ENROLLED AGENT STUDY GUIDE

Dynasty School

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INTRODUCTION AND Q & A's

The Internal Revenue Service Special Enrollment Examination is offered Once each year for individuals who wish to be enrolled to practice before the Internal Revenue Service (Enrolled Agents). It is comprised of four parts. Candidates must take all four parts of the examination in the first year. Those who pass at least one part of the examination in the first year may take the failed parts in the following three years with these provisions:

Candidates must achieve the minimum retention score on EACH part failed in the first year. The minimum retention score is 90 percent of the passing score set for the part(s) failed.

Candidates MUST take ALL failed parts of the examination in the second year, all remaining parts the third year, and all remaining parts the fourth year.

Candidates must achieve a score no less than 90 percent of the passing score for any parts taken in the second and third years in order to remain eligible to try again. That is to say that if you score below the minimum retention score on any part taken in the second or third year, you would be required to retake the examination in its entirety should you wish to continue.

Candidates who do not pass all four parts of the examination by the end of the fourth year must start over again.

Candidates who pass three of the four parts the first year do NOT have to achieve the minimum retention score on the part failed. Therefore, they would be required to take only the part failed the following year.

IMPORTANT DATES

Exam Applications available from IRS call 800-829-3676	**June 1**
Deadline to submit exam applications to IRS	**July 31**

Questions & Answers

Question: If an individual is unable to retake the examination in a subsequent year, would he/ she lose credit for examination parts passed?

Answer: Yes, in most cases, since the examination assumes continuity. However, if the candidate is able to give compelling reasons for a waiver, e.g. serious illness or a death in the family, it could be granted.

Question: In the above situation, does the candidate still have only four years to complete the examination successfully or is the candidate allowed additional years?

Answer: The years a candidate misses taking the examination under a waiver will not count against the four years. Each waiver would extend the period one year. However, there is a six year [imitation. That is, the candidate must complete the examination successfully within six years if granted any waiver, including years for which waivers are granted.

Question: May an individual change the district in which he/she takes the examination from year to year?

Answer: Yes.

Question: Would an individual who passed one or more parts of the examination in the first year and again failed the parts he/she had to take in the second year be able to carry over first year credit?

Answer: Yes. The candidate would retain credit for any part passed iii the first year for the remaining three years, provided he/she met the minimum retention score and parts required to be taken conditions as set forth above.

Question: What if an individual took all four parts of the examination in 1996 and did not pass any of the four parts?

Answer: The four year requirement does not take effect until the candidate passes at least one part of the examination.

Question: May an individual take one part of the examination per year for four years?

Answer: No. Candidates must take all four parts the first year, all failed parts the second year, all remaining failed parts in the third year, and all remaining failed parts in the fourth year.

Question: How many years may an individual take the examination without passing at least one part?

Answer: There is no limit.

TIPS TO PASS THE EXAM

- *Because the tax information is enormous, so we have extracted the key points relating to the examination together with "exercises" to form a four-part WORKBOOK. We recommend you study the WORKBOOK and the PAST IRS EXAMINATIONS AND QUESTIONS we supplied to you. You do not need to study all the IRS publications (SEE Package), you should use them as the indispensable references.*

- *Use the enclosed Special Enrollment Examination (SEE) Study Material Request and Mailing Label attached to order your IRS publications. (next page)*

- *Study the important Q-Cards (index cards) we prepared for you. These index cards contain the key information on topics relating to the IRS EA exam.*

- *You are not allowed to bring a calculator into the exam, so practice those computation questions by hand.*

- *Pay more attentions to the computational questions in Section C first. These questions are worth 3 points each and it is important you finish them first. Answer the TRUE/FALSE questions (Section A)) last, because they are worth one point each and you have a 50% chance of picking the right answer.*

- *Many of the questions on Part 4 can be answered using common sense. The IRS likes to ask a few esoteric questions that will not be familiar to you. Read the questions carefully, if the question sounds like it makes sense, mark true.*

- *Most of the true questions in Section A are statements right out of the IRS publications, IRC code, or regulations. Make sure you memorize all those true questions. On the last five year's exams if you had answered true to every questions on Section A, you would have passed that section of the exam.*

Do NOT attempt to learn every specific details of the tax law. You cannot. We have designed this course to give you "enough" tax information to pass all four parts of the exam the first time. The passing grade for last five years exams were between 50% to 58%.

We have prepared you to pass the exam. The rest is on your hands.

GOOD LUCK TO YOUR EXAM & BEST WISHES TO YOUR CARRIER AS AN EA.

Dynasty School

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Special Enrollment Examination *(SEE)*
Study Material-Request and Mailing Label

You may request the SEE Kit by internet: www.irs.gov/pub/irs-fill/f2587.pdf or you may order, free of charge, the IRS publications which provide much of the basic information to assist you in the preparation for the examination. In addition, IRS produces most of the information included in the SEE kit electronically on "The Federal Tax Products" CD-ROM (Publication 1796).

❑ Electronic or CD-ROM (publication 1796) Version of the 2001 See Kit Study Material (plus the Printed Copy Version of Items not included on the CD-ROM).

❑ Please send me the printed Version of SEE kit Study Material and CD-ROM ROM Publication 1796.

Please complete the lower portion of this page and mail it to the address listed below. Please print "SEE " in the lower left front corner of your envelope. (Please do not send this form with your application Form 2587)

Send to: IRS Western Area Distribution Center Rancho Cordova,. CA. 95743-0001

Return label - Fill in your name and address below.

Please expedite shipment of the Special Enrollment Examination Study Material to:

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City___________________________State _______Zip___________

1. PART 1 - INDIVIDUALS

TABLE OF CONTENTS

INTRODUCTION

Part 1 of the exam covers individual returns. The exam consists of three sections: “A” is true or false questions, "B" is multiple choice, and "C" is multiple choice requiring some computation. The exam follows Form 1040 and Publication 17. For example, the first questions in each section will start with issues discussed in Part One of Publication 17 and then work through the publication.

MAIN TOPICS

- ❖ Section A — The Income Tax Return
- ❖ Section B — Income
- ❖ Section C — Gains and Losses
- ❖ Section D — Adjustments, Deductions, Credits, and Taxes

STUDY MATERIALS

The official answers are based on the code and regulations. Generally, the publications reflect the code and regulations and will be sufficient for study purposes.

The following publications will be helpful in preparing for Part 1 of the exam:

Publication	17	Tax Guide For Individuals
Publication	501	Exemptions, Standard Deduction, and Filing Information
Publication	502	Medical and Dental Expenses
Publication	503	Child and Dependent Care Expenses
Publication	504	Divorced or Separated Individuals
Publication	505	Tax Withholding and Estimated Tax
Publication	508	Tax Benefits for Work-Related Education
Publication	523	Selling Your Home
Publication	525	Taxable and Nontaxable Income
Publication	535	Business Expenses
Publication	537	Installment Sales
Publication	544	Sales and Other Dispositions of Assets
Publication	547	Nonbusiness Disasters, Casualties, and Thefts
Publication	550	Investment Income and Expenses
Publication	551	Basis of Assets
Publication	553	Highlights of 20xx Tax Changes
Publication	925	Passive Activity and At-Risk Rules
Publication	926	Employment Taxes for Household Employers

PART 1 - THE INCOME TAX RETURN

1. Filing Requirements

A. General Rules:

If you are a U.S. citizen or resident, whether you must file a federal income tax return depends upon your gross income, your filing status, your age, and whether you are a dependent. The filing requirements apply even if you owe no tax.

You may have to pay a penalty if you are required to file a return but fail to. If you willfully fail to file a return, you may be subject to criminal prosecution.

1. **Gross Income** - All income received in the form of money, property, and services that is not exempt from tax.
2. **Filing Status** - As determined on the last day of the tax year.
3. **Age** - Considered 65 on the day before one's 65th birthday.

B. Exemption:

The amount you can deduct for each exemption has increased from $2,800 in 2000 to $2,900 in 2001.

** Study Tip * An individual must file if gross income equals or exceeds the sum of one's exemption amount and standard deduction. These amounts are used to form the table showing gross income filing requirements.*

C. Gross Income Filing Requirements For Most Taxpayers (Table 1 Pub. 501)

Filing Status	**Age**	**2001 Gross Income**	**2000 Gross Income**
S	Under age 65 Age 65 or older	$7,450 $8,550	$7,200 $8,300
HH	Underage 65 Age 65 or older	$9,550 $10,650	$9,250 $10,350
MFJ	Both under age 65 One spouse 65 or older Both spouses 65 or older	$13,400 $14,300 $15,200	$12,950 $13,800 $14,650

MFS*	Any age	$2,900	$2,800
QW	Under age 65 Age 65 or older	$10,500 $11,400	$10,150 $11,000

No standard deductible allowed.

D. A self-employed individual is required to file if the gross income, including gross business income, is at least as much as the filing requirements for the individual's marital status and age or the net earnings from self-employment is at least **$400**. (see Pub. 533)

Note: If you are self-employed in a business that provides services (where products are not a factor), gross income is gross receipts from that business. If you are self-employed in a business involving manufacturing, merchandising, or mining, gross income is total sales from that business minus the cost of goods sold. To this figure, you add any income from investments and from incidental or outside operations or sources.

E. A taxpayer is required to file in other situations even if the gross income filing requirements are not met.

1. The taxpayer owes any special taxes:

    a) Social Security and Medicare tax on unreported tips,
    b) Uncollected Social Security tax and Medicare tax on reported tips,
    c) Uncollected Social Security on group term life insurance,
    d) Alternative minimum tax,
    e) Tax on an IRA or qualified retirement plan, or
    f) Tax from recapture of investment credit, low-income housing credit, federal mortgage subsidy, or qualified electric vehicle credit.

2. The taxpayer received wages from a church or church related organization exempt from employer Social Security and Medicare tax.

3. The taxpayer received advanced earned income credit payments from an employer.

F. The **gross income filing requirements** is different for dependents.
(See Table 2, Pub. 501: 2000 Filing Requirements for Dependents).

Table 2: 2001 Filing Requirements for Dependents (Pub. 501)

Dependent	2001 Must File If:

Status	
Single, under 65, not blind	You must file a return if any of the following apply • Your earned income was more than $4,550 • Your unearned income was more than $750. • Your gross income was more than the larger of $750 or Your earned income (upto $4,300) plus $250.
Single, 65 or older or blind	• Earned income was more than $5,650 ($6,750 if 65 or over and blind), **or** • Unearned income more than $1,850 ($2,950) if 65 or over and blind), **or** • Gross income was more than the total of earned income (up to $4,300) plus 250 or $750, whichever is larger, plus $1100 ($2,200 if 65 or over and blind).
Married, under 65, not blind	• Gross income at least $5, spouse files MFS and itemizes deductions. • Your earned income was more than $3,800, **or** • Your gross income was more than the larger of $750 or Your earned income (upto $3,550) plus $250.
Married, 65 or older or blind	• Earned income was more than $4,700 ($5,600 if 65 or over and blind), **or** • Unearned income was more than $1,650 ($2,550 if 65 or over and blind), **or** • Gross income was more than the total of earned income (up to $3,550) plus $250 or $750, whichever is larger, plus $900 ($1,800 if 65 or older and blind).

Exercise 1: Rosa, who turned 14 on December 1, 2001, received interest income of $700 during 2001. Rosa did not make any estimated tax payments or have any federal income tax withheld. She had no other income. Rosa is properly claimed as a dependent by her parents. Rosa is required to file an income tax return for 2001. (True or False)

False. For 2001, a return must be filed by any dependent who is single, under age 65, and has received unearned income in the amount of $750 or more.

G. The **standard deductions** for 2001

The standard deduction for an individual for whom an exemption can be claimed on another person's tax return is generally limited to the greater of:

1. $750, or
2. The individual's earned income for the year plus $250 (but not more than the regular standard deduction amount, generally $4,550).

   However, if the individual is 65 or older or blind, the standard deduction may be higher.

See Pub 501: Exemptions: Standard Deduction Charts & Worksheets.

Filing Status	**2001 Amount**	**2000 Amount**
Single (S)	$4,550	$4,400
Married Filing Jointly (MFJ) or Qualified Widow(er) With Dependent Child (QW)	$7,600	$7,350
Married Filing Separately (MFS)	$3,800	$3,675
Head of Household (HH)	$6,650	$6,450

* An additional standard deduction is available for the taxpayer and spouse if age 65 or over or blind. The additional amount for blindness is part of the standard deduction but is not used for determining gross income filing requirements. See chart below. (10311g29.gif, pub 17, ch21.)

2001 Standard Deduction Tables

Caution: If you are married filing a separate return and your spouse itemizes deductions, or if you are a dual-status alien, you cannot take the standard deduction even if you were 65 or older or blind.

Table 21–1. **Standard Deduction Chart for Most People***

IF your Filing Status is ...	Your Standard Deduction is:
Single	$4,550
Married filing joint return or Qualifying widow(er) with dependent child	7,600
Married filing separate return	3,800
Head of household	6,650

*DO NOT use this chart if you were 65 or older or blind, OR if someone else can claim an exemption for you (or your spouse if married filing jointly). Use Table 21-2 or 21–3 instead.

Table 21–2. **Standard Deduction Chart for People Age 65 or Older or Blind***

Check the correct number of boxes below. Then go to the chart.

You 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

IF your Filing Status is ...	AND the Number in the Box Above is ...	THEN your Standard Deduction is:
Single	1 2	$5,650 6,750
Married filing joint return or Qualifying widow(er) with dependent child	1 2 3 4	8,500 9,400 10,300 11,200
Married filing separate return	1 2 3 4	4,700 5,600 6,500 7,400
Head of household	1 2	7,750 8,850

*If someone else can claim an exemption for you (or your spouse if married filing jointly), use Table 21–3 instead.

Table 21–3. **Standard Deduction Worksheet for Dependents***

If you were 65 or older or blind, check the correct number of boxes below. Then go to the worksheet.

You 65 or older ☐ Blind ☐

Your spouse, if claiming spouse's exemption 65 or older ☐ Blind ☐

Total number of boxes you checked ☐

1. Enter your **earned income** (defined below). If none, enter -0-.	**1.** ______
2. Additional amount	**2.** $250
3. Add lines 1 and 2.	**3.** ______
4. Minimum amount	**4.** $750
5. Enter the **larger** of line 3 or line 4.	**5.** ______
6. Enter the amount shown below for your filing status. • Single, enter $4,550 • Married filing separate return, enter $3,800 • Married filing jointly or Qualifying widow(er) with dependent child, enter $7,600 • Head of household, enter $6,650	**6.** ______
7. Standard deduction. **a.** Enter the **smaller** of line 5 or line 6. If under 65 and not blind, stop here. This is your standard deduction. Otherwise, go on to line 7b.	**7a.** ______
b. If 65 or older or blind, multiply $1,100 ($900 if married or qualifying widow(er) with dependent child) by the number in the box above.	**7b.** ______
c. Add lines 7a and 7b. This is your standard deduction for 2001.	**7c.** ______

Earned income *includes wages, salaries, tips, professional fees, and other compensation received for personal services you performed. It also includes any amount received as a scholarship that you must include in your income.*

*Use this worksheet ONLY if someone else can claim an exemption for you (or your spouse if married filing jointly).

Example:
Michael is single. His parents claim an exemption for him on their 2001 tax return. He has interest income of $780 and wages of $150. He has no itemized deductions. Michael uses Table *to find his standard deduction. He enters $150 (his earned income) on line 1, $400 ($150 plus $250) on line 3, $750 (the larger of $400 and $750) on line 5, and $4,550 on line 6. The amount of his standard deduction, on line 7a, is $750 (the smaller of $750 and $4,550).*

Due Dates

A. Form 1040:

1. Calendar year taxpayers should have filed by April 15, each year.

2. Fiscal year taxpayers should file by the 15th day of the 4th month after the close of the tax year.

3 With the automatic 4-month extension obtained by filing Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, a calendar year return is due August 15, each year.

Note: The automatic extension of time to file is not an automatic extension of time to pay.

4 With a second extension obtained by filing Form 2688, Application for Additional Extension of Time To File US individual Income Tax Return, the due date for a calendar year return is October 15, each year. The second extension is for two months and is not automatic. it should be filed early enough to get IRS approval.

B. A special automatic 2 month extension to file and pay is available:

1. if the taxpayer is living outside of the US and the main place of business or post of duty is outside of the U.S., or the taxpayer is in the military or naval services on duty outside of the U.S.

2. By attaching a statement to the return when it is filed.

C. Form 1040NR for Nonresident Aliens:

1. Nonresident aliens with wages subject to U.S. income tax withholding have the same due dates as residents of the U.S.

2. Nonresident aliens who do not have wages subject to U.S. income tax withholding must file by June 15, (calendar year) or by the 15th day of the 6th month after the end of the fiscal year.

D. When the due date for doing any act for tax purposes falls on a Saturday, Sunday, or legal holiday, that act can be done on the next business day.

E. Quarterly estimated payments are due on the 15th day of the 4th, 6th, and 9th month of the current year and the 15th day of the first month after the end of the year.

F. An amended return or claim for refund generally must be filed within three (3) years from the date the original return was filed or within two (2) years from the date the tax was paid, whichever is later. If the original return was filed before the due date, without extensions, the return is considered to be filed on the due date.

G. A balance due on an electronically filed return must have been paid by April 15, to avoid interest and penalties. The payment is submitted with Form 1040-V.

2. Filing Status

A. Single (S) - A taxpayer's filing status is single if that taxpayer is unmarried or separated from a spouse by a divorce or separate maintenance decree and does not qualify for another filing status.

B. Married Filing Jointly (MFJ) - The taxpayers may choose this status if they are married and both agree to file a joint return.

1. Taxpayers are considered married for the whole year if on the last day of the tax year, they are:

a) Married and living together as husband and wife,
b) Living together in a common law marriage that is recognized in the state where they now live or in the state where the common law marriage began,
c) Married and living apart, but not legally separated under a decree of divorce or separate maintenance, or
d) Separated under an interlocutory (not final) decree of divorce.

2. If a taxpayer's spouse died during the year and that taxpayer did not remarry, he or she can file a joint return with the deceased spouse. If the taxpayer did remarry, he or she can file joint with the current spouse, and the deceased individual would file married filing separately

3. If an individual obtains a court decree of annulment, which holds that no valid marriage ever existed, that individual must file as single or head of household, whichever applies. The individual must also amend all prior years affected by the annulment that are not closed by the statute of limitations.

4. Both taxpayers may be held jointly and individually responsible for any tax, interest, or penalty due on a joint return. This applies to divorce situations for any joint return filed before divorce. A divorce decree stating that one spouse will be liable for any amounts due on prior returns will not relieve either spouse of a joint liability.

5. Under certain circumstances, one spouse may not have to pay the tax, interest, and penalties on a joint return. That spouse must establish that he/she did not know, and had no reason to know, that there was a substantial understatement of tax that resulted because the other spouse:

   a) Omitted a gross income item, or
   b) Claimed a deduction, credit, or property basis in an amount for which there is no basis in fact or law.

6. For a return to be a valid joint return, both husband and wife must sign the return.

Exercise 2:
Mr. and Mrs. Jacobs filed their joint 2001 tax return on April 17, 2002. On June 1, 2001, Mr. Jacobs was arrested and charged with embezzling $50,000 cash from his employer during 2001. Mrs. Jacobs was NOT aware of the embezzlement. The $50,000 was NOT reported on their 2001 return as filed. Concerning the understatement of tax, Mrs. Jacobs may NOT be separately liable for ALL additional tax, penalties, and interest due. (True or False)

True. Where a substantial understatement of tax in a joint return is attributable to the grossly erroneous items of one spouse, the other spouse may be an “innocent spouse” and relieved of liability, including interest and penalties, if the innocent spouse had no knowledge of (or reason to know of) the substantial understatement, and, based on all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency.

C. **Married Filing Separately (MFS)** - Taxpayers may choose married filing separately if they are married on the last day of the tax year.

1. The taxpayer reports only his or her income, exemptions, credits, and deductions. The taxpayer may claim an exemption for the spouse if that spouse had no earned income and is not a dependent of another.

2. Limitations if MFS is elected:

   a) If one spouse itemizes, the standard deduction for the other spouse is zero. As such, the other spouse should itemize. There is an exception to the zero standard deduction rule if the other spouse meets the qualifications to be considered unmarried.

   b) Generally, neither spouse can claim the Child and Dependent Care Credit.

   c) A MFS taxpayer is not eligible for Earned Income Credit.

   d) The taxpayer cannot exclude interest from Series EE U.S. Savings Bonds used for higher education.

   e) Unless spouses lived apart the entire year, a MFS taxpayer cannot take the Credit for the Elderly or Disabled.

   f) As MFS, more Social Security benefits may be taxable.

   g) The taxpayer's IRA deduction may be phased out faster.

   h) The offset against nonpassive income from a rental real estate activity with active participation is reduced to $12,500 (lived apart all year) or $0 (lived together at any time during the year).

3. Amending - Taxpayers can amend and change filing status from MFS to MFJ, but generally cannot change from MFJ to MFS after the due date of the return.

D. Qualifying Widow(er) With Dependent Child (QW) - Possible status for two years after the year of the spouse's death. Rules for eligibility:

1. The taxpayer was entitled to file a joint return with the spouse for the year the spouse died.

2. The taxpayer did not remarry before the end of the tax year.

3. The taxpayer has a child, stepchild, adopted child, or foster child who qualifies as a dependent for the year.

4. The taxpayer paid more than half of the cost of keeping up a home that is the main home for the taxpayer and qualifying child for the entire year.

E. Head Of Household (HH) - Applicable if unmarried or considered unmarried on the last day of the tax year, and the taxpayer paid more than half of the cost of maintaining a home for oneself and a **qualifying person** for over one-half of the tax year.

1. Considered unmarried - The taxpayer must meet all of the following tests:

   a) File a separate return,

   b) Pay more than half the cost of keeping up a home for the tax year,

   c) The spouse did not live in the home during the last six months of the year, and

   d) The home was, for *more than half the year*, the main home of the taxpayer's child, stepchild, adopted child, or foster child whom the taxpayer can claim as a dependent. A waiver of exemption or decree of divorce allowing the noncustodial parent to claim the child's exemption does not disallow the HH filing status for the custodial parent.

2. **Qualifying person**:

   a) The taxpayer's child, grandchild, stepchild, or adopted child. A single child does not have to be a dependent; a married child must qualify as a dependent.

   b) Other relatives (must be dependent):

Parent	Step-father	Father-in-law
Grandparent	Step- mother	Mother-in-law
Brother	Step-brother	Brother-in-law
Sister	Step-sister	Sister-in-law
Half brother or sister	Son-in-law	Daughter-in-law

   Foster child if other rules are met.
   If related by blood: Nephew, Niece, Uncle, or Aunt.

   c) A parent does not have to live with the taxpayer if the taxpayer paid more than half the cost of maintaining the parent's home for the entire year. This includes paying more than half the cost of keeping a parent in a rest home or home for the elderly.

3. Keeping up the home (must pay over half of the cost of upkeep).

a) Costs include: rent, mortgage interest, taxes, insurance on the home, repairs, utilities, food eaten in the home, or other expenses related specifically to the home.

b) **Costs do not include**: clothing, education, medical, vacations, life insurance, transportation, rental value of home, or the value of taxpayer services.

Exercise 3: Malcolm and Glenda who are legally married lived apart beginning June 1, 2001. Their one minor child lived with Glenda all of 2001. Glenda worked all year and provided more than half the cost of keeping up the home for herself and her minor child Glenda signed Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, allowing Malcolm to claim the exemption for their child on his separately filed return. Glenda's proper filing status is:

A. Single
B. Married filing jointly
C. Married filing separately
D. Head of household

D. Head of household. A divorced or single parent who otherwise qualifies is entitled to head-of-household filing status even if she is not entitled to the exemption because of a waiver.

3. Personal Exemptions and Dependents

A. **Personal Exemptions** - Each taxpayer is entitled to claim one exemption for himself or herself and if married, one exemption for his or her spouse.

1. If the taxpayer is eligible to be claimed as a dependent on another person's return, the taxpayer is not allowed his or her own personal exemption.

2. Special rules apply if MFS. A spouse is never considered a dependent, however, if the taxpayer's spouse has no gross income and cannot be claimed as a dependent on another person's return, the taxpayer filing MFS can claim the personal exemption for the spouse.

B. **Dependency Tests** - A taxpayer is allowed one exemption for each person he or she can properly claim as a dependent. A person is a dependent if all **five** (5) of the dependency tests are met.

1. **Member of Household or Relationship test**:

   a) Member of Household - The person must live with the taxpayer the entire year as a member of the household.

      (1) Before a legal adoption, a child placed with the taxpayer is considered the taxpayer's child if placed there by an authorized agency. If not an authorized agency, the child must live with the taxpayer the entire year.

      (2) A foster child or adult must live with the taxpayer the entire year (not eligible as dependent if the taxpayer is receiving foster care payments).

      (3) A cousin will qualify if living with the taxpayer the entire year.

      (4) An individual temporarily absent due to special circumstances (education, illness, military, etc.) will still be considered as a member of the household.

      (5) A person who died during the year, but was a member of the household until death, will meet the test. A person who is born during the year and lived in the household the rest of the year will meet the test.

      (6) A person does not meet the test if at any time during the year the relationship between the taxpayer and the other person violates local law.

   b) **Relationship test** - The person does not have to live with the taxpayer.

      (1) Eligible persons include: child, grandchild, step child, legally adopted child, brother, sister, step-brother, step-sister, half-brother, half-sister, parent, grandparent, other direct ancestor, step parent, aunt, uncle, father-in-law, mother-in-law, sister-in-law, brother-in-law, son-in-law or daughter-in-law.

      (2) Any of these relationships established by marriage are not ended by death or divorce.

2. **Citizenship test** - The person must be a U.S. citizen, resident, national, or a resident of Canada or Mexico for some part of the calendar year in

which the taxpayer's tax year begins. Children are usually citizens or residents of the country of their parents.

3. **Joint Return test** - A dependency exemption is generally not allowed if the dependent files a joint return with his or her spouse. If the other tests are met, the taxpayer may take a dependency exemption if:

   a) Neither the dependent nor the dependent's spouse are required to file a return,

   b) Neither the dependent nor the spouse would have a tax liability if they filed separate returns, and

   c) They only file a joint return in order to get a refund of tax withheld.

4. **Gross Income test** - A dependency exemption is not allowed if the person had gross income equal to or more than his or her exemption amount. The gross income for 2001 is $2900 (see Pub. 501). The gross income test does not apply to a child under age 19 or a full-time student under age 24.

   a) Gross income includes all income in the form of money, property, and services that is not exempt from tax.

   b) A full-time student is a person who is enrolled for the number of hours or courses the school considers to be full-time attendance. The individual must be a student for some part of each of five (5) calendar months during the calendar year.

5. **Support test** - The taxpayer must provide over one-half of the individual's total support during the calendar year. Total support includes amounts spent by that individual. In figuring total support, include tax exempt income, savings, borrowed funds, and any other amounts actually used for support.

   a) Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. Expenses not directly related to one person, such as food costs, must be allocated to all family members. Lodging means the fair rental value of the room, apartment, or house in which the person lives.

Exercise 4:
Ms. Clark purchased a color television set for $250 as a birthday present for her 12-year-old son. The television set is placed in his bedroom. For purposes of

whether Ms. Clark is able to claim her son as a dependent, she should include the cost of the television set in the total support of her son. (True or False)

True. The fair market values of capital items, such as furniture, appliances, and cars, that are bought for a person during the tax year may be included in the dependency support computation.

b) Support does not include income taxes, Social Security taxes, and Medicare taxes paid by the individual; life insurance premiums; funeral expenses; scholarships for full-time student; or survivor and dependent educational assistance.

c) If no one individual provides over half of a person's support but two or more individuals, each of whom would be able to take the exemption but for the support test, together provide more than half of the person's support, a multiple support agreement can be used. Any one individual who provides more than 10% of the support can claim the exemption if the other providers consent and sign a multiple support agreement.

Exercise 5:
For 2001, Mr. and Mrs. Randall filed a joint return. During 2001 they provided more than 50% support for the following individuals:

- *The Randall's single son, age 18, was a full-time student for four months. He lived with them all year and he earned $3,500 which was spent on his support.*
- *The Randall's single daughter, age 25 and a full-time student for twelve months, lived with them all year. She earned $2,400 which was spent on her support.*
- *The Randall's granddaughter, age 3, who lived with them from June to December.*
- *Mrs. Randall's mother, age 68, a Canadian citizen living in Canada received social security benefits of $3800.*
- *Mrs. Randall's cousin, age 16, lived with them all year and earned $1,200 which was spent on her support.*

How many exemptions may Mr. and Mrs. Randall claim on their 2001 tax return?

A. 7
B. 6
C. 5
D. 4

A. 7. While Mrs. Randall's cousin fails to satisfy the relative requirement because she is only a cousin, she qualifies as a dependent because she was a member of the taxpayer's household for the entire year.
Although the son's earned income ($3,500) was in excess of the 2001 exemption ($2,900), he qualifies because he had not yet attained the age of 19 before December 31, 2001.
While Mrs. Randall's mother's income ($3,800) exceeded the 2001 deduction amount, her full income from Social Security, which is ordinarily excluded from gross income, is disregarded.

6. An alternate support test is applied for divorced or separated parents.

   a) The custodial parent is considered to provide more than one-half of the child's total support (it does not matter whether that parent actually provided more than half) if the following conditions are met:

      (1) The parents are divorced or legally separated under a decree of divorce or separate maintenance, separated under a written separation agreement, or lived apart at all times for the last six (6) months of the year;

      (2) One or both parents provide over half of the child's total support for the calendar year; and

      (3) One or both parents have custody of the child for more than half of the year.

   b) Custody is usually determined by the terms of the most recent decree of divorce or separate maintenance. If there is no decree, then the written separation agreement applies. If neither is available, then the parent who has physical custody of the child for the greater part of the year is considered to have custody of the child.

NOTE: Joint custody seldom works out exactly equal when counting hours per day that each parent has custody. If exactly even, then neither parent has custody for "more than one-half of the year."

   c) The noncustodial parent will be treated as providing more than half of the child's support if:

      (1) The custodial parent signs a written declaration that he or she will not claim the exemption for the child and the noncustodial parent attaches it to his or her return (Form

8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, is available for this purpose),

(2) A decree or agreement executed after 1984 unconditionally states that the noncustodial parent can claim the child as a dependent, or

(3) A decree or agreement executed before 1985 provides that the noncustodial parent is entitled to the exemption and he or she provides at least $600 for the child's support during the year.

d) Support provided by a third party for a divorced or separated parent is not included as support provided by that parent.

e) If remarried, support provided by the new spouse is included as support provided by that parent.

f) The amount of support provided by the noncustodial parent is not reduced by any back child support owed. Any payment of back child support is not support provided for either the year accrued or for the year paid.

C. Effective 1997, a Social Security number is required for any dependent claimed on a tax return. Taxpayers who claim dependents living in Mexico or Canada must have Social Security numbers for these dependents.

4. Decedent's Return

A. The same filing requirements that apply to individuals determine if a final return is required for a decedent.

B. When filing for a decedent, write "DECEASED", the decedent's name, and the date of death across the top of the tax return.

C. If a personal representative has been assigned, the personal representative must sign the return. If the return is a joint return with the surviving spouse, the surviving spouse must also sign the return. With no personal representative or surviving spouse, the person in charge of the decedent's property must file and sign as "personal representative".

D. For any filer other than a surviving spouse, Form 1310 must be filed to claim a refund for a decedent.

Exercise 6: John Smith, whose father died June 15, 2001, is the executor of his father's estate. John is required to file a final income tax return for his father. When is this return due if he does NOT file for an extension?

A. October 17, 2001
B. March 15, 2002
C. April 17, 2002
D. June 15, 2002

C. April 17, 2002. The last date for filing an income tax return for a calendar-year decedent who died in 2001 (absent extensions) is April 17, 2002.

5. Estimated Tax

A. General Rule - A taxpayer is required to make estimated payments if he or she expects to owe at least $1000 in tax for year 2001 and after, after subtracting withholding and credits, and expects withholding and credits to be less than the smaller of:

1. 90% of the tax to be shown on the current tax year return, or

2. 110% of the tax shown on your previous year tax return. The previous year return must cover 12 months.

B. Exceptions
There are exceptions to the general rule if you are a farmer or fisherman, and certain higher income taxpayers. See Publication 505 for more information.

C. No estimated tax payment is required if the taxpayer had no tax liability for the previous tax year (tax was zero or the taxpayer was not required to file); the taxpayer was a U.S. citizen or resident for the whole year; and the previous tax year covered a 12-month period.

D. For most taxpayers, estimated tax payments are due April 15, June 15, and September 15 of the current year, and January 15 of the next year. Farmers and fishermen have only one payment due date, January 15 (calendar year filers). They would then file their return by April 15. Those who file by March 1 and pay all of the tax owed, do not need to pay estimated tax.

Exercise 8:

All of the following individuals file their income tax returns as single. Which is required to make estimated tax payments for 2002?

A. Ms. Salinas, who had no tax liability for 2001 expects to owe $1,200 self-employment tax for 2002 (she has no withholding tax or credits).
B. Mr. Lane, who had a $1,000 tax liability for 2001 expects $1,100 tax liability for 2002 and withholding of $900.
C. Ms. Givonni who had a $4,000 tax liability for 2001 expects a tax liability of $4,400 for 2002 with $3,900 withholding.
D. Mr. Charles, who had a 2001 tax liability of $10,000 expects a tax liability of $19,500 for 2002 with $10,500 withholding.

C. Ms. Givonni, who had a $4,000 tax liability for 2001, expects a tax liability of $4,400 for 2002 with $3,900 withholding.
Ms. Salinas is not required to make estimated tax payments because she had no tax liability in 2001;
Mr. Lane is not required to make estimated tax payments because the difference between his withholding and his tax liability for 2001 is less than $1000;
Mr. Charles is not required to make an estimated tax payments because the amount withheld for 2002 was at least as great as his tax liability for 2001.

E. Underpayment Penalty - If the taxpayer did not have enough paid in through withholding and estimated tax, a penalty can be assessed.

1. General rule:

a) A taxpayer may owe a penalty for the tax year if the total of withholding and estimated tax payments did not equal at least the smaller of 90% of the tax year's tax or 100% of the previous tax year.

b) The penalty is computed on Form 2210. Form 2210 does not have to be filed unless:

(1) The taxpayer requests a waiver.

(2) The taxpayer uses the annualized income installment method.

(3) The taxpayer uses the actual withholding for each period.

(4) The taxpayer based any installment on previous year tax information and filed a joint return in either previous year or this year, but not both.

2. The taxpayer will generally not have a penalty if:

   a) Total withholding and estimated tax payments were at least as much as the previous year's tax and special rules do not apply,

   b) The balance due is less than 10% of the total this year's tax and all estimated payments were timely,

   c) This year's tax minus withholding is less than $1000, or

   d) The taxpayer did not owe tax for previous year (an individual had no tax liability if the total tax was zero or the individual was not required to file).

PART 2 – INCOME

Income Items

Generally Include	Generally does NOT include
Alimony	Accident and health insurance proceeds
Bartering income	Child support payments
Canceled debt income	Gifts and inheritances
Dividends	Housing allowance for clergy
Gain on the sale of personal items	Interest on state and local government obligations
Gambling winnings	Life insurance proceeds
Income from activity not for profit	Meals and lodging provided by employer
Interest	Military allowances
Part of Social Security/Railroad Retirement benefits	Part of scholarships and fellowship grants
Pensions and annuities	Part of Social Security/Railroad Retirement
Recoveries of amounts previously deducted	Veterans' benefits
Rental income	Welfare and other public assistance benefits
Royalties	Workers' compensation or similar payments for sickness/injury
Share of estate and trust income	
Share of partnership or S Corp. income	
Tips	
Wages, salaries, and other earnings	

6. Accounting

A. Cash basis taxpayers report all items of income in the year in which actually or constructively received.
Income is constructively received when it is credited to one's account or set apart in a way that makes it available to the taxpayer. Constructive receipt includes the following:

1. Garnished wages used to pay the taxpayer's debts,
2. Profits from brokerage or other similar accounts when earned,
3. Debts canceled or paid by another,
4. Amounts paid to a third party on the taxpayer's behalf
5. Income received by a taxpayer's agent is considered received in the year the agent receives it, and
6. A valid check received or made available even if not cashed.

B. Accrual-basis taxpayers report income in the year earned, whether or not actually received.
If income is received under an agreement to perform services by the end of the

next tax year, the taxpayer can elect to defer an advance payment, but not later than the year following the year received.

C. Once a method is adopted, IRS permission is usually required to change. A taxpayer can use a different method for each business.

Exercise 9:
Income was actually or constructively received in 2001 in each of the following situations except:

A. Earned income of a taxpayer was received by his agent on December 26, 2001, but not received by the taxpayer until January 3, 2002.
B. Taxpayer was informed his check for services rendered was available on December 29, 2001, but he waited until January 10, 2002, to pick up the check
C. Taxpayer received a check on December 31, 2001 for services rendered, but was unable to make the deposit until January 2, 2002.
D. A payment on the sale of real property was made to an escrow account on December 28, 2001, but the payment was not received by the taxpayer until January 15, 2002 when the transaction was closed and the buyer authorized release of the money held in escrow.

D. A payment on the sale of real property was made to an escrow account on December 28, 2001, but the payment was not received by the taxpayer until January 15, 2002, when the transaction was closed and the buyer authorized release of the money held in escrow. Where a contract of sale is executed subject to conditions as to title, and the purchase money is placed in escrow, income on the sale is not taxable until the purchasers have found the title satisfactory and authorized release of monies held in escrow.

7. Wages, Salaries, and Other Earnings

A. Employee Compensation

Employee compensation generally includes anything received in payment for services. It includes (but is not limited to) the following:

1. Advance commissions and other amounts for services to be performed in the future.

2. Back pay awards - Amounts awarded in a settlement or judgment for back pay, including unpaid life insurance premiums, and unpaid health insurance premiums.

3. Bonuses and awards paid for outstanding work. If the prize or award is in the form of goods or services, the fair market value is included in income.

4. Holiday gifts if cash, a gift certificate, or similar item convertible to cash. If the employer gives a turkey, ham, or other item of nominal value as a holiday gift, the value is not income.

5. The excess of an allowance or reimbursement over the expense of travel or other transportation.

6. An advance, allowance, or reimbursement of nondeductible moving expenses and any amounts received for deductible expenses if under a nonaccountable plan.

7. If property is purchased from one's employer for less than fair market value, the difference between the FMV and amount paid is included in wages.

8. Severance pay is taxable as wages. When retiring on disability, a lump-sum payment for accrued annual leave is wages.

9. Sick pay and short term disability. If the taxpayer paid the premiums on an accident or health insurance policy, the benefits received under the policy are not taxable.

10. Social Security and Medicare taxes paid for by the employer and not withheld are treated as additional wages.

11. Stock appreciation rights when exercised. When exercised, the taxpayer should receive a cash payment equal to the amount by which the FMV of the stock on the date of exercise has increased over the FMV on the date the right was granted.

12. Unemployment compensation, which is any amount received under an unemployment compensation law of the United States or a state, is taxable but not treated as wages.

    a) Supplemental unemployment benefits received from a company-financed fund are not unemployment compensation but should be treated as wages.

    b) Unemployment benefit payments from a private fund to which the taxpayer voluntarily contributes is taxable to the extent the total amount received is more than the total payments. Taxable benefits are included in gross income on line 21, Form 1040.

c) Benefits to an unemployed union member paid out of union dues are included as gross income on line 21, Form 1040.

13. Union benefits and dues deducted from an employee's pay are still included in gross wages.

14. Property received for services is generally included in income at the property's fair market value. If the taxpayer receives stock or other property that has certain restrictions that affect its value, the value is not included in income until it has been substantially vested. Until the property becomes substantially vested, it is treated as still owned by the person who made the transfer. Income from such property is included in the year received, such as dividends on restricted stock. Property is substantially vested when:

a) It is transferable, or

b) No longer subject to a substantial risk of forfeiture.

B. Fringe Benefits

The value of fringe benefits received from an employer is taxable and must be included as compensation unless the benefits are specifically excluded by law or the taxpayer pays fair market value for them.

1. Excludable fringe benefits include:

a) No-additional-cost-service is typically a service offered to employees which is the same as that offered to customers in the ordinary course of the line of business in which the employee works. Generally, the employer will not have any substantial additional cost. Examples: excess capacity airline ticket or a hotel room while on duty.

b) Qualified employee discount is a price reduction given to employees on certain property or services offered to customers in the ordinary course of the line of business in which the employees perform services.

c) Working condition fringe is the value of property or services that an employee could deduct as a trade or business or depreciation expense if paid for by that employee. This may include the business use portion of an employer vehicle or total use of a qualified nonpersonal use vehicle.

d) De minimis fringe is any property or service that has so small a value that accounting for it would be unreasonable or administratively impractical. Examples could include the personal use of the copy machine or coffee and doughnuts furnished to employees.

e) On premises gym or other athletic facility if substantially all use is by employees, spouses, or dependent children.

f) Health insurance coverage or payments to employees under a self-insured medical reimbursement plan.

g) Payments up to $5,000 for qualified dependent care assistance.

h) Benefits elected under a cafeteria plan.

i) Employer contributions to a qualified retirement plan.

j) Meals and lodging if provided at the employer's place of business, provided for the employer's convenience, and required as a condition of employment.

k) Qualified transportation fringe up to certain limits.

(1) A qualified transportation fringe is:

(a) Transportation in a commuter highway vehicle between the employee's home and work place,
(b) A transit pass, or
(c) Qualified parking.

(2) Cash reimbursement under a qualified plan is also excludable.

(3) The exclusion for transportation (vanpool) and a transit pass cannot exceed $65 per month. The exclusion for qualified parking cannot exceed $175 per month.

l) The cost of up to $50,000 group term life insurance coverage. The cost of insurance in excess of $50,000, reduced by the amount the employee pays, is included in income. The entire cost is included in income if the coverage is provided through a qualified trust, such as a pension plan.

2. Certain exclusions are denied if the employer discriminates in favor of highly compensated employees or key employees.

C. Disability Income

1. If retired on disability, any amount received for disability through an accident and health plan paid for by the employer is includable in income.

2. If the employee contributed to the cost of the plan, only the proceeds attributable to the employer's cost are included in income.

3. If retired on disability, any lump sum payment received for accrued annual leave is a salary, not a disability payment.

D. Pension and Annuity Contributions

1. Employer contributions to a qualified retirement plan are not income to the employees when the contribution is made. Employee contributions, such as through payroll deduction, are included in income.

2. Employer contributions to a non-qualified plan are included in income when the contribution is made or when the employee has a nonforfeitable right to the funds, whichever occurs later.

E. Special Rules for Certain Employees

1. Clergy

a) In addition to a salary (W-2 income on line 7, Form 1040, not on Sch. C), a member of the clergy must also include offerings and fees received for marriages, baptisms, funerals, masses, or any other payment for a service provided. These additional payments will be reported on Schedule C.

b) Do not include in income the rental value of a home provided to the clergy member. Also exclude a housing allowance paid as part of salary to the extent the allowance was used to provide a home or pay utilities for a home. Such amount must be officially designated by the employer before such payment is made. The amount that can be excluded cannot exceed the fair rental value of the home plus the cost of utilities, regardless of how much is designated as a housing allowance.

c) Both the salary and housing are included for determining self-employment tax.

d) A properly designated housing allowance provided to retired clergy is excluded from income and self-employment tax.

Exercise 10: During 2001, Alan, an ordained minister, received a salary of $10,000, a designated housing allowance of $12,000, and $500 for marriages performed which he donated to his church. ALL of the housing allowance was used for mortgage payments including taxes and insurance. Alan itemized deductions and deducts the mortgage interest and real estate taxes on the home. What amount must Alan include in gross income on his 2002 income tax return?

A. $10,000
B $10,500
C. $22,000
D. $22,500

B. $10,500. A member of the clergy must include in income any compensation received in exchange for services rendered. Rental value of a dwelling house furnished to an ordained minister as part of compensation is excludable from gross income.

2. A U.S. citizen or resident reports total worldwide income.
If a U.S. citizen is employed by a foreign government, an international organization, a foreign embassy, or any foreign employer, the taxpayer must consider any salary as income. (May be eligible for exclusion).

3. A majority of the payments received as a member of the military are included in taxable income. Exclusions include:

   a) Certain allowances, such as subsistence, uniform, and quarters allowances. Certain payments or services provided, as related to a spouse or dependent are generally excluded.

   b) A member of the U.S. Armed Forces who serves in a combat zone may exclude certain pay from income. A combat zone is an area so designated by the President in an executive order.

4. Veterans' benefits under any law, regulation, or administrative practice that was in effect on September 9, 1986, and administered by the Department of Veterans Affairs, are not included in gross income.

8. Tip Income

A. A taxpayer must report all tip income as wages. Tips include non-cash items such as passes, tickets, goods, or services.

B. A daily record or other documentation is needed to prove the amount of tip income. Records should contain appropriate identifying information for the taxpayer and the employer. For each workday, the taxpayer will identify cash tips received directly from customers, credit card tips when received from employer, amounts paid out to other employees through tip splitting, and identification of others with whom tips were split.

C. Report tips to the employer by giving the employer a written statement of tips for each month by the 10th day of the next month. Reporting is required for each month the taxpayer receives tips of $20 or more while working for that employer. A total less than $20 per month does not have to be reported to the employer but is still includable in income.

D. Withholding for income tax, Social Security tax, and Medicare tax is required for tips reported to the employer. If an employee's pay check is insufficient to cover the amount required to be withheld, the uncollected amount will be reported on the W-2, and the employee is required to include that amount on the tax return.

E. Allocated tips is an amount the employee is deemed to have received but did not report, while employed at a large food and beverage establishment. Allocated tips are shown on the W-2. They are taxable unless the taxpayer has adequate records to prove otherwise.

F. All cash, check, or charge card tip income is subject to Social Security and Medicare tax. Form 4137, Social Security and Medicare Tax on Unreported Tip Income, will be used to report all tip income and calculate Social Security and Medicare tax. The amount reported on Form 4137 will include all tips reported to the employer, all unreported tips, and allocated tips. Social Security and Medicare tax will be calculated on the amounts for which there was no withholding.

9. Interest Income

A. General Information

1. Seller-financed mortgage - If a seller finances the sale of a home, the seller must report the buyer's name, address, and Social Security number on line 1 of Schedule B (or Schedule 1).

2. Tax-exempt interest must be shown on the return even though not subject to income tax.

Exercise 11: During the tax year Jeff received tax-exempt interest income of $200 from municipal bonds. Jeff's NOT required to report the $200 on his income tax return. (True or False)

False. Although interest from tax-exempt municipal bonds is generally not taxable, the amount of interest received must be reported on the taxpayer's return.

3. Interest income is portfolio income. Portfolio income cannot be used to offset passive activity losses.

4. If a child is under age 14, has more than $1,400 of investment income and is required to file a return, and either parent is alive at the end of the year, part of that child's investment income may be taxed at the parent's tax rate. Form 8615 is used for this purpose. Investment income of a child under age 14 may be reported by the parents on their tax return by filing Form 8814, Parents' Election to Report Child's Interest and Dividends.

5. A taxpayer must give his or her Social Security number to any entity required by federal law to make a return, statement, or other document that relates to that taxpayer. If an account is held jointly with another person, the Social Security number given should be that of the first person listed on the account.

6. Interest income is subject to **31% backup withholding** if name and Social Security number are not verified.

7. Report all interest income, whether reported on 1099-INT or not. If received as a nominee, a subtraction is taken on Schedule B.

8. A taxpayer can exclude any interest credited during the year on frozen deposits that could not be withdrawn by the end of the year. The Form 1099 amount is reported on Schedule B and the "Frozen Deposit" amount is then subtracted on Schedule B. The amount that can be excluded is the interest that is credited on the frozen deposits minus the net amount withdrawn from these deposits during the year and the amount that could have been withdrawn as of the end of the year.

Example:
$100 of interest was credited on your frozen deposit during the year. You withdrew $80 but could not withdraw any more as of the end of the year. Your net amount withdrawn is $80. You must exclude $20. You must include $80 in your income for the year.

B. Taxable Interest

1. Includes, but is not limited to, interest received from bank accounts, interest on loans made to others, certain dividends, gifts for opening an

account, interest on insurance dividends, interest on U.S. obligations, interest on tax refunds, and installment sale interest.

2. Certain distributions commonly called dividends are actually interest. This includes amounts from:

    a) Cooperative banks,
    b) Credit unions,
    c) Domestic savings and loan associations,
    d) Federal savings and loan associations, and
    e) Mutual savings banks.

3. Interest is generally taxable when credited to the taxpayer's account and available for use.

4. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States, is taxable for federal income tax purposes but is exempt from all state and local income tax.

5. U.S. Savings Bonds

    a) A cash basis taxpayer will generally report interest on U.S. Savings Bonds when it is received. An accrual basis taxpayer must report the interest when it accrues.

    b) Series H and Series HH are issued at face value. Interest is paid twice per year by check or direct deposit. Cash basis taxpayers must report interest income in the year received.

    c) Series F and Series FE are issued at a discount. The difference between purchase price and face amount payable at maturity is taxable interest. One can report the increase in redemption value as interest each year or postpone reporting any interest until the bond is cashed or matures.

        (1) A switch from the postponed reporting to reporting the interest each year can be done without IRS permission. All interest accrued and not previously reported is reported in the year of change.

        (2) A switch from yearly reporting to postponed reporting can be accomplished by filing Form 3115, Application for Change in Accounting Method. The form is attached to the return timely

filed for the year of change, and permission is considered automatically granted.

d) If bonds are co-owned, the interest is taxable to the individual whose funds were used to purchase the bond. This is true even if another co-owner cashes the bond and receives the Form 1099.

e) If the original purchaser has the bonds reissued in another person's name, the original purchaser must include in income all interest earned to date which was not previously reported. This also applies to transferring a Series E/EE bond to a trust.

f) If transferred due to death, the time to report interest depends on the accounting and reporting method used by the decedent. If the accrual method was used, or the cash method with the election to report interest each year, the interest earned during the year up to the date of death must be reported on the decedent's final return. If the cash method and deferred reporting was chosen, the surviving spouse or personal representative can elect to report all interest earned up to the date of death on the decedent's final return. If this election is not made, the income earned up to the date of death is income in respect of a decedent and not reported on the final return. The beneficiary, if using the cash method, may elect to report interest as earned or defer reporting until maturity.

g) No taxable income is recognized on the transfer of Series B/EE for R/HH unless cash was received in the trade. When the H/HH bond matures, the taxpayer reports as interest the difference between the redemption amount and the cost.

h) Interest on Series EE bonds issued after 12/31/89 may be excluded under the Education Savings Bond Program if redemption proceeds are used to pay qualified higher education expenses during the same year. The purchaser must be at least age 24 (or the taxpayer's spouse if co-owned) and the bond is issued in the taxpayer's name. The exclusion is not available if filing as MFS.

(1) Eligible expenses are tuition and fees required for the taxpayer, spouse, or dependent.

(2) All current year's interest may be excluded if total expenses exceed proceeds. If proceeds are more, the excludable amount is based on a fraction. The numerator is the qualified higher education expenses paid during the year. The denominator is the total redemption proceeds received.

(3) Form 8815 is used to calculate and report the interest exclusion and compute modified AGI.

Example:
In April 2001, Mark and Joan, a married couple, cashed qualified Series EE U.S. Savings Bonds they bought in November 1997. In 2001, they helped pay for their daughter's college tuition. They received proceeds of $5,800, representing principal of $5,000 and interest of $800. They qualified higher education expenses they paid during 2001 totaled $4,000. They can exclude $552 ($800 x ($4,000 / $5,800)) of interest in 2001.

6. If the taxpayer is receiving life insurance proceeds in installments, part of each payment is includable as interest income. Divide the amount held by the insurance company by the number of payments to be received. The amount of each payment in excess of this result is interest.

   a) If payments are to be received over the beneficiaries life, the divisor is the life expectancy.

   b) If a spouse died before October 23, 1986 and the taxpayer is receiving insurance proceeds in installments, the taxpayer is eligible to exclude up to $1,000 of interest per year. This is in addition to the part of the each payment which is excludable as a recovery of the lump-sum payable at death.

Example:
The lump-sum payable at death is $75,000. The beneficiary elects to receive the payment in installments over the next ten years. The insurance company agrees to pay $10,000 for each of these years. The yearly interest is $2,500 ($10,000 - ($75,000 / 10)).

7. **Original issue discount (OID)** is a form of interest includable in income when it accrues whether or not the payments are received. OID usually results when a long-term debt instrument is issued for a price that is less than its stated redemption price at maturity. The amount of OID is the difference between the principal amount and the issue price of the instrument. The taxpayer can disregard the discount and treat it as zero if it is less than one fourth of one percent (.25%) of the stated redemption price at maturity.

8. State and local government interest is normally exempt from federal tax.

Example:

The taxpayer bought a ten-year bond with a stated redemption price at maturity of $1,000, issued at $980 and having OID of $20. One-fourth of 1% of the stated redemption price of $1,000 ($1,000 x .25%) times 10 (the number of full years from the date of original issue to maturity equals $25. Because the $20 discount is less than $25, the taxpayer can disregard reporting OID.

Exercise 12: All of the following are taxable interest income except:

A. Original Issue Discount
B. Dividends received on a credit union account
C. Fair market value of a gift received for opening a savings account
D. Series F Bonds traded for Series HH Bonds and no cash was received.

D. Series E Bonds traded for Series HH Bonds and no cash was received. Owners of Series E bonds who exchange such bonds for Series H bonds and elect to defer Series E bond interest for tax purposes are not required to report such interest until the Series H bonds are redeemed, disposed of, or mature, whichever comes first.

C. Interest Exclusion

The interest exclusion is limited if your modified adjusted gross income (modified AGI) is:

- $53,100 to $68,100 for taxpayers filing single or head of household, and
- $79,650 to $109,650 for married taxpayers filing jointly or for a qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

D. When To Report Interest

1. Cash method taxpayers generally report interest income in the year that it is actually or constructively received. Interest is constructively received when it is credited to the taxpayer's account or made available to the taxpayer.

2. Accrual method taxpayers report interest when it is earned.

Exercise 13: Ms. Smith's books and records reflect the following for the year 2001:

Salary	*$35,000*
Interest on money market account	*$1,000*
Interest on money from a long-term savings plan	*$500*

where interest cannot be withdrawn until December 31, 2001, but principal can be withdrawn at any time (she has principal of $5,000 and accumulated interest of $700)

What is the amount Ms. Smith must include in her gross income for 2000?

A. $35,000
B. $35,500
C. $36,000
D. $36,500

B. $35,500. Salary is included is gross income. Interest credited on a savings account is taxable to an accrual basis and a cash basis taxpayer when credited.

E. How to Report Interest Income

1. Part 1 of Schedule B is required if filing Form 1040 and any of the following apply:

   a) Taxable interest is more than $400,

   b) Excluding Educational Savings Bond interest,

   c) Received interest from a seller financed mortgage,

   d) Received Form 1099-INT for tax-exempt interest,

   e) Received interest as a nominee,

   f) Reporting OID different than what is shown on Form 1099-OID, or

   g) Electing to reduce bond interest by amortizable bond premiums.

2. The taxpayer will report the full amount of interest received as a nominee for another individual on Schedule B. The nominee amount is then shown as a separate item below the subtotal and reduces taxable interest.

3. A withdrawal from a time savings may result in a penalty. The taxpayer must include in gross income the interest paid or credited to his/her account without subtracting the penalty. The penalty is deducted on Form 1040, line 28.

10. Dividends and Other Corporate Distributions

A. A taxpayer that receives a dividend distribution as a nominee for another should issue a Form 1099-DIV to that other person.

B. Dividends from a regulated investment company or real estate investment trust may be declared in October, November, or December, payable on a certain day of such month, but not received until January of the following year. Such dividends are considered received by December 31 and included in income for the current year.

C. Ordinary dividends are paid out of the earnings and profits of a corporation and are taxed as ordinary income.

1. Dividends paid on stock held as joint tenants, tenants by the entirety, or tenants in common should be reported proportionately by each co-owner.

2. Dividends may be used to purchase more stock under a dividend reinvestment plan.

    a) The dividend is included in income if the price paid to purchase the additional stock is equal to fair market value.

    b) If stock is purchased for less than fair market value, the taxpayer must report as income the fair market value of the stock on the dividend payment date.

    c) If the plan also allows the taxpayer to invest more cash to purchase additional shares at less than fair market value, the taxpayer must report the difference between the cash invested and the fair market value of the stock received.

Exercise 14: E-Z Corporation, which has a dividend re investment plan, paid dividends of $20 per share during the year. Carlos, who owned 100 shares of E-Z Corporation prior to the distribution, participated in the plan by using ALL the dividends to purchase 20 additional shares of stock. He purchased the stock for $100 per share when the fair market value was $125 per share. How much dividend income must Carlos report on his income tax return?

A. $2,500
B. $2,000
C. $500
D. $0

A. $2,500. Shareholders who elect to receive shares of greater value than their dividends under a dividend reinvestment plan receive taxable distributions to the extent of the fair market value of their shares.

3. Dividends include amounts paid on money market funds and payments on stock of savings and loan associations. Statements frequently call this interest but this amount should be reported as dividends.

D. Capital gain distributions are dividends paid by regulated investment companies, mutual funds, and real estate investment trusts. These distributions should be reported as long term capital gain regardless of how long the taxpayer owned the stock.

1. The taxpayer must also include any amounts that the investment company or mutual fund credited as a capital gain distribution even though not actually received.

2. The taxpayer can file Form 2439, Notice to Shareholders of Undistributed long-term Capital Gain, to take a credit for any tax that the investment company or mutual fund paid for the taxpayer on undistributed capital gains.

3. The taxpayer would increase the basis in stock by the difference between the amount of undistributed capital gain that is reported and the amount of the tax paid by the fund.

Exercise 15: Mr. and Mrs. Cone are investors in a mutual fund which is NOT part of a qualified retirement plan. For 2001, the fund notified them that it had a/located an $8,500 capital gain to their account. Of this total, $7,500 was distributed in 2001. In addition, the fund paid $500 federal tax on their behalf what is the correct amount of long-term capital gain that the Cones should report on their 2001 tax return?

A. $9,000
B. $8,500
C. $7,500
D. $0

B. $8,500. Capital gains dividends are reportable as long-term capital gains, regardless of how long the shareholder may have owned the stock in the mutual fund.

E. Nontaxable Distributions

1. A return of capital reduces the basis of the taxpayers stock. This is an amount that is not paid out of the corporation's earnings and profits (thus not a dividend) and is not taxed until the basis in stock is fully recovered. Return of capital distributions in excess of basis are reported as capital gain. If stock is purchased in different lots at different times, reduce basis in the earliest purchased stock first. Report on Schedule D for no gain or loss.

Exercise 16: Larry purchased stock in 1997 for $100. During 1999, he received a return of capital of $80 on this stock. During 2001, he received another return of capital of $30. Larry had NO other stock transactions in 2001. What amount should he report on his 2001 income tax return and what is his basis in the stock at the end of 2001?

A. $30 capital gain, $100 stock basis
B. $30 dividend income, $100 stock basis
C. $10 capital gain, zero stock basis
D. $10 dividend income, zero stock basis

C. $10 capital gain, zero stock basis. A return of capital on a shareholder's stock reduces the basis of the stock. The excess of the return of capital over the shareholder's basis is gain from the sale or exchange of property.

2. A liquidating distribution is received in a partial or complete liquidation of a corporation. This is a return of capital which is not taxable until stock basis is recovered. Once basis is zero, further liquidating distributions are reported as capital gain. The distribution will be allocated to each block of stock owned. If the total received in liquidation distributions is less than the basis in stock, a capital loss can be recognized only after the final distribution.

3. Distributions of stock or stock rights generally are not taxable. Distributions of stock are referred to as stock dividends. Stock rights or options are rights to subscribe to the corporation's stock.

   a) A distribution of stock or stock rights will be taxable if

      (1) Any shareholder has the choice to receive cash or other property instead of stock or stock rights,

      (2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders,

(3) If different classes of stock are offered to common stock shareholders, or

(4) The distribution is on preferred stock.

b) If the stock dividends or stock rights are taxable, the fair market value at the time of the distribution is included in income and is the taxpayer’s basis in the stock or right received. If nontaxable, the taxpayer's basis in the old stock is divided between the old and the new.

c) The corporation may establish a plan in which fractional shares are not issued, but sold and then the cash is distributed. This is reported as a sale on the shareholder's Schedule D with the gain or loss being the difference between the cash received and the basis in fractional shares.

Example:
In 1999 the taxpayer bought one share of common stock for $100. On June 30, 2001, the corporation declared a common stock dividend of 5%. The fair market value of the stock on June 30, 2001 was $200. The corporation had a plan by which no fractional shares would be issued. The stock dividend that taxpayer was entitled to did not amount to a full share, so the corporation sold the fractional share on the taxpayer’s behalf and paid $10 for the fractional share stock dividend. The taxpayer will figure gain or loss as follows:

FMV of old stock	*$200*
FMV of stock dividend	*$10*
Total FMV	*$210*
Basis of old stock after dividend (($200/$210)x$100)	*$95.24*
Basis of dividend ($10/$210)x$100)	*$4.76*
Total Basis	*$100.00*
Cash received	*$10.00*
Basis of stock dividend	*$4.76*
Gain	*$5.24*

F. Other Distributions

1. Exempt interest dividends from regulated investment companies are not taxable but are reported as exempt interest.

2. Dividends on insurance policies are a return of premiums paid and are taxable when premiums are fully recovered. Interest on these dividends is taxable.

3. Dividends on veterans' insurance policies are not taxable and interest earned on the dividends is not taxable.

4. Patronage dividends are taxable unless:

    a) Paid on the purchase of property bought for personal use, or

    b) Paid on the purchase of capital assets or depreciable property bought for use in business. For business purchases, the basis of the property bought must be reduced. If already reduced to zero, the excess is taxable.

5. Amounts received from money market funds are taxable as dividends, not interest.

G. Total dividends of $400 or less, none of which is received as a nominee can be reported directly on the Form 1040. Capital gain distributions can also be reported directly on Form 1040. Capital gains are taxed at a maximum of 28% as opposed to the higher tax rates.

11. Rental Income and Expenses

A. Rental Income

1. Rental income is any payment received for the use or occupancy of property. Generally, all rent is includable in income in the year received. Included are advance rent, payments to cancel a lease, expenses paid for by the tenant, and the fair market value of property or services received. If the services are provided at an agreed upon or specific price, that price is the fair market value in the absence of evidence to the contrary

2. A security deposit is not included in income when received if the owner plans to return it to the tenant at the end of the lease term. If not returned, it is then included in income. If a security deposit is to be used for the last month's rent, then it is advance rent reported when received.

Exercise 17: Troy, a cash basis taxpayer, owns an office building. His records reflect the following for 2001:

- *On March 1, 2001, office B was leased for twelve months. A $900 security deposit was received which will be used as the last month's rent.*

- *On September 30, 2001, the tenant in office A paid Troy $3,600 to cancel the lease on March 31, 2001.*
- *The lease of the tenant in office C expired on December 31, 2001, and the tenant left improvements valued at $1,400. The improvements were NOT in lieu of any required rent.*

Considering just these three amounts, what amount must Troy include in rental income on his income tax return for 2001?

A. $5,900
B. $5,000
C. $4,500
D. $1,800

C. $4,500. A cash basis taxpayer must include in gross income for the year all items of taxable income actually or constructively received during the year, whether in cash, property or services, However, a lessor does not realize income upon termination of a lease merely because he thereby acquires improvements made by the lessee. Advance rent received upon execution of a lease is includible in gross income in the year received, whether the taxpayer is on the cash or the accrual basis.

Exercise 18: Andre, an accrual basis taxpayer, rents a house for $1,000 per month. The house was rented from January through October when the tenant moved out and left substantial damages. Andre did NOT refund their $600 security deposit. Andre hired Jerry, a carpenter, to repair the house for $2,400 which included all labor and materials. Jerry completed the work on November 30, 2001. Instead of paying Jerry for the work, Jerry rented the house from Andre beginning December 1, 2001. They agreed the work would be in exchange for December 2001 and January 2002 rent. Jerry will begin paying rent of $1,000 per month on February 1, 2002. Jerry was NOT required to pay a security deposit. What amount should Andre include in gross rent on his income tax return for 2001?

A. $10,000
B. $10,600
C. $12,400
D. $13,000

D. $13,000. Accrual basis taxpayers report income when it is earned. Taxpayers who barter property or services are taxed on their fair market value. Security deposits are income if and when the lessor becomes entitled to the funds by reason of the lessee's violation of *the terms of the lease. Advance rent received upon execution of a lease is includible in gross income in the year received, whether the taxpayer is on the cash or accrual basis. Andre must include $10,000 for the ten months that the house was rented to the first tenant. The $600 security deposit is includible because Andre became entitled to the funds, due to the damages sustained by the premises. Although Andre and Jerry have agreed that Jerry's work is in exchange for December 2001 and January 2002 rent, the entire fair market value of Jerry's work ($2,400) is includible in Andre's gross rent for 2001 because it constitutes advance rent.*

B. Rental expenses include repairs and other expenses incurred in renting property. They are deductible in the year paid or incurred, depending on the method of accounting. From the time made available for rent, expenses for managing, conserving, or maintaining the property may be deducted, even if vacant for a time.

1. Repairs keep the property in good operating condition. They do not materially add to the value of the property or substantially prolong its useful life. The cost of repairs are currently deductible. Examples include: repainting inside and outside, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows.

2. An improvement adds to the value of the property, prolongs its useful life, or adapts it to new uses. This generally involves replacement with new items or an addition. Repairs made as part of an extensive remodeling project should be treated as part of the improvement. The cost of improvements are depreciable. Examples include: putting on a new addition or room, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, or paving a driveway.

3. Other expenses include advertising, janitor or maid service, utilities, fire and liability insurance allocable to the current year, real estate taxes, mortgage and other interest on loans traced to the rental property, salaries, wages, commissions, professional fees, and ordinary and necessary travel and transportation expenses.

4. Charges for local benefits that increase the value of the property, such as putting in streets, sidewalks, or water and sewer systems, are not deductible. These are nondepreciable capital expenditures which are added to the basis of the property.

5. If only part of the property is rented, common expenses have to be divided. The most common methods for dividing expenses are based on the number of rooms or based on square footage.

6. Property converted from personal to rental will have expenses allocated based on the portion of the year attributable to both personal and rental. The basis for depreciation is the lesser of the FMV or the adjusted basis on the date of conversion.

7. If the property is not rented for profit, expenses are deductible only to the extent of income and no excess is carried over. Income is reported on Form 1040, line 21, expenses are deducted on Schedule A, line 22 subject to the 2% of AGI limitation.

C. Personal Use of Vacation Homes and Other Dwelling Units.

1. A dwelling unit includes a house, apartment, condominium, boat, mobile home, or similar property. A dwelling unit is not property used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

2. A dwelling unit is used as a home if the taxpayer uses it for personal purposes more than the greater of 14 days, or 0% of the total number of days it is rented to others at a fair rental price.

Example:
You rent out a guest bedroom in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stays in the room, rent free, for the last three weeks of July (21 days). The room is used as a home because you use it for personal use for 21 days. That is more than the greater of 14 days or 10% of the total days rented.

3. A day of personal use is any day that a unit is used by:

   a) The taxpayer or any other person who has an interest in the property unless rented as a home to the other owner,

   b) A member of the taxpayer's family or a member of the family of any other person who has an interest in the property unless rented as a home at fair rental value (family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors, and lineal descendants),

   c) Anyone under an agreement that lets the taxpayer use some other dwelling unit, or

d) Anyone less than a fair rental price.

4. Any day the taxpayer spends working substantially full-time repairing and maintaining the property is not counted as a day of personal use, even if family members use the property for recreational purposes the same day.

5. Do not count as days of personal use the days on which the property was used as a main home either before or after renting it or offering it for rent if:

   a) The taxpayer rented or tried to rent the property for 12 or more consecutive months, or

   b) Less than 12 months and the period ended because the property was sold or exchanged.

6. If the dwelling unit is used for both rental and personal, expenses have to be divided. For this division, any day that the unit is rented at fair rental value is a day of rental even if the taxpayer personally used it that day, and a unit is not considered used for rental during the time that it is available but not actually rented.

7. If the dwelling unit is not used as a home, divide the expenses between personal use and rental use based on the number of days it was used for each purpose. Report the rental income and rental expenses on Schedule F. Within limits, a loss will be allowed.

Exercise 19: Mr. and Mrs. Thomas own a vacation home at the lake. They are trying to determine their days of personal use for 2001. Which of the following would be considered personal use days?

A. Mr. and Mrs. Thomas, their daughter and grandchildren spent seven days in May. Mr. Thomas spent substantially all of his time painting the interior. Mrs. Thomas and the others spent all of their time on recreation.
B. Mr. and Mrs. Thomas rented the house for four days in September to Mrs. Thomas's nephew, Jacob. Jacob paid fair rental price.
C. Mr. and Mrs. Thomas rented a mountain cabin from Lucia for four day's in October. Lucia rented their lake house for four days also. They each paid a fair rental price.
D. The Thomas's son, Seth, rented the lake house for thirty days in December. He does not have an interest in the property and he used it as his main home. Seth paid fair rental price.

C. MR. and Mrs. Thomas rented a mountain cabin from Lucia for four days in October. Lucia rented their lake house for four days also.

They each paid a fair rental price. Lucia's use of the Thomas house under a reciprocal arrangement is a personal purpose.

8. If used as a home, reporting depends on number of days rented.

   a) If rented fewer than 15 days, report no income. All expenses are personal so only the interest, taxes, or a casualty or theft loss would be eligible for deducting on Schedule A.

   b) If rented for 15 days or more during the year, all rental income is included. Expenses will be allocated based on the number of days used for each purpose. If the rental is a net profit, all expenses will be deducted. If a net loss, the expenses will be limited. The rental portion of deductible mortgage interest, real estate taxes, casualty or theft losses, and certain indirect rental expenses will be fully deductible. This will be applied against rental income first. Operating expenses and depreciation will then be deducted, in that order, to the extent of income remaining. Any amount in excess of income will be carried forward.

Exercise 20: Francis Snow, who lives in Aspen, Colorado went out of town for two weeks in February 2001. During this time he rented his townhouse, which is used as his principal residence, for $2,000. Mr. Snow is NOT required to report this rental income on his income tax return. (True or False)

True. If a home is rented out for fewer than 15 days during the tax year, no rental income is includible in gross income, and no business expenses attributable to rental are deductible.

D. The correct amount of depreciation should be claimed each year. If not taken in an earlier year, an amendment can be filed. An amount that should have been taken in an earlier year cannot be taken in the current year, but the basis is still reduced by what should have been deducted. Land is never depreciable. This includes the cost of clearing, grading, planting, and landscaping.

1. Modified Accelerated Cost Recovery System (MACRS) applies to all tangible property placed in service in the tax year. A taxpayer may elect the Alternate Depreciation System (ADS) instead of using the General Depreciation System (GDS).

   a) MACRS must be used for a dwelling unit used as a home and changed to rental use in the tax year.

   b) MACRS recovery periods: appliances, furniture, and other personal property with no class life is 7 years under GDS and 12 years under

ADS roads and shrubs are 15 years under GDS and 20 years under ADS; a residential building is 27.5 years GDS and 40 years ADS; and commercial real property is 39 years GDS and 40 years ADS. Improvements and additions will use the class life of the property to which the addition or improvement was made, determined as if the property was placed in service at the same time as the addition or improvement.

c) Basis is the original cost plus improvements. Only the business percent is depreciable. Original basis may be other than cost if obtained by inheritance, gift, or exchange.

2. ACRS is for property placed in service after 1980 and before 1987 and old depreciation rules apply to property placed in service before 1981.

E. Limits On Rental Losses - Rental activities are generally considered passive activities and the amount of loss allowed is limited.

1. Passive rules do not apply to rental property used as a home during the year.

2. At-risk rules place a limit on the amount deductible from activities often described as tax shelters. Real property held prior to 1987 is not subject to the at-risk rules. Any loss from an activity subject to the at risk rules is allowed only to the extent of the total amount the taxpayer is at risk, which is to the extent of cash and the adjusted basis of property contributed to the activity and certain amounts borrowed for use in the activity.

3. Once past the at-risk limits, the loss is subject to the passive activity rules. Other income generally cannot be offset with losses from passive activities, except for other passive income. Rental activities are classified as passive activities. Form 8582, Passive Activity Loss Limitations, is used to compute the current year allowed passive loss and any amount to be carried over.

4. Special rule - A passive loss of up to $25,000 can be taken against nonpassive income if the loss was incurred in a rental real estate activity in which the taxpayer actively participated. The allowable amount is $12,500 if MFS and spouses lived apart for the entire year. If MFS and spouses lived together at all during the year, no special offset is allowed.

a) Active participation - The taxpayer owns at least 10% of the rental property and makes management decisions in a significant and bona fide sense, such as approving new tenants, deciding on rental terms, and approving expenditures.

b) This offset is reduced by 50% of the amount that modified AGI exceeds $100,000. Modified AGI does not include taxable Social Security, IRA or §501(c)(18) deductions, U.S. bond exclusion for higher education, any passive activity loss, or the deduction for one-half SE tax.

Exercise 21: Henry and George file a joint income tax return for 2001. During 2001, Henry received wages of $120,000 and taxable Social Security benefits of $5,000. George actively participated in a rental real estate activity in which she had a $30,000 loss. They had NO other income during 2001. How much of the rental loss may they deduct on their 2001 income tax return?

A. $0
B. $12,500
C. $15,000
D. $25,000

C. $15,000. A taxpayer who actively participates in rental real estate activities may use up to $25,000 of passive activity losses from such activities as deductions against nonpassive income. The $25,000 is reduced, but not below zero, by 50 percent of the amount by which the taxpayer's adjusted gross income for the year exceeds $100,000. For this purpose, adjusted gross income is calculated without regard to taxable social security benefits or any passive activity loss.

5. A rental activity in which the taxpayer materially participates will not be a passive activity if it is a real property trade of business. Losses from this activity will not be limited by the passive loss rules.

   a) Material participation in a real property trade or business must be more than half of the time spent performing all personal services during the year, and more than 750 hours.

   b) A real property trade or business is one that develops, redevelops, constructs, reconstructs, acquires, converts, rents, operates, manages, leases, or sells real property.

F. If renting out a building and providing only minimal services, if any, income and expenses are reported on Schedule E.

G. If services are provided or the rental is not real property, report rental income and expenses on Schedule C.

12. Social Security and Equivalent Railroad Retirement Benefits

A. Up to 85% of a taxpayer's Social Security or tier 1 Railroad Retirement benefits may be taxable. The taxable amount is calculated by first comparing income plus one-half of the benefits to a base amount and then an adjusted base amount.

Filing Status	**Base Amount**	**Adjusted Base Amount**
S, HH, and QW(er)	$25,000	$32,000
MFS, did not live with spouse at any time	$25,000	$32,000
MFS, did live with spouse	$0	$0
MFJ	$32,000	$44,000

B. If income is:
1. Less than the base amount, none of the benefits will be taxable.

2. More than the base amount but less than the adjusted base amount, up to 50% of the benefits can be included in taxable income.

3. More than the adjusted base amount, up to 85% of the benefits can be included in taxable income.

Exercise 22:
Mr. and Mrs. Jones are both over 65 years of age and are filing a joint return. Their income for the tax year consisted of the following:

Taxable interest	*$3,000*
Social Security payments	*$25,000*
Tax-exempt interest	*$1,000*
Taxable pension	*$20,000*

How much of the Social Security benefits is taxable?
A. $12,500
B. $5,500
C. $2,250
D. $1,500

C. $2,250. The amount of social security benefits that an individual must include in gross income is the lesser or (1) one-half of the annual benefits received or (2) one-half of the amount that remains after subtracting the appropriate base amount from the taxpayer’s provisional income. Provisional income is the sum of the taxpayer’s modified adjusted gross income and one-half of his social security benefits. Modified adjusted gross income is the individuals adjusted *gross income (excluding any social security or tier 1 railroad benefits) increased by the amount of tax-exempt interest received during the tax year. The base amount is $32,000 for married individuals filing a joint return.*

C. A special computation is required if a non-deductible IRA contribution was made during the year.

D. Lump sum benefits received in 1999 for an earlier year will be shown on the 1999 SSA-1099. The full amount can be treated as 1999 benefits or a special election can be made to determine how much of the benefits allocable to an earlier year would have been taxable in that year, and then including the amount as taxable in the current year.

13. Other Income

A. Miscellaneous Taxable Income

1. Alaska oil royalties are reportable as miscellaneous income.

2. Alimony is taxable. Child support is never taxable.

3. Allowances and reimbursements not accounted for under an accountable plan are taxable as wages.

4. A canceled debt or a debt paid for by another might be debt forgiveness income reportable on line 21. It is not income if the cancellation of payment is intended as a gift. Part or all of the canceled amount may be excluded if the taxpayer is insolvent or in bankruptcy.

5. Court awards and damages may be taxable, depending on what the settlement is replacing. The following would be ordinary income:

   a) Interest on an award,

   b) Compensation for lost wages or lost profits,

   c) Punitive damages awarded in cases not involving physical injury or sickness,

   d) Amounts received in settlement of a pension right (no taxpayer contributions),

e) Damages for patent or copyright infringement, breach of contract, or interference with business operations, or

f) Any recovery under the Age Discrimination in Employment Act.

6. Income of an estate or trust which is not taxed at the entity level.

7. Fees received as a corporate director, executor, notary public, or election precinct official.

8. Gambling winnings include cash and noncash winnings from lotteries, raffles, and illegal gambling. The gross amount is reported as income, expenses are deductible on Schedule A.

9. Illegal income, such as from theft or embezzlement.

10. Jury duty. If the taxpayer is required to turn this amount over to an employer and receives a regular wage during that time, the amount turned over can be taken as an adjustment on line 30.

11. Kickbacks, side commissions, or push money.

12. Notes received for services.

13. Prizes and awards.

14. Gain on the sale of personal items.

B. Bartering income is property or services received in exchange for property or services. Include in taxable income the fair market value of the property or service received. If the value is agreed upon ahead of time by both parties, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Example:
You are self-employed and a member of a barter club. The club uses "credit units" as a means of exchange. The club adds credit units to your account for goods or service you provide to members, which can be used to purchase goods or services offered by other members of the barter club. The club subtracts credit units form your account when you receive goods or services from other members. You must include in income the value of credit units that are added to your account, even though you may not actually receive goods or services from other members until a later year.

C. Partnership or S Corporation Income - Each partner/shareholder reports his or her share of business income, credits, deductions, and tax preference items passed through on the K- 1.

D. Recoveries of previously deducted items are included in income if a tax benefit was derived from the deduction.

   1. If a recovery and expense occur in the same year, the recovery reduces the deduction and is not reported as income.

   2. A recovery that is for amounts paid in two or more separate years has to be allocated pro-rata between the years.

   3. If no tax benefit was derived from the prior year deduction, the recovery is not included in income. This can result if credits reduced tax liability to zero or the taxpayer was subject to AMT.

E. Repayments of an amount included in income because the taxpayer thought he or she had an unrestricted right to it can be deducted in the year repaid. The type of deduction depends on the type of income that was reported.

   1. If $3,000 or less and reported as wages, unemployment compensation, or other ordinary income, deduct it on Schedule A line 22 in the year repaid. If the income was reported as a capital gain, deduct it on Schedule D.

   2. Over $3,000, the taxpayer can deduct it on Schedule A or take a credit against tax for the repayment, whichever method is most advantageous. The credit is determined by figuring the tax for the prior year with and without the amount. The difference is the credit claimed on line 60 of Form 1040.

F. Royalties from copyrights, patents, and oil, gas, or mineral properties are taxable as ordinary income.

G. Income Not Taxed

   1. Campaign contributions, unless diverted to personal use.

   2. Cash rebates.

   3. Employee achievement awards. Up to $400 can be excluded if from nonqualified plans, and $1,600 from both qualified and nonqualified plans.

   4. Energy conservation subsidies.

   5. Foster care payments if for less than five individuals.

6. Gifts and inheritances (income produced by such property is taxable).

7. Welfare and other public assistance benefits.

8. Damages or awards for physical injury or sickness.

9. Various payments made due to sickness or injury. These include: worker's compensation, Federal Employees' Compensation Act payments, compensatory damages for injury or sickness, benefits received under an accident or health insurance policy, compensation paid for permanent loss or use of a part or function of the body, and reimbursement for medical care.

H. Life insurance proceeds paid due to death are not taxable, unless the policy was turned over to the taxpayer for a price.

1. If paid in other than regular intervals, include in income only the amount that is more than that payable at the time of the insured person's death (interest).

2. If paid in installments, a part of each installment can be excluded. Interest, the amount in excess of the lump sum payable at death, is included in income.

3. A surrender of a policy is excluded to the extent of premiums paid.

4. The first $5,000 of payments made by or for an employer because of an employee's death can be excluded from income of the beneficiaries.

I. Scholarships or fellowships may be excludable, partially taxable, or totally taxable.

1. Only a candidate for a degree can exclude amounts received as a qualified scholarship. A qualified scholarship is any amount received that is for tuition and fees to enroll at or attend an educational organization; or fees, books, supplies, and equipment required for courses at the educational institution.

2. Amounts used for room and board do not qualify.

3. All amounts received as payment for services must be included in income even if the services are a condition of receiving the grant and are required of all candidates for the degree. This includes the amounts for teaching and research.

4. Scholarship prizes are not scholarships or fellowships if the taxpayer does not have to use the prize for educational purposes.

5. A qualified tuition reduction is excluded from income. This is the amount of reduction in tuition for education furnished to an employee of an educational institution (or certain other persons) provided certain requirements are met.

Exercise 23: Kevin is a candidate for a master's degree at a local university. During 2001, he was granted a fellowship that provided the following:

Tuition	*$18,000*
Books & supplies	*$2,000*
Room and board	*$14,800*

What amount can Kevin exclude from gross income in 2000?

A. $20,000
B. $25,000
C. $29,800
D. $34,800

A. $20,000. A degree candidate at a qualified educational organization may exclude from gross income amounts of a fellowship grant used for tuition and course-related fees, books, supplies, and equipment. Amounts received for room and board are includible in gross income.

PART 3 - GAINS AND LOSSES

* ***Study Tip*** * Basis, realized gain, and recognized gain will be questioned extensively in Part I, Part II, and Part III of the exam.

14. Basis of Property

This chapter discusses how to figure your basis in property and covers the following topics.

- Cost basis of property you buy.
- Adjustments to basis after you receive property.
- Basis other than cost.

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure the amount of gain or loss on the sale, exchange, or other disposition of property. Also use it to figure the deduction for depreciation, amortization, depletion, and casualty losses. You must keep accurate records of all items that affect the basis of property so you can make these computations.

If you use property for both business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.

Generally, the higher your basis for an asset, the less gain you will have to report on its sale. The higher your basis in a depreciable asset, the higher your depreciation deductions.

A. Cost Basis

1. The cost is the amount of cash and debt obligations paid for property as well as the fair market value of other property or services the taxpayer provides in obtaining property.

2. Includes additional expenses:

   a) Sales tax charged on the purchase,

   b) Freight charges to obtain the property,

   c) Installation and testing charges,

d) Excise taxes,

e) Legal and accounting fees (when required to be capitalized),

f) Revenue stamps,

g) Recording fees, and

h) Real estate taxes (if assumed for the seller).

3. If purchased on installment with little or no interest, part of the stated purchase price needs to be allocated to interest. The basis in the property is the stated purchase price less the amount allocated as interest.

Exercise 24: If you buy a business or investment property on any time-payment plan that charges little or no interest; the basis of your property is your stated purchase price, less the amount considered to be unstated interest. (True or False)

True. The buyer's basis in the property does not include the portion of the payments that is considered to be "interest expense."

4. Real property is generally defined as land and anything erected on, growing on, or attached to land.

   a) Assumption of a mortgage increases basis.

   b) Settlement fees and other costs are included in basis. These fees need to be allocated between land and improvements and include the following items:

      (1) legal and recording fees,

      (2) Abstract fees,

      (3) Charges for installing utility services,

      (4) Surveys,

      (5) Transfer taxes,

      (6) Title insurance, and

(7) Any amounts the seller owes that the buyer agrees to pay.

c) Expenses to obtain a mortgage, such as points, are generally capitalized and deducted ratably over the term of the mortgage. Special rules apply to points on a home mortgage. (Discussed in Section D.)

d) Real estate taxes owed by the seller that the buyer agrees to pay is part of the cost of the property, not a currently deductible expense.

Exercise 25:
John bought land with a building on it that he planned to use in his business. His costs in connection with the purchase were as follows:

Cash down payment		*$40,000*
Mortgage on property		*$300,000*
Survey costs	*$2,000*	
Transfer taxes		*$1,800*
Charges for installation of gas lines		*$3,000*
Back taxes owed by seller and paid by John		*$12,00*

What is John's basis in this property?
A. $348,000
B. $346,800
C. $345,000
D. $343,000

A. $348,000. Basis of property acquired by purchase consists of its cost (both cash and debt obligations) plus certain fees and expenditures. These expenditures include survey costs, transfer taxes, charges for installing utility services, and amounts that the seller owes that the purchaser agrees to pay.

B. Adjusted basis includes all items properly charged to a capital account.

1. Increases to basis:

a) Capital improvements increase the value of the property, lengthen the property's useful life, or adapt it to a different use. This includes:

(1) Putting an addition on one's home,
(2) Replacing an entire roof,
(3) Paving the driveway,

(4) Installing central air conditioning, or
(5) Rewiring the home.

b) Assessments for local improvements increase the value of the property assessed and are not to be deducted as taxes. Typical assessments include:

(1) Water connections,
(2) Sidewalks, or
(3) Roads.

c) Expenditures to restore property after a casualty loss.

2. Decrease the basis by any item that represents a return of capital or a deferred gain.

a) Section 179 expense deduction,
b) The exclusion from income of a subsidy for energy conservation measures or residential energy credit taken,
c) Deduction for clean-fuel vehicle or property or credit for qualified electric vehicles,
d) Amount received for granting an easement,
e) Casualty and theft loss deductions, any insurance reimbursement, or recognized losses on other involuntary conversions,
f) Nontaxable corporate distributions,
g) Deferred gain on the sale of a residence, and
h) Depreciation allowable even if not taken.

C. Basis Other Than Cost

1. Fair market value (FMV) is the price at which property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all necessary facts.

a) Property received for services is included in income at the FMV of the property. This also becomes the basis of that property.

Exercise 26:
The basis of property received for services performed is equal to

A. The lower of cost or market price of the property.
B. The cost of the property.
C. The cost of the services provided
D. The fair market value of the properly

D. The fair market value of the property. The basis of property received for services performed is equal to the fair market value of the property, less the amount paid, if any, for the property.

b) Bargain purchases result in taxable income which is the difference between the purchase price and the FMV. The FMV then becomes the basis.

c) A taxable exchange may result in gain or loss being recognized. The basis of the property received is generally the FMV at the time of the exchange.

2. Involuntary Exchange:

a) The basis of property received which is similar or related in service or use to the property exchanged is the same as the old property's basis on the date of the exchange.

(1) The carryover basis is decreased by any loss recognized on the exchange, and any money received that was not spent on similar property.

(2) The carryover basis is increased by any gain recognized on the exchange, and the cost of acquiring replacement property.

b) If money or other property not similar or related in use is received and the taxpayer buys similar or related property, the basis of the new property is the cost of the new, decreased by the amount of gain that is not recognized on the exchange.

Example:
The state condemned your property and paid you $31,000 for it. Your adjusted basis was $26,000, so there is a realized gain of $5 $00. Yap buy similar replacement property for $29,000. Your recognized gain is $2,000 ($31,000 - $29,000), the unspent part of the payment from the state. Gain not recognized is $3,000. The basis of the new property is $26,000 (cost of $29,000 less gain not recognized of $3,000).

c) If more than one property is purchased, the basis is allocated among properties acquired based on their respective costs.

3. A nontaxable exchange is an exchange in which gain is not taxed and any loss cannot be deducted.

a) The basis of property received is usually the same as the basis of the property given up.

b) A partially nontaxable exchange is an exchange in which money or unlike property is received in addition to the like-kind or like-class property. The basis of the new property is usually the same as the basis of the property exchanged:

(1) Decreased by any money received and any loss recognized on the exchange, and

(2) Increased by any additional costs incurred and any gain recognized on the exchange.

(3) Allocate the basis among properties, other than money, received in the exchange. The basis of unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Exercise 27:
Mr. Brown owned a parcel of real estate having an adjusted basis of $25,000, that he was holding for investment. Mr. Brown exchanged the real estate for the assets listed below:

Land to be held for investment, fair market value	*$30,000*
A boat for personal use, fair market value	*1,500*
Cash	*1,000*

What is Mr. Brown's basis in the real estate that he received?

A. $22,500
B. $25,000
C. $29,000
D. $30,000

B. $25,000. If an exchange is only partially tax-free because it involves an exchange of both like-kind property and "other" property or money so that gain must be recognized, the basis for the like-kind property received is the adjusted basis of the property transferred, minus the sum of the money and the fair market value of any other property received, plus the amount of the gain that was recognized.

c) If a sale and purchase are, in fact, a single transaction or dependent on each other, the taxpayer cannot increase the basis of property for depreciation by selling the old property and buying the new property from the same dealer. The transaction is treated as an exchange no matter how it is carried out.

Example:
You are a salesperson and use one of your cars 100% for business. You have used this car in your sales activities for 2 years and have depreciated it. Your adjusted basis in the car is $2,600, and its FMV is $3,100.

You are interested in a new car with a listed retail price of $8,695 which usually sells for $8,000. If you trade your old car and $4,900 for the new one, your basis for depreciation for the new car would be $7,500 ($4,900 plus $2,600 basis in the old car). However, you want a higher basis for depreciating the new car, so you agree to pay the dealer $8,000 for the new car if he will pay you $3,100 for your old car.

Since the sale and purchase are dependent on each other, you are treated as if you had exchanged your old car for the new one. Your basis for depreciation is $7,500.

4. The basis of property received as a gift depends on the donor's adjusted basis, the FMV on the date given, and any gift tax paid.

   a) If the FMV is less than donor's adjusted basis, the donee starts with the donor's adjusted basis when determining any gain on the sale or other disposition of the property, and when determining depreciation. The basis for determining loss on a sale or other disposition starts with the FMV at the time received. Appropriate increases and decreases will be made for adjustments attributable to the period the taxpayer owns the property.

   b) If FMV is equal to or greater than donor's adjusted basis, the donee's basis is the same as the donor’s adjusted basis at the time of the gift. The basis will be increased by all or part of the gift tax paid.

      (1) If received before 1977, the basis is increased by all of the gift tax paid but cannot exceed the FMV at the time of the gift.

      (2) If received after 1976, the basis is increased by the part of the gift tax paid that is due to the net increase in value of the gift and is figured by multiplying the gift tax by a fraction. The numerator is the net increase in value of the gift and the denominator is the amount of the gift.

Exercise 28:
Chester received a gift of stock having an adjusted basis of $11,000 and a fair market value of $7,200 at the time of the gift. Chester sold the stock for $9,000. What is the amount of Chester's capital gain or (loss)?

A. $9,000
B. $1,800
C. $0
D. $(2,000)

> *C. $0. There is no gain or loss. The basis for gain is the adjusted basis in the hands of the donor ($11,000). The result of subtracting the basis from the sale price ($9,000 - $11,000) is a negative number. A gain cannot be less than 0. The basis for loss is the fair market value at the time of the gift, when the adjusted basis is greater than the fair market value. The result of subtracting the basis from the sale price ($9,000 - $7,200) is a positive number. A loss cannot be larger than 0.*

5. A taxpayer's basis in inherited property is usually the FMV on the date of the decedent's death.

   a) If an estate tax return is filed, the basis can be the FMV on the alternate valuation date if so elected by the executor.

   b) If a federal estate tax return does not have to be filed, the basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

   c) Inherited property is always considered held long term.

Exercise 29: On July 15, 2001, Jeff received 50 shares of stock as an inheritance from his father who died April 15, 2001. His father's adjusted basis in the stock was $50,000. The stock's fair market value on April 15, 2001, was $65,000. On July 15, 2001, its value was $70,000 and on October 15, 2001, it was $80,000. The alternate valuation date was NOT elected on the federal estate tax return. Jeff's basis in the inherited stock is:

A. $50,000
B. $65,000
C. $70,000
D. $80,000

B. $65,000. When an alternate valuation date is not elected, the income tax basis of property acquired from a decedent is the fair market value of the property on the date of the decedent's death.

6. For property converted from personal to business or rental use, the basis for depreciation is the lesser of the FMV or the adjusted basis on the date of conversion. The basis for gain is the adjusted basis in the property. The basis for loss is the smaller of the adjusted basis or the FMV at the time of the conversion plus or minus required adjustments.

Example:
You sell your house, which you had changed to rental property after using it as your home. When converted to rental use, it had a FMV of $33,000 and an adjusted basis of $35,000. The original cost of the house and the adjusted basis were the same, as there were no increases or decreases to basis since its purchase.

Your basis for depreciation is $33,000, the lesser of FMV or adjusted basis. You claimed $3,000 depreciation, figured under the straight line method, while renting it.

Your adjusted basis at the time of the sale, for figuring gain, is $32,000 ($35,000 original cost - $3,000 depreciation).

Your adjusted basis at the time of the sale, for figuring loss, is $30,000 ($33,000 FMV on conversion - $3,000 depreciation). In this example, FMV must be used because it was smaller than the adjusted basis at the time the house was changed to rental use.

If the sales price is between $30,000 and $32,000, you have neither gain nor loss on the sale.

D. Stocks and Bonds

1. The basis in stocks and bonds is generally the purchase price plus the costs of purchase. If acquired by other than purchase, the basis will be the FMV or other party's adjusted basis as determined under the previous rules. The basis will be adjusted for certain events.

2. Identification of which shares are sold is required, or the basis of shares sold is the basis of the shares acquired first. Identification can be accomplished by delivering certificates to a broker and identifying a specific purchase date or a specific purchase price. If stock is left with the broker or agent, inform the broker which stock is to be sold and receive written confirmation.

3. The basis of mutual fluid shares can be determined on a cost basis or an average basis.

    a) Cost basis can be either a specific share identification method or a first-in first-out (FIFO) method.

    b) An average basis method can be used if the shares are acquired at various times and for various amounts, and the shares are left on deposit in an account with the custodian or agent. The basis is figured using either the double-category method or the single-category method.

    c) Unless the requirements for specific share identification are met or an election is made to use an averaging method, the FIFO method must be used.

4. Dividend reinvestment plans invest the dividends in additional shares or fractional shares of stock. The basis is the actual cost of the shares. If purchased at a discount, the discount is included in income and the basis is the FMV.

5. For a per share basis of stock received as nontaxable stock dividends, the taxpayer's adjusted basis of the old stock is divided between the shares of old stock and the new stock.

    a) If the old and new stock are identical, the adjusted basis is divided by total number of old and new shares.

    b) If not identical, the division is in a ratio of the FMV of each lot of stock to the total FMV of both lots.

    c) If the old stock is purchased at various times and prices, the basis is allocated to each lot based on the dividend attributable to that lot. Allocation within lots also applies to stock splits.

    d) The holding period for the new stock received as a nontaxable dividend or split is the same as the old stock.

6. For taxable stock dividends, the basis of the new stock is the FMV on the date of distribution.

Exercise 30: In 1998, Chim purchased 100 shares of preferred stock of Donald Corporation for $5,000. In 2001, she received a stock dividend of 20 additional shares of preferred stock in Donald. On the date of the distribution, the preferred *stock had a fair market value of $40 per share. What is Chim's basis in the new stock she received as a result of the stock dividend?*

A. $1,000
B. $833
C. $800
D. $0

C. $800. Dividends on preferred stock are taxable under the dividend distribution rules. Under these rules, the basis of stock received is the fair market value of the stock on the date received.

7. Stock rights may be exercised or sold, or may expire.

   a) If the rights are taxable, the basis of the right is the FMV at the time of the distribution.

   b) If nontaxable when received, the basis is zero if allowed to expire. If the right is exercised or sold and if at the time of the distribution:

      (1) The rights had a FMV of 15% or more of the FMV of the old stock, the taxpayer must divide the adjusted basis of the stock between the stock and the rights based on the FMV of each.

      (2) A FMV of rights less than 15%, the basis is zero.

8. If exercised, the basis of the new stock is its cost plus the basis of the stock rights exercised.

Exercise 31: Which of the following statements is CORRECT?

A. Stock dividends are distributions made by a corporation of another corporation's stock
B. In computing basis for new stock received as a result of a nontaxable dividend, it is immaterial whether the stock received is identical or not to the old stock
C. If a stock dividend is taxable, the basis of the old stock does NOT change.
D. If you receive nontaxable stock rights and allow them to expire, you have a loss equal to the fair market value of the rights.

C. If a stock dividend is taxable, the basis of the old stock does NOT change. The basis of the old stock would be adjusted only if the distribution were nontaxable; no allocation of the adjusted basis of *the old stock, between the old and new stock, occurs when the distribution is taxable.*

9. If the taxpayer receives investment property in complete or partial liquidation of a corporation and if gain or loss is recognized when the property is acquired, the basis in the property is its FMV at the time of the distribution.

10. If taxable bonds are purchased at a premium and the taxpayer elects to amortize the premium paid, the basis is reduced by the amount of the amortized premium deducted each year. Even though no deduction is allowed for the premium of tax-exempt bonds, each year the premium is amortized and the basis is reduced.

11. Increase basis in OID debt instruments by the amount of OID included in income. Special rules apply to tax-exempt bonds.

Basis Reference Chart

How Acquired	**Basis For Gain, Loss And Depreciation**
Purchase	Usually cost. Includes cash, FMV of other property and services, sales tax, freight, testing and installation, closing costs, and indebtedness assumed.
Non-taxable and partially taxable exchanges	Basis of property acquired is the same as the basis of the property given up, increased by additional costs and any gain recognized, and decreased by money or unlike property received and any loss recognized.
Gifts	Gain or depreciation: Same as donor's basis, increased (not over FMV) by the gift tax allocated to appreciation. Loss: Lesser of basis for gain or FMV.
Conversion from personal use to business use	Gain: Adjusted basis. Loss or depreciation: Lesser of adjusted basis or FMV at the date of conversion.
Inherited	FMV at date of death or alternate valuation date if elected.
Transfer between spouses	Carryover of basis prior to transfer. No gain or loss recognized.
Replacement	Adjusted basis less gain deferred on the sale of the old

residence - on sale of old	residence. Loss is not recognized.
Stocks and Bonds	Usually cost. First acquired, first sold. Stock split: Divide the original basis between the old and new stock. Dividend reinvestment: FMV on the dividend payment date. Reduced by nontaxable distributions.
Mutual Fund Shares	Cost, may use average basis if bought at different times and prices.
Original Issue Discount	Cost, increased by OID included in income.

15. Sales and Trades

A. A sale is a transfer of property for money or a promise to pay money, and a trade is a transfer of property for other property or services.

B. A transaction is not a trade when the taxpayer voluntarily sells property for cash and immediately buys similar property to replace it unless the transactions are contingent and with the same person.

C. A redemption of stock will receive sale treatment if:

1. The redemption is not essentially equivalent to a dividend,
2. There is a substantially disproportionate redemption of stock,
3. There is a complete redemption of the shareholder's stock, or
4. The redemption is in partial liquidation of a corporation.

D. A redemption or retirement of bonds or notes at their maturity is a reportable sale or trade.

E. Gain or loss is the difference between the adjusted basis in property and the amount realized.

1. The adjusted basis of property is the original cost or other original basis adjusted for certain items. Adjustments include such items as depreciation, casualty loss, improvements, or special assessments.

2. The amount realized is all money and the FMV of property or services received. This includes any indebtedness that is paid off as part of the transaction or that is assumed by the buyer. If the taxpayer trades

property and cash for other property, the amount realized is the FMV of the property received.

3. Realized gain or loss is the amount realized less the adjusted basis of the property.

4. Recognized gain or loss is the gain or loss included in determining gross income.

Exercise 32:
In 2001, Robert sold a building used in his business. His books and records reflect the following information:

Original cost of building	*$150,000*
Improvements made to building	*$50,000*
Broker's commissions paid on sale	*$10,000*
Cash received on sale	*$100,000*
Total property taxes paid by Robert	*$3,000*
Portion of property taxes imposed on purchaser and reimbursed in a separate payment to Robert by purchaser under IRC 164(d)	*$1,000*
Mortgage assumed by buyer	*$80,000*
Accumulated depreciation	*$70,000*
Fair market value of other property received	*$20,000*

What is the amount of gain Robert must RECOGNIZE from the sale of the property?

A. $60,000
B. $61,000
C. $70,000
D. $71,000

A. $60,000. The gain from a sale or exchange of property is the excess of the amount realized from the sale or exchange over the property's adjusted basis. The adjusted basis of an asset is generally its original cost plus the cost of any capital improvements to the property and less any deprecation or depletion. In computing the amount realized, the sell does not include any reimbursement for real property taxes treated under Code Sec. 154(d) as imposed on the purchaser.

F. An exchange may be nontaxable, partially taxable, or taxed as a sale.

1. Nontaxable Exchange - A taxpayer must postpone paying tax on gain or deducting a loss until the property received is sold or disposed of.

   a) Like-kind Exchange - To be nontaxable, a trade must meet the following conditions:

      (1) Both the old and new property must be held for business or investment purposes,

      (2) The property must not be property held for sale

      (3) There must be an exchange of like-kind property. Real property may be improved or unimproved. Tangible personal property must be either like-kind or like-class to qualify for nonrecognition, and

      (4) The property must not be stocks, bonds, notes, or other securities or evidence of indebtedness, including partnership interests.

Exercise 33:
Which of the following examples of property may qualify for a like-kind exchange?

A. Inventories
B. Rental house
C. Accounts receivable
D. Raw materials

B. Rental house. Like-kind property includes property held for productive use in a trade or business or for investment purposes.

      (5) The property to be received must be identified on or before the 45th day after the date of transfer of the property given up.

      (6) The exchange must meet the completed transaction requirement. The new property must be received on or before the earliest of the 180th day after the date the property given up was transferred, or the due date (including extensions) for the return for the year in which the property given up was transferred.

Exercise 34: If you transfer property in a deferred like-kind exchange, it will NOT qualify for nonrecognition if the replacement property is NOT in existence or being produced at the time you identify the property. (True or False)

False. Property transferred in a deferred exchange will qualify for nonrecognition even if the replacement property is not in existence or is being produced at the time that it is identified as the replacement property.

b) A partially nontaxable exchange occurs when like property and money or other unlike property is received in exchange for the property given up.

(1) The taxpayer will be taxed on the gain realized to the extent of the money and the fair market value of the unlike property received. An assumption of a liability is treated as cash received. If both parties transfer a liability with the property, the one transferring the larger liability will be treated as receiving cash equal to the amount of the excess over the liability assumed.

(2) If the taxpayer gives up nonlike-kind property as well as like-kind property, gain or loss must be recognized on the nonlike-kind property. The gain or loss is the difference between the adjusted basis of the nonlike-kind property and its FMV.

c) Generally, the transfer of property between spouses or a transfer incident to divorce is not treated as a sale or exchange and no gain or loss is recognized.

d) An exchange of common stock for common stock or preferred stock for preferred stock in the same corporation can be completed without having to recognize gain or loss.

e) An exchange of life insurance policies and annuities can receive nonrecognition treatment.

Exercise 35:
James transferred an apartment building he held for investment to Ray an unrelated party, in exchange for an office building. At the time of the exchange, the apartment building had a fair market value of $90, 000, and an adjusted basis to James of $70, 000. The apartment building was subject to a liability of $30,000

which Ray assumed for legitimate business purposes. The office building had an adjusted basis to Ray of $30,000, and a fair market value of $80,000. In addition, James received $10,000 cash in the exchange. What is James RECOGNIZED gain on this exchange?

A. $10,000
B. $30,000
C. $40,000
D. $50,000

> *C. $40,000. If, in an exchange of property for property of like kind, other (unlike) property or money is received in addition to the like-kind property, gain is recognized, but only up to the sum of the money and the fair market value of the other property received. The amount of any liabilities of the taxpayer assumed by the other party to an exchange is treated as money received by the taxpayer.*

2. Related party transactions.

   a) The like-kind exchange nonrecognition rules apply to related parties. However, if either related party disposes of the like-kind property within two (2) years after the exchange, the gain or loss on the exchange must be recognized. Each party would report the gain or loss on the return for the year in which the later disposition occurred.

   b) Other than a distribution in complete liquidation of a corporation, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between related parties. Related parties for this rule are:

      (1) Members of one's family - include only brothers, sisters, half-brothers or sisters, spouse, ancestors, and lineal descendants.

      (2) A corporation in which the taxpayer owns, directly or indirectly, more than 50% in value of outstanding stock.

      (3) A tax-exempt charitable or educational organization controlled in any manner by the taxpayer or family member.

      (4) A trust created by the taxpayer or in which the taxpayer is a beneficiary.

Exercise 36:

In April 2001, Pamela sold stock with a cost basis of $15,000, to Lisa, her sister, for $10,000. In September 2001, Lisa sold the same shares of stock to their cousin, Niki, for $8,000. What is the amount of Pamela's deductible loss for 2001?

A. $0
B. $2,000
C. $5,000
D. $7,000

A. $0. Pamela may not claim any deductible loss because she sold the stock to her sister, a related party.

c) If a taxpayer sells or trades at a gain property that was acquired from a related party, the taxpayer would recognize gain only to the extent it is more than the loss previously disallowed to the transferor. This rule applies only if the taxpayer is the original transferee and acquired the property by purchase or exchange.

G. Capital or Ordinary Gain or Loss.

1. A capital asset is, for the most part, everything the taxpayer owns and uses for personal purposes, pleasure, or investment. Examples would include: stocks or bonds, personal residence and household furnishings, an automobile used for personal purposes or commuting, coin or stamp collections, gems, or jewelry.

2. Noncapital assets include property held mainly for sale to customers, depreciable or real property used in a trade or business, accounts or notes receivable, U.S. Government publications, and any copyright, literary, musical, or artistic composition, letter or memorandum, or similar property created by or for the taxpayer.

3. Nonbusiness bad debts arc debts not obtained in the course of operating a trade or business. To be deductible, the debt must be a genuine and totally worthless debt, and the taxpayer must have a basis in it. Nonbusiness bad debts are deducted as short-term capital losses on Schedule D.

Exercise 37: In 1998, Mr. Baldwin loaned his nephew, Phillip, $6,000 to assist him while in college. Phillip did not sign a note and no terms for repayment were established. They both lived in the same state which requires that agreements be in writing to be legally binding. Phillip did not repay any of the $6,000 and Mr.

Baldwin made no efforts to collect it. Mr. Baldwin can deduct the $6,000 as a nonbusiness bad debt on his income tax return for 2001. (True or False)

> *False. In order for a debt to be deductible, it must, among other things, be a valid and enforceable obligation to pay a fixed or determinable sum of money. Mr. Baldwin loaned money to a related party, without benefit of a written note or established payment plan in a jurisdiction that requires a writing for an agreement to be binding. No payments have actually been made and no effort has been made to collect the amount due. Based on these facts, this debt is not a valid or enforceable obligation, and is, therefore, nondeductible.*

4. Losses on Small Business Stock (§1244 stock) may be deducted as an ordinary loss up to $50,000 ($100,000 if MFJ), by reporting on Form 4797, Sales of Business Property. If this stock is a capital asset in the hands of the taxpayer, gain from the disposition is capital gain.

5. Holding period is used to determine whether gain or loss is reported as short term or long term.

    a) Short-term is property held for one year or less, long-term is more than one year.

    b) The holding period starts on the date after the property is acquired and ends on the date disposed of For securities traded on an established market, it starts on the day after the trading date and ends on the trading date.

    c) If property is acquired in an exchange, where the basis of the new property is determined, in whole or in part, by the basis of the old property, the holding period for the new property begins on the day following the date the old property was acquired.

    d) The donor's holding period will carry over on gifts.

    e) Inherited property is generally treated as held long-term.

    f) The holding period of stock received as a nontaxable stock dividend begins on the same day as the holding period of the old stock.

Exercise 38:
Which of the following statements concerning the holding period of assets is CORRECT?

A. In the case of stocks and bonds, the holding period begins on the day after the trading dare.
B. In the case of nontaxable exchanges, the holding period begins 45 days after the date you transfer the property.
C. In the case of a gift the holding period begins on the date you receive the gift.
D. in the case of inherited property, there is no holding period.

A. In the case of stocks and bonds, the holding period begins on the day after the trading day. With respect to a security that is purchased and sold on a registered security exchange, the holding period begins on the day after the taxpayer purchases the security.

6. Gain up to $50,000 from the sale of publicly traded securities may receive tax-free rollover treatment if qualified replacement property is purchased within 60 days. To qualify:

   a) The sale of the publicly-traded securities is after August 9, 1993.

   b) The gain is a capital gain.

   c) The replacement property is either common stock or a partnership interest in a specialized small business investment company (SSBIC).

Exercise 39:
Stan sold the following capital assets on December 1, 2001:

Asset	*Gain or (Loss) on the Sale*
XYZ stock acquired December 1, 1999	*($14,000)*
ABC stock acquired January 13, 2001	*15,000*
Personal automobile acquired February 2, 2001	*2,000*
Land held for investment acquired March 3, 1997	*8,000*

In addition, Stan received a capital gain distribution of $1,000 from the Lucky Mutual Fund during 2001. What are the respective net short-term capital gains and the net long-term capital loss that Stan must report on his 2001 Schedule D (Form 1040)?

	Short-term	*Long-term*
A.	*$17,000*	*($3,000)*

B. $17,000 ($5,000)
C. $17,000 ($6,000)
D. $18,000 ($6,000)

B. $17,000; ($5,000). Gains and losses resulting from the sale or exchange of capital assets held for not more than one year are characterized as short-term. Gains and losses resulting from the sale or exchange of capital assets help for more than one year are characterized as long-term (Code Sec. 1222). Capital gain dividends are taxed as long-term capital gains regardless of how long the shareholder has owned stock in the fund (Code Sec. 852(b)(3)(B). The ABC stock ($15,000) and the automobile ($2,000) were the only items generating short-term gain, resulting in a net of $17,000. The XYZ stock ($14,000), the land ($8,000) and the mutual fund distribution ($1,000) were all long-term assets, resulting in a net loss of $5,000.

16. Reporting Gains and Losses

Introduction

This section discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers,
- How to figure your tax using the maximum tax rates on a net capital gain, and
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, Sales and Other Dispositions of Assets, before completing Schedule D.

Schedule D

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on line 1 of Part I or line 8 of Part II, as appropriate. Include all these transactions even if you did not receive a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* or Form 1099-S, *Proceeds From Real Estate Transactions* (or substitute statement). You can use Schedule D-1 as a continuation schedule to report more transactions.

Installment sales. You cannot use the installment method to report a gain from the sale of stock or securities traded on an established securities market. You must report the entire gain in the year of sale (the year in which the trade date occurs).

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on **Form 8582.** In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099-B transactions. If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099-B or equivalent statement from the broker. Use the Form 1099-B or the equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099-B as the ***gross sales price*** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099-B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that ***net sales price*** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

Form 1099-S transactions. If you sold or traded reportable real estate, you generally should receive from the real estate reporting person a Form 1099-S showing the gross proceeds.

"Reportable real estate" is defined as any present or future ownership interest in any of the following:

- Improved or unimproved land, including air space,
- Inherently permanent structures, including any residential, commercial, or industrial building,
- A condominium unit and its accessory fixtures and common elements, including land, and
- Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A "real estate reporting person" could include the buyer's attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer's broker, or the person acquiring the biggest interest in the property.

Your Form 1099-S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on line 1 or 8 as appropriate.

Reconciling Forms 1099 with Schedule D. Add the following amounts reported to you for 2001 on Forms 1099-B and 1099-S (or on substitute statements):

Proceeds from transactions involving stocks, bonds, and other securities, and Gross proceeds from real estate transactions (other than the sale of your main home if you had no taxable gain) not reported on another form or schedule.

If this total is more than the total of lines 3 and 10 of Schedule D, attach a statement to your return explaining the difference.

Sale of property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write "Various" in column (b) for the "Date acquired."

Sale expenses. Add to your cost or other basis any expense of sale such as brokers' fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

Property held for personal use only, rather than for investment, is a capital asset and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

Long-term gains and losses. A capital gain or loss on the sale or trade of property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Schedule D. If the amount in column (f) is a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

1. Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),

2. Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
3. All capital gain distributions from mutual funds and REITs not reported directly on line 10 of Form 1040A or line 13 of Form 1040, and
4. Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 16 of Schedule D).

28% rate gain or loss. Enter in column (g) the amount, if any, from column (f) that is a 28% rate gain or loss. Enter any loss in parentheses.

A 28% rate gain or loss is:

1. Any collectibles gain or loss, or
2. The part of your gain on qualified small business stock that is equal to the section 1202 exclusion.

Capital gain distributions only. You do not have to file Schedule D if ***all*** of the following are true.
The only amounts you would have to report on Schedule D are capital gain distributions from box 2a of Form 1099-DIV (or substitute statement).

You do not have an amount in box 2b, 2c, 2d, or 2e of any Form 1099-DIV (or substitute statement).
You do not file Form 4952 or, if you do, the amount on line 4e of that form is not more than zero.
If all the above statements are true, report your capital gain distributions directly on line 13 of Form 1040 and check the box on that line. Also, use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax.

You can report your capital gain distributions on line 10 of Form 1040A, instead of on Form 1040, if both of the following are true.

1. None of the Forms 1099-DIV (or substitute statements) you received have an amount in box 2b, 2c, 2d, or 2e.
2. You do not have to file Form 1040 for any other capital gains or any capital losses.

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 16). Enter the result on line 17, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses,* next. If both lines 16 and 17 are gains and line 39 of Form 1040 is more than zero.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

1. $3,000 ($1,500 if you are married and file a separate return), or
2. Your total net loss as shown on line 17 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the $3,000 limit.

Capital loss carryover. If you have a total net loss on line 17 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1. Your allowable capital loss deduction for the year, or
2. Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss that you can carry over to next year.

Example:
Bob and Gloria sold securities in 2001. The sales resulted in a capital loss of $7,000. They had no other capital transactions. Their taxable income was

$26,000. On their joint 2001 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 - $3,000), can be carried over to 2002.

If their capital loss had been $2,000, their capital loss deduction would have been $2,000. They would have no carryover.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

Decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

Capital Gain Tax Rates

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to a net capital gain. In most cases, the 15% and 28% rates do not apply either. Instead, your net capital gain is taxed at a lower capital gain rate.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

The capital gains rate may be 8%, 10%, 15%, 20%, 25%, or 28%, or a combination of those rates, as shown in Table 17-1 (Pub. 17).

Table 17.1 What is Your Capital Tax Rate?

If your net capital gain is from	THEN your capital gain rate is
Collectibles gain	28%
Gain on qualified small business stock equal to the section 1202 exclusion	28%
Unrecaptureed section 1250 gain	25%
Other gain, [1] and the regular tax rate that would apply is 27.5% or higher	20%
Other gain, and your regular tax rate is	8% or 10% [2]

15%	

1: "Other gain" means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.

2: The rate is 8% only for qualified 5-year gain.

Investment interest deducted.

If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on lines 20-22 of Schedule D. For more information about the limit on investment interest.

Collectibles gain or loss.

This is gain or loss from the sale or trade of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held more than 1 year.

Gain on qualified small business stock.

If you realized a gain from qualified small business stock that you held more than 5 years, you exclude one-half of your gain from income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See Gains on Qualified Small Business Stock, in chapter 4 of Publication 550.

Unrecaptured section 1250 gain.

Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and section 1231 gain, see chapter 3 of Publication 544.

Using Schedule D.

You apply these rules by using Part IV of Schedule D (Form 1040) to figure your tax. You will need to use Part IV if both of the following are true.

1. You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D are gains. (Line 16 is your net long-term capital gain or loss. Line 17 is your net long-term capital gain or loss combined with any net short-term capital gain or loss.)
2. Your taxable income on Form 1040, line 39, is more than zero.

See the Comprehensive Example, later, for an example of how to figure your tax on Schedule D using the capital gain rates.

Using Capital Gain Tax Worksheet.

If you have capital gain distributions but do not have to file Schedule D, figure your tax using the Capital Gain Tax Worksheet in the Form 1040 instructions. For more information, see Capital gain distributions only, earlier.

Example:
Emily Jones is single and, in addition to wages from her job, she has income from some stocks and other securities. For the 2001 tax year, she had the following capital gains and losses, which she reports on Schedule D. All the Forms 1099 she received showed net sales prices. Her filled-in Schedule D is shown in this chapter.

Capital gains and losses — Schedule D. Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock that she had bought in February. She had an adjusted basis of $650 in the stock and sold it for $900, for a gain of $250. In July, she sold 25 shares of Computer Co. stock that she bought in June. She had an adjusted basis in the stock of $2,500 and she sold it for $2,000, for a loss of $500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Emily had three other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. In February, she sold 60 shares of Car Co. for $2,100. She had inherited the Car Co. stock from her father. Its fair market value at the time of his death was $2,500, which became her basis. Her loss on the sale is $400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock. She enters the loss in column (f) of line 8.

In June, she sold 500 shares of Furniture Co. stock for $14,000. She had bought 100 of those shares in 1988, for $1,000. She had bought 100 more shares in 1990 for $2,200, and an additional 300 shares in 1992 for $1,500. Her total basis in the stock is $4,700. She has a $9,300 ($14,000 - $4,700) gain on this sale, which she enters in column (f) of line 8.

In December, she sold 20 shares of Toy Co. for $4,100. This was qualified small business stock that she had bought in September 1994. Her basis is $1,100, so she has a $3,000 gain which she enters in column (f) of line 8. Because she held the stock more than 5 years, she has a $1,500 section 1202 exclusion. She enters that amount in column (g) as a 28% rate gain and claims the exclusion on the line below by entering $1,500 as a loss in column (f).

She received a Form 1099-B (not shown) from her broker for each of these transactions.

Capital loss carryover from 2001. Emily has a capital loss carryover to 2002 of $800, of which $300 is short-term capital loss, and $500 is long-term capital loss. She enters these amounts on lines 6 and 14 of Schedule D.

She kept the completed Capital Loss Carryover Worksheet in her 2001 Schedule D instructions (not shown), so she could properly report her loss carryover for the 2002 tax year without refiguring it.

Tax computation (Part IV).

Because Emily has gains on both lines 16 and 17 of Schedule D and has taxable income, she uses Part IV of Schedule D to figure her tax. She had already filled out her Form 1040 through line 39 and enters the amount from that line, $30,000, on line 19 of Schedule D. After filling out the rest of Part IV, she finds that her tax is $4,484. This is less than the tax she would have found using the Tax Table, $5,060.

Reconciliation of Forms 1099-B.

Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 10 of Schedule D is not less than the total of the amounts shown on the Forms 1099-B she received from her broker.

Adjustments to Income

The three adjustments to income that you can deduct in figuring your adjusted gross income, these are:

- Contributions you make to traditional individual retirement arrangements (IRAs),
- Moving expenses you pay, and
- Alimony you pay.

Other adjustments to income are discussed in other parts of this publication or in other publications and instructions. They are deductions for:

- Interest paid on student loans — instructions for Form 1040, line 24, or Form 1040A, line 16,
- Contributions to a medical savings account,
- Self-employment tax,
- Self-employed health insurance,
- Payments to a Keogh retirement plan or self-employed SEP or SIMPLE plan — Publication 560, Retirement Plans for Small Business,
- Penalty on early withdrawal of savings.
- Amortization of the costs of reforestation — Publication 535, Business Expenses,
- Contributions to Internal Revenue Code section 501(c)(18) pension plans — instructions for Form 1040, line 32,
- Expenses from the rental of personal property,
- Expenses of fee-basis officials or certain performing artists,

- Certain required repayments of supplemental unemployment benefits (sub-pay),
- Foreign housing deduction,
- Jury duty pay given to your employer, and
- Part of the cost of qualified clean-fuel vehicle property — chapter 15 of Publication 535, Business Expenses.

Example:
On November 2, 2000, John Aubrey purchased 100 shares of Gizmo Inc. for $5,000. On May 8,2001, Aubrey sold the 100 shares for $20,000. Aubrey will compute his tax on his $15,000 capital gain by using his ordinary income tax rate (e.g., 15%. 28%, 31%, 36%, 39.6%). The ordinary income rates apply because he did not hold the stock more than 12 months.

Example:
Assume the same facts as in previous example, except that Aubrey sold the shares on December 1, 2001. In this situation, he is entitled to use the new long-term rate of 20% (or 10% if he is in a 15% tax bracket) because he held the stock more than 12 months.

A. Schedule D is used to report capital gains and losses.

1. Form 1099-B, Box 2, is reported as the gross sales price. If the broker advises the taxpayer that the net amount (gross minus commissions) was reported to the IRS, then the taxpayer reports the net as the sales price.

2. Real estate transactions are reported to the taxpayer on Form 1099-S.

3. Sales expenses are added to the cost or basis of the property.

4. Short-term gains and losses for property held one year or less are reported in Part I. Include short term gains and losses from partnerships, S corporations, fiduciaries, and any short-term carryover, with current year short-term gains and losses to determine the net.

5. Long-term gains and losses for property held more than one year or eligible inherited property are reported in Part II. Part II also includes: all capital gain distributions from regulated investment companies and real estate investment trusts; the taxpayer's share of long-term gains or losses from partnerships, S corporations, and fiduciaries; and long-term capital loss carryovers.

6. Total net gain or loss is computed in Part III and combines short term and long term.

7. Current year deduction for capital losses may be limited. The current year loss and carryover is combined on a worksheet and the allowable deduction is carried to Part III, and then to Form 1040.

   a) The allowable capital loss deduction for any year is limited to the lesser of:

      (1) $3,000 ($1,500 if MFS), or

      (2) The capital loss as shown on Schedule D, line 18.

Exercise 40:
Individuals who have capital losses in excess of capital gains MUST deduct the excess, up to $3,000 ($1,500 if married filing a separate return), even if they do NOT have ordinary income to offset it. (True or False).

True. If loss deductions exceed gross income for the tax year, the excess is taken into account as negative taxable income up to $3,000 ($1,500 if married filing a separate return).

   b) Loss in excess of the current year allowable deduction is carried over to later years until completely used up. The carryover will retain its character as long-term or short-term.

   c) When used in a later year, short-term losses are used before long-term losses.

   d) The carryover is figured on a worksheet and is the amount of the net capital loss that exceeds the lesser of:

      (1) The allowable capital loss deduction for the year, or

      (2) The taxpayer's taxable income increased by the allowable capital loss deduction for the year and the deduction for personal exemptions. If deductions exceed gross income, use the negative taxable income for this computation.

   e) If MFS, the capital loss deduction is limited to $1,500. If the original loss is determined on a joint return and the taxpayers now file separate returns, the capital loss carryover can be deducted only on the return of the person who actually had the loss.

Exercise 41: During 2001, Michael sold the following assets used in his business.

Machinery	
Sales price	*$22,500*
Original Cost	*$20,000*
Accumulated depreciation	*$7,500*
Computer Equipment:	
Sales Price	*$17,000*
Original cost	*$14,000*
Accumulated depreciation	*$ 8,000*

Michael had a net section 1231 loss in 2001 of $4,000. What is the amount and character of his gain for 2001?

A. $19,500 ordinary income; $1,500 capital gain
B. $15,500 ordinary income; $1,500 capital gain
C. $8,000 ordinary income; $26,000 capital gain
D. $0 ordinary income; $21,000 capital gain

A. $19,500 ordinary income; $1,500 capital gain. The Section 1231 gain ($21,000) is recharacterized as ordinary income to the extent of depreciation recaptured ($15,500). The remaining $5,500 portion is also recharacterized as ordinary income to the extent of unaccounted for Section 1231 loss over the preceding five years ($4,000).

B. A short sale occurs when the taxpayer agrees to sell property not owned or property the taxpayer does own but does not wish to sell.

1. The taxpayer generally borrows property to deliver to the buyer.

2. At a later date, the taxpayer buys identical property and delivers it to the lender to close the sale.

3. Gain or loss is not recognized until the sale is closed. Holding period is determined by the time the taxpayer holds property delivered to the lender to close the sale.

C. A wash sale occurs when the taxpayer sells stock or securities at a loss and within 30 days before or after the sale:

1. Buys substantially identical stock or securities,

2. Acquires such stock or securities in a fully taxable trade, or

3. Acquires a contract or option to buy such stock or securities.

4. A loss on a wash sale is not deductible, but gain is taxable.

D. A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price.

1. A §1256 contract that is acquired and remains open at the end of the tax year will generally be treated as sold at its fair market value on the last business day of the year (marked-to-market rules).

2. 60/40 rule - 60% of the gain or loss the taxpayer would have had on the sale on the last business day will be treated as long-term capital gain or loss. 40% will be treated as short-term capital gain or loss.

Installment Sales

A. Installment sales are sales in which one or more payments are received after the close of the tax year. If a sale qualifies as an installment sale, it must be reported under the installment method unless the taxpayer elects to report the entire gain in the year of sale. The installment method of reporting can not be used if the sale resulted in a loss.

1. Payments for the year consist of three components:

   a) Interest, which is taxable interest income,

   b) Return of basis, which is not taxed, and

   c) Gain which may be taxed, postponed, or in some cases, excluded.

2. Form 6252, Installment Sale Income, is used to report the installment sale and show the computation of gain. If the taxpayer elects not to have the installment sale rules apply, the entire sale is reported on Schedule D or Form 4797, Sale of Business Property. Electing out needs to be done on the tax return for the year of the sale, including extensions.

3. Selling price is the total cost to the buyer. It includes: cash; FMV of any property the seller receives; liabilities the buyer pays, assumes, or takes the property subject to; and any selling expenses the buyer pays for the seller.

4. Installment sale basis is the adjusted basis plus selling expenses and depreciation recapture income.

5. Gross profit is the selling price, minus the installment sale basis, and any gain excluded or deferred on the sale of a residence.

6. Contract price is the total amount the buyer will pay the seller, plus the amount by which any liability assumed by the buyer exceeds the seller's installment sale basis.

7. Gross profit percentage is the gross profit divided by the contract price. This percentage will remain constant each year unless the contract is revised. This percentage represents the portion of each payment that is reported as gain from the sale.

8. Installment sale income is the payments received during the year (less interest) multiplied by the gross profit percentage. This is the amount of the yearly payments included in income.

NOTE: Familiarity with Form 6252, Installment Sale Income, or the following worksheet will be very helpful when taking the exam. Identify the key terms and where they fit in the installment sale computations.

A. Gross Profit

1. Selling price of old 1.__________
2. Adjusted basis of old 2.__________
3. Selling expenses 3.__________
4. Income from depreciation recapture 4.__________
5. Installment sale basis, add lines 2, 3, and 4 5.__________
6. Gain, line 1 minus line 5 6.__________
7. Residence excluded and postponed gain 7.__________
8. Gross profit, line 6 minus 7 8.__________

B. Contract Price

9. Mortgage and other debts buyer assumed 9.__________
10. Line 9 minus line 5 (If -0- or less, enter -0-) 10._________
11. Line 1 minus line 9 11._________
12. Contract price, line 10 plus line 11 12._________

C. Gross Profit Percentage and Installment Sale Income

13. Divide line 8 by line 12 (enter as a %) 13._________
14. Payments received during year (For year of sale, include line 10)14._____
15. Multiply 14 by 13 15._________

Exercise 42:

In 2001, Mr. Bradshaw sold property that had an adjusted basis to him of $19,000. The buyer assumed Bradshaw's existing mortgage of $15,000 and agreed to pay an additional $10,000 consisting of a cash down payment of $5,000, and payments of $1,000, plus interest, per year for the next five (5) years. Mr. Bradshaw paid selling expenses totaling $1,000. What is Bradshaw's gross profit percentage?

A. 20%
B. 40%
C. 50%
D. 100%

C. 50%. Bradshaw's gross profit percentage is 50%. It is calculated by dividing the gross profit ($5,000) by the total contract price ($10,000). The gross profit is determined by subtracting the adjusted basis ($19,000) and the sale expense($1,000) from the total amount received ($25,000). The total contract price is determined by subtracting the mortgage assumed by the buyer ($15,000) from the total amount received ($25,000).

B. Disposition of an installment obligation includes a sale, exchange, cancellation, bequest, distribution, or transmission of the obligation. Gain or loss will be reported in full in the year that the obligation is disposed of.

1. The amount of profit on the sale not yet received is the gross profit percentage times the unpaid balance. The remainder of the unpaid balance is the basis in the obligation.

2. If the taxpayer sells or exchanges the obligation, or accepts less than face value in satisfaction of the obligation, gain or loss is the difference between the basis in the obligation and the amount realized.

3. If disposed of in any other manner, such as by gift or cancellation, the gain or loss is the difference between the basis in the obligation and its fair market value at the time of the disposition.

4. If the taxpayer accepts part payment on the unpaid balance and forgives the rest, it is treated as a sale or exchange. The gain or loss is the difference between the basis in the obligation and the amount realized on settlement.

5. If the selling price is reduced but the debt is not forgiven, it is not a disposition but a renegotiation. The gross profit percentage must be redetermined and applied to payments after the reduction.

6. If the buyer disposes of the property and the original seller agrees to let the new buyer assume the original obligation, it is not treated as a disposition.

7. A transfer due to death is not treated as a disposition unless the obligation is transferred to the buyer.

Exercise 43:
During 2001, Juan sold a piece of unimproved real estate to Catherine for $20,000. Juan acquired the property in 1985 for $10,000. During 2000, Juan received $4,000 cash and Catherine's note for $16, 000 as the balance of the sales price, payable in subsequent years. Juan filed his 2001 return using the installment method to report the sale. During 2002, before Catherine made any further payment, Juan sold the note for $15,000 in cash to Frank. What is the amount of the gain or (loss) Juan will show on his 2002 income tax return?

A. ($1,000)
B. $0
C. $7,000
D. $9,000

C. $7,000. The amount Juan will show on his income tax return is a gain of $7,000. If an installment obligation is sold, the gain or loss is the difference between the "basis" of the obligation and the "amount realized" by the holder of the obligation. "Basis" is defined as the excess of the face amount of the obligation over the income that would be returnable if it were paid in full. "Amount realized" includes the cash paid or credit to the account of the seller. The selling price ($20,000) less the down payment received ($4,000) and less the installments received prior to sale ($0) results in the balance unpaid ($16,000). The balance unpaid ($16,000) less the remaining income returnable (50% gross profit ratio x balance unpaid ($16,000)) results in the basis of the obligation ($8,000). The amount realized on the sale of the note ($15,000) less the basis of the obligation ($8,000) results in the gain to the taxpayer of $7,000.

C. Repossession, after an installment sale, requires a determination of gain or loss on repossession and a redetermination of the basis in the repossessed property.

1. For personal property, gain or loss is determined by subtracting the basis in the installment obligation and any expenses of repossession from the fair market value of the property. The new basis in the property is the fair market value at the time of repossession.

2. The repossession of real property restores the taxpayer to approximately the same position as prior to the sale. The basis in the property is the original basis. The taxpayer reports gain on the sale which is the gross profit from the original sale, minus the sum of gain previously reported and the repossession costs.

17. Selling Your Home (Pub. 523)

Important Reminders **Home sold with undeducted points.**	If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of sale. See Points in Part I of Publication 936, Home Mortgage Interest Deduction.

A. Gain or loss from Sale of Residence

Generally, your main home is the one in which you live most of the time.

Gain.

If you have a gain from the sale of your main home, you may be able to exclude from income up to a limit of $250,000 ($500,000 on a joint return in most cases).

Loss.

You cannot deduct a loss from the sale of your main home.

Worksheets.

Publication 523, Selling Your Home, includes worksheets to help you figure the adjusted basis of the home you sold, the gain (or loss) on the sale, and the amount of the gain that you can exclude.

Reporting the sale.

Do not report the sale of your main home on your tax return unless you have a gain and at least part of it is taxable. Report any taxable gain on Schedule D (Form 1040).

Main Home

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

More than one home.

If you have more than one home, only the sale of your main home qualifies for postponing or excluding gain. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time.

Example
You own and live in a house in town. You also own a beach house, which you use in the summer months. The town house is your main home; the beach house is not.

Example
You own a house, but you live in another house that you rent. The rented home is your main home.

Property used partly as your home.

If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see Property used partly as your home and partly for business or rental during the year of sale under Business Use or Rental of Home, later.

Rules for Sales in 2001

Use the rules in this chapter if you sold your main home in 2001.

You may be able to exclude any gain from income up to a limit of $250,000 ($500,000 on a joint return in most cases). If you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Schedule D (Form 1040).

The main topics in this chapter are:

- How to figure gain or loss,
- Basis,
- Excluding the gain,
- Ownership and use tests,
- Special situations,
- Reporting the gain, and
- Real estate and transfer taxes.

This chapter includes worksheets you can use to figure your gain (or loss) and your exclusion. Use *Worksheet 1* to figure the adjusted basis of the home you sold. Use

Worksheet 2 to figure the gain (or loss), the exclusion, and the taxable gain (if any) on the sale. In some situations, you may also need to use *Worksheet 3* to figure a reduced maximum exclusion.

How To Figure Gain or Loss On the Sale

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis.

Selling price

The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

Amount realized

The amount realized is the selling price minus selling expenses.

Selling expenses

- Selling expenses include:
- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or "points."

Amount of gain or loss

When you know the amount realized and the home's adjusted basis, you can figure your gain or loss. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable.

To figure your home's adjusted basis, see Basis, later.

Jointly owned home

If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns

If you file separate returns, each of you must figure and report your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married

If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure and report your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

Trading homes
If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home that had an adjusted basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new house priced at $80,000. You are considered to have sold your old home for $50,000 and to have had a gain of $9,000 ($50,000 - $41,000).

If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, your sales price would still be $50,000 (the $27,000 trade-in allowed plus the $23,000 mortgage assumed).

Foreclosure or repossession
If your home was foreclosed on or repossessed, you have a sale.

Gain On Sale
You will generally exclude all or part of the gain on the sale of your main home under the new rules. If you sold your home before 1998 different rules could apply. For more information and the rules that could apply to you, get Publication 523.

Loss on Sale
You cannot deduct a loss on the sale of your home. It is a personal loss.

Basis
You will need to know your basis in your home as a starting point for determining any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way, its basis is either its fair market value when you received it or the adjusted basis of the person you received it from.

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis is used to figure gain or loss on the sale of your home.

Settlement fees or closing costs.
When buying your home, you may have to pay settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs you pay for buying the home. You cannot include in your basis the fees and costs for getting a mortgage loan. A fee for buying the home is any fee you would have had to pay even if you paid cash for the home.

Adjusted Basis
Adjusted basis is your basis increased or decreased by certain amounts.

Increases to basis
These include any:

- Improvements that have a useful life of more than 1 year,
- Additions,
- Special assessments for local improvements, and
- Amounts you spent after a casualty to restore damaged property.

Decreases to basis
These include any:

- Gain you postponed from the sale of a previous home before May 7, 1997,
- Deductible casualty losses,
- Insurance payments you received or expect to receive for casualty losses,
- Payments you received for granting an easement or right-of-way,
- Depreciation allowed or allowable if you used your home for business or rental purposes.

Improvements
These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of improvements to the basis of your property.

Examples. Putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements.

Repairs
These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Recordkeeping
You should keep records to prove your home's adjusted basis. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold your home. But if the basis of your old home affects the basis of your new one, such as when you sold your old home before May 7, 1997, and postponed tax on any gain, you should keep those records as long as they are needed for tax purposes. The records you should keep include:

- Proof of the home's purchase price and purchase expenses,

- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis,
- Any worksheets you used to figure the adjusted basis of the home you sold, the gain or loss on the sale, the exclusion, and the taxable gain,
- Any Form 2119 that you filed to postpone gain from the sale of a previous home before May 7, 1997, and
- Any worksheets you used to prepare Form 2119, such as the Adjusted Basis of Home Sold Worksheet or the Capital Improvements Worksheet from the Form 2119 instructions.

Excluding The Gain
You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under Maximum Amount of Exclusion, next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion. In that case, you will have to pay tax on your entire gain, unless you choose to use the rules in chapter 3 of Publication 523.

Maximum Amount of Exclusion
You can exclude the entire gain on the sale of your main home up to:
- $250,000, or
- $500,000 if all of the following are true.
- You are married and file a joint return for the year.
- Either you or your spouse meets the ownership test.
- Both you and your spouse meet the use test.
- During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home (not counting any sales before May 7, 1997).

More Than One Home Sold During 2-Year Period
You cannot exclude gain on the sale of your home if, during the 2-year period ending on the date of the sale, you sold another home at a gain and excluded all or part of that gain. If you cannot exclude the gain, you must include it in your income.

However, if you sold the home due to a change in health or place of employment, you can still claim an exclusion. The maximum amount you can exclude is reduced. See Reduced Maximum Exclusion, earlier.

Ownership and Use Tests
To claim the exclusion, you must meet the ownership and use tests. This means that during the ***5-year period*** ending on the date of the sale, you must have:

1. ***Owned*** the home for at least ***2 years*** (the ownership test), ***and***

2. ***Lived in*** the home as your main home for at least ***2 years*** (the use test).

Exception. If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. The maximum amount you can claim will be reduced. See *Reduced Maximum Exclusion*, earlier.

Period of ownership and use. The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous.
You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 × 2) during the 5-year period ending on the date of sale.

Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent the property during the absences, are counted as periods of use. See *Ownership and use tests met at different times,* later.

> *Example***.** *Professor Paul Beard, who is single, bought and moved into a house on August 28, 1998. He lived in it as his main home continuously until January 5, 2000, when he went abroad for a 1-year sabbatical leave. During part of the period of leave, the house was unoccupied, and during the rest of the period, he rented it. On January 5, 2001, he sold the house at a gain.*
>
> *Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, unless he sold the house due to a change in place of employment or health, as explained under* Reduced Maximum Exclusion, *earlier. Even if he did sell the house due to a change in place of employment or health, he cannot exclude the part of the gain equal to the depreciation he claimed while renting the house. See* Depreciation for business use after May 6, 1997*, later.*

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

> *Example***.** *In 1992, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 1998. In 1999, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 10, 2001, while still living in her daughter's home, she sold her apartment.*
> *Helen can exclude gain on the sale of her apartment because she met the ownership and use tests. Her 5-year period is from July 11, 1996, to July 10, 2001, the date she sold the apartment. She owned her apartment from December 1, 1998, to July 10, 2001 (over 2 years). She lived in the apartment*

from July 11, 1996 (the beginning of the 5-year period), to April 14, 1999 (over 2 years).

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

1. Owned the stock for at least 2 years, and
2. Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the use test if during the 5-year period before the sale of your home:

1. You become physically or mentally unable to care for yourself, and
2. You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Gain postponed on sale of previous home. For the ownership and use tests, you may be able to add the time you owned and lived in a previous home to the time you lived in the home on which you wish to exclude gain. You can do this if you postponed all or part of the gain on the sale of the previous home because of buying the home on which you wish to exclude gain.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the ***same*** home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see *Maximum Amount of Exclusion,* earlier.)

Example 1 - one spouse sells a home. *Emily sells her home in June 2001. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to $250,000 of gain on a separate or joint return for 2001.*

Example 2 - each spouse sells a home. *The facts are the same as in* Example 1 *except that Jamie also sells a home. He meets the ownership and use tests on his home. Emily and Jamie can each exclude up to $250,000 of gain.*

Death of spouse before sale. If your spouse died before the date of sale, you are considered to have owned and lived in the property as your main home during any period of time when your spouse owned and lived in it as a main home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

1. You owned it, and
2. Your spouse or former spouse is allowed to live in it under a divorce or separation instrument.

Business Use or Rental of Home

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1. *On May 30, 1995, Amy bought a house. She moved in on that date and lived in it until May 31, 1997, when she moved out of the house and put it up for rent. The house was rented from June 1, 1997, to March 31, 1999. Amy moved back into the house on April 1, 1999, and lived there until she sold it on January 31, 2001. During the 5-year period ending on the date of the sale (February 1, 1996 - January 31, 2001), Amy owned and lived in the house for more than 2 years as shown in the table below.*

Five Year Period	***Used as Home***	***Used as Rental***
2/1/96 - 5/31/97	*16 months*	
6/1/97 - 3/31/99		*22 months*
4/1/99 - 1/31/01	*22 months*	
	38 months	*22 months*

Amy can exclude gain up to $250,000. But she cannot exclude the part of the gain equal to the depreciation she claimed for renting the house, as explained after Example 2.

Example 2. *William owned and used a house as his main home from 1995 through 1998. On January 1, 1999, he moved to another state. He rented his house from that date until April 30, 2001, when he sold it. During the 5-year period ending on the date of sale (May 1, 1996 - April 30, 2001), William owned and lived in the house for 32 months (more than 2 years). He can exclude gain up to $250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed for renting the house, as explained next.*

Depreciation for business use after May 6, 1997

If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997. If you can show by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, the amount you cannot exclude is the smaller figure.

Example. *Ray sold his main home in 2001 at a $30,000 gain. He meets the ownership and use tests to exclude the gain from his income. However, he used part of the home for business in 2000 and claimed $500 depreciation. He can exclude $29,500 ($30,000 - $500) of his gain. He has a taxable gain of $500.*

Property used partly as your home and partly for business or rental during the year of sale. In the year of sale you may have used part of your property as your home and part of it for business or to produce income.

Examples are:

- A working farm on which your house is located,
- An apartment building in which you live in one unit and rent out the others,
- A store building with an upstairs apartment in which you live, or
- A home with a room used for business or to produce income.

If you sell the entire property you should consider the transaction as the sale of two properties. The sale of the part of your property used for business or rental is reported on Form 4797, Sales of Business Property . For more information, see Property used partly as your home and partly for business or rental during the year of sale, under Business Use or Rental of Home, in chapter 2 of Publication 523.

Reporting the Gain

If you have any taxable gain on the sale of your main home, report the entire gain realized on Schedule D (Form 1040), Capital Gains and Losses, with your return. Report it on line 1 or line 8 of Schedule D, depending on how long you owned the home. If you qualify for an exclusion, show it on the line directly below the line on which you report the gain. Write "Section 121 exclusion" in column (a) of that line and show the amount of the exclusion in column (f) as a loss (in parentheses).

Tax rate on capital gains.
Your net capital gain is taxed at a tax rate of 10%, 15%, 20%, 25%, or 28%, depending on your situation.

Installment sale.
Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called installment sales. If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you may have an installment sale. If the sale qualifies, you can report the part of the gain you cannot exclude on the installment basis. Use Form 6252, Installment Sale Income, to report the sale.

Seller-financed mortgage.
If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must report the interest you receive as part of each payment separately as interest income. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number (SSN) of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her SSN and you must give the buyer your SSN. Failure to meet these requirements may result in a $50 penalty for each failure. If you or the buyer does not have and is not eligible to get an SSN.

Individual taxpayer identification number (ITIN).
If either you or the buyer of your home is a nonresident or resident alien who does not have and is not eligible to get an SSN, the IRS will issue you (or the buyer) an ITIN. To apply for an ITIN, file Form W-7 with the IRS.

If you have to include the buyer's SSN on your return and the buyer does not have and cannot get an SSN, enter the buyer's ITIN. If you have to give an SSN to the buyer and you do not have and cannot get one, give the buyer your ITIN.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

PART 4 - ADJUSTMENTS, DEDUCTIONS, CREDITS AND TAXES

In this part we discuss three of the adjustments to income that you can deduct in figuring your adjusted gross income. These sections cover:

- Contributions you make to traditional individual retirement arrangements (IRAs),
- Moving expenses you pay, and
- Alimony you pay

Some other adjustments to income are discussed in other parts of this publication or in other publications and instructions. They are deductions for:

- Interest paid on student loans -- instructions for Form 1040, line 24, or Form 1040A, line 17,
- Self-employment tax,
- Self-employed health insurance,
- Payments to self-employed SEP, SIMPLE, and qualified plans -- Publication 560, **Retirement Plans for Small Business,**
- Penalty on early withdrawal of savings,
- Expenses from the rental of personal property,

18. Individual Retirement Arrangements (IRAs)

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement.

We will discusses:
1. The rules for a ***traditional IRA*** (those that are not Roth or SIMPLE IRAs), and
2. The ***Roth IRA,*** which features nondeductible contributions and tax-free distributions.

Traditional IRAs

A traditional IRA is any IRA that is not a Roth IRA or a SIMPLE IRA. Two advantages of a traditional IRA are:

1. You may be able to deduct some or all of your contributions to it, depending on your circumstances, and,
2. Generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

Who Can Set Up a Traditional IRA?

You can set up and make contributions to a traditional IRA if:

You (or, if you file a joint return, your spouse) received taxable compensation during the year, and
You were not age 70 1/2 by the end of the year.

What is compensation? Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts you receive for providing personal services. The IRS treats as compensation any amount properly shown in box 1 (Wages, tips, other compensation) of Form W-2, Wage and Tax Statement, provided that amount is reduced by any amount properly shown in box 11 (Nonqualified plans). Scholarship and fellowship payments are compensation for this purpose only if shown in box 1 of Form W-2. Compensation also includes commissions and taxable alimony and separate maintenance payments.

Self-employment income. If you are self-employed (a sole proprietor or a partner), compensation is the net earnings from your trade or business (provided your personal services are a material income-producing factor) reduced by the total of:

1. The deduction for contributions made on your behalf to retirement plans, and
2. The deduction allowed for one-half of your self-employment taxes.

Compensation includes earnings from self-employment even if they are not subject to self-employment tax because of your religious beliefs. See Publication 533, Self-Employment Tax, for more information.

When and How Can a Traditional IRA Be Set Up?
You can set up a traditional IRA at any time. However, the time for making contributions for any year is limited. See When Can Contributions Be Made, later.

You can set up different kinds of IRAs with a variety of organizations. You can set up an IRA at a bank or other financial institution or with a mutual fund or life insurance company. You can also set up an IRA through your stockbroker. Any IRA must meet Internal Revenue Code requirements.

Kinds of traditional IRAs. Your traditional IRA can be an individual retirement account or annuity. It can be part of either a simplified employee pension (SEP) or an employer or employee association trust account.

How Much Can Be Contributed?
There are limits and other rules that affect the amount that can be contributed and the amount you can deduct. These limits and other rules are explained below.

Community property laws. Except as discussed later under Spousal IRA limit, each spouse figures his or her limit separately, using his or her own compensation. This is the rule even in states with community property laws.

Brokers' commissions. Brokers' commissions paid in connection with your traditional IRA are subject to the contribution limit.

General limit. The most that can be contributed to your traditional IRA is the smaller of the following amounts:

1. Your compensation (defined earlier) that you must include in income for the year, or
2. $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if you are 50 or older).

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible. (See Nondeductible Contributions, later.)

Example 1. Betty, who is single, earned $24,000 in 2001. Her IRA contributions for 2001 are limited to $2,000.

Example 2. John, a college student working part time, earned $1,500 in 2001. His IRA contributions for 2001 are limited to $1,500, the amount of his compensation.

Spousal IRA limit. If you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts:

$2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if you are 50 or older), or
The total compensation includible in the gross income of both you and your spouse for the year, reduced by the following two amounts.

1. Your spouse's contribution for the year to a traditional IRA.
2. Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as $4,000 for 2001 ($6,000 for 2002, or $6,500 for 2002 if only one of you is 50 or older, or $7,000 for 2002 if both of you are 50 or older).

When Can Contributions Be Made?
As soon as you set up your traditional IRA, contributions can be made to it through your chosen sponsor (trustee or other administrator). Contributions to a traditional IRA must be in the form of money (cash, check, or money order). Property cannot be contributed.

Contributions must be made by due date. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, not including extensions. For most people, this means that contributions for 2001 must be made by April 15, 2002.

Age 70 1/2 rule. Contributions cannot be made to your traditional IRA for the year in which you reach age 70 1/2 or for any later year.

Designating year for which contribution is made. If an amount is contributed to your traditional IRA between January 1 and April 15, you should tell the sponsor to which year (the current year or the previous year) the contribution is for. If you do not tell the sponsor which year it is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

Filing before a contribution is made. You can file your return claiming a traditional IRA contribution before the contribution is actually made. However, the contribution must be made by the due date of your return, not including extensions.

Contributions not required. You do not have to contribute to your traditional IRA for every tax year, even if you can.

How Much Can I Deduct?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit (or the spousal IRA limit, if it applies).

However, if you or your spouse was covered by an employer retirement plan, you may not be able to deduct this amount. See Limit if Covered by Employer Plan, later.

Trustees' fees. Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. However, they may be deductible as a miscellaneous itemized deduction on Schedule A (Form 1040). See chapter 30.

Brokers' commissions. Brokers' commissions are part of your IRA contribution and, as such, are deductible subject to the limits.

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of:

1. $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if you are 50 or older), or
2. 100% of your compensation.

This limit is reduced by any contributions made to a 501(c)(18) plan on your behalf.

Spousal IRA. In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

1. $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if 50 or older), or
2. The total compensation includible in the gross income of both spouses for the year reduced by the following two amounts.

The IRA deduction for the year of the spouse with the greater compensation.
Any contributions for the year to a Roth IRA on behalf of the spouse with more compensation.
This limit is reduced by any contributions to a 501(c)(18) plan on behalf of the spouse with less compensation.

Note. If you were divorced or legally separated (and did not remarry) before the end of the year, you cannot deduct any contributions to your spouse's IRA. After a divorce or legal separation, you can deduct only contributions to your own IRA and your deductions are subject to the rules for single individuals.

Covered by an employer retirement plan. If you or your spouse was covered by an employer retirement plan at any time during the year for which contributions were made, your deduction may be further limited. This is discussed later under Limit If Covered by Employer Plan. Limits on the amount you can deduct do not affect the amount that can be contributed. See Nondeductible Contributions, later.

Can I Move Retirement Plan Assets?
Traditional IRA rules permit you to transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. The rules permit the following kinds of transfers.

- Transfers from one trustee to another.
- Rollovers.
- Transfers incident to a divorce.

Transfers to Roth IRAs. Under certain conditions, you can move assets from a traditional IRA to a Roth IRA. See Can I Move Amounts Into a Roth IRA? under Roth IRAs, later.

Trustee-to-Trustee Transfer
A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers, discussed later

under Rollover From One IRA Into Another. For information about direct transfers to IRAs from retirement plans other than IRAs, see Publication 590.

Rollovers
Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution."

Note. The amount you roll over tax free is generally taxable when the new plan distributes that amount to you or your beneficiary.

Kinds of rollovers to an IRA. There are two kinds of rollover contributions to a traditional IRA.

You put amounts you receive from one traditional IRA into the same or another traditional IRA.
You put amounts you receive from an employer's qualified retirement plan for its employees into a traditional IRA.

Distributions after December 31, 2001, can be rolled over into a traditional IRA from:

1. A deferred compensation plan of a state or local government (section 457 plan), or
2. A tax-sheltered annuity (section 403(b).

For more information, see Publication 553, Highlights of 2001 Tax Changes.

Treatment of rollovers. You cannot deduct a rollover contribution, but you must report the rollover distribution on your tax return as discussed later under Reporting rollovers from IRAs and under Reporting rollovers from employer plans.

Kinds of rollovers from an IRA. For distributions after December 31, 2001, you can roll over, tax free, a distribution from your IRA into a qualified plan, including a deferred compensation plan of a state or local government (section 457 plan) and a tax-sheltered annuity (section 403(b) plan). The part of the distribution that you can roll over is the part that would otherwise be taxable (includible in your income). Qualified plans may, but are not required to, accept such rollovers. Rules applicable to other rollovers, such as the 60-day time limit, apply.

Time limit for making a rollover contribution. You, generally, must make the rollover contribution by the 60th day after the day you receive the distribution from your traditional IRA or your employer's plan.

For distributions made after December 31, 2001, the IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as a casualty, disaster, or other event beyond your reasonable control.

Extension of rollover period. If an amount distributed to you from a traditional IRA or a qualified employer retirement plan is a frozen deposit at any time during the 60-day period allowed for a rollover, special rules extend the rollover period. For more information, get Publication 590.

Rollover From One IRA Into Another
You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in an IRA.

Waiting period between rollovers. If you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.

The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA.

Example. If you have two traditional IRAs, IRA-1 and IRA-2, and you make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3), you can also make a tax-free rollover of a distribution from IRA-2 into IRA-3 (or into any other traditional IRA) within 1 year of the distribution from IRA-1. These can both be tax-free rollovers because you have not received more than one distribution from either IRA within 1 year. However, you cannot, within the 1-year period, make a tax-free rollover of any distribution from IRA-3 into another traditional IRA.

Rollover From Employer's Plan Into an IRA
If you receive an eligible rollover distribution from your (or your deceased spouse's) employer's qualified pension, profit-sharing or stock bonus plan, annuity plan, or tax-sheltered annuity plan (403(b) plan), you can roll over all or part of it into a traditional IRA.

For distributions made after December 31, 2001, if you receive an eligible rollover distribution from your (or your deceased spouse's) governmental deferred compensation plan (section 457 plan), you can roll over all or part of it into a traditional IRA.

Eligible rollover distribution. Generally, an eligible rollover distribution is the taxable part of any distribution of all or part of the balance to your credit in a qualified retirement plan.

Maximum rollover. The most that you can roll over is the taxable part of any eligible rollover distribution (defined earlier). All of the distribution you receive generally will be taxable unless you have made nondeductible employee contributions to the plan.

When Can I Withdraw or Use IRA Assets?
There are rules limiting use of your IRA assets and distributions from it. Violation of the rules generally results in additional taxes in the year of violation. See What Acts Result in Penalties.

Age 59 1/2 rule. Generally, if you are under age 59 1/2, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59 1/2 are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

Early distributions tax. The 10% additional tax on distributions made before you reach age 59 1/2 does not apply to these tax-free withdrawals of your contributions. However, the distribution of interest or other income must be reported on Form 5329 and, unless the distribution qualifies as an exception to the age 59 1/2 rule, it will be subject to this tax.

When Must I Withdraw IRA Assets? (Required Distributions)
You cannot keep funds in your traditional IRA indefinitely. Eventually they must be distributed. If there are no distributions, or if the distributions are not large enough, you may have to pay a 50% excise tax on the amount not distributed as required. See Excess Accumulations (Insufficient Distributions), later. The requirements for distributing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

Required distributions not eligible for rollover. Amounts that must be distributed (required distributions) during a particular year are not eligible for rollover treatment.

IRA owners. If you are the owner of a traditional IRA, by April 1 of the year following the year in which you reach age 70 1/2, you must either:

1. Receive the entire balance in your IRA, or
2. Start receiving periodic distributions from your IRA.

April 1 of the year following the year in which you reach age 70 1/2 is referred to as the required beginning date.

More information. For more information, including how to figure your minimum required distribution each year and how to figure your required distribution if you are a beneficiary of a decedent's IRA, see Publication 590.

Are Distributions Taxable?

In general, distributions from a traditional IRA are taxable in the year you receive them.

Ordinary income. Distributions from traditional IRAs that you include in income are taxed as ordinary income.

Distributions Fully or Partly Taxable
Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one), you have no basis in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received. See Reporting taxable distributions on your return, later.

Partly taxable. If you made nondeductible contributions to any of your traditional IRAs, you have a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

Roth IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

You can make contributions for 2001 by the due date (not including extensions) for filing your 2001 tax return. This means that most people can make contributions for 2001 by April 15, 2002.

Contributions not reported. You do not have to report Roth IRA contributions on your return.

What Is a Roth IRA?
A Roth IRA is an individual retirement plan that, except as explained in this chapter, is subject to the rules that apply to a traditional IRA (defined below). It can be either an account or an annuity. Individual retirement accounts and annuities are described in Publication 590.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions (discussed later) are tax free. Contributions can be made to your Roth IRA after you reach age 70 1/2 and you can leave amounts in your Roth IRA as long as you live.
Traditional IRA. A traditional IRA is any IRA that is not a Roth IRA or SIMPLE IRA.

Can I Contribute to a Roth IRA?
Generally, you can contribute to a Roth IRA if you have taxable ***compensation*** (defined later) and your ***modified AGI*** (defined later) is less than:

- $160,000 for married filing jointly,
- $10,000 for married filing separately and you lived with your spouse at any time during the year, and
- $110,000 for single, head of household, qualifying widow(er) or married filing separately and you did not live with your spouse at any time during the year.

Is there an age limit for contributions? Contributions can be made to your Roth IRA regardless of your age.

Can I contribute to a Roth IRA for my spouse? You can contribute to a Roth IRA for your spouse provided the contributions satisfy the spousal IRA limit (discussed in *How Much Can Be Contributed?* under *Traditional IRAs*) and your modified AGI is less than:

- $160,000 for married filing jointly,
- $10,000 for married filing separately and you lived with your spouse at any time during the year, and
- $110,000 for married filing separately and you did not live with your spouse at any time during the year.

Compensation. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, and taxable alimony and separate maintenance payments.

Modified AGI. Your modified AGI for Roth IRA purposes is your adjusted gross income (AGI) as shown on your return modified as follows.

1. ***Subtract*** any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA (conversion income).
2. ***Add*** the following deductions and exclusions:
    a. Traditional IRA deduction,
    b. Student loan interest deduction,

c. Foreign earned income exclusion,
d. Foreign housing exclusion or deduction,
e. Exclusion of qualified savings bond interest shown on Form 8815, and
f. Exclusion of employer-paid adoption expenses shown on Form 8839.

You can use *Worksheet 18-2* to figure your modified AGI.

Worksheet 18-2. Modified Adjusted Gross Income for Roth IRA Purposes
Use this worksheet to figure your modified adjusted gross income for Roth IRA purposes.

1.	Enter your adjusted gross income (Form 1040, line 33 or Form 1040A, line 19)	**1.**
2.	Enter any income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA	**2.**
3.	Subtract line 2 from line 1	**3.**
4.	Enter any traditional IRA deduction (Form 1040, line 23 or Form 1040A, line 16)	**4.**
5.	Enter any student loan interest deduction (Form 1040, line 24 or Form 1040A, line 17)	**5.**
6.	Enter any foreign earned income exclusion (Form 2555, line 40 or Form 2555-EZ, line 18)	**6.**
7.	Enter any foreign housing exclusion or deduction (Form 2555, line 34 or 48)	**7.**
8.	Enter any exclusion of bond interest (Form 8815, line 14)	**8.**
9.	Enter any exclusion of employer-paid adoption expenses (Form 8839, line 26)	**9.**
10.	Add the amounts on line 3 through 9. This is your **modified adjusted gross income** for Roth IRA purposes	**10.**

How Much Can Be Contributed?
The contribution limit for Roth IRAs depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRAs only. If contributions are made only to Roth IRAs, your contribution limit generally is the lesser of:

- $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if you are 50 or older), or
- Your taxable compensation.

However, If your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later under *Contribution limit reduced.*

Roth IRAs and traditional IRAs. If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs generally is the same as your limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

This means that your contribution limit is the lesser of:

- $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if you are 50 or older) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

Contribution limit reduced. If your modified AGI is above a certain amount, your contribution limit is gradually reduced. Use *Table 18-3* to determine if this reduction applies to you.

Figuring the reduction. If the amount you can contribute to your Roth IRA is reduced, see Publication 590 for how to figure the reduction.

Table 18-3. Effect of Modified AGI on Roth IRA Contribution
This table shows whether your contribution to a Roth IRA is affected by the amount of your modified adjusted gross income (modified AGI).

IF you have taxable compensation and your filing status is ...	**AND** your modified AGI is ...	**THEN** ...
Married Filing Jointly	Less than $150,000	You can contribute up to $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if age 50 or older).
	At least $150,000 but less than $160,000	The amount you can contributed is reduced as explained under *Contribution limit reduced.*
	$160,000 or more	You cannot contribute to a Roth IRA.
Married Filing Separately and you lived with your spouse at any time during the year	Zero (-0-)	You can contribute up to $2,000 for 2001 ($3,000 for 2002 or $3,500 for 2002 if 50 or older).
	More than zero (-0-) but less than $10,000	The amount you can contribute is reduced as explained under *Contribution limit reduced.*
	$10,000 or more	You cannot contribute to a Roth IRA.
Single, Head of Household, Qualifying Widow(er), or	Less than $95,000	You can contribute up to $2,000 for 2001 ($3,000 for

Married Filing Separately and you did not live with your spouse at any time during the year		2002 or $3,500 for 2002 if age 50 or older).
	At least $95,000 but less than $110,000	The amount you can contribute is reduced as explained under *Contribution limit reduced.*
	$110,000 or more	You cannot contribute to a Roth IRA.

When Can I Make Contributions?
You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).

Can I Move Amounts Into a Roth IRA?
You may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You may be able to recharacterize contributions made to one IRA as having been made directly to a different IRA. You can roll amounts over from one Roth IRA to another Roth IRA.

You can convert a traditional IRA or a SIMPLE IRA to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers, described under *Rollover From One IRA Into Another* under *Traditional IRAs,* earlier, apply to these rollovers. However, the 1-year waiting period does not apply.

Conversion methods. You can convert amounts from a traditional IRA to a Roth IRA in ***any*** of the following three ways.

1. ***Rollover***. You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.
2. ***Trustee-to-trustee transfer***. You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.
3. ***Same trustee transfer***. If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Same trustee. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Converting from any traditional IRA. You can convert amounts from a traditional IRA into a Roth IRA if, for the tax year you make the withdrawal from the traditional IRA, *both* of the following requirements are met.

1. Your modified AGI (explained earlier) is not more than $100,000.

2. You are not a married individual filing a separate return. (See *Lived apart from spouse* under *Filing status,* earlier.)

Required distributions. Amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 70 1/2) under the required distribution rules (discussed under *Traditional IRAs,* earlier) cannot be converted.

Inherited IRAs. If you inherited a traditional IRA from someone other than your spouse, you cannot convert it to a Roth IRA.

Income. You must include in your gross income distributions from a traditional IRA that you would have to include in income if you had not converted them into a Roth IRA. You do not include in gross income any part of a distribution from a traditional IRA that is a return of your basis, as discussed earlier under *Traditional IRAs*.

If you must include any amount in your gross income, you may have to make estimated tax payments.

Converting from a SIMPLE IRA. Generally, you can convert an amount in your SIMPLE IRA to a Roth IRA under the same rules explained earlier under *Converting from any traditional IRA.*
However, you cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date you first participated in any SIMPLE IRA plan maintained by your employer.
More information. For more detailed information on conversions, see Publication 590.

Rollover From a Roth IRA

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. Most of the rules for rollovers explained under *Rollover From One IRA Into Another* under *Traditional IRAs,* earlier, apply to these rollovers.

Are Distributions From My Roth IRA Taxable?
You do not include in your gross income ***qualified distributions*** or distributions that are a return of your regular contributions from your Roth IRA(s). You also do not include distributions from your Roth IRA that you roll over tax free into another Roth IRA. You may have to include part of other distributions in your income. See *Ordering rules for distributions,* later.

What are qualified distributions? A qualified distribution is any payment or distribution from your Roth IRA that meets the following requirements.

1. It is made after the 5-taxable-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit, and
2. The payment or distribution is:
    a. Made on or after the date you reach age 59 1/2,
    b. Made because you are disabled,
    c. Made to a beneficiary or to your estate after your death, or
    d. To pay certain qualified first-time homebuyer amounts discussed in Publication 590.

Additional tax on distributions of conversion contributions within 5-year period. If, within the 5-year period starting with the year in which you made a conversion contribution of an amount from a traditional IRA to a Roth IRA, you take a distribution from a Roth IRA of an amount attributable to the portion of the conversion contribution that you had to include in income, you generally must pay the 10% additional tax on early distributions. (See *Ordering Rules for Distributions,* later, to determine the amount, if any, of the distribution that is attributable to the conversion contribution.) The 5-year period is separately determined for each conversion contribution.

Additional tax on other early distributions. The taxable part of other distributions from your Roth IRA(s) that are not qualified distributions is subject to the additional tax on early distributions. See Publication 590 for more information.

Ordering rules for distributions. If you receive a distribution from your Roth IRA that is ***not*** a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Regular contributions are distributed first. See Publication 590 for more information.

Am I required to take distributions when I reach age 70 1/2? You are not required to take distributions from your Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.
More information. For more detailed information on Roth IRAs, see Publication 590.

Important Changes Increased traditional IRA contribution and deduction limit.	The most that can be contributed to your traditional IRA is the smaller of the following amounts: • Your compensation that you must include in income for the year, or • ***$3,000*** (up from $2,000). If you are 50 years of age or older, the most that can be contributed to your traditional IRA is the smaller of the following amounts: • Your compensation that you must include in

	income for the year, or • ***$3,500*** (up from $2,000). For more information, see *How Much Can Be Contributed?* under *Traditional IRAs*.

19. Moving Expenses

A. Requirements For Deductibility

1. Moving expenses must be closely related, both in time and place, to the start of work at a new job location.

   a) Closely related in time occurs if incurred within one year from the date the taxpayer reported to work. It is not necessary to have the new job before moving.

   b) Closely related in place occurs if the distance from the new home to the new job location is not more than the distance from the former home to the new job.

2. **Distance Test**

   a) The move will meet this test if the new main job location is at least 50 miles farther from one's former home than the old job location.

   b) If the taxpayer goes to work full-time for the first time, the place of work must be at least 50 miles from the former home to meet the test.

   c) A move due to change of station in the Armed Forces does not have to meet this test.

3. **Time Test**

   a) A taxpayer must work full-time for at least 39 weeks during the first 12 months after arriving in the general area of the new job.

   b) If self-employed, the taxpayer must work full-time for at least 39 weeks during the first 12 months and a total of at least 78 weeks during the first 24 months after arriving in the area of the new job location.

Example. Your family moved more than a year after you started work at a new location. You delayed the move for 18 months to allow your child to complete high school. You can deduct your allowable moving expenses.

4. If MFJ, only one person needs to meet the time test. They cannot combine work of both spouses.

5. You can deduct expenses even if the time test is not met by year's end if the taxpayer expects to meet the requirement.

B. Deductible expenses are the reasonable expenses of moving household goods and personal effects and traveling expenses to the new location.

1. The cost of moving household goods includes the cost of packing, crating, and transporting the goods to the new home. This can also include the cost of storing and insuring household goods and personal effects within any period of 30 consecutive days after the day the items are moved from the former home and before delivery to the new home. Include the cost of disconnecting and connecting utilities and shipping a car or household pet.

2. Travel expenses for one trip to the new location are allowed. This includes the expenses within one day of no longer being able to live in the former home and the day of arriving at the new location. The "one trip" is for each family member, and family members do not have to travel together. If traveling by car, the taxpayer can include actual expenses of the vehicle or 10 cents per mile**.**

C. **Nondeductible expenses include**:

1. Meal expenses during house hunting and traveling,

2. Pre-move house hunting if a new job is already obtained,

3. Temporary living expenses,

4. Expenses of selling the old home or buying the new home, or breaking or getting a lease,

5. Home improvements to help sell the old home,

6. Loss on the sale of the home,

7. Mortgage penalties,

8. Real estate taxes,

9. Car tags, or drivers license,

10. Losses from disposing of club memberships, and

11. Any part of the purchase price of the new residence.

Exercise 50: Susan met all the requirements to deduct moving expenses when she moved from Arizona to Nevada in 2001. which of the following are deductible as moving expenses?

A. Pre-move house hunting trips.
B. Meal expenses.
C. Expenses of buying or selling a home.
D. Traveling to her new home.

D. Traveling to her new home. "Moving expenses" include the reasonable expenses of traveling from the former residence to the new place of residence.

D. Report on Form 3903, Moving Expenses. Reporting of deductible expenses or income depends on whether or not the taxpayer received reimbursement and whether or not the reimbursement was under an accountable plan. Employer paid expenses or reimbursement should be reported to the taxpayer on Form 4782, Employee Moving Expense Information.

1. Unreimbursed deductible expenses are carried to line 24, Form 1040 as an adjustment to income.

2. Reimbursement for deductible expenses, under an accountable plan, should be reported in box 13 of W-2, code P. There is no income to report and no deduction for the reimbursed expense.

3. Reimbursement from a nonaccountable plan and reimbursement for nondeductible expenses are included as compensation on the W-2. Allowable deductions are carried to line 24, Form 1040.

20. Alimony

A. Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not required by a divorce or separation instrument. Alimony is deductible by the payer and is taxable income to the recipient.

B. Divorce or Separation Instrument:

1. A decree of divorce or separate maintenance or a written instrument incident to that decree,

2. A written separation agreement, or

3. A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse, including a temporary decree, an interlocutory (not final) decree, and a decree of alimony *pendente lite* (while awaiting action on the final decree or agreement).

C. Payments to a third parry on behalf of a spouse under the terms of the divorce or separation instrument may be alimony.

D. If required by decree, some payments on a jointly-owned home qualify.

1. If required to make all mortgage payments, one-half can be deducted as alimony.

2. If required to pay all taxes and insurance:

   a) Property held as *tenants in common,* one-half of the payment can be deducted as alimony.

   b) Property held as *tenants by the entirety or joint tenants* (right of survivorship), none of the payment is alimony.

E. Instruments Executed or Modified after 1984.

1. To be treated as alimony, spouses cannot file a joint return and all of the following requirements are met:

   a) Payments must be in cash, which includes check and money order. Cash payments to a third parry can qualify. Transfer of services or property, execution of a debt instrument, or the use of property do not qualify.

   b) The instrument does not designate the payments as NOT alimony. A written statement signed by both parties can make a designation of an amount not deductible by the payer and excluded from income of the recipient.

   c) The spouses cannot be members of the same household if separated under a decree of divorce or separate maintenance.

Exception: If not legally separated under a decree of divorce or separate maintenance, any payment under a written separation agreement, support decree, or other court order may qualify as alimony even if both parties are members of the same household when payment is made.

d) There is no liability to make payments after the death of the recipient spouse. If payments must continue, none of the payments before or after are alimony.

e) The payments are not treated as child support. Child support can be an amount specifically designated or an amount treated as specifically designated to the extent the payment is reduced either on the happening of a contingency relating to the child or at a time that can be clearly associated with the contingency.

Exercise 51: Which of the following items might be considered as alimony:

A. Child support payments.
B. Non-cash payments.
C. Premiums paid under a divorce or separation agreement for insurance to the extent that the other spouse owns the policy
D. Payments made for the 12-month period after the death of the recipient spouse.

C. Premium paid under a divorce or separation agreement for life insurance to the extent that the other spouse owns the policy. Alimony consists of any payment is cash received by, or on behalf of, a spouse under a divorce or separation instrument. It does not include child support payments or a payment made because of a liability to make such payment after the payee spouse’s death.

2. Payments are not alimony if the payment is:

a) Designated as child support,
b) A noncash property settlement,
c) A spouse's part of community income,
d) To keep up the payer's property, or
e) Not required by a divorce or separation instrument.

F. If alimony payments decrease or terminate during the first three (3) calendar years, starting with the first year in which an alimony payment is made, alimony may be subject to recapture rules.

1. Alimony recaptured is included in income on line 11, crossing out "received" and writing in "recapture" and the spouse's name and Social Security number.

2. The spouse originally receiving the alimony would be allowed a deduction for the recaptured amount. This is reported on line 29, crossing out "paid" and writing in "recapture", and the spouse's Social Security number.

Exercise 52: If a taxpayer's alimony payments decrease or terminate during the first three calendar years, the taxpayer may have to recapture part of the alimony deduction claimed in the earlier years. (True or False)

True. Alimony payments that decrease of terminate during the first three years may be subject to the recapture rule.

PART 5 - STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

21. Standard Deduction

A. The standard deduction is a dollar amount by which a taxpayer can reduce taxable income. If itemized deductions are more, the taxpayer should itemize.

B. A change from the standard deduction to itemizing can be accomplished on an amended return.

C. For the following, the standard deduction is zero and he/she should itemize:

1. MFS and the taxpayers spouse itemizes,
2. The taxpayer is filing a short tax year, or
3. Non-resident or dual-status alien during the year.

22. Limit on Itemized Deductions (Pub. 17)

A. If your itemized deductions are subject to the limit, the total of all your itemized deductions is reduced by the smaller of:

1. 3% of the amount by which your AGI exceeds $132,950 ($66,475 if married filing separately), or
2. 80% of your itemized deductions that are affected by the limit. See *Which Itemized Deductions Are Limited,* earlier.

Before you figure the overall limit on itemized deductions, you must first complete lines 1 through 27 of Schedule A (Form 1040), including any appropriate forms (such as Form 2106, Form 4684, etc.).

The overall limit on itemized deductions is figured after you have applied any other limit on the allowance of any itemized deduction. These other limits include charitable contribution limits, the limit on certain meals and entertainment, and the 2%-of-adjusted-gross-income limit on certain miscellaneous deductions.

B. All items on Schedule A are affected by the overall limit on itemized deductions except for medical and dental expenses (after the 7.5% AGI limit), investment interest expenses, nonbusiness casualty and theft losses, and gambling losses.

C. Itemized Deductions of High-Income Taxpayers Reduced. When AGI Exceeds Inflation- Adjusted Dollar Amount.

An individual whose adjusted gross income exceeds a threshold amount is required to reduce the amount of allowable itemized deductions by three percent of the excess over the threshold amount. No reduction is required, however, in the case of deduction for medical expenses, investment interest, and casualty, theft or wagering losses.

23. Medical and Dental Expenses

Important Reminders. Self-employed health insurance deduction.	From 1999, the amount you can deduct increased from 45% to 60% of the amount you paid.
Stop-smoking programs.	You can now include in medical expenses amounts you pay for a program to stop smoking. If you paid for a stop-smoking program in 1996, 1997, or 1998, you may be able to file an amended return on Form 1040X, Amended U.S. Individual Income Tax Return, to include in medical expenses the amounts you paid for that stop-smoking program. However, you cannot include in medical expenses amounts you pay for drugs that do not require a prescription, such as nicotine gum or patches, that are designed to help stop smoking.
Important Reminder. Medical savings account.	You may be able to make deductible contributions to a medical savings account (MSA). If you are an employee of a small business (fewer than 50 employees), or self-employed and covered only by a

	high deductible health plan, you may be eligible to have an MSA. You deduct MSA contributions on Form 1040, line 25, not on Schedule A (Form 1040) as a qualified medical expense. See Publication 969, Medical Savings Accounts (MSAs), for more information.
Standard mileage rate	The standard mileage rate allowed for out-of-pocket expenses for your car when you use your car for medical reasons is now 12 cents a mile.

A. Medical expenses incurred on behalf of oneself are deductible as well as the expenses for the following:

You can deduct only the amount of your medical and dental expenses that is ***more than 7.5%*** of your adjusted gross income (line 34, Form 1040).

The term "7.5% limit" is used to refer to 7.5% of your adjusted gross income.

Example:
Your adjusted gross income is $20,000, 7.5% of which is $1,500. You paid medical expenses of $800. You cannot deduct any of your medical expenses because they are not more than 7.5% of your adjusted gross income.

B. You can include medical expenses you pay for yourself and for the individuals discussed in this section.

1. Spouse. You can include medical expenses you paid for your spouse. To claim these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example:
Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary's expenses in his separate return. Mary would include the amounts she paid during the year in her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example:
This year, John paid medical expenses for his wife Louise, who died last year.

John married Belle this year and they file a joint return. Because John was married to Louise when she incurred the medical expenses, he can include those expenses in figuring his medical deduction for this year.

3. **Dependent.** You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if:

    1. That person lived with you for the entire year as a member of your household or is related to you,
    2. That person was a U.S. citizen or resident, or a resident of Canada or Mexico, for some part of the calendar year in which your tax year began, and
    3. You provided over half of that person's total support for the calendar year.

    You can include the medical expenses of any person who is your dependent even if you cannot claim an exemption for him or her on your return.

    Example:
    In 2001 your son was your dependent. In 2002 he no longer qualified as your dependent. However, you paid $800 in 2002 for medical expenses your son incurred in 2001 when he was your dependent. You can include the $800 in figuring your medical expense deduction for 2002. You cannot include this amount on your 2001 tax return.

    3. Adopted child. You can include medical expenses that you paid for a child before adoption, if the child qualified as your dependent when the medical services were provided or when the expenses were paid. If you pay back an adoption agency or other persons for medical expenses they paid under an agreement with you, you are treated as having paid those expenses provided you clearly substantiate that the payment is directly attributable to the medical care of the child. But if you pay back medical expenses incurred and paid before adoption negotiations began, you cannot include them as medical expenses.

    What if you pay medical expenses of a deceased spouse or dependent? If you paid medical expenses for your deceased spouse or dependent, include them as medical expenses on your Form 1040 in the year paid, whether they are paid before or after the decedent's death. The expenses can be included if the person was your spouse or dependent either at the time the medical services were provided or at the time you paid the expenses.

C. Deductible medical expenses include, but are not limited to the following items.

1. Medical insurance premiums paid for policies that provide payment for a majority of medical or dental services and prescription medications. This includes amounts paid for Medicare B and membership in an association that gives cooperative or "free-choice" medical services, or group hospitalization and clinical care.

Exercise 53: During 2001, Norm Ashby paid $1,000 of medical expenses for his father, Jerome. Norm may NOT claim Jerome as a dependent SOLELY because Jerome's income exceeds $2,450. Norm may nevertheless include the $1,000 as a medical expense (itemized deduction) on his tax returns. (True or False)

True. For purposes of the medical expense deduction, the term "dependent" has the same meaning as it does for determining the dependency exemptions except that the gross income test does not apply.

NOTE: Do not include premiums paid by an employer sponsored plan (cafeteria plan) unless included in income or the portion of health insurance deducted as an adjustment to income for self-employed individuals.

2. Meals and lodging:

   a) Deductible if provided by a hospital or similar institution as a necessary part of medical care.

   b) Lodging not provided by a hospital may be deductible while away from home if it is essential to the medical care provided by a doctor in a licensed hospital or equivalent, it is not lavish or extravagant, and there is no significant element of personal pleasure, recreation, or vacation with the travel. (Maximum of $50 per night, per person.)

3. Transportation - Can include out of pocket expenses or nine (9) cents a mile as a standard mileage rate.

4. Impairment related work expenses may be medical or business. As business, the expense is not reduced by AGI and may reduce SE tax.

5. Capital expenses for equipment or improvements to one's home if the expense is needed for medical care. The amount eligible as a medical expense is the excess of the amount spent over the increase in value of the property. As long as the medical reason for the capital expense continues to exist, expenses for maintenance and upkeep are also eligible deductions.

Exercise 54: Billy had bypass heart surgery in February 2001. At the advice of his doctor, he had an elevator installed in his home so that he would not have to climb stairs. The costs associated with this capital improvement are as follows:

Cost of elevator installed 6/30/2001	*$5,000*
Increase in value of home due to elevator	*$2,500*
Cost of decorative lattice work over elevator 6/30/2001	*$ 500*
Increase in value of home due to lattice work	*$ 0*
Maintenance and repair of elevator 9/30/2001	*$ 500*

None of the expenses were covered by insurance. How much would qualify as a deductible medical expense in 2001, BEFORE any limitation?

A. $3,000
B. $2,500
C. $3,500
D. $5,500

A. $3,000. The amount of capital expenditure deductible as medical expenses is $3,000. Although capital expenditures are generally not deductible, there can be a medical expense deduction in connection with a capital expenditure to the extent that the amount of such expenditure exceeds the amount of the increase in the value of the property affected.

6. Cost and care of guide dogs or other animals aiding the blind, deaf and disabled.

7. Part of a life-care fee paid to a retirement home if designated for medical care.

8. Prescription medicines and insulin.

9. Hospital service fees or medical service fees.

10. Many other expenses for which there is a medical reason.

C. Not includable are expenses for general health, health club dues, household help, funeral, burial or cremation, illegal operation or treatment, maternity clothes, nonprescription medicines, cosmetic surgery, diaper service, etc.

D. Total medical expenses are reduced by all reimbursements received from insurance or other sources prior to inclusion on Schedule A.

E. Total expenses are reduced by 7.5% of adjusted gross income.

Exercise 55:
The Pack Family incurred the following medical expenses during the tax year 2001:

Doctors fees	*$1,200*
Prescription medicine	*450*
Health club dues (advised by doctor)	*2,000*
Medical insurance premiums	*1,600*
Medical insurance reimbursements	*500*

The Pack's AGI for the tax year was $30,000. What is the amount the Packs would be able to deduct on their tax return AFTER any limitation?

A. $2,750
B. $2,500
C. $1,000
D. $500

D. $500. The amount deductible is $500. Doctor's fees, costs of prescription medicine and the costs of medical insurance premiums are all deductible. Medical insurance reimbursements must be offset against the medical expense amounts. Expenses for health club dues, even though suggested by a physician, are not deductible since only those expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness are deductible. The amount deductible is the amount of allowable expenses which exceeds 7.5% of the taxpayer's AGI.

24. Taxes

A. Tests for Deductibility

1. The tax must be imposed on the taxpayer,

2. The tax must be paid during the tax year.

B. Income Taxes

1. Deductible taxes include state and local income taxes, including estimated tax payments. Foreign income taxes and contributions to a state disability fund or state unemployment fund are also deductible.

2. Foreign income tax included as a credit on Form 1116, Foreign Tax Credit, is not included on Schedule A.

3. Deductions do not include federal income taxes or employee contributions to private or voluntary disability plans.

C. Real Estate Taxes

1. Include any state, local, or foreign taxes on real property levied for the general public welfare. They must be based on assessed value and charged uniformly against all property.

2. Deductible taxes include a tenant-shareholder's portion of real estate tax paid by the corporation.

Exercise 56:
All of the following taxes are deductible as an itemized deduction except:

A. Foreign income taxes.
B. Personal property taxes.
C. One-half of the self-employment tax.
D. Foreign real estate taxes.

> *C. One-half of the self-employment tax. A taxpayer may deduct one-half of his self-employment tax liability for the year as a business expense in arriving at adjusted gross income; it cannot be taken as an itemized deduction.*

3. Do not include taxes for local benefits, trash and garbage pickup fees, transfer taxes, rent increases due to higher taxes, or homeowners association charges.

4. In the year real estate is sold, the taxes must be prorated between the seller and the buyer. This is prorated according to the number of days in the tax year each party held the property. The seller is considered to have paid his/her portion of the real property taxes at the time of the sale, even though it may not be paid to the taxing authority at that time.

D. Personal property tax is a state or local tax charged on personal property, based only on the value of that property, and charged on a yearly basis.

E. For itemizing, taxes not considered are trade or business taxes, taxes on rental or royalty property, occupational taxes, sales tax, excise taxes, fees or charges such as driver's license or water bills, federal estate and gift taxes, or Social Security and other employment taxes for household workers. (Some taxes may be deductible on other schedules).

25. Interest Expense

Important Reminders Personal interest.	Personal interest is not deductible. Examples of personal interest include interest on a loan to purchase an automobile for personal use and credit card and installment interest incurred for personal expenses. But you may be able to deduct interest you pay on a qualified student loan. For details, see Publication 970, *Tax Benefits for Higher Education.*

A. General Rules

1. Personal interest is not deductible.

2. The taxpayer must be legally liable for the debt upon which the interest is assessed.

3. Interest is deductible in the tax year to which it applies. Amounts paid in advance are spread over the period to which the interest applies. (An exception for points later.)

B. Home mortgage interest is any interest paid on a loan secured by the taxpayer's main home or second home.

1. If the mortgage fits into one of the following categories, all of the interest is deductible:

   a) Mortgages taken out on or before October 13, 1987 (grandfathered debt).
   b) Mortgages taken out after October 13, 1987, to buy, build, or improve one's home (home acquisition debt), but only if these mortgages plus grandfathered debt totaled $1 million or less.
   c) Mortgages taken out after October 13, 1987, other than to buy, build, or improve one's home (home equity debt), but only if these mortgages totaled $100,000 or less.
   d) If the taxpayer has more than one home, the interest limits above apply to the total mortgages on both homes.

Exercise 58:
Janice, a single individual, took out a mortgage on her home in 1989 for $125,000. In March of 2000, when her home had a fair market value of $150,000, she took out a home equity loan of $25,000. She used the $25,000 to purchase

tax-exempt bonds. Janice can deduct ALL of the interest on BOTH mortgages. (True or False)

False. No deduction is allowed for interest on indebtedness incurred to purchase tax-exempt securities.

2. "Points" are charges paid by a borrower to obtain a home mortgage, determined as a percentage of the amount borrowed. Points are also referred to as loan origination fees, maximum loan charges, loan discount, or discount points. If the payment is for the use of money, it is interest.

   a) **General rule -** Points are not deductible in full in the year paid but are spread over the term of the mortgage.

   b) **Special Rule -** The taxpayer can deduct the amount of points paid if the loan is used to buy or improve the main home and is secured by that home. All of the following tests must be satisfied:

      (1) The payment of points must be an established business practice in the area,

      (2) The points paid must not exceed the number of points generally charged in this area,

      (3) The points must be computed as a percentage of the principal amount of the mortgage, and

      (4) If the loan was used to improve the main home, the points must be paid with funds other than those obtained from the mortgage lender. If the loan is used to buy the main home, the taxpayer must have provided funds at the time of closing other than those obtained from the lender or mortgage broker at least equal to the points charged.

   c) Points paid by the seller are not considered as amounts borrowed from the lender or mortgage broker. These points are deductible to the buyer and the basis is reduced.

   d) The special rules do not apply to points paid on loans secured by a second residence.

NOTE: The rule above also applies to a loan origination fee charged for services for getting a VA or FHA loan to buy one's main home.

3. The remaining balance of points being amortized can be deducted in full if the mortgage ends early, such as through prepayment, refinancing at another institution, foreclosure, or sale.

4. Points paid to refinance a mortgage are not deductible in full. The portion of points attributed to the new loan amount used to improve the main home may be fully deducted. The remainder of the points are deducted over the life of the loan.

C. A late payment charge on a mortgage payment or a mortgage prepayment penalty may be deducted as interest unless charged for a service provided by the lender.

D. If the taxpayer claimed a mortgage interest credit, the interest deduction is reduced by the amount of the credit.

E. Closing costs are not deductible as interest or business expenses. These costs are added to the basis of the property, which will be recovered when sold.

F. Interest other than home mortgage interest must be traced to the use of the principal.

26. Contributions

Important Reminders Disaster relief.	You can deduct contributions earmarked for flood relief, hurricane relief or other disaster relief to a qualified organization (defined later under Organizations That Qualify To Receive Deductible Contributions). However, you cannot deduct contributions earmarked for relief of a particular individual or family.
Written acknowledgment required.	You can claim a deduction for a contribution of $250 or more only if you have a written acknowledgment of your contribution from the qualified organization or if you have certain payroll deduction records. For more information, see *Records To Keep.*
Payment partly for goods or services.	A qualified organization must give you a written statement if you make a payment that is ***more*** than $75 and is partly a contribution and partly for goods or services. The statement must tell you that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

A. Qualified Organizations

1. The United States, any state, the District of Columbia, a U.S. possession, a political subdivision of a state or U.S. possession, or an Indian tribal government.

2. A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the U.S. It must be organized and operated only for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to children or animals.

3. War veterans' organizations.

4. Domestic fraternal societies, orders, and associations operating under a lodge system when contributions are used solely for charitable, religious, etc. purposes.

5. Contributions to certain Canadian charities and certain Mexican charities may be deductible if permitted by the income tax treaty with that country.

Quick Reference Chart of Charitable Contributions

DEDUCTIBLE	**NONDEDUCTIBLE**
Money or property given to: • Federal, state, and local governments, if solely for public purposes. • Nonprofit schools and hospitals. • Public parks and recreation facilities. • Salvation Army, Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts, Girl Scouts, Boys and Girls Clubs of America, etc. • War veterans' groups. • Costs paid for a student living with you, sponsored by a qualified organization. • Out-of-pocket expenses when	Money or property given to: • Civic leagues, social and sports *clubs,* labor unions, and chamber of commerce. • Foreign organizations. • Groups that are run for personal profit. • Groups whose purpose is to lobby for law changes. • Homeowner s associations. • Individuals. • Political groups or candidates for political office. • Cost of raffle, bingo, or lottery tickets. • Dues, fees or bills paid to country clubs, lodges, fraternal orders, or

you serve a qualified organization as a volunteer.	clubs, lodges, fraternal orders, or similar groups. • Tuition. • Value of one's time or services. • Value of blood given to a blood bank.

B. Deductible contributions generally include contributions of money or property made to or for the use of a qualified organization.

1. If a benefit is derived by the individual, the individual can deduct only the amount of the contribution that is more than the value of the benefit received.

2. If the taxpayer makes a donation to a college or university and receives a right to purchase tickets for a sporting event, only 80% of the payment is a contribution. If the donation includes payment for tickets, the payment is reduced by the price of the tickets first, and then 80% of the remainder is an eligible contribution.

Example:
You pay $300 a year for membership in an athletic scholarship program maintained by the university and you receive one season ticket for the stated purchase price of $120 from the $300 payment, the result is $180. Eighty percent or $144 is a charitable contribution.

3. The full amount of a contribution is deductible if the taxpayer receives only token items - bookmarks, calendars, etc.

4. For a payment of $75 or more which is partly a contribution and partly for goods and services, the qualified organization must give the taxpayer a written statement. The statement must indicate that only a portion is deductible and provide a good faith estimate of the value of the goods and services.

5. Up to $50 per month of expenses for a foreign or American student in the twelfth or lower grade if the student lives in the taxpayer's home under a written agreement with a qualified organization (not under a mutual exchange program). This student cannot be a dependent or relative of the taxpayer.

6. Unreimbursed out of pocket expenses incurred in giving service to a qualified organization. The standard mileage allowance for charitable purposes is 12 cents per mile.

7. Travel expenses necessarily incurred while away from home performing services for a charitable organization are deductible as long as there is no significant element of personal pleasure, recreation, or vacation in such travel.

C. Contributions of property are generally deductible at the FMV of the property at the time of the contribution.

1. A contribution of partial interest in property is not deductible.

2. A contribution of a future interest in tangible personal property is not deductible until all of the interest in or rights to the possession and enjoyment of the property have been relinquished.

3. If the FMV is less than basis, the deduction is limited to FMV.

4. If the FMV is more than basis, the deduction may be reduced.

a) If ordinary income property, for which a sale at FMV on the date of the contribution would have resulted in ordinary income or in short-term capital gain, the deduction would be the FMV less the amount which would be ordinary income or short-term capital gain.

b) If capital gain property (long-term if sold), the deduction is generally the FMV. The deduction is reduced if the charity's use of the property is unrelated use or the taxpayer chooses the 50% limit instead of the 30% limit.

D. Limits on Deductions - A deduction may be limited to 20%, 30%, or 50% AGI depending on the type of property and the type of organization.

1. The 50% limit applies to gifts to eligible organizations, except for gifts of capital gain property for which the deduction is figured using FMV without a reduction for appreciation.

2. The 30% limit applies to gifts for the use of any organization and gifts (other than capital gain property) to all qualified organizations other than the *50%* limit organizations - veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

a) The limit includes expenses for a student living with the taxpayer.

b) Special 30% limit applies to gifts of capital gain property to *50%* limit organizations. The special 30% limit will not apply when the taxpayer reduces FMV by what would be long-term capital gain if sold.

3. The 20% limit applies to gifts of capital gain property to all qualified organizations other than 50% limit organizations.

E. Records and Reporting

1. The taxpayer needs to be able to substantiate cash contributions by amount, organization, and date.

2. For each cash contribution less than $250, the taxpayer must keep a canceled check, bank statement, a receipt, or other reliable written records.

3. For each cash contribution of $250 or more (including separate checks written on the same day to the same organization), the taxpayer must have written acknowledgment from the organization.

4. For noncash contributions of less than *$250,* the taxpayer must have a receipt or other documents showing the name of the organization, the date and location of the contribution, and a reasonable description of the property.

5. For noncash contributions of at least $250 but not more than *$500,* the taxpayer needs an acknowledgment from the organization. The acknowledgment must show the name, date, and description as well as meeting three tests:

   a) It must be written.

   b) It must include a description of the property, whether the organization gave any goods and services, and a description and good faith estimate of the value of goods and services.

   c) The acknowledgment must be received by the filing date or the due date (including extensions) of the return.

Exercise 59:
Beginning with the 1994 tax year, the written acknowledgment you need from any charitable organization to claim a deduction for any cash contribution of $250 or more in a single donation, must include all of the following except:

A. The amount of cash contributed.
B. Whether the organization is a 50% or 30% organization.
C. Whether goods or services were provided to the donor

D. A description and good faith estimate of the value of any goods or services provided to the donor.

B. Whether the organization is a 50% or 30% organization. A written acknowledgment of a charitable contribution of at least $250 must include the amount of the cash contribution, whether the donee provided any goods or services in consideration of the donation, and a description and good-faith estimate of the value of any goods or services provided to the donor, but not whether the organization is a 50% or 30% organization.

6. Noncash contributions over $500 and not over $5,000 - A receipt is required as well as records showing all of the previous information. File Form 8283, Noncash Charitable Contributions, Section A.

7. Noncash contributions over $5,000 - All of the previously mentioned information as well as an appraisal is needed. File Form 8283, Section B.

27. Nonbusiness Casualty and Theft Losses

A. Loss on deposits occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. The taxpayer has a choice of how to deduct such a loss.

1. Nonbusiness bad debt is deducted as a short-term capital loss on Schedule D in the year that the actual loss is determined.

2. Casualty loss has no maximum limit but is reduced by a $100 floor amount and 10% AGI. Deducted on Schedule A.

3. Ordinary loss if not over $20,000 reduced by any state insurance proceeds. This option is only available on a loss from a qualified financial institution such as an account not federally insured (FDIC). This is deducted as a miscellaneous 2% item on Schedule A.

4. A casualty or ordinary loss can be deducted in a year in which the taxpayer can reasonably estimate how much of the deposits are lost in an insolvent or bankrupt financial institution.

Exercise 60:

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incur such a loss, you may be able to deduct it as any one of the following except:

A. Short-term capital loss.
B. Long-term capital loss,
C. Casualty loss.
D. Ordinary loss.

B. Long-term capital loss. Individuals may treat a loss on a deposit in an insolvent financial institution as an ordinary loss, a personal casualty loss in the year in which the loss can be reasonably estimated, or a short-term capital loss in the year in which there is no prospect of recovery.

B. Casualty - The damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

1. This can also include a government-ordered demolition or relocation of a home unsafe to use due to a disaster.

2. Nondeductible losses:

   a) A loss from a car accident if the taxpayer's willful negligence or willful act caused the accident.

   b) Accidental breakage of glassware or other items under normal conditions or due to a family pet.

   c) Damage caused by: termites or moths, disease, progressive deterioration, or drought.

C. Theft is the unlawful taking or removing of money or property with the intent to deprive the owner of it. Theft also includes larceny, robbery, and embezzlement.

D. The loss cannot be more than the smaller of either the decrease in fair market value due to the casualty, or the adjusted basis in the property before the casualty, decreased by insurance or other reimbursement.

E. An appraisal fee is not part of a casualty or theft loss, but can be a miscellaneous deduction subject to 2% AGI.

F. Insurance and Other Reimbursement

1. If covered by insurance, a claim must be filed.

2. Reimbursement must be subtracted in calculating a loss. This includes insurance that the taxpayer expects to receive. Reimbursement in excess of basis results in gain which may be taxable or eligible for postponement.

3. Reimbursement may include loan forgiveness, court awards, assistance from relief agencies, payment from bonding companies, etc. Insurance, grants, gifts, and other payments are considered reimbursement only if specifically designated to repair or replace property. Payments for living expenses are not reimbursement, but the amount for normal living expenses is taxable income.

4. Disaster relief such as food, medical supplies, and other forms of assistance received do not reduce the casualty loss unless they are replacements for lost or destroyed property. These items are not taxable income.

G. Deduction Limits

1. The loss must be figured separately for each item stolen, damaged, or destroyed in an event.

2. A single $100 reduction applies to each casualty or theft no matter how many pieces of property are involved.

3. The total of all casualty and theft losses for the year must be reduced by 10% of the taxpayer's AGI.

H. When Deductible

1. Casualty losses are deducted in the tax year in which the casualty took place.

2. Theft losses are deductible in the year that the theft is discovered.

3. In a federally declared disaster area, the loss can be claimed on a return for the year preceding the year in which the loss took place.

28. Travel, Transportation, and Other Employee Business Expense

A. Travel expenses include ordinary and necessary expenses that the taxpayer incurs while traveling away from home for one's business, profession, or job. An ordinary expense is one that is common and accepted in the taxpayer's field of business, trade, or profession. A necessary expense is one that is helpful and appropriate in one's business.

1. A taxpayer is traveling away from home if the job duties require the taxpayer to be away from the general area of the tax home substantially longer than an ordinary day's work and the taxpayer needs to get sleep or rest to meet the demands of the work while away from home.

2. Tax home is generally the regular place of business or post of duty, regardless of where the taxpayer maintains a family home. It includes the entire city or general area in which the business or work is located. If the taxpayer has more than one regular place of business, the tax home is the individual's main place of business. If the taxpayer has no regular place of business, the tax home may be the place where one regularly works. The tax home of a transient is where he works.

    a) The main place of business or work is determined by considering the total time spent working in each area, the degree of business activity in each area, and the relative income from each area.

    b) If the time, activity, and income do not indicate a main place of business, the tax home may be the area where the taxpayer lives if the following conditions are met:

        (1) Part of the business is in the area of one's main home and the taxpayer uses that home for lodging while doing business there,

        (2) The taxpayer has living expenses at a main home that are duplicated because the business requires the individual to be away from that home, and

        (3) The taxpayer has not left the area in which both the traditional place of lodging and the main home are located, the taxpayer has a member or members of his family living at that main home, or the taxpayer often uses that home for lodging.

    c) If a taxpayer lives in one city (family home) but works in another city, the city where the taxpayer earns a living is considered the taxpayer's "tax home." Therefore, the travel expenses between the residence (family home) and the tax home are not deductible. However, if the taxpayer is then assigned to work in the area of his or her family home, he or she may be considered as traveling away from his or her tax home.

Exercise 61:
Sydney is an outside salesman with a sales territory covering several states. His employer's main office is in Milwaukee, but Sydney does not go there for business reasons. Sydney's work assignments are temporary and he has no way of knowing where his future assignments will be located. He often stays with a sister in Cleveland or a brother in Chicago over some weekends during the year, but he does no work in those areas either. He does not pay his sister or brother for the use of the rooms. Which location is considered Sydney's tax home?

A. Milwaukee
B. Chicago
C. Cleveland
D. Sydney does NOT have a tax home.

D. Sydney does NOT have a tax home. Sydney is a itinerant, since he has no established residence.

Exercise 62:
Don Cramer is required by his employer to work four months a year in Pittsburgh, where he maintains a home for his family. He works for the same employer in Baltimore for the remainder of the year. His salary remains constant ft)r the entire year. Don rents an apartment in Baltimore and also incurs other living expenses. Since Don's tax home is Baltimore, he may deduct his share of living expenses while he is living and working in Pittsburgh.(True or False)

True. Because Mr. Cramer spends most of his working time and earns most if his salary in Baltimore, it is his tax home. However, when he returns to Pittsburgh to work, he is away from his tax home and can deduct his portion of living expenses even though he is staying in the family home.

3. A temporary assignment or job is one that is expected to end within a fixed and reasonably short time and does not last more than one year. If away from the tax home, expenses are deductible.

   a) If the assignment or job is indefinite, the taxpayer is not considered away from home and the travel expenses are not deductible. Employment with an understanding that the individual will keep the job if work is satisfactory during a probationary period is an indefinite assignment.

   b) An assignment or job expected to last for more than one year is considered indefinite and presumed not to be temporary.

c) Travel expenses incurred by a taxpayer to go home on days off are deductible up to the amount it would have cost for meals and lodging if the taxpayer had stayed in the area of the temporary place of work.

4. Eligible Travel Expenses

a) The cost of airplane, train, or bus fare between one's home and business destination.

b) The cost of taxi, airport limousines, buses, or other types of transportation between the airport and the hotel, and between the hotel and work site.

c) Baggage or shipping cost from main job to temporary job.

d) Cost of operating arid maintaining a car when traveling away from home on business.

e) Lodging if travel is overnight or long enough to require sleep or rest.

f) Meals if away from home overnight or long enough to require sleep or rest. Allowed the actual cost or a standard amount. (50% limit) The standard meal allowance covers meals and incidental expenses. The standard allowance can be used regardless of whether or not reimbursed and can be used by employees or self-employed individuals.

The standard meal allowance is the federal M&IE rate. For travel in 2001, the rate is ***$30 a day*** for most small localities in the United States. Most major cities and many other localities in the United States are designated as high-cost areas, qualifying for higher standard meal allowances. Locations qualifying for rates of $34, $38, $42, or $46 a day are listed in Publication 1542. The rate to use when traveling to more than one location is the rate in effect at the location in which the taxpayer stops for sleep or rest.

a) Transportation workers can use an average of $32 per day. The average is available if the travel takes the worker into high and low cost areas.

b) Travel of less than 24 hours at the beginning or end of a trip requires the standard meal allowance to be prorated by dividing the day into 6 hour increments.

6. Travel primarily in the U.S. for business is deductible. If the travel is partly personal, only the business portion is deductible. If primarily personal, travel to the location is not deductible but directly related business expenses while there are deductible.

7. Expenses for travel outside of the U.S. are deductible if the trip is entirely business.

    a) Even if some time is spent away from business, the trip can be considered entirely business if one of the following tests are met:

        (1) The taxpayer did not have substantial control over arranging the trip,

        (2) The taxpayer was outside of the U.S. for one week or less,

        (3) The taxpayer spent less than 25% of the total time out of the U.S. in nonbusiness activities, or

        (4) The taxpayer can establish that a personal vacation was not a major consideration.

    b) If not meeting any test, expenses are allocated business days to total days.

B. Entertainment expenses incurred to entertain a client, customer, or employee may be deductible if the expense meets the ordinary and necessary business requirements. In addition, it must pass the directly related test or the associated test.

    1. Directly Related Test - The taxpayer must show that the main purpose of the combined business and entertainment was the active conduct of business, that business was conducted with the person during the entertainment period, and there was more than a general expectation of getting income or some other specific business benefit at some time in the future.

    2. Associated Test - This must show that the entertainment directly precedes or follows a substantial business discussion. Expenses for spouses are not deductible unless a clear business purpose can be established.

    3. Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation. Generally, the only entertainment facility for which a deduction is eligible is a club, which can include social, athletic, sporting, and country club. Other facilities such as a yacht, hunting lodge, fishing camp, etc., are not eligible for deduction unless used for other than entertainment.

    4. No deduction is allowed for club dues and membership fees in any club organized for business, pleasure, recreation, or other social purposes.

C. Limitation on Meals and Entertainment

1. In general, the deduction for business related meals and entertainment is limited to 50% of the expense. This applies to employees or their employers and to self-employed persons or their clients depending on whether the expenses are reimbursed.

2. Exception to the 50% limit is as an employee, the employer reimburses under an accountable plan and does not treat the reimbursement as wages.

D. Business gift expenses are deductible up to a $25 value given directly or indirectly to any one person during the tax year.

1. Incidental costs, such as engraving, packaging, and mailing, are generally not included in determining the cost of a gift. A related cost is incidental only if it does not add substantial value.

2. The $25 limit does not apply to an item which is one of a number of identical items that cost $4 or less and has the business name permanently imprinted on it; nor does it apply to promotional materials used on the business premises.

Exercise 63:
During the tax year, Mr. Banks incurred the following unreimbursed business expenses for which he has adequate proof for the amounts and purpose.

Business meals	*$2,000*
Business entertainment	*$1,000*
Business gifts (10 gifts at $30 each to 10 different people)	*$300*

Based on the above, what is the amount Banks can deduct BEFORE the percentage of adjusted gross income limitation?

A. $1,625
B. $1,650
C. $1,750
D. $2,650

C. $1,750. The amount Banks can deduct before the percentage of adjusted gross income limitation is $1,750. The deduction for business meals and entertainment is limited to 50% of the actual expense. Business gifts are limited to $25 per donee.

E. Local Transportation Expenses

1. Commuting expenses are costs of taking a bus, trolley, subway, taxi, or driving a car between a residence and the main or regular place of work. Commuting expenses are not deductible even if working during the trip.

    a) Parking fees paid to park at work are nondeductible commuting expenses.

    b) Using a vehicle in a nonprofit car pool, hauling tools or instruments to and from work, and advertising on a car does not change commuting to business use.

2. Deductible expenses are noncommuting business related.

    a) Round trip transportation between your office and a client or customer's place of business is deductible.

    b) If an employer requires the taxpayer to attend a training session in another office in the same city, the travel directly from the taxpayer's home to the training site and back each day is deductible.

    c) The taxpayer's only office is in the home. The taxpayer can deduct the round trip business related local transportation expenses between the qualifying home office and the client's or customer's place of business.

    d) The taxpayer has no regular office and no office in home. Transportation expenses between home and the first business contact and between the last business contact and home are nondeductible commuting expenses. Travel between the first and last client is deductible.

    e) If the taxpayer has one or more regular places of business, transportation between home and a temporary location is deductible.

    f) With no regular place of business other than the metropolitan area, transportation outside of that area to a temporary location is deductible. Transportation to temporary locations within the area is not deductible.

    g) Transportation between two places of work in the same day is deductible.

    h) Transportation to an Armed Forces reserve meeting is deductible if the meeting is held on a business day. If on a nonbusiness day, the expense is generally nondeductible.

3. Car expenses can be deducted using the actual expenses or the standard mileage rate. Regardless of which method, the taxpayer needs records to show when business use started, cost or other basis, business miles, and total miles.

   a) Actual expenses include depreciation, garage rent, gas, oil, insurance, lease fees, licenses, parking fees, rental fees, repairs, tires, and tolls. Other expenses may or may not be deductible. For self-employed individuals, this also includes interest on a loan to purchase a vehicle.

   b) An employer-provided car may be included in taxable compensation, depending on employer treatment. If the full value is included in compensation, business-related expenses are deductible.

Depreciation and section 179 deduction.
Decrease the basis of your business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.
For more information about depreciation and the section 179 deduction, see Publication 946.

Exercise 64:
In March 2001, Jesse traded in a 1997 van for a new 2001 model. He used both the old van and the new van 75% for business. Jesse has claimed actual expenses for the business use of the old van since 1997. He did NOT claim a section 179 deduction of the old OR new van. Jesse paid $12, 800 for the old van in June 1997. Depreciation claimed on the 1997 van was $7,388, which included 1/2 year for 2001. Jesse paid $9,800 cash in addition to a trade-in allowance of $2,200 to acquire the new van. What is Jesse's depreciable basis in the new van?

A. $11,409
B. $9,562
C. $9,009
D. $9,000

B. $9,562. The basis for figuring depreciation for the new van is (1) the adjusted basis of the old van ($5,412), determined by subtracting the depreciation taken ($7,388) from the cost of the old van ($12,800), plus (2) any additional amount paid for the new van, ($9,800) totaling $15,212, minus (3) the excess, if any, of the total amount of depreciation that would have been allowable before the trade if the old van had been used 100% or business ($9,850), over the total amounts actually allowable as depreciation during those years ($7,388), totaling $2,462. The total depreciation basis for the new van ($12,750) must be reduced by the mount of personal use (25%) to determine the depreciation basis for the new van ($9,562).

c) The **standard mileage rate** can only be used on a car the taxpayer owns. The rate for 2001 is 34.0 cents per mile for all business miles.

(1) If choosing the standard rate, the taxpayer cannot deduct actual expenses.

(2) The choice to use the standard mileage rate must be elected the first year the vehicle is used for business. In later years, the taxpayer can choose either standard or actual. A choice to use the standard rate is considered an election not to use MACRS, so accelerated depreciation and § 179 are not allowed. If the taxpayer switches to actual expenses in a later year, the remaining useful life has to be determined and depreciation would be allowed using the straight line method.

(3) The standard mileage rate is not allowed if the vehicle is used for hire (such as a taxi) or the taxpayer operates two or more vehicles at the same time (fleet). The standard rate cannot be used if ACRS, MACRS or §179 was claimed in a prior year.

Example:
Chris owns a repair shop and an insurance business. He uses his pickup truck for the repair shop and his car for the insurance business. No one else uses either the pickup truck or the car for business purposes. Chris can take the standard mileage rate for the business use of the truck and car.

(4) In addition to the standard mileage rate, the taxpayer can deduct any business-related parking fees and tolls (if not related to commuting expenses).

Exercise 65:
In 2001, Dan got a new job which requires him to extensively use his car for business purposes. Dan is NOT reimbursed for his expenses and he has NOT claimed any depreciation on his car in the past. Dan's records reflect he incurred the following expenses for 2001.

Gasoline and oil		*$3,100*
Repairs on auto		*$850*
Business parking and tolls	*$200*	
Depreciation	*$2,200*	
Insurance	*$795*	
Licenses, tags, etc.	*$100*	
Total	*$7,245*	

Total miles driven: $30,000
Business miles: $24,000

What is the MAXIMUM deduction that Dan is allowed for the business use of his car? (Giving standard mileage rate is 34.0 cents per mile.)

A. $8,360
B. $7,160
C. $6,850
D. $5,796

A. $8,360. $8,360 is the maximum amount deductible by Dan in 1994. That is, the standard mileage allowance multiplied by Dan's total business miles, 24,000x.29 ($8,160) plus Dan's business parking and tolls ($200) equals $8,360.

F. Recordkeeping

1. The taxpayer must be able to substantiate deductions for travel, entertainment, business gifts, and local transportation. Estimates and approximations do not qualify as proof of an expense. A record of the elements of an expense or a business use should be made at or near the time of the expense or use.

2. Adequate records will show the name and location of the hotel or restaurant, dates, charges for lodging, meals, or calls, and the number of people served at a restaurant.

G. Reporting - Self-employed individuals deduct expenses on Schedule C or F. Employees report the unreimbursed expenses on Form 2106, Employee Business Expenses and carry the amount to Schedule A, Miscellaneous Itemized Deductions subject to the 2% AGI limit.

1. Accountable plans are reimbursement or allowance arrangements that require substantiation to the employer.

   a) Accountable plans require the employee to meet all three of the following rules:

      (1) The expenses must have a business connection and be paid or incurred while performing services for the employer,

      (2) The taxpayer must adequately account to the employer for these expenses within a reasonable period of time, and

      (3) The taxpayer must return any excess reimbursement or allowance within a reasonable period of time.

b) If these rules are met, reimbursement should not be included on the W-2. If expenses equal reimbursement, no Form 2106 is required.

Exercise 66:
With regard to employer reimbursements under an accountable plan, which of the following statements is FALSE?

A. The expenses must have been paid or incurred while performing services as an employee.
B The expenses must be adequately accounted for to the employer within a reasonable period of time.
C. Any excess reimbursement must be returned within a reasonable period of time.
D. Any reimbursement paid must be based on a fixed daily amount not to exceed the Government's per diem rate.

D. Any reimbursement paid must be based on a fixed daily amount not to exceed the Government's per dim rate. If a reimbursement arrangement between an employee and employer meets the requirements of a business connection, substantiation, and return of excess payments, then all amounts paid under the arrangement are treated as paid under an accountable plan.

c) Reimbursement in excess of substantiated amounts or actual expense, or for nondeductible expenses is considered as under a nonaccountable plan and is taxable income.

d) Per diem allowance reimbursement may be taxed depending on the federal rate and the actual expense. The federal rate can be determined using the regular federal per diem rate, the high-low method, or the standard meal allowance.

e) If the per diem allowance is less than or equal to the federal rate, the allowance will not be included in boxes 1, 3, or 5 of Form W-2. Neither the expense nor the reimbursement needs be reported. If actual expenses are more than the allowance, Form 2106 can be completed to deduct the excess expenses. This also applies if the standard mileage reimbursement is less than or equal to 30 cents.

f) If the per diem allowance is more than the federal rate, the employer is required to include the allowance amount up to the federal rate in box 13 (code L) on Form W-2. This amount is not taxable. The excess will be included on the W-2 and reported as income. For reimbursement of vehicle use, an excess would occur if reimbursed more than the standard rate.

2. Adequate accounting is required for all amounts received from an employer as advances, reimbursements, or allowances.

   a) If the employer reimburses for lodging, meals, and incidental expenses at a fixed amount per day of business travel, the "per diem allowance" satisfies the adequate accounting if the time, place, and business purpose is proven and the expense is reasonably within limits of ordinary and necessary requirements.

   b) The federal per diem rate is an amount for lodging, meals, and incidental expenses while traveling away from home. The rate to be used is the one applicable to the location where the taxpayer stops for sleep or rest.

3. Nonaccountable plans are reimbursement or expense allowance arrangements that do not meet the accountable rules. Nonaccountable plan amounts are included in wages, and Form 2106 is required to deduct any expense. Excess amounts paid under an accountable plan and not returned to the employer are treated as paid under a nonaccountable plan.

H. All reimbursement is reported on Form 2106. This includes amounts received from an employer or other party which is not included in income. If the employer reimbursed a single amount to cover meals or entertainment as well as other business expenses under an accountable plan, reimbursement needs to be allocated. The following worksheet can be used for allocating reimbursement.

1. Enter the total amount of the reimbursement paid that is not reported in box 1 of Form W-2	______
2. Enter the total amount of expenses	_
3. Of the amount on line 2, enter the part of the total expense for meals and entertainment	_
4. Divide line 3 by line 2. (Enter as a decimal, two places)	_
5. Multiply line 1 by line 4. Enter the result in Column B, line 7 (M&E) (Form 2106)	_
6. Subtract line 5 from line 1. Enter the result in Column A, line 7 (other than M&E)(Form 2106)	_

Example:
Your employer paid an expense allowance of $5,000. It is not clear how much of the allowance is for deductible meals. Your actual expenses were $2,000 for meals and $4,500 for automobile use. first divide your meal expenses by your

total expenses ($2,000 ÷ $6,500). The result is 0.31. Multiply your reimbursement by this decimal ($5,000 x 0.31). The resulting $1,550 is the amount attributable to meals.

29. Employee's Educational Expenses

A. Qualifying education is deductible even though the education may lead to a degree.

B. "Qualifying education" is education required by the employer or the law to keep one's present salary, status, or job, or the education must be to maintain or improve skills needed in one's present work.

Example:
You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires you to take an additional college course each year to keep your teaching job. This is qualifying education even if you eventually receive a mater's degree and an increase in salary because of this extra education.

C. Non-qualifying education includes education to meet minimum requirements. The minimum necessary is generally determined by laws and regulations, the standards of the profession, or one's employer.

1. Already doing the work does not mean the minimum requirements have yet been met. Once met, and the minimum requirements change, the rule does not have to be satisfied again.

2. Requirements for teachers and others employed by educational organizations are usually set by the state or school district. If no requirements exist, the teacher will have met the minimum requirements when he/she becomes a faculty member. If the minimum requirements are met and the teacher moves to a new state, that teacher is considered to have met the requirements of the new state. This applies even if the teacher is required to take some additional education to be certified in the new state.

3. Education that is part of a program of study that can qualify the individual for a new trade or business is nondeductible even if the individual is not planning a job change.

a) Review courses to prepare for the bar exam or CPA exam are nonqualifying.

b) Teaching and related duties are considered the same general kind of work. For example, a change from a classroom teacher to a guidance counselor or a school administrator is not considered a new business.

Exercise 67:
In regard to education expenses, which of the following statements is CORRECT?

A. Education expenses are deductible, even though they may be qualifying an individual for a new trade or business, so long as they improve skills in a present trade or business.
B. Education expenses are deductible, even though they lead to meeting the minimum educational requirements for employment.
C. If the minimum educational requirements have been met, then all additional education expenses are deductible in ALL cases.
D. Education expenses are deductible as long as the minimum educational requirements have been met, the education is not qualifying for a new trade or business, and the education is necessary to maintain or improve skills in the established trade or business.

D. Education expenses are deductible as long as the minimum educational requirements have been met, the education is not qualifying for a new trade or business, and the education is necessary to maintain or improve skills in the established trade or business. Education expenses are not deductible if they are required the to meet the minimum educational requirements to qualify for the taxpayer's present employment or if the education qualifies the taxpayer for a new trade or business. In addition, the education must maintain or improve a skill required of the taxpayer in his or her employment.

D. Deductible expenses are reported on Form 2106 if the expense includes meals or travel. Deductible expenses are carried to Schedule A as miscellaneous itemized deductions subject to 2% AGI.

1. Expenses include tuition, books, supplies, lab fees, and similar items.

2. Transportation and travel costs:

a) Transportation costs of going directly from work to school are deductible. If regularly employed and going to school on a strictly temporary basis, the costs of returning from school to home or the round trip between home and school are also deductible. You can use actual expense or the standard mileage rate of 30 cents per mile.

Example:
You regularly work in Camden, New Jersey, and also attend school for 6 consecutive Saturdays, non-work days, to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

b) Travel, meals, and lodging are deductible if the taxpayer travels overnight to obtain qualifying education and the main purpose of the trip is to attend a work-related course or seminar. Expenses for any personal activities are not deductible. A seminar or course in connection with a cruise or convention is limited.

c) The cost of travel that is in itself a form of education is not deductible even though the travel may be directly related to one's work or business duties.

E. Self-employed individuals are allowed an educational expense deduction on their business form and will not be limited by 2% AGI.

30. Miscellaneous Deductions

A. Miscellaneous deductions are divided into those limited to 2% of AGI and those not limited by AGI. The 2% limitation applies after any other limitations, such as the 50% reduction in meals.

B. Unreimbursed Employee Business Expenses subject to the 2% AGI limit:

Business liability insurance and malpractice premiums
Damages paid to former employer for breach of employment contract
Depreciation on home computer or cellular telephone *
Dues to Chamber of Commerce if membership helps in your job
Dues to professional societies
Home office or part of home used regularly and exclusively in work
Job search expenses in your present occupation
Laboratory breakage fees
Medical examinations *
Occupational taxes paid
Passport for business trip

Repayment of income aid payments
Research expenses of college professor
Subscriptions to professional journals and trade magazines related to work
Tools and supplies used in work
Union dues and expenses
Work uniforms

* Employer required

C. Other Expenses Subject to 2% Limit

Appraisal fees for a casualty or charitable contributions
Clerical help and office rent in caring for investments
Depreciation on home computers to the extent used for investments
Dividend reinvestment plan service charges
Excess deductions on termination of an estate or trust
Fees to collect interest and dividends
Hobby expenses, but not more than hobby income
Indirect miscellaneous deductions passed through grantor trusts, partnerships, and S Corporations
Investment fees and expenses
Legal fees related to producing or collecting taxable income, protecting your job, or getting tax advice
Loss on deposits in an insolvent or bankrupt financial institution
Repayments of income or Social Security benefits
Repayments under a claim of right of $3,000 or less
Safe deposit box rental
Separately billed IRA administrative fees
Tax advice and preparation fees, including fees for electronic filing
Trustee's fees for your IRA, if separately billed and paid

D. Deductible Expenses Not Subject to the 2% Limit

Amortizable premium on taxable bonds
Federal estate tax on income in respect of a decedent
Gambling losses to the extent of gambling winnings
Impairment-related work expenses of persons with disabilities
Repayments under a claim of right of more than $3,000
Unrecovered investment in a pension

E. Nondeductible Expenses

Adoption expenses
Burial or funeral expenses
Campaign expenses
Capital expenses

Losses on sale of home, furniture, personal car, etc.
Lost or misplaced property
Lunches with co-workers

Check-writing fees
Commuting expenses
Disability insurance premiums
Expenses to influence general public on legislation or elections
Fees and licenses (auto, marriage)
Fines and penalties
Health spa expenses
Hobby losses
Home repairs, insurance, and rent
Illegal bribes and kickbacks
Life insurance premiums
Meals while working late
Personal legal expenses
Personal, living, and family expenses
Political contributions
Professional reputation expenses
Relief fund contributions
Residential telephone line
Stockholders' meeting (expenses to attend)
Tax-exempt income expenses
Voluntary unemployment benefit fund contributions
Wristwatches

Domestic Employees

A. Defined

1. A domestic employee includes, but is not limited to: cooks, waiters, waitresses, butlers, housekeepers, maids, cleaning people, gardeners, and chauffeurs of automobiles for family use.

2. The determination of an employment relationship is based on the element of control the employer has over the employee.

3. Cash wages include wages paid with check, money orders, etc. It does not include the value of food, lodging, clothing, and other noncash items.

B. Social Security and Medicare Taxes

1. If a taxpayer pays a household employee cash wages of $1,100 or more in 1999, all cash wages paid to that employee in 1999 are Social Security and Medicare wages.!!

2. Social Security and Medicare wages do not include wages paid to: a spouse, the taxpayer's child under age 21, a parent, or an employee under age 18 at any time during the year. The exception for an employee under age 18 at any time during the year does not apply if the household services is that employees principal occupation.

3. The tax is 6.2% for Social Security and 1.45% for Medicare if the employee's share is properly withheld from the employee's wage.

Exercise 68:

Beginning in 1999, the wage threshold for Social Security and Medicare taxes for a household employee is:

A. $1,000 or more in a year.
B. $625 or more in a quarter.
C. $625 or more in a year.
D. $50 or more in a quarter.

A. $1,000 or more in a year. Individuals who employ domestic workers are required to withhold and pay Social Security and Medicare taxes for any employee for whom they pay $1,000 or more in a calendar year.

C. Federal Unemployment Tax (FUTA)

1. The FUTA tax is 6.2% of the employee's FUTA wage.

2. If cash wages paid to household employees totals $1,100 or more in any calendar quarter of 1998, the first $7,000 paid to each employee in 1998 and 1999 is FUTA wages.!!

3. If the taxpayer pays less than $1,100 cash wages in each calendar quarter of 1999 but paid household employees $1,000 in any quarter in 1998, the wages paid in 1999 are FUTA wages.

D. Federal Income Tax Withholding

1. Federal income tax withholding is not required unless the employee asks the employer to withhold and the employer agrees to do so.

2. Federal income tax withholding is computed on both cash and noncash wages.

3. If the employer pays the federal income tax without withholding it from the employee's pay, the amount must be included in income of the employee and is subject to FICA and FUTA.

E. Tax Payments and Reporting

1. The employer can pay the taxes due on wages paid to domestic workers using Schedule H filed with his/her Form 1040. An extension to file Form 1040 will also apply to Schedule H.

2. An employer, filing Form 940 and Form 941, MAY include taxes for household employees on these forms.

3. The household employer is required to have an EIN when filing Forms W-2 and Schedule H.

Exercise 69:
Mr. and Mrs. Franks, who do not own any businesses, are wage earners who have household employees. Mr. and Mrs. Franks' employment taxes on the wages paid to their household employees will be filed and paid with their annual Form 1040. (True or False)

True. Because the taxpayers are wage earners, and not sole proprietors, they may report and pay employment taxes for household employees on their annual Form 1040, Schedule H.

PART 6 - FIGURING YOUR TAXES AND CREDITS

In this part we will explain how to figure your tax and how to figure the tax of certain children who have more than $1,500 of investment income. They also discuss tax credits that, unlike deductions are subtracted directly from your tax and reduce your tax, dollar for dollar.

31. How To Figure Your Tax

After you have figured your income and deductions as explained in *Parts One through Five,* your next step is to figure your tax. This chapter discusses:

- The general steps you take to figure your tax,
- An additional tax you may have to pay called the alternative minimum tax, and
- The conditions you must meet if you want the IRS to figure your tax.

Figuring Your Tax

Your income tax is based on your taxable income. After you figure your income tax, subtract your tax credits and add any other taxes you may owe. The result is your total tax. Compare your total tax with your total payments to determine whether you are entitled to a refund or owe additional tax.
This section provides a general outline of how to figure your tax. You can find step-by-step directions in the instructions for Forms 1040EZ, 1040A, and 1040.

Tax. Most taxpayers use either the Tax Table or the Tax Rate Schedules to figure their income tax. However, there are special methods if your income includes any of the following items.

- Capital gains.

- Lump-sum distributions.
- Farm income (see Schedule J (Form 1040), *Farm Income Averaging*).
- Investment income over $1,500 for children under age 14.

Credits. After you figure your income tax, determine your tax credits. This chapter does not explain whether you are eligible for these credits. You can find that information in chapters 33 through 38 and your form instructions. See the following table for credits you may be able to subtract from your income tax.

Alternative Minimum Tax (AMT)

A. AMT is a minimum tax some taxpayers are required to pay when benefiting from special tax treatment afforded some types of income, special deductions, or credits.

B. The tax is based on Alternative Minimum Taxable Income (AMTI) in excess of a base amount. AMTI is taxable income redetermined by accounting for specific adjustments and preferences.

Filing Status	Base Amount (2001)
MFJ or QW	$49,000
S or HH	$35,750
MFS	$24,500

C. AMTI Adjustments

1. Addition of personal exemptions and the standard deduction or itemized deductions claimed for state and local taxes, certain interest, most miscellaneous deductions, and part of medical expenses.

2. Subtraction of any refund of state and local taxes included in income.

3. Accelerated depreciation in excess of straight line.

4. A change in determining income from long-term contracts.

5. The difference between gain and loss on the sate of property reported using regular tax basis and AMT basis.

6. The excess of fair market value over purchase price for an incentive stock option.

7. A change in determining income from installment sales.

8. A change in determining a passive activity loss deduction.

Exercise 70:
In regard to the alternative minimum tax for individuals, you may use your personal exemption in figuring alternative minimum taxable income. (True or False)

False. The deduction for personal exemptions is not allowed in computing AMT.

D. AMTI Preferences

1. That part of a deduction for certain depletion that is more than the adjusted basis of the property.

2. Part of a deduction for certain intangible drilling costs if the deduction is more than 65% of the net income from oil, gas, and geothermal properties.

3. Tax-exempt interest on certain private activity bonds.

4. Accelerated depreciation on certain property placed in service before 1987.

32. Tax on Investment Income of Certain Minor Children

A. Two special tax rules that apply to certain investment income of a child under age 14.

1. If the child's interest, dividends, and other investment income total more than $1,500, part of that income may be taxed at the parent's tax rate instead of the child's tax rate. (See *Tax for Children Under Age 14 Who Have Investment Income of More Than $1,500, Pub. 17, Chap. 31.*)

2. The child's parent may be able to choose to include the child's interest and dividend income (including capital gain distributions) on the parent's return rather than file a return for the child. (See *Parent's Election To Report Child's Interest and Dividends,* later.)

For these rules, the term "child" includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent.

These rules do ***not*** apply if:

1. The child is not required to file a tax return, or
2. Neither of the child's parents were living at the end of the tax year.

33. Child and Dependent Care Credit

Important Reminders	
Taxpayer identification number needed for each qualifying person.	You must include on line 2 of Form 2441 or Schedule 2 (Form 1040A) the name and taxpayer identification number (generally the social security number) of each qualifying person.
You may have to pay employment taxes.	If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer who has to pay employment taxes. Usually, you are ***not*** a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business.

A. Tests which must be met to claim the credit:

1. The care must be for one or more qualifying persons.

2. Taxpayer (and spouse if married) must keep up a home that the taxpayer lives in with the qualifying person or persons.

3. Taxpayer (and spouse) must have earned income during the year.

4. Taxpayer must pay child and dependent care expenses so he or she (and spouse) can work or look for work.

5. The taxpayer's filing status is single, head of household, qualifying widow(er) with dependent child, or married filing jointly. Taxpayer must file joint if married or an exception applies.

6. Taxpayer must identify the care provider on the tax return.

7. Taxpayer must make payments for child and dependent care to someone he or she (or spouse) cannot claim as a dependent.

8. Taxpayer excludes less than $2,400 ($4,800 if two qualifying persons cared for) of dependent care assistance benefits.

B. Qualifying Persons:

1. The taxpayer's dependent who was under age 13 when the care was provided and for whom the taxpayer can claim an exemption,

2. The taxpayer's spouse who was physically or mentally unable to care for himself or herself, or

3. The taxpayer's dependent who was physically or mentally unable to care for himself or herself and for whom the taxpayer can claim an exemption, or could claim an exemption except the person had $2,750 in 1999 or more of gross income.

4. Children of divorced parents:

   a) The custodial parent can treat a child as a qualifying person even if that parent cannot claim the child's exemption.

   b) The noncustodial parent cannot treat the child as a qualifying person even if that parent can claim the child's exemption.

C. Keeping up the home includes costs for property taxes, mortgage interest, rent, utilities, home repairs, insurance on the home, and food eaten in the home. The taxpayer must pay more than half of the cost of keeping up a home.

D. The earned income test applies to the taxpayer and the spouse if married.

1. Earned income includes wages, salaries, tips, other employee compensation, and net earnings from self-employment. Earned income is reduced by a net loss from self-employment.

2. A spouse is treated as having earned income for any month, up to $200 for one qualifying person or $400 for two or more qualifying persons, if he or she is a full-time student or physically or mentally not capable of self-care.

E. The work related test means expenses that allow the taxpayer (and spouse) to work or look for work and are for a qualified person's care. A daily allocation of expense is required if the taxpayer only works, or looks for work, for part of the year. Amounts paid while off of work due to illness are not work-related expenses.

F. Care expenses for the qualifying person includes:

1. Expenses for household services if part of the service is for care.

2. Expenses if the main purpose for the care of the qualifying person is the person's well-being and protection.

3. Total expense for sending a child to school if the child is not in the first grade or any higher grade and the amount paid for schooling is incident to and cannot be separated from the cost of care.

4. Expenses for care outside of the home do not include the cost of sending a child to an overnight camp (not considered work-related).

5. Employment taxes paid on wages to household workers that provide qualifying child and dependent care services.

G. If married, the taxpayers must file a joint return unless the spouse did not live in the taxpayer's home for the last 6 months of the year.

H. Care provider must be identified by name, address, and taxpayer identification number.

I. In figuring the credit, prepaid expenses are not deductible until the year the care is provided and employer-provided benefits are not included.

J. Limitation of credit based on AGI. The child credit begins to phase out when modified adjusted gross income (AGI) reaches $110,000 for joint filers, $55,000 for married filing separately, and $75,000 for singles. The credit is reduced by $50 for each $1,000, or fraction thereof, of modified AGI above the threshold.

K. Earned Income Limit:

1. The amount of work-related expenses cannot be more than the taxpayer's earned income for the year if single at the end of the year, or the smaller of the taxpayer's earned income or the spouse's earned income for the year if married.

2. If legally separated or married and living apart or if a spouse died during the year, the taxpayer is not considered married for the earned income limit.

3. Self-employed's earned income is generally the amount on Schedule SE line 3 less the deduction for one half of the self-employment tax. If Schedule SB is not required because income is less than $400, still

include that income. If there is a net loss on self-employment income, the loss must reduce other earned income.

L. Dollar Limit

1. $2,400 for one qualifying dependent, $4,800 for two or more qualifying dependents.

2. Employer benefits not included in income will reduce these limits.

M. The credit is determined by a percentage derived from a table. Up to $10,000 AGI, the percentage is 30%. This decreases 1% for each $2,000 increment over $10,000, to a minimum amount of 20%.

34. Credit for the Elderly and Disabled

A. If you qualify, the law provides a number of credits that can reduce the tax you owe for a year. One of these credits is the credit for the elderly or the disabled. The maximum credit available is $1,125. You may be able to take this credit if you are:

- Age 65 or older, or
- Retired on permanent and total disability.

B. To be eligible for the credit, the taxpayer (U.S. citizen or resident) must be age 65 or older at the end of the tax year, or if under age 65, retired on permanent and total disability and receiving taxable disability benefits.

B. To Calculate the Credit

1. Start with the **initial amount**.

S, HH(QW)			
65 or older	$5,000		
Under 65 and retired on disability *		$5,000	
MFJ			
Both 65 or older		7,500	
Both under 65, one retired on disability *		5,000	
Both under 65, both retired on disability *			7,500
One 65 or over, other under 65 and retired on disability			7,500
One 65 or over, other under 65 and not retired on disability		5,000	
MFS, did not live with spouse at all during year 65 or older		3,750	
Under 65 and retired on disability *		3,750	

* Base amount cannot be more than total taxable disability income
** Base amount is $5,000 plus taxable disability, but not over $7,500

2. Total any nontaxable Social Security or Railroad Retirement benefits and other nontaxable pension or disability benefits.

3. Determine excess AGI ((AGI - a standard amount) / 2). The standard amount is: $7,500 if S, HH, QW; $10,000 if MFJ; or $5,000 if MFS and lived apart the entire year.

4. If the sum of step 2 and step 3 amounts exceed the base amount, no credit is allowed. If the base amount is more, then the base amount, less the sum of steps 2 and 3, multiplied by 15% equals the credit.

Exercise 71:
If you are 65 or older and your spouse is UNDER 65 and NOT retired on permanent and total disability, you are ineligible to claim a Creditor the Elderly or the Disabled on a jointly filed return. (True or False)

False. Generally, individuals who are married at the close of the tax year must file a joint return in order to claim the elderly and disabled credit.

35. Child Tax Credit

Important Reminders Child tax credit increased.	The maximum child tax credit for each qualifying child is increased to $600 for 2001.
Additional child tax credit expanded.	For tax years after 2000, the qualifications for claiming the additional child tax credit have been expanded to include qualifying individuals with fewer than three children. See *Additional Child Tax Credit,* later, for more information.

The child tax credit is a credit that can reduce your tax. You may be able to take a credit on your tax return of up to $600 for each of your qualifying children.

The child tax credit is not the same as the credit for child and dependent care expenses. For information on the credit for child and dependent care expenses, see chapter 33.

This chapter gives you information about the child tax credit. It explains:

- Who is a qualifying child.

- How much is the credit.
- How do I claim the credit.
- Why should I check my tax withholding.

If you have no tax. Credits, such as the child tax credit, the adoption credit, or the credit for child and dependent care expenses, are used to reduce tax. If your tax on line 42 (Form 1040) or line 26 (Form 1040A) is zero, do not figure the child tax credit because there is no tax to reduce. However, you may qualify for the additional child tax credit on line 63 (Form 1040) or line 40 (Form 1040A).

36. Education Credits

The following two tax credits are available to persons who pay higher education costs.

- The Hope credit.
- The lifetime learning credit.

Hope Credit
You may be able to claim a Hope credit of up to $1,500 for qualified tuition and related expenses paid for each eligible student.

Eligible student for the Hope credit. For purposes of the Hope credit an eligible student is a student who meets ***all*** of the following requirements.

Did not have expenses that were used to figure a Hope credit in any 2 earlier years.

Had not ***completed the first 2 years*** of postsecondary education (generally, the freshman and sophomore years of college).

Was ***enrolled at least half-time*** in a program that leads to a degree, certificate, or other recognized educational credential, for at least one ***academic period*** beginning in 2001.

Was free of any federal or state felony conviction for possessing or distributing a controlled substance as of the end of 2001.

Completion of first 2 years. A student who was awarded 2 years of academic credit for postsecondary work completed before 2001 has completed the first 2 years of postsecondary education. This student would not be an eligible student for purposes of the Hope credit.

Any academic credit awarded solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed 2 years of postsecondary education.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standards may not be lower than those established by the Department of Education under the Higher Education Act of 1965.

Amount of credit. The amount of the Hope credit is the sum of:

1. 100% of the first $1,000 qualified tuition and related expenses you paid for each eligible student, ***and***
2. 50% of the next $1,000 qualified tuition and related expenses you paid for each eligible student.

The maximum amount of Hope credit you can claim in 2001 is $1,500 times the number of eligible students. You can claim the full $1,500 for each eligible student for whom you paid at least $2,000 of qualified expenses. However, the credit may be reduced based on your modified adjusted gross income.

Example
Jon and Karen are married and file a joint tax return. For 2001, they claim an exemption for their dependent daughter on their tax return and their modified adjusted gross income is $70,000. Their daughter is in her sophomore (second) year of studies at the local university and Jon and Karen pay qualified tuition and related expenses of $4,300 in 2001.

Jon and Karen, their daughter, and the local university meet all of the requirements for the Hope credit. Jon and Karen can claim a $1,500 Hope credit in 2001. This is 100% of the first $1,000 qualified tuition and related expenses, plus 50% of the next $1,000.

How to figure the Hope credit. The Hope credit is figured in Parts I and III of Form 8863.

Lifetime Learning Credit
You may be able to claim a lifetime learning credit of up to $1,000 for qualified tuition and related expenses paid for ***all*** students enrolled in eligible educational institutions.
The lifetime learning credit is different than the Hope credit in the following ways.

1. The lifetime learning credit is not based on the student's work load. It is allowed for one or more courses.

2. Expenses for graduate-level degree work are eligible.

3. Expenses related to a course of instruction or other education that involves sports, games, hobbies, or other noncredit courses are eligible if they are part of a course of instruction to acquire or improve job skills.
4. There is no limit on the number of years for which the lifetime learning credit can be claimed for each student. It is not limited to students in the first 2 years of postsecondary education.
5. The amount you can claim as a lifetime learning credit does not vary (increase) based on the number of students for whom you pay qualified expenses.

Amount of credit. The amount of the lifetime learning credit is 20% of the first $5,000 qualified tuition and related expenses you pay for all eligible students. The maximum amount of lifetime learning credit you can claim for 2001 is $1,000 (20% × $5,000). However, that amount may be reduced based on your modified adjusted gross income. See *Does the Amount of Your Income Affect the Amount of Your Credit*, earlier.

Example:
Bruce and Toni are married and file a joint tax return. For 2001, their modified adjusted gross income is $50,000. Toni is attending the community college (an eligible educational institution) to earn credits towards an associate's degree in nursing. She already has a bachelor's degree in history and wants to become a nurse. In August 2001, Toni paid $4,000 for her fall 2001 semester. Bruce and Toni can claim an $800 (20% × $4,000) lifetime learning credit on their 2001 joint tax return.

How to figure the lifetime learning credit. The lifetime learning credit is figured in Parts II and III of Form 8863.

Income limitation.
The allowable amount of the credits is reduced for taxpay*ers* who have modified adjusted gross income (AGI) above certain amounts. The phaseout of the credits begins for most taxpayers when modified AGI reaches $40,000; the credits are completely phased out when modified AGI reaches $50,000. For joint filers, the phaseout range is $80,000 to $100,000. Modified AGI is AGI increased by income earned outside the United States (amounts otherwise excluded from income under Code Secs. 911, 931, and 933). Income earned in Puerto Rico and U.S. possessions is considered to be earned abroad. The income ranges for the phaseout of the credits will be indexed for inflation occurring after the year 2000. The Hope credit and the lifetime learning credit are not available to married taxpayers who file separate returns. The credits are available to married individuals (as defined in Code Sec. 7703) only if a joint return is filed.

Coordination with other provisions. For any tax year, a taxpayer is permitted to elect only one of the following with respect to one student: (1) the Hope credit, (2) the lifetime learning credit, or (3) the exclusion for distributions from an education IRA used to pay higher education costs under Code Sec. 530. In addition, the amount of qualified higher education expenses, otherwise taken into account in determining the Series EE U.S. Savings bond exclusion, is reduced by the amount taken into account in computing the credit.

37. Earned Income Credit (EIC)

A. The credit is based on the taxpayers earned income, adjusted gross income, and whether or not the taxpayer has a qualifying child.

B. To get the credit, a tax return must be filed even if the taxpayer has no tax liability or did not earn enough to meet the gross income filing requirements.

C. Taxpayers who work and have one or more qualifying children are eligible for a higher credit if all requirements are met.

1. The eligibility requirements are as follows:

   a) The taxpayer and the qualifying child must live in the same main home, in the United States, for more than one-half of the year.

   b) The taxpayer must have earned income during the year.

   c) The taxpayer's earned income and adjusted gross income must each be less than $32,121 (2001) with qualifying children or ($10,710 if you do not have any qualifying children).

   d) The return must cover a 12-month period, except in the case of an individual's death.

   e) The taxpayer's filing status can be any except MFS.

   f) The taxpayer cannot be a qualifying child of another person.

   g) The taxpayer's qualifying child cannot be the qualifying child of another person whose adjusted gross income is more than the taxpayer's.

   h) The taxpayer usually must claim as a dependent a qualifying child who is married.

i) The taxpayer did not file Form 2555 to exclude foreign earned income or exclude foreign housing.

2. A married taxpayer must file MFJ unless the cost of keeping up the home test is met and the spouse did not live in the home for the last six months of the year. (Considered unmarried for tax purposes.)

3. Qualifying child must meet three tests:

a) Relationship Test - The child must be the taxpayer's:

(1) Son, daughter, or adopted child (or a descendent of one's son, daughter, or adopted child),

(2) Stepson or stepdaughter, or

(3) Eligible foster child - which is any child that lived with the taxpayer all year for whom the taxpayer cared for as his or her own.

b) Residency Test - Taxpayer and child must live in the same main home (located in the U.S.) for more than one-half of the year (whole year for an eligible foster child). Starting in 1995, military personnel stationed outside of the U.S. will be treated as maintaining a residence in the U.S.

c) Age Test - The child must meet one of three rules:

(1) The child must be under age 19 at the end of the year,

(2) The child must be a full-time student under age 24 at the end of the year, or

(3) The child must be permanently and totally disabled at any time during the tax year, regardless of age.

4. If the taxpayer is a qualifying child of another person, the taxpayer cannot claim EIC no matter how many qualifying children he or she may have.

5. If the taxpayer and another person have the same qualifying child, then the child qualifies only the person with the higher AGI who may or may not be eligible for EIC.

6. A correct and valid Social Security number is required for each person listed on the tax return.

D. Taxpayer's without qualifying children may be eligible for a reduced credit, if his/her earned income and AGI is less than $10,000.

1. Married taxpayers must generally file a joint return.

2. The taxpayer cannot be a qualifying child of another person.

3. The taxpayer must be at least age 25 but under age 65 as of the end of the year. If MFJ, either spouse can meet the age requirement.

4. The taxpayer must be eligible to claim his/her own exemption.

E. Earned income includes all income received from work, including nontaxable and deferred amounts.

1. If the taxpayer participates in a cafeteria plan in which the individual agrees to a salary reduction for receiving a nontaxable benefit, the amount of the salary reduction is earned income for purposes of EIC.

2. Net earnings from self-employment is included as earned income. The net earnings is the business gross income less business expenses and one half of the self-employment tax. This is included even if less than the $400 requirement for Schedule SE. A net loss will reduce other earned income.

   a) Statutory employees are generally considered self-employed, but for purposes of EIC, they are treated as employees. Include the gross amount received from employment.

   b) Ministers may need to make an adjustment to the amount carried from Form 1040 line 7 because some of this income may also be reported on Schedule SE.

3. Community property laws are ignored for determining each individual taxpayer's earned income.

4. Examples of includable and excludable income for EIC purposes:

INCLUDED	NOT INCLUDED
• Wages, salaries, and tips • Union strike benefits • Long-term disability benefits received prior to minimum retirement age	• Interest and dividends • Social Security and Railroad Retirement benefits • Welfare benefits (including AFDC payments)

• Net earnings from self-employment • Voluntary salary deferrals • Pay earned in a combat zone • Basic quarters and subsistence allowances and in-kind quarters and subsistence for the U.S. military • The value of meals or lodging provided by an employer for the convenience of the employer • Housing allowance or rental value of a parsonage for the clergy • Excludable dependent care benefits • Voluntary salary reductions (cafeteria plan) • Anything else of value received from someone for services performed even if not taxable.	• Pensions and annuities • Veteran's benefits • Workers' compensation benefits • Alimony • Child support • Unemployment compensation (insurance) • Taxable scholarship or fellowship grants that were not reported on From W-2 • Variable housing allowance for the military • Disability payments received after reaching minimum retirement age.

Exercise 72:
Which of the following items is considered earned income for the earned income credit?

A. Welfare benefits.
B. Earnings from self-employment.
C. Social Security benefits.
D. Veterans' benefits.

B. Earnings from self-employment. The post-1993 earned income credit is based on "earned income," which includes earnings from self-employment.

F. Advanced earned income payments may be received throughout the year if the taxpayer would be eligible for EIC and files Form W-5 with the employer.

NOTE: Advanced EIC is available only to taxpayers who have at least one qualifying child.

Exercise 73:
An employee can get ALL of his/her earned income credit from his/her employer in advance. (True or False)

False. The amount of the earned income credit that may be received as an advance payment is limited to 60% of the maximum credit available *to an individual with one qualifying child. The advance payment is not available to an individual who does not have a qualifying child.*

38. Other Credits

A. Nonrefundable credits may reduce tax to zero, excess credit is lost.

1. **Credit for prior year minimum tax** - The credit is the prior year AMT reduced by the part of the minimum tax generated by exclusion items.

2. Credit for **electric vehicles** is up to 10% of the cost of a qualified electric vehicle. The credit is limited to $4,000 for each vehicle placed in service in 2001.

3. Foreign tax credit applies if not claimed as an itemized deduction. Form 1116 can be used to take a credit for taxes paid or accrued to a foreign country.

4. **Adoption credit.** You may be able to take a tax credit of up to $5,000 for qualifying expenses paid to adopt an eligible child. The credit can be as much as $6,000 if the expenses are for the adoption of a child with special needs.

   If your modified adjusted gross income (AGI) is more than $75,000, your credit is reduced. If your modified AGI is $115,000 or more, you cannot claim the credit.

5. **Mortgage interest credit** applies to a taxpayer who was issued a mortgage credit certificate (MCC) under a qualified state or local MCC program.

B. **Refundable Credits** - The excess after reducing the tax to zero is refunded to the taxpayer.

1. Credit for excess Social Security tax, Medicare tax, or Railroad Retirement tax withholding if the taxpayer worked for two or more employers during the year.

2. Credit from a regulated investment company. A mutual fund may allocate capital gain distributions, yet not actually make a distribution. If the fund paid the tax on the capital gain, this tax would be considered paid by the taxpayer.

3. Credit on diesel-powered highway vehicles available to the first owner of that qualified vehicle.

2. PART 2 - SOLE PROPRIETORSHIPS & PARTNERSHIPS

TABLE OF CONTENTS

INTRODUCTION

Part II covers sole proprietorships and partnerships. This part of the exam is divided into three sections. Section A consists of true or false questions, Section B is multiple choice and Section C is multiple choice that requires some computation. The majority of the questions on Part II of the exam come directly from Publication 334. Part II of this text will also follow Publication 334 and other related IRS publications. Each section of this text will be followed by an exam that consists of questions from prior exams.

MAIN TOPICS

- Section A   Business Organizations
- Section B   Income, Loss, and Expenses
- Section C   Sales, Exchanges, and Basis
- Section D   Partnerships

STUDY MATERIALS

Most of the questions on the exam are covered in the publications provided by the IRS. There are a few questions, however, that can only be answered by referring to the code and regulations.

The following publications will be helpful in preparing for Part II of the exam:

Publication	225	Farmer's Tax Guide
Publication	334	Tax Guide for Small Business
Publication	349	Federal Highway Use Tax on Heavy Vehicles
Publication	463	Travel, Entertainment and Gift Expenses
Publication	534	Depreciation
Publication	538	Accounting Periods and Methods
Publication	541	Tax Information on Partnerships
Publication	544	Sales and Other Dispositions of Assets
Publication	551	Basis of Assets
Publication	946	How to Depreciate Property

SECTION A - BUSINESS ORGANIZATIONS

I. General Information

A. Sole Proprietorships - A sole proprietorship is the simplest form of doing business. The business does not exist apart from the owner. Its liabilities are the personal liabilities of the owner and the ownership interest ends with the proprietor's death. The income is directly attributable to the owner and is taxed on Form 1040. Profit or loss is reported on Schedule C or C-EZ (Schedule F for farmers). A net profit of $400 or more is subject to self-employment tax.

B. Partnership - A partnership is not a taxable entity. The partnership files an information return using Form 1065. Income or loss is passed through to the partners on Schedule K-l.

1. The term "partnership" includes a syndicate, group, pool, joint venture, or similar organization formed to carry on a trade or business and that is not classified as a trust, estate, or corporation.

2. Each partner shares in the profits and losses according to the partnership agreement. Any modifications to the original agreement must be agreed to by all the partners or adopted in any other manner provided by the partnership agreement. The agreement or the modification may be oral or written.

   a) Partners can modify the agreement for a particular tax year after the close of the tax year but not later than the due date for filing the return. This filing date excludes extensions.

   b) If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

3. Certain partnerships may choose to be excluded completely or partially from being treated as a partnership for federal tax purposes if all the partners agree. This exclusion applies to unincorporated investing or operating agreement partnerships where there is no active conduct of a trade or business.

   NOTE: *A joint undertaking to share expenses is not a partnership. Mere co-ownership of property that is maintained and leased or rented is not a partnership. However, if the co-owners provide services to the tenants, a partnership exists*

C. Taxpayer Identification Number - Generally, a person's Social Security number is his or her taxpayer identification number. However, every partnership, corporation (including an S corporation) and certain sole proprietorships must have an employer identification number (EIN).

1. Sole proprietorships must have an EN if they:

   a) Pay wages to one or more employees, or

   b) Are required to file any pension or excise tax returns, including those for alcohol, tobacco, or firearms.

   NOTE: *when a sole proprietorship is required to have an EIN, it is included on Schedule C along with the Social Security number. If the sole proprietorship is not required to have an EIN then the Social Security number is used as the taxpayer identification number and the line for the EIN is left blank.*

2. Change in organization - A new EIN is required for the following changes:

   a) A sole proprietorship incorporates,

   b) A sole proprietorship takes on partners and operates as a partnership,

   c) A partnership incorporates,

   d) A partnership is taken over by one of the partners and is operated as a sole proprietorship, or

   e) A corporation changes to a partnership or sole proprietorship. A corporation that elects to be taxed as an S Corporation does not need to get a new EIN.

3. Change in ownership - A new EIN is required for the following changes in ownership:

   a) You purchase or inherit an existing business that you will operate as a sole proprietorship. (You cannot use the same EIN of the former owner even if that owner is a spouse).

   b) You represent an estate that operates a business after the death of the owner.

   c) You terminate a partnership and begin a new one.

II. Books and Records

A. Adequate records are needed to monitor your business operations, prepare financial statements, verify income and expenses, and to support items reported on your tax return.

B. Employment tax records need to specify each employee's name, address, and Social Security number; cash and non-cash payments; withholding allowance certificates; amounts and dates paid; and all items withheld. Employment tax records should be retained for at least 4 years after the date the tax becomes due or is paid, whichever is later.

C. Asset records are needed to adequately account for depreciation and gain or loss on a disposition. Records for assets should be retained until the period of limitations expires for the year in which the property is disposed of in a taxable transaction.

D. Tax returns should be retained for as long as needed in regard to one of the preceding paragraphs or until the period of limitations for the return runs out. The period of limitations is generally 3 years after the date the return is due or 2 years after the date the tax is paid, whichever is later.

III. Accounting Periods

A. Taxpayers adopt an accounting period when the first income tax return is filed This is done by filing the first tax return by the due date not including extensions of time to file.

Entity	Tax Year	Due Date
Sole Proprietorship	Adopts the same tax year as the owner, generally a calendar year	15th day of the 4th month following the end of the tax year
Partnership	Adopts the same tax year as the partners owning 50% or more	15th day of the 4th month following the end of the tax year
C Corporation	Fiscal or calendar year	15th day of the 3rd month following the end of the tax year
S Corporation	Calendar year unless there is a valid Section 444 election in effect	5th day of the 3rd month following the end of the tax year

B. Calendar Year - A calendar year is a period of twelve consecutive months ending on December 31.

1 An individual taxpayer that begins a sole proprietorship during the tax year must use the same tax year he is currently using unless he gets permission to change to a different year. For most individuals this is a calendar year.

2. An individual must adopt a calendar year if:

   a) The taxpayer does not keep adequate records,

   b) The taxpayer has no annual accounting period, or

   c) The taxpayer's present tax year does not qualify as a fiscal year.

C. Fiscal Year - A fiscal year can be either 12 consecutive months ending on the last day of any month except December, or a tax year that varies from 52 to 53 weeks. If you elect a *52-53* week year, your tax year will always end on the same day of the week. The year may end on either:

1. The date on which a specified day of the week last occurs in a particular month, or

2. The date that day of the week occurs nearest to the last day of a particular calendar month.

D. Short Tax Year - A short tax year is a tax year which is less than 12 months. This can occur when the entity is not in existence for the entire tax year or when the entity changes its accounting period or form of organization. A short tax year is considered a full tax year. The requirements for filing the short tax year return and paying the tax are the same as for a full tax year that ended on the same day.

E. Generally, IRS approval is required for a change in accounting period. Approval can be obtained by filing Form 1128 and submitting a user fee. This form must be filed by the 15th day of the second month following the close of the short tax year.

Example: *John, a sole proprietor, filed his return using the calendar year. For business purposes, he wanted to change to a fiscal year ending June 30. John will have a short tax year for the period January 1 to June 30. John must file Form 1128 by August 15, the 15th day of the second calendar month after the close of the short tax year.*

Exercise 1: *Ally a sole proprietor, must get approval to change his tax year by filing a current Form 1128 by the 15th day of the 2nd calendar month after the close of the short tax year and pay the correct user fee, if any (True or False)*

True. In general, a change in accounting period will be approved when it is established that there is a substantial business purpose for making the change.

F. A partnership has limits on the tax year it may use. If all the partners are individuals, the tax year will generally be a calendar year. However, a partnership must use what is called a "required year" determined by adapting its tax year to the partners' tax years as follows:

1. If one or more partners having the same tax year own an interest in partnership profits and capital of more than *50%* (a majority interest), the partnership must use the tax year of those partners. This is a majority interest tax year.

2. If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.

3. If there is no majority interest tax year or the principal partners do not have the same tax year, the partnership must generally use a tax year that results in the least aggregate deferral of income to the partners.

G. Section 444 provides an opportunity for a partnership, S Corporation, or personal service corporation to have a tax year that is different than the permitted tax year.

1. A partnership may elect a tax year other than a required year (generally a calendar year) under §444 if:

   a) It is not a member of a tiered structure under Reg. §1.444-2T,

   b) It has not previously had a §444 election in effect, and

   c) It elects a year that meets the deferral period requirement.

2. The deferral period is the number of months between the end of the tax year it wants to use and the close of the required year. The deferral period must not be longer than the shorter of:

   a) Three months, or

   b) The deferral period of the tax year being changed.

   ***Example**: A newly formed partnership, owned by calendar year partners, began operations December 1, 2000. The partnership wants to make a*

Section 444 election to adopt a September 30 tax year. The deferral period for the tax year beginning on December 1, 2000 is 3 months, the number of months between September 30 and December 31, 2001.!!

3. The election is made by filing Form 8716 by the earlier *of:*

   a) The due date of the return resulting from the Section 444 election, or

   b) The 15th day of the sixth month of the tax year for which the election will be effective.

Exercise 2*: Lori, Anne, and Barbara have formed the LAB Partnership. Each partner's respective ownership interest and fiscal year end is shown below:*

Partner	*Share and Ownership*	*Fiscal Year End*
Lori	*40%*	*February 28*
Anne	*35%*	*July 31*
Barbara	*25%*	*October 31*

Assuming the partnership does NOT make a Section 444 election and does NOT establish a business reason for a specific tax year, determine what will be the required tax year of the LAB Partnership.

A. *December 31*
B. *October 31*
C. *July 31*
D. *February* 28

C. July 31. The correct year is determined using the least aggregate deferral rule.

IV. Accounting Methods

A. The accounting method is chosen when the entity files its first tax return. If the entity wants to change its accounting method, it must first get permission from the IRS.

B. Cash Method - The cash method of accounting may be used by individuals and most businesses without inventories. This includes sole proprietorships and partnerships, provided the partnership does not have a C Corporation as a partner.

1. Income is reported when actually or constructively received or when made available without restriction. Property and services received are included in income at fair market value.

2. Expenses are deducted when actually paid. However, expenses paid in advance can only be deducted in the year to which they apply. This includes payments made with a credit card.

3. The cash method cannot be used by the following:

    a) Corporations other than S Corporations.

    b) Partnerships that have a C Corporation as a partner.

    c) Tax shelters.

    NOTE: *Failure to meet any of the exceptions for limits on the use of the cash method of accounting will require the taxpayer to change to the accrual method.*

4. Exceptions that allow the use of the cash method:

    a) A farming business with $25 million or less in gross receipts,

    b) A qualified personal service corporation, or

    c) Any entity (except a tax shelter) with average annual gross receipts of $5 million or less.

C. Accrual Method - All income is reported when earned regardless of when received. Prepaid income for services may be accrued over the period for which the services are to be performed provided the period does not extend beyond the next tax year.

1. All expenses are deducted or capitalized when the taxpayer becomes liable for them regardless of when they are paid.

2. Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If inventories are necessary to clearly reflect income, the accrual method must be used for sales and purchases.

3. An accrual method taxpayer cannot deduct expenses incurred to a related cash basis taxpayer until actually paid and included in the related taxpayer's income.

D. Hybrid Method - The hybrid method is any combination of cash, accrual, or special method of accounting that clearly reflects income and is consistently used. Taxpayers may use the accrual method for purchases and sales and the cash method for all items of income and expenses with the following restrictions:

1. If the cash method is used for figuring income, the cash method must be used for reporting expenses, and

2. If the accrual method is used for reporting expenses, the accrual method must be used for figuring income.

NOTE: *Different methods of accounting can be used for each separate and distinct business owned by the same taxpayer provided the method used clearly reflects the income of each business. Special methods of accounting are available for certain items of income and expenses such as installment sales, long-term contracts, and bad debts.*

Exercise 3*: With regard to accounting methods, all of the following statements are CORRECT* ***except:***

A. You may account for business and personal items under different accounting methods.
B. You choose your accounting method when you file your first tax return.
C. You must use the same accounting method from year to year unless you get consent from the IRS to change your accounting method
D. If you operate several businesses, you must use the same accounting method for each of the businesses.

D. If you operate several businesses, you must use the same accounting method for each of the businesses. When a taxpayer has two or more separate businesses and keeps a complete and separate set of books and records for each, he may use a different method of accounting for each business so long as such method clearly reflects income of that particular enterprise.

V. Changing Accounting Methods

A. A change to a different method of accounting generally requires the permission of the IRS.

B. To request a change in accounting method, the taxpayer must file Form 3115, Application for Change in Accounting Method.

   1. For an automatic change, Form 3115 must be filed no later than the due date including extensions, for filing the income tax return.

   2. For a change requiring IRS consent, the application must be filed within the first 180 days of the tax year for which the change is requested. If the request requires the consent of the IRS, a $500 user fee must be included with Form

   3. Form 3115 is required to be filed regardless of whether consent is required.

C. Consent from the IRS is required in the following situations:

   1. Cash to accrual or accrual to cash (unless the change is required),

   2. Change in the method or basis used to value inventories, or

   3. Change in the method of figuring depreciation (except for changes to the straight-line method).

***Exercise 4**: All of the following are considered changes in the method of accounting requiring the consent of the Internal Revenue Service, **except**:*

A. A change from the cash method to the accrual method or vice versa.
B. A change in the method or basis used to value inventories.
C. A change in the method of figuring depreciation.
D. An adjustment in the useful life of depreciable asset NOT subject to ACRS or MACRS property.

D. An adjustment in the useful life of depreciable asset NOT subject to ACRS or MACRS property. An adjustment in the useful life of a depreciable asset is not considered a change in the method of accounting requiring consent of the IRS because it is an item that is traditionally corrected by adjustments in the current and future years.

VI. Business Assets

A. Capital expenses are not currently deductible but are charged to a capital asset account. The main types of costs that must be capitalized include expenses of going into business, the cost of business assets, and the cost of improvements.

1. Going into business generally requires incurring a number of expenses before the business is operating.

   a) **Start-up Costs** - Start-up costs are those that are paid or incurred prior to opening the doors for business. These are the costs incurred in setting up an active trade or business, or investigating the possibility of creating or acquiring an active trade or business. They include the following:

      (1) A survey of potential markets,

      (2) An analysis of available facilities, labor, supplies, etc.,

      (3) Advertisements for opening the business,

      (4) Salaries and wages for training employees and their instructors,

      (5) Travel and other necessary expenses for securing prospective suppliers, distributors, or customers, and

      (6) Salaries/fees for executives, consultants, or other professionals.

      NOTE: *Start up costs do not include deductible interest, taxes, or R&D costs.*

   b) **Organizational Costs** - Organizational costs are those that are incident to the creation of the partnership (§709) or a corporation (§248).

      (1) The cost must be chargeable to a capital account.

      (2) The cost must be one that could be amortizable over the life of the partnership/corporation if the partnership/corporation had a fixed life.

2. If the taxpayer fails to actually go into business, the expenses that have already been incurred fall into one of two categories:

   a) Costs incurred before making a decision to enter a specific business are personal and nondeductible. They include any cost incurred in the course of a general search for, or a preliminary investigation of a business or investment possibility.

   b) Costs incurred in connection with an attempt to acquire or begin a specific business are capital expenditures and are deducted as a capital loss.

B. Property owned by the business and used, directly or indirectly, to earn its income are business assets. The fill cost of the asset, including freight, installation, and testing, must be capitalized. If property is produced for use in the trade or business, all cost of producing that property should be capitalized under the uniform capitalization rules.

C. The costs of making improvements to a business asset should be capitalized if the improvement adds to the value of the asset, appreciably lengthens the time that the asset can be used, or adapts the asset to a different use.

VII. Basis of Assets

A. Cost basis is the amount the business has invested in the property for tax purposes.

1. This includes amounts paid for:

    a) Sales tax,

    b) Freight charges to obtain the property,

    c) Installation and testing charges,

    d) Excise taxes,

    e) Legal and accounting fees,

    f) Recording fees and revenue stamps, and

    g) Real estate taxes (if assumed for seller).

2. If the buyer of real property pays real estate taxes owed by the seller, these taxes become part of the buyer's basis.

3. Certain settlement expenses paid on the purchase of real property are included in basis. This does not include fees and costs of getting a loan. These fees must be allocated between the land and the buildings, generally based on the fair market value of each. Settlement expenses do not include amounts placed in escrow for the future payment of expenses.

4. If an existing mortgage is assumed, basis includes the amount paid for the purchase plus the amount of the mortgage assumed.

5. For multiple assets purchased for a lump sum amount, the buyer and the seller may agree to a specific allocation of the purchase price to each asset. The generally accepted method of allocation is proportionate to, but not in excess of the fair market value of each asset.

Exercise 5: *Matt purchased a high-volume dry cleaning store on January 1, 2001, for $960,000. NO liabilities were assumed. The fair market values of the assets at the time of the purchase were as follows:*

Cash in banks	*$210,100*
US. government securities	*$100,200*
Building and land	*$312,200*
Accounts receivable	*$100,000*
Fixtures and equipment	*$202,000*

Matte will NOT change the name of the cleaners. What is Matt 's basis for goodwill or going concern value?

A. $0
B. $35,500
C. $91,300
D. $110,560

B. $35,500. Using the residual method, the purchase price is allocated first to the assets to the extent of their fair market value (FMV) and any excess is allocated to goodwill and going concern value. Here, the FMV of the assets ($942,500) is subtracted from the purchase price ($960,000) for goodwill and going concern value of $35,500.

B. Uniform Capitalization Rules

1. Uniform capitalization (UNICAP) rules require that certain costs are added to basis in certain circumstances. UNICAP rules apply in the following situations.

    a) The taxpayer produces real property or tangible personal property for use in a trade or business or an activity engaged in for profit.

    b) The taxpayer produces real property or tangible personal property for sale to customers.

    c) The taxpayer acquires property for resale.

2. Direct costs and an allocable portion of indirect cost incurred due to production or resale activities must be included in basis.

3. The UNICAP rules do not apply to certain property:

a) Property the taxpayer produces that is not for use in his/her trade, business, or activity conducted for profit;

b) Costs paid or incurred by an individual or qualified employee-owner of a corporation who is a writer, photographer, or artist;

c) Property produced under a long-term contract;

d) Research and development expenses allowable as a deduction under §174; and

e) Costs for personal property acquired for resale if average annual gross receipts do not exceed $10 million. (The UNICAP rules for inventory and interest deductions will be discussed later.)

C. Adjusted Basis

1. The basis of property will be increased by:

a) Capital improvements (having a useful life of more than one year),

b) Assessments for local improvements,

c) Rehabilitation expenses reduced by any rehabilitation credit taken,

d) Restoration after a casualty loss,

e) Certain legal fees, and

f) Zoning costs.

2. The basis of property will be decreased by:

a) Energy conservation subsidies,

b) Casualty and theft losses,

c) Certain credits allowed on the property,

d) Deferred gain,

e) Section 179 expense,

f) Certain canceled debt excluded from income,

g) Rebates received from the manufacturer or seller,

h) Depreciation, and

i) Various nontaxable distributions.

3. The taxpayer can elect to deduct or capitalize certain costs:

a) Carrying charges, such as interest and taxes,

b) Research and experimentation costs,

c) Intangible drilling and developmental costs for oil, gas, and geothermal wells,

d) Exploration costs for new mineral deposits,

e) Mining and development cost for new mineral deposits,

f) The cost or removing architectural and transportation barriers for people with disabilities and the elderly, and

g) The cost of increasing the circulation of a newspaper or other periodical.

D. Other Basis

1. The fair market value of property received for services is included in income and then becomes the basis in that property.

2. Property received in a taxable exchange will have a basis equal to the fair market value of the property at the time of the exchange.

3. Property received in an involuntary exchange, if similar or related in service or use to the property exchanged, will generally have a basis equal to the old property's basis with the following adjustments:

a) Decreased by:

(1) Any loss recognized on the exchange, and

(2) Any money received that was not spent on similar property.

b) Increased by:

(1) Any gain recognized on the exchange, and

(2) Any cost of acquiring replacement property.

4. Property received in a nontaxable or like kind exchange will generally have the same basis as the old property given up.

5. Property received in a partially nontaxable exchange will generally have the same basis as the old property given up with the following adjustments:

   a) Decreased by:
      (1) Any money received, and

      (2) Any loss recognized on the exchange.

   b) Increased by:
      (1) Any additional costs incurred, and

      (2) Any gain recognized on the exchange.

   c) The basis of unlike property received is its FMV on the date of the exchange. The remainder of the old property's adjusted basis will be the basis of the new like property.

   d) If the other party assumes the taxpayers liability on the property transferred, the amount of the liability assumed will be treated as money transferred to the taxpayer.

Exercise 6: *Lou and Casey are independent, unrelated taxi drivers who decide to swap cabs. The relevant facts are as follows:*

Original Owner	*Lou*	*Casey*
Original Cost	*$12,000*	*$15,000*
Fair Market Value	*3,000*	*5,000*
Depreciation Claimed	*10,000*	*12,250*

Lou had to pay $2,000 cash and his old cab in order to acquire Casey's cab. What are Lou and Casey's adjusted bases in their new cabs?

	Lou	*Casey*
A.	*$4,000*	*$3,000*
B.	*$4,000*	*$2,750*
C.	*$4,750*	*$3,000*
D.	*$4, 750*	*$2,750*

B. $4,000; $2,750. Lou and Casey's adjusted bases in their cabs before the exchange are $2,000 and $2,750, respectively. After the exchange, Casey does not recognize any gain even though he received cash in the exchange. However, Lou's basis of his new cab is the adjusted basis of his old cab increased by the amount of additional cash paid for the new cab. ($2,000 adjusted basis plus $2,000 cash).

***Exercise 7**: Reggie owned an asset used in his business that had an adjusted basis to him of $12,000 and was subject to an outstanding liability of $2,000. In exchange for the asset Reggie received an asset of like-kind to be used in his business plus $1,000 in cash. The asset received had a fair market value of $11,000 at the time of the exchange. Reggie's liability was assumed by the other party for legitimate business purposes. what is Reggie's basis in the new asset?*

A. $9,000
B. $10,000
C. $11,000
D. $12,000

C. $11,000. If in addition to receiving like-kind property, a taxpayer also receives money, the amount of recognized gain is the lesser of the amount of money received or the amount of gain on the exchange. The amount of money received here is $3,000 (i.e., $1,000 cash plus the $2,000 of assumed liabilities) and the amount of gain on the exchange is $2,000 ($11,000 in property received plus $1,000 cash plus $2,000 of assumed liabilities minus $12,000 in property transferred). The lesser of these two amounts is $2,000. The aggregate basis of the like-kind property received is the adjusted basis of property transferred ($12,000), minus the sum of the money received ($3,000 - $1,000 cash plus the $2,000 assumed liability), plus the amount of any gain recognized as a result of the exchange (the aforementioned $2,000). As indicated, the amount of any liabilities of the taxpayer assumed by the other party to an exchange is treated as money received by the taxpayer in the exchange. Thus, $12,000 - $3,000 +$2,000 = $11,000 (Code Sec. 1031 and Reg. Sec. 1.1031 (d)-2).

SECTION B - INCOME, LOSS AND EXPENSES

Meal expense deduction subject to "hours of service" limits.	In 2002, this deduction increases to 65% of the reimbursed meals your employees consume while they are subject to the Department of Transportation's "hours of service" limits. For more information, see *Meal expenses when subject to "hours of service" limits*. (Pub. 535)

I. Income

A. Business income is the income received when products and services are sold or delivered. Business income also includes interest, dividends, rents, royalties, payment for services (including fees, commissions, and fringe benefits), gains from dealings in property, and the distributive share of partnership income.

1. **Property or Service (Barter Income)**

   a) The fair market value of property or services received as bartering income is included in business income at the time received.

   b) If both parties agree ahead of time on the value for services to be provided, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

2. **Rental Income -** The amount received for the rental of property is included in gross income.

   a) Prepaid Rent - Advance payments received under a lease that does not put any restriction on the use or enjoyment of the fluids are included in income in the year received. It does not matter what method of accounting the taxpayer uses.

   b) Lease Bonus - A bonus that is received from a tenant for granting a lease is an addition to the rent and included in rental income in the year received.

   c) Lease Cancellation Payments - Payments received from a tenant for canceling a lease are reported in income in the year received.

   d) Payments to Third Parties - If a tenant makes payments to someone else under an agreement to pay the debts of the landlord, the payments are included in rental income when the tenant makes the payment.

e) Settlement Payments - Payments received by the landlord in settlement of a tenant's obligation to restore the leased property to its original condition are income to the extent the settlement payments exceed the leasehold improvements that were destroyed, removed, or disconnected by the tenant.

3. **Interest Income -** Business income includes interest income if the taxpayer is in the business of lending money. In any business, interest received on notes receivable that have been accepted in the ordinary course of business is business income.

a) If the taxpayer is in the business of lending money, any payment received on a discounted loan usually includes interest and principal.

(1) For a cash basis taxpayer, part of the discount is interest income when each payment is received.

(2) For an accrual basis taxpayer, the amount of the discount is includable in income as it accrues over the term of the loan or it is includable as payments are received if payments are made before they accrue.

b) If a loan becomes uncollectible during the year and the taxpayer uses the accrual method of accounting, interest that has accrued up to the date the loan became uncollectible is included in gross income. When accrued interest is later determined to be uncollectible, a bad debt deduction is taken.

c) when there is little or no interest charged on an installment sale, unstated interest is considered to be included in each payment received.

4. **Dividends** - For most people engaged in a business, dividends are nonbusiness income. Dividends are business income to securities dealers. Dividends are also business income to partnerships and corporations that have invested their fluids in stocks.

5. **Canceled Debt**

a) General rule - If a debt the taxpayer owes is canceled or forgiven, other than as a gift or bequest, the canceled amount is included in gross income. This applies to any debt for which the taxpayer is liable or which attaches to property the taxpayer holds.

b) Exceptions:

(1) Income is not realized to the extent the payment of the debt would have given rise to a deduction. Under the accrual method of accounting, the

canceled debt would be included in income because the expense would have been deducted when incurred.

(2) If the taxpayer owes a debt on purchased property and the seller reduces the amount owed, the reduction is treated as a purchase price adjustment and reduces the basis in the property.

(3) Forgiveness of qualified real property business indebtedness, in the case of a taxpayer other than a C Corporation, can be excluded by making an election. The basis of depreciable property is then reduced by the excluded amount.

(4) Canceled debt is excluded if the cancellation takes place when the taxpayer is in bankruptcy, or to the extent insolvent, or if the debt is qualified farm debt.

Exercise 8: *Ted, a cash basis taxpayer, owned and operated a business. He began having difficulty paying his business debts in late 2000. Ted owed Jeff his computer consultant, $800 for services rendered to his business and $3,00 for personal services. In 2001, Jeff forgave the entire debt of $1,100. Ted is NOT bankrupt nor insolvent. What is the amount Ted will he required to include in income on his tax return for 2001?*

A. $0
B. $300
C. $800
D. $1,100

B. $300. A solvent individual taxpayer generally realizes income to the extent that his debts are forgiven (Code Sec. 108(a)). On his individual tax return, Ted need only include the forgiveness of his personal debt of $300. The remaining $800 of debt constitutes income to Ted's business.

6. **Capital Gains -** Gains from the sale or exchange of capital assets are included in gross income.

7. **Franchises, Trademarks, and Trade Names -** Amounts received that are based on productivity, use, or disposition of a franchise, trademark, or trade name are included as ordinary income.

8. Promissory notes and other evidence of indebtedness are includable in income at fair market value when they are received, if received as part of the sales price and the business uses the cash method of accounting.

9. Damages due to patent infringement, breach of contract or fiduciary duty, antitrust injury, or for punitive reasons is included in gross compensation.

B. Prepaid Income - Prepaid income that is subject to free and unrestricted use is included in gross income in the year received regardless of the taxpayer's method of accounting. However, there are some exceptions for accrual accounting.

1. Advanced income received under an agreement for services to be performed by the end of the next tax year may be postponed until the next year. The election to postpone reporting does not apply:

    a) To income under guarantee or warranty contracts,

    b) To prepaid rent or prepaid interest,

    c) If the agreement requires any part of the work to be performed immediately after the close of the following year, or

    d) The services are to be performed at any unspecified future date.

2. Advanced income from sales may be reported in the tax year received or under an alternative method. Under the alternative method, income is included in the earlier tax year in which:

    a) The advanced payments are included in gross receipts under the method of accounting used for tax purposes, or

    b) Any part of the advanced payment is included in income for any financial reports under the method of accounting used for these reports.

Exercise 9: *If an accrual method taxpayer, under an agreement, receives advanced payments for services to be performed by the end of the next tax year, the taxpayer can make an election to postpone including the advanced payments in income until they are earned, but not beyond the year after the year in which they were received. (True or False)*

True. An accrual method taxpayer who, pursuant to an agreement, receives payment in one tax year for services required to be performed by him before the end of the next succeeding tax year may include such payments in gross income as earned through the performance of the services.

C. Items Not Considered Income - The receipt of money or property is not considered income in the following cases:

1. Issuance of stock or income from the sale of treasury stock,

2. Contributions to capital,

3. Loans,

4. Exchange of business property for like property, or

5. Consignments.

II. Cost of Goods Sold

A. Cost of Goods Sold

Taxpayers that make or sell goods are entitled to a deduction on their tax return for the cost of goods sold. Inventories must be maintained to determine these costs. When inventories are required to be accounted for, the accrual method of accounting must be used for purchases and sales.

1. Inventory at the beginning of the year will be identical to the closing inventory of the year before. Any differences must be explained in a schedule attached to the return.

2. Inventory is increased by merchandise or raw materials purchased. This is included at the price paid, so the stated price is reduced by trade discounts and, depending on the method used, cash discounts. Cash discounts may be credited to a separate account in which case the stated price is not reduced, and the credit balance is included in income. Returns and allowances and all merchandise withdrawn for personal use will also reduce the amount for merchandise or raw materials purchased.

3. Labor costs are included in cost of goods sold only in a manufacturing or mining business. In a manufacturing business, labor costs include both the direct and indirect labor used in fabricating the raw material into the finished product.

   a) Direct labor costs are the wages paid to those employees who spend their time working directly on the product being manufactured.

   b) Indirect labor costs are the wages paid to employees who perform a general factory function that does not have any immediate or direct connection with making a salable product but is nonetheless a necessary part of the manufacturing process.

c) Other labor costs that are not chargeable to the cost of goods sold are deducted as selling or administration expenses.

4. Materials and supplies used in manufacturing goods.

5. Other costs incurred that are chargeable to the cost of goods sold include:

a) Freight-in, express-in, and cartage-in on raw materials and supplies that are used in production, and merchandise that is purchased for sale.

b) Overhead expenses such as rent, heat, utilities, depreciation, taxes, insurance, and maintenance incurred as a direct and necessary expense of the manufacturing process.

6. Inventory at the end of the year is then subtracted from the total of the costs included in inventory to arrive at the cost of goods sold.

Exercise 10: *A dealer MUST reduce the stated price of articles in inventory by any TRADE discounts. CASH discounts, on the other hand, may be shown as either income from cash discounts or as a reduction to the overall cost of purchases for the year. (True or False)*

True. cash discounts representing a fair interest rate may or may not be subtracted in computing the cost of goods purchased, at the taxpayer's election. A trade discount must be treated as a reduction in the cost of new items in inventory in the year of purchase.

B. Inventories

1. Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor in the business.

a) The most common inventories are:

(1) Merchandise or stock in trade,

(2) Raw materials,

(3) Work in process,

(4) Finished products, and

(5) Supplies that physically become part of the item intended for sale.

b) The value of inventories at the beginning and end of each year is required to determine taxable income. To accomplish this, a method of identifying items of inventory and a method of valuing these items is required.

c) Inventories include all finished or partly finished goods and the raw materials and supplies that become part of the merchandise for sale.

d) Merchandise is included in inventory only if the taxpayer has title to it. This includes goods in transit before the taxpayer actually has physical possession.

e) Containers are part of inventory if title to them has not passed to the buyer of the contents. Examples include cases, bottles, drums, and kegs.

f) If merchandise is sold by mail with payment and delivery to happen at the same time, title passes when payment is made. The merchandise remains in closing inventory until the buyer pays for it.

2. **Cost Identification** - There are three methods of identifying items in inventory.

a) Specific identification method - This method is used to identify the cost of each inventoried item by matching the item with its cost of acquisition. This includes all allocable costs such as labor and transportation.

b) First-in first-out (FIFO) - This method assumes that the items the taxpayer purchased or produced first are the first items sold or consumed.

c) Last-in first-out (LIFO) - This method assumes that the items of inventory purchased or produced last are sold or removed from inventory first. To adopt the LIFO method, the taxpayer is required to file Form 970, Application To Use LIFO Inventory Method. The form or statement containing the same information must be attached to the timely filed return that first uses the LIFO method.

3. **Valuing Inventory** - Valuing the items in inventory is a major factor in determining taxable income. There are two common methods used to value non-LIFO inventory.

a) Specific Identification Method (cost) - To properly value inventory at cost, all direct and indirect costs associated with it must be included.

(1) For merchandise on hand at the beginning of the year, cost means the inventory price of the goods.

(2) For merchandise purchased during the year, cost means the invoice price less appropriate discounts. Amounts required to be included under the uniform capitalization rules are also included.

(3) For merchandise produced during the year, cost means all direct and indirect costs required to be capitalized under the uniform capitalization rules.

b) Lower of Cost or Market Method - Under this method, the market value of each item on hand at the inventory date is compared with its cost. The lower of the two amounts is its value.

(1) Market value under ordinary circumstances means the usual bid price at the date of the inventory

(2) When goods are offered for sale at prices that are lower than market, the sales price may be used.

(3) If no market exists, the taxpayer may use whatever evidence of fair market value exists at the nearest date of inventory.

(4) Unsalable goods that are in inventory arc valued at selling price less direct costs of disposition regardless of what method is used to value the rest of the inventory. Unsalable goods may not be valued for less than scrap value.

4. Uniform Capitalization of Inventory - Taxpayers are required to capitalize direct costs and the allocable portion of indirect costs that benefit or are incurred because of production or resale activities.

a) Taxpayers subject to the uniform capitalization rules include:

(1) Taxpayers that produce real property or tangible personal property for use in a trade or business or in an activity engaged in for profit,

(2) Taxpayers that produce real property or tangible personal property for sale to customers, and

(3) Taxpayers that acquire property for resale, but not personal property if average annual gross receipts for the preceding three (3) tax years are not more than $10 million.

b) Property that is not subject to the uniform capitalization rules include:

(1) Property used for personal or nonbusiness purposes,

(2) Qualified creative expenses paid or incurred by an individual (other than as an employee) or a qualified employee-owner of a personal service corporation in the business of being a writer, photographer, or artist,

(3) Property that is produced under a long-term contract,

(4) Personal property that is purchased for resale if annual gross receipts for the three (3) prior tax years are $10 million or less, and

(5) Research and experimental costs that are allowed as a current deduction under §174.

NOTE: *The uniform capitalization rules do not apply to personal property acquired for resale if the retailer's annual gross receipts for the 3 preceding tax years are $10 million or less. This $10 million test is not available for real property acquired for resale.*

c) Direct costs that must be capitalized include:

(1) Direct labor costs incurred for production or resale activities. This labor cost includes basic, overtime, sick, and vacation pay, plus all payroll taxes.

(2) Direct labor includes payments to a supplemental unemployment benefit plan.

(3) Material costs that become an integral part of the asset plus material used in the ordinary course of business.

d) Indirect costs include all costs other than direct labor and materials. Such costs may include:

(1) Repair and maintenance of equipment or facilities,

(2) Utilities,

(3) Rent of equipment, facilities, or land,

(4) Indirect labor and associated costs,

(5) Indirect material and supplies,

(6) Tools and equipment not otherwise required to be capitalized,

(7) Certain taxes that are not otherwise treated as part of cost,

(8) Depreciation, amortization, and depletion,

(9) Administrative costs, and

(10) Insurance on equipment and facilities.

NOTE: *Producers using the simplified production method qualify for an exception from UNICAP under the de minimis rule if total indirect costs are $200,000 or less.*

Exercise 11: *The uniform capitalization rules apply to all of the following business related costs* ***except***:

A. Direct materials.
B. Indirect materials
C. Direct labor.
D. Research.

D. Research. Research costs are considered currently deductible expenses and do not need to be capitalized under the uniform capitalization rules.

III. Business Expenses

A. Employees' Pay

1. Employees' pay consists of salaries, wages, commissions, gifts, and fringe benefits. Payment can be made in the form of cash or other property.

2. To be deductible, employees' pay must meet all the following tests:

a) Ordinary and Necessary - Salaries, wages, and other payments for services employees render must be ordinary, necessary, and directly connected to the taxpayer's trade or business.

b) Reasonable - Reasonable pay is determined by all the relevant facts and circumstances. This test is based on the circumstances at the time the taxpayer contracts for the services and not those existing at the time payment is made.

c) For Services Performed - The taxpayer must be able to prove the payments were for services actually performed.

d) Paid or Incurred - The taxpayer must have actually made the payment or incurred the expense during the year.

(1) Cash-basis taxpayers deduct salaries and wages in the year paid.

(2) Accrual-basis taxpayers deduct salaries and wages when the obligation is established and economic performance occurs.

(3) A special rule applies to payments made by accrual-method taxpayers to certain related cash basis taxpayers. The deduction for payments to related taxpayers is not allowed until the tax year the related taxpayer includes the payment in income.

3. Bonuses and gifts are deductible if they meet certain tests.

a) Bonuses paid to employees are deductible if they are intended as additional pay for services and not as gifts. When bonuses are paid, they must be reasonable in addition to the employee's regular pay.
b) Gifts of nominal value such as turkeys, hams, and other merchandise distributed to employees at holidays is not taxable as salaries or wages and remains deductible to the employer. The employer may not deduct more than $25 per employee per year. Cash, gift certificates, or other property that is easily converted to cash is taxable as additional wages regardless of the amount or value.

4. Loans or advances made to employees that are not expected to be repaid are deducted as wages.

5. Vacation pay is deductible if actually paid even though the employee chooses not to take a vacation.

a) Cash basis taxpayers deduct vacation pay when payment is made.

b) Accrual basis taxpayers can deduct vacation pay in the year earned by employees only if it is paid:

(1) By the close of the employer's tax year, or

(2) Within 2-½ months after the close of the tax year if the amount is vested.

Exercise 12*: Mrs. Smith, a calendar year cash basis taxpayer, made payments of $25,000 as vacation pay to her employees during 2001. Additional vacation pay of $25,000 was earned by her employees in 2001,* *but NOT paid Vacation pay becomes vested on the last day of the year in which the vacation pay is earned Mrs. Smith may deduct $50,000 of vacation pay for calendar year 2001. (True or False)*

False. A vacation pay deduction is generally limited to the amount of pay earned during the year to the extent (1) the amount is paid to employees during the year or (2) the amount is vested as of the last day of the tax year and is paid to employees within 2.5 months after the end of the year. If such vacation pay is not paid until after the expiration of the 2.5-month period, the employer may deduct vacation pay when paid in its tax year that includes the last day of the employee's tax year for which the payment is reported as income by the employee.

6. Unpaid Salaries

   a) If there is a definite, fixed, and unconditional agreement to pay an employee a certain salary for the year, but payment is deferred until the following year, the deductibility depends on the method of accounting.

      (1) Using the accrual method, the full salary can be deducted when economic performance has occurred.

      (2) Using the cash method, only the amount actually paid each year can be deducted.

      (3) An exception applies for an accrual method taxpayer making payments to a related party. The salary is deductible for:

         (a) The tax year the payment is made, and

         (b) The amount is included in income of the person paid.

7. The exclusion amount for employer-provided educational assistance is up to $5,250. If the employer pays or reimburses educational expenses for an employee enrolled in a course not required for the job or not otherwise job related, the full amount of the payment can be deducted as wages.

8. Amounts paid for qualified moving expenses, either reimbursed to employees or paid on their behalf, can be deducted as a qualified fringe benefit. Qualified moving expenses include:

   a) Moving household goods and personal effects from the old home to the new home, and

b) Traveling (including lodging) from the old home to the new home. Meals are not included.

9. Capital assets transferred to an employee can be treated as wages at the fair market value of the asset, less any amount the employee pays for the transfer. The employer will treat the deductible amount as an amount received in exchange for the asset and will recognize any gain or loss realized on the transfer.

Exercise 13*: Brett transferred an automobile used in his business to Jim, an employee, as payment for services. The value of the services provided by Jim was $7,000. At the time of the transfer, the automobile had a fair market value of $8,000 and an adjusted basis to Brett of $6,000. How does Brett show this transfer on his 2001 income tax return?*

A. Wage expense $8,000; gain on sale $2,000.
B. Wage expense $7,000; gain on sale $1,000.
C. Wage expense $7,000; gain on sale $0.
D. Wage expense $0; gain on sale $2,000.

A. Wage expense $8,000; gain on sale $2,000. An employee who receives property as compensation for services for an amount less than the property's fair market value (FMV) must include in gross income the difference between the amount paid for the property and the amount of its FMV at the time of the transfer. A gain results because the FMV is more than the adjusted basis.

10. A salary paid to an employee-shareholder must meet the same tests for deductibility as the salary for any other employee.

11. The four tests for deductibility also apply to payments to a relative, including a minor child.

12. Payments made to an employee's beneficiary because of the employee's death are deductible if reasonable in relation to past services performed by the employee.

Exercise 14*: Payments made to employees are NORMALLY currently deductible as business expenses* ***except****:*

A. Vacation pay paid to an employee even when the employee chooses not to take a vacation.

B. Wages paid to employees for constructing a new building to be used in the business.
C. Reasonable salaries paid to employee-shareholders for services rendered.
D. Payments made to the beneficiary of a deceased employee that is reasonable in relation to the employee's past services.

B. Wages paid to employees for constructing a new building to be used in the business. Salaries incurred in connection with the construction of capital assets are not currently deductible; they must be recovered through depreciation under the uniform capitalization rules.

B. Employee benefit programs can include cash or noncash payments for life insurance, health and accident insurance, retirement plans, dependent care assistance, or educational assistance.

1. Dependent care assistance expenses can be deductible. This can include providing the care facility, payments to a third party, or reimbursing the employees directly. If certain requirements are met, up to $5,000 can be excluded from an employee's pay for dependent care assistance.

2. Amounts paid to a welfare benefit fund that provides supplemental unemployment benefits for employees can be deducted.

3. Cafeteria plans, including flexible spending arrangements, are written plans that allow employees to choose among two or more benefits consisting of cash and qualified benefits. The plan may not discriminate in favor of highly - compensated individuals as to eligibility, contributions, or plan benefits. If the plan is found to be discriminatory, highly-compensated individuals must include the amounts in income and are subject to withholding.

4. Life insurance premiums paid by the employer are not included in the employee's W-2 income if it is a group term policy for $50,000 or less of protection and the employer is not the beneficiary.

5. Health and accident insurance premiums paid by the employer are generally not included in the employee's income. This benefit may be through a self-insured plan or an insurance policy. A self-insured plan may not discriminate in favor of highly-compensated individuals.

6. Meals and lodging furnished to employees are deductible if included as part of the employee's pay. If the employer reimburses meal and entertainment costs, only ***50%*** is deductible by the employer. Meals and lodging are not included in the employee's income if the following tests are met:

a) Meals and lodging are provided on the employer's business premises,

b) Meals and lodging are provided for the employer's convenience, and

c) In the case of lodging only, the employee must be required to accept the lodging as a condition of employment.

7. The following employee fringe benefits may be excluded from an employee's income and can still be deducted as business expenses.

   a) A no-additional cost service.

   b) A qualified employee discount.

   c) A working condition fringe.

   d) A de minimis fringe.

   e) A qualified transportation fringe, up to $60 per month for combined commuter highway vehicle transportation and transit passes, and $160 per month for qualified parking for each employee.

   f) Certain athletic facilities unless the facility is made available to the general public through the sale of memberships, renting the facility, or similar arrangements.

   g) Qualified moving expense reimbursement.

C. Qualified retirement plan contributions provided by the employer are generally excluded from income of employees and deductible by the employer. Contributions to nonqualified plans are deductible by the employer in the tax year in which the employee includes the amount in income.

D. Rent Expense

1. Rent is any amount paid for the use of property which the taxpayer does not own. To be deductible, rent must be reasonable.

   a) Rent paid in advance is deductible over the period to which it applies.

   b) Lease expenses are deducible as an ordinary expense provided the lease was not intended as a purchase from the beginning of the lease term. If it is a lease and not a purchase, the lease payments and any taxes paid on the leased property are deducted as rent. The cost of acquiring the lease is amortized over the term of the lease.

2. The cost of acquiring a lease is not rent. Generally, this will arise in conjunction with acquiring an existing lease from another lessee.

   a) If acquiring an existing lease on property or equipment to use in business, this cost is amortized over the remaining term of the lease. The term of the lease will include all renewal options if less than 75% of the cost is for the term of the lease remaining on the purchase date.

   b) If an additional amount is paid to change certain provisions of the lease, this amount is also amortized over the remaining term of the lease.

__Exercise 15__: In 2000, Bob purchased a lease for an office for 4 years, beginning January 1, 2001, to use in his tax practice. Of the $21,600 he paid $5,000 was for the purchase of the existing lease with 4 years remaining and NO options to renew. The remaining amount was for monthly lease payments paid in advance. How much can Bob deduct for 2001?

A. $0
B. $1,500
C. $3,800
D. $5,400

D. $5,400. Assuming that Bob is a cash-basis taxpayer, generally, rental expenses are deductible by a cash-basis taxpayer-lessee in the tax year in which they are paid. However, the general rule does not apply to advance rental payments. Advance rental payments made by a cash-basis taxpayer-lessee are generally NOT deductible in the tax year in which they are made but must be allocated over the period of time for which the premises may be used as a result of such payments.

3. Commissions, bonuses, and fees paid to obtain a lease must be amortized over the term of the lease.

4. The cost of improvements to leased property are generally depreciated over the appropriate recovery period under the modified accelerated cost recovery system. The taxpayer may have a gain or loss if the improvement is not retained when the lease expires. The gain or loss is based on the adjusted basis of the improvement at the time the lease expires.

__Exercise 16__: In 2001, Nancy leased a building for use in her business. She signed a 6-year lease with an option for an additional 3 years. In

2001, she made leasehold improvements to the building costing a total of $8,200. Nancy must:

A. Amortize the improvements over the remaining term of the initial lease period
B. Amortize the improvements over the remaining term of the initial lease period plus the option period
C. Depreciate the improvements using the modified cost recovery system (MACRS).
D. Deduct the cost of improvements as a current expense.

C. Depreciate the improvements using the modified cost recovery system (MACRS). The cost of improvements made to lease property by the lessee is recovered under the MACRS rules without regard to the lease terms.

5. The costs to rent equipment, facilities, or land are considered indirect costs if the taxpayer is subject to UNICAP.

Exercise 17: *You rent space in a facility to conduct your business of manufacturing precision tools. All of the annual rent that you paid to occupy the facility can be deducted as a current expense. (True or False)*

False. When a cash-basis taxpayer-lessee makes advance rental payments (i.e., payments that are consideration for the use of the rented premises in future years), such payments are generally not deductible in the tax year in which they are made but must be allocated over the period of time for which the premises will be used. Although the official answer is False, CCH believes that the question is misleading because it does not specify that the rental payments are for periods beyond the present tax year.

E. Travel, Entertainment, and Gift Expenses

1. Travel expenses are ordinary and necessary expenses while traveling away from home for the taxpayer's profession or business.

2. Travel is away from home if:

a) The duties require the taxpayer to be away from the general area of his or her tax home substantially longer than an ordinary day's work, and

b) The taxpayer needs to get sleep or rest to meet the demands of work while away from home.

3. Generally, a tax home is the main place of business or post of duty regardless of where the taxpayer maintains the family home. This includes the entire city or general area in which the business or work is located.

   a) If the taxpayer has more than one regular place of business, the tax home is the main place of business. If the taxpayer has no regular or main place of business, the tax home may be the place where the taxpayer regularly lives.

   b) If the taxpayer has more than one place of work, the following factors can be used to determine the main place of business or work:

      (1) The total time spent working in each area,

      (2) The degree of business activity in each area, and

      (3) The relative amount of income from each area.

   c) With no main place of business or work, use the following factors to determine a tax home. If all three factors are satisfied, the tax home is the home where the taxpayer regularly lives.

      (1) Part of the business is in the area of the main home and the taxpayer uses that home for lodging while doing business there.

      (2) The taxpayer has living expenses at the main home that are duplicated because business requires the taxpayer to be away from that home.

      (3) The taxpayer has not left the area in which both the traditional place of lodging and the main home are located; members of the taxpayers family live in that home; or the taxpayer often uses that home for lodging.

   d) if only one of the previously listed factors are met, the taxpayer is a transient and has no tax home from which to determine deductible travel expenses.

   e) If an assignment away from the main place of work is temporary, the tax home does not change and the travel expenses are deductible. A temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for one year or less If the assignment is indefinite, the tax home has changed.

4 Deductible travel expenses may include:

a) Air transportation, train, or bus between the tax home and the business destination,

b) Taxi, commuter bus, or limousine fares between the airport and the hotel and between the hotel and the work location,

c) Baggage and shipping,

d) Operating and maintaining a car when traveling from home,

e) Lodging,

f) Meals,

g) Cleaning,

h) Telephone, and

i) Tips.

5. The expenses of another individual accompanying the taxpayer is deductible only if that other individual:

   a) Is an employee,

   b) Has a bona fide business purpose for the travel, and

   c) Would otherwise be allowed to deduct the travel expenses.

6. The standard meal allowance may be used instead of deducting the actual cost of meals while traveling away from home on business. Publication 1542 lists the allowable per diem rates for most cities within the United States.

   a) The standard meal allowance for most areas of the United States is $32 per day.

   b) Other locations may qualify for rates of $40 per day.

   c) Eligible individuals in the transportation industry may use an average rate of $36 per day.

7. Actual costs for lodging are allowed. A standard per diem for lodging is allowed only for purposes of employer reimbursements. A self-employed

taxpayer or an employee cannot use the lodging per diem in lieu of actual costs.

8. If the business travel is within the United States, all the travel expenses are deductible if the trip is entirely business related. If the trip was primarily for business, any expenses related to a nonbusiness side trip would be nondeductible. Round trip travel costs would still be allowed in full. If the trip was primarily personal round trip travel costs would be nondeductible. However, business related expenses would remain deductible.

9. If the business trip was outside the United States and the entire time was spent on business, all expenses are deductible subject to the applicable meal and entertainment limitations (50%).

   a) If the taxpayer spent 25% or more time on nonbusiness activities, the transportation expenses may be limited.

   b) If travel expenses are limited, the taxpayer must allocate travel expenses of getting to and from the destination between the business and nonbusiness activities.

***Exercise 18**: During October 2001, Dr. Waters, a marine biologist specializing in sharks, attended a convention in Australia concerning the feeding and migration habits of sharks. The convention was beneficial to his business since it was held in an area renowned for its abundance of sharks. Also, the foremost shark authorities in the world live there. He spent seven full days attending the convention and three days sightseeing He incurred expenses of $2,000 for airfare, $1,000 for lodging and $500 for meals. How much may Dr. Waters deduct for the trio on his income tax return for 2001?*

A. $3,250
B. $2,275
C. $1,750
D. $0

B. $2,275. Dr. Water's deduction is limited because, although he traveled outside the United States primarily for business purposes, more than 25% of his time was spent on nonbusiness activities. Therefore, he may deduct $1,400 (70%) of the air travel costs, $700 (70%) of his lodging costs and $175 of his meal expenses. The meal deduction is subject to the 50% limitation, which must be applied before the deductible amount can be figured. Thus, $500 meal expenses subject to the 50% limit equals $250. 70% of the $250 is deductible $175.

10. Meal and entertainment expenses must be directly related to business or associated with the active conduct of a business. This includes entertaining at night clubs, theaters, and sporting events.

    a) Directly-Related Test:

        (1) The main purpose of the combined business and entertainment was the active conduct of business,

        (2) The taxpayer did engage in business with the person during the entertainment period, and

        (3) The taxpayer had more than a general expectation of getting income or some other specific business benefit at some future time.

    b) Associated Test:

        (1) The entertainment is associated with the trade or business, and

        (2) The entertainment directly precedes or follows a substantial business discussion.

    c) The cost of entertainment *for* the taxpayer's spouse and the spouse of the business customer are generally not deductible. Such expense can be deducted if the taxpayer can show a clear business purpose, rather than personal or social purpose, for providing the entertainment.

    d) Club dues and membership fees are no longer deductible as business expenses. Dues paid to any club organized for business, pleasure, recreation, or other social function are not deductible. Nondeductible dues include dues paid to country clubs, golf and athletic clubs, airline clubs, hotel clubs, and luncheon clubs.

    e) Dues paid to professional associations such as bar or medical associations, and civic or public service organizations such as Kiwanis, Lions, Rotary, or other similar organizations remain deductible.

    f) Only **50%** of business related meal and entertainment expenses are deductible. This limitation applies to employees, employers, and self-employed persons or their clients. If a reimbursement is made, the payer is subject to the **50%** limit. Amounts subject to the limit include taxes and tips related to the business meal, cover charges for admission to a night club, rent paid for the room to hold the dinner, or the amount paid for parking at a sports arena. The limit is applied after determining the amount that would otherwise qualify.

Exercise 19: *Ms. Patel, a self-employed attorney is a member of Executive Club which is a professional businesspersons' club. Ms. Patel uses the club on a regular basis to entertain clients. Ms. Patel had the following detailed records to substantiate the expenses of Executive Club during 2001:*

Dues	$2,400
Meals directly related to bona fide business discussions with clients	$2,000
Tips	$ 400
Transportation to/from meals	$ 300

What amount may Ms. Patel deduct on her income tax re turn for 2001?

A. $5,100
B. $2,600
C. $1,700
D. $1,500

D. $1,500. The expenses of a meal include amounts spent on food and tips relating to the meal. The amount allowable as a deduction for meal expenses is limited to 50 percent of the expenses. Transportation expenses to and from a business meal are 100 percent deductible. No deduction is permitted for club dues.

11. Business gifts are limited to a deduction of $25 per individual per year. Spouses are treated as one taxpayer even if they have separate businesses and a separate connection to the individual. Partnerships and partners are also treated as one taxpayer.

    a) Items that cost $4 or less, have the taxpayer's name permanently imprinted, and which are one of a number of identical items distributed are not considered part of the *$25* limit.

    b) Incidental costs for engraving and gift wrapping are allowed in addition to the $25.

    c) Employee achievement awards are not considered gifts.

d) Tickets to a theater or sporting event can be treated as a gift or an entertainment expense if the taxpayer does not accompany the customer.

Exercise 20: *Mr. Crowell, a self-employed seafood wholesaler, arranged a business meeting with his five principal clients during March 2001. The night the clients arrived in town, Mr. And Mrs. Crowell entertained the clients and their spouses at their home. The cost of the food and beverages was $400. As each client left, they were given a cheese and fruit basket which cost $40 each. The business meeting was held the next day at Mr. Crowell's office. Assuming NO other similar expenses during 2001, what amount of the above expenses may Mr. Crowell deduct?*

A. $0
B. $125
C. $300
D. $325

D. $325. $200 (50 percent) of the meal expense is deductible and the deduction for gifts to clients is limited to $25 per person. Here, the Crowells gave each of 5 clients a $40 gift. The Crowells may deduct $125 of this $200 gift expense.

12. Automobile expenses are allowed within certain limits. Taxpayers have the option of deducting actual expenses or electing the standard mileage rate.

a) Actual expenses can be deducted to the extent of the business use percent. Depreciation, including any §179 deduction, is limited depending on when the car was placed in service.

b) The standard mileage rate is 34.5¢ per business mile for 2001!! The standard mileage rate is not allowed if:

(1) The taxpayer does not own the car,

(2) The taxpayer uses the car for hire (such as a taxi),

(3) The taxpayer operates two or more cars at the same time, or

(4) The taxpayer claimed a deduction for the car in an earlier year using:

(a) ACRS or MACRS depreciation, or

(b) Section 179 deduction.

13. Reimbursing an employee for the above expenses is generally deductible. The manner and amount depend on whether it is under an accountable plan or a nonaccountable plan.

    a) Reimbursement under an accountable plan must meet the three requirements:

        (1) The employee's expense must have a business connection,

        (2) The employee must adequately account to the employer for the expenses within a reasonable period of time (60 days), and

        (3) The employee must return any excess reimbursement or allowance within a reasonable period of time (120 days).

    b) If the plan rules are met, the expense is deductible as if the business paid them. If the rules are not met, the reimbursement is under a nonaccountable plan and reported as income by the employee.

F. Interest paid or accrued on a debt related to a trade or business is deductible. The taxpayer must be liable for the debt.

1. Allocation rules apply if money borrowed is used partially in a trade or business and partially for personal or investment purposes or in a passive activity. Allocation is completed by tracing disbursements to specific uses. The type of expenditure to which the debt is allocated determines the limitation, if any, that applies to the interest expense deduction.

2. If any part of a loan allocated to more than one use is repaid, the amount is treated as repaid in the following order:

    a) Amounts allocated to personal use,

    b) Amounts allocated to investments and passive activities,

    c) Amounts allocated to passive activities in connection with a rental real estate activity in which the taxpayer actively participates,

    d) Amounts allocated to former passive activities, and

    e) Amounts allocated to trade or business use and to expenses for certain low-income housing projects.

3. Deductible interest includes:

a) Interest amounts paid on amounts borrowed against a life insurance, endowment, or annuity contract if the loan proceeds were used for business purposes.

b) Mortgage interest payments on business property. This includes points paid for the use of the money. This also includes a prepayment penalty charged by the lender for paying the loan off early.

c) The interest portion of payments on business assets purchased using the installment method.

4. Nondeductible interest:

a) A cash basis taxpayer does not deduct interest until paid in cash or its equivalent.

b) Interest that must be capitalized.

c) Commitment fees or standby charges.

d) Interest on an income tax liability on the taxpayer's individual return.

e) Interest related to tax-exempt income.

5. Interest on debt used to finance the production of real or tangible personal property must generally be capitalized. Interest paid or incurred during the production period must be capitalized if the property produced is designated property. Designated property is:

a) Real property,

b) Personal property with a class life of 20 years or more,

c) Personal property with an estimated production period of more than 2 years, or

d) Personal property with an estimated production period of more than one year if the estimated cost of production is more than $1 million.

<u>Exercise 21</u>: *On January 2, 2001, DLW Partnership purchased and placed in service a machine used for production purposes. The machine cost $10,000 plus $500 sales tax. DLW financed the entire purchase price. During 2001, DLW paid total interest of $850 on the note. Concerning the* *income tax treatment of the above expenses, which of the following statements is CORRECT?*

A. Under the uniform capitalization rules, the interest AND sales tax should be included in the basis of the machine.
B. Under the uniform capitalization rules, the interest should be included in the basis of the machine and the sales tax should be deducted as a current expense.
C. The interest should be deducted as a current expense and the sale tax should be included in the basis of the machine.
D. The interest AND sales tax are separately stated items which 'flow-through" to the partners.

C. The interest should be deducted as a current expense and the sales tax should be included in the basis of the machine. Generally, interest expense is currently deductible when paid, but sales tax incurred in connection with an acquisition of property is added to the basis of the property.

6. When interest is charged at a rate below the applicable federal rate (below market loan), the borrower is treated as having received:

   a) A loan in exchange for a note that requires the payment of interest at the applicable federal rate, and

   b) An additional payment. The additional payment is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment depending on the purpose of the transaction.

G. Insurance premiums are ordinarily deducted in the tax year to which they apply, even for a cash basis taxpayer.

1. Deductible premiums include:

   a) Fire, theft, flood, or other casualty,

   b) Merchandise or inventory insurance,

   c) Credit insurance to cover losses from unpaid debts,

   d) Employees' group hospitalization and medical plans,

   e) Employers' liability,

   f) Public liability,

g) Malpractice or professional liability,

h) Workers' compensation,

i) Contributions to state unemployment funds,

j) Business interruption insurance,

k) Car and truck insurance, and

l) Employee performance bonds required by law.

2. Self-employed taxpayers are allowed to deduct 30% of the cost of health insurance that covers themselves and their dependents. They are not allowed a deduction if they are eligible to be covered under a plan subsidized by an employer or a spouse's employer. To be eligible for this deduction, the taxpayer must be:

   a) Self-employed,

   b) A general partner of a partnership, or

   c) A more than 2% shareholder of an S Corporation.

3. Life insurance premiums paid on policies covering the lives of officers and employees are deductible if the taxpayer is not the beneficiary under the contract. The premiums are nondeductible if the taxpayer is, directly or indirectly, the beneficiary of the policy.

4. Premiums on group term life insurance for an amount up to $50,000 are deductible. Premiums for the cost over this amount are included in the employee's income and are deducted as a wage expense.

H. Taxes

1. Taxes paid in the course of an active trade or business are allowed as a deduction. Deductible taxes include:

   a) Real estate taxes,

   b) Personal property tax,

   c) Employment taxes,

   d) Sales tax if included in gross receipts, and

e) Highway use tax.

(1) Vehicles subject to highway use tax include highway motor vehicles that have a taxable gross weight of 55,000 pounds or more. The tax period is July 1 through June 30. The tax is incurred when a highway vehicle is first used on any public highway in the United States. If the vehicle is first used in July, a full year's tax is due. If the vehicle is first placed in service in a month after July, tax for a partial year is due.

(2) Trucks traded in during the year do not get credit for a partial year usage. If the tax has not been paid, the new owner of a used vehicle will owe the tax for the entire period the vehicle was used, even if the use was by the first owner prior to the sale or trade in.

(3) Form 2290, Heavy Vehicle Use Tax Return, is used to figure and pay the tax due on heavy vehicles used on public highways. Form 2290 can also be used to get a suspension of tax liability if a vehicle otherwise subject to the tax is used on public highways for 5,000 miles or less (7,500 or less for agricultural vehicles) during the period.

(4) The due date for Form 2290 for the tax on vehicles used in July is August 31. For newly acquired vehicles, the due date is the last day of the month after the month the vehicle is first used on public highways. For example, if it was first used in November the due date is December 31.

Exercise 22: *EVERY person in whose name a highway motor vehicle, having a taxable gross weight of 55,000 pounds or more, is registered at the time of its first taxable use in any tax period MUST file Form 2290, Heavy Vehicle Use Tax Return. (True or False)*

> *True. Every person in whose name a highway motor vehicle is registered at the time of its first taxable use in any tax period must file Form 2290, Heavy Vehicle Use Tax Return.*

I. Other Business Expenses

1. Advertising that relates to the business activity. This can include public service advertising to keep the business name before the community.

2. Business use of a home used regularly and exclusively for business.

3. Subscriptions to professional, technical, and trade journals.

4. Education and training of employees or for the taxpayer's own trade or business education.

5. Environmental cleanup costs to clean up the land and treat groundwater contaminated by the taxpayer's business waste.

6. Interview expense allowance or reimbursement made to job candidates.

7. Legal and professional fees that are ordinary and necessary to operate the business. Fees associated with the purchase of assets are part of the cost bases of those assets.

8. License and regulatory fees paid to state or local governments.

9. Medical expenses necessary for the taxpayer to be able to work.

10. The cost of moving machinery from one city to another or from one part of a plant to another, plus the cost of installing the machinery at the new location.

11. The cost of outplacement services provided employees.

12. Penalties for the late performance or nonperformance of a contract, but not for a penalty due to a violation of a law.

13. Repair costs to keep business property in normal and efficient operating condition.

14. Repayment of an amount included in income because the taxpayer had an unrestricted right to the income.

15. Material and supplies consumed and used during the tax year.

16. Utilities.

17. A deduction for part of the cost of clean-fuel vehicle property is allowed against gross income. The vehicle is not required to be used in a trade or business, but if used in the business, it is an other deduction on the form used to report the business activity. This is not part of the general business credit.

Exercise 23*: Individuals are allowed a limited deduction from gross income for the cost of qualifying clean fuel vehicle property. Which of the following is NOT a requirement for the credit?*

A. The property must be placed in service AFTER June 30, 1993.

B. The property must be used in a trade or business.
C The amount of the deduction limit is based on the Gross Vehicle Weight Rating.
D. A taxpayer may deduct the cost of property that modifies an existing motor vehicle from one that is NOT propelled by a clean-burn mg fuel into one that is propelled by a clean-burning fuel.

B. The property must be used in a trade or business. The taxpayer is not required to use the clean-fuel vehicle property in a trade or business in order to claim the deduction.

J. Nondeductible expenses include:

1. Bribes and kickbacks if they are payments, directly or indirectly, to employees of the government or payments, directly or indirectly, to a person in violation to any federal or state law.

2. Charitable contributions are not business expenses. Corporations are allowed a deduction for charitable contributions.

3. Demolition expenses or losses.

4. Lobbying expenses.

***Exercise 24**: Dino and Virgil operated a service station for many years as a partnership. In 2001, they purchased a vacant service station and land at a better location and moved their business to the new location. As a result of the move, Dino and Virgil incurred the following related expenses:*

Cost of land and building at new location	*$150,000*
Cost to move and install the existing machinery, equipment, etc., from the old location to new location	*10,000*
Environmental costs to clean up old location contamination	*35,000*

How much of the expenses shown above can Dino and Virgil currently deduct (not considering depreciation or section 179 applicability) as an expense on their partnership income tax return?

A. $0
B. $10,000
C. $35,000
D. $45,000

D. $45,000. Land is a business asset that must be capitalized (Pub. 334). Environmental clean-up costs are deductible as a business expense. See Pub. 334. The costs of moving machinery from one location to a new location is also deductible as a business expense.

IV. Depreciation, Section 179, Amortization & Depletion

A. Modified Accelerated Cost Recovery System (MACRS) must be used for all tangible property placed in service after 1986. MACRS consists of two systems for depreciation, the General Depreciation System (GDS) and the Alternative Depreciation System (ADS). GDS is generally used.

1. Allowable depreciation is determined under one of three different conventions. The convention is determined when the asset is placed in service. The asset's basis, assigned class life, and the convention and method chosen determine the amount of depreciation allowed.

a) Half-year convention means all property placed in service during the year is considered to be placed in service during the mid-point of the tax year. This allows the taxpayer to deduct one-half of a full year's depreciation for the first year the asset is placed in service. The half-year convention applies to assets with a class life of 3, 5, 7, 10, 15 and 20 years.

b) Mid-quarter convention applies if more than 40% of the aggregate bases of all property is placed in service during the last three months of the tax year. The aggregate basis of all property does not include property placed in service and disposed of in the same year.

c) Mid-month convention applies only to residential rental property in the **27.5** year class and nonresidential real property in the 39 year class. Property is treated as if it were placed in service during the mid-point of the month.

d) Under MACRS, there are five methods that can be used:

(1) 200% declining balance,

(2) 150% declining balance over GDS recovery period,

(3) Straight line over GDS recovery period,

(4) 150% declining balance over ADS recovery period, and

(5) Straight line over ADS recovery period.

Exercise 25: *On March 15, 2001, Alexander purchased and placed in service an apartment building which contained six units. The total cost of the building was $350,000. All of the units were rented to unrelated third parties. For MACRS depreciation purposes, which recovery period AND convention should Alexander use when filing his income tax return for 2001?*

A. 27.5 years, half-year convention
B. 27.5 years, mid-month convention
C. 31.5 years, half-year convention
D. 31.5 years, mid-month convention

B. 27.5 years, mid-month convention. MACRS depreciation rules require that non-residential real property placed in service after 1986 be depreciated over 27.5 years using the mid-month convention.

2. Some tangible property is not depreciable. Examples include land, leased property, and costs to demolish a building.

3. Depreciation is allowed or allowable. Allowable depreciation is the amount the taxpayer is entitled to under the applicable method and convention. If the taxpayer does not claim depreciation he or she is entitled to, the basis of the property must still be reduced by the entitled amount. No depreciation deduction is allowed for property placed in service and disposed of in the same tax year.

B. Alternate MACRS method is used for tangible property placed in service after 1986 and certain transitional property. The depreciation deduction is computed using the straight line method with no salvage value over the asset's class life. Personal property that has no assigned class life has a 12 year recovery period. All real property is assigned a 40 year life. The same conventions apply as in regular MACRS.

Exercise 26: *Missed depreciation deductions in lax years barred by the statute of limitations would INCREASE the basis of property. (True or False)*

False. Basis of property is adjusted downward for depreciation allowable rather than allowed.

C. Section 179 Deduction.

1. The maximum allowable deduction under §179 is $18,500 and is limited to the net income from all the taxpayer's active trades or businesses.

2. If the cost of qualifying §179 property exceeds $200,000, the $18,500 limit is reduced dollar for dollar by the amount that is over $200,000. For purposes of these limits, married taxpayers filing a separate return are treated as one taxpayer.

3. The §179 deduction can only be taken on an original return for the year the qualifying property was placed in service. Any disallowed amount that was the result of the taxable income limitation can be carried forward to the next succeeding tax year.

4. If the business use of an asset drops to 50% or less before the end of the recovery period, the §179 deduction must be recaptured and taxed as ordinary income on Form 4797.

Exercise 27: *Jane Jerrard, who is single, is a fifty-percent partner in AB Partnership. During 2001, AB placed in service section 179 property having an adjusted basis to AB of $210,000. The partnership's total income for the year was $17,500. In addition to being a partner in AB, Jerrard also operates a business as a sole proprietorship. During 2001, she placed in service in her business a computer costing $8,000. For 2001, this business had taxable income of $20,000 (before any section 179 deduction). What is the maximum section 179 deduction Jerrard may claim for 2001?*

A. $8,750
B. $11,750
C. $16,750
D. $17,500

B. $11,750. The adjusted basis of the property exceeds the $20,000 threshold by $10,000, the maximum dollar amount is $7,500 ($17,500 minus $10,000). Jerrard's share of the partnership deduction is $3,750. Jerrad may deduct the full $8,000 for the computer. Her maximum Section 79 deduction is $11,750 ($3,750 plus $8,000).

D. Amortization

1. Amortization allows a taxpayer to recover certain costs in much the same way as straight line depreciation.

2. Only specific expenses can be amortized by making an election on Form 4562 and attaching the required statement to the return. The statement should include total costs, description, date incurred, month business began, and the number *of* months in the amortization period (not less than 60).

3. Capitalized cost of certain intangibles (Section 197 intangibles) acquired after August 10, 1993, must be amortized. The amount of the deduction is the adjusted basis amortized over 15 years starting with the month acquired.

> ***Exercise 28***: *The capitalized costs of goodwill or going concern value acquired after August 10, 1993, must be amortized over a 15-year period beginning with the month acquired. (True or False)*
>
> > *True. Taxpayers may deduct the ratably amortized capital costs of specified intangible assets referred to as "section 197 intangibles" over a 15-year period beginning in the month of acquisition.*

4. Section 197 intangibles include:

   a) Goodwill,

   b) Going concern value,

   c) Workforce in place, including its components, terms, and conditions of employment,

   d) Business books and records, operating systems, and any other information base, including customer lists,

   e) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item,

   f) A customer-based intangible,

   g) A supplier-based intangible,

   h) A license, permit, or other right granted by a government unit or agency,

   i) A covenant not to compete entered into in connection with an acquisition of an interest in a trade or business, and

   j) A franchise, trademark, or trade name.

5. A §197 intangible is treated as depreciable property used in a trade or business, qualified for §1231 treatment. Recapture is treated as §1245 property.

__Exercise__ 29: A workforce in place, including its composition, terms and conditions (contractual or otherwise) of employment, is a section 197 intangible asset. (True or False)

True. A workforce in place, including its composition, terms and conditions (contractual or otherwise) of employment, is a section 197 intangible asset.

6. Start-up cost incurred in setting up a trade or business and organizational cost incurred for a partnership or corporation (presented in Section A of this text) are amortizable over 60 months or more.

__Exercise__ 30: Sally opened a cafe on July 1, 2001. Prior to opening the business, she incurred the following costs:

Consultant for market survey	*$2,000*
Business taxes and license	*600*
Accounting fees	*1,000*
Fixtures for the cafe	*400*
Hiring and training employees	*1,200*
Advertising for grand opening	*500*

What amount of amortization may Sally claim, if she elects to use the shortest period allowed, on her income tax return for 2001?

A. $570
B. $530
C. $470
D. $280

C. $470. Eligible business start-up expenses include the consultant fees, accountant fees, expenses for hiring and training employees and advertising expenses. Sally can deduct expenses over a period of time not less than 60 months and can claim 6 months of amortization in 2001.

E. Depletion deductions are allowed on oil, gas, geothermal wells, standing timber, and mineral property. There are two ways of computing depletion.

1. Cost depletion is figured by dividing the adjusted basis of the property by the total number of recoverable units. This result is then multiplied by the number of units sold. Cost depletion is used for timber and mineral deposits.

2. Percentage depletion is deducted as a certain percent of the gross income from the property with the following limitations:

   a) It cannot exceed 50% of the taxable income from the property,

   b) It's allowed for only certain domestic oil and gas production,

   c) It can be used for mine, geothermal, and other natural deposits, and

   d) The deduction is the greater of cost depletion or percentage depletion.

F. Business Bad Debts

1. Business bad debts are deductible directly from gross income if they are closely related to the taxpayer's business activity. They must result from credit sales to customers or loans to suppliers, clients, employees, or distributors.

2. Accrual method taxpayers can deduct bad debts when they are unable to collect what is owed to them, provided the amount has been included in income.

3. Cash method taxpayers generally may not take a bad debt deduction because they do not report income until payment is received.

4. If the taxpayer guaranteed a business loan and then had to pay it off it may qualify as a business bad debt, a nonbusiness bad debt, or a nondeductible gift.

   a) If the reason for guaranteeing the loan was closely related to the taxpayers trade or business, the debt can be treated as a business bad debt.

   b) If the taxpayer entered the guarantee transaction with a profit motive or to protect an investment, the debt can be treated as a nonbusiness bad debt.

   c) If the taxpayer makes the guarantee as a favor to a friend and receives no consideration in return, the transaction is a gift.

Exercise 31*: In order to protect her investment, Beth, an officer and principal shareholder of Turbo Corporation, guaranteed payment of a bank loan Turbo received During 2001, Turbo defaulted on the loan and Beth made full payment. Beth is entitled to a business bad debt deduction. (True or False)*

False. Since Beth's guarantee of Turbo Corporation was made to protect her investment in the business as an officer and principal shareholder, she may not deduct the amount guaranteed at the time of default as a business bad debt. To qualify as a business bad debt, Beth's dominant motive for making the guarantee must be proximately related to the guarantor's trade or business.

5. There are two ways in which to treat amounts that have become uncollectible.

   a) Specific charge-off method.

      (1) Partially worthless bad debts are limited to the amount charged off the books. This does not have to be done annually. No part of the bad debt may be deducted in a year after the year in which the debt becomes worthless.

      (2) Totally worthless bad debts are deducted only in the tax year they become worthless.

Exercise 32*: In 2001, Ms. Azalea had gross income of $80,000, a bad debt deduction of $7500, and other allowable deductions of $67,000 on her Schedule C (Form 1040). She uses the accrual method of accounting and the specific charge-off method for bad debts. During 2001, she recovered $5,500 of the debt that she had deducted in 2000. How must Ms. Azalea report the recovery of the bad debt?*

A. She must reduce her bad debt deduction for 2000 by $5,500.
B. She must include $5,500 in "other income" on her Schedule C for 2001.
C. She must include $5,500 in nonbusiness "other income" on her Form 1040 for 2001.
D. She must file an amended income tax return for 2000.

B. She must include $5,500 in "other income" on her Schedule C for 2001. Recovery of previously deducted bad debt amounts is reported as "other income" on Schedule C.

   b) Nonaccrual-experience method.

(1) Can be used by qualifying accrual method taxpayers.

(2) Applies only to amounts to be received for the performance of services. Taxpayers are not required to accrue income they do not expect to collect.

(3) May not be used for amounts due for which interest or a late payment penalty is required.

(4) May not be used for amounts owed because the taxpayer is engaged in the business of lending money, selling goods, or acquiring receivables or other rights to receive payment from other persons.

***Exercise 33**: Carolina Partnership, which uses the accrual method of accounting derives ALL of its income from services. ft does NOT accrue income that it does NOT expect to receive AND it does NOT charge a late penalty on past due accounts. Carolina may use the nonaccrual-experience method of accounting for bad debts. (True or False)*

> *True. Taxpayers who use an accrual method of accounting, derive all their income from services and do not charge interest or penalties for late payments may use the nonaccrual-experience method to report bad debts.*

** **Study Tip** * In past years, the enrolled agents exam has had at least one question regarding the "nonaccrual experience" method of deducting bad debts. Although this may be uncommon in real life, the exam may test the concept.*

6. If a bad debt deduction is taken and in a later year all or part of the debt is recovered, the recovery must be included in income. The recovery may be excluded to the extent the deduction did not reduce the tax in the year the bad debt was deducted. A bad debt deduction may add to or produce a net operating loss.

G. Not-for-Profit Activities

1. An activity that shows a profit in at least 3 of the last 5 years is presumed to have a profit motive. Activities that consist primarily of breeding, training, showing, or raising horses are presumed to have a profit motive if they show a profit in at least 2 of the last 7 years.

2. Factors to consider in determining if an activity is engaged in for profit include the following:

a) Whether the taxpayer carries on the activity in a businesslike manner.

b) whether the time and effort put into the activity indicates an intent to make it profitable.

c) whether the taxpayer depends on the income from the activity for his or her livelihood.

d) Whether the losses from the activity are due to circumstances beyond his or her control.

e) Whether the taxpayer changes methods of operation in an attempt to improve the profitability of the activity.

I) whether the taxpayer, or advisors, have the knowledge needed to carry on the activity as a successful business.

g) whether the taxpayer was successful in making a profit in a similar activity in the past.

h) Whether the activity makes a profit in some years, and how much profit it makes.

i) Whether the taxpayer can expect to make a future profit from the appreciation of the assets used in the activity.

3. Activities that are not engaged in for profit are limited in their deductions in the following order:

   a) Deductions allowed for personal as well as business activities are allowed first, such as interest, taxes, and casualty losses.

   b) Deductions other than depreciation and amortization are deducted to the extent of the remaining income.

   c) Basis reduction items are allowed to the extent there is any income remaining after the deductions from 1 and 2 above.

4. Allowable deductions are shown as itemized deduction on Schedule A limited by 2% of adjusted gross income.

Exercise 34: *Spencer operates a fishing yacht during three months of the year and is not engaged in this activity for profit. He uses the yacht for his* *own personal use for one month and leases it to other persons for two months. For 2001, his income and expenses relating to the yacht were as follows:*

Income		*$2500*
Mortgage interest	*$1,200*	
Personal property taxes		*$ 800*
Maintenance and insurance		*$1,500*
Depreciation	*$1,200*	

Without regard to the limitation on itemized deductions, what amount is deductible by Spencer on his 2001 income tax return?

	Interest and Taxes	*Maintenance and Insurance*	*Depreciation*
A.	*$1,200*	*$900*	*$1,200*
B.	*$1,200*	*$900*	*$400*
C.	*$2,000*	*$900*	*$400*
D.	*$2,000*	*$500*	*$0*

D. $2,000; $500; $0. The hobby loss rules apply to an activity not engaged in for profit, since the law does not use the word “hobby.” Deductions are allowed, to a certain extent, to individuals and S corporations according to a 3-tiered ordering rule.

H. Net Operating Losses

1. Net Operating Losses - A net operating loss (NOL) occurs when certain deductions for the year exceed income.

2. To have an NOL, the loss must be caused by:

   a) Deductions from a trade or business,

   b) Deductions taken by an employee that are work related, or

   c) Deductions taken for casualty or theft losses.

3. An NOL cannot result from the deduction of:

   a) Net capital losses,

   b) Personal or dependent exemptions,

   c) Nonbusiness losses, or

d) Nonbusiness deductions.

4. Nonbusiness income and deductions must be separated from business income and deductions.

Business income includes:

- Income from a trade or business
- Salary earned as an employee
- Gain from the disposition of assets used in a trade or business
- Rental income on Schedule E
- Income from a general partnership or S Corporation reportable on Schedule E

Business deductions include:

- Ordinary and necessary expenses from a trade or business, which includes moving expenses
- Personal casualty and theft losses reportable on Schedule A
- Deductible employee business expenses
- State and local income tax on business profits
- State and local income tax withheld from W-2 wages
- Section 1244 losses
- Losses from an S corporation or partnership
- Unrecovered investment in employee annuity contract
- Interest on business indebtedness
- Losses on the sale of assets used in a trade or business

Nonbusiness income includes

- Interest and dividends
- Alimony
- Taxable pensions and annuities
- Income from a limited partnership
- Gambling and/or lottery winnings
- Gains from the sale of property held for investment
- Taxable distributions from an

Nonbusiness expenses include

- Alimony paid
- Medical expenses after the AGI limitation
- Charitable contributions
- IRA, SEP, and Keogh contributions
- Gambling losses
- Standard deduction
- Tax preparation fee
- Safe deposit box rental

IRA or Keogh	• Investment expenses • IRA custodial fees

5. Determining the NOL

   a) Personal and dependent exemptions cannot be claimed.

   b) NOL carryover/carryback from other years cannot be deducted.

   c) Nonbusiness capital losses are limited to nonbusiness capital gains.

   d) Nonbusiness deductions are limited to the total of:

      (1) Nonbusiness capital gains that are more than nonbusiness capital losses, and

      (2) Nonbusiness income.

   e) Business capital losses are limited to the total of:

      (1) Nonbusiness capital gains that are more than the total of nonbusiness capital losses and excess nonbusiness deductions, and

      (2) Business capital gains.

***Exercise 35**: In 2001, Sherri, who is single, started a leasing business. Her 2001 income tax return reflected the following income and deductions.*

Income		
Wages from part-time job	*$1,225*	
Interest income		*$ 425*
Net short-term capital gain (business)		*$2,000*
Total income	*$3,650*	
Deductions		
Net loss from business		*$5,000*
Net long-term capital loss on sale of stock		*1,000*
Personal exemption	*2,450*	
Standard deduction	*3,800*	
Loss on small business stock		*1,000*
Total deductions	*$13,250*	

Using the above facts, what is the amount of Sherri's net operating LOSS for 2001?

A. $9,600

B. $3,350
C. $2,775
D. $2,350

C. $2,775. Sherri's deductions exceeded her income by $9,600. The required adjustment reduce Sherri's net operating loss to $2,775. $9,600 minus $2,450 (personal exemption) minus $3,375 (standard deduction minus interest income) minus $1,000 (capital loss on sale of stock).

6. The NOL is carried back 3 years and carried forward for up to 15 years for the losses in tax years beginning before 8/16/97 and is carried back 2 years and forward to 20 years thereafter, until used. Any unused portion is lost after the final carry-forward year.

   a) A carryback can be accomplished by either of two methods:

      (1) Form 1045, Application for Tentative Refund, can be filed no later than one year after the close of the NOL year.

      (2) Form 1040X is used within 3 years of the due date, including extensions for filing the tax return for the NOL year.

   b) For a carryforward, the NOL is listed as negative income on the "Other Income" line of Form 1040

   c) An irrevocable election to forego the carryback period can be made by attaching a statement to the tax return for the loss year. This statement must be filed no later than the due date, including extensions, for filing the income tax return.

7. Modified taxable income is used only to determine if there is any excess NOL to be carried to the next tax year. Modified taxable income:

   a) Step One - Figure AGI as usual except deduct capital losses only to the extent of capital gains (no deduction for any part of a net capital loss is allowed). Do not deduct the NOL carried from the NOL year or any later tax years. Be sure to deduct any allowable NOL carryovers from years before the NOL year.

   b) Step Two - Take deductions from AGI that are normally allowed. Refigure deductions and credits that are based on a percentage of AGI using the modified AGI from step one.

8. Partnerships and S Corporations are not allowed an NOL deduction. The losses are passed through to the partners or shareholders separately and deducted on their individual income tax returns.

Exercise 36: *All of the following statements about forgoing the net operating loss (NOL) carryback period are CORRECT* ***except****:*

A. The election should be made as a written statement attached to the tax return for the NOL year citing the appropriate Internal Revenue Code section.
B. Once the election is made, the taxpayer CANNOT later revoke it for that tax year.
C. A taxpayer may amend a prior year's return to include the election as long as the election is made before the expiration of the statute of limitations.
D. A taxpayer who wants to for go the carryback period for more than one NOL must make a separate election for each NOL year.

C. A taxpayer may amend a prior year's return to include the election as long as the election is made before the expiration of the statute of limitations. An NOL election may be made on an amended return if the return is filed on or before the due date for filing returns for the year the election is sought. An election, once made for any tax year, is irrevocable.

SECTION C - SALES, EXCHANGES, AND OTHER TOPICS

I. General Information

A. A sale is the transfer of property for money, a mortgage, note, or other promise to pay money. An exchange is the transfer of property for other property or services. A transaction must be a sale or exchange for any gain to be taxable or any loss deductible.

B. The gain is the excess of the amount realized over the adjusted basis of the property. The loss is the excess of the adjusted basis over the amount realized.

C. Basis is generally the cost of the property if acquired by purchase. Basis may be different than cost if the property was acquired by gift, inheritance, or in some way other than by purchase.

D. Adjusted basis is the original cost or other basis plus certain additions such as improvements or selling expenses; minus certain deductions such as depreciation, amortization, and casualty losses.

E. The amount realized is the total of all money received plus the fair market value of all property and services received. The amount realized also includes any liabilities that were assumed by the buyer and liabilities to which the property traded is subject (mortgage, real estate taxes, etc.) The amount realized is not necessarily the same amount that is included in income and subject to tax.

F. The amount recognized is the amount that is included or deducted in determining gross income for tax purposes. The amount recognized can differ from the amount realized. An example of this may occur in a like-kind exchange.

G. The fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller when both have reasonable knowledge of all the facts and neither is required to sell.

II. Sales and Exchanges

A. Foreclosures and Repossessions

1. A foreclosure or repossession is treated as a sale or exchange from which the borrower may realize a gain or loss.

2. The transaction is reported the same as other sales with the gain or loss being the difference between the adjusted basis in the property and the amount realized.

B. Like-Kind Exchange

1. When an exchange qualifies as "'like-kind" the gain is not taxed and losses are not deductible. Several requirements must be met before an exchange will qualify under the like-kind rules.

2. The property exchanged must be business or investment property. Both the property given up and the property received must be held for business or investment use. Property held for sale such as inventory or merchandise held for resale does not qualify.

3. The property must be "like-kind" property.

    a) Personal property for similar personal property such as a truck for a van.

    b) The exchange of livestock of different sexes will not qualify under the like-kind rules (heifers for bulls).

    c) Real property for real property. Unimproved land for improved land will qualify as like-kind.

4. Generally stocks, bonds, notes, other securities or evidence of indebtedness or interest, or the exchange of a partnership interest will not qualify.

5. The exchange may be a deferred exchange in which business or investment property is transferred, and at a later time, replacement property is received. A deferred exchange must meet certain requirements.

    a) The property to be received in the exchange must be identified within 45 days after the date in which the property exchanged is transferred.

    b) The taxpayer then has 180 days from the date the property is relinquished to take possession of the replacement property.

6. The basis of the property received in a nontaxable exchange is the basis of the property given up plus any additional cash paid or liabilities assumed.

7. A partially nontaxable exchange is one in which a taxpayer receives unlike property or money in addition to like property. The basis of property in a partially nontaxable exchange is the basis of the old property with the following adjustments:

    a) Decreased by money received, any liabilities transferred, and any loss recognized on the exchange.

b) Increased by any additional costs incurred, money paid, liabilities assumed, and gain recognized on the exchange.

C. Related Party Exchanges - Exchanges between related parties are nontaxable provided certain rules are followed. These rules became effective July 10, 1989.

1. Related parties include:

a) Members of a family (spouse, brother, sister, parent, child, etc.), and

b) A corporation in which the taxpayer owns more than a *50%* interest, or a partnership in which the taxpayer owns, directly or indirectly, a more than *50%* interest in the capital or profits.

2. If either patty to the exchange disposes of the property within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. The gain or loss, on the original exchange, must be recognized as of the date of that later disposition.

3. Exceptions to the related party rules include the following:

a) Dispositions due to the death of either related person,

b) Involuntary conversions, and

c) Exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

D. Trade-Ins - Property which is traded-in for other property is treated as an exchange. The transaction is treated as an exchange regardless of how the parties try to avoid the trade-in rules. An example of a like-kind exchange is the trade-in of a used vehicle for a new vehicle. The basis of property for depreciation cannot be increased by selling the old property to a dealer and then buying new property from the same dealer. If the sale and purchase are dependent on each other, it will be treated as a trade-in.

E. Foreign Real Property - Transfers of real property located in the United States for real property that is located outside the United States are not considered like-kind exchanges. Therefore, if the taxpayer exchanges foreign real property for property located in the U.S., any gain on the exchange is fully taxable.

III. Gains and Losses

A. If the property sold or exchanged is a capital asset, the owner's gain or loss will be a capital gain or loss. If the property is not a capital asset, the gain or loss is an ordinary gain or loss. Taxpayers must distinguish between capital and ordinary gain and between long and short-term transactions. Capital assets generally include everything the taxpayer owns ***except***:

   1. Property held mainly for sale to customers (inventory) or property that will physically become part of that property,

   2. Accounts or notes receivable that are acquired in the ordinary course of a trade or business,

   3. Depreciable property used in a trade or business, even if fully depreciated,

   4. Real property used in a trade or business, or

   5. A copyright, a literary, musical or artistic composition, a letter or memorandum, or some other similar type property.

B. Gain on the sale or exchange of property, that is depreciable property in the hands of the party who receives it, may be taxed as ordinary income if the transaction was with a related party.

   1. Related parties for this purpose include:

      a) A person and the person's controlled entity,

      b) A taxpayer and any trust in which the taxpayer is a beneficiary, and

      c) An employer and a welfare benefit fund that is controlled directly or indirectly by the employer.

   2. A controlled entity is:

      a) A corporation in which more than *50%* of the value of all outstanding stock, or a partnership in which more than *50%* of the capital interest or profits interest, is owned, directly or indirectly, by or for that person.

      b) An entity whose relationship with that person is one of the following:

         (1) A corporation and partnership if the same persons own more than *50%* in value of outstanding stock and more than *50%* of the capital interest or profits interest.

         (2) Two corporations that are members of the same controlled group.

(3) Two S Corporations, if the same persons own more than *50%* in value of the outstanding stock of each corporation.

(4) Two corporations, one being an S, if the same person owns more than *50%* in value of the outstanding stock of each.

3. No deduction is allowed for losses from sales or exchanges between related parties. However, if the person receiving the property later sells that property at a gain, the gain is recognized only to the extent that it is more than the loss not allowed to the related party. For this purpose, in addition to the relationships just presented, related parties also include:

   a) Members of the immediate family, including only brothers and sisters, husband and wife, ancestors, and lineal descendants.

   b) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two trusts if the same person is the grantor of both.

   c) Certain educational or charitable organizations and a person who controls that organization.

   d) A trust fiduciary and a corporation if the more than *50%* in value of outstanding stock is owned by or for the trust or by or for the grantor.

   e) The grantor and fiduciary and the fiduciary and beneficiary of any trust.

   f) A personal service corporation and any employee-owner.

C. Goodwill is an asset that may or may not exist within a business. The reporting of its sale depends on the date it was acquired and how it was treated by the taxpayer. If goodwill was acquired before July *25,* 1991 the sale would result in a capital gain or loss. However, if goodwill was acquired after August 10, 1993 (or July 25, 1991 if an election was made to apply §197 to such intangibles) the sale is treated as the sale of §1245 property. If a business with goodwill is sold, allocation of the selling price to goodwill must be made by the residual method. Allocate to other assets an amount of the purchase price in proportion to (but not in excess of) fair market value in the following order:

   1. Cash, demand deposits, and similar accounts,

   2. CDs, US government securities, other readily marketable stock or securities, and foreign currency,

   3. Noncompete covenant,

4. All other assets except goodwill, and

5. Any remaining purchase price, after the above allocations, is the purchaser's basis in goodwill or the seller's amount received for the sale of goodwill.

D. Timber held as investment property is treated as a capital asset. Its sale will result in a capital gain or loss. The sale of timber held primarily for sale to customers in the ordinary course of business results in ordinary income.

IV. Holding Period

A. Before gains and losses can be determined, the assets must be classified as long-term or short-term.

1. For assets held one year or less, the gain or loss will be short-term.

2. Assets held more than one year will be treated as long-term gain or loss.

3. In counting for the one year period, start counting on the day following the day the property was acquired and include the day the property is disposed of. The same date of each month is the beginning of a new month.

B. The holding period for stock and securities begins the day after the purchase date. For the sale of securities, the date of disposition is the trade date and not the settlement date. If payment is received in a later tax year, gain or loss is still recognized on the trade date.

C. The holding period for inherited property is always long-term regardless of how long the taxpayer or the person from whom the property was inherited actually owned the property.

D. For property sold on the installment method, if the property sold was held short-term, the gain will be reported as short-term gain for the duration of the agreement. If the property sold was held long-term, the gain will be long-term.

E. When a taxpayer acquires an asset in a nontaxable exchange, the holding period for the new asset includes the holding period of the old asset.

F. The holding period for property received as a gift includes the donor's holding period.

G. The holding period for real property begins the day after title to the property is received.

H. The holding period for the later sale of repossessed property includes the period the property was held before the original sale, as well as the period after the repossession.

V. Reporting Gains and Losses

A. Section 1231 Property - Property used in a trade or business or held for the production of rents and royalties and held for more than one year is referred to as §1231 property.

1. In a disposition, first figure the ordinary part of the gain. Any remaining gain is included in the §1231 computation.

    a) Combine all §1231 gains and losses for the year. If the §1231 gains exceed losses, there will be a net §1231 gain.

    b) If §1231 losses equal or exceed §1231 gains, then treat each item as an ordinary gain or loss.

2. A net §1231 gain is treated as ordinary to the extent the taxpayer has nonrecaptured net §1231 losses taken in prior years.

3. Nonrecaptured net §1231 losses are those §1231 losses deducted in the taxpayer's five most recent tax years that have not been applied against any net §1231 gains in a tax year beginning after 1984.

4. The amount of the taxpayer's net §1231 gain that is not treated as ordinary income is long-term capital gain.

B. Section 1245 Property - Personal property used in a business, held for more than one year, subject to an allowance for depreciation, and sold for a gain is §1245 property. Any depreciation, §179 expense deduction, recovery allowance, and any downward basis adjustment allowed or allowable, is taxed as ordinary income to the extent of the gain.

Exercise 37: *Betty Lou sold a rental condominium she owned for several years. Her records reveal the following:*

Item to be Allocated	*Total*	*Personal Property*	*Building*	*Land Rights*
Original purchase price	*$100,000*	*$15,000*	*$80,000*	*$5,000*

	0			
Total depreciation claimed	*67,000*	*15,000*	*52000*	*0*
Excess depreciation claimed	*10,000*	*N/A*	*10,000*	*0*
Allocated selling price	*150,000*	*12,000*	*130,000*	*8,000*

How much of the gain to be recognized on this transaction will be reported as section 1245 recapture?

A. $24000
B. $15,000
C. $12,000
D. $10,000

C. $12,000. Section 1245 property and Section 1245 recovery property are both subject to the Code Sec. 1245 recapture rules. Section 1245 property is generally depreciable personal property used in a trade or business. Accordingly, Betty Lou must recapture the $12,000 gain on the personal property. The residential rental property and the intangible land rights are specifically excluded from the definition of Section 1245 recovery property.

C. Section 1250 property includes all real property held long-term, that is or has been subject to an allowance for depreciation, and is not and has never been §1245 property.

1. Gain on the sale of business or rental real estate is generally §1250 property unless the property is nonresidential real property depreciated under ACRS. Nonresidential real property for which ACRS deductions were taken is considered §1245 property.

2. Gain on the sale of residential rental property will be treated as ordinary income to the extent of the excess depreciation under ACRS over straight line.

3. Ordinary income rules will not apply to residential real property or nonresidential real property placed in service after December 31, 1986 because MACRS for this property is determined using the straight line method.

D. If the basis of §1250 property received as a gift or inheritance, or in a tax-free exchange, is reduced by the depreciation that was either allowed or allowable to the former owner, a separate statement showing the basis determination must be attached to the return for the year the property was acquired.

***Exercise 39**: Brent received a gift of section 1250 property from his grandfather. The basis of this property is reduced by the depreciation that was either allowed or allowable to his grandfather. Therefore, Brent must attach a separate statement to his return for the year he received the gift to indicate how his basis in the property was determined. (True or False)*

True. All property placed in service after 1986 is depreciated under the straight-line basis, so there is no excess depreciation to recover.

E. Section 1244 Stock Loss - A taxpayer that has a loss from the disposition of "small business stock" can treat the loss as an ordinary loss (rather than a capital loss). The maximum amount of the loss that can be treated as an ordinary loss for the tax year is limited to *$50,000* ($100,000 for MFJ tax returns). The determination as to whether the stock qualifies as §1244 stock is made at the time it is issued. §1244 stock must meet all of the following requirements:

1. At the time the stock is issued, the corporation must be a small business corporation. For purposes of this section, a corporation will be considered to be a small business corporation if the aggregate amount of money and other property received by the corporation in exchange for stock, or as a contribution to capital (paid-in-surplus), does not exceed $1,000,000.

2. The stock issued by the corporation was for money or other property (other than stock and securities), and

3. During the period of the 5 most recent tax years ending before the date of the loss, the corporation derived more than 50 percent of its aggregate gross receipts from sources other than rents, royalties, dividends, interest, annuities, and sales or exchanges of stocks or securities.

***NOTE:** An ordinary loss under §1244 can only be claimed by an individual to whom the stock was originally issued.*

***Exercise 40:** Ms. Witherby purchased 100 shares of qualifying small business (Section 1244) stock for $10,000 on January 2, 2001. On July 1, 2001, Ms. Witherby had to make an additional $2,000 contribution to capital which increased her total basis in the 100 shares to $12,000. On November 9, 2001, Ms. Witherby sold the 100 shares for $9,000 to an unrelated party. What is the amount and character of the gain or (loss) Ms. Witherby may claim on her 2001 income tax return?*

Ordinary (Loss)	Capital Gain or (Loss)

A	*($12,000)*	*$9,000*
B	*($3,000)*	*$0*
C	*($2,500)*	*($500)*
D	*$0*	*($3,000)*

C. ($2,500); ($500). If an owner of Section 1244 stock invests additional capital but is not issued additional shares of stock, the amount of the additional investment is added to the basis of the originally issued stock, but this subsequent increase to the basis of the originally issued stock does not qualify for ordinary loss treatment. Any resulting loss must then be apportioned between the qualifying Section 1244 stock and the non-qualifying additional capital interest (Code Sec.1244). Since the additional capital interest of $2,000 is one-sixth of the total basis of $12,000, the $3,000 loss is apportioned as follows: $500 of capital loss (one-sixth of $3,000) and $2,500 of capital loss (one-sixth of $3,000) and $2,500 of qualifying ordinary loss.

VI. Capital Loss Carryover

A. Capital gains and losses are netted together regardless of whether they were held short-term or long-term. The excess of the losses over the gains are allowed up to $3,000 annually. The remaining losses are carried over until they are used up. If the taxpayer has a net capital loss, it must be deducted even if there is no ordinary income to offset the loss.

B. Carryovers retain the original character as Long-Term or short-term. when figuring how much capital loss to carry over, use short-term losses *first,* even if incurred after long-term losses.

C. The method for figuring the amount of capital loss carryover for tax years beginning after 1986 has changed. The capital loss carryover is the amount of the capital loss that exceeds the lesser of:

1. The allowable loss deduction for the year, or

2. The taxpayer's taxable income increased by the allowable capital loss deduction for the year and the deduction for the personal exemptions.

NOTE: *The maximum capital gains tax rate remains at 28%..*

Section 1231

Land and depreciable property used in a business, held over one year

Sold at a Gain

Section 1245

- Personal property
- Nonresidential real property depreciated using ACRS

Treated as ordinary gain up to the amount of depreciation. The remaining gain is §1231 gain

Section 1250

- Residential rental property
- Nonresidential real property depreciated using straight line.

ACRS

- Depreciation in excess of straight line is recaptured as ordinary income. The remaining gain is §1231 gain

SL or MACRS

No recapture All gain is treated as capital §1231

Sold at a Loss

All losses will be treated as §1231 ordinary losses

VII. Installment Sales

A. Sales that result in a gain and provide for all or part of the selling price to be paid in a later year are installment sales. Each payment received on an installment sale consists of three parts:

1. Return of the seller's investment (basis) in the property sold,
2. Gain on the sale, and
3. Interest.

NOTE: *If the sale results in a loss, the installment method cannot be used. A loss on the sale of business assets is deductible only in the year of the disposition.*

B. Recapture of depreciation under §179, §1245, and §1250 is treated as ordinary income to the extent of the gain. This income is taxed in the year of sale regardless of when the seller receives payment.

Exercise 41*: On December 15, 2001, Miranda, a calendar year taxpayer; sold two business assets on the installment method for a total of $300,000. Her section 1245 property accounted for $100,000 of the selling price and was subject to depreciation recapture of $65,000. Her section 1250 property sold for the remaining $200,000 and was subject to a $25,000 depreciation recapture. Miranda received $60,000 as a down payment in 2001. The remaining payments will be made in subsequent years. How much TOTAL depreciation recapture will Miranda be required to report on her 2001 income tax return?*

A. $0
B. $18,000
C. $60,000
D. $90,000

D. $90,000. Since any depreciation recapture under Code Secs. 1245 and 1250 is includible in income in the year that the property is disposed of in an installment sale, Miranda must report $90,000 ($65,000 plus $25,000) of depreciation recapture on her return (Code Sec. 453(I)).

C. A dealer or anyone who regularly sells property on the installment plan may not use the installment method to report the gain from the sale of real or personal property. This also applies to real property held for sale to customers in the ordinary course of a trade or business.

D. The sale of stock or securities traded on an established securities market cannot be reported using the installment method. The sale must be reported in the year in which the trade date falls.

E. If an installment obligation from the sale of business or rental property for more than $150,000 is used as security for any debt, the net proceeds from the debt are treated as a payment against the installment obligation.

F. Installment method reporting is required unless the taxpayer makes an election not to use the installment method. If the election is made, the entire gain is taxable in the year of sale. The election is made by the due date, including extensions, for the tax year the sale takes place.

G. Income from property sold under the installment method is reported on Form 6252, Installment Sale Income.

1. If the property sold is a capital asset, the capital gain portion is included on Schedule D.

2. If the property sold is business property and the property is held long-term, report the depreciation recapture income in the year of sale up to the amount of gain on Part II, Form 4797, and the amount of §1231 gain in Part I.

H. The Gross Profit Ratio represents the portion of each payment (excluding the portion for interest) which is reported as gain from the sale. This ratio is referred to as the gross profit percentage and remains the same for each payment. All interest, including unstated interest, is reported on Schedule B.

Gross Profit Percentage = Gross Profit / Contract Price

1. Gross profit is the amount of gain to report under the installment method. It is figured as the amount realized, less the installment sale basis.

2. Contract price is the total amount the buyer will pay the seller, plus the amount by which any liability assumed by the buyer exceeds the seller's installment sale basis.

3. Installment sale basis is the adjusted basis plus the selling expenses and any ordinary income recapture required to be reported.

4. If taxpayers are able to postpone or exclude all or part of the gain on the installment sale of their main home, none of that gain is included in the gross profit for figuring the gross profit percentage.

I. Related Persons - Special rules apply if property is sold to related persons under the installment method and that person sells or otherwise disposes of the property within two (2) years of the first sale.

1. The amount the related person realizes as a result of the second disposition is treated as if it had been received by the person making the first disposition.

2. Gain recognized to the initial seller is based on the gross profit ratio and is recognized only to the extent the amount realized from the second disposition exceeds actual payments received under the installment sale.

J. Payments considered to be received include:
1. If the buyer pays or assumes any of the seller's expenses from selling the property, this amount is treated as a payment in the year of sale.

2. If the buyer assumes or pays off a mortgage:

a) If the mortgage is less than the seller's installment sale basis in the property, it is not considered a payment and the contract price equals the selling price minus the mortgage.

b) If the mortgage is more than the installment sale basis, the entire basis is recovered and the amount in excess of the basis is treated as a payment in the year of sale. The contract price is the same as the gross profit from the sale.

K. The single sale of several assets requires determining gain or loss on each asset. The sale, at a gain, of separate and unrelated assets of the same class under a single contract is reported as a single transaction. Any assets sold at a loss cannot be included in the installment sale reporting.

L. Each payment under the installment method contains an interest component. If interest is less than the applicable federal rate or not stated, the imputed or unstated interest must be determined. This amount reduces the stated selling price and the gross profit percentage.

* **Study Tip** * *Installment sales have been consistently tested on prior exams. You should be familiar with how to compute gain, gross profit percentage, and contract price.*

VIII. Involuntary Conversions

A. An involuntary conversion is the result of a casualty, theft, or condemnation.

1. If business property is completely destroyed, the deductible loss is the adjusted basis of the property minus any salvage value and any reimbursement received or expected to be received.

2. If property is partially destroyed, the deductible loss is the lesser of the decrease in fair market value or the adjusted basis of the property reduced by any reimbursements.

3. A gain may be postponed if the replacement property is bought within a specific period.

B. A theft is the unlawful taking of another person's property. To be deducted as a theft loss, the taxpayer must be able to show a theft occurred under the law of the state where the theft occurred, when the property was determined to be missing, and ownership of the property.

1. If the business property is stolen, the deductible loss is the adjusted basis of the property reduced by any reimbursement received.

2. The theft of inventory is deducted through the cost of goods sold by adjusting the ending inventory to reflect the theft.

3. Mislaid or lost property is not a theft.

4. Theft losses are generally deducted only in the year of discovery

C. A casualty is the result of an identifiable event that is sudden and unexpected such as an act of nature or an accident. Casualty losses are generally deductible only in the year in which the casualty occurred.

__Exercise 42__: Baron Landers owned a 3-story building which he built on leased land in Castroville, California. Baron used two floors (2/3 of the building) in his business and he lived on the third floor (1/3 of the building). The building cost $140,000 and he made no improvements or additions to it. In March 2001, a flood damaged the entire building. The fair market value of the building was $133,000 immediately before the flood and $120,000 afterwards. Baron's insurance company reimbursed him $9, 000 for the flood damage. Depreciation on the business part of the building before the flood totaled $8,400. Baron's adjusted gross income for 2000 was $50,000. what is the amount of Baron's deductible BUSINESS casualty loss?

A. $0
B. $2,567
C. $2,667
D. $4,000

C. $2,667. In general, the amount deductible as a business casualty loss is the difference between the fair market value of the business property immediately before the casualty reduced by the fair market value of that property immediately after the casualty, reduced by any insurance received (Code Sec. 165). Accordingly, ($133,000 minus $120,000) minus $9,000 equals $4,000. Since only two-thirds of Baron's loss was attributable to business property, Baron's deductible business casualty loss is $2,667 (2/3 x $4,000).

D. Disaster Area losses are losses resulting from a disaster in an area designated as such by the President of the United States. Such losses may be deducted on the return for the immediately preceding tax year or on the tax return for the year of the disaster.

1. An election (irrevocable after 90 days) to deduct the loss in the preceding year is to be made by the later of:

a) The original due date of the tax return for the year the disaster occurred, or

b) The due date of the preceding year's return, including extensions.

2. A disaster loss to inventory may be deducted on the preceding year's return by decreasing opening inventory for the year of the loss so the loss will not show up in inventory.

Exercise 43: *On October 2, 2001, Pamela's freezers in her grocery store went off due to a tornado causing her to lose $5,000 of frozen foods. Her insurance company reimbursed her $4,000 on January 7, 2002. Pamela had a beginning inventory' of $10,000, purchases of $8,000, and an ending inventory of $3,000. Which of the following is a proper method to account for this event?*

A. Do nothing for 2001, report the $4,000 as additional gross receipts for 2002.
B. Do nothing to inventory' for 2001, report the $4,000 as additional gross receipts in 2001.
C. Reduce beginning inventory by $5,000 for 2001 and deduct a $1,000 loss on her 2002 return.
D. Reduce purchases by $5,000 for 2001 and deduct a $1,000 loss on her 2002 tax return.

B. Do nothing to inventory for 2001, report the $4,000 as additional gross receipts in 2001. If property is involuntarily converted into money or other property not similar to the converted property, such as insurance proceeds, the taxpayer must report the realized amount as gain in the year the money or other property is received.

E. Condemnation is the legal taking, without the owner's consent, of private property for public use by a federal, state or local government or political subdivision, for a reasonable amount of money or property. A condemnation award is money paid or the value of other property received for the condemned property. This includes the amount paid for the sale of property under threat or imminence of condemnation.

1. A gain results if the condemnation award, less expenses of obtaining it, are more than the adjusted basis in the property. If the property is not replaced within a specific period or dissimilar property or cash is received, the gain is taxable. To postpone the entire gain, the cost of the replacement property

must be equal to or more than the reimbursement for the property. A taxpayer may choose to postpone reporting the gain if:

a) The taxpayer purchases property similar or related in service or use to the condemned property, or

b) The taxpayer purchases a controlling interest (at least 80%) in a corporation that owns similar property.

2. A loss results when the money or other property received is less than the adjusted basis in the property.

3. The replacement period begins for a casualty or theft on the date the property was damaged, destroyed, or stolen. For a condemnation or threat of condemnation, the replacement period begins on the earlier of the date the condemned property was disposed of or the date on which threat of condemnation began.

4. The replacement period ends two years after the close of the first tax year in which any part of the gain from the condemnation, casualty, or theft is realized. The replacement period ends three years after the end of the first tax year in which any part of the gain from a condemnation of real property held for business or investment is realized.

IX. Business Credits

A. General Business Credit

1. The general business credit is limited to the net income tax minus the larger of:

a) The tentative minimum tax, or

b) 25% of the net regular tax liability that is more than $25,000.

Exercise 44: *Your general business credit is limited to your net income tax minus the larger of 25% of your regular tax liability that is more than $25,000 or:*

A. Your alternative minimum tax.
B. Your tentative minimum tax.
C. Your net income tax.
D. Your taxable income.

B. Your tentative minimum tax. The amount that may be claimed as the general business credit is limited based on tax liability. The general business credit may not exceed net income tax minus the greater of the tentative alternative minimum tax or 25% of net regular tax liability above $25,000.

2. The general business credit consists of the following credits:

   a) Investment credit - The investment credit is the total of:

      (1) Reforestation credit,

      (2) Rehabilitation credit, and

      (3) Business energy credit.

   b) Jobs credit - The jobs credit provides an incentive to hire persons from targeted groups that have a particularly high unemployment rate. This credit only applies to qualified first year wages. This credit is not available for an individual that begins work for the employer after December 31, 1999.

   c) Alcohol fuel credit - Available only to a person that blends or uses alcohol as a fuel in a trade or business.

   d) Research credit - The credit is equal to 20% of the increase in research expenses for the year over the base period research expenses. The base period is the 3 prior tax years.

      Exercise 45*: Research expenditures related to changing the STYLE of the product qualify for the research credit. (True or False)*

      False. Costs incurred for alterations to existing products do not qualify for the credit.

   e) Low-Income Housing credit - The credit is 70% of the qualified basis of each new low-income building placed in service after 1986. The credit is taken over a 10-year period.

   f) Disabled Access credit - The credit is equal to 50% of the expenses over $250 but not more than $10,250 incurred to provide access to persons with disabilities. Thus, the maximum amount of the disabled access credit for any tax year is $5,000.

g) Enhanced Oil Recovery credit - The credit is *15%* of qualified enhanced oil recovery costs for the *tax* year.

g) Renewable Electricity Production credit - The credit is based on electricity that was sold to an unrelated party and was produced from qualified energy resources.

i) Credit for Unused Payments into the Trans-Alaska Pipeline Fund.

j) Indian Employment credit - This credit is effective after December, 1993. Employers are allowed a tax credit of up to $4,000 per qualified Indian hired after 1993 and before year 2004.

k) Credit for employer's portion of Social Security taxes paid for an employee's cash tips. This credit applies to amounts paid or incurred after December 31, 1993.

l) Credit for contributions to certain community development corporations.

m) Empowerment Zone Employment credit - Available for qualified zone wages paid or incurred during calendar years 1994 - 2004.

B. Rule for Carrybacks and Carryovers - In general, the unused portion of the credit is carried back 3 years and then forward to the next 15 years. Credits must be used in the order in which they are earned.

1. Use the credit carryovers from the earliest year first.

2. Next, use the current year's credit.

3. Finally, use the credit carrybacks, from the earliest year first.

X. Special Rules for Farming

A. Estimated Tax Payments - If at least two-thirds of total gross income is from farming, the taxpayer has two options for filing the income tax return and paying estimated tax payments.

1. The farmer (or fisherman) may pay only one estimated tax payment by January 15 and then file the income tax return by April 15.

2. File the income tax return by March 1 and pay all the tax due with the return. With this option, there are no estimated tax payments due and no penalties for failure to make estimated tax payments.

3. Gross income from farming includes:

   a) Farm income from line 11, Schedule F,

   b) Farm rental income from line 7, Form 4835*,*

   c) Gross farm income from pass-through entities reported on Schedule E, and

   d) Gains from the sale of livestock used for draft, breeding, sport, or dairy purposes reported on Schedule D or Form 4797.

4. Income from farming reported on Schedule F includes amounts received from cultivating the soil or raising or harvesting agricultural commodities. This includes income from operating a stock, dairy, poultry, fish and aquaculture products, bee, fruit, or truck farm, and income from operating a plantation, ranch, nursery, orchard, or oyster bed.

5. Income reported on the Schedule F does not include gains from the sales of:

   a) Farm land or depreciable farm equipment, or

   b) Livestock held for draft, breeding, sport, or dairy purposes.

6. Rent received for the use of farm land is generally reported on Form 4835 and Schedule E. If the taxpayer materially participates, the rental income is reported on Schedule F.

7. Most government program payments are included in income on Schedule F.

8. Farm income does not include wages received as a farm employee. This is also true for wages received by a farm corporation shareholder.

   ***Exercise** 46: Max, a cash basis farmer, operates a cow-calf breeding operation. The breeder cows are NOT held primarily for sale. In addition to raising calves on his farm, Max also purchases calves for resale. During 2001, Max had the following acquisitions and dispositions of cattle.*

Purchase of 25 calves for resale	*$2,875*
Sale of above 25 calves purchased for resale	*$5,700*
Sale of 40 calves raised by Max	*$9,200*
Sale of 10 breeder cows	*$6,750*

Original cost of breeder cows	*$5,500*
Accumulated depreciation on breeder cows	*$2,860*

What amount should Max include in gross income on his Schedule F for 2001?

A. $12,025
B. $16,135
C. $18,775
D. $21,650

A. $12,025. Max should include $12,025 ($9,200 + ($5,700 - $2,875)) in gross income on his Schedule F. Cash basis farmers must report any gain from the sale of breeder cows on Form 4797 (Code Sec. 1231 (b)(3)).

***Exercise 47**: Jack and Diane Jarco had the following total gross income in 2001:*

Interest and dividend income		*$43,500*
Rental income (Schedule E)		*$1,500*
Farm income (Schedule F)	*$75,000*	
Farm rental income (Form 4835)		*$15,000*
Schedule D income (sale of dairy cows)		*$5,000.*
Total gross income	*$140,000*	

Which of the following statements BEST describes the Jarco's ESTIMATED tax responsibilities?

A. They MUST file and pay estimated taxes in quarterly installments in April, June, September, and January.
B. They can wait until January 17, 2002, to make their first and only estimated tax payment.
C. They MUST file their return by January 31, 2002, and pay all the tax that is due in order to avoid an estimated tax penalty.
D. Their adjusted gross income will be too high to take advantage of ANY special estimated tax filing breaks.

B. They can wait until January 17, 2002, to make their first and only estimated tax payment. They special rules that apply to farmers regarding estimated tax liability allow farmers to ignore the first three installment dates and pay all estimated tax by January 15 (or the first business day after that date) of the following year and file their tax return by the regular due date.

B. Drought Sales - Farmers may elect to postpone reporting for one year the gain from the sale of livestock if the sale was due to drought conditions. This election applies to all livestock held for sale, draft, breeding, dairy, or sporting purposes. To qualify for this election, the following conditions must be met:

1. The taxpayer's principal business must be farming,

2. The farmer must use the cash method of accounting,

3. The farmer must be able to show that under normal business practices, the sale would not have occurred except for the drought, and

4. The area was designated as eligible for assistance by the federal government. The livestock does not have to be raised in a drought area. However, the sale must occur solely because of the drought conditions affecting grazing, water, or other requirements that made the sale necessary.

C. Crop Insurance and Disaster Payments - An election to postpone reporting these payments from the tax year the crops were damaged to the following year can be made if:

I. A statement is attached to the return making the election indicating the crops were damaged, the cause of the damage, and the total insurance payment received, and

2. Under normal business practice, the income from the crop would have been reported in the following year if the damage had not occurred.

D. Farm Expenses

1. The deductibility of farm expenses generally follow the rules previously discussed.

2. To deduct accelerated depreciation of farm assets under MAC RS, the *150%* declining balance method must be used.

E. Employment Tax Responsibilities

1. Federal income tax must be withheld if the gross cash and noncash wages paid to a farm employee are more than the dollar value of withholding allowances for that pay period.

2. Social Security and Medicare taxes are required to be withheld and deposited if the farmer has one or more employees who meet either of the following tests:

    a) The employee was paid $150 or more in cash wages during the year, or

    b) During the year, $2,500 or more in cash and noncash wages were paid to all employees.

3. Federal unemployment (FUTA) is required to be paid if cash wages are paid and either of the following tests are met:

    a) Cash wages of $20,000 or more were paid to farm workers in any calendar quarter during the current or preceding calendar year, or

    b) Ten or more farm workers were employed for some part of at least one day during each of 20 different calendar weeks during the current or preceding year.

4. Commodity wages (payments in kind) are not considered wages for purposes of employment tax withholding. However, the value of these noncash wages is reported in box one of the farm employee's W-2.

XI. Self-Employment Tax

A. Self-employment (SE) tax provides Social Security coverage for self-employed individuals. A person is self-employed if that individual carries on a business as a sole proprietor, an independent contractor, a member of a partnership, or otherwise in business for himself/herself.

1. A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit.

2. A statutory employee would use a separate Schedule C to report income and expenses related to the earnings as a statutory employee, however, this net income is not subject to SE tax.

3. Individuals must pay SE tax if:

    a) They had net earnings from self-employment of $400 or more, or

    b) They are church employees with income of $108.28 or more.

B. Self-employment Income

1. Resident aliens are subject to the same rules as U.S. citizens. Nonresident aliens do not pay SE tax.

2. Depreciation recapture or §179 recapture because business use dropped to *50%* or less is included in determining SE income.

3. If the taxpayer reduces or stops the business activity, any payments received for lost income of the business from insurance or other sources are SE income.

4. Fees received for performing services as a corporate director are SE income. Income as an employee or officer of the corporation is not SE income.

5. An S Corporation shareholder is not self-employed with respect to the corporation's taxable income.

6. Newspaper carriers are generally not self-employed. However, if over age 18 and paid the difference between a fixed sales price and the cost of the newspaper to the carrier, the income is SE income.

7. A distributive share of partnership income or loss and guaranteed payments from the partnership are treated as SE income.

8. Rent received by a real estate dealer is included in income subject to SE tax.

9. Income paid by an insurance company to a retired insurance agent that is based on a percentage of commissions received prior to retirement is SE income.

<u>Exercise 48</u>: *All of the following are subject to self-employment tax* ***except****:*

A. Troy, a 60% owner in a S Corporation, received $40,000 as his distributive share of the corporation's taxable income.
B. Lloyd, a real estate dealer, had net rental income of $67,000.
C. Dave, a general partner, received a $20,000 guaranteed payment.
D. Patrick, a corporate director, received $35, 000 for services performed as a director

A. Troy, a 60% owner in a S corporation, received $40,000 as his distributive share of the corporation's taxable income. Although S corporation shareholders are treated similarly to partners for many tax purposes, they are not subject to the self-employment tax on their shares of the S corporation's ordinary income.

C. Net self-employment income usually includes all business income less all business deductions allowed for income tax purposes.

1. If the taxpayer has more than one trade or business, the net earnings from each business is combined to determine net SE income.

2. A loss in one business will reduce a gain in another business for determining income subject to self-employment tax.

Exercise 49: *If you have more than one trade or business, you must compute self employment tax for each business separately. (True or False)*

False. For the purposes of computing self-employment tax, net earnings from self-employment includes the total amounts of income derived from the operation of any trade or business. The tax is computed on an aggregate basis from total earnings from self-employment.

D. The self employment tax rate is 15.3% (12.4% Social Security and 2.9% Medicare tax).

1. No more than $76,200 (2000) (1999 is $72,600) of combined wages, tips, and net SE earnings is subject to the 12.4% for Social Security.

2. All wages, tips, and SE earnings are subject to the 2.9% Medicare tax.

SECTION D - PARTNERSHIPS

I. General Information

A. A partnership is an entity of two or more persons who join together to carry on a trade or business with each person contributing money, property, labor, or skill and each expecting to share in the profit or loss.

1. Persons may include an individual, a corporation, a trust, an estate, or another partnership.

2. Partnership includes a syndicate, group, pool, joint venture, or similar organization that is carrying on a trade or business and is not classified as a trust, estate, or corporation.

Exercise 50: *Two brothers each inherited a 50% ownership interest in a building from their mother. The building is subject to a lease whereby the brothers provide NO services to the tenant. The brothers agree to split the rental income and expenses and share equally in any profits or losses. which of the following statements is CORRECT?*

A. Because the brothers received the property in a distribution from their mother's estate, they must report the income and expenses associated with the property on Form 1041.
B. Because the brothers jointly inherited the property, they have a partnership and must report the property's income and expenses on Form 1065.
C. Because the brothers have an agreement to share in the profits and losses they have a partnership and must report the property's income and expenses on Form 1065.
D. Because the brothers' co-ownership of the property is NOT a trade or business, they do NOT have a partnership. Each brother must report his respective share of income and expenses on Schedule E, Form 1040.50

D. Because the brother's co-ownership of the property is NOT a trade or business, they do NOT have a partnership. Each brother must report his respective share of income and expenses on Schedule E, Form 1040. Selection of the proper schedule for reporting rental income depends upon whether services are provided to tenants. In this fact situation, since no services are provided, Schedule E is the appropriate reporting vehicle.

B. A **Limited Liability Company (LLC)** is an entity formed under state law by filing articles of organization.

1. An LLC may be taxed as a corporation or a partnership. It is classified as a partnership if it has no more than two of the following characteristics:

    a) Centralization of management,

    b) Continuity of life,

    c) Free transferability of interests, or

    d) Limited liability.

2. Converting a partnership into an LLC does not terminate the partnership. The partnership's tax year does not close, and the LLC continues to use the old partnership EIN.

C. Family members can be partners.

1. Family members will be recognized as partners only if one of the following requirements is met.

    a) If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction, actually own the partnership interest, and actually control the interest.

    b) If capital is not a material income-producing factor, they must have joined together in good faith to conduct a business. In addition, they must have agreed that their contributions entitle them to a share in the profits. Some capital or services must be provided by each partner.

2. Family members include only spouses, ancestors, and lineal descendants, or any trust for their primary benefit.

Exercise 51: *Members of a family can be partners. Members of a family who must meet*
special requirements to be recognized as partners include all of the following except:

A Trusts for the benefits of lineal descendants.
B Brothers and sisters.
C Spouses.
D Ancestors.

B. Brothers and sisters. The "family" of any individual includes only a spouse, ancestors, lineal descendants and any trusts for the primarily benefit of such persons.

3. Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital.

4. A capital interest is an interest in partnership assets that is distributable to the owner of the interest if:

   a) He or she withdraws from the partnership, or

   b) The partnership liquidates.

5. If a family member receives a gift of a capital interest in which capital is a material income-producing factor, the donee's distributive share of partnership income is limited.

   a) The partnership income must be reduced by reasonable compensation for services rendered to the partnership by the donor, and

   b) The donee-partner's share of the remaining profits allocated to donated capital must not be proportionately greater than the donor's share attributable to the donor's capital.

6. An interest purchased from another family member is considered a gift.

   Exercise 52: *Mr. Clysdale is a partner in Clysdale and Associates Partnership. The other two partners are his sister and his 17-year old son, Gregory. The partnership's income consists mostly of compensation for services performed by Mr. Clysdale and his sister. Gregory is a high school student and acquired his one-third interest by gift Gregory is recognized as a partner in the firm for tax purposes. (True or False)*

   False. In a family partnership where the material income-producing factor is not a capital asset, the family member must provide substantial or vital services to the partnership to be considered a partner for federal tax purposes.

7. A husband-wife carrying on a business together and sharing in the profits and losses may be a partnership regardless of whether or not there is a formal partnership agreement. They should not file a Schedule C in the name of one spouse as a sole proprietor.

II. Form 1065

A. A partnership is not a taxable entity but must file an annual information return using Form *1065,* U.S. Partnership Return of Income. The return must be signed by one of the partners and filed every year of existence even though there is no partnership income for the year. Form *1065* is due by the 15th day of the 4th month following the close of the tax year (April 15th for calendar year partnerships). A partnership is eligible for an automatic 3 month extension by filing Form 8736.

B. The partner's distributive share of separately reportable partnership items are shown on Schedules K and K-1, Form 1065. A copy of Schedule K-1 must be furnished to all partners. Failure to do so will result in a penalty of $50 per statement per year. A small partnership (10 or fewer partners) may avoid the penalty by showing reasonable cause and each partner reports his/her share on an individual return.

C. When a partnership terminates, the tax year ends on the date of termination. If terminated before the end of the tax year, a short period return is due by the 15th day of the fourth month following the date of termination. A partnership terminates when:

1. All of its operations are discontinued and no part of any business, financial operations, or venture is continued by any of its partners in a partnership or LLC, or

2. At least *50%* of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

NOTE: *The partnership agreement, electing out of partnership treatment, and tax year are discussed in Section A.*

III. Partnership Income

A. Partnership profits are not taxed to the partnership but rather passed through and taxed to the partners. The partnership computes its income and files its return in the same manner as individuals. However, a partnership must state certain items of gain, loss, income, etc. separately and certain deductions are not allowed to the partnership.

1. Separately stated items include the following:

a) The ordinary income or loss from the trade or business.

b) Net income or loss from rental real estate activities.

c) Net income or loss from other real estate activities.

d) Gains and losses from sales or exchanges of capital assets.

e) Gains and losses from sales or exchanges of §1231 property.

f) Charitable contributions.

g) Dividends for which corporate partners can claim a deduction.

h) Taxes paid or accrued to foreign countries and U.S. possessions.

i) Any §179 expense deduction, which is limited at both the partnership level and the partner level.

j) Depletion and intangible drilling costs.

k) Distributive shares of any partnership items which, if taken into account separately by each partner would result in a tax different from the tax if the item had not been taken into account separately.

2. The partnership makes most choices about how to compute income.

   a) Accounting method.

   b) Depreciation method.

   c) Accounting for specific items, such as depletion, amortization, or installment sales.

   d) Nonrecognition of gain on involuntary conversions of property.

   e) Amortization of certain organization fees and business start-up costs.

3. Each partner chooses how to report the partner's share of:

   a) Foreign and U.S. possessions taxes,

   b) Certain mining exploration expenses, and

   c) Income from cancellation of debt.

Exercise 53: *The partnership, NOT the partners, makes choices about all of the following* ***except****:*

A. Depreciation methods.
B. Nonrecognition of gain on involuntary conversions of property.
C. Amortization of certain organization fees.
D. Income from discharge of indebtedness.

D. Income from discharge of indebtness. Most elections affecting the computation of taxable income derived from a partnership must be made by the partnership. However, the election to reduce the basis of depreciable property for amounts excluded from gross income because of discharge of indebtness must be made by each partner separately.

B. A partnership can choose to amortize certain organizational expenses over a period of not less than 60 months.

1. Amortizable expenses include those that:

   a) Are incident to the creation of the partnership,

   b) Are chargeable to the capital account, and

   c) Are the type that would be amortized if they were incurred in the creation of a partnership having a fixed life.

2. Such expenses must be for the creation of the partnership, not for starting or operating the partnership trade or business.

3. Examples of amortizable expenses include:

   a) Legal fees for services incident to the organization of the partnership (preparing the partnership agreement),

   b) Accounting fees for services incident to the organization, and

   c) Filing fees.

IV. Partner's Income

A. A partner's distributive share of partnership items is generally determined by the partnership agreement. If the partnership agreement does not address an allocation or if the allocation does not have substantial economic effect, the distributive share will be determined by the partner's interest in the partnership. A partner's distributive share of certain items of income, gain, loss, deduction, or credit must be reported on the individual's tax return even though the partnership does not actually distribute any money to the partner.

B. The character of certain items of income, gain, loss, deduction, or credit included in a partner's distributive share is determined as if the partner:

1. Realized the item directly from the same source as the partnership, or

2. Incurred the item in the same manner as the partnership.

C. Members of a partnership that carry on an active trade or business must include their share of the partnership income or loss in net earnings from self-employment. This includes guaranteed payments made to partners for services or use of capital if the payments are made without regard to the income of the partnership.

D. Losses are allowed to the extent of the adjusted basis in the partner's interest in the partnership. The adjusted basis is figured as of the end of the partnership's tax year in which the loss occurred, before taking the loss into account. The excess can be used to reduce any restored basis in the following years. The basis can never be less than zero.

Exercise 54: *Partners Ray, Fay, and Kay of RFK, a calendar year partnership, share partnership profits and losses in a ratio of 4.3:3, respectively. All three materially participate in the partnership business. Each partner's adjusted basis in the partnership as of December 31, 2001, was as follows:*

Ray	*$10,000*
Fay	*$ 8,000*
Kay	*$12,000*

The partnership incurred an operating LOSS of $30,000 in 2001. What is Ray's, Fay's, and Kay's share of the loss to be reported on their 2001 individual income tax returns?

	Ray	*Fay*	*Kay*
A.	*$6,000*	*$4,800*	*$3,600*
B.	*$10,000*	*$8,000*	*$9,000*
C.	*$10,000*	*$8,000*	*$12,000*
D.	*$12,000*	*$9,000*	*$9,000*

B. $10,000; $8,000; $9,000. An active partner's deductible loss cannot exceed the amount of the adjusted basis of his or her interest in the partnership at the end of the partnership tax year in *which the loss occurred (Code Sec. 704(d)). Since the $30,000 loss is to be shared 4:3:3 ($12,000: $9,000: $9,000), Ray's and Fay's losses are limited to their adjusted bases of $10,000 and $8,000. However, since Kay's adjusted basis is $12,000, she can take her full $9,000 share of the loss.*

E. The at-risk rules limit the loss a partner can deduct to the amount the partner is considered at-risk.

1. The amount of money and the adjusted basis of property contributed to the activity.

2. The partner's share of net income retained by the partnership.

3. Certain amounts borrowed by the partnership for use in the activity if the partner is personally liable for repayment or the amounts borrowed are secured by the partner's property.

Exercise 55: *Todd has a 45% interest in a partnership, and he materially participates in the partnership's business. Todd's adjusted basis in the partnership was $60,000 at the beginning of 2000. There were no distributions to Todd during the year. During 2001, the partnership borrowed $400, 000 for the following reasons:*

Purchase equipment needed for business	*$240,000*
Pay balance of existing note in full	*160,000*

All of the partners are personally liable for all partnership debts. The partnership incurred a $600,000 loss in 2001. What amount can Todd claim as a loss from the partnership on his 2001 individual tax return?

A. $60,000
B. $168,000
C. $240,000
D. $270,000

B. $168,000. A general partner's basis in his partnership interest is increased by his share of the partnership's recourse liabilities (Code Sec. 752 (a)). Todd's share of the additional partnership liability (45 percent of $240,000=$108,000) plus his original basis of $60,000 gives him an adjusted basis of $168,000. Although Todd's share of the partnership loss is 45 percent of $600,000, or $270,000, his deductible loss is limited to his adjusted basis of $168,000 (Code Sec. 704(d)).

F. The passive activity rules do not apply to the partnership. They do apply to each partner's share of loss or credit from the activity.

__Exercise 56__: The JLC Partnership, which is NOT a rental real estate partnership, was formed on January 1, 2001, and incurred a $24,000 loss for the year ending December 31, 2001. The partnership had NO portfolio income. The three partners share profits and losses equally. Mr. C is a passive investor in JLC. On January 1, 2001, C contributed $3,000 to the partnership and an additional $5,000 during 2000. Mr. C had draws totaling $1,000 during 2001. What is C's deductible loss from JLC for 2001 if he had $4,500 in income from other passive investments?

A. $4,500
B. $6,000
C. $7,000
D. $8,000

A. $4,500. Losses arising from a passive activity generally are deductible only against income from that or another passive activity (Code Secs. 469(a) and (d)). Since Mr. C is a passive investor in JLC, his deductible loss is limited to his $4,500 passive income from other sources.

G. A partner cannot deduct partnership expenses paid out of personal funds unless required to do so by the partnership agreement.

H. If a partnership terminates and one of the partners is insolvent and cannot pay any of the partnership debts, the other partner(s) may have to pay more than his or her share. As such, that partner can take a bad debt deduction for any part of the insolvent partner's share of debts that he or she is required to pay.

__Exercise 57__: Bridget and Brenda formed B & B Partnership in 1999 as equal partners. They closed the business during 2001 because it was not profitable. After the partnership closed they had debts to pay. Because Bridget was insolvent, she paid only part of her share of the partnership's debts. Brenda was required to pay ALL of the remaining debts during 2001. which of the following statements reflects the correct treatment of the debts paid by Brenda on her tar return for 2001?

A. She cannot deduct ANY of the debt she paid.
B. She can deduct ONLY her payment of her share of the debt as a bad debt.
C. She can deduct ALL of the debt she paid as a bad debt

D. She can deduct ONLY her payment of Bridget's share of debt as a bad debt

D. She can deduct ONLY her payment of Bridget's share of debt as a bad debt. A partner that pays more than her proportionate share of a partnership debt that becomes uncollectible is permitted to take a bad debt deduction equal to the amount in excess of that partner's share of the debt.

I. If an individual borrows money to purchase an interest in a partnership, the loan proceeds and interest expense are allocated among all the assets of the partnership. If the loan proceeds are contributed to capital of the partnership, the allocation is made based on the assets or by tracing the proceeds to the partnership's expenditure.

J. Partnership distributions include basically anything distributed from a partnership and is not taken into account in determining the partner's distributive share of partnership income or loss. A partnership distribution is treated as a distribution received on the last day of the partnership's tax year.

1. The partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the amount of money and the adjusted basis of property distributed to the partner.

2. A partner generally recognizes gain on a partnership distribution only to the extent any money included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is treated as a sale of a partnership interest on the date of the distribution. If property is distributed, gain is generally not recognized until that property is disposed of For distribution rules, a distribution of marketable securities is treated as a distribution of money.

Exercise 58*: The adjusted basis of Eliot's interest in a partnership was $60,000. He received a nonliquidating distribution of $48,000 cash plus apiece of equipment with a fair market value and a partnership adjusted basis of $18,000. Eliot's basis for the equipment is:*

A. $18,000
B. $12,000
C. $6,000
D. $0

B. $12,000. The basis of property received in a nonliquidating distribution from a partnership, while generally the same as the basis of the property in the hands of the partnership, cannot exceed *the basis of the recipient-partner's partnership interest, reduced by the amount of money received by the partner in the same transaction (Code Sec. 732(a)(2)). Accordingly, Eliot's partnership interest is reduced to $12,000 on the receipt of the $48,000 nonliquidating distribution, and although the equipment has a fair market value and an adjusted basis of $18,000, its basis is limited to Eliot's $12,000 basis in his partnership interest.*

V. Partner's Dealings with Partnership

A. For certain transactions between a partner and the partnership, the partner is treated as not being a partner. These transactions include:

1. Performing services for or transferring property to a partnership if:

   a) There is a related allocation and distribution to a partner, and

   b) The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner.

2. Transferring money or other property to the partnership if:

   a) There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and

   b) The transactions together are properly characterized as a sale or exchange of property.

B. To determine ownership in partnership capital or profits, the following rules apply.

1. An interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.

2. An individual is considered to own the interest that is directly or indirectly owned by or for the individual's family. Family includes only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.

Exercise 59: *Norita is a partner in MNO Partnership. Under which of the following combinations would she have more than a 50% ownership in the partnership's capital and profits?*

A.	*Norita*	*40 percent*
	Corporation owned entirely by Norita's	*60 percent*

	husband	
B.	*Norita*	*40 percent*
	Norita's mother	*10 percent*
	Norita's niece	*50 percent*
C.	*Norita*	*25 percent*
	Norita's husband	*20 percent*
	Norita's aunt	*55 percent*
D.	*Norita*	*40 percent*
	Norita's aunt's trust	*60 percent*

A. Norita. 40 percent; Corporation owned entirely by Norita's husband. 60 percent. Norita is treated as owning the stock owned by her spouse, children, grandchildren and parents. Here, Norita is treated as owning her husband's 60 percent interest, attributing to her a more than 50 percent ownership in the partnership's capital and profits.

3. If a person is considered to own an interest using rule (1), that person (the constructive owner) is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest, thus making another person the constructive owner.

C. Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income.

1. Guaranteed payments are reported as ordinary income by the partner and are generally subject to self-employment tax.

2. If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

3. Premiums for health insurance paid by the partnership on behalf of a partner for services as a partner are treated as guaranteed payments.

4. If the guaranteed payment creates a loss, the partner still includes the full amount of payment in income and then reports a proportionate share of the partnership loss.

Exercise 60: *Jay and Ray are partners in JR and Associates. Under the terms of the partnership agreement, Jay is to receive 25% of all partnership income or loss plus a guaranteed payment of $60,000 per* *year. In 2001, the partnership had $50,000 of ordinary income before any deduction for Jay's guaranteed payment. what is the amount of income or loss Jay would report on his 2001 tax return, assuming he materially participates in partnership activities?*

A. $15,000 guaranteed payment, $2,500 loss
B. $57, 500 guaranteed payment
C. $60,000 guaranteed payment
D. $60,000 guaranteed payment, $2,500 loss.

D. $60,000 guaranteed payment, $2,500 loss. Even though a partnership incurs a loss for a tax year, an active partner who receives a guaranteed payment must nevertheless take into account the full amount of such payment (Code Sec. 707(c)). This inclusion is required even when the partnership loss is caused by that guaranteed payment to the partner. Furthermore, the partner must also take into account his distributive share of the partnership loss. Accordingly, Jay must include his $60,000 guaranteed payment and 25 percent of the $10,000 loss ($50,000-$60,000) on his individual return.

D. Sale or Exchange of Property

1. Losses will not be allowed from a sale or exchange of property directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than *50%.*

2. This also applies if the sale is between two partnerships in which the same persons directly or indirectly own more than *50%* interest of the capital or profits of both partnerships.

Exercise 61: *Jackie owns a 52% interest in Brown Partnership and a 70% interest in Black Partnership. In March 2000, Brown sold land having an adjusted basis to Brown of $170,000 to Black Partnership for $140,000. In July 2001, Black sold the land to Sharon, an unrelated individual, for $152,000. what is the amount of gain or (loss) Black Partnership would recognize in 2001?*

A. $0
B. $12,000
C. ($12,000)
D. ($18,000)

A. $0. If a taxpayer purchases property from a related party who sustained a loss on the transaction but was not allowed a deduction *for the loss due to the related party rules, any gain realized by the taxpayer on a subsequent sale of the property is recognized only to the extent that the gain exceeds the amount of the previously disallowed loss (Code Sec. 267(d)). In this question, the $30,000 loss in the sale of the property is disallowed since the two partnerships involved are related parties. The Black Partnership recognizes no loss when it sells the property for $12,000 more than it paid for the property, but it also does not recognize any gain since that $12,000 is less than the $30,000 previously disallowed loss.*

3. Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following apply:

   a) More than 50% of the capital or profits interest in the partnership(s) is directly of indirectly owned by the same person(s), and

   b) The property in the hands of the transferee immediately after the transfer is not a capital asset.

Exercise 62: *Mr. Thomas is the 70% owner of A & T Partnership. On August 1, 2001, Mr. Thomas bought A & T's computer system for $50,000 for use in his Schedule C business. The system had an adjusted basis to A & T of $34,000. The accumulated depreciation on the system that was subject to recapture was $12,000. what is the amount and character of the gain to be reported by A & T Partnership in 2001?*

	Capital Gain	Ordinary Income
A.	$0	$16,000
B.	$16,000	$ 0
C.	$12,000	$ 4,000
D.	$4,000	$12,000

A. $0; $16,000. A taxpayer who realizes a capital gain on the disposition of certain depreciable property must recapture all or part of that gain as ordinary income. The amount that must be recaptured is the lesser of the total of depreciation deductions allowed or allowable with respect to the property, or the total gain realized (Code Sec. 1245). Furthermore, capital gain does not result from the sale or exchange of depreciable property between "related persons," defined as a person and any entities controlled (more than a 50-percent interest) by him. Thus, in the case of a sale or exchange between related persons, any gain remaining after recapture of depreciation is also treated as ordinary income

(Code Sec. 1239 and Reg. §1.1245-6(f)). In this example, the $16,000 difference between the sale price and the computer system's adjusted basis is all characterized as ordinary income: $12,000 pursuant to Code Sec. 1245 and the remainder because Mr. Thomas and his 70-percent owned partnership are related persons.

E. Contributions of Property

1. Generally, neither the partner nor the partnership recognize a gain or loss when property is contributed to a partnership in exchange for a partnership interest.

2. Gain or loss may be recognized if within a short period of time:

   a) Before or after the contribution, other property is distributed to the contributing partner and the contributed property is kept by the partnership, or

   b) After the contribution, the contributed property is distributed to another partner.

   Exercise 63: *During 2001, Scott contributed property having an adjusted basis to him of $10,000, to the Phillips & Phillips Partnership for a 45% interest in the partnership. At the time of the contribution, the property had a fair market value of $20,000 what is the amount and character of Scott's gain on this transaction to be reported on his 2001 tax return?*

   A. $0
   B. $4,500 long-term capital gain
   C. $10,000 ordinary income
   D. $10,000 long-term capital gain

   A. $0. Generally, no gain or loss is recognized to either the partnership or its partners (including the contributing partner) on a contribution of property to the partnership in exchange for a partnership interest (Code Sec. 721(a)). Accordingly, Scott's property contribution to the partnership in exchange for a 45-percent interest in the partnership is a nonrecognition transaction.

3. If contributed property is distributed to another partner within 5 years of the contribution, gain or loss must be recognized by the contributing partner. The gain or loss is equal to the amount the contributing partner would have

recognized if the property had been sold for its fair market value when it was distributed.

4. The partnership's basis for determining depreciation, depletion, and gain or loss is the same as the partner's adjusted basis of the property when it was contributed, increased by any gain recognized by the partner at that time.

F. Contribution of Services

1. A partner can acquire an interest in partnership capital or profits as compensation for services.

2. The fair market value of a capital interest must generally be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture.

3. The receipt of a profit interest in the partnership is not a taxable event for the partner or the partnership.

VI. Basis of Partner's Interest

Contributed Interest	Basis is the amount of money contributed plus the adjusted basis of any property contributed increased by any gain recognized on the transfer. Any increase in a partner's individual liability because of an assumption of partnership liabilities is also treated as a contribution of money. If the partnership assumes debt on property contributed, the partner's basis is reduced by the liability assumed by the other partners.
Purchased Interest	Basis is the money paid for the interest.
Inherited Interest	Basis is the fair market value of the interest at the date of death or alternate valuation date increased by the estate or other successor's share of partnership liabilities and decreased to the extent such value is attributable to income in respect of a decedent.

A. Increases to Basis - The partner's beginning basis is increased by the following:

1. Increase in partnership liabilities,

2. Increase in liabilities assumed on partner's property,

3. Tax exempt income,
4. Depletion deductions in excess of basis,
5. Taxable income of partnership, including capital gain, and
6. Additional contributions to capital.

B. Decreases to Basis - The partner's beginning basis is decreased by the following:

1. Decrease in partnership liabilities,
2. Depletion deductions for oil and gas property,
3. Partnership losses including capital losses,
4. Partnership expenses not deducted on return,
5. Withdrawals of cash or property, and
6. Partner's share of any §179 expenses, even if the partner cannot deduct the entire amount on his or her individual tax return.

Exercise 64: *Audra acquired a 50% interest in a partnership by contributing property that had an adjusted basis of $20,000 and a fair market value of $50,000. The property was subject to a liability of $44,000, which the partnership assumed for legitimate business purposes. Which of the following statements is CORRECT?*

A. Audra must include a gain from the sale or exchange of a capital asset on her individual return, and her basis in her partnership interest increases.
B. Audra must include a gain on her individual return, and her basis in her partnership interest is zero.
C. Audra is NOT required to include a gain on her individual return, and her basis in her partnership interest is zero.
D. Audra is NOT required to include a gain on her individual return, but the gain increases her basis in her partnership interest.

B. Audra must include a gain on her individual return, and her basis in her partnership interest is zero. When encumbered property is contributed to a partnership, a partner recognizes gain to the extent the partner is deemed to be relieved of a portion of the debt. Audra has a $42,000 basis upon contribution ($20,000 property basis plus $22,000, which is half the $44,000 debt). She is also deemed to *receive a cash distribution of $44,000 (the amount of the debt), creating a gain of $2,000. This gain does not affect Audra's basis in her partnership interest.*

C. A partner's share of partnership liabilities depends on whether the liability is recourse or nonrecourse.

1. A liability is recourse liability to the extent that any partner or related person has an economic risk of loss for that liability. The partner's share of such liabilities equals the partner's share of the economic risk of loss.

2. A liability is a nonrecourse liability if no partner or related party has an economic risk of loss for that liability. A partner's share of such liability generally is determined by the partner's ratio for sharing partnership profits.

VII. Basis of Property

A. The partner's basis of property, other than money, distributed by a partnership (other than in liquidation) is the partnership's adjusted basis immediately before the distribution.

1. The basis of the property received may not be more than the adjusted basis of the partner's interest reduced by any money received in the same transaction.

2. The holding period for distributed property to the partner includes the period the property was held by the partnership.

B. The partner's basis of property received in a complete liquidation of the partner's interest is equal to the adjusted basis of the partner's interest reduced by any money received. The basis of the interest is allocated among the assets received in proportion to the adjusted basis of the assets to the partnership in the following order:

1. Allocation is first made to unrealized receivables and substantially appreciated inventory items. The adjusted basis for inventory items and unrealized receivables will offset the partner's basis dollar for dollar.

2. The balance is allocated to the remaining property distributed in proportion to their adjusted bases in the hands of the partnership before the distribution.

C. Generally, a partnership may not adjust the basis of its retained property as the result of a distribution of other property to a partner or a transfer of an interest in the partnership. However the partnership may choose to make an optional adjustment to the basis of its property upon the transfer provided the election is in writing (§754 election).

VIII. Disposition of a Partner's Interest

A. A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss if:

1. The transaction is not a sale or exchange.

2. The partner has not received an actual or deemed distribution from the partnership. Even a de minimis actual or deemed distribution makes the loss a capital loss.

Exercise 65: *On December 31, 2001, Kay-Ann's adjusted basis in GEM Partnership was zero and her share of partnership liabilities was $30,000. The partnership had no unrealized receivables or substantially appreciated inventory items. Kay-Ann withdrew from the partnership on December 31, 2001, and was relieved of any partnership liabilities. As a result she had a $30,000 capital LOSS. (True or False).*

False. Relief of partnership liabilities is treated as a distribution of money to the partner. Consequently, any amount of the relief that exceeds the partner's basis in her partnership interest must be recognized as a capital gain.

B. A sale or exchange of a partner's interest usually results in capital gain or loss.

1. Gain or loss is the difference between the amount realized and the partner's adjusted basis in his or her partnership interest.

2. If the selling partner is relieved of any partnership liabilities, the amount of liability relief is included in the amount realized.

3. The sale of a partnership interest at a gain can be reported on the installment method. The gain is treated as part capital gain and part ordinary income if the partnership's assets included unrealized receivables and substantially appreciated inventory items.

Exercise 66: *The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. Select the CORRECT statement:*

A. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership.
B. If the selling partner is relieved of any partnership liabilities, the selling partner does NOT include the amount of the liability relieved as part of the amount realized.
C. If the partnership had substantially appreciated inventory items, the amount realized that is attributable to these items is capital gain or loss.
D. A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if the transaction was a sale or exchange.

A. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. Generally, a partnership interest is a capital asset, so gain or loss on the exchange or sale of the interest is capital gain or loss.

C. Ordinary Income - Any amount that would be recaptured if the partnership had sold its depreciable property at the time the partner sells his interest is treated as ordinary income. The partner's share of unrealized receivables and substantially appreciated inventory is also treated as ordinary income.

***Exercise 67**: Cynthia is a partner in CF Partnership. The adjusted basis of her partnership interest is $19,000 of which $15, 000 represents her share of partnership liabilities. Cynthia's share of the partnership's unrealized receivables is $6,000. The partnership has NO substantially appreciated inventory items. Cynthia sells her partnership interest for $28,000 cash. What is the amount and character of her gain?*

A. $6, 000 capital gain
B. $6, 000 ordinary income; $18,000 capital gain
C. $18,000 capital gain
D. $18,000 ordinary income; $6,000 capital gain.

B. $6,000 ordinary income; $18,000 capital gain. To the extent that money received by a partner in exchange for her partnership interest is attributable to her share of the value of unrealized receivables, that money is treated as ordinary income (Code Sec. 751). The remainder is treated as income attributable to a capital asset (Code Sec. 741). Accordingly, after Cynthia is relieved of her share of partnership liabilities, her partnership basis is $4,000 ($19,000 - $15,000) (Code Sec. 752). On the sale of her interest for $28,000, she has $24,000 above her basis to account for. Since her share of unrealized receivables is $6,000, she has $6,000 of *ordinary income, and the remaining $18,000 constitutes capital gain.*

D. Liquidation of Partner's Interest

1. Payments made in liquidation of a partner's entire interest in exchange for the partner's interest in the property are treated as distributions to the partner.

2. Payments to a retiring partner in liquidation of an interest, that are not considered payments for the interest in partnership property, are treated as distributed shares of the partnership income or guaranteed payments. These payments are generally taxed as ordinary income.

Exercise 68: *Asya's interest in ATP Partnership has an adjusted basis of $300,000. In a complete liquidation of her interest; she received the following:*

	ATP'S Adjusted Basis	*Fair Market Value*
Cash	*$140,000*	*$140,000*
Building	*160,000*	*180,000*
Computer	*40,000*	*20,000*
Inventory	*60,000*	*60,000*

What is Asya's basis in the building and computer, respectively?

	Computer	*Building*
A.	*$30,000*	*$120,000*
B.	*$20,000*	*$80,000*
C.	*$10,000*	*$90,000*
D.	*$30,000*	*$135,000*

B. $80,000; $20,000. When the basis of property in the hands of a partner is determined from the basis of his partnership interest, as is the case with distributions in liquidation of a partner's entire interest, the amount of a partner's basis in his partnership interest is allocated among the properties received after subtracting the amount of any cash and inventory items received. The allocation of the remaining basis to these properties must then be made in proportion to the partnership's adjusted bases in such property (Code Sec. 732). In this case, Asya's $300,000 partnership interest, minus $140,000 for the cash and minus the $60,000 in inventory leaves a remaining basis of $100,000. This $100,000 is then allocated to the building and computer according to the 4:1 basis proportion ($160,000: $40,000) of the ATP Partnership in the building and computer, resulting in a $80,000:$20,000 basis ratio for Asya.

E. Deceased Partner

1. The estate of a deceased partner or other successor in interest will report on its return the decedent's share of partnership items for the partnership year in which the death occurred.

2. The partnership's tax year does not end when a partner dies unless the partnership agreement is set up as such. If a partnership terminates with the death of a partner, the deceased partner's share of the partnership items for that year would be included on the deceased partner's final return. If the partner's tax year is different than the partnership's, the decedent's final return would include both:

   a) The share of partnership items for the partnership year ending with the decedent's death, and

   b) The share of the partnership items of any partnership year ending earlier in the decedent's last year.

Exercise 69: *Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction (or its equivalent) for the partnership. (True or False)*

> *True. Payments to a retiring partner are treated as made in exchange for the partner’s interest in partnership property, not as a distributive share or guaranteed payment.*

NOTE: *For purposes of computing the self-employment income for the deceased partner, include the partner's distributive share of income or loss from the partnership through the end of the month in which the death occurred. For this purpose, the partnership's distributive share of the income or loss is considered to be earned ratably over the partnership's tax year.*

3. PART 3 - CORPORATIONS, ESTATES, TRUSTS & GIFT TAXES

TABLE OF CONTENTS

INTRODUCTION

Part III of the exam covers Corporations, S Corporations, Estates, Trusts, and Gift Taxes. The exam is divided into three sections with Section A being true or false questions, Section B is multiple choice questions, and Section C is multiple choice questions that involve computation.

STUDY MATERIALS

MAIN TOPICS

- ❖ Section A   Corporations
- ❖ Section B   S Corporations
- ❖ Section C   Fiduciaries, Estates, and Gift Tax

Included in the Part III discussion:

- ❖ Trusts
- ❖ Basis
- ❖ Recognized gain
- ❖ Corporate Liquidations

The following Publications will assist in your preparation for Part III of the exam. There is no IRS publication which discusses corporate liquidation, so the information in this text will be the primary source of information, other than the Code and regulations.

Publication	334	Tax Guide for Small Business
Publication	448	Federal Estate and Gift Taxes
Publication	542	Tax Information on Corporations
Publication	559	Survivors, Executors, and Administrators
Publication	589	Tax Information on S Corporations

SECTION A - CORPORATION

I. General Requirements

A. Corporations include associations and unincorporated organizations that have associates, are organized to carry on a business, divide gains, and have a majority of the following characteristics:

1. Continuity of life

2. Centralization of management

3. Limited liability

4. Free transferability of interests

B. Corporations also include professional service corporations (PSCs) made up of doctors, lawyers, CPAs, veterinarians, etc. To be classified as a corporation, the PSC must be organized and operated as a corporation.

C. Filing Requirements - Corporations must file unless they are specifically exempt, regardless of their gross income or taxable income. They must continue to file even if there is no activity and only cash is retained to pay state taxes. A corporation does not need to file after dissolution even if the charter has not expired.

D. Due Date - The due date for the corporation's tax return is the 15th day of the third month following the close of the tax year. For a calendar year corporation, the due date is March *15.*

E. Forms - The taxable corporation files Form 1120, U.S. Corporation Income Tax Return. Form I 120A is a short form that can be used only if the corporation's gross receipts and assets do not exceed $500,000 and the corporation is not in liquidation or a member of a controlled group. An S Corporation files Form 1120S, U.S. Income Tax Return for an S Corporation.

F. Extensions - An automatic six month extension for filing can be obtained by filing Form 7004, Application for Automatic Extension of Time To File Corporation Income Tax Return. No further extension of time to file is available. This form can be used by both the C and S Corporation. The IRS can terminate the extension to file at any time by mailing a notice of termination to the corporation. If the return is not filed by the due date, a penalty of 5% per month (not to exceed *25%)* will be assessed. If the return is not filed within 60 days of the due date, the minimum penalty of $100 or the balance due, whichever is less, applies. Corporations can avoid the penalty by showing reasonable cause.

***Exercise 1**: Which of the following statements concerning the extension of time to file a corporate tax return is FALSE?*

A. A corporation will receive an automatic 6-month extension of time for filing by submitting Form 7004.
B. The Internal Revenue Service can terminate the extension to file at any time by mailing a notice of termination to the corporation.
C. Form 7004 must be filed by the due date of the corporation's income tax return.
D. An automatic extension of time for filing a corporate income tax return also extends the time for paying the tax due on the return.

D. An automatic extension of time for filing a corporate income tax return also extends the time for paying the tax due on the return. In most cases, a corporation must pay the full amount of the tentative unpaid tax liability estimated on Form 7004 by the original due date.

G. Prompt Assessment - If a dissolving corporation is filing its final return, the corporation may wish to wind up affairs without waiting for the statute of limitations to expire. The corporation would do so by requesting prompt assessment after filing its final return. This request is made by filing Form 48l0, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d). The filing of this form will mean that the IRS must review the return within 18 months of the request.

* **Study Tip** * *Questions on transfers to a corporation have historically been a major concept on Part III of the EA exam. Look for a substantial number of questions relating to transfers. Questions in the past require that you know how to treat such transfers and how basis is determined after the transfer both for the shareholder and for the corporation.*

II. Transfers to a Corporation

A. A corporation is generally formed when a person or persons transfer money or property to the corporation in exchange for stock. A mandatory provision under *§351* enables a tax-free transfer of property if certain conditions are met.

B. No gain or loss is recognized by the person(s) transferring property if that person(s) receives only stock of the corporation and immediately after the transfer, has control (80% or more interest) of the corporation. This enables owners of unincorporated businesses to change their business entity without recognizing any gain on the transfer. (IRC §351)

C. Receipt of Other Property - It is possible to receive money and/or other property in addition to the stock when transferring property to a corporation. This is called "boot' and could result in the recognition of gain. Liabilities transferred with property are considered boot. If the liability assumed by the corporation exceeds the property's adjusted basis, the transferor will recognize gain to the extent of the excess.

* **Study Tip** * *Recognized vs. Realized Gain - Realized gain involves economically incurred gains and losses from which recognized gains and losses are derived. Recognized gain is that much of the realized gain taken into account for purposes of federal income tax reporting. For example, tax-free exchanges of like-kind property frequently involve substantial realized gains, none of which are currently recognized.*

Exercise 2*: Mr. Carol transferred the title of a condo he owned in Mexico to his 100% owned accounting corporation in exchange for stock worth $5,000. Carol used the condo for personal purposes and there was no bona fide business reason for the transfer. At the time of the transfer, the condo had a fair market value of $170,000, an adjusted basis of $160,000, and a mortgage of $165,000 (which was assumed by the corporation). What is the amount of Mr. Carol's recognized gain?*

A. $165,000
B. $10,000
C. $5,000
D. $0

B. $10,000. Without a bona fide purpose, the transfer cannot be made tax free. The $5,000 worth of stock is a dividend. Because liabilities assumed by the transferee corporation on the condo ($165,000) exceed its adjusted basis ($160,000), Carroll recognizes gain to the extent of the excess ($5,000). Thus, the combined taxable gain is $10,000.

IMPORTANT*! Boot, or money, received in an exchange is generally taxable to the transferor. Re careful to consider the boot in an exchange. If the boot received is more than the taxpayer's adjusted basis of the property transferred there may be recognized gain.*

D. The gain or loss on a transfer of property to a corporation will be recognized if the 80% ownership rule is not met after the transfer. The property transferred will be treated as sold at FMV.

* **Study Tip** * *Remember the 80% rule. If there are two or more shareholders, the rule applies if the new shareholders collectively hold 80% or more of the outstanding stock of the corporation. (The adjusted basis of*

the property transferred in a §351 exchange is increased by any gain recognized by the transferor.)

E. If the shareholder receives stock in exchange for services, the shareholder will have taxable compensation. The amount of the compensation will be the shareholder's basis in the stock.

F. Capital Contributions- Contributions by shareholders to the corporation may be made in exchange for stock as paid-in capital. Capital contributions are not taxable to the corporation..

G. Formula to Determine Gain - First determine exactly what the question is asking for: amount realized, gain realized, or gain recognized.

Step 1:
FMV of stock received
+FMV of other property received including cash received
= Amount realized

Step 2:
Amount realized from Step 1
- Adjusted basis of Property transferred Including cash Paid
= Gain realized

Step 3:
FMV of other property received including cash received
+ Debt relief only to the extent it exceed the adjusted basis of all assets transferred
= Boot received

Step 4:
Smaller of "Gain realized" from step 2 or "Boot received" from step 3
= Gain Recognized (Taxed)

Exercise 3: *In exchange for his old stretch limo that had a fair market value of $50, 000 and an adjusted basis of $35,000, Jeeves received 100% of the stock of Wegofast Corporation. The Wegofast stock had a fair market value at the time of the transaction of $40,000. Jeeves also received a used limo that had an adjusted basis to Wegofast of $8,000 and a fair market value at the time of the transaction of $10,000. What is the amount of Jeeves' recognized gain on this transaction?*

A. $0
B. $10,000

C. $13,000
D. $15,000

B. $10,000. The official answer is B. $10,000. However, it is CCH's contention that choice A may also be correct. Choice B is correct if it is assumed that either the limo transferred by Jeeves, or the limo received by him, was held for personal use and not for productive use in a trade or business or for investment (that is, the limos are not like-kind property). If it is assumed that either limo was personal-use property, the usual rules governing transfers to controlled corporations apply. Thus, while transferors generally recognize no gain or loss on transfers of property for stock, transferors recognize gain, but not loss, to the extent of any other property (money or property other than stock of the controlled corporation) received in the exchange. The amount of the gain recognized may not exceed the value of the property received in the exchange. Thus, the $10,000 value of the limo (other property) is taxable to Jeeves. However, if it is assumed that both limos were property held for productive use in a trade or business or for investment, the like-kind exchange rules could apply. Those rules state that neither gain nor loss is recognized when property held for productive use in trade or business or for investment is exchanged for like-kind property. Application of those principles would create in essence a transfer to a controlled corporation coupled with a like-kind exchange of limos. In that case, Jeeves would recognize no gain on the combined transfer.

III. Basis Rules for Stock Received and Property Transferred

A. The basis of stock received by the transferor:

1. In a §351 transfer the basis is the same as the basis of property transferred to the corporation:

   a) DECREASED by:
      - The FMV of other property received,
      - Money received,
      - Liabilities assumed by the corporation, and
      - Loss recognized on the exchange.

   b) INCREASED by:
      - Any amount treated as a dividend, and
      - Any gain recognized on the exchange.

2. In a taxable transaction the basis of stock is its FMV.

B. Basis of property received by the corporation

1. The basis of the property transferred into the corporation in an 80% control transaction as paid-in surplus or as a contribution to capital, is the same as it was in the hands of the transferor prior to the transfer increased by any gain recognized on the exchange.

   Exercise 4: *Kim transferred property with an adjusted basis of $16,000 and a fair market value of $25,000, to Corporation K in exchange for 90% of K's only class of stock and $3,000 cash. The stock received by Kim had a fair market value of $22,000 at the time of the exchange. What is Corporation K's basis in the property received from Kim?*

   A. $25,000
   B. $22,000
   C. $19,000
   D. $16,000

   NOTE: *The holding period of property transferred in a §351 transfer includes the transferor's holding period.*

   . C. $19,000. The basis of the property received by the controlled corporation in exchange for its stock is equal to the transferor's basis in the property ($16,000), increased by the amount of any gain recognized by the transferor ($3,000 as a result of the cash distribution). Thus, corporation K takes the property with a $19,000 basis.

2. The basis of property transferred to a corporation, other than in an 80% control transaction, is the fair market value of the stock received (if it can be determined) or the fair market value of the property transferred (if the stock has no established value).

   Exercise 5: *Ms. R transferred property with an adjusted basis of $60,000 and a fair market value of $55,000 to Rain Corporation. She received in exchange 60% of Rain Corporation's only class of stock At the time of the transfer, the stock Ms. R received had a fair market value of $65,000. What is Rain Corporation's basis in the property after the exchange?*

   A. $0
   B. $55,000
   C. $60,000
   D. $65,000

   . D. $65,000. Because Ms. R receives only 60 percent of the Rain stock, she is not in control, and the transfer is not tax free. Accordingly,

the basis of the property received by Rain in exchange for its stock is equal to the Ms. R's basis in the property ($60,000), increased by the amount of any gain recognized by Ms. R $5,000 ($65,000 fair market value of the stock less $60,000 basis).

SECTION 351 TRANSFER

Assets Transferred	Basis to Corporation	Basis in Stock
Services	Fair market value	Transfer of services for stock results in taxable compensation to shareholder. Basis in stock is the value of the services taxed as compensation
Cash	Fair market value	Amount of cash
Property w/o Liability	Adjusted basis of property received	Adjusted basis of property transferred
Property with liability less than adjusted basis	Adjusted basis of property received (no gain is recognized by shareholder on transfer)	Adjusted basis of property transferred decreased by liability assumed by corporation
Property with liability that is more than adjusted basis	Adjusted basis of property received increased by gain recognized by shareholder (gain recognized is excess of liability over adjusted basis of property)	Adjusted basis of property transferred decreased by liability assumed by corporation and increased by gain recognized

IV. Dividend Received Deduction

A. A corporation is allowed a deduction for a percentage of certain dividends received. The greater the ownership in the corporation issuing the dividends, the greater the percentage of dividends eligible for deduction. For domestic (U.S.) corporations the deduction is:

1. 70% of dividends received or accrued when stock ownership in the paying corporation is less than 20%,

2. 80% of dividends received or accrued if the ownership in the paying corporation is 20% or more,

3. 100% of dividends received if the recipient corporation is a small business investment company, or

4. 100% of dividends received from a member if in the same affiliated group.

B. The dividends received deduction is limited to 70% or 80% of the taxable income of the corporation. There is an ordering rule if the corporation has both types of dividends.

C. The taxable income is determined without regard to an NOL deduction or capital loss carryback. The 80% or 70% taxable income limitation does not apply where the deduction of dividends received either results in, or increases a net operating loss.

D. Dividends received in the form of property are included in income at the lesser of fair market value or adjusted basis to the distributing corporation plus the amount of gain recognized on the transaction.

***Example 1**: (From Publication 542). A corporation loses $25,000 from operations. It receives $100,000 in dividends from a 20%-owned corporation. Therefore, its taxable income is $75,000 before the deduction for dividends received. If it claims the full dividend-received deduction of $80,000 ($100,000 x 80%) and combines it with the operations loss of $25,000, it will have a net operation loss of $5,000. Therefore, the 80% of taxable income limit does not apply. The corporation can deduct $80,000.*

***Example 2**: Assume the same facts as in Example 1 except that the corporation loses $15,000 from operations. Therefore, its taxable income is $85,000 before the deduction for dividends-received. However, after claiming the dividends-received deduction of $80,000 ($100,000 x 80%), its taxable income is $5,000. But because the corporation will not have a net operating loss after a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or $68,000 ($85,000 x 80%).*

V. Extraordinary Dividend

A. If a corporation receives an extraordinary dividend on a share of stock that was held two years or less before the dividend announcement date, the corporation's basis in the stock is reduced, but not below zero, by the non-taxed portion of the dividend.

B. An extraordinary dividend is any dividend on a share of stock that equals or exceeds 5% of the corporation's adjusted basis for the stock that is preferred or 10% of the corporation's adjusted basis for other stock.

VI. Preoperational Expenses

A. Start-Up Costs - These expenses are ordinary and necessary expenses of a business which would be deductible if the business activity had started. The expenses are not currently deductible however, an election may be made to amortize the expenses over a period of not less than 60 months. The period begins with the first month the business becomes active. These expenses may include surveys of potential markets, advertising for the opening of the business, and training wages. It does not include interest, taxes, and research and experimental expenses.

B. Organizational Costs - Expenses directly related to the creation of the business may not be deductible. These expenses may be amortized over a period of not less than 60 month. The election must be made when the first return as an active business is filed. The expenses included in this category would be expense of temporary directors, organizational meetings of directors, fees paid to a state for incorporation, and accounting and legal fees incident to the organization.

Exercise 6*: An accrual basis corporation's organizational expenses are amortizable:*

A. Starting with the month the corporation incurred the expenses.
B. Starting with the month the corporation paid the expenses.
C. Starting with the month the corporation actively engages in business.
D. NEVER, they MUST be capitalized and later deducted when the corporation liquidates.

C. Starting with the month the corporation actively engages in business. A corporation's organizational expenditures may be amortized over any period of at least 60 months that the taxpayer selects, but the period must begin with the month in which the corporation begins business.

VII. Charitable Contributions

A. The deduction for charitable contributions is limited to 10% of the corporation's taxable income.

B. Taxable income is computed without regard to the following:

1. Deduction for the contributions.
2. Deduction for dividends received and paid.
3. Deduction for any NOL or capital loss carryback.

C. Any excess deduction can be carried forward 5 years. There is no allowance for a carryback of excess charitable contributions. Current year contributions are deducted before any carryover contributions and an excess contribution cannot increase an NOL carryover.

***Exercise 7**: During 2001, XYZ Corporation had the following income and expenses:*

Gross receipts		*$1,000,000*
Salaries	*$350,000*	
Contributions to qualified charitable organizations		*$ 75,000*
Operating Expenses		*$395,000*
Dividend income from 20% owned corporation		*$ 65,000*
Dividends received deduction		*$ 52,000*

What is the amount of XYZ's charitable contribution carryover to 2002?

A. $32,000
B. $43,000
C. $51,000
D. $75,000

B. $43,000. The charitable contribution deduction cannot exceed 10 percent of taxable income for the year. For this purpose, taxable income includes dividend income, but is not affected by charitable deduction or the dividends received deduction. Thus XYZ has taxable income for the year of $320,000 ([$1,000,000 gross receipts plus $65,000 dividend income], minus [$350,000 salaries plus $395,000 operating expenses]). The charitable contribution deduction for the year is $32,000 ($320,000 multiplied by 10 percent). This leaves $43,000 ($75,000 minus $32,000) available as a carryover.

VIII. Capital Losses

A. Capital losses are deducted only to the extent of capital gains.

B. Any excess capital losses are carried back three years, then forward five years. Capital losses cannot be carried back or forward to a year the corporation was a S Corporation. If two or more capital losses are carried to the same year, the loss from the earliest year is applied first, either to reduce current gain or as a deduction. The character of any capital loss carryover becomes a short-term capital loss carryover.

***Exercise 8**: McCormick, Inc., a C Corporation, had the following transactions during 2001:*

Long-term gain from sale of land	*$10,000*
Long-term gain from sale of stock	*$20,000*
Long-term loss from sale of securities	*(40,000)*

What is the amount of long-term capital loss that may be taken as a deduction by McCormick in 2001?

A. $0
B. $10,000
C. $30,000
D. $40, 000

C. $30,000. Capital losses of a corporation may be deducted only to the extent of its capital gains.

IX. Net Operating Loss

A. A corporate net operating loss (NOL) is figured in the same way as the corporation's taxable income. The NOL deduction is carried back 3 years and then forward 15 years before 8/6/97 and back 2, forward 20 on or after 8/16/97. There are limitations on the deductions allowed for a corporate NOL such as:

B. The NOL is computed without a deduction for an NOL carryback or carryover *from* other years.

C. The deduction for the dividends received is not limited to a percentage of the corporation's taxable income if the corporation has an NOL.

D. The corporation figures how much of its NOL to deduct in the year it is carried to by subtracting the NOL from the modified taxable income of that carryback or carryover year. If the NOL is greater than the taxable income of the year it is carried to, the corporation must modify its taxable income to determine how much of the NOL is used up in that year and how much is carried over to the next year. The corporation must figure the deduction for charitable contributions without considering any NOL carrybacks.

E. The corporation may elect to forego the carryback period and carry the loss forward. The election is made on a year by year basis.

Exercises 9*: During 2001, Pack Corporation reported gross income from operations of $350,000 and operating expenses of $400,000. Pack Corporation also received dividend income of $100,000 from Smith Inc., a domestic corporation, of which Pack is a 20% shareholder. The NOL carryover from 1999 is $20,000. What is the amount of Pack's net operating loss for 2001?*

A. $50,000
B. $30,000
C $20,000
D. $10,000

B. $30,000. The dividends received deduction is not affected by any NOL carryovers. Further, based on the taxable income limitation discussed in answer #53, above the limitation does not apply here since there would be a net operating loss of $30,000 (negative $50,000 (operating loss) plus $100,000 (dividend) less $80,000 (the otherwise available dividends received deduction based on $100,000 multiplied by 80 percent)). Since the limitation is not applicable, Pack Corporation may deduct the full $80,000, resulting in a current year net operating loss of $30,000, as computed above. Again, the 1993 NOL carryover is irrelevant.

** **Study Tip** * Dividend received deductions, capital loss computations, and NOLs are often 3 point questions for part III of the exam. Practice these computations until you understand them well!*

X. Corporate Tax

A. Corporations are subject to graduated tax rates ranging from 15% to 34% with an additional 5% tax for corporations with taxable income in excess of $100,000, then 35% over $10 million. There is an additional 3% surtax for incomes over $15 million.

Taxable Income		**Tax** is	**Of the amount over**
Over	**But not over**		

$0	$50,000	15%		$0
50,000	75,000	$7,500	+25%	50,000
75,000	100,000	13,750	+34%	75,000
100,000	335,000	22,250	+39%	100,000
335,000	10,000,000	113,900	+34%	335,000
10,000,000	15,000,000	3,400,000	+35%	10,000,000
15,000,000	18,333,333	5,150,000	+33%	15,000,000
18,333,333			35%	0

B. **Personal Service Corporations** - PSCs are taxed a flat 35% for tax years beginning on or after 1-1-93. PSCs are professional corporations performing services in the fields of accounting, health, law, architecture, engineering, actuarial science, performing arts, or consulting.

C. **Alternative Minimum Tax** - The corporate AMT is similar to the individual AMT. The rate for corporations is 20%. The corporation is allowed a $40,000 exemption which is reduced by *25%* of the amount by which the alternative minimum taxable income exceeds $150,000. The tax due is the greater of the alternative minimum tax or the regular tax.

Exercise 10: *Given the following facts, what is the amount of Wood Corporation's alternative minimum tax?*

Taxable income before net operating loss deductions	*$85,000*
Total adjustments to taxable income	*(2,000)*
Total tax preference items	*$45,000*
Regular income tax	*$17,150*

A. $1,250
B. $850
C. $450
D. $0

C. $450. Alternative minimum tax is the excess of tentative alternative minimum tax over the regular tax liability. In this case, tentative alternative minimum tax is $17,600, determined by adding taxable income ($85,000) to preference items ($45,000), subtracting total adjustments to taxable income ($2,000), subtracting the exemption amount ($40,000), and multiplying by the alternative minimum tax rate of 20 percent. (That is: $85,000 plus $45,000 equals $130,000 less $2,000 equals 128,000 less $40,000 equals $88,000 multiplied by 20% equals $17,600.) Because regular tax liability ($17,150) is less than the tentative alternative minimum tax ($17,600), the excess ($450) is the alternative minimum tax.

D. **Estimated Tax**

1. A corporation must make estimated tax payments if it is expected to have a tax liability of $500 or more.

2. A corporation making estimated tax payments must do so by making installment payments of its "required annual payment," which equals the lesser of 100% of the tax shown on the return for the current year or 100% of the tax shown on the prior year's return. The corporation is not allowed to base the required annual payment on 100% of the prior year's tax if:

   a) The corporation did not file a return for the preceding tax year showing a tax liability.

   b) The preceding year was a tax year of less the 12 months.

   c) The corporation is considered a "large corporation" for federal income tax purposes. A corporation is a large corporation if it had taxable income of $1,000,000 or more for any of the three immediately preceding years.

XI. Corporate Earnings and Profits

A. The calculation of earnings and profits is necessary to determine the status of corporate distributions. Earnings and profits differ from retained earnings since the later is measured on tax basis rather than book basis.

B. The calculation of earnings and profits begins with taxable income and is adjusted as follows:

1. Subtract the actual federal tax liability

2. Add the full amount of capital losses and charitable contributions incurred during the year. Adjustments to taxable income must be made to avoid a double deduction when the carryovers are used.

3. Adjust the insurance deduction for the amount of the premiums in excess of the cash surrender value.

4. Subtract nondeductible interest expenses and nondeductible contributions.

5. Add tax-exempt interest

6. Add insurance proceeds in excess of the cash surrender value.

7. Add the recovery of debt previously written off but not deducted on the tax return.

8. Add the difference between the depreciation deducted on the tax return and the straight line depreciation allowed for earnings and profits.

C. Distributions first reduce current earnings and profits. Any excess reduces accumulated earnings and profits.

Exercise 11: *Vernon Corporation, a calendar-year C Corporation, had accumulated earnings and profits of $100,000 as of January 1, 2001. Vernon had a deficit in earnings and profits for 2001 in the amount of ($140,000). Vernon distributed $35,000 cash to its shareholders on July 1, 2001. Vernon Corporation's accumulated earnings and profits as of December 31, 2001 is:*

A. $0
B. ($40,000)
C. ($70,000)
D. ($75,000)

C. Negative $70,000. On the distribution date, July 1 (the half-way point in the calendar year), Vernon had earnings and profits of $30,000 ($100,000 accumulated minus $70,000 first half-year deficit in current earnings and profits). Of the $35,000 distributed, only $30,000 is a dividend (the amount of earnings and profits). Therefore, only $30,000 is subtracted from remaining earnings and profits, leaving a balance of $0 on that date. The corporation's accumulated earnings and profits as of December 31, 2001, is a $70,000 deficit (the $70,000 second half-year deficit in current earnings and profits plus the $0 accumulated balance resulting from the July 1 distribution).

D. Accumulated Earnings Tax

1. If the corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of 39.6%.

2. An accumulation of $250,000 or less is considered to be within reasonable limits. This limit is $150,000 for PSCs.

Exercise 12: *Blitz, an accrual method C Corporation, had unappropriated retained earnings of $50,000 as of December 31, 2001. For its 2002 tax year, Blitz's books and records reflect the following:*

Net income per books (after federal income taxes)	*$125,000*
Cash distributions	*$ 12,500*
Federal income tax refund	*$ 17,000*

Based on the above, what is Blitz Corporation's unappropriated retained earnings as of December 31, 2002?

A. $204,500
B. $192,000
C. $179,500
D. $175,500

C. $179,500. Unappropriated retained earnings equal the opening balance ($50,000), plus net income ($125,000), plus the tax refund ($17,000), minus the cash distributions ($12,500).

XII. Distributions

A. Distributions from a corporation are taxed according to type. They may be dividends, stock distributions, or a return of capital.

B. Distributions from corporate earnings and profits are paid to shareholders as dividends. (This does not apply to S Corporations without prior C Corporation retained earnings since all earnings pass through to shareholders.) Taxable distributions (dividends) are first paid from the current earnings of the corporation and then from accumulated earnings. The profit of the corporation can be paid out to the shareholders, retained, or accumulated for future use.

1. If the corporation's accumulated earnings is negative at the end of the year, but was positive at the time the distribution was made, to the extent of the earnings, the distribution will be a taxable dividend.

2. Dividends of $10 or more are reported on Form 1099-DIV. The 1099-DIV is due to the shareholders by January 31 and to the IRS by February 28.

C. Nontaxable dividends are distributions that exceed the corporation's accumulated earnings and profits. Form *5452,* Corporate Report of Nondividend Distributions, must be filed if nontaxable dividends are paid to shareholders. The shareholders will received a Form 1099-DIV including the amount.

D. Earnings and profits are reduced by any distributions made in cash and by the adjusted basis of any property distributed, but not below zero. Distributions in excess of earnings and profits are generally not taxable, but will reduce the basis in the shareholder's stock. If the distribution exceeds the basis in stock, it is treated as gain from the sale of property and generally receives capital gain treatment.

E.

Exercise 13*: Dublin, a calendar-year C Corporation, had accumulated earnings and profits of $32,000 as of January 1, 2001. Dublin had a deficit in earnings and profits for 2001 of $40,000. On October 1, 2001, Dublin distributed $15,000 to one of its shareholders, Mr. Murphy. The adjusted basis of Murphy's stock before the distribution was $2,000. what is the amount of Murphy's ordinary dividend income and capital gain as of the date of the distribution?*

	Dividend Income	Capital Gain
A.	$0	$13,000
B.	$2,000	$13,000
C.	$2,000	$11,000
D.	$15,000	$0

C. $2,000 dividend income; $11,000 capital gain. Because the distribution date is October 1 (three-fourths into the calendar year), $30,000 of the current year's earnings and profits deficit ($40,000 multiplied by 3/4) reduces the accumulated earnings and profits as of that date to $2,000 ($32,000 minus $30,000). A dividend cannot exceed earnings and profits. Thus, only $2,000 of the distribution is a dividend. The next $2,000 eliminates Murphy's basis in his stock, and the remaining $11,000 is treated as a capital gain.

E. Stock Distributions - Distributions of stock or rights to acquire stock are not taxable to the shareholder unless:

1. The distributions are made in lieu of money or the shareholder could elect to receive the cash equivalent,

2. The distribution is disproportionate,

3. The distribution is made on preferred stock,

4. It is a distribution of convertible preferred stock unless it does not result in a disproportionate distribution, or

5. A distribution of common and preferred stock resulting in the receipt of preferred stock by some common stock shareholders and common stock by other common stock shareholders.

F. The distribution of appreciated property is being treated as if it were sold. The corporation recognizes gain on the excess of the FMV over the adjusted basis of the property. The character of the gain will be determined by the type of property distributed. Some of the gain may be ordinary based on the recapture rules.

Exercise 14*: Belle Corporation owns as an investment, 10% of the stock of Gaston Corporation with an adjusted basis of $4,000 and a fair market value $44,000. Belle uses the Gaston stock to redeem approximately 1%, or $10,000 par value, of its own outstanding stock from unrelated, noncorporate shareholders. As a result oft his transaction, Belle must report a gain of:*

A. ($15,000)
B. $0
C. $2,000
D. $44,000

C. $40,000. A corporation that distributes property in redemption of its stock generally recognizes gain, but not loss, if it pays all or part of the redemption price by transferring property whose fair market value exceeds its basis to the corporation. Thus, Belle Corporation must recognize the $40,000 gain inherent in the difference between the value of the Gaston stock ($44,000) and its basis ($4,000).

G. If property being distributed is subject to a liability which is greater than the adjusted basis of the property, the fair market value is treated as not less than the liability assumed or acquired by the shareholder.

Exercise 15*: Rally Corporation distributed a sailboat to its sole shareholder, Ms. H At the time of the distribution, the sailboat had a fair market value of $175,000 and an adjusted basis to Rally of $150,000. The sailboat was subject to a loan of $190,000, which Ms. H assumed. What is the amount of Rally's gain or (loss) on the distribution.?*

A. ($15,000)
B. $0
C. $25,000
D. $40,000

D. $40,000. A corporation that makes an in-kind shareholder distribution of property subject to a liability recognizes gain as if it had sold the property to the shareholder at an amount not less than the liability.

H. Distributions of stock in satisfaction of debt may is taxable to the recipient. The fair market value of the stock is considered the payment. If the value of the stock is less than the debt satisfied, the corporation will recognize debt forgiveness income.

***Exercise 16**: Scott Corporation transferred stock with a fair market value of $20,000 to its creditor in satisfaction of indebtedness of $30,000. The stock's book value was $15,000. How much income from this transaction should Scott include' in its 1999 income tax return?*

A. $0
B. $5,000
C. $10,000
D. $15,000

C. $10,000. If a corporation issues stock to a creditor in satisfaction of its indebtedness, the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. The excess of the debt ($30,000) over the fair market value of the stock ($20,000) is income to the corporation.

XIII. Liquidations

A. A liquidation is generally accomplished by the corporation redeeming (buying back) its outstanding stock for cash, property, or a combination of both. This redemption is treated as if the corporation sold the property for fair market value to the shareholder for his or her stock. If property is subject to a liability, the FMV cannot be less than the liability assumed by the shareholder.

B. Distributions to shareholders are considered full payment in exchange for the stock. They are reported on Schedule D or Form 4797, Sales of Business Property, if the stock is qualified § 1244 stock.

***DEFINITION**: §1244 Stock is the stock of a domestic corporation issued after 11/6178 subject to the following requirements. The stock must be original issue stock issued in exchange for money or property. The issuing corporation must have must have capitalization of $1 million or less.*

Exercise 17: *when is a corporation required to file a Form 1099-DIV for a liquidating distribution?*

A. Never, liquidating distributions do NOT require a Form 1099-DIV
B. When the' liquidating distribution equals or exceeds $10 in a calendar year.
C. When the liquidating distribution equals or exceeds $600 in a calendar year.
D. Always, liquidating distributions in any amount require the filing of a Form 1099-DIV

C. When the liquidating distribution equals or exceeds $600 in a calendar year. When a corporation makes distributions to a shareholder, in partial or complete liquidation, that exceed $600 in any one calendar year, the corporation must furnish the shareholder with Form 1099-DIV.

C. Partial Liquidation - a redemption of stock by a non-corporate shareholder is treated as a sale or exchange of the stock if:

1. The distribution in redemption of the stock is not essentially equivalent to a dividend (determined at the corporate rather than the shareholder level). A distribution will not be considered equivalent to a dividend if:

    a) The distribution is attributable to the distributing corporation's ceasing to conduct a qualifying trade or business which was actively conducted throughout the 5-year period ending on the date of the redemption.

    b) Immediately after the distribution, the distributing corporation must be actively engaged in conducting another trade or business that also had been carried on for at least five years before the redemption.

2. The distribution is made pursuant to a plan of partial liquidation, or

3. The distribution is made either in the year the plan of partial liquidation is adopted or in the following year.

D. Partial distributions to a corporate shareholder in redemption of stock (other than one that is in complete liquidation or is substantially disproportionate) are treated as dividends to the extent of earnings and profits of the corporation.

E. Basis of Property Received in Liquidation - If gain or loss is recognized, the basis of the property is the fair market value at the time of the distribution. If gain or loss is not recognized, the basis is the shareholder's adjusted basis in the stock given up.

Exercise 18: *Select the answer that best describes what happens when shareholders receive a series of distributions, NOT part of an installment obligation, covering two or more consecutive tax years in redemption of ALL of the stock of a corporation pursuant to a plan intended to result in the complete liquidation of the corporation.*

A. The shareholders will be allowed to recover their respective basis in the stock before recognizing any gains.
B. The shareholders will treat the distributions as dividends to the extent of the corporation's earnings and profits.
C. The shareholders will recognize a pro- rata portion of the gain in each of the years that distributions are received
D. NO losses from the transactions will be deductible.

A. The shareholders will be allowed to recover their respective basis in the stock before recognizing any gains. If a corporation makes a series of distributions in the course of a complete liquidation, each shareholder is entitled to recover his entire basis in his shares before recognizing gain.

XIV. Controlled Groups

A. A controlled group of corporations is limited to one apportionable $50,000 amount and one $25,000 amount in each taxable income bracket below 34%. The income must be apportioned equally unless there is an apportionment plan adopted. The statement of consent must be attached to the return of each corporation. A parent-subsidiary is the only controlled group allowed to file a consolidated return. The controlled group is allowed one $250,000 accumulated earnings credit for the group.

B. Parent - Subsidiary: These corporations are connected through stock ownership with a common parent corporation and:

1. 80% or more of the voting stock or 80% or more of all classes of stock of each corporation is owned by one or more of the other corporations.

2. The common parent owns 80% or more of voting stock or 80% or more of all classes of stock of at least one of the other companies.

C. Brother - Sister: These are two or more corporations who are owned by the same five or fewer persons who own:

1. 80% or more of voting stock or 80% or more of the total value of all classes of stock of each corporation, and

2. 50% or more of voting stock or 50% or more of the total value of all classes of stock if taking into consideration the stock owned by these 5 or fewer shareholders to the extent of identical ownership.

D. Combined Group

1. A group of three or more corporations,

2. Each corporation is a member of a parent-subsidiary or brother-sister group, and

3. At least one of the corporations is the common parent of a parent-subsidiary and is also a member of a brother-sister controlled group.

Exercise 19: *With regard to a controlled corporate group, all of the following statements are CORRECT* ***except****:*

A. The controlled group is allowed only ONE set of graduated income tax brackets.
B. Controlled groups are allowed ONE $40,000 exemption amount for alternative minimum tax purposes.
C. The controlled group is allowed a $250,000 accumulated earnings credit for EACH member.
D. The tax benefits of the graduated rate schedule are to be allocated equally mount the members of the group unless they all consent to different apportionment.

C. The controlled group is allowed a $250,000 accumulated earnings credit for EACH member. A controlled corporate group is permitted only one $250,000 accumulated earnings credit, shared among the members.

XV. Constructive Ownership of Stock

A. By Family Members - An individual is considered to own the stock owned either directly or indirectly by the following family members.

1. Spouse (other than a spouse who is legally separated under a decree of divorce or separate maintenance), and

2. Children, grandchildren, and parents.

3. For the purpose of the redemption of stock under §302, brothers and sisters are considered family members.

B. By the Corporation - The corporation is considered to own the stock owned directly or indirectly by any individual who owns *50%* or more of the value of the stock of the corporation.

C. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.

D. Any individual owning, other than by applying (A), any stock in a corporation, is treated as owning the stock owned, directly or indirectly, by or for his/her partner.

E. Stock Options - If an individual has an option to acquire stock, that stock should be considered owned by the individual.

F. Stock constructively owned by a person under paragraph (C), for purposes of applying paragraphs (A), (B), or (D), is treated as actually owned by that person. But stock constructively owned by an individual under paragraph (A) or (D) is not treated as owned by him or her, for again applying either paragraph (A) or (D), to make another person the constructive owner of that stock.

Exercise 20*: Ranger Corporation's only class of stock is owned as follows:*

Matthew	*40%*
Darlene, Matthew's sister	*25%*
Matthew's and Darlene's father	*25%*
Matthew's and Darlene's grandfather	*10%*

What is Matthew's percentage of stock ownership under the attribution rules for stock redemption?

A. 65%
B. 75%
C 90%
D. 100%

A. 65 percent. An individual is treated as constructively owning stock owned directly or indirectly by his spouse, children, grandchildren and parents. Thus, Matthew is treated as owning his shares (40 percent) and his father's (25 percent).

** **Study Tip** *: Attribution and related party rules apply differently in different situations. Be sure to see exactly what the question is asking for, before you decide which application applies.*

** **Study Tip** *: Occasionally, the IRS will put what seems to be a uncommon question on the exam. If the question is unusual, you may not have studied that area. Concentrate on the questions that are most common. Here is last year's unusual question for Part III.*

***Exercise 21**: One of the factors that is considered in establishing whether a foreign corporation's fixed or determinable annual or periodic income from US. sources is effectively connected with a US. trade or business is whether the activities of that trade or business were a material factor in the realization of the income generated. (True or False).*

True. One test for determining when fixed or determinable annual or periodical income, gains or losses are effectively connected with a U.S. trade or business is whether the activities are a material factor in the realization of the income generated.

SECTION B - S CORPORATION

I. Requirements to Qualify for S Corporation Status

A. Domestic Corporation - It must be a corporation that is either organized in the United States or organized under federal or state law. The term "corporation" includes a joint-stock company, certain insurance companies, or an association that has the characteristics of a corporation.

B. One Class of Stock - All outstanding shares of the corporation confer identical rights to distributions and liquidation proceeds. Stock may have differences in voting rights and still be considered one class of stock.

C. Number of Shareholders Limited - It must have no more than **75** shareholders. When counting shareholders, the following rules apply:

1. Count the persons who are considered beneficiaries if the stock is actually held by a trust. Do not count the trust itself as a shareholder.

2. Count a husband and wife and their estates, as one shareholder, even if they own stock separately.

3. Otherwise, count everyone who owns any stock, even if the stock is owned jointly with someone else.

D. It must have as shareholders only individuals, estates (including estates of individuals in bankruptcy), and certain trusts. Partnerships and corporations cannot be shareholders in an S Corporation.

E. It must have shareholders who are citizens or residents of the United States. Nonresident aliens cannot be shareholders. U.S. residents married to alien spouses who have an ownership interest in the stock through community property laws will not be eligible shareholders. (§1.1361 - 1(G))

Exercise 22*: All of the following would qualify as a shareholder of an S Corporation* ***except****:*

A. A resident of the United States
B. An estate of an individual in bankruptcy
C. A trust owned by an individual who is a United States citizen.
D. A partnership.

D. A partnership. Only individuals and specified trusts and estates may be S corporation shareholders. Other entities, including partnerships and corporations, are ineligible.

F. The following domestic corporations are ineligible to elect S Corporation status:

1. A member of an affiliated group of corporations.

2. A Domestic International Sales Corporation (DISC) or former DISC.

3. A corporation that takes the Puerto Rico and possessions tax credit for doing business in a United States possession.

4. A financial institution that is a bank, including mutual savings banks, cooperative banks, and domestic building and loan associations.

5. An insurance company taxed under Subchapter L of the Internal Revenue Code.

II. Electing S Corporation Status

A. If the corporation meets the eligibility requirements it must file Form 2553, Election By Small Business Corporation, to elect S Corporation status.

B. The election requires the consent of all shareholders of record on the date filed. If filed after the beginning of the tax year for which it is to be effective, the consent of any shareholder that owned stock on any day during the tax year before the date of filing Form 2553 is needed.

C. Select a Tax Year - The permitted tax year is the calendar year, or any other accounting period for which the corporation establishes a substantial business purpose to the satisfaction of the IRS. In addition, an S Corporation may elect under §444 to have a tax year other than the permitted tax year.

D. File Form 2553 with the IRS center where the S Corporation will file its income tax return. The election of S Corporation status is effective for a tax year if Form 2553 is filed at any time during the previous tax year or by the 15th day of the third month of the tax year to which the election is to apply.

III. Separately Stated Items

A. Items of income, loss, expense, and credit that must be separately stated are those items that, when separately treated on the shareholder's income tax return (not as part of a lump sum amount) could affect the shareholder's tax liability.

B. Some items included are:

1. Net income or loss from rental real estate or other rental activities,
2. Portfolio income or loss (interest, dividends, royalty income, capital gains/losses) and expenses related to portfolio income or loss,
3. Section 1231 net gain or loss, Section 179 expense deduction,
4. Charitable contributions,
5. Health insurance premiums,
6. Credits (low-income housing credit, qualified rehabilitation expenses, etc.),
7. Investment interest expense, and
8. Tax preference and adjustment items needed to figure shareholder's alternative minimum tax.

IV. Related Parties for Disallowed Losses

A. The family of an individual includes only his or her brothers and sisters (half-brothers or half-sisters), spouse, children, grandchildren, and parents.

B. Two corporations that are members of the same controlled group of corporations determined by applying a 50% ownership test.

C. An individual and a corporation if more than 50% of the value of the outstanding stock is owned by the individual.

D. A trust fiduciary and a corporation if the trust or grantor of the trust owns more than 50% in value of the outstanding stock of the corporation.

F. The grantor and a fiduciary of any trust, a fiduciary of a trust and a beneficiary of the trust.

F. Any two S Corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.

G. An S Corporation and a corporation that is not an S Corporation if the same persons own more than *50%* in value of the outstanding stock of each corporation.

H. A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest in the partnership.

V. Related Parties for Deducting Business Expenses

A. An accrual method S Corporation must use the cash method for purposes of deducting business expenses and interest owed to cash method related parties. For this purpose, related parties also include:

   1. An S Corporation and a shareholder who owns, directly or indirectly, any stock of the S Corporation.

   2. An S Corporation and any person who owns, directly or indirectly, any capital or profits interest of a partnership in which this S Corporation owns, directly or indirectly, any capital or profits interest. This rule applies to a transaction only if this transaction is related either to the operations of the partnership or to an interest in this partnership.

3. Any person related under the related party rules to a person described in (A) or (B).

B. This rule will apply even if the S Corporation and the related person cease to be related before the expenses or interest are includible in that person's gross income.

VI. S Corporation Taxes

A. An S Corporation may be subject to the following taxes:

1. The tax on excess net passive income,

2. The tax on certain capital gains,

3. The tax on built-in gains,

4. The tax from recomputing a prior-year investment credit, or

5. LIFO recapture tax.

B. The corporation (not the shareholder's individually) must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year. If the tax totals $500 or more, quarterly estimated payments are required. Tax payments and estimated payments must be deposited with an authorized financial institution or Federal Reserve Bank and must be accompanied by a federal tax deposit coupon. Payments are not sent to the IRS.

VII. Tax On Excess Net Passive Income

A. If an S Corporation has pre-S Corporation earnings and profits at the end of a tax year and its passive investment income is more than 25% of its gross receipts, the S Corporation may be subject to a tax on excess net passive income. If passive investment income is more than *25%* of gross receipts for 3 consecutive tax years and the corporations has pre-S Corporation earnings and profits at the end of each of those years, the corporation's status as an S Corporation will be terminated.

1. Gross receipts is the total amount an S Corporation receives or accrues under the method of accounting it uses to figure its taxable income. This includes the total amount received or accrued from the sale or exchange of any kind of property (except capital assets and stock or securities), from services rendered, or from investments. Only the capital gain net income from

the sale or exchange of capital assets and only the gains from the sale or exchange of stock or securities are included in gross receipts.

2. Passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities, and sale or exchanges of stock or securities. Rent does not include payments for use or occupancy if significant services are also provided. Interest includes tax-exempt interest and unstated interest.

3. Net passive income is passive investment income reduced by deductions directly connected with the production of passive investment income.

4. Excess net passive income is the amount that has the same ratio to net passive income as the amount of passive investment income that exceeds *25%* of gross receipts has to passive investment income. This cannot be more than the S Corporation's taxable income for the year.

B. An S Corporation is liable for a tax at a rate of 35% on excess net passive income.

DEFINITION*: Excess net passive income = net passive income x [(passive investment income - 25% of gross receipts) / passive investment income]*

Exercise 23*: In the context of the tax on excess net passive income paid by S Corporations, net passive income does NOT include:*

A. Interest and dividends.
B. Annuities.
C. Net operating losses.
D. Sales or exchanges of stock

C. Net operating losses. Net passive income includes the gross receipts derived from royalties, rents, dividends, interest, annuities, and the sale or exchange of stock or securities. The term does not include "net operating losses."

VIII. Capital Gains Tax

A. An S Corporation that elected S Corporation status before 1987 may be liable for a capital gains tax if:

1. Its net long-term capital gain exceeds its net short-term capital loss by more than $25,000,

2. The excess is more than 50% of the corporation's taxable income, and

3. Taxable income is more than $25,000.

B. If the S Corporation is also liable for the tax on excess net passive income it should figure that tax before figuring the capital gains tax.

IX. Tax On Built-In Gains

A. If an S Corporation has a net recognized built-in gain for any tax year beginning in the recognition period, a tax is imposed on the income of the S Corporation for that tax year.

1. The tax generally applies only to a corporation that converted from a regular corporation to an S Corporation after 1986.

2. The recognition period is the 10-year period beginning with the first day of the first tax year the corporation was an S Corporation.

B. Net Recognized Built-In Gain

1. The least of the amount that would be taxable income of an S Corporation for the tax year if only recognized built-in gains and recognized built-in losses were taken into account,

2. The amount that would be taxable income of the corporation if it were not an S Corporation, or

3. The amount by which its net unrealized built-in gains is more than its net recognized built-in gain for all prior tax years in the recognition period (net unrealized built-in gains limitation).

C. Recognized Built-In Gains - Any gain recognized on the disposition of any asset during the recognition period, except to the extent the S Corporation shows that:

1. The asset was *not* held by the S Corporation as of the beginning of its first tax year as an S Corporation, or

2. The gain is more than the fair market value of the asset at the beginning of the first tax year minus the adjusted basis of the asset at the beginning of that year.

D. Recognized Built-In Loss - Any loss recognized when any asset is disposed of during the recognition period, to the extent the S Corporation shows that:

1. The asset was held by the S Corporation at the beginning of the first tax year as an S Corporation, and

2. The loss is not more than:

   a) The adjusted basis of the asset at the beginning of its first tax year as an S Corporation, minus
   b) The fair market value of the asset at the beginning of that year.

3. Amount of tax is figured by applying the highest corporate rate (35%) to the net recognized built-in gain for the tax year.

X. Stock Basis

A. The beginning basis of stock is determined by what was transferred to the corporation in exchange for the stock. If money was transferred for stock, the amount transferred is the beginning basis of the stock. *(See the chart on Section 351 transfer for the basis of stock when property other than money was transferred for the stock)*

B. Increases - The following items increase the shareholder's basis in S Corporation stock:

1. All income items of the S Corporation, including tax-exempt income, that are separately stated and passed through to the shareholder,

2. Any non-separately stated income of the S Corporation, and

3. The amount of the deductions for depletion that is more than the basis of the property being depleted.

C. Decreases - The following items decrease basis:

1. Distributions by the S Corporation that were not included in the shareholder's income (Example - corporation distributes a vehicle to the shareholder),

2. All loss and deduction items of the S Corporation that are separately stated and passed through to the shareholder,

3. Any non-separately stated loss of the S Corporation,

4. Any expense of the S Corporation that is not deductible in figuring its income and not properly chargeable to a capital account (Example - fines, 50% of meal and entertainment expenses), and

5. The shareholder's deduction for depletion of oil and gas property held by the S Corporation to the extent it does not exceed the proportionate share of the adjusted basis of that property allocated to the shareholder.

***Exercise 24**: All of the following would reduce the basis of a shareholder's stock in an S Corporation **except**:*

A A shareholder's pro rata share of any nonseparately stated loss of the S Corporation.
B A shareholder's share of all loss and deduction items of the S Corporation that are separately stated.
C. A shareholder's pro rata share of any nondeductible expenses of the S Corporation that are not properly chargeable to capital account.
D. A shareholder's pro rata share of any nonseparately stated income of the S Corporation.

D. A shareholder's pro rata share of any nonseparately stated income of the S corporation. Allocations of income increase a shareholder's basis. They do not decrease basis.

XI. Loan Basis

A. If stock basis decreases exceed the amount needed to reduce stock basis to zero, the excess (excluding a decrease due to distributions) will be used to reduce the basis of any loans the shareholder made to the corporation.

B. If a shareholder's loan basis is reduced, any increase for a later year requires that loan basis must be restored before increasing stock basis.

C. Distributions that exceed stock basis are taxed as capital gains and do not reduce loan basis.

** **Study Tip** * Basis for an S Corporation fluctuates more than for a C Corporation. The reason is that the S Corporation is a pass-through entity transferring the taxation of gains and losses directly to the shareholder. Since loans to the corporation allow a shareholder additional basis in which losses can be deducted, the repayment of such loans may result in income to the* *shareholder. Untaxed items (for example: tax exempt interest) also adjust the basis of the shareholders stock.*

XII. At-Risk Limitations

A. The deductible loss allow to the shareholder of an S Corporation may be limited by the at-risk rules.

B. A shareholder is at risk for the following amounts

1. The shareholder's cash contributions and the adjusted basis of property contributed to the corporation by the shareholder, plus

2. Amounts borrowed for use in the activity either that the shareholder is personally liable for the repayment of, or for which the shareholder has pledged property not used in the activity as security.

C. The limitation applies at the shareholder level.

Exercise 25*: On January 1, 2001, Mr. Karl purchased 50% of Olive Inc., an S Corporation, for $75,000. At the end of 2001, Olive Inc. incurred an ordinary loss of $160,000. How much of the loss can Mr. Karl deduct on his personal income tax return for 2001?*

A. $160,000
B. $80,000
C. $75,000
D. $37,500

C. $75,000. The amount of losses and deductions an S corporation shareholder can claim is limited to the adjusted basis of the shareholder's stock. Thus, Karl can deduct only $75,000 of the loss.

XIII. Distributions

A. S Corporation With No Earnings and Profits (a corporation which has always been an S Corporation or a prior C Corporation that distributed all retained earnings) -Distributions would be a treated as a nontaxable return of capital and/or gain from the sale of property. The type of gain will be determined at the end of the year after the shareholder has adjusted basis for any increases and decreases attributable to the current year.

1. Distributions up to the adjusted basis are treated as a nontaxable return of capital.

2. If the distributions are more than the adjusted basis in the shareholder's stock, the excess is a gain from the sale or exchange of property. As such, the gain is generally long- or short-term capital gain.

   Exercise 26*: Mr. Oliver received a distribution from an S Corporation that was in excess of the basis of his stock in the corporation. The S Corporation had NO earnings and profits. Mr. Oliver should treat the distribution in excess of h is basis as:*

   A. A return of capital.
   B. Previously taxed income.
   C. A capital gain.
   D. A reduction in the basis of his stock.

   C. A capital gain. For S corporations having no accumulated earnings and profits, distributions are tax-free up to the shareholder's basis in the corporation's stock. Distributions in excess of stock basis are treated as a capital gain.

B. S Corporation With Earnings and Profits - If an S Corporation has earnings and profits but has not elected to distribute them first, any distribution it makes will come from one or more of the following sources in the following order:

1. Treated as coming out of the accumulated adjustments account (AAA). A distribution out of AAA is applied against and reduces the shareholder's adjusted basis in the stock. A distribution out of AAA in excess of basis is treated as gain from the sale or exchange of property. If distributions during the tax year exceed the AAA at the close of the tax year, the AAA generally is allocated to each distribution made during the year in proportion to the sizes of the distributions.

2. If the shareholder has pre-1983 previously taxed income (PTI), the PTI is the next source of distribution. This is a nontaxable distribution which is applied against and reduces the shareholder's basis in stock.

3. A distribution is then treated as coming out of the prior C Corporation's earnings and profits (Retained Earnings). This distribution is treated as a dividend up to the amount of corporation's earnings and profits. This does not change the shareholder's stock basis.

4. A distribution is applied against and reduces the shareholder's basis in stock.

5. The distribution is treated as a sale or exchange of property.

__Example__: Cord, an S Corporation, has accumulated earnings and profits of $10,000. It distributes $80,000 to its only shareholder, Don. His basis in the stock is $50,000. Cord has $30,000 in its AAA. The order of distributions and how they are taxes follow:

Distribution	*Source*	*Type of Distribution*	*Taxable Yes/No*
$80,000	*Form AAA*	*Reduction in Basis*	*No*
-30,000			
$50,000	*From E&P*	*Dividend*	*Yes*
-10,000			
$40,000	*Remaining Basis*	*Reduction in Basis*	*No*
-20,000			
$20,000	*Excess of Basis*	*Sale or Exchange of Property*	*Yes*
-20,000			
0			

C. If the S Corporation with earnings and profits elects to distribute earnings and profits first, all shareholders receiving distributions during the year must consent to the election. The election is binding for that year only. After all earnings and profits have been distributed, the S Corporation will treat all remaining distributions under the rules for S Corporations with no earnings and profits.

__Exercise 27__: In 1999, Lisa acquired 100% of the stock of Computers Inc. for $25,000 cash. Computers Inc. incurred a loss of $7,800 for 1999. On January 1, 2000, Computers Inc. properly elected S Corporation status. Its net income for 2001 was $10,000. A dividend of $2,500 was declared and paid in 2001. What is Lisa's basis in Computers Inc. as of December 31, 2001?

A. $35,000
B. $32,500
C. $25,500
D. $25,000

B. $32,500. Lisa's basis in Computers without taking the dividend into account was $35,000 ($25,000 purchase price plus $10,000 income). The $2,500 dividend reduces that basis to $32,500. The $7,800 loss (a C corporation year) is a built-in loss and does not affect the basis computation.

NOTE: *The IRS exam may call S Corporation distributions, dividends. This does not necessarily mean that the S Corporation was a prior C Corporation with retained earnings.*

XIV. Terminating S Corporation Status

A. An S election can be revoked for any tax year. It can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S Corporation's stock consent to the revocation. The consenting shareholders must own their stock at the time the revocation is made.

B. The revocation would be effective:

1. On the first day of the tax year if the revocation is made by the 15th day of the 3rd month of the same tax year,

2. On the first day of the following tax year if the revocation is made after the 15th day of the third month, or

3. On the date specified if the revocation specifies a date on or after the day the revocation is made.

C. Terminating an S election means that a corporation generally may not re-elect S status for a period of 5 years.

XV. Ceasing To Qualify

A. Certain events may cause the S Corporation to cease to qualify.

B. Terminating events include:

1. Having more than 75 shareholders,

2. Transferring stock in the S Corporation to a corporation, a partnership, an ineligible trust, or a nonresident alien,

3. Creating a second class of stock, or

4. Acquiring a subsidiary, other than certain non-operating subsidiaries.

NOTE: *The termination will be effective as of the date the terminating event took place.*

C. Violating the passive income restrictions will terminate the S election if both of the following conditions occur for three consecutive years:

1. It has pre-S Corporation earnings and profits at the end of each tax year, and

2. Its passive investment income for each tax year is more than 25% of gross receipts.

NOTE: *Termination will become effective on the first day of the tax year that follows the third consecutive tax year referred to above.*

Exercise 28*: Which of the following events would cause an S Corporation to cease to qualify as an S Corporation?*

A. A 25% shareholder sells her shares to an individual who wants to revoke S Corporation status.
B. The corporation is liable for tax on excess net passive investment income for two consecutive years.
C. A shareholder has zero basis in his stock
D. The S Corporation issues its stock to another corporation.

D. The S corporation issues its stock to another corporation. Only individuals and specified trusts and estates may be S corporation shareholders. Other entities, including corporations and partnerships, are ineligible. Thus, issuing stock to a corporation renders the corporation ineligible for subchapter S status.

SECTION C - FIDUCIARIES, ESTATES, AND GIFT TAX

RETURNS FOR DECEDENTS

Form	Requirements	Due Date
SS-4Application for Employer Identification Number	Needed on all returns, statements, and other documents filed concerning the estate. Must also give this number to payers of interest, dividends, and other income items. Penalty of $50 for each failure to supply a number.	As soon as possible after the date of death.
56 Notice Concerning Fiduciary Relationship	Filed by the fiduciary to notify the IRS of the creation, or termination, of a fiduciary relationship under Section 6903.	As soon as possible after receiving an employer identification number.
706 United States Estate (and Generation-Skipping Transfer) Tax Return	Filed if the gross estate is more than $600,000, reduced by the total amount of adjusted taxable gifts made after 1976. Reports the value of a decedent's estate. Not an income tax, but a tax on the transfer of the decedent's property.	Due 9 months after the date of death, unless an extension has been granted.
709 U.S. Gift (and Generation-Skipping Transfer) Tax Return	Required if a gift was made by the decedent prior to death but before filing.	The earlier of: the due date (with extensions) for filing the donor's estate tax return; or April 15 of the year following the calendar year when the gift was made.
1040 U.S. Individual Income Tax Return	Filed as a final income tax return for the year of death. Includes all income, deductions, and credits up to the date of death.	Generally, April 15th of the year after the year of death.
1041 U.S. Fiduciary Income Tax Return	Filed for an estate if its gross income is more than $600 for the tax year. Reports any	The 15th day of the fourth month after the end of the estate's tax

	income the decedent had a right to receive but did not receive prior to death. Also reports earnings on property after death.	year.
1310 Statement of Person Claiming Refund Due A Deceased Taxpayer	Required by any person filing a return for a decedent and claiming a refund. Not required of surviving spouse filing a joint return or a court appointed personal representative.	Filed with Form 1040 if refund is due.
2758 Application for Extension of Time To File Certain Excise, Income, Information and Other Returns	To request an extension of time to file an estate return. Generally up to 90 days, can go up to 6 months. Does not extend the time to pay. File the original and one copy.	Sufficiently early to allow the IRS to consider the extension and reply before the due date of Form 1041.
4768 Application for Extension of Time To File U.S. Estate (and Generation-Skipping Transfer) Tax Return and/or Pay Estate (and Generation-Skipping Transfer) Taxes	To request an extension of time to file Form 706. Not more than 6 months. Two copies required. Can also be used to extend time to pay for up to 10 years, this requires four copies to be filed. See Reasonable cause discussion. *	Sufficiently early to allow the IRS to consider the extension and reply before the due date of Form 706.
4810 Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)	A request of prompt assessment will limit the time the IRS has for assessing a tax, or for beginning court action to collect it, from 3 years to 18 months.	After filing the return for which the prompt assessment is requested.

I. Major Forms for Reporting

A. Final 1040 - The last 1040 tax return is called the final return. It is filed for the year of death and includes any income received (by a cash-basis taxpayer) or accrued (by an accrual basis taxpayer) up to the time of death. Do not confuse the final return with the 1041 return for a decedents estate.

B. Form 1041, U.S. Fiduciary Income Tax Return

1. The fiduciary of a domestic decedent's estate, trust, or bankruptcy estate uses Form 1041 to report:

   a) The income received by the estate or trust,

   b) The income that is either accumulated or held for future distribution or distributed currently to the beneficiaries, and

   c) Any applicable tax liability of the estate or trust.

   NOTE: *An estate or trust is a separate legal entity (except a grantor type trust) for federal tax purposes.*

2. Form 1041 - Estate - A decedent's estate is created upon the death of an individual. Form 1041 is used to report income the decedent had a right to receive, but did not receive prior to death. It also includes the earnings on the decedent's property after death. For example, wages paid after a taxpayer died (for a cash-basis taxpayer) or rental income earned by property owned by the decedent. Form 1041 is required if the gross income of the decedent's estate is $600 or more.

3. Form 1041 - Trusts - A trust may be created during an individual's life (inter vivos) or upon his or her death under a will (testamentary). Form 1041 is used to report income earned by a trust. A trust return must be filed if there is any taxable income.

4. Beneficiaries pay the tax on income that is passed through to them from Form 1041 for either an estate or trust. Income items are reported to beneficiaries on Form 1041, Schedule K-l.

C. Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return is used to report the value of the decedent's estate. The computed tax is not an income tax but a tax on the transfer of the decedent's property. Form 706 is required if the gross value of the estate is $625,000 or more. If the decedent made taxable transfers of gifts during his or her lifetime the $6250,000 filing requirement is reduced by the amount of the taxable gifts. The estate pays the tax on the value of the gross estate.

D. Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return relates closely to Form 706 since a taxpayer is allowed only one $625,000 exemption from estate and gift tax during one's lifetime. However, certain gifts are not included for purposes of the $625,000 exemption. The donor (the giver of the gift) is generally responsible for any gift lax on a transfer to a donee (the recipient of the gift.)

** **Study Tip** * When someone dies with an estate valued at $625,000 or more, there are three tax returns that generally apply to the individual. The final 1040 return is filed with the same due date as if the person were living. Next, income earned after the date of death is reported on Form 1041. This form continues to be filed until the assets of the estate are distributed and the estate is terminated. Third, Form 706 is filed to report the gross value of the estate and to pay the estate inheritance tax due, if any. Remember, the final 1040 and 1041 report income. Form 706 is used to report and pay the transfer tax on the decedent's property.*

II. Definitions

A. Executor (or Executrix) is named in a decedent's will to administer the estate and distribute properties as the decedent has directed.

B. Administrator (or Administratrix) is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve.

C. Personal Representative is an executor, administrator, or anyone who is in charge of the decedent's property. The primary duties of a personal representative are to collect all of the decedent's assets, pay the creditors, and distribute the remaining assets to the heirs or other beneficiaries. In addition, the personal representative must file any income tax return and estate tax return when due and pay the tax determined up to the date of discharge from duties.

D. Fiduciary is any person acting for another person. It applies to persons who have positions of trust on behalf of others. The term fiduciary includes a trustee of a trust or the executor, executrix, administrator, administratrix, personal representative, or a person in possession of property of a decedent's estate.

E. Corpus is the principal of the estate or trust, compared with the earnings of an estate or trust. The earnings are taxable, the corpus is not taxable.

III. Final Return of Decedent - Form 1040

A. The personal representative must file a final income tax return of the decedent for the year of death and any returns not filed for preceding years. The filing requirements are based on age, income, and filing status.

B. Generally, a personal representative is required to file the joint return for the decedent and the surviving spouse. However, the surviving spouse alone can file the joint return if no personal representative has been appointed. The income of the decedent that was includible on his or her return for the year up to the date of death and the income of the surviving spouse for the entire year must be included in the final joint return.

C. If the surviving spouse has remarried before the end of the year of death, the filing status for the decedent is married filing separately.

D. The personal representative must apply for an employer identification number for the estate. Once the number is received, the personal representative should file Form *56,* Notice Concerning Fiduciary Relationship, with the IRS.

E. Income Included on Final 1040 - The income included depends on if the decedent was a cash or accrual method taxpayer.

   1. *Cash method:* If the decedent accounted for income only as it was actually or constructively received, only these same items are accounted for in the final return. Dividends are constructively received when available for use by the decedent. If dividends were declared prior to death but not paid until after death, do not include the dividend as income.

Exercise 29*. Mr. Cross, a cash method, calendar year taxpayer; leased his farm for pasture land each August for one year at $2,000 per year, payable when the lease was signed. He died on June 30, 2001. Your review of his records, as personal representative, reflected that as of date of his death, he had received interest of $8,000. You also found a dividend check which was undeposited and had been received on June 15, 2001, in the amount of $650. What is the amount of income to be included on Mr. Cross's final income tax return?*

A. $8,000
B. $8,650
C. $10,000
D. $10,650

B. $8,650. Only the items of income actually or constructive received by a cash-basis method taxpayer before death are accounted for on the final return. Mr. Cross must include the interest ($8,000) actually *received and dividends ($650) constructively received, but not the rental income ($2,000) due in August since that amount was not actually or constructive received by Mr. Cross as of his date of death.*

2. *Accrual method:* Only the income items accrued before death are to be included in the final return.

3. If the decedent was a partner, include the distributive share of partnership income for the partnership's tax year ending within or with the decedent's last tax year (year ending on date of death). The partnership does not terminate as long as the decedent's estate or successor continues. The distributive share of partnership income for the tax year ending after the date of death is not included. For purposes of self-employment income, a decedent's distributive share of partnership income or loss through the end of the month in which death occurred is included.

4. Interest and dividends earned prior to death are included on the final return. Interest and dividends earned after death should be reported on the estate income tax return or the beneficiaries tax return. Separate Form 1099s should be prepared for prior to and after death, with the decedent's social security number for prior to and the estate employer identification number for after.

F. Exemptions and Deductions- Generally, the rules for exemptions and deductions allowed to an individual also apply to the decedent's final return.

1. For a non-dependent, the personal exemption can be claimed in full on the final income tax return.

2. If not itemizing, the lull amount of standard deduction is allowed regardless of the date of death.

3. Medical expenses paid before death are deductible on the final return. Medical expenses not deductible on the final return are liabilities of the estate and are shown on the federal estate tax return. However, if medical expenses for the decedent are paid out of the estate during the one-year period beginning with the day after death, the personal representative can elect to treat all or part of the expenses as paid by the decedent. Amounts incurred *in* the final year can be deducted on the final return. A Form 1040X would be required for amounts incurred in a prior year.

4. A decedent's net operating loss from business operations and any capital losses sustained during his or her last tax year or any carryover can only be deducted on the decedent's final return. An unused net operating loss deduction or capital loss cannot be deducted on the estate's income tax

return. A net operating loss can be carried back to a decedent's prior tax years.

5. The at-risk limits will continue to apply on any allowable loss on the decedent's final return.

6. If a passive activity interest is transferred because of the death of a taxpayer, the accumulated unused passive activity losses may be allowed as a deduction against the decedent's income in the year of death. Losses are allowed only to the extent they are greater than the excess of the transferee's basis of the property over the decedent's adjusted basis in the property immediately before death.

G. Credits, Other Taxes and Payments

1. A decedent is allowed any credits that applied prior to death. This includes:

   a) EIC, even if the return does not include a full 12 months,

   b) The Credit for the Elderly or Disabled, if the decedent was eligible, and

   c) Unused business tax credits being carried forward. In the final year, the decedent may take a deduction for any unused business tax credit amount.

2. Self-employment tax may be owed on self-employment income earned up to the date of death, if net earnings are $400 or more.

3. The final return may also be subject to alternative minimum tax.

4. Withholding and estimated tax payments are credited the same for a decedent as would apply had death not occurred.

H. Signing the Final Return - The word "deceased," the deceased's name, and the date of death should be written across the top of the tax return. If a personal representative has been assigned, that person must sign the return. If it is a joint return, the surviving spouse must also sign. If no personal representative has been assigned, a surviving spouse can sign and write in the signature area "Filing as surviving spouse." If not a joint return, the person in charge of the decedent's property must file and sign the return as "personal representative."

I. Due Date - The final return for a decedent who was a calendar year taxpayer is due on or before April 15 following the year of death regardless of when during the year the taxpayer died.

Exercise 30: *John died on August 18, 2001. All of the following statements are CORRECT **except**:*

A. John's death does NOT close the tax year of the partnership in which he was partners before it normally ends.
B. Medical expenses paid by John before his death are deductible on his final income tax return if deductions are itemized
C. On John's final return, all income is reported on the accrual method of accounting regardless of the accounting method that John had employed
D. Any tax credits that applied to John before his death may be claimed on his final income tax return.

C. On John's final return, all income is reported on the accrual method regardless of the accounting method John had employed. In computing income for the decedent's last tax year, only amounts properly includible under the taxpayer's method of accounting are included.

IV. Form 1041, Income Tax Return of an Estate

A. An estate is a separate taxable entity, formed on the date of death, and terminated when all assets are distributed. Any income earned during this period is subject to income tax and is reported annually on either a calendar year or fiscal year basis. The tax generally is computed in the same manner and on the same basis as for individuals. However, there is one major distinction. A trust or decedent's estate is allowed an income distribution deduction for distributions to beneficiaries. The computation is made on Schedule B of Form 1041. The income distribution deduction determines the amount of the distribution that is to be taxed to the beneficiary.

B. Filing Requirements - Every domestic estate with gross income of $600 or more during a tax year, or with a beneficiary who is a nonresident alien, must file a Form 1041. The personal representative has the responsibility of filing a tax return and a Schedule K-1 for each beneficiary. A Schedule K-1 must also be given to each beneficiary on or before the date the Form 1041 is filed.

Exercise 31*: Mr. Alisamiros, a nonresident alien, is a beneficiary of a domestic estate. The personal representative of the domestic estate must file a return even if the gross income was less than $600. (True or False)*

True. The personal representative of the domestic estate must file an income tax return for the estate regardless of income because Mr. Alisandros is a beneficiary who is a nonresident alien.

C. Tax Liability - The income tax liability of an estate attaches to the assets of the estate. If the income is distributed or required to be distributed during the current tax year, it is reportable by each beneficiary on his or her individual income tax return.

D. Income of the Estate - If the income is not required to be distributed and is not distributed but is retained by the estate, the tax on the income is payable by the estate. If the tax is not paid and the income is later distributed, the beneficiary can be liable for the tax due.

E. Tax Year - The personal representative chooses a fiscal or calendar year and the method of accounting for the estate when filing the first income tax return.

F. Income to Include - Gross income of an estate consists of all items of income received or accrued during the tax year. This includes dividends, interest, rents, royalties, gain from the sale of property, and income from businesses, partnerships, trusts, and any other sources.

G. Income in Respect of the Decedent (IRD) - All gross income that the decedent would have received had death not occurred and in a proper manner was not included on the final return.

1. The character of income an individual receives in respect of the decedent is the same as it would have been to the decedent if he or she were alive.

2. If an individual transfers a right to income in respect of a decedent, he or she must include in income the greater of:

   a) The amount received for the right, or

   b) The fair market value of the right transferred.

3. If the right to income is transferred by gift, the individual must include in income the fair market value of the right at the time of the gift.

4. Installment obligations that are transferred to the buyer, cause the balance of the installment obligation to be reported under the rules for the transfer of a right to income received in respect of a decedent. The amount of income to be included is the greater of

   a) The amount received, or

   b) The fair market value of the installment obligation at the time of the transfer, reduced by the basis of the obligation.

c) If the transferor and the buyer are related, the fair market value cannot be less than its face value.

5. Any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner that is for the period ending with the date of the decedent's death is income in respect of a decedent. Any partnership income for the period after the date of death is income of the estate or other successor in interest.

6. Reporting of series B or BE U.S. Savings Bonds is determined by how the decedent was reporting the interest.

   a) Bonds that were owned by a cash-method individual who had chosen to report the interest each year are transferred because of death, the increase in value of the bonds in the year of death up to the date of death must be reported on the decedent's final return. The transferee reports on its return only the interest earned after the date of death.

   b) If the interest were not reported each year and the deceased had purchased the bonds entirely with personal funds, then interest earned before death must be reported in one of the following ways:

      (1) The personal representative can elect to report interest up to the date of death on the decedent's final return. The transferee includes interest only after the date of death.

      (2) If the election is not made, interest earned to the date of death is income in respect of a decedent and is not included on the final return. All of the interest earned before and after the decedent's death is income to the transferee. The transferee may defer reporting until the bonds are cashed or the date of maturity.

H. Deductions in Respect of the Decedent (DRD) - Items such as business expenses, income-producing expenses, interest and taxes, for which the decedent was liable but which are not properly allowable as deductions on the decedent's final income tax return will be allowed when paid:

   1. As a deduction to the estate, or

   2. If the estate was not liable, as a deduction to the person who acquired an interest in the decedent's property because of death.

I. Income that a decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This "income in respect of the decedent" is also taxed when received by the estate or beneficiary. However, an income tax deduction is allowed to the person (or estate) *receiving* the income. This person *(or* estate) may qualify to claim the deduction for estate tax if he or she (or estate) must include in gross income for any tax year an amount of income in respect of the decedent. For an individual, this would be an itemized deduction not subject to the 2% AGI limit.

J. Exemptions and Deductions

1. An estate is allowed an exemption deduction of $600 in computing its taxable income in any year other than the final year. No exemption for dependents is allowed to an estate.

2. Charitable Contributions - An estate qualifies for a deduction for amounts of gross income paid or permanently set aside for qualified charitable organizations. To be deductible, specific provisions for the contribution must be in the decedent's will. If the contribution is to be paid out of the estate's gross income, the contribution will be fully deductible. If there is no will, the contributions will not be deductible even though all beneficiaries agree to make the gift.

3. Capital Losses - An estate can claim a deduction for a loss that it sustains upon the sale of property even if the sale is to the personal representative or other beneficiary. The sale of stock to a personal representative or other beneficiary does not qualify for the deductible loss treatment.

4. NOLs - An estate can claim a net operating loss, computed as for individuals, except that distributions to beneficiaries and the deduction for charitable contributions are not considered. Losses due to casualties or thefts can be deducted if not claimed on the estate return.

5. Administration Expenses - Administrative expenses can be deducted from the gross estate in figuring the federal estate tax or from the estate's gross income in figuring the estate's income tax, but not both. Administrative expenses allocated to tax-exempt income are not deductible.

6. Depreciation and Depletion - The allowable deductions for depreciation and depletion that accrue after the decedent's death must be apportioned between the estate and the beneficiaries depending upon the income of the estate that is allocable to each.

7. Amounts Distributed to Beneficiaries - An estate is allowed a deduction for the tax year for any amount that must be distributed currently and for other amounts that are properly paid or credited or that must be distributed to beneficiaries out of the estate's income. The deduction is limited to the distributable net income of the estate.

NOTE: *No deduction can be taken for funeral expenses or medical and dental expenses on the estate's income tax return.*

K. Credits, Tax, and Payments - Estates generally are allowed the same tax credits that are allowed to individuals. The credits are generally allocated between the estate and the beneficiaries. Estates are not allowed the Credit for the Elderly or Disabled or EIC.

L. Tax Tables - An estate cannot use the Tax Table that applies to individuals. The Tax Rate Schedule to use is included with Form 1041 instructions. An estate may be liable for AMT.

M. The estate’s income tax liability must be paid in full when the return is filed. Estates with tax years ending 2 or more years after the date of the decedent's death must pay estimated tax in the same mariner as individuals.

N. Name, Address, Signature, and Due Date - The Form 1041 requires the exact name and address of the estate, as reported when filing for an EIN and the name and address of the personal representative. The personal representative must sign the return.

O. Due Date - The Form 1041 is due by the 15th day of the 4th month after the end of the tax year (April 15 if a calendar year was chosen).

P. Distributions to Beneficiaries From an Estate - If an individual is the beneficiary of an estate that must distribute all its income currently, the individual must report his or her share of the distributable net income whether or not it is actually received.

   1. If an individual is the beneficiary of an estate, and the fiduciary has discretionary powers to distribute all or a part of the current income, the individual must report all income that is required to be distributed plus all other amounts actually paid or credited to him or her, to the extent of his or her share of distributable net income. For an amount to be currently distributable income, there must be a specific requirement for current distribution either under local law or by the terms of the decedent's will. If there is no such requirement, income is reportable only when distributed.

   2. If the currently distributable income is more than the estate's distributable net income figured without deducting charitable contributions, each beneficiary must include in gross income a ratable part of the distributable net income.

Exercise 32*: Under the terms of the will of Jim Shaw, $9,000 a year is to be paid to his widow and $6,000 a year is to be paid to his son out of the estate's income during the period of administration. There are no charitable* *contributions. For the year, the estate's distributable net income is $10,000. How much must the widow include in her gross income?*

A. 53,000
B. $5,000
C. $6,000
D. $9,000

C. $6,000. Unless the terms of the will provide otherwise, the widow includes $6,000, representing her pro rate share (60 percent of $10,000) in gross income.

3. Current income required to be distributed includes any amount that must be paid out of income or corpus to the extent the amount is satisfied out of income for the tax year. An annuity that must be paid in all events would qualify as income required to be distributed currently to the extent there is income of the estate not paid, credited, or required to be distributed to other beneficiaries for the tax year.

4. Any other amounts paid, credited, or required to be distributed to the beneficiaries for the tax year must also be included in the beneficiary's gross income. Such an amount is in addition to those amounts that must be currently distributed. If the sum of the amounts that must be currently distributed and other amounts paid, credited, or required to be distributed exceeds distributable net income, then these amounts are included in the beneficiary's gross income only to the extent that they do not exceed distributable net income. Other amounts would include:

   a) Distributions made at the discretion of the personal representative,

   b) Distributions required by the terms of the will upon the happening of a specific event,

   c) Annuities required to be paid in any event, but only out of corpus,

   d) Distributions of property in kind, and

   e) Distributions required for the support of the decedent's widow, widower, or other dependent for a limited period, but only out of corpus.

5. If an estate discharges a legal obligation of a beneficiary, that is treated as income to that beneficiary.

6. An amount distributed to a beneficiary for inclusion in gross income retains the same character for the beneficiary that it had for the estate.

7. If no charitable contributions are made during the tax year, distributions are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income.

8. If a charitable contribution is made and the will or local law provides for the contribution to be paid from a specific source, that provision governs. If no will or law dictates the charitable contribution deduction must be allocated among the items entering into the computation of the taxable income of the estate before allocation of the deductions for distribution to beneficiaries.

Q. Reporting - A taxpayer must include his or her share of the estate income on his or her income tax return for the tax year in which the last day of the estate tax year falls.

R. Termination of the Estate - The termination of an estate generally is marked by the end of the period of administration and by the distribution of the assets to the beneficiaries under the terms of the will or laws of succession of the state if there is no will.

1. Unused NOL - An unused net operating loss carryover or capital loss carryover existing upon termination of the estate is allowed to the beneficiaries succeeding to the property of the estate.

2. Excess Deductions - If the deductions in an estate's last tax year are more than gross income for that year the beneficiaries succeeding to the estate's property can claim such excess on their income tax returns as a miscellaneous itemized deduction subject to 2% of AGI.

S. Gifts, Insurance, and Inheritances

1. Property received as a gift, bequest, or inheritance is not included in the individual's income. Income received from such property, whether directly or through a trust, is includible in the individual's income.

2. The proceeds from a decedent's life insurance policy is not income to the beneficiary. However, if the proceeds are to be paid in installments, part of each installment will be taxable income. The part of each installment to exclude is the amount held by the insurance company (generally, the total lump sum payable at the insured's death) divided by the number of periods in which the installments are to be paid (or life expectancy if to be received for life). Amounts received in excess of the excludable part must be included as interest income.

T. The basis of property inherited from a decedent is generally the value used for estate tax purposes. For depreciable property, an individual must generally use the modified accelerated cost recovery system.

> ***Exercise 33****: NO gain is reported on depreciable personal property or real property that is transferred at a taxpayer's death to his or her estate or beneficiary (True or False)*
>
> *True. No gain is reported on the transfer of property from a decedent to his or her estate or beneficiary because there is no sale or other taxable disposition of the property.*

V. Trusts, Form 1041

A. The term "trust" refers to an arrangement created either by a will (testamentary) or by an inter vivos (living) declaration by which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. A trust (except a grantor type trust) is a separate legal entity for Federal tax purposes.

B. Grantor Trust

1. A "grantor-type trust" is a legal trust under applicable state law that is not recognized as a separate taxable entity for income tax purposes because the grantor or other substantial owners have not relinquished complete control over the trust. If the trust instrument contains certain provisions, then the person creating the trust (the grantor) is deemed to be the owner of the trust's assets and the trust is treated as a "grantor type trust." The income of a grantor trust is taxed to the grantor on his or her individual tax return.

2. The grantor will be treated as the owner of any portion of a trust whose income may be distributed without the consent of any adverse party or at the discretion of the grantor or a nonadverse party even thought the trust may be irrevocable. The income of the trust will not automatically be taxable to the grantor merely because it may be used for support of a beneficiary (other than the spouse) whom the grantor is legally obligated to support. (§677)

> ***Exercise 34****: Bill, the grantor, set up two irrevocable trusts: Trust A and Trust B. The income of Trust A is to be accumulated for distribution to Bill's spouse after Bill's death. The income of Trust B is to be accumulated for Bill's children, whom Bill is legally obligated to support, and the trustee has the discretion to use any part of the income for the children's support. Half of the*

income was so used in 2001. Based on this information, which of the following statements is CORRECT?

A. ALL the income from both trusts is taxed to Bill.
B. NONE of the income from either trust is taxed to Bill.
C. NO income from Trust A is taxed to Bill and HALF of the income from Trust B is taxed to Bill.
D. ALL the income from Trust A and HALF from Trust B is taxed to Bill.

D. ALL the income from Trust A and HALF from Trust B is taxed to Bill. Income from Trust A is fully includible by the grantor when it is held or accumulated for future distribution to the grantor or spouse. Income from Trust B is includible to the extent it is distributed to satisfy a legal obligation of the grantor to the recipient beneficiary, other than the grantor's spouse.

C. Simple Trust - A trust is a simple trust if:

1. The trust requires that all income must be distributed currently,

2. It does not allow amounts to be paid, permanently set aside, or used in the tax year for charitable purposes, and

3. The trust does not distribute amounts allocated to the corpus of the trust.

D. Complex Trust - A complex trust is any trust that does not qualify as a simple trust.

** **Study Tip** * A trust may be a simple trust one year and a complex trust the next year. For example, a trust that does not distribute all income in the current year becomes a complex trust because it failed to meet the conditions of a simple trust.*

***Exercise 35**. A beneficiary of a COMPLEX TRUST must include in his taxable income the income that is required to be distributed, whether or not it is actually distributed during the tax year. (True or False)*

True. If income of a complex trust is required to be distributed, it is currently taxable to the beneficiary whether or not it is actually distributed.

E. Taxation of Trusts - A trust computes its gross income in much the same manner as an individual. Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there is one major distinction. A trust (or a decedent's estate) is allowed an income distribution deduction for distributions to beneficiaries.

F. Distributable net income (DNI) is the estate's income available for distribution. It is the taxable income of the estate without considering distributions to beneficiaries, the exemption, generally capital gains and losses. Tax-exempt interest which is excluded from taxable income is included in DNI.

Exercise 36*: Under the terms of the trust agreement, the income of the Y Trust is required to be currently distributed to Brad during his life. Capital gains are allocable to Corpus, and all expenses are charged against corpus. During the taxable year, the trust had the following items of income and expenses:*

Dividends	*$35,000*	
Taxable interest		*25,000*
Nontaxable interest	*10,000*	
Long-term capital gains		*15,000*
Commissions and miscellaneous expenses allocable to Corpus		*7,000*

The trust's distributable net income is:

A. $53,000
B. $60,000
C. $63,000
D. $70,00

C. $63,000. Taxable income ($68,000) is modified by adding tax-exempt interest ($10,000) and subtracting capital gains allocable to corpus ($15,000).

G. The income distribution deduction (IDD) allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries is limited to the distributable net income. This limit is also used to determine how much of an amount paid, credited or required to be distributed to a beneficiary will be includible in his or her gross income.

H. Character of Distributions - An amount distributed to a beneficiary for inclusion in gross income retains the same character for the beneficiary that it had for the estate.

Exercise 37*: With regard to a trust, all of the following statements are CORRECT* ***except****..*

A. A trust is a separate taxable entity.
B. Generally, the trust is taxed on the income currently distributed and on the portion it has accumulated

C. If income is required to be distributed currently or is properly distributed to a beneficiary, the trust is regarded as a conduit with respect to that income.

D. The income allocated to a beneficiary retains the same character in his hands as it had in the hands of the trust.

B. Generally, the trust is taxed on the income currently distributed and on the portion it has accumulated. A trust is allowed a distribution deduction for amounts required to be distributed currently and any other amounts properly paid, credit or required to be distributed.

VI. Estate Tax Return

A. Form 706 - The federal estate tax applies to the transfer of property at death. It is not an income tax, but is a tax on the gross value of the decedent's property transferred. The estate is responsible for paying any tax due. If not paid by the estate the beneficiaries may be held liable.

B. The estate tax return is filed by the executor of an estate. The return is due 9 months after the date of death unless an extension has been granted. If the individual was neither a resident nor a citizen and owned property located within the United States, the Form 706NA is required.

Filing requirement. The following table lists the filing requirement for the estate of a decedent dying after 1997. Previously, the amount was $600,000.

Year of Death	Filing Requirement 1998 $625,000
1999	$650,000
2000 and 2001	$675,000
2002 and 2003	$700,000
2004	$850,000
2005	$950,000
After 2005	$1,000,000

C. Gross Estate - The gross estate includes the value of all property to the extent of the decedent's interest in the property at the time of death. It includes property that was owned by a decedent at the time of death and was transferred at death by a will or by intestacy laws. It may also include other property interests that the decedent did not own at death.

1. It does not include property that the decedent owned but could not transfer by will or by intestacy laws.

2. The gross estate includes, but is not limited to, the following items.

a) Outstanding dividends declared to stockholders of record on or before the date of death. Those declared after the date of death are not included.

b) Unpaid interest that has accrued on savings certificates from the date of the last interest payment to the date of death, plus the face amount of the certificate.

c) U.S. Government bonds or other U.S. Government indebtedness. This also includes bonds issued by a state government agency and secured by a pledge of a loan by the federal government.

d) No-fault insurance benefits are included if paid to the estate. Do not include a "survivor's loss benefit" paid to a survivor.

e) An income tax refund is included in the gross estate. If the refund is based on a joint return the estate includes a percentage of the refund. The percentage is derived by determining both spouses tax liability as MFS and then making an allocation.

f) Medical insurance reimbursements if the decedent had a right to the amount at death.

g) The value of a surviving spouse's dower or curtesy interest in the decedent's estate is included.

h) The value of property transferred before death if that person kept possession or enjoyment of the property or reserved certain rights or interests in it.

i) The value of property interests transferred that take effect at death, if the following conditions are met:

   (1) The beneficiaries could have possessed or enjoyed the transferred property through ownership of it, only by surviving the decedent,

   (2) The decedent kept a reversionary interest in the property, and

j) The value of the reversionary interest immediately before death was more than 5% of the value of the entire property.

k) Revocable transfers subject to exercisable powers of the decedent. (If the decedent, within 3 years of death, transferred a retained interest, a reversionary interest, or a power relating to above items h, i, or j transfers, the value of the property is included.)

l) The proceeds of a life insurance policy are included if the decedent made a completed gift of the policy within 3 years of death. Also included are proceeds on the decedent's life if:

(1) The proceeds are receivable by the estate,

(2) The proceeds are receivable by another for the benefit of the estate, or

(3) The proceeds are not receivable by or for the benefit of the estate and the decedent possessed incidents of ownership in the policy. Also included is the replacement value of a policy of life insurance on the life of another, owned by the decedent.

m) The amount of gift tax paid by the decedent or the estate on any gift made by the decedent or the decedent's spouse during the 3 year period ending on the date of the decedent's death.

n) The value of an annuity or other payment that a beneficiary is due to receive because he or she survives the decedent. This does not include a single life policy.

o) The value of the following jointly held property:
(1) One-half of the value of property held jointly with a spouse, and

(2) Entire value of other joint interests except that part of the property that was acquired by a person other than the decedent for adequate and full consideration in money or money's worth.

p) The value of property interests over which the decedent had a general power of appointment are included.

q) Terminable interest property for which a marital deduction was allowed is also include.

***Exercise 38**: Ed died on November 1, 2000. The alternate valuation method was NOT elected. The assets in his estate as of the date of death were as follows:*

Home	*$300,000*	
Life insurance (proceeds receivable by the estate)		*300,000*
Stocks, bonds, & savings		*150,000*
Jewelry	*25,000*	
Car	*15,500*	
Accrued interest on savings as of November 1, 2000		*6,000*
Dividend" declared July 1, 2000, NOT paid as of November 1, 2000		*1,500*

What is the amount of Mr. James' gross estate?

A. $596,500
B. $790,500
C. $796,500
D. $798,000

D. $798,000. All of Ed's listed items including accrued interest and dividends declared but unpaid as of his date of death are includible in his gross estate. A dividend is includible in decedent's gross estate only if the decedent dies after the record date of the dividend; the record date is the date when the shareholder of record becomes entitled to receive the dividend. This question assumes that the record date was the date the dividend was declared.

D. **Estate Valuation**

1. Fair market value on the date of death is generally used to value a decedent's property for estate tax purposes. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, if neither one is under any compulsion to buy or sell and if both have reasonable knowledge of all relevant facts. It cannot be determined by a forced sale or by the sale price in a market other than that in which the item is most commonly sold to the public.

2. Alternate Valuation Date Method is an election under which the property included in the decedent's gross estate is valued as of a date 6 months after the date of death. The executor may elect the alternate valuation method provided the following requirements are met:

   a) A return must be required to be filed.

   b) The election applies to all property in the estate.

   c) The election must be made on the first estate tax return filed for the estate and the return must be filed within one year of the due date (including extensions) for filing the return.

   d) The election may be made only if it will decrease the value of the gross estate and the amount of the estate tax. Once the election is made, it is irrevocable.

3. If elected, the property is *valued* according to the following rules:

a) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date on which it was first distributed, sold, exchanged, or otherwise disposed of.

b) Any property not disposed of within 6 months after the decedent's death is valued as of 6 months after the date of the decedent's death.

c) Any property, interest, or estate that is affected by mere lapse of time is valued as of the date of the decedent's death. However, this is adjusted for any difference in value not due to mere lapse of time as of 6 months after the decedent's death or if earlier, as of the date of its disposition. (Patents, remainders, reversions)

d) Values of life estates, remainders, and similar interests are figured by using the ages of the recipients on the date of the decedent's death and the value of the property on the alternate valuation date.

4. Special Use Valuation can be elected to value qualified real property that is included in the decedent's estate and is devoted to farming or is used in a closely held business on the basis of its actual use for these purposes.

Exercise 39*: Ms. Rose died on October 15,2000. The assets which comprised her estate were valued as follows:*

	10/15/2000	*02/15/2001*	*04/15/2001*
House	*$ 950,000*	*$ 900,000*	*$ 800,000*
Stocks	*1,950,000*	*1,865,000*	*1,880,000*
Bonds	*500,000*	*500,000*	*540,000*

The executor sold the home on February 28, 2001, for $900,000. The executor properly elected the alternate valuation date method. What is the value of Ms. Rose’s estate.

A. $3,220,000
B. $3,320,000
C. $3,265,000
D. $3,400,000

B. $3,320,000. When alternative valuation is elected, the value of the decedent’s gross estate is determined six months after the decedent’s death or on earlier disposition. Since the house was sold prior to end of the six-month period, it’s value for the estate tax purposes was $900,000, not $800,000.

F. **Taxable Estate** - The taxable estate is the gross estate minus the following items:

1. Administrative and funeral expenses.

   a) Funeral expenses are a deduction if they are actually paid, are allowable out of property subject to claims under local law, and satisfy the limitation for the total amount of expenses allowed. May include the cost of a tombstone, monument, mausoleum, a burial lot, a reasonable expenditure *for* it's future care, and transportation expenses for bringing the body to the place of burial.

   b) Administrative expenses incurred in administering property subject to claims are deducted including executor commissions, fees of attorneys for the estate, and miscellaneous expenses such as court costs, accountant's fees, appraisal fees, and other expenditures necessary for preserving and distributing the estate. These may also include selling expenses and interest expenses that accrue after death on federal or state income tax deficiencies or estate or gift taxes.

2. Claims against the estate, including outstanding obligations to which the property is subject, if the value of the property is included in the gross estate and is undiminished by the outstanding indebtedness, are deducted.

3. Casualty and theft losses incurred during the settlement of the estate are deducted.

4. The marital deduction is a deduction from the gross estate of the value of property that is included in the gross estate but that passes or has passed to the surviving spouse. To be eligible, the spouse must survive the decedent and be married to the decedent at the time of the decedent's death. The spouse must be a citizen of the United States at the time the estate return is filed in order to qualify for the marital deduction.

5. Charitable contributions are deducted for the value of property in the decedent's gross estate that the decedent transferred during life or by will to or for the use of a qualified organization.

6. A deduction is allowed for amounts payable out of property subject to claims (generally, the probate assets).

   Exercise 40: *All of the following would be allowed as deductions from the Gross Estate in computing the Taxable Estate* ***except****:*

   A. Funeral expenses paid out of the estate.

B. Debts owed by the decedent at the time of death.
C. Income tax on income received after decedent's death.
D. Casualty and theft losses that occur during settlement of the estate.

C. Income tax on income received after decedent's death. Unpaid income taxes are deductible if they are on income includible in a decedent's income tax return for a period before, but not after, the decedent's death.

F. **Estate Tax Computation** - There is one Unified Rate Schedule that applies to both estate and gift taxes. This schedule is used to determine the tentative tax on the taxable amount of all gifts whether made by the individual prior to death or through the estate.

1. The ***gross estate tax***, Your gross estate includes the value of all property in which you had an interest at the time of death. Your gross estate will also include:
   - Life insurance proceeds payable to your estate or, if you owned the policy, to your heirs,
   - The value of certain annuities payable to your estate or your heirs, and
   - The value of certain property you transferred within 3 years before your death.

2. The ***net estate tax payable*** is the gross estate tax reduced by the following items.

   a) The Unified credit. (see Pub. 950)

   b) The credit for state death taxes - A credit for any estate, inheritance, legacy, or succession tax actually paid to any state or the District of Columbia, on account of any property included in the gross estate of the decedent. This applies only to taxes that actually were paid and for which the credit was claimed within 4 years after filing the estate tax return.

   c) The credit for gift taxes - No credit is allowed for any gift tax paid on gifts made after 1976 and only when the gift tax has been paid on the transfer of non-probate assets and double taxation would result.

   d) Credit for tax on prior transfers - The credit is applied against the gross estate tax for federal estate taxes paid on the transfer of property to the decedent from a transferor who died within 10 years before or 2 years after the decedent's death. The property does not have to be identified in the decedent's estate, nor does it have to exist at the time of death. What matters is that the transfer was subject to federal estate tax in the estate of the transferor.

e) Credit for foreign death taxes - The credit is applied against the gross estate tax for any estate, inheritance, legacy, or succession taxes actually paid by the decedent's estate to any foreign country, including possessions or political subdivisions of foreign states and possessions of the United States.

NOTE: *If any amount of taxes claimed as a credit for state death taxes or for foreign death taxes is refunded, the executor or any person recovering the taxes must notify the IRS within 30 days. The IRS will redetermine the federal estate tax.*

Exercise 41*: Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, was filed for the estate of John Doe in 2001. The gross estate tax was $250,000. Which of the following items CANNOT be credited against the gross estate tax to determine the net estate tax payable?*

A. Credit for marital deduction.
B. Credit for gift taxes.
C. Credit for state and foreign death taxes.
D. Credit for tax on prior transfers.

A. Credit for marital deduction. The marital deduction is not a credit against the estate, but rather is a deduction from the gross estate in determining the taxable estate.

G. Assessment period - Generally, no tax may be assessed later than 3 years after the estate tax return is filed or is due, whichever is later. The period of assessment is extended to 6 years where there is an understatement of the value of the estate of 25% or more. The assessment period is 4 years for recipients of property included in the gross estate.

H. Reasonable Cause For Extending the Due Date of the Form 706

1. Assets needed to pay the tax are located in several jurisdictions and are not within the executor's immediate control, cannot be readily collected.

2. Most of the estate's assets consist of rights to receive payments in the future. Cannot borrow against these assets without causing a loss.

3. An estate includes a claim to substantial assets that cannot be collected without a lawsuit. Cannot determine total estate.

4. Made an effort to convert assets to cash, but would have to borrow at an interest rate higher than generally available to have enough funds to:

a) Pay the estate tax when due;

b) Provide a reasonable allowance for spouse and dependents while the estate is being administered; and

c) Satisfy claims against the estate that are due and payable.

VII. Generation-Skipping Transfer Tax

A. This tax applies to all transfers of property, whether or not the transfer is subject to estate or gift tax, that skips a generation. This is a tax on the value of property included in the estate that passes to the skip person. The skip person is an individual who is in a generation two or more generations below the generation of the decedent.

B. A generation skipping transfer can take place through:

1. A taxable distribution - distributions made from trust accounting income to a skip person,

2. A taxable termination - the interest in property held in a trust coming to an end, or

3. A direct skip - transfer of property subject to estate or gift tax.

C. A special $2 million per grandchild exclusion applied to transfers before January 1, 1990.

D. Each individual is entitled to a $1 million lifetime transfer exemption for generation skipping.

E. The tax is the taxable amount multiplied by a determined rate based on a federal excise tax rate of 55% and an inclusion ratio.

VIII. Gift Tax

A. The federal gift tax is imposed on the gratuitous transfer of property. The person making the gift **(Donor)** must generally pay the tax. If the donor does not pay the gift tax, the person receiving the gift **(Donee)** may have to pay the tax. Federal gift tax applies to all transfers by gift of property, wherever situated, by U.S. citizens or residents.

B. Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, is used to report taxable gifts. The form is required for the transfer of all gifts other than:

1. A transfer that is not more than the annual exclusion,

2. A qualified transfer for educational or medical expenses, or

3. A transfer to your spouse that qualifies for unlimited marital deduction.

C. Due Date - All gift and generation skipping taxes (GST) are computed and filed on a calendar year basis regardless of the taxpayer's income tax accounting period. An extension of time to file a gift tax return (up to 6 months) may be requested from the District Director or Service Center. There is no form provided for this purpose, but it can be completed with a letter which explains the reason for the request. An extension to file an income tax return that is a calendar year automatically extends the time for filing a gift tax return. An extension of time to pay (up to 6 months) can be obtained from the Service Center where filed. With no extension, the tax is due when the return is filed.

D. A penalty for failure to pay is one-half percent per month of the unpaid balance, up to 25%.

E. Gifts in General - The gift tax applies to a transfer of real or personal property. The property may be tangible or intangible. The gift may be direct, indirect, or transferred in trust.

1. The tax may apply to transfers made for valuable consideration if the value of the property transferred is more than the consideration received. (part sale/part gift)

2. Below market loans may have as a gift the reasonable value of the use of the money loaned. This provision does not apply to gift loans between individuals for any day on which the total outstanding amount of the loan between such individuals is not more than $10,000 unless the loan is directly attributable to the purchase or carrying of income-producing assets.

3. A consideration that is not reducible to a value in money or money's worth must be considered as totally gratuitous.

4. The gift tax is not imposed on the receipt of gift property but rather upon the donor's act of making a completed gift. A gift is completed if the donor has parted with dominion and control over the transferred property or property interest, leaving the donor without the power to change its disposition, whether for the benefit of the donor or for the benefit of others.

5. A promise to make a gift becomes taxable in the year the obligation becomes binding and not when the discharging payments are made.

***Exercise 42**: A Form 709, United States Gift (and Generation-Skipping Transfer) Tax*
Return, is required to be filed for

A. A transfer of a present interest that is not more than the annual exclusion ($10,000).
B. A qualified transfer for educational or medical expenses.
C. A transfer of a future interest that is not more than the annual exclusion ($10,000).
D. A transfer to your spouse that qualifies for the unlimited marital deduction.

C. A transfer of a future interest that is not more than the annual exclusion ($10,000). Since a gift of a future interest is not eligible for the $10,000 annual exclusion, a gift tax return must be filed, irrespective of the gift's value.

F. Special Rules

1. A *Power of Appointment* is a power to determine who will own or enjoy the property subject to that power. The exercise or complete release of a general power of appointment is treated as a gift unless the exercise or release was for adequate consideration. A power to manage, invest, or control assets or to allocate receipts and disbursements, when exercised only in a fiduciary capacity, would not be considered a power of appointment.

2. If a person makes a *qualified disclaimer* with respect to any interest in property, the property will be treated as if it had never been transferred to that person. Accordingly, the disclaimer is not regarded as making a gift to the person who receives the property because of the qualified disclaimer.

3. Transfers of property or property interests made under the terms of a written agreement between spouses in *settlement* of their marital or property rights are considered to be for adequate consideration in money or money's worth and therefore, are exempt from gift tax if the spouses get a final decree of divorce within 2 years after entering into the agreement. A release of support rights constitutes a consideration in money or money's worth. However, a transfer in settlement of dower or curtsey inheritance rights is not reducible to money and results in a gift.

4. A gift generally results when an employee who has an unqualified right to an *annuity* elects to receive a lesser amount so that at the employee's death a survivor annuity will be paid to the employee's designated beneficiary. The gift is made in the calendar year in which the employee gives up the power to deprive the beneficiary of the survivor annuity by making the election irrevocable.

5. The disposition of all or part of a qualifying income interest in any qualified terminable interest property (QTIP), for which a spouse or spouse's estate has been allowed a marital deduction, results in a transfer of all interest in the property and is subject to gift tax.

G. **Valuation** - The value of a gift is the fair market value of the property on the date the gift is made. There is no alternative valuation date for federal gift tax. If the donee pays the gift tax, the value is reduced by the amount the donee pays, which is viewed as partial consideration paid for the gift. The donor's available unified credit must also be used to reduce the tax liability of the donee. The fair market value of annuities, life estates, terms for years, remainders, and reversions is their present value derived through the use of present value tables.

H. **Gift Splitting** - A gift made by a person to someone other than a spouse may be considered as made one-half by each spouse. A lower gift tax rate bracket may apply and the annual exclusion and unified credit of each spouse would apply. The requirements follow:

1. Both spouses must consent to gift-splitting.

2. Spouses must be legally married at the time of the gift. If divorced during the year and neither remarries, may still split gifts.

3. Both spouses must be citizens or residents of the U.S. on the date of the gift.

4. If both consent to gift-splitting, all gifts made during the year that qualify must be split.

5. If a gift is to be split, both spouses must indicate their consent on the gift tax return. If only one spouse made the gift and they both consent to split, the other spouse is not required to file a return if:

   a) The total value to any one donee is not more than $20,000, and

   b) The property is not a gift of future interest.

6. If the consent is to split gifts of a future interest, both spouses must file gift tax returns regardless of the value of the gift.

7. The consent to split gifts cannot be made after a gift tax return has been filed and the due date for filing the return has passed. The consent can be revoked, but not after April 15 of the year following the year of the gift.

__Exercise 43__: Which of the following statements regarding gift splitting by married couples is CORRECT?

A. If only one spouse has made gifts during the year and the spouses consent to split the gift the other spouse is always required to file a gift tax return.
B. If both spouses consent to split a gift of future interest, both spouses must file gift tax returns only if the value of the gift is greater than $20,000.
C. A consent to split gifts may be made on an amended gift tax return after the due date of the original return.
D If the spouses are divorced during the year, they still may split a gift made before the divorce so long as neither marries anyone else during that year.

D. If the spouses are divorced during the year, they still may split a gift made before the divorce so long as neither marries anyone else during that year. Gift-splitting does not apply if a spouse remarries during the tax year in which the gift is made.

I. **Taxable Gifts** - Total gifts made during the year, minus the annual exclusion, minus the charitable deduction, and minus the marital deduction will equal the taxable gifts. Total gifts do not include a qualified transfer.

J. **Annual Exclusion** - The first $10,000 of gifts made to any one person during any calendar year is excluded in determining the total amount of gifts for the calendar year. This applies to all gifts of a present interest made during the year. It does not apply to gifts of future interest.

K. **Future interests** is a legal term that includes reversions, remainders, and other interests or estates that are to commence in use, possession, or enjoyment at some future date.

L. **Marital Deduction** - A taxpayer may deduct from the total amount of gifts made during the year, the value of gifts made to one's spouse. This amount is unlimited. To qualify:

1. The spouses must be married at the time of the gift, and

2. The donee spouse must be U.S. citizen. Gifts to noncitizen spouses do not qualify for the unlimited marital deduction. However, there is a $100,000

(rather than the $10,000) annual exemption. The $100,000 exclusion only applies to gifts that would qualify for the marital deduction if the donee were a U.S. citizen. This applies to gifts made after June 29, 1989.

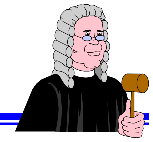
3. The $100,000 annual exclusion for gifts made to a noncitizen spouse applies regardless of the citizenship of the donor spouse. Gifts to a citizen spouse will qualify for the marital deduction regardless of the citizenship of the donor spouse.

M. **Gift Tax Computation** - The Unified Rate Schedule is used to determine the amount of tax on taxable gifts. The gift tax on all gifts is then offset by a *Unified Credit*. The amount of unified credit a taxpayer may claim for the year may not exceed the amount of the tax for the calendar year.

Exercise 44*: All of the following are deductions allowed in determining the gift tax* ***except****:*

A. A gift to the state of Pennsylvania for exclusively public purposes.
B. The value of a gift made to one's spouse who is NOT a United States citizen.
C. A gift made to one's spouse, a United States citizen, in excess of $100,000.
D. A gift of a copyrightable work of art to a qualified organization if you do not transfer the copyright to the charity.

B. The value of a gift made to one's spouse who is NOT a United States citizen. Although a marital deduction is available for a gift to a spouse who is a U.S. citizen, regardless of the spouse who is a U.S. citizen, regardless of the citizenship or residence of the donor, the marital deduction is not available for a gift made to a spouse who is not a U.S. citizen.



4. PART IV - - ETHICS, RECORDKEEPING, APPEAL PROCEDURES, ETC.

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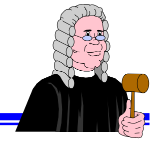


INTRODUCTION

Part IV of the exam covers ethics, record keeping procedures, appeal procedures, practitioner penalty provisions, research materials, examination and collection procedures, retirement plans and exempt organizations. This part of the exam is divided into two sections. Section A consists of true and false questions, and Section B consists of multiple choice questions. Some multiple choice questions require computation, but the majority are consistent with the format of the first three parts.

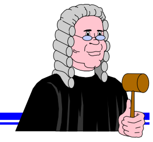
STUDY MATERIALS

MAIN TOPICS

Circular 230 Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service

Publication 216	Conference and Practice Requirements
Publication 334	Tax Guide for Small Business
Publication 552	Recordkeeping for Individuals
Publication 556	Examination of Returns, Appeal Rights, and Claims for Refunds
Publication 557	Tax-Exempt Status for Your Organization
Publication 560	Retirement Plans for the Self-Employed
Publication 575	Pension and Annuity Income (Including Simplified General Rule;)
Publication 586A	The Collection Process (Income Tax Accounts)
Publication 590	Individual Retirement Accounts
Publication 594	The Collection Process Employment Accounts)
Publication 908	Tax Information on Bankruptcy
Publication 947	Practice Before the IRS and Power of Attorney
Publication 1345	Handbook for Electronic Filers of Individual Income Tax Returns

Section A Rules for Practice, Ethics, Preparer Rules, Power of Attorney, Courts and the Legal System, Research Materials
Section B Examinations, Appeals, Collections
Section C Records, Retirement Plans, Exempt Organizations, Electronic Filing



SECTION A - RULES FOR PRACTICES, ETHICS, PREPARER RULES, POWER OF ATTORNEY

I. Circular 230

A. Rules of Practice

1. A person is practicing before the Internal Revenue Service if he or she:

   a) Communicates with the IRS for a taxpayer regarding the taxpayer's rights, privileges, or liabilities under laws and regulations administered by the IRS,

   b) Represents a taxpayer at conferences, hearings, or meetings with the IRS, or

   c) Prepares and files necessary documents with the IRS for a taxpayer.

2. **Who may practice?** - Attorneys, certified public accountants, enrolled agents, or enrolled actuaries. These people may practice as long as they are not under suspension or disbarment.

   a) The Director of Practice may grant enrollment to an applicant who demonstrates competence in tax matters by written examination.

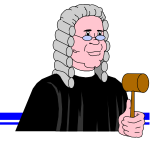
      (1) Attorneys and CPAs are not required to take the examination. If such individuals want to use the EA designation, prior enrollment or an examination is required.

      (2) Enrollment can be granted to IRS employees or former employees who have completed 5 years of continuing employment with the Service. The examination is not required.

   b) Temporary recognition may be granted but this does not constitute enrollment to practice. Temporary enrollment may be withdrawn at any time by the Director of Practice.

   c) Appeal Process if Application Denied - The Director of Practice shall inform the applicant of the reason. The applicant has 30 days after the receipt of the notice of denial to file a written appeal.

   Exercise 1: *The term "Practice Before the Internal Revenue Service" includes the representation of clients in the United States Tar Court for cases being handled under the "small tax case procedure". (True or False)*



False. Only communication with the IRS concerning a taxpayer's rights, privileges or liabilities are included. "Practice Before the Internal Revenue Service" doe not include representation before the United States Tax Court.

3. Enrollment Cycle and Renewal

a) An enrollment cycle is a three year period. Applications for renewal are required between November 1, (current year), and January 31, (next year), and every third year thereafter. Those who receive initial enrollment during the renewal application period shall apply for renewal of enrollment by March 1 of the renewal year.

c) The effective date of renewed enrollment is April 1. The current period of enrollment is April 1, (current year), through March 31, (current year+3).

NOTE: *The current enrollment cycle ends January 31, 2003. Applications for renewal are required between November 1, 2002, and January 31, 2003.*

Exercise 2: *If an enrolled agent has an enrollment date of May 10, 2001, on what date would his/her enrollment card terminate?*

A. May 11, 2002
B. February 1, 2004
C. April 1, 2004
D. May 11, 2004

C. April 1, 2004. Renewal dates are April 1, 2004, and every three years thereafter. Therefore, the enrollment card of an enrolled agent who was initially enrolled on May 10, 2001, would terminate on April 1, 2004.

(1) Minimum of 72 hours of continuing education must be completed in an enrollment cycle (three years). This is an average of 24 credits per year.

(2) A minimum of 16 credits must be completed in each year.

(3) An individual who receives initial enrollment during an enrollment cycle must complete a minimum of 2 credits for each month enrolled. Enrollment for any part of the month is considered enrollment for the full month.

(4) Qualifying programs may include formal programs (required attendance), correspondence or individual study programs, serving as an instructor (including subject preparation time up to 50% of the required credits), or credit for published articles, books, etc. (not to exceed 25% of the required credits).

> ***NOTE:*** *You may also complete the requirement by taking (and passing) all four parts of the EA exam during the three year period prior to renewal and by completing at least 16 credits of continuing education during the last year of an enrollment cycle. As you might expect, few enrolled agents choose this form of meeting the educational requirements to maintain enrollment.*

(5) Waivers can be granted by the Director of Practice for various reasons including: health, extended active military duty, absence from the U.S., or other compelling reasons.

(6) Each individual applying for renewal of enrollment shall retain CPE information for three years. The records shall include the following information:

(a) The name of the sponsoring organization.

(b) The location of the program.

(c) The title of the program and description of its contents.

(d) The dates attended.

(e) The credit hours claimed.

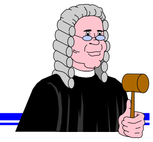
(f) The name(s) of the instructor(s).

(g) The certificate of completion or a signed statement of the hours of attendance obtained from the sponsor.

(7) An individual who is ineligible to practice by virtue of disciplinary action is required to meet the requirements for renewal during the period of ineligibility (if they want to resume enrollment after the suspension).

4. Limited Practice

a) Individuals may appear on their own behalf, or represent a member of his or her immediate family.



b) An individual may represent his or her regular full-time individual employer.

c) A general partner or regular full-time employee may represent the partnership.

d) Corporations may be represented by bona fide officers or regular full-time employees.

e) Trusts, receiverships, guardianships, or estates may be represented by their trustees, receivers, guardians, administrators, executors, or their regular full time employees.

f) An individual (not under disbarment) who signs a return as having prepared it for the taxpayer, or prepares the return but is not required to sign it, may appear without enrollment as the taxpayer's representative before revenue agents and examining officers of the Examination Division with proper authorization from the taxpayer.

Exercise 3:

With regard to the categories of individuals who may practice before the Internal Revenue Service, which of the following statements is CORRECT?

A. Only enrolled agents, attorneys, or CPAs may represent trusts and estates before any officer or employee of the IRS.

B. An individual who is NOT an enrolled agent, attorney or CPA, who signs a return as having prepared it for the taxpayer may, with proper authorization from the taxpayer, appear as the taxpayer's representative, with or without the taxpayer, at an IRS regional Appeals Office conference with respect to the tax liability of the taxpayer for the taxable year or period covered by that return.

C Under the limited practice provisions in Treasury Department Circular No. 230, ONLY general partners may represent a partnership.

D Under the limited practice provisions in Circular No. 230, an individual who is under suspension or disbarment from practice before the IRS may NOT engage in limited practice before the IRS

D. Under the limited practice provisions in Circular 230, an individual who is under suspension or disbarment from practice before the IRS may NOT engage in limited practice before the IRS. If an individual is suspended or disbarred from practice before the IRS, he may not engage in practice before the IRS on behalf of a client under any *circumstances. In addition, an individual may not knowingly aid another person to practice before the IRS when that person is suspended or disbarred from practice before the IRS.*

NOTE: *The prepare who is not enrolled may NOT represent taxpayers before the Collections Division even if they prepared the tax return in question.*

B. Duties and Restrictions Relating to Practice

1. No enrolled individual shall neglect or refuse promptly to submit records or information in any matter before the IRS, upon proper and lawful request by a duly authorized officer or employee of the IRS, unless he believes in good faith and on reasonable grounds that such record or information is privileged or the request is of doubtful legality.

2. When the Director of Practice requests information concerning possible violations of the regulations by other parties, the practitioner must provide it, and be prepared to testify in disbarment or suspension proceedings.

3. A enrolled practitioner who knows that his or her client has not complied with the revenue laws, or has made an error in or omission from any return, document, affidavit, or other required paper, has the responsibility to advise the client promptly of the noncompliance, error, or omission.

Exercise 4: *If an enrolled agent, attorney, or CPA knows that a client has NOT complied with the revenue laws of the United States with respect to a matter administered by the IRS, the enrolled agent, attorney, or CPA is required to:*

A. Do nothing until advised by the client to take corrective action.
B. Advise the client of the noncompliance.
C. Immediately notify' the IRS.
D. Advise the client AND notify the IRS

B. Advise the client of the noncompliance. The enrolled agent, CPA or attorney has the duty to advise the client of the noncompliance. However, he is not required to notify the IRS.

4. An enrolled practitioner shall exercise due diligence in preparing or filing returns or documents; in determining the correctness of oral and written representations made to the IRS; and in determining the correctness of oral and written representations made to clients with reference to any matter administered by the IRS.

5. An enrolled practitioner must not unreasonably delay the prompt disposition of any matter before the IRS.

6. An enrolled practitioner must not knowingly and directly or indirectly do the following:

    a) Employ or accept assistance from any person who is under disbarment or suspension from practice before the IRS.

    b) Accept employment as an associate, correspondent, or subagent, or share fees with any such person.

    c) Accept assistance from any former government employee where provisions of the regulations would be violated.

Exercise 5:
A practitioner could be suspended from practice before the IRS if the practitioner employs, accepts assistance from, or shares fees with any person who is under disbarment or suspension from practice before the IRS. (True or False)

True. A practitioner may be suspended or disbarred from practicing before the IRS if he knowingly aids another person to practice before the IRS when that person is suspended, disbarred or otherwise ineligible to do so.

7 If the enrolled practitioner, who is a notary public, is employed as counsel, attorney, or agent in a matter before the IRS, or has material interest in the matter, he or she must not engage in any notary activities relative to the matter.

Exercise 6:
Allen is an enrolled agent and a notary public. He is representing Ms. Scott before the IRS. The revenue agent involved in the case requests certified copies of the contracts relating to the sale of a building. Allen can secure copies of the contracts and then certify them using his notary public stamp. (True or False)

False. An attorney, certified public accountant, or enrolled agent as well as a notary public is not permitted to certify papers, administer oaths, or perform any official act with respect to any matter before the IRS in which he is employed as counsel, attorney or agent.

8. A practitioner may not charge an unconscionable fee for representing a client in a matter before the IRS. Nor can a practitioner charge a contingent fee for

preparing the original return. A contingent fee includes a fee that is based on the refund or percentage of taxes saved.

a) Fee Information - M individual eligible to practice before the IRS may disseminate the following fee information.

(1) Fixed fees for specific routine services.

(2) Hourly rates.

(3) Range of fees for particular services.

(4) Fee charged for an initial consultation.

(5) Availability of written schedule of fees.

b) Those individuals that disseminate fee information shall be bound to charge the hourly rate, the fixed fee for specific routine services, the range of fees for particular services, or the fee for an initial consultation published for a reasonable period of time, but no less than thirty days from the last publication of such hourly rate or fees.

9. Solicitation

a) No individual eligible to practice before the IRS shall in any way use or participate in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim.

b) Enrolled agents may not use the term "certified" or indicate any employer/employee relationship with the IRS.

c) No enrolled agent shall make, directly or indirectly, an uninvited solicitation of employment, in matters related to the IRS. This includes in-person contacts and telephone communications. The restriction does not apply to:

(1) Seeking new business from an existing or former client in a related matter,

(2) Communications with family members,

(3) Making the availability of professional services known to other practitioners, so long as the person contacted is not a potential client,

(4) Solicitations by mailing, or

(5) Non-coercive in-person solicitation while acting as an employee, member, or officer of an exempt organization.

Exercise 7:

Norm, an enrolled agent, wanted to have Malt as a new client. Without invitation, Norm approached Malt at a local club and explained how he could assist him with his federal tax matters and would like to have him as a client. Norm is NOT in violation of the solicitation regulations set forth in Treasury Department Circular No. 230. (True or False)

False. An enrolled agent is prohibited from making an uninvited solicitation of employment to a potential new client in a matter related to the IRS. However, this restriction does not apply to seeking new business from an existing or former client in a related matter.

10. Permissible Advertising

a) An individual eligible to practice before the IRS may publish, broadcast, or use in a dignified manner, the following:

(1) The name, address, telephone number, and office hours of the practitioner or firm.

(2) The names of individuals associated with the firm.

(3) A factual description of the services offered.

(4) Acceptable credit cards and other credit arrangements.

(5) Foreign language ability.

(6) Membership in pertinent, professional organizations.

(7) Pertinent professional licenses.

(8) A statement that an individual's or firm's practice is limited to certain areas.

b) Communications may include professional lists, telephone directories, print media, permissible mailings, radio and television, and any other method as long as the method chosen does not become untruthful or misleading. In the case of radio and television, the broadcast shall be pre-recorded and the practitioner shall retain a recording of the actual audio transmission. In the case of direct mailing, the practitioner shall retain a copy of the mailer and a list of all persons to whom the communication was mailed. Such copies are required to be kept for at least 36 months.

Exercise 8:

An enrolled agent may make the availability of his/her professional services known to other practitioners, provided the person or firm contacted is NOT a potential client. (True or False)

True. Although an enrolled agent generally cannot make, either directly or indirectly, uninvited solicitations of employment in matters related to the IRS, according to IRS Circular 230, Practice Before the IRS, the restriction does not apply to making the availability of professional services known to others practitioners, as long as the person or firm contacted is not a potential client.

11. An enrolled agent may use the phrase, "enrolled to represent taxpayers before the IRS" or "enrolled to practice before the IRS".

12. Enrolled practitioners, who are income tax return preparers, must not endorse or otherwise negotiate any refund check issued to the taxpayer.

13. A practitioner who provides a tax-shelter opinion analyzing the federal tax effects of a tax-shelter investment:

    a) Must make inquiry as to all relevant facts;

    b) Must relate the law to the actual facts;

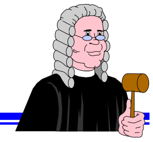
    c) Must ascertain that all material federal tax issues have been considered; and

    d) Provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue.

C. Standards for Position Taken, Preparing, and Signing Returns.

1. A practitioner may not sign a return as a preparer if the practitioner determines that the return contains a position that does not have a realistic possibility of being sustained on its merits unless the position is not frivolous and is adequately disclosed to the Service.

2. A practitioner advising a client to take a position on a return, or preparing or signing a return, must inform the client of the penalties reasonably likely to apply to the client with respect to the position.



3. A practitioner may rely in good faith without verification upon information furnished by the client. The practitioner must make reasonable inquiries if the information appears incorrect.

4. A position is considered to have a realistic possibility of being sustained on its own merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits.

D. An enrolled preparer can be disbarred or suspended for disreputable conduct. Disreputable conduct includes, but is not limited to the following:

1. Conviction of any criminal offense under the revenue laws of the U.S. or of any offense involving dishonesty or breach of trust.

2. Participating in or giving false or misleading information to the Department of Treasury.

3. Prohibited solicitation of employment, as previously covered.

4. Willfully failing to make a federal tax return in violation of revenue laws. This includes knowingly counseling or suggesting to a client an illegal plan to evade taxes.

5. Misappropriation of client funds.

6. Directly or indirectly influencing or attempting to influence an action of an IRS employee through threats, false accusations, offer of special inducement, gifts, etc.

7. Disbarment or suspension by the State, etc.

8. Knowingly aiding or abetting a suspended, disbarred, or ineligible person to practice before the IRS.

9. Contemptuous conduct in connection with practice before the IRS.

10. Giving a false opinion knowingly, recklessly, or through gross incompetence.

E. Disciplinary Proceedings

1. Whenever the Director of Practice has reason to believe that an attorney, certified public accountant, enrolled agent, or enrolled actuary has violated

any provision of the laws or regulations governing practice before the Internal Revenue Service, the Director of Practice may reprimand such person or institute a proceeding for disbarment or suspension for such person. The proceeding begins with a complaint which names the respondent and is filed with the office of Director of Practice.

2. Failure to answer the allegations within the time prescribed in the complaint shall constitute an admission of the allegations of the complaint and a waiver of hearing, and the Administrative Law Judge may make a decision by default without a hearing or further procedure.

3. The respondent may appear in person or he/she may be represented by counsel or another representative who need not be enrolled to practice before the Internal Revenue Service. If either party fails to appear at the hearing, the Administrative Law Judge may make a decision against the party by default.

Exercise 9:

Marty, an enrolled agent, had been properly notified to appear at a hearing in regards to a complaint which could result in his suspension from practice before the Internal Revenue Service. If Marty fails to appear for the hearing, he shall be deemed to have waived the right to a hearing and the Administrative Law Judge may make his decision against Marty by default.(True or False)

True. If the enrolled agent fails to appear at a hearing after receiving notice, he shall be deemed to have waived his right to a hearing and the administrative law judge may make his decision against him by default.

II. Income Tax Return Preparer Rules

A. Reg. §301.7701-15 defines an income tax return preparer as any person who prepares for compensation, or employs one or more persons to prepare for compensation, all or a substantial portion of any return or claim for refund.

B. A person shall not be considered an "income tax return preparer" merely because such person:

1. Furnishes typing, reproducing, or other mechanical assistance,

2. Prepares a return or claim for refund of an employer by whom he is regularly and continuously employed,

3. Prepares, as a fiduciary, a return or claim for refund for any person, or

4. Preparers a claim for refund for a taxpayer in response to any notice of deficiency issued to the taxpayer or in response to any waiver of restriction after an audit of such taxpayer.

Exercise 10:
Which of the following would NOT be an income tax return preparer?

A. Someone who employs one or more persons to prepare for compensation, other than for the person, all or a substantial portion of any tax return under subtitle A of the Code.
B. Someone who prepares a substantial portion of a return or claim for refund under subtitle A of the Code.
C. Someone who prepares an information return for a person or entity under subtitle A of the Code.
D. Someone who prepares, as a fiduciary, a return or claim for refund for any person.

D. Someone who prepares, as a fiduciary, a return or claim for refund for any person. Someone that prepares a return solely in a fiduciary capacity is not deemed to be an income tax return preparer.

C. In accordance with Reg. §1.6060-1, each person who employs (or engages) one or more income tax return preparers to prepare any return of tax or claim for refund, other than for that person, at any time during a return period shall satisfy the following requirements:

1. Retain a record of the name, taxpayer identification number, and principal place of work during the return period of each income tax return preparer employed (or engaged) by the person at any time during the period.

2. Make that record available for inspection upon request by the district director.

3. This record must be retained and kept available for inspection for the 3-year period following the close of the return period to which that record relates.

4. The person may choose any form of documentation to be used as a record of the preparers employed during the return period. However, the record must disclose on its face which individuals were employed (or engaged) as income tax return preparers during that period.

5. Any individual who, acting as an income tax return preparer, is not employed by another shall be treated as his or her own employer and shall retain and make available such records in respect to himself or herself.

6. A partnership shall be treated as the employer of the partners of the partnership and shall retain and make available a record with respect to the partners and others employed (or engaged) by the partnership.

D. Reg. §1.6107-1 requires the person who is the income tax return preparer of any income tax or claim for refund shall furnish a completed copy of the original return or claim for refund to the taxpayer (or nontaxable entity) not later than the time the original return or claim for refund is presented for the signature of the taxpayer (or nontaxable entity).

E. The person who is the income tax return preparer shall:

1. Retain a completed copy of the return or claim for refund, or retain a record, by list, card file, or otherwise of the name, taxpayer identification number, and taxable year of the taxpayer (or nontaxable entity) for whom the return or claim for refund was prepared and the type of return or claim for refund prepared.

2. Retain a record, by retention of a copy of the return, maintenance of a list or card file or otherwise, for each return or claim for refund presented to the taxpayer (or nontaxable entity) of the name of the individual preparer required to sign the return.

3. Make a copy or record of returns and claims for refund, and a record of the individuals required to sign, available for inspection upon request by the district director.

4. The records described here shall be retained and kept available for inspection for the 3-year period following the close of the return period during which the return or claim for refund was presented for signature.

F. Internal Revenue Code §6694 provides for tax return preparer penalties for the understatement of a taxpayer's liability.

1. §6694(a) penalty is imposed for an understatement of liability due to a position for which there was not a realistic possibility of being sustained on its own merits.

a) Only one individual associated with a firm is considered the income tax return preparer. If two or more individuals are associated with a return and one is the signing preparer, only one of the individuals will be considered the preparer. This will generally be the individual with the overall supervisory responsibility. The firm may also be subject to the penalty, as well as the individual within the firm.

b) A person who is the preparer and knew, or should have known of such a position, is subject to a penalty of $250 with respect to that return.

c) Exceptions to the penalty can be granted for adequately disclosing a nonfrivolous position on the return, or if the understatement was due to reasonable cause and the preparer acted in good faith.

2. §6694(b) penalty is imposed for an understatement of liability that is due to a willful attempt to understate tax liability, or that is due to reckless or intentional disregard of rules or regulations.

   a) The preparer is subject to a penalty of $1,000 with respect to such a return.

   b) The preparer will have the burden of proof on whether he/she has negligently or intentionally disregarded a rule or regulation.

   c) With respect to non-frivolous positions, the penalties provided under §6694 (a) and (b) will not be imposed if such position is sufficiently disclosed on the return or claim for refund.

   d) If the imposition of both the unrealistic position penalty, (§6694(a)) and the willful or reckless conduct penalty (§6694(b)) apply to the same return, the penalty for willful or reckless conduct is reduced by any amount *assessed and collected* against the preparer under §6694(a).

Exercise 11:

Internal Revenue Code §6694(a) provides for a penalty against a return preparer for understatement of tax liability due to an unrealistic position. IRC section 6694(b) provides for a penalty if any part of the understatement is due to willful or reckless conduct. Both of these penalties may be assessed simultaneously on a given return but the total amount of the penalties CANNOT exceed the IRC §6694(b) penalty. (True or False)

True. Although the penalty for willful or reckless conduct is $1,000, that amount is reduced by any preparer penalty paid under the $250 understatement penalty for unrealistic positions. As a result, the total of the two penalties cannot exceed $1,000.

Exercise 12:

Bernard is an income tax return preparer. While preparing a 2001 tax return for a client, Bernard determines the client owes a substantial amount of tax. In order to generate a refund for the client, Bernard substantially overstates itemized deductions and expenses claimed on the Schedule C. Bernard is subject to a penalty of:

A. $1,000
B. $500
C. $250
D. $100

A. $1,000. A $1,000 penalty may be imposed on an income tax return preparer if any part of an understatement of tax on an income tax return or refund claim is attributable to a willful attempt by the preparer in any manner to understate tax liability of another person.

3. Within 30 days after the day on which a notice and demand of either of these penalties is made, the preparer may:

   a) Pay the entire amount assessed and may file a claim for refund of the amount paid at any time not later than 3 years after the date of payment, or

   b) Pay an amount which is not less than 15% of the entire amount assessed and immediately file a claim for refund of the entire amount.

G. Other Penalties §1.6695-1:

1. $50 Penalties (per failure)

   a) Failure to furnish the taxpayer (including a nontaxable entity such as a partnership or an S Corporation) with a copy of the return no later than when the return is presented for signature.

***Exercise 13**:*

Cameron, an income tax return preparer, prepared at different times during the tax season both Mr. Murphy 's individual income tax return and his S Corporation's income tax return. Cameron was' compensated for the preparation of both returns. Cameron is ONLY required to furnish a copy of his client's original income tax return at the time the second return is presented for signature. (True or False)

False. An income tax return preparer must furnish a completed copy of the original income tax return to the taxpayer no later than when the original return (the individual return) is presented for the taxpayer's signature. It cannot be furnished when the second return (the S corporation return) is presented for signature.

b) Failure to sign a return. The return must be signed manually (facsimile stamp is not acceptable) prior to presenting it to the taxpayer for signature. If more than one preparer is involved in the preparation of a tax return, or claim for refund , the preparer with primary responsibility for the overall accuracy of the return is required to sign.

Exercise 14:

Anthony is a partner in AC Partnership. He is responsible for the overall substantive accuracy of all income tax returns prepared by the employees. Anthony does NOT collect the necessary information NOR does he preparer tax returns. Anthony should NOT sign the returns as a preparer. (True or False)

False. If more than one return preparer is involved in the preparation of an income tax return, the individual who has the primary responsibility for the overall substantive accuracy of the return is considered to be the return preparer who is required to sign the return.

c) Failure to furnish a preparer identification number.

d) Failure to retain a copy or record. The preparer of an income tax return or claim for refund must either retain a copy of the return or retain a record, by list, of the taxpayer 1.D. number, the taxable year for the taxpayer (or nontaxable entity), and the type of return or claim for refund prepared. The information described should be kept available for a 3-year period following the close of the return period during which the return or claim for refund was presented for signature to the taxpayer.

***Exercise 15**:*

Each person who employs (or engages) one or more income tax return preparers to prepare returns other than for that person must retain a record, to be kept available for inspection for the 3-year period folio wing the close of the return period to which the record relates, of the name, taxpayer identification number, and principal place of work during the return period (the 12-month period beginning July 1 of each year) of each income tax return preparer employed at any time during that period. (True or False)

True. The IRS requires each person who employs a return preparer to retain for three years a record of the name, taxpayer identification number, and principal place of work of each employee employed during any return period.

e) Failure to retain and make available a record of the preparers employed during the return period, plus *$50* for failure to include a required item in such record, up to a maximum of $25,000.

Exercise 16:

Which one of the following would result in a penalty on the preparer for failure to sign a tax return?

A. L, a law firm, employs A, an attorney, to prepare tax returns. A obtains the information from X L's client, and determines X's tax liability. A signed the tax return instead of his employer.
B. N, an individual, has an arrangement with C, a corporation, to preparer tax returns for compensation. C does not provide office space, supplies, etc., N uses forms provided by C which N sends back to C to be reviewed by E, C's employee, for math and proper application of tax law. N signed the return instead of C or E.
C. D, who is NOT an enrolled agent, attorney or CPA prepares and signs income tax returns for compensation.
D. P, prepared income tax re turns for compensation, and signed the income tax returns with a facsimile signature stamp.

D. P, prepared income tax returns for compensation, and signed the income tax returns with a facsimile signature stamp. One qualifying as an income tax return preparer must put his original signature on the tax return. The signature must be manually applied; a facsimile signature does not satisfy this requirement. A paid preparer subject to the signature requirement need not be an enrolled agent attorney or CPA.

2. *A* $500 penalty will apply for negotiating or endorsing a check for a taxpayer. (Exception and special rules apply to preparer-banks.)

Exercise 17:

Which of the following persons would be subject to the penalty for improperly negotiating a taxpayer's refund check?

A. An income tax return preparer who operates a check cashing agency that cashes, endorses, or negotiates income tax refund checks for returns he prepared.

R An income tax return preparer who operates a check cashing business may cash checks for his clients as part of a second business.

C. The firm which prepared the tax return is authorized by the taxpayer to receive an income tax refund, but NOT to endorse or negotiate the check

D. A business manager prepares income tax returns for clients who maintain special checking accounts against which the business manager is authorized to sign certain checks on their behalf The clients 'federal income tax refunds are mailed to the business manager, who has the clients endorse the checks and deposits them in the special accounts.

A. An income tax return preparer who operates a check chasing agency that cashes, endorses, or negotiates income tax refund checks for returns he prepared. A return preparer operating a check chasing agency that cashes the refund check of a taxpayer whose return the preparer prepared is subject to the penalty for negotiating a taxpayer's refund check.

3. Disclosure or use of tax information without formal consent of the taxpayer is a misdemeanor, and upon conviction thereof, the preparer shall be fined not more than $1,000 or imprisoned not more than one year or both. Disclosure of tax information can be made under the following conditions:

   a) Quality or peer review,

   b) Under the order of any court of record,

   c) Disclosure to a duly appointed fiduciary of the taxpayer or his estate, or the fiduciary's authorized agent, or

   d) Disclosures in connection with rendering professional services.

Exercise 18:

Which of the following situations describes a disclosure of tax information by an income tax preparer which would subject the preparer to a penalty?

A. Ron dies after furnishing tax return information to his tax return preparer. Ron's tax return preparer discloses the information to Jerry, Ron's nephew, who is NOT the fiduciary of Ron's estate.

B. In the course of preparing a return for Duck Company Jan obtained information indicating the existence of illegal kickbacks. Jan gave the information to Bill, an auditor in her firm, who was performing a *financial audit of the company Bill confirmed illegal kickbacks were occurring and brought the information to the attention of Duck Company officers.*

C. Glade informed the proper Federal officials of actions he mistakenly believed to be illegal.

D. Les, a return preparer, obtained information from Tom while selling Tom life insurance. The information was identical to tax return information that had been furnished to him previously Les discussed this information with Mary, his wife, who was NOT an employee of any of his businesses.

A. Ron dies after furnishing tax return information to his tax return preparer. Ron's tax return preparer discloses the information to Jerry, Ron's nephew, who is NOT the fiduciary of Ron's estate. A return preparer may not disclose tax return information of a decedent to an individual that is not a fiduciary of the decedent's estate.

III. Power of Attorney (POA) Rules

A. A power of attorney (for IRS purposes) is a written authorization which allows one person to act for another in tax matters. A POA allows one to:

1. Represent a taxpayer before any office of the IRS.

2. Sign a waiver agreeing to a tax adjustment or an offer of waiver of restriction on assessment or collection of a tax deficiency, or a waiver of notice of disallowance of claim for credit or refund.

3. Sign a consent to extend the statutory time period for assessment or collection of a tax.

4. Sign a closing agreement under §7121 of the Internal Revenue Code.

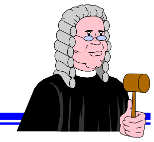
5. Receive, but not endorse or negotiate, a check drawn on the U.S. Treasury.

6. Sign employment tax returns.

B. The representative named under a POA is not permitted to sign a person's individual income tax return, unless:

1. The signature is permitted under the Code and regulations, and

2. The taxpayer authorizes this in his/her power of attorney.



C. In the case of incapacity or incompetence, the POA can continue if specifically authorized.

D. A POA is most often required when a taxpayer wants to authorize another individual to perform at least one of the following actions on his or her behalf:

1. Represent a taxpayer at a conference with the IRS.

2. File a written response to the IRS.

3. Sign a consent or extension.

Exercise 19:

*A properly executed Form 2848, Power of Attorney and Declaration of Representative, is required to allow a representative to perform all of the following **except:***

A. Sign a waiver agreeing to an income tax adjustment.
B. Sign a consent to extend the statutory time period for assessment of tax.
C. Execute closing agreements.
D. To request the disclosure of confidential tax return information.

D. To request the disclosure of confidential tax return information. To request the disclosure of confidential tax return information, an individual must make a request under the Freedom of Information Act (FOIA). The rules under FOIA determine an individual's entitlement to confidential return information. Although Form 2848 can be used, it need not be used for tax return information disclosures.

E. Form 2848, Power of Attorney and Declaration of Representative is used to appoint a representative.

1. An unenrolled preparer can represent a taxpayer only before revenue agents and examining officers of the examination division, and only for the period covered by the return.

2. A document other than Form 2848 can be used if the document contains all of the information requested on Form 2848. This includes a statement by the representative referred to as the Declaration of Representative.

3. If the non-IRS power of attorney is missing some information, an attorney-in-fact can provide the information, provided that the POA filed authorized the attorney-in-fact to handle federal tax matters.

F. The POA is entered in the Central Authorization File (CAF), which enables IRS personnel, who do not have a copy of the POA, to verify the authority of the representative.

G. A POA can be updated or changed by filing a new Form 2848.

1. A new POA revokes a prior POA if it is granted by the taxpayer to another recognized representative with respect to the same matter.

2. A revocation copy of Form 2848 can be submitted to revoke a POA. A POA not filed on Form 2848 can be revoked by writing a letter requesting a revocation.

3. A recognized representative may withdraw from representation in a matter by filing a statement with the IRS office where the POA is to be revoked.

4. Any representative appointed in a power of attorney may substitute or delegate authority under the POA to another recognized representative if substitution or delegation is specifically authorized under the POA. A substitution or delegation is effected by filing the required information with the IRS where the power of attorney has been filed. The following items are required for the substitution or delegation of a recognized representative:

a) Notice of substitution or delegation,

b) Declaration of Representative, and

c) A power of attorney which specifically authorizes the substitution or delegation.

Exercise 20:

Nancy, who is enrolled to practice before the Internal Revenue Service, has been appointed in a power of attorney to represent Lee in a matter before the IRS. Nancy wants to delegate the authority to another representative. Regarding this substitution of authority, all of the following statements are CORRECT ***except:***

A. The power of attorney whether it is IRS Form 2848, Power of Attorney and Declaration of Representative, or a non-IRS power of attorney must specifically provide that Nancy can substitute her authority.

B. The new representative must be an individual who is recognized to practice before the IRS.

C. The new representative must file a written declaration in accordance with the regulations with the appropriate IRS offices.
D. Nancy need ONLY file a signed statement (notice of substitution or delegation) with the appropriate IRS offices.

D. Nancy need ONLY file a signed statement (notice of substitution or delegation) with the appropriate IRS office. A substitution is made by filing the following items with the IRS: (1) a notice of substitution or delegation signed by the practitioner who was appointed under the power of attorney, (2) a declaration of representative made by the new representative, and (3) a power of attorney that authorizes the substitution or delegation.

H. Non-IRS powers of attorney. If Form 2848 is not used, a taxpayer can obtain a power of attorney with a written document which contains the following information:

1. The taxpayer's name and mailing address,

2. The taxpayer's Social Security number and/or employer ID number,

3. The name and address of the representative,

4. The types of tax involved,

5. The federal tax form number,

6. The specific year(s) or period(s) involved,

7. For estate tax matters, the decedent's date of death,

8. A clear expression of the taxpayer's intention concerning the scope of authority granted to the representative,

9. The taxpayer's signature and date, and

10. The "Declaration of Representative" statement, made by the taxpayer's representative , which is contained in Part II of Form 2848 and should read as follows:

    a) I am not currently under suspension or disbarment from practice before the Internal Revenue Service or other practice of my profession by another authority,

b) I am aware of the regulations contained in Treasury Department Circular No. 230 (31 C.F.R., Part 10) concerning the practice of attorneys, certified public accountant, enrolled agents, enrolled actuaries, and others;

c) I am authorized to represent the taxpayer(s) identified in the power of attorney; and

d) I am authorized to practice before the Internal Revenue Service as an individual described in 26 CFR 601.502(a) in my capacity as _______ (attorney, certified public accountant, enrolled agent, etc.).

Exercise 21:

If a representative chooses to use a non-IRS power of attorney form, all of the following "Declarations of Representative" statements would be required in order for the power of attorney to be valid ***except:***

A. A declaration that the representative is NOT currently under suspension or disbarment from practice before the IRS or other practice of his or her profession by ANY other authority
B. A declaration that the representative is aware of the regulations contained in Treasury Department Circular No. 230 concerning the practice of enrolled agents, attorneys, CPAs, etc.
C. A declaration that the representative is NOT currently under investigation by the IRS
D. A declaration that the representative is authorized to practice before the IRS in his or her capacity as an attorney, certified public accountant, enrolled agent, etc.

C. A declaration that the representative is NOT currently under investigation by the IRS. The Declaration of Representative is a statement made by a representative under the penalty of perjury that he or she is: (1) one of the types of persons authorized to practice before the IRS; (2) not currently suspended or disbarred from practice before the IRS; (3) authorized to represent the taxpayer for the matter specified in the power of attorney; and (4) aware of the regulations governing practice before the IRS. It is filed with a power of attorney and its failure to indicate current investigation by the IRS will not invalidate the power of attorney.

I. POA is not required in the following situations.

1. A POA is not required to authorize the IRS to disclose information concerning a taxpayer's tax account to an individual or other party. For this purpose use Form 8821, Tax Information Authorization.

2. A tax matters partner or person [§6231 (a)(7) and §6244] is authorized to perform various acts on behalf of a partnership or S Corporation. This may include the power to delegate authority to represent the TMP and to sign documents in that capacity.

3. A fiduciary (trustee, executor, administrator or receiver) stands in the position of the taxpayer and, in effect, is recognized as the taxpayer. He or she is not considered a representative of the taxpayer. Therefore, a power of attorney is not required. However, a fiduciary should file Form 56, Notice Concerning Fiduciary Relationship, to notify the IRS of the fiduciary relationship.

4. The Tax Court has its own rules of practice and procedure and its own rules for admission to practice before it. Accordingly, a power of attorney is not required to be submitted by an attorney of record in a case which is docketed in the Tax Court.

IV. Centralized Authorization File (CAF) System

A. Information from both powers of attorney and tax information authorizations is recorded onto the CAF system. Such information enables IRS personnel who do not have access to the actual power of attorney or tax information authorization to determine whether a person is the taxpayer's representative.

B. The issuance of a CAF number does not indicate that a person is either recognized or authorized to practice before the IRS. Form 8821 is strictly a disclosure authorization form and cannot be used to name an individual to represent a taxpayer before the IRS.

> ***Exercise 22:***
> *Form 8821, Tax Information Authorization, can be used when you want to authorize an individual to represent you before the IRS. (True or False)*
>
> *False. Form 8821, Tax Information Authorization, only authorizes an appointee to receive certain confidential tax information.*

C. A tax information authorization or power of attorney which does not include a CAF number will not be rejected based on the absence of a CAF number.

D. Although a POA or tax information authorization may be on file, the information cannot be recorded onto the CAF system unless it meets certain criteria:

1. Only matters relating to a specific tax period will be recorded onto the CAF system. If a specific period is not named, it cannot be entered into the system.

2. The system is limited to accepting three future years. Prior years are accepted for years under consideration by the IRS.

3. Not more than three representatives appointed under a power of attorney or designated under a tax information authorization will be recorded onto the CAF system.

4. The fact that a power of attorney or tax information authorization cannot be recorded onto the CAF system is not determinative of the (current or future) validity of the document.

Exercise 23:

With regard to Centralized Authorization File (CAF) numbers, which of the following statements is CORRECT?

A. The CAF number is entered into the IRS database which allows the IRS to automatically send copies of notices to the representative.
B. A CAF number indicates that the individual is either recognized or authorized to practice before the IRS.
C. A CAF number is assigned only to enrolled agents, CPAs and attorneys.
D. A power of attorney submitted without a CAF number will BE rejected based on the absence of a CAF number.

A. The CAF number is entered into the IRS database which allows the IRS to automatically send copies of notices to the representative. The Centralized Authorization File (CAF) is an automated system designed to allow IRS personnel to identify representatives and the scope of their authority.

V. Research Materials

A. The Internal Revenue Code is the law, as passed by Congress, governing taxation. It is binding on all courts except when held to violate the Constitution. The judiciary gives great importance to the literal language of the Code, but also considers the history of a particular Code section, its relationship to other Code sections, the reports of congressional committees, and Treasury regulations, IRS revenue rulings, and other IRS pronouncements published in the Internal Revenue Bulletin.

B. Treasury Regulations provide explanations, definitions, examples, and rules which explain the language of the Internal Revenue Code. IRS employees are bound by the regulations, however, the courts are not.

Exercise 24:
All courts except the Tax Court are bound by legislative regulations. (True or False)

False. Regulations represent the official Treasury interpretation of the Code. They generally are accorded the force and effect of law as long as they are reasonable and consistent with the statutory provisions they interpret. The Tax Court is bound by the legislative regulations to the same extent that other courts are.

1. Most income tax regulations are issued under the authority of *§7805(a).* These regulations are called *interpretative* regulations. Some other Code sections specifically authorize regulations to provide the details of the meaning and rules for that particular code section. Regulations issued under this authority are called *legislative* regulations.

2. All regulations are written by the Office of the Chief Counsel, IRS, and approved by the Secretary of the Treasury.

3. Temporary regulations are issued to provide guidance for the public and IRS employees until final regulations are issued. Public hearings are not held on temporary regulations.

NOTE: *Temporary regulations issued after November 20, 1988, will expire within 3 years.*

4. Proposed regulations are issued to solicit public written comments and public hearings are held if written requests are made. Proposed regulations do not replace temporary regulations unless the proposed regulations specifically say they replace them.

5. Final regulations are issued after the public comments on proposed regulations are evaluated, and they supersede the temporary regulations.

Exercise 25:
*All of the following statements with respect to classes of regulations are CORRECT **except:***

A. All regulations are written by the Office of Chief Counsel, IRS, and approved by the Secretary of the Treasury.
B. Public hearings are NOT held on temporary regulations.
C. Although IRS employees are bound by the regulations, the courts are NOT
D. Public hearings are NOT held on proposed regulations.

D. Public hearings are NOT held on proposed regulations. The purpose of proposed regulations is to give the public an opportunity to be heard before the regulations are promulgated in their final form.

C. Revenue Rulings and Revenue Procedures

1. Revenue rulings are the published conclusions of the IRS concerning the application of tax law to a specific set of facts.

2. Revenue procedures are official statements of procedures that either affect the rights or duties of taxpayers or other members of the public or should be a matter of public knowledge. Revenue procedures are directive and not mandatory.

3. The purpose of revenue rulings is to promote a uniform application of the tax laws, and therefore, IRS employees must follow the rulings as well as the Treasury Regulations. While taxpayers can rely on the rulings, they can also appeal adverse return examination decisions based on those rulings to the Tax Court or other federal courts.

D. The Courts

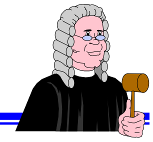
1. Tax Court

a) A taxpayer may petition the United States Tax Court for a judicial determination of his or her tax liability within a specified period (generally 90 days) after receiving a notice of deficiency, but before he or she pays the tax.

b) The Tax Court is authorized by Internal Revenue Code but is entirely separate from the Internal Revenue Service.

c) The Tax Court has jurisdiction over income, estate and gift taxes, some excise taxes, and certain declaratory judgments involving taxes.

d) Decisions of the Tax Court are issued as either a regular report or a memorandum decision. The service's acquiescence or nonacquiescence in adverse decisions are published in the Internal Revenue Bulletin.



Exercise 26:

The Tax Court has jurisdiction over employment taxes. (True or False)

False. The Tax Court lacks jurisdiction over employment taxes. However, it does have jurisdiction over the self-employment tax.

2. District Court and Claims Court

   a) A taxpayer may choose to pay a disputed deficiency and then file a claim for refund. If the claim is denied by the IRS or if no decision is made within 6 months, the taxpayer may petition either the United States Claims Court or the United States District Court.

   b) Cases before the District Court may be tried by jury.

Exercise 27:

Which of the following statements is FALSE?

A. The Tax Court will issue either a regular report or a memorandum decision depending upon the issues involved and the relative value of the decision being made.
B. The Commissioner of Internal Revenue does NOT issue a public acquiescence or nonacquiescence on District or Claims court cases.
C. Interpretative regulations are issued under the general authority of Internal Revenue Code Section 7805 (a) and legislative regulations are issued under the authority of specific Internal Revenue Code section to which they relate.
D. The government prints the regular and memorandum Tax Court decisions in bound volumes.

D. The government prints the regular and memorandum Tax Court decisions in bound volumes. Only Tax Court regular decisions are printed by the government in bound volumes.

3. Appellate Courts

   a) Both the taxpayer and the government may appeal decisions of the Tax Court, District Court, or Claims Court to the Court of Appeals.

   b) Decisions of the United States Tax Court and the United States District Court can be appealed to one of thirteen Courts of Appeals and then to the United States Supreme Court. Decisions of the United States Claims

Court can be appealed to the United States Court of Appeals for the Federal Circuit and then to the United States Supreme Court.

4. Supreme Court

   a) Decisions of the Court of Appeals and some decisions of other federal courts may be reviewed by the United States Supreme Court. The Supreme Court is not obligated to hear all cases so requested.

   b) Petition to the Supreme Court to hear a case that is not subject to obligatory review is by *writ of certiorari.* The writ is initially requested by the appealing party and is issued by the Supreme Court to the lower appellate court, requesting the record of a case for review. The Supreme Court is said to have denied certiorari when it refuses to issue such a writ.

5. Decisions of the courts other than the Supreme Court are binding on the Commissioner of Internal Revenue only for the particular taxpayer and for the years litigated. The Commissioner may decide to acquiesce to an adverse regular Tax Court decision. Acquiescence generally means that the IRS will follow the Tax Court decision in cases involving similar facts.

Exercise 28:

Nonacquiescence by the Commissioner of Internal Revenue to an adverse decision in a regular Tax Court case means the Internal Revenue Service will NOT accept the decision and will NOT follow it in cases involving similar facts. (True or False)

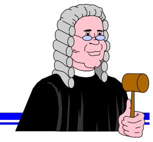
True. An acquiescence or nonacquiescence represents the Commissioner's official response to a Tax Court decision that is adverse to the IRS. A nonacquiescence means that the IRS does not accept the decision and will not follow it in cases involving similar facts.

6. Court Terminology

   a) ***Decision*** is the court's formal answer to the principal issue in litigation. It has legal sanction and is enforceable by the authority of the court.

   b) ***Dictum*** is a court's statement of opinion on a legal point not raised by the facts of the case. It is not controlling, but may be persuasive to another court deciding the issue dealt with by the dictum.

   c) ***Memorandum Decision*** is a report of a Tax Court decision thought to be of little value as a precedent because the issue has been decided many times.



d) ***Acquiescence*** is notice given by the Commissioner of Internal Revenue of intent to follow, to the extent indicated in the Cumulative Bulletin, an adverse Tax Court decision.

SECTION B - EXAMINATIONS, APPEALS AND COLLECTIONS

I. Examinations

A. If the IRS examined the taxpayer's return for the same items in either of the 2 previous years and proposed no change to the tax return, contact the IRS and they may discontinue the audit. However, if the return was selected for examination as part of a random sample for TCMP, the examination will continue.

Exercise 29:

Lamar's income tax returns for 1997 and 1999 were examined by the IRS. Both examinations covered Schedule C income and expenses and resulted in NO change in income tax. On September 15, 2001, he received notice that his income tax return for 2000 will be examined as part of the IRS Taxpayer Compliance Measurement Program. Lamar should contact the IRS immediately to exclude his income tax return from examination under the repetitive audit procedures. (True or False)

False. The IRS may not initiate an examination to harass a taxpayer. However, the IRS has wide latitude in determining what a legitimate purpose is for the initiation of an examination. The Taxpayer Compliance Measurement Program (TCMP) is a random selection system used to determine a taxpayer's correct tax liability.

B. The IRS Problem Resolution Office can help to solve administrative or procedural problems. The taxpayer should first try to resolve the problem by discussing it with the examiner's supervisor.

C. A tax return is generally examined in the IRS district where the taxpayer lives. However, if the return can be examined more quickly and conveniently in another district, such as where the books and records are located, a request can be made to transfer the examination to that district.

Exercise 30:

Under which of the following conditions can an examination of an income tax return be transferred to another IRS district?

A. James lives in Maryland and his accountant is located in New York His records are in Maryland where he works. James wishes a transfer of h is case from Maryland to New York for the convenience of his accountant.
B. Donna lives in Kentucky. Her books and her records are in Kentucky where her business is located. On occasion she works in Ohio. She wants the examination of her return transferred to Ohio.
C. Herb lives in Washington and travels to California on business 2 months at a time. His records are in New York where his business is located. Herb wants his case transferred to California to coincide with a business trip there.
D. Tom lives in New Jersey His books and records are in Delaware where his business is located and where he works. Tom wishes a transfer of examination of his return to Delaware. 30

True. The purpose of filing a notice of federal tax lien is to give notice to the taxpayer's creditors that the government has a claim against all the taxpayer's property. The federal tax lien attaches to all property and rights to property, whether real or personal, belonging to the taxpayer at the time the lien arises, as well as to property subsequently acquired during the period of the lien.

D. If the taxpayer agrees with a proposed change, he or she can sign an agreement form and pay any additional tax, interest, and penalties due. If the taxpayer pays when signing the agreement form, interest will be assessed from the due date of the return to the date of payment. If not paid when signed, the IRS will send a bill. Interest will be assessed from the due date to the billing date (not more than 30 days from signing the agreement). If paid within 10 days of receiving the bill, no additional interest is due. If not paid within 10 days, interest will be assessed from the due date to the date of payment.

E. If the taxpayer does not agree with a proposed change, he or she can request an immediate meeting with the examiner's supervisor. If the taxpayer cannot reach an agreement with the supervisor, or the examination took place outside of an IRS office, the taxpayer's case will be sent to the district office for processing. The taxpayer will then be sent a 30-day letter. The taxpayer then has 30 days from the date on the letter to accept or appeal the proposed change.

F. If a taxpayer does not respond to the 30-day letter or reach an agreement with an appeals officer, the IRS will send the taxpayer a 90-day letter which is also known as a statutory notice of deficiency. The taxpayer has 90 days (150 days if the taxpayer is outside of the U.S.) from the date of this notice to file a petition with the Tax Court.

** **Study Tip** * Study the appeals chart from Publication* 556, *Examination of Returns, Appeal Rights and Claims for Refunds. The chart explains the process of appeals. Time spent memorizing this process will prove beneficial when taking this part of the exam.*

Exercise 31: *If a taxpayer does not respond to a 30-day letter OR if he/she does not reach an agreement with an Appeals Officer, he/she will receive a statutory notice of deficiency. A statutory notice of deficiency allows a taxpayer 90 days (150 days if mailed when the taxpayer is outside the United States) from the date of this notice to file a petition with the Tax Court. (True or False)*

True. The Tax Court's jurisdiction to redetermine deficiencies by the IRS depends on the issuance of a notice of deficiency by the IRS and the filing of a Tax Court petition by the taxpayer. The petition must be filed within 90 days of the issuance of the notice of deficiency (150 days if mailed when the taxpayer is outside the United States).

G. If the taxpayer thinks he or she may owe additional tax before the examination ends, he or she can stop the accrual of interest by sending a payment of tax or a deposit to the IRS. Interest will stop accruing on any part of the amount covered by this payment or deposit.

1.. A deposit can be returned without filing a claim for refund. A written request must be submitted to have the submitted amount treated as a deposit.

2. The IRS will treat the amount as a tax payment if:

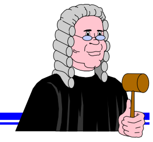
a) There is no request for it to be treated as a deposit,

b) The money is sent after being notified of a proposed tax liability, and

c) The amount sent is large enough to cover the proposed liability.

3. If a payment is enough to cover a proposed liability, no notice of deficiency will be sent. If a taxpayer agrees with the examiner's proposed change, a deposit will be used to pay the tax and no notice of deficiency will be sent. If no notice of deficiency is sent, the taxpayer will not have the right to take the case to Tax Court (discussed later).

Exercise 32:
If a taxpayer agrees with the results of an IRS examination that he/she owes additional tax and signs an agreement form, the taxpayer will NOT be billed for additional interest for more than 30 days from the



date the agreement was signed if the taxpayer pays the total amount due within 10 days of the billing date. (True or False)

True. If the taxpayer pays the total amount due within ten days of the billing date, he will not be billed for additional interest.

II. Appeals Conference

A. A taxpayer may appeal an IRS decision to the regional Appeals Office, the only level of appeal within the IRS. When requesting an appeals conference, a written protest or brief written statement may be required.

B. A written statement or protest is not required if:

1. The proposed increase or decrease in tax is not more than $2,500 for any of the tax periods involved, or

2. The examination was handled by mail or in an IRS office by a tax auditor.

C. A brief written statement is required if the proposed increase or decrease in tax, including penalties or refund, determined by the examination is more than $2,500 but not more than $10,000.

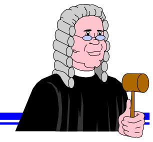
Exercise 33:

If the proposed increase or decrease in tax resulting from an IRS examination, conducted at the taxpayer's place of business, exceeds $2,500 but not more than $10,000, the taxpayer or the taxpayer's representative must provide a brief written statement explaining the disputed issues within 30 days of the issuance of the 30-day letter. (True or False)

True. If the proposed adjustments in a field examination case, including penalties and interest, exceed $2,500 but do not exceed $10,000, the taxpayer must file a brief written statement of the issues to initiate an administrative appeal.

D. A written protest of disputed issues is required if the proposed increase or decrease in tax, including penalties or claimed refund, is more than $10,000. A written protest needs to be filed within the time limit specified and should contain the following information:

1. Taxpayer's name and address,



2. A statement that the taxpayer wants to appeal the examination findings to the Appeals Office,

3. The date and symbols from the letter showing the proposed changes and findings that the taxpayer disagrees with,

4. The tax periods or years involved,

5. An itemized schedule of the changes with which the taxpayer disagrees,

6. A statement stating the law or other authority on which the taxpayer relied, and

7. A statement of facts supporting the taxpayer's position on any issue of disagreement.

   a) The taxpayer must sign a declaration that the statement of facts is true under penalties of perjury.

   b) If the protest is submitted by the taxpayer's representative, he or she may substitute a declaration stating:

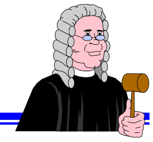
      (1) That he or she prepared the protest and accompanying documents, and

      (2) Whether he or she knows personally that the statement of facts in the protest and accompanying documents are true and correct.

Exercise 34:

All of the following statements concerning the procedure for a written protest submitted by a representative to obtain an Appeals Office conference are correct ***except:***

A. A written protest is required when the tax due, INCLUDING penalties, is MORE than $10,000.
B. A written protest MUST contain the tax years involved AND a statement that the taxpayer wants to appeal to the Appeals Office.
C. A written protest MUST contain a statement of facts for EACH disputed issue and a statement of law or other authority relied upon for each issue.
D. A written protest MUST contain a declaration under penalties of perjury, signed by the taxpayer that the statement of facts is true and correct.



D. A written protest MUST contain a declaration under penalties of perjury, signed by the taxpayer that the statement of facts is true and correct. Although a written protest generally must contain a sworn statement made by the taxpayer under penalty of perjury declaring that the statement of facts presented in the protest, and in any accompanying schedules, are true, correct and complete to the taxpayer's best knowledge and belief, a substitute declaration may be submitted by the taxpayer's representative stating that the taxpayer prepared the protest and accompanying documents, and whether the representative knows personally that the protest and accompanying documents are true and correct.

III. Appeals to the Court

A. If an agreement is not reached with the Appeals Officer, the IRS will send a Statutory Notice of Deficiency. A notice of deficiency will not be sent if the taxpayer remits payment of the same or more than the proposed change. If a Notice of Deficiency is not received, the taxpayer cannot take the case to Tax Court.

B. If the taxpayer elects to bypass the IRS's appeal system, the taxpayer may take his or her case to the United States Tax Court, the United States Claims Court, or the United States District Court, all of which are independent of the IRS.

C. If the taxpayer elected to bypass the appeals process with the IRS, the Tax Court may impose a penalty of up to $5,000 if it determines that the taxpayer did not pursue available administrative remedies.

D. The United States Tax Court can handle disagreements with the IRS over income tax, estate tax, gift tax, windfall profit tax on crude oil, on certain excise taxes of private foundations, public charities, qualified pension and other retirement plans, or real estate investment trusts.

1. The taxpayer must file a petition within 90 days of the date on the Notice of Deficiency. If not filed on time, the IRS will send a bill and the taxpayer may not take the case to Tax Court.

2. With the taxpayer's consent, the IRS can withdraw a Notice of Deficiency. Once withdrawn, both the IRS and the taxpayer are back to the same position as before the notice was filed. The taxpayer cannot petition the Tax Court based on this notice.

3. The Tax Court generally hears cases before any tax has been assessed and paid. However, a case petitioned to the United States Tax Court will normally

be considered for settlement by a regional Appeals Office before the Tax Court hears the case.

Exercise 35:

Mr. Garcia's individual income tax return was examined and the IRS issued a statutory notice of deficiency He wishes to contest the liability by bypassing the IRS's appeals system and taking his case straight to court. Mr. Garcia should:

A. Contact the IRS Problem Resolution Officer.
B. NOT pay' the lax and petition the US. Tax Court.
C. NOT pay the tax, file a written protest requesting immediate consideration by the US. Claims Court.
D. PAY the tax, file a claim for refund requesting that the claim be immediately rejected so he may file a refund suit in District Court

D. PAY the tax, file a claim for refund requesting that the claim be immediately rejected so he may file a refund suit in District Court. The official answer is D. However, it is CCH's contention that choice B is also correct. A taxpayer has three basic alternatives in contesting an adverse determination by the IRS or a preliminary or statutory notice of deficiency: requesting an administrative appeal; not pay the tax and petition Tax Court; or pay the tax, file a refund claim, and file a refund suit in a district court or Court of Federal Claims. Therefore, B and D are both correct.

E. If the amount in the case does not exceed $50,000 ($10,000 for proceedings commenced prior 7/23/98; including additions and penalties), the taxpayer can request, and if the Tax Court approves, the case can be handled under "small tax case procedures". The decision under small tax case procedure is final and cannot be appealed.

Exercise 36:

*With respect to the small case procedure in the Tax Court, all of the following statements are CORRECT **except:***

A. Within 90 days of receiving a statutory notice of deficiency, the taxpayer must pay a filing fee AND file a petition form with the Tax Court in Washington, DC.
B. The total disputed deficiency (tax and penalties) for ALL tax years at issue must be $10,000 or less.
C. The decision of the Tax Court CANNOT be appealed to another court and CANNOT be used as a precedent for any other case or year.

D. The proceedings are conducted in accordance with such rules of evidence and procedures as the Tax Court may prescribe.

B. The total disputed deficiency (tax and penalties) for ALL tax years at issue must be $10,000 or less. The official answer is B. However, it is CCH's contention that choice D is ambiguous and arguably a correct choice, too. The question states that one of the four choices is an incorrect statement. Choice B is an incorrect statement because according to Tax Court Rule 171 the $10,000 monetary cap is tested on a year-by-year basis and not by aggregating all the tax years before the court. Although choice B is an incorrect statement, choice D is a confusing and misleading statement and thus arguably an incorrect statement, too. Trials in a small tax court proceeding are more informal than regular Tax Court trials, and, unlike regular Tax Court trials, small tax court proceedings are not bound by the Federal Rules of Evidence.

F. If the taxpayer pays the tax after receiving a Notice of Deficiency and a claim for credit or refund has been filed, the case can be heard in the U.S. District Court or the U.S. Claims Court. The taxpayer would file a claim for refund if he/she thinks the tax is incorrect or excessive. If the claim is rejected or no action is taken within 6 months, the taxpayer may then file a suit for refund. This must be filed no later than 2 years after the claim for refund was rejected or after filing Form 2297, Waiver of Statutory Notification of Claim Disallowance.

Exercise 37:

An income tax case NOT resolved at an appeals conference can proceed to the United States Tax Court WITHOUT the taxpayer paying the disputed tax, but generally, the United States District Court and United States Claims Court hear tax cases ONLY after the tax is paid and the claim for credit or refund is filed by the taxpayer and is rejected by the IRS or the IRS has not acted on the taxpayer's claim within six months from the date of filing the claim for refund (True or False)

True. The Tax Court has deficiency jurisdiction (disputed tax does not have to be paid first) whereas the federal district courts and the Court of Federal Claims have refund jurisdiction (disputed tax must be paid before an action is brought for a refund).

IV. Claim For Refund

A. A claim for refund, Form 1040X, must be filed for each tax year or period involved.

B. A claim for refund must be filed within 3 years from the date of filing the original return, or 2 years from the date the tax was paid, whichever is later.

> ***Example**: You made estimated payments of $500 and got an automatic extension of time to August 15, 2001 to file your 2000 income tax return. You filed your return October 31, 2001, 2 1/2 months after the extension period ended, and paid an additional $200. Three years later, on October 25, 2004 you file an amended return and claim a refund of $700. Although filed within 3 years from the date you filed your original return, the refund is limited to $200. The estimated tax of $500 was paid before the 3-year plus 4-month extension period.*

C. The credit or refund cannot be more than the part of the tax paid within the 3 years (plus extensions) before filing the claim.

D. If a claim for refund is filed after the 3 year period but within 2 years from the time the tax is paid, the credit or refund cannot be more than the amount paid within the immediate 2 years.

E. If the taxpayer is filing a claim for credit or refund based only on contested income tax, or on estate tax or gift tax issues considered in previously examined returns, and does not want to appeal within the IRS, he or she should request in writing that the claim be immediately rejected. A Notice of Claim Disallowance will then be sent.

F. The taxpayer has 2 years from the date of mailing the Notice of Claim Disallowance to file a refund suit in the United States District Court having jurisdiction or in the United States Claims Court.

V. The Examination of a Partnership or S Corporation

A. This will begin with a notification to the Tax Matters Person (TMP).

B. At least 120 days before a final administrative adjustment is mailed to the TMP, the partners or shareholders will be notified of the examination.

C. Each partner or shareholder has a right to take part in the examination. Any settlement agreement is binding on all partners or shareholders who take part in the settlement.

D. Partners or shareholders cannot file a claim for credit or refund on partnership or corporate items. Instead, they must file an administrative adjustment request.

VI. Enforced Collection

A. Installment payments can be arranged if the taxpayer cannot pay the full amount of tax liability due. An installment agreement is initiated by the taxpayer filing Form *9465,* Installment Agreement Request. The IRS charges a $43 user fee for the initial installment agreement.

1. Form 433A or 433F will be completed by individuals and Form 433B will be completed by businesses to determine monthly income, expenses, and minimum payment.

2. If the taxpayer is making installment payments, the IRS may file a Notice of Federal Tax Lien to secure the Government's interest until the final payment is made.

3. The taxpayer has a right, unless collection is endangered, to a 30-day notification of the termination, alteration, or modification of an agreement based on an IRS determination of change in financial condition.

4. The IRS may frequently request current information to determine if there is a change in the taxpayer's ability to pay.

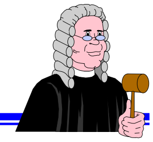
5. If the taxpayer does not provide financial information when requested, or does not meet the terms of the agreement, the entire tax becomes due and the IRS will take enforced collection action.

B. An offer in compromise can be submitted as a practical way to resolve an outstanding tax liability. Under certain conditions, the IRS will settle unpaid accounts for less than the full amount of the balance due. This applies to all taxes arising under the Internal Revenue Code, including any interest, penalty, or additional amount.

1. By law, the taxpayer has a right to submit an offer in compromise on the tax bill. The Commissioner of the IRS cannot compromise taxes relating to alcohol, tobacco and firearms.

2. A compromise may be made on one or both of two grounds:

   a) Doubt as to liability, or



b) Doubt as to the ability to make full payment on the amount owed.

3. Submission of an offer in compromise does not automatically suspend collection of an account. If there is any indication that the filing of the offer is solely for the purpose of delaying collection of the tax or that delay would negatively affect collection of the tax, the IRS will continue collection efforts.

C. The IRS can file a Notice of Federal Tax Lien. This is a public notice to creditors that the Government has a claim against all of the taxpayer's property. This includes property purchased after the lien has been filed.

1. The notice can be filed once the IRS:

a) Assesses a tax,

b) Sends a notice for demand and payment, and

c) The taxpayer neglects or refuses to pay the tax or otherwise resolve the tax problem (within 30 days),

Exercise 38:

By filing a Notice of Federal Tax Lien against a taxpayer, the Government is providing a public notice to the taxpayer's creditors that the Government has a claim against all of the taxpayer's property, INCLUDING property that the taxpayer acquires after the lien was filed (True or False)

True. The purpose of filing a notice of federal tax lien is to give notice to the taxpayer's creditors that the government has a claim against all the taxpayer's property. The federal tax lien attaches to all property and rights to property, whether real or personal, belonging to the taxpayer at the time the lien arises, as well as to property subsequently acquired during the period of the lien.

2. Property subject to a tax lien may be released under the following circumstances:

a) The tax liability is satisfied by payment or adjustment.

b) IRS acceptance of a bond guaranteeing payment.

c) Other property subject to the lien is worth at least twice the amount owed.

d) The IRS receives the value of the Government's lien interest in the property and the taxpayer is giving up ownership.

e) The IRS determines that the Government's interest in the property is valueless and the taxpayer is giving up ownership.

f) The property is being sold and there is a dispute as to who is entitled to the sale proceeds, and the sale proceeds are placed in escrow while the dispute is being resolved.

3. All fees charged by the state or other jurisdiction for both filing and releasing the lien will be added to the balance owed by the taxpayer.

4. The taxpayer may appeal the filing of an erroneous lien. A filing is erroneous under one of the following conditions:

a) The liability was satisfied before the lien was filed.

b) The taxpayer was in bankruptcy and subject to the automatic stay.

c) The examination assessment was improperly made.

d) The statute of limitations for collection expired prior to filing the lien.

Exercise 39:
A Notice of Federal Tax Lien is considered incorrect if the IRS assessed the tax and filed the lien when the taxpayer was in bankruptcy under title 11 of the US. Code. (True or False)

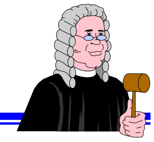
True. Although a bankruptcy stay does not prevent tax assessments, a tax lien generally does not take effect during the pendency of a bankruptcy.

D. A levy is the taking of property to satisfy a tax liability. Levies can be made on property in the hands of third parties (employers, banks, etc.) or in the taxpayer's possession (automobile, real property, etc.). Once served, a levy on salary or wages continues in effect until it is released or the tax liability is satisfied or becomes unenforceable due to lapse of time.

1. For taxes assessed after November 5, 1990, and within the statutory period of limitation for assessment, the tax may be collected by levy or a proceeding in court, if the levy is made or the court proceeding is begun:

a) Within 10 years after the assessment of the tax, or

b) By the end of any period of collection agreed upon in writing between the taxpayer and the IRS.



2. Court authorization is not required before levy action is taken unless Collection personnel must enter into private premises to accomplish their levy action (actual seizure of property). Generally there are three legal requirements before levy action can be taken:

    a) The tax must be owed,

    b) A notice and demand for payment must have been sent to the last know address of the taxpayer, and

    c) If payment is not made, a Final Notice (Notice of Intent to Levy) must be give to the taxpayer at least 30 days in advance. Such notice may be given to the taxpayer in person, left at the taxpayer's dwelling or usual place of business, or sent by certified or registered mail to the taxpayer's last known address.

3. If collection is endangered, the Service may take immediate collection action. Jeopardy levies may occur when the Service waives the 10-day Notice and Demand period and/or Final Notice (Notice of Intent to Levy) 30-day period, because delay would endanger collection of the tax.

4. If a bank account is levied, the bank is required to hold funds currently on deposit (up to the amount owed) for 21 days. If arrangements to pay have not been made, the bank is then required to send the money to the IRS.

5. The IRS must release a levy if:

    a) The tax, penalty, and interest for which the levy was made is paid,

    b) The statute of limitations expired prior to the levy,

    c) The IRS determines the release will help collect the tax,

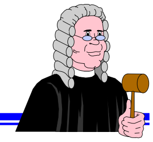
    d) The taxpayer has received approval for a current installment agreement for the tax on the levy,

    e) The IRS determines the levy is creating an economic hardship, or

    f) The fair market value of the property exceeds the levy and its release would not hinder the collection of tax.

6. Property exempt from levy includes:

    a) Wearing apparel and school books (furs don't qualify),



b) Fuel, provisions, furniture, and personal effects, not to exceed *$1,650* in value,

c) Books and tools used in a trade or business, not to exceed $ I ,100 in value,

d) Unemployment benefits,

e) Undelivered mail,

f) Certain annuity and pension benefits,

g) Certain service-connected disability payments,

h) Workmen's compensation,

i) Salary, wages, or other income subject to a prior judgment for court-ordered child support payments,

j) Certain public assistance payments,

k) Assistance under the Job Training Partnership Act,

l) Principal residence, unless prior written approval of the district director or assistant district director is secured or jeopardy exists,

m) Deposits to the special Treasury fund made by members of the armed forces and Public Health Service employees on a permanent duty assignment outside the U.S. or its possessions, and

n) A minimum weekly exemption for wages, salary, and other income based on the standard deduction plus the number of allowable personal exemptions divided by 52. If the taxpayer does not provide a certification of exemption, the exempt amount will be computed as if the taxpayer were married filing separately with one exemption.

Exercise 41:

When levies are attached, the IRS has the authority to take property to satisfy a tax debt. The IRS may levy all of the following ***except:***

A. Accounts receivables
B. Workmen's compensation
C. Rental income

D. Commissions

B. Workmen's compensation. Workmen's compensation, including any amount payable for dependents, is property which is exempt from levy.

E. Upon the filing of a bankruptcy petition and during the period the debtor's assets are under the jurisdiction of the bankruptcy court, all IRS collection efforts against the debtor and the debtor's property are automatically stayed.

Exercise 42:

Filing a petition in bankruptcy under title 11 of the United States Code automatically stays assessment and collection of a tax. The stay remains in effect until the bankruptcy court discharges liability for the tax or lifts the stay (True or False)

True. Filing a petition in bankruptcy automatically stays the IRS from collecting tax from the debtor. The stay lasts until the bankruptcy case is closed or dismissed or the debtor is discharged or denied a discharge.

F. Seizures and Sales

1. A seizure may not be made on any property if the estimated cost of the seizure and sale exceed the fair market value of the property to be seized, at the time of the seizure. Property cannot be seized or levied on the day the taxpayer attends a collection interview in response to a summons (unless jeopardy exists).

2. The taxpayer has a right to an administrative review of the seizure action when the IRS has taken personal property that you own which is necessary for the maintenance of the taxpayer's business.

3. Once property is seized, the taxpayer will be given a notice of proposed sale. The sale cannot be earlier than 10 days after giving the taxpayer the notice (unless the property is perishable).

4. The IRS will determine a "minimum bid price", which is the lowest amount that will be accepted on the sale.

5. The taxpayer has a right to redeem his property at any time prior to the sale. Redemption consists of paying the tax due, including interest and penalties, together with the expenses of seizure.

6. The taxpayer may get real property back within 180 days of the sale by paying the purchaser the amount paid plus 20% interest.

7. After the sale, proceeds are applied first to the expenses of the levy and sale. The remaining amount is then applied against the tax bill. If the sale proceeds are less than the tax bill and the expenses of levy and sale, the taxpayer will still be liable for the remaining unpaid tax.

Exercise 43:

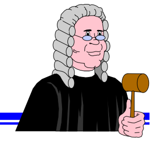
*With respect to the IRS's seizures and sales of personal property to satisfy a federal tax debt, all of the following statements are CORRECT **except:***

A. After the notice of sale has been given to the taxpayer, the IRS must wait 10 days before conducting the sale unless the property is perishable and must be sold immediately
B. After the sale, the IRS uses the proceeds first to satisfy the tax debt.
C. If real estate was sold, the taxpayer; or anyone with an interest in the property, may redeem it at any time within 180 days after the sale by paying the purchaser the amount paid for the property plus a certain percentage of interest.
D. Before the date of sale, the IRS computes a "minimum bid price " which is the lowest amount the IRS will accept for the sale of that property to protect the taxpayer's interest in that property.

B. After the sale, the IRS uses the proceeds first to satisfy the tax debt. The sale proceeds are applied first against the expenses of the proceedings, next against any federal excise tax imposed directly on the property, and then against the tax liability for which the levy was made, including a separate supporting statement containing the basis for the taxpayer's explanation.

G. If interest and dividends are not properly reported on the tax return, or if the taxpayer fails to give the payers a correct taxpayer identification number, the payer is responsible to withhold tax on such payments.

H. A Trust Fund Recovery Penalty can be assessed against employers who fail to pay the withheld income tax and the employee's portion of the employment tax. The amount of the penalty is equal to 100 percent of the tax required to be collected and paid over. The penalty is computed based on both the withheld income tax and the employee's (but not the employer's) portion of the employment tax or collected excise tax. The penalty can apply regardless of whether the taxpayer is out of business or without assets.



1. The penalty may be assessed against any person responsible for collecting or paying over income and employment taxes or paying over collected excise taxes, who willfully fails to do so.

2. The responsible person may be an officer or an employee of a corporation, a member or employee of a partnership, a corporate director or shareholder, a volunteer member of a board of trustees of a nonprofit organization or another person with sufficient control over fluids to direct their disbursement.

Exercise 44:

The trust fund penalty may be imposed against any person who is responsible for collecting or paying withheld income and employment taxes AND who willfully fails to collect OR pay them. (True or False)

True. The trust and fund recovery penalty may be imposed against any person required to collect, account for, and pay over trust fund taxes who willfully fails to do so. Trust fund taxes include withheld income taxes and employment taxes.

VII. Taxpayer Rights

A. A taxpayer has the right to be treated fairly, professionally, promptly, and courteously by IRS employees. With any change or initial notice from the IRS, the taxpayer should receive Publication 1, Your Rights as a Taxpayer.

B. The taxpayer has a right to request that the case be transferred to another district or to another office within a district. Generally, the request will be honored if there is a valid reason such as a change of address before or during the tax case resolution.

C. Throughout the examination, the taxpayers may act on their own behalf or have someone else represent them. If the representative is to meet with the IRS alone, the representative must have written authorization, power of attorney.

D. Taxpayers who have been unable to resolve their tax problems with another IRS department, can contact the Problem Resolution Office (PRO) to help resolve the problem. However, before contacting PRO, the taxpayer should first request assistance from an employee or manager in an IRS Collection office.

E. If a taxpayer has a significant hardship due to the collection of a tax debt, additional assistance is available from the IRS by filing Form 911. Application for Taxpayer Assistance Order (ATAO) to Relieve Hardship. A significant hardship may occur if the taxpayer cannot maintain necessities such as food, clothing, and shelter.

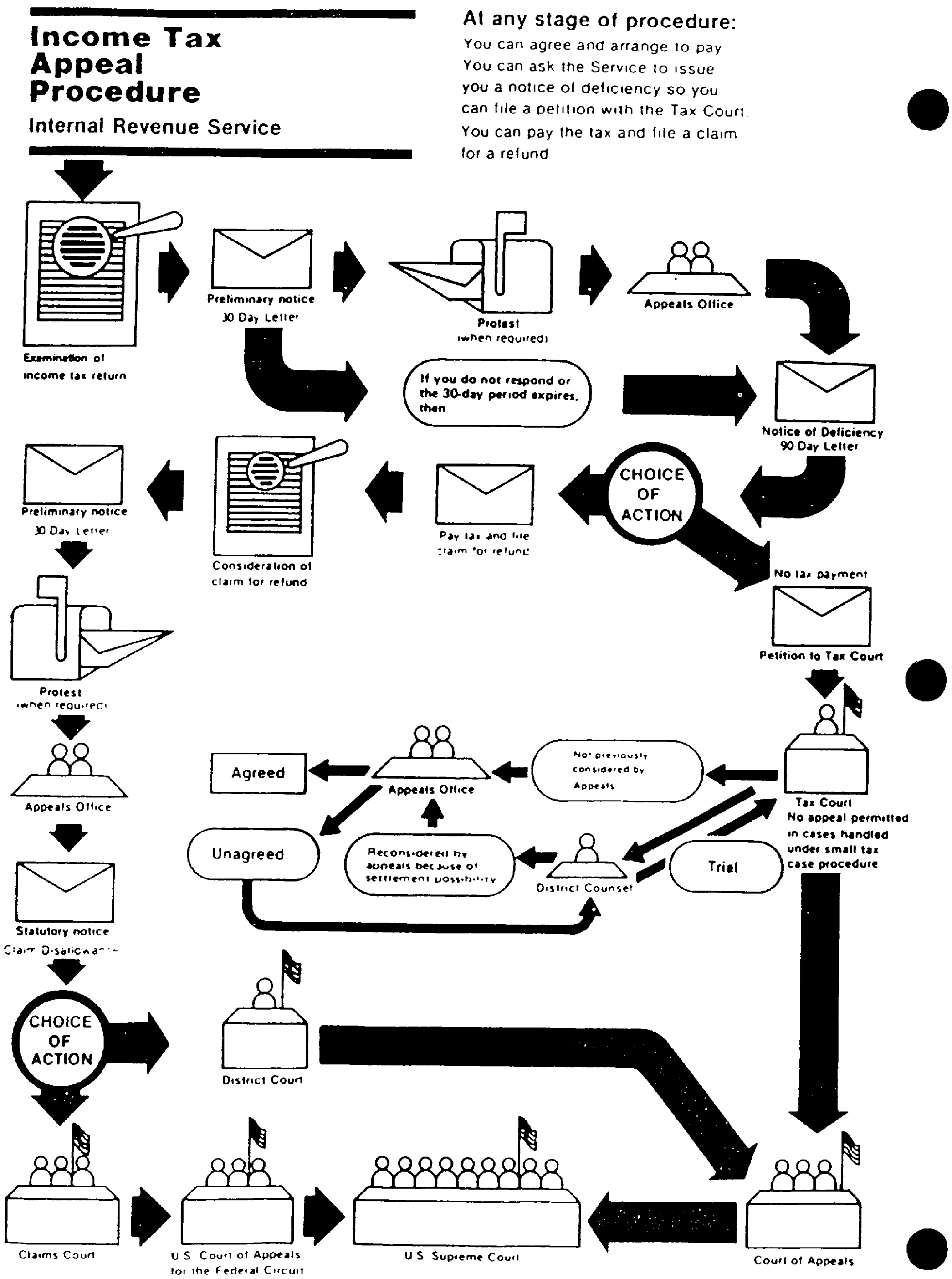
F. If the IRS made a mistake or misplaced a taxpayer's check, he/she may file a claim for reimbursement of the fees, charged by the bank, related to the erroneous levy.

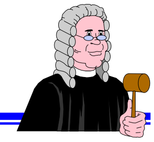
Exercise 45: *All of the following statements with respect to resolving tax problems involving the collection process are CORRECT* ***except:***

A. You may be entitled to a reimbursement for fees charged by your bank if the IRS has erroneously levied your account.
B. You should first request assistance from IRS collection employees or their managers before seeking assistance from the Problem Resolution Officer.
C. If you suffer a significant hardship because of the collection of the tax liability, you may request assistance from the IRS on Form 911, Application for Assistance Order to Relieve Hardship.
D. While you are making installment payments, interest will continue to accrue only on the tax liability due.

D. While you are making installment payments, interest will continue to accrue only on the tax liability due. Interest accrues on the unpaid tax liability as well as on unpaid interest and penalties, too.

Income Tax Appeal Procedure:


Income Tax Appeal Procedure
Internal Revenue Service
At any stage of procedure:
You can agree and arrange to pay
You can ask the Service to issue you a notice of deficiency so you can file a petition with the Tax Court
You can pay the tax and file a claim for a refund
Examination of income tax return
Preliminary notice 30 Day Letter
Protest (when required)
Appeals Office
If you do not respond or the 30-day period expires, then
Notice of Deficiency 90-Day Letter
CHOICE OF ACTION
Pay tax and file claim for refund
Consideration of claim for refund
Preliminary notice 30 Day Letter
Protest (when required)
Appeals Office
Statutory notice
No tax payment
Petition to Tax Court
Tax Court
No appeal permitted in cases handled under small tax case procedure
Not previously considered by Appeals
Appeals Office
Agreed
Unagreed
Reconsidered by appeals because of settlement possibility
District Counsel
Trial
CHOICE OF ACTION
District Court
Claims Court
U S Court of Appeals for the Federal Circuit
U S Supreme Court
Court of Appeals



SECTION C - RECORDS, RETIREMENT PLANS, EXEMPT ORGANIZATIONS, ELECTRONIC FILING

I. Recordkeeping

A. The IRS does not require a particular form for keeping records. To verify deductions, the taxpayer should keep sales slips, invoices, receipts, and canceled checks or financial statements. To verify income, the taxpayer should keep Forms W-2, Forms 1099, brokerage statements, or other documents proving amounts shown on the return.

B. The most often used proof of payment is a canceled check or cash receipt. A canceled check is no longer sufficient documentation for a charitable contribution.

C. The taxpayer should keep records that show the basis of property owned. If basis is determined by reference to other property, such as the deferral of gain on the sale of a residence, basis information for the old property should be retained.

D. Generally, the taxpayer must keep records for as long as they are important for federal tax purposes. For most items on a tax return, records should be kept at least 3 years from the date the return was filed or 2 years from the date the tax was paid. For unreported income which is more than 25% of the income shown on the return, the period of limitations does not expire until 6 years after the return is filed.

Exercise 46:
All of the following statements with respect to effective record keeping are CORRECT ***except:***

A. Records that support the basis of property should be kept until the statute of limitations expires for the year that the property was acquired
B. Records of income should identify its source in order to determine if it is taxable or nontaxable.
C. If an individual CANNOT provide a canceled check to prove payment of an expense item, he/she may be able to prove it with certain financial account statements.
D. Records should show how much of an individual's earnings are subject to self employment tax.

A. Records that support the basis of property should be kept until the statute of limitations expires for the year that the property was acquired. Records regarding the basis of property are relevant and *should be kept for as long as the taxpayer owns the asset. If the taxpayer exchanges an asset for another asset, for which the basis in the new asset is determined by the basis in the exchanged asset, the records regarding the basis of the exchanged asset should also be maintained as long as the new asset is owned by the taxpayer.*

Computerized records.
Many retail stores sell computer software packages that you can use for recordkeeping. These packages are relatively easy to use and require little knowledge of bookkeeping and accounting.
If you use a computerized system, you must be able to produce legible records of the information needed to determine your correct tax liability. In addition to your computerized records, you must keep proof of payment, receipts, and other documents to prove the amounts shown on your tax return.

E. With regard to the time period for the preservation of records, any person that is required by Reg. §31.6001 - 1 to keep records in respect of employment taxes (whether or not such person incurs the liability for the tax), shall maintain the records for at least four years after the due date of the tax return to which the records relate, or the date such tax is paid, whichever is later.

Exercise 47:
Employers are required to keep records on employment taxes (income tax withholding, Social Security, Medicare, and federal unemployment tax) for:

A. An indefinite time.
B. The statutory period for assessment of the employees' taxes.
C. At least 4 years after the due date of the return or after the date the tax is paid, whichever is later.
D. At least 3 years after the due date of the return or 2 years after the date the tax is paid, whichever is later.

C. At least 4 years after the due date of the return or after the date the tax is paid, whichever is later. Unemployment tax records must be retained for at least four years after the tax to which the records relate is due, or four years after the tax is paid, whichever is later.

II. Exempt Organizations

A. To obtain a determination or ruling for exempt status, most organizations must file a written application with the key District Director in which the organization's principal office or business is located.

B. Most organizations will not be treated as tax exempt until their application for exempt status is filed with the local IRS district, unless they file the application for exempt status within 15 months from the end of the month in which they were organized.

> ***Exercise 62:*** *An organization described in IRC Section 501(c)(3) must apply for tax exempt status with its key IRS District Director. If approved by the IRS, the organization will be recognized as exempt retroactively to the date it was organized if the application was filed within 15 months from the end of the month it was organized. (True or False)*
>
> *True. To establish its exemption, an organization must file a written application with the key director for the district in which the principal place of business or principal office of the organization is located. There are specific forms depending on the type of organization applying for the exemption. If filed within the 15-month period, then retroactive treatment is available.*

C. Every organization exempt from federal income tax under §501(a) must file an annual information return (Form 990 series) except for: (this is a condensed list)

1. Churches, related religious organizations, or exclusively religious activities (such as mission societies and schools below college level),
2. A stock bonus, pension or profit-sharing trust which qualifies under §401,
3. A state institution the income of which is excluded from gross income under §115,
4. A §501(c)(l) corporation that is an instrumentality of the U.S. and is exempt from federal income tax,
5. A black lung benefit trust, or
6. An exempt organization (other than a private foundation) having gross income that is generally not more than $25,000.

D. Tax-exempt organizations, other than private foundations, must file Form 990, Return of Organizations Exempt from Income Tax (or the shorter Form 990EZ).

E. All private foundations exempt under §501(c)(3) must file Form 990-PF.

F. The due date for Forms 990, 990-EZ, or 990-PF is the 15th day of the 5th month after the end of the organizations accounting period.

G. Even though an organization is recognized as tax exempt, it still may be liable for tax on its unrelated business income. Unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or to the purpose constituting the basis for the organization's exemption. An exempt organization that has $1,000 or more gross income from an unrelated business must file Form 990-T. Estimated tax payments must be made quarterly if an organization expects its tax to be $500 or more.

Exercise 63: *With respect to the filing requirements of an exempt organization (including private foundations), which of the following statements is CORRECT?*

A. A central or parent organization may file Form 990, Return of Organizations Exempt From Income Tax, for two or more local organizations that are NOT private foundations. However, this return is in addition to the central or parent organization's separate annual return fit must file one.
B. EVERY organization exempt from income tax must file an annual information return.
C. Forms 990, 990-EZ, and 990-PF are required to be filed by the 15th day of the 3rd month after the end of the organization's accounting period
D. An exempt organization must have at LEAST $5,000 gross income from an unrelated business before it is required to file Form 990-T, Exempt Organization Business Income Tax Return.

A. A central or parent organization may file Form 990, Return of Organization Exempt From Income Tax, for two or more local organizations that are NOT private foundations. However, this return is in addition to the central or parent organization’s separate annual return if it must file one. A parent or central exempt organization files a separate return for itself. If it chooses, the organization may also file a group information return for two or more local organizations, as long as none of the local organizations are private foundations.

H. Every employer, including an organization exempt from federal income tax, who pays wages to employees, is responsible for withholding, depositing, paying, and reporting federal income tax, Social Security taxes and federal unemployment taxes. Exceptions: Services performed by a minister of a church are not subject to FICA or FUTA tax.

III. Electronic Filing

A. A firm, organization, or individual that participated in the Electronic Filing Program is known as an electronic filer.

1. An Electronic Return Originator (ERO), which can be a for-profit or a not-for-profit organization, deals directly with the taxpayer and is defined as an:

   a) *"Electronic Return Preparer"* who prepares tax returns, including Forms *8453,* for taxpayers who intend to have their returns electronically filed; or

   b) *"Electronic Return Collector"* who accepts completed tax returns, including Forms *8453,* from taxpayers who intend to have their returns electronically filed.

2. A Software Developer is categorized as a firm, organization or individual who develops software for the purpose of:

   a) Formatting returns according to the Service's electronic return specifications; and/or,

   b) Transmitting electronic returns directly to the Service. A software developer may also sell its software.

3. A Transmitter is a firm, organization, or individual who transmits electronic returns directly to the IRS Data Communication Subsystem This includes, but is not limited to:

   a) Entities which receive information to be reformatted and sent to IRS, i.e. third party Transmitters; and

   b) Entities which receive reformatted information then speed it up for forwarding to the IRS (commonly know as providing "Bump-Up" services).

4. A Service Bureau is defined as a firm, organization, or individual who:

   a) Receives tax return information on any media from an ERO, formats the return information, and either forwards the return information to the Transmitter or sends the return information back to the ERO; and

b) May or may not process Forms 8453 and send them to the appropriate Service Center.

> ***NOTE:*** *A "Service Bureau" does not send returns directly to the IRS. If returns are being sent directly to the IRS, the Service Bureau is a "Transmitter".*

B. All organizations or individuals that wish to be considered for participation in the 1996 Electronic filing program as NEW applicants, must submit a completed Form 8633, Application to Participate in the Electronic Filing program. Applicants should use the official Form 8633 or an approved substitute. Use of unapproved forms could delay the acceptance for participation in the electronic filing program.

C. Applicants must file a NEW Form 8633 with fingerprint cards for the appropriate individuals if:

1. The applicant has never participated in the electronic filing program;

2. The applicant has previously been denied participation in the electronic filing program;

3. The applicant has been suspended from the electronic filing program.

> ***NOTE:*** *Applicants that are required to submit fingerprints must use an official fingerprint card from the Internal Revenue Service. A substitute fingerprint card cannot be used.*

D. Applicants in one of the following categories may submit evidence of professional status in lieu of the fingerprint card:

1. Attorney,

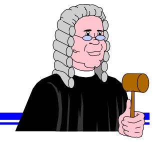
2. Certified Public Accountant (CPA),

3. Enrolled Agent,

4. Banking official who is bonded and has been fingerprinted within the last two years, and

5. An Officer of a Publicly Owned Corporation.

E. The application period, for new applications, is from August 1 to December 1 each year.



F. The service can suspend, without notice, an Electronic Filer from the electronic filing program. The suspension of an owner or a Responsible Official is also grounds for suspension of all entities with whom the individual is associated.

G. An electronic filer shall comply with the advertising and solicitation provision of the Treasury Department Circular No.230. Any claims concerning faster refunds by virtue of electronic filing must be consistent with the language in official service publications. In addition, the Electronic Filer must adhere to all state and city consumer protection laws.

H. The use of improper methods of advertising may result in immediate suspension from the electronic filing program. Violations include, but are not limited to:

   1. The use of the Services name, "Internal Revenue Service", or "IRS" within a firm's name; or

   2. The use of improper or misleading advertising in relation to the electronic filing program (including the time frames for refunds and RALs).

I. An electronic filer may only accept returns for electronic filing directly from Drop-off Collection Point(s) accurately identified on Form 8633, taxpayers, or from another accepted electronic filer.

J. If an electronic filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or on the amount of taxes. An electronic filer may not charge a separate fee for Direct Deposit.

K. An electronic filer must ensure that an electronic return is filed on or before the due date of the return. A tax return is not considered filed until the electronic portion of the tax return has been acknowledged as accepted for processing and a completed and signed Form 8453 has been received by the IRS.