elect to take the credit in the previous year. For example, a taxpayer who established a new qualified plan in 2004 can elect to treat 2003 as the first credit year.

The credit is subject to the general business credit limitations and cannot be used to reduce AMT.

The credit is claimed by completing Form 8881, *Credit for Small Employer Pension Plan Startup Costs.* Any amount of credit unused in the current year is carried back and forward as part of the general business credit.

> **Example 26.** Kathy is the owner of a calendar year C corporation landscaping business. The corporation had not established any qualified employer retirement plan during 2000, 2001, or 2002. It established an IRC §401(k) plan in June 2003. The corporation had 45 employees in 2002 who earned at least $5,000.
>
> The corporation incurred $1,400 of qualified start-up IRC §401(k) costs in 2003.
>
> The corporation is entitled to the maximum $500 credit (50% of the first $1,000 of start-up costs) for 2003. See the completed 2003 Form 8881. The $900 balance of the $1,400 start-up costs will be deducted as a business expense on the 2003 Form 1120.

For Example 26

Form **8881**

Department of the Treasury
Internal Revenue Service

Credit for Small Employer Pension Plan Startup Costs

▶ **Attach to your tax return.**

OMB No. 1545-1810

2003

Attachment Sequence No. **130**

Name(s) shown on return: **Kathy's Landscaping, Inc.**

Identifying number **37-0000000**

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

1	Qualified startup costs incurred during the tax year. **Do not** enter more than $1,000	**1**	**1,000**		
2	Enter one-half of line 1			**2**	**500**
3	Form 8881 credits from pass-through entities: If you are a— / Then enter the Form 8881 credits 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			**3**	
4	Add lines 2 and 3			**4**	**500**
5	**Current year credit.** Enter the **smaller** of line 4 or **$500**			**5**	**500**

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

6	Regular tax before credits: • Individuals. Enter the amount from Form 1040, line 41 • 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**	**17,300**
7	Alternative minimum tax: • Individuals. Enter the amount from Form 6251, line 35 • Corporations. Enter the amount from Form 4626, line 14 • Estates and trusts. Enter the amount from Form 1041, Schedule I, line 56			**7**	**0**
8	Add lines 6 and 7			**8**	**17,300**
9a	Foreign tax credit	**9a**			
b	Credit for child and dependent care expenses (Form 2441, line 11)	**9b**			
c	Credit for the elderly or the disabled (Schedule R (Form 1040), line 24)	**9c**			
d	Education credits (Form 8863, line 18)	**9d**			
e	Credit for qualified retirement savings contributions (Form 8880, line 14)	**9e**			
f	Child tax credit (Form 1040, line 49)	**9f**			
g	Mortgage interest credit (Form 8396, line 11)	**9g**			
h	Adoption credit (Form 8839, line 18)	**9h**			
i	District of Columbia first-time homebuyer credit (Form 8859, line 11)	**9i**			
j	Possessions tax credit (Form 5735, line 17 or 27)	**9j**			
k	Credit for fuel from a nonconventional source	**9k**			
l	Qualified electric vehicle credit (Form 8834, line 20)	**9l**			
m	Add lines 9a through 9l			**9m**	**0**
10	Net income tax. Subtract line 9m from line 8. If zero, skip lines 11 through 14 and enter -0- on line 15			**10**	**17,300**
11	Net regular tax. Subtract line 9m from line 6. If zero or less, enter -0-	**11**	**17,300**		
12	Enter 25% (.25) of the excess, if any, of line 11 over $25,000 (see instructions)	**12**			
13	Tentative minimum tax (see instructions): • Individuals. Enter the amount from Form 6251, line 33 • Corporations. Enter the amount from Form 4626, line 12 • Estates and trusts. Enter the amount from Form 1041, Schedule I, line 54	**13**	**0**		
14	Enter the greater of line 12 or line 13			**14**	**0**
15	Subtract line 14 from line 10. If zero or less, enter -0-			**15**	**17,300**
16	**Credit allowed for the current year.** Enter the **smaller** of line 5 or line 15 here and on Form 1040, line 52; 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 15 is smaller than line 5, see instructions			**16**	**500**

For Paperwork Reduction Act Notice, see page 2. Cat. No. 33435N Form **8881** (2003)

NEW MARKET CREDIT

The Community Renewal Tax Relief Act of 2000 created the IRC §45D credit available for investments made after December 31, 2001.

A nationally designated investment limitation exists each calendar year for the maximum annual amount of qualifying equity investments available for the credit. This amount for 2003 is $1.5 billion dollars ($2 billion for 2004 and 2005, and $3.5 billion for 2006 and 2007).

The credit was created to encourage qualified equity investments in a qualified community development entity (CDE). The main purpose of the CDE is serving, or providing investment capital for, low-income communities or low-income persons. An investor could receive a maximum tax credit of 39% over a period of seven years.

