

“The City Mouse” 2002 Federal Tax Forms

2002 Income Tax Forms & Examples

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Material Prepared By:

**Lawrence J. Beckman
Daniel L. Fretheim
Smith Peterson Law Firm, LLP
35 Main Place, Suite 300
Council Bluffs, IA 51503
Telephone: (712) 328-1833
E-mail: ljbeckman@smithpeterson.com**

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FACTUAL BACKGROUND

Walter and his wife Stacey are both 28. Walter is an information systems specialist at L.C., Inc. He also worked at Jiffy Computer Consulting for part of the year. Walter also has a consulting business. Stacey is an elementary school teacher for the Iowa City School District. The couple had their first child, George, in September of 1998. They also adopted Grace, age 4, in 1999. Based on an interview with them and after reviewing their records, the following information was obtained:

A. FAMILY FACTS:

Walter and Stacey file a joint tax return.

Walter's social security number is 483-73-5777. Stacey's is 169-38-5543.

B. FAMILY INCOME:

- a) Walter's two W-2's for 2002 contained the following: (FORM 1040, LINES 7, 62 and 65) (SCHEDULE A, LINE 5)

2222		FORM 1040 USE ONLY OMB NO. 1545-0045	
Employer identification number 77 7627824		1. Gross wages, tips and other compensation \$ 62,500.00	2. Federal income tax withheld \$ 1,900.00
Employer's name (include full name) L.C., Inc. 1733 F 7th Avenue Iowa City IA 52240		3. Social Security tax \$ 62,500.00	4. State income tax withheld \$ 2,167.00
		5. State Social Security tax \$ 29,500.00	6. Local income tax withheld \$ 906.00
		7. Union dues and other deductions \$	8. Other deductions \$
Employee's social security number 483-73-5777		9. Health insurance \$	10. Dependent care benefits \$
Employee's name (last, first, middle initial) WALTER EJRNS		11. Flexible savings account \$	12. Rollover from a previous employer \$
Employee's address (street, city, state, ZIP+4) 125 FOURTH STREET IOWA CITY, IA 52240		13. Other \$	14. Other \$
Employee's home telephone number IA		15. Total wages, tips and other compensation \$ 62,500.00	16. Total federal income tax withheld \$ 5,013.00
		17. Total state and local income tax withheld \$	18. Total other deductions \$

2222		FORM 1099-JAN 2002 OMB NO. 1545-0045	
EE 7630900		1 Wages, salaries, tips, etc. \$30,250.00	2 Tax-exempt interest \$3,893.00
JIFFY COMPLIANCE CONSULTING 12 JIFFY LANE KWACITY, IA 52240		3 Social Security taxes \$30,250.00	4 State and local taxes \$1,076.00
		5 Non-qualified annuities \$30,250.00	6 Rollover benefits \$429.00
		7 IRA ROLLOVER PAY \$	8 UNEMPLOYMENT \$
483-72-5777 CITY OF KWARAQUANNA WALTER		9 ROTH IRA ROLLOVER \$	10 Dependent care benefits \$
125 FOURTH STREET KWACITY, IA 52240		11 ROTH IRA ROLLOVER \$	12a Social Security benefits \$
		12b Other \$	12c \$
		12d \$	12e \$
		12f \$	12g \$
13 State IA	14 Federal \$26,260.00	15 Total \$1,600.00	16 Total \$
17 \$	18 \$	19 \$	20 \$

W-2 Wage and Tax Statement 2002

Form W-2 For Social Security Administration Use Only
2002 Form W-2 is the Social Security Administration's standard form for reporting wages and taxes.

2002 Form W-2 is the Social Security Administration's standard form for reporting wages and taxes.

b) Stacey's W-2 for 2002 contained the following: (FORM 1040, LINES 7 and 62) (SCHEDULE A, LINE 5) (FORM 2441)

2222		FORM 1099-JAN 2002 OMB NO. 1545-0045	
24 581012		1 Wages, salaries, tips, etc. \$26,780.00	2 Tax-exempt interest \$2,993.00
KWACITY SCHOOL DISTRICT 43 SCHOOL B STREET DR WF KWACITY, IA 52240		3 Social Security taxes \$26,780.00	4 State and local taxes \$1,090.00
		5 Non-qualified annuities \$26,780.00	6 Rollover benefits \$309.00
		7 IRA ROLLOVER PAY \$	8 UNEMPLOYMENT \$
154-26-5549 CITY OF KWARAQUANNA STACEY		9 ROTH IRA ROLLOVER \$	10 Dependent care benefits \$3,900.00
125 FOURTH STREET KWACITY, IA 52240		11 ROTH IRA ROLLOVER \$	12a Social Security benefits \$
		12b Other \$	12c \$
		12d \$	12e \$
		12f \$	12g \$
13 State IA	14 Federal \$26,780.00	15 Total \$1,204.00	16 Total \$
17 \$	18 \$	19 \$	20 \$

W-2 Wage and Tax Statement 2002

Form W-2 For Social Security Administration Use Only
2002 Form W-2 is the Social Security Administration's standard form for reporting wages and taxes.