Qualified Equity Investment

A qualified equity investment is any equity investment in a CDE if:

- The investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash,
- Substantially all (normally at least 85%) of the cash is used by the CDE to make qualified low-income community investments, and
- The investment is designated for the new market tax credit under IRC §45D by the CDE on its books and records using any reasonable method.

The investments by the CDE must be made no later than 12 months after the date the cash is paid by the taxpayer to the CDE.

The equity investment includes stock in an entity that is a corporation for federal tax purposes and any capital interest in an entity that is a partnership for federal tax purposes. It also includes an investment in other business entities if they are classified as a partnership or corporation under the regulations in Treas. Reg. §§301.7701-1 through 301.7701-3.

Any investments made in an entity are not eligible to be qualified equity investments if they are made before the entity enters into an allocation agreement under IRC §45D with the Secretary of Treasury. However, an investment in an entity is eligible if:

- The equity investment is made on or after the date the Community Development Financial Institutions (CDFI) Fund publishes a Notice of Allocation of Availability (NOAA) in the Federal Register,
- The designation of the equity investment as a qualified equity investment (QEI) is made for a credit allocation received pursuant to an allocation application submitted to the CDFI Fund under that NOAA, and
- The entity investment otherwise satisfies the requirements of IRC §45D and Temp. Reg. §1.45D-1T.

If the entity in which the equity investment is made does not receive an allocation under that NOAA, the equity investment will not be eligible to be designated as a QEI under future NOAAs.

A qualifying equity investment that meets the conditions in the above exception is treated as made on the effective date of the allocation agreement between the CDE and the Secretary.

An equity investment does not include any investment made more than five years after the date that the CDE receives an allocation of the national limit. Since this is a new credit, this will not be a concern for a few more years. It also does not include an investment made by a CDE in another CDE, if the first CDE has received an allocation under IRC §45D.

Qualified low-income community investments include:

- Investments in a **qualified active low-income community business;**

- Purchases from another CDE of any loan made by the CDE that is a qualified low-income community investment;
- Financial counseling and other services provided to any qualified active low-income community business, or to any residents of a low-income community; and
- Equity investments in, or loans to, another CDE that uses the proceeds in one of the above manners.

A **qualified active low-income community business** includes a corporation (including nonprofit corporations) or a partnership that meets the following provisions:

- At least 50% of the total gross income is from the active conduct of a qualified business within any low-income community. In some cases this decreases to 40%.
- At least 40% (in value) of the use of the tangible property of the business is within any low-income community.
- At least 40% of the services performed for the business by its employees are performed in a low-income community.
- Less than 5% of the average aggregate bases of the entity's property is attributable to collectibles other than those held primarily for sale to customers in the ordinary course of business.
- Less than 5% of the average aggregate bases of the entity's property is attributable to nonqualified financial property. This includes debt instruments with a term in excess of 18 months and certain other types of transactions.[30]

A **qualified active low-income community business** also includes a business carried on by an individual as a sole proprietor. However, the business must have qualified as an **active low-income community business** if the business was incorporated. Further requirements include:

- The primary mission of the entity is serving, or providing investment capital for, low-income communities or low-income persons.
- The entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity.
- The entity is certified by the Secretary as being a qualified community development entity.

A qualified business activity includes any trade or business with some exceptions. It also includes the rental of improved nonresidential real estate. It does not include businesses which predominately develop or hold intangibles for sale or license, golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other gambling facilities, or any store which principally sells alcoholic beverages for off-premises consumption. It also does not include farming, if the sum of the aggregate unadjusted bases of the assets owned and used in the business and the value of assets leased for use in the business total more than $500,000 at the end of any taxable year.

Amount of Credit

The credit may be claimed over a period of seven years. To determine the amount of the credit, the amount paid to the qualified CDE is multiplied by the investment percentage allowed.

- 5% for the year the investment is made and each of the next two years.
- 6% for each of the next four years.

The 5% and 6% credit amounts are calculated on Form 8874, *New Market Credit.* The basis in the equity investment must be reduced by the amount of the new market tax credit.

Limitation

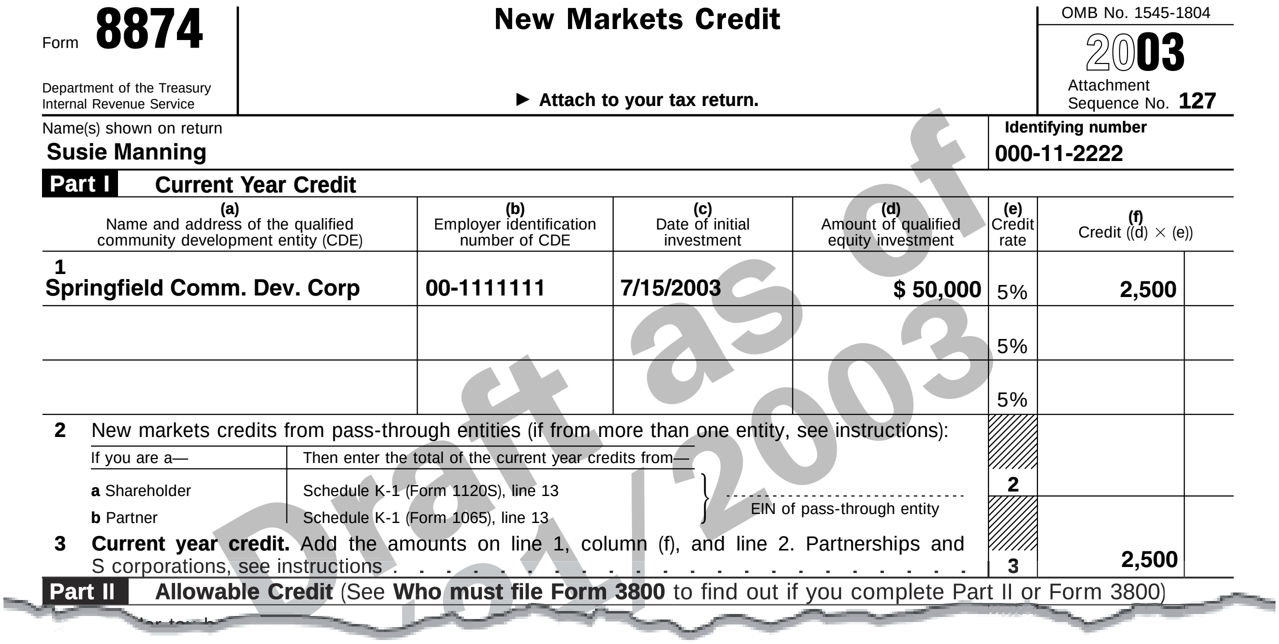
This credit is part of the general business credit and is subject to the normal general business credit limitations.

Recapture

A recapture occurs if any of the following events occur:

- The entity ceases to be a CDE.
- The proceeds of the investments cease to be used to make low income community investments.
- The investment is redeemed by the CDE.

Example 27. In 2003, Susie invests $50,000 in the Springfield Community Development Corporation, a qualified CDE. Her tax credit is computed as follows:



Form **8874**
Department of the Treasury
Internal Revenue Service

New Markets Credit

► **Attach to your tax return.**

OMB No. 1545-1804
2003
Attachment Sequence No. **127**

Name(s) shown on return: **Susie Manning**

Identifying number: **000-11-2222**

Part I **Current Year Credit**

(a) Name and address of the qualified community development entity (CDE)	**(b)** Employer identification number of CDE	**(c)** Date of initial investment	**(d)** Amount of qualified equity investment	**(e)** Credit rate	**(f)** Credit ((d) × (e))
1 Springfield Comm. Dev. Corp	00-1111111	7/15/2003	$ 50,000	5%	2,500
				5%	
				5%	

2 New markets credits from pass-through entities (if from more than one entity, see instructions):

If you are a—	Then enter the total of the current year credits from—
a Shareholder	Schedule K-1 (Form 1120S), line 13
b Partner	Schedule K-1 (Form 1065), line 13

EIN of pass-through entity **2**

3 **Current year credit.** Add the amounts on line 1, column (f), and line 2. Partnerships and S corporations, see instructions **3** 2,500

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

If Susie continues her investment until 2009, her total credit will equal 39% of her original investment. This will reduce her basis.

If Susie sells her investment in 2005, it will be **subject to recapture** in an amount equal to the credits claimed **plus interest for the resulting underpayment.**

> **Note.** A recent announcement regarding the New Market Tax Credit program appears in the Treasury Department News Release JS-574. On July 17, 2003, the Treasury Department announced there would be a second round of bidding for $3.5 billion in qualified equity investments.

ENDNOTES

1 IRC §1231(b)(1)(C)
2 IRC §1231(b)(1)(D)
3 IRC §1221(2)

4 IRC §1231(a)(3)

5 IRC §1231(b)(2)

6 IRC §1231(b)(2)

7 IRC §1231(b)(3)(A)

8 IRC §1231(b)(3)(A)

9 IRC §50(c)(4)(a)

10 IRC §179(d)(10)

11 Treas. Reg. §1.179-1(e)(1)

12 IRC §280F(d)

13 Treas. Reg. §1.179-1(e)(2)

14 Treas. Reg. §1.162-3

15 IRC §83

16 IRC §§6721(a) and (b) through 6724

17 For example, see IRC §1056 for the basis limitation for player contracts transferred in connection with the sale of a franchise.

18 IRC §197(e)

19 IRC §453(b)

20 IRS Pub. 334, *Tax Guide for Small Businesses*

21 Treas. Reg. §1.1038-1

22 Treas. Reg. §1.453-6(c)(1)

23 Treas. Reg. §1.453-6(c)(1)

24 Rev. Proc. 1997-37

25 Rev. Proc. 2001-10

26 Rev. Proc. 2002-27

27 Rev. Proc. 2002-28

28 Rev. Proc. 2002-12

29 Rev. Rul. 2001-60

30 IRC §1397C(e)(1)