2002 Form W-2 is the Social Security Administration's standard form for reporting wages and taxes.

c) Walter and Stacey received the following interest reported on Forms 1099 INT in 2002: (SCHEDULE B, PART I)

Iowa City Municipal Bond	120
Wells Fargo Bank	217
SolomonSmithBarney	1,104

First National Bank	40
TOTAL	1,481

- a) Walter loaned \$15,000 to his younger brother, Roger, on October 1, 2002, for college expenses. The two agreed that they would treat the loan as a demand loan with no interest. (SCHEDULE B, PART I)
- b) Walter and Stacey received the following dividends reported on Form 1099 DIV in 2002: (SCHEDULE B, PART II)

Pioneer Growth Fund	1,190
DOT.COM, Inc.	410
XYZ, Corp.	108
ABBD, Inc.	80
TOTAL	1,788

\$210 of the dividends received from Pioneer Growth Fund were from long term capital gains. (SCHEDULE D, LINE 13)

- a) Walter's records show he sold the following stock in 2002: (SCHEDULE D, PARTS I and II)

<u>Stock</u>	<u>Date Acquired</u>	<u>Date Sold</u>	<u>Selling Price</u>	<u>Purchase Price</u>	<u>Sales Comm.</u>
SHORTCO, Inc.	05-04-01	02-03-02	780	400	20
Winner, Corp.	07-10-86	05-03-02	2,710	500	10
ABL, Inc.	08-09-97	10-01-02	140	1,620	10

- a) On October 4, 2002, Walter sold a stamp collection that he had inherited from his uncle in 1982. The sale price was \$4,000. His basis in the collection (from his uncle) was \$100. (SCHEDULE D, PART II AND WORKSHEET FROM SCHEDULE D INSTRUCTIONS PAGE D-9)
- b) Walter and Stacey were very lucky on their trips to Prairie Meadows in Des Moines, where Stacey hit a jackpot. Stacey received a W-2G from the casino. The W-2G indicates that Stacey won \$6,500 in 2002, there was \$1,755 of federal income tax withheld on the W-2G (income tax is withheld at a flat rate of 27% on gambling winnings) plus Iowa withholding of \$650. The couple also had sustained gambling losses of \$1,700 in 2002. (FORM 1040, LINE 21) (SCHEDULE A, LINES 5 AND 27) (FORM 1040, LINE 62)

B. OTHER INVESTMENTS:

- a) Walter has an interest in PTP, Limited, a publicly traded limited partnership. Walter received a 2002 Schedule K-1 from this limited partnership with rental loss of \$210 and interest income of \$51. (SCHEDULE E, PAGE 2) (SCHEDULE B, PART I) (FORM 8271) (FORM 8582)
- b) In 2002 Walter continued to lease the duplex rental unit in Iowa City. The rental income amounted to \$15,400, the rental expenses included: \$50 for advertising, \$540

for insurance, \$8,210 mortgage interest, \$3,880 for real estate taxes and \$653 for repairs. Walter also had the depreciation of this duplex. Neither Walter nor any other family members have used this duplex for personal purposes in 2002. (SCHEDULE E) (FORM 8582)

- c) Walter received a Schedule K-1 from NewCo, LLC for 2002. The Schedule K-1 from NewCo, LLC shows a rental loss of \$4,700. (SCHEDULE E PAGE 2) (FORM 8582)

C. WALTER'S FACTS:

- a) In 2002, Walter's home-based business had gross sales of \$14,540; office expense of \$297, supply expense of \$480, advertising expense of \$78, and telephone expense of \$490.

In addition, Walter sold the computer that he purchased in 1998 for \$2,500. The sales price was \$185. This computer was not fully depreciated. He used this computer 80% for business and 20% for personal purposes. He also has the computer he purchased in 2001, which he now uses 80% for business and 20% for personal purposes. Walter purchased a new computer on December 1, 2002 for \$3,205 (100% business use). Walter also has the office furniture that he purchased in 2000 for \$2,100. Walter has an office in his home where he performs some of the services for this business. The size of the office is 200 sq. ft. The total size of his house is 1800 sq. ft. (SCHEDULE C; FORM 4562; FORM 4797; FORM 8829)

- b) Walter also purchased a 2002 Toyota Prius on January 15, 2002. This vehicle is a hybrid vehicle. The total cost of the vehicle was \$22,000. The dealer informed Walter that the total cost to acquire and install the vehicle's electric motor and related generating, storage and delivery equipment exceeds \$2,000. Walter used this vehicle 60% for business and 40% for personal use. He had a total fuel, insurance and maintenance costs of \$2,150. He also paid license fee of \$228. (See Schedule A, Line 7 regarding license fee). (FORM 1040, LINE 34, SCHEDULE C AND FORM 4562)

D. STACEY'S FACTS:

- a) In 2002, Stacey spent the following amounts on items for school that she was not reimbursed for by her employer: (FORM 1040, LINE 23 AND FORM 2106-EZ PART I)

Instruction Materials	240
Supplies	510
Student Project Supplies	705
Prizes	76
TOTAL	1,531

- a) Stacey drove her car 705 miles for her employer in 2002. Stacey was not reimbursed for these miles. (FORM 2106-EZ)

B. OTHER INFORMATION:

- a) Tax Data: Walter and Stacey received a refund of \$1,688 in 2002 from the State of Iowa and had itemized their 2001 deductions. Their refund was delayed for some unknown reason, and the Iowa Dept. of Revenue and Finance included \$29 of interest with the refund. (FORM 1040, LINE 10 AND SCHEDULE B, PART I)

- b) Investment:

- (1) Both Walter and Stacey contributed \$3,000 each into their Roth IRAs that they established in 1998. (FORM 8606 COMMENTARY)
- (2) The couple opened an account at SolomonSmithBarney where they incurred \$475 of investment interest expense on their margin account in 2002. (SCHEDULE A, LINE 13)

c) Personal:

- (1) They rent a safe deposit box at \$35 per year. (SCHEDULE A, LINE 22)
- (2) Walter and Stacey's medical expenses were covered by the medical insurance provided by Stacey's employer as a fringe benefit to Stacey's employment. However, \$425 of prescription expenses were not reimbursed by the insurance company. Additionally, Walter had elective surgery in 2002 that was not covered by insurance. The total cost of his surgery was \$4,950. (SCHEDULE A, LINE 1)
- (3) Walter paid \$340 and Stacey paid \$310 for qualified long term care insurance policies in 2002. (FORM 1040, LINE 30 & SCHEDULE A, LINE 1)
- (4) Walter and Stacey made a number of charitable contributions in 2002. The cash gifts were as follows: (SCHEDULE A, LINE 15)

United Way	240
American Canter Society	200
St. Patrick Catholic Church	<u>4,725</u>
TOTAL	5,165

They also gave charitable gifts in the form of clothing and household items as follows: (FORM 8283, LINE 1)

	FMV	BASIS
Goodwill Industries	240	1,200
Salvation Army	<u>1,200</u>	<u>7,200</u>
TOTAL	1,440	8,400

They also gave 50 shares of NewCo, Inc. stock to the AMVETS. The stock's fair market value was \$2,700 and their basis was \$720. Walter had owned this stock since 1982. (FORM 8283)

- (1) Walter and Stacey incurred some interest expense in 2002, which includes:
 - (a) Home mortgage interest for their Iowa City residence totaling \$9,640. (FORM 8829, LINE 10 AND SCHEDULE A, LINE 10)
 - (b) Walter began paying back his student loans on June 5, 1998. Walter continued to pay back his student loans in 2002. The total interest paid on these loans in 2002 was \$1,520. (FORM 1040 LINE 25)
 - (c) Stacey began paying back her student loans on September 15, 1998. Stacey continued to pay on her student loans in 2002. She paid \$3,140 of interest on her loans in 2002. (FORM 1040 LINE 25)

- (2) The couple paid \$590 in homeowner's insurance premiums in 2002. **(FORM 8829, LINE 17)**
- (3) The couple paid \$1,820 in electric bills and \$1,400 in gas bills in 2002. **(FORM 8829, LINE 19)**
- (4) The couple paid us \$480 for tax preparation in 2002. **(SCHEDULE A, LINE 21 AND SCHEDULE C, LINE 17)**
- (5) In 2002, Walter and Stacey paid real estate taxes on their Iowa City home of \$3,890. **(FORM 8829, LINE 11 AND SCHEDULE A, LINE 6)**
- (6) In 2002, the couple paid \$151 for the license of Stacey's car, and \$228 for Walter's new car. **(SCHEDULE A, LINE 8 AND SCHEDULE C)**
- (7) The couple has a full time nanny, Esther, in their home to care for their children. Esther was paid \$135 per week and worked 29 weeks in 2002. **(SCHEDULE H) (FORM 2441)**
- (8) On occasion, when their in-house provider was unable to care for their children, they took the kids to Gramma's Care, a nearby day care center. They paid a total of \$1,240 to Gramma's Care in 2002. **(FORM 2441)**
- (9) Walter and Stacey contributed \$2,180 to the College Savings Iowa Program for both of their children instead of utilizing the Coverdell Education Savings Account. **(SEE DISCUSSION AT THE END OF THIS OUTLINE)**
- (10) Stacey has continued to take classes towards receiving her Masters degree in teaching. In 2002 she paid a total of \$1,205 in tuition for these classes. **(FORM 1040, LINE 26)**

Label
See INSTRUCTIONS on page 10.
Use the IRS label. Otherwise, please print it properly.

For the year ending Dec. 31, 2002 of the taxpayer filing 2002 and on 20	
Your first name and initial WALTER	Last name BURNS
A joint return with spouse's last name and initial STACEY	Last name BURNS
Home address (number or street, if you have a P.O. box, see page 21) 123 - 4TH STREET	Apartment, suite, or other address Apt. 10
City, town or post office, state and ZIP code. If you have a foreign address, see page 21. IOWA CITY, IA 52240	

OMB No. 1545-0047

Your social security number
483 | 78 | 5777

Spouse's social security number
169 | 38 | 5543

Important!
You must enter your SSN(s) above.

Presidential Election Campaign
See page 21.

Note: Checking "Yes" will not change your address on your return.
Do you or your spouse file a joint income tax return for 2002? Yes No

Filing Status

Check only one box.

1 Single

2 Married filing jointly (even if only one had income)

3 Married filing separately (enter spouse's SSN above and full name above)

4 Head of household (with qualifying person (see page 21) if the qualifying person is a child but not your dependent, enter the child's name here)

5 Qualifying widow(er) or dependent of a deceased individual (see page 21)

Exemptions

Enter the number of exemptions claimed.

6a Yourself. (If you are not the taxpayer and you are not dependent on the taxpayer, do not check this box.)

b Spouse

c Dependents:

(1) First name (last name)	(2) Dependent's social security number	(3) Dependent's relationship to you	Qualifying child (see page 21)
GEORGE BURNS	484 74 5888	SON	<input checked="" type="checkbox"/>
GRACE BURNS	123 45 6789	DAUGHTER	<input checked="" type="checkbox"/>
			<input type="checkbox"/>
			<input type="checkbox"/>
			<input type="checkbox"/>

d Total number of exemptions claimed: **4**

No. of boxes checked on line and 6b: **2**

No. of children on line 6c who:

- lived with you
- did not live with you due to divorce or separation (see page 21)

Dependents on line not listed above:

Enter numbers on lines above: **4**

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099 if tax was withheld.

If you do not file a W-2, see page 24.

Choose, but do not check, only one option. Attach Form 1040-V.

7 Wages, salaries, tips, etc. (Attach Form(s) W-2)	7	119,530
8a Taxable interest. Attach Schedule B if required	8a	1,517
b Tax-exempt interest. Do not include on line 8a	8b	120
9 Ordinary dividends. Attach Schedule B if required	9	1,578
10 Tax-exempt dividends. Attach Schedule B if required (see page 24)	10	1,688
11 Annuity income	11	
12 Business income or (loss). Attach Schedule C or C-EZ	12	871
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	13	5,180
14 Other gains or (losses). Attach Form 4797	14	(388)
15a IRA distributions	15a	
b Taxed amount (see page 24)	15b	
16a Pensions and annuities	16a	
b Taxed amount (see page 24)	16b	
17 Rental real estate, royalties, or the like, S corporations, trusts, etc. Attach Schedule E	17	(7,580)
18 Farm income or (loss). Attach Schedule F	18	
19 Unemployment compensation	19	
20a Social security benefits	20a	
b Taxed amount (see page 24)	20b	
21 Other income (see instructions on page 24) GAMBLING WINNINGS	21	8,500
22 Add lines 7 through 21. This is your total income	22	129,128

Adjusted Gross Income

23 Excess of contributions over receipts	23	250
24 IRA deduction (see page 24)	24	
25 Student loan interest deduction (see page 31)	25	175
26 Tuition and fees deduction (see page 32)	26	1,205
27 Archer MSA deduction. Attach Form 8853	27	
28 Moving expenses. Attach Form 3902	28	
29 Charitable contributions (see page 33)	29	12
30 Self-employed health insurance deduction (see page 33)	30	168
31 Self-employed SEP, SIMPLIFIED, and qualified plans	31	
32 Penalty on early withdrawal of savings	32	
33a Alimony paid (if Form 1041-SS)	33a	
34 Add lines 23 through 33. CLEAN FUEL VEHICLE DEDUCTION \$600	34	2,310
35 Subtract line 34 from line 22. This is your adjusted gross income	35	126,528

I. **FORM 1040 (Page One) AND COMMENTARY**

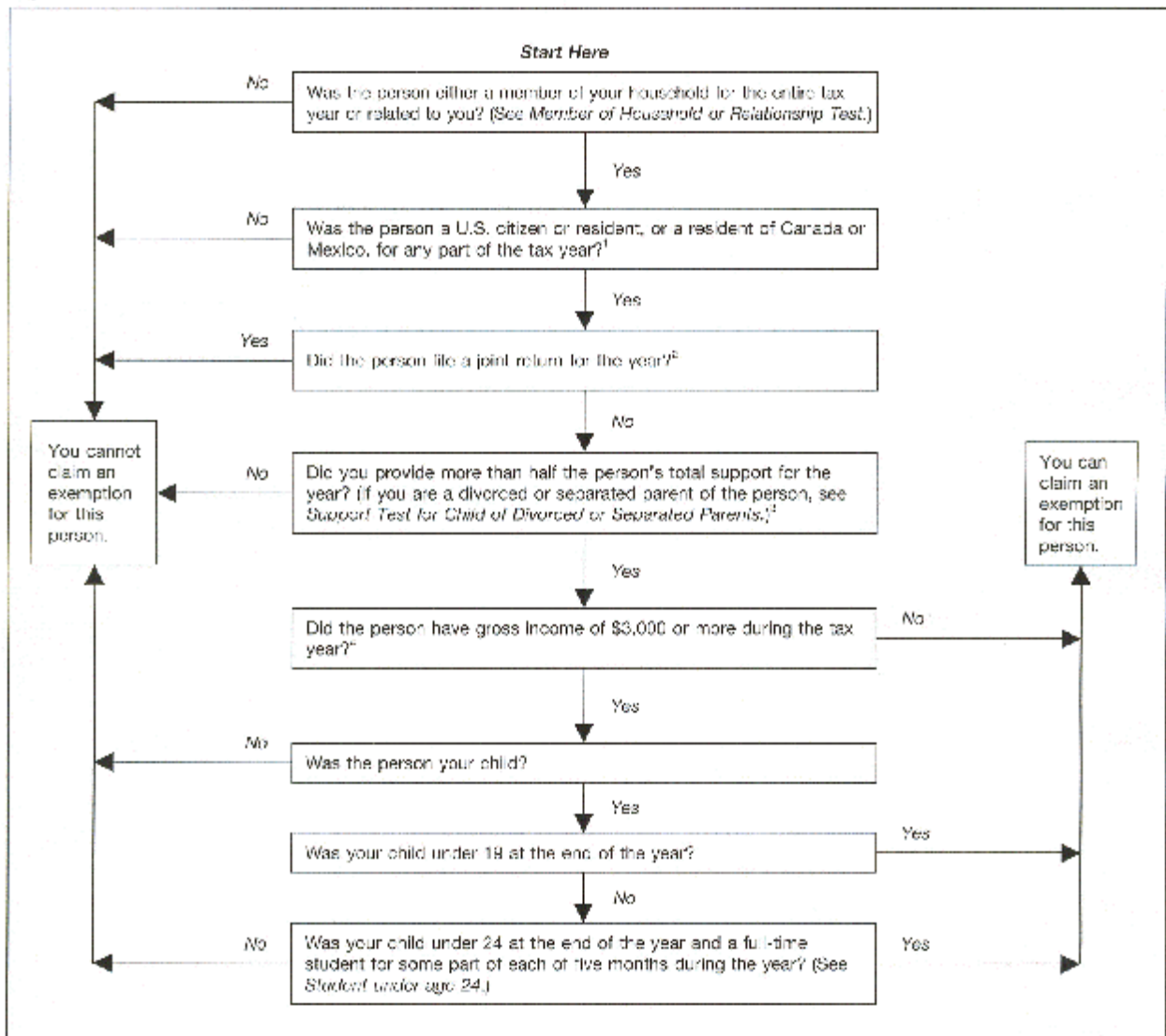
II. **"A" D**

A. **EXEMPTIONS (Line 6)**

For each dependent claimed on a tax return, the taxpayers are required to provide the correct social security number. A taxpayer who fails to include in his tax return the identification number (SSN or TIN) of any dependent may be disallowed to claim that dependent and will potentially be subject to a \$5.00 penalty for each failure, unless it is shown that the failure was due to reasonable cause and not willful neglect. See Burns v. McGill, 99-2 USTC Paragraph 50, 954 and Miller v. Commissioner, 114 T.C. No. 32 (June 23, 2000).

IRS Publication 501 sets forth the following flowchart to determine whether an individual can be claimed as a dependent on another's tax return:

Figure A. **Can You Claim an Exemption for a Dependent?**



¹If the person was your legally adopted child and lived in your home as a member of your household for the entire tax year, answer "yes" to this question.
²If neither the person nor the person's spouse is required to file a return, but they file a joint return only to claim a refund of tax withheld, answer "no" to this question.
³Answer "yes" to this question if you meet the multiple support requirements under Multiple Support Agreement.
⁴Gross income for this purpose does not include income received by a permanently disabled individual at a sheltered workshop. (See Disabled dependents.)

The Community Renewal Tax Relief Act of 2000 ("CRTR 2000") clarified that a missing child may still be claimed by parents for purposes of the dependency exemption, child tax credit and earned income credit, until the tax year following the calendar year in which the child is determined to be dead.

The Tax Court ruled that despite the fact that the taxpayer's divorce decree stated he was entitled to the dependency exemption for his child, he was not entitled to claim the child because his ex-wife refused to sign the Form 8332. Reiss v. Comm'r., T.C. Summary 2002-112.

A. **INCOME**

Line 7 Wages, Salaries, Tips, etc.

- a. **Tip Income.** The IRS issued Rev. Rul. 95-7 which addresses the issue of FICA taxes on tips. "Wages" for FICA includes all remuneration except those paid in non-cash form and those that are under \$20 a month. Section §3121(q) requires the employer to pay FICA on the total amount of cash tips received by an employee up to and including contributions and benefit base under § 3121(a). If an employee fails to report tips to the employer, the employer is responsible for only the employer portion of the FICA taxes, and the employee is liable only for the employee portion of the FICA taxes on tips. Additionally, the 11th Circuit ruled that the IRS may assess the employer's share of FICA taxes on an employee's tip income without determining the employee's individual share in Morrison Restaurants, Inc. v. U.S., 118 F.3d 1526 (11th Cir. 1997). However, the 9th Circuit recently held that an aggregate assessment based on inaccurate estimates forces the employer to pay the price for its employee's dereliction. Fior D'Italia, Inc. v. U.S., 242 F.3d 844 (9th Cir. 2001).

Employees in the food and beverage industry can enter into either The Tip Rate Determination Agreement, which requires a determination of tip rates or a Tip Reporting Alternative Commitment which educates employees on reporting tips. These voluntary programs ensure the employer will not undergo a tip audit. Additionally, the IRS now allows for the employer to set up their own version of the educational program, but the IRS may revoke its acceptance at any time. See Notice 2001-1 (which superseded Notice 2000-21). The IRS has pro forma Tip Rate Determination Agreements available at its website at www.irs.gov/bus_info/msu-info.html.

- b. **Qualified Transportation Fringes.** The Energy Policy Act of 1992 created new Code § 132(f), governing the treatment of "qualified transportation fringes." These involve employer payment of certain commuting costs of employees. On 1/17/94, the IRS issued a Notice 94-3 clarifying the rule. Rev. Proc. 2001-59 increases the limit on transportation fringe benefits to \$100 per month and increases the qualified parking to \$185 per month. Under this rule, an employer may provide the following fringe benefits tax-free to an employee:
- (1) Vanpool or mass transit transportation to the job. The maximum tax-free amount is limited to \$100 per month. Amounts in excess of this limit are taxable. For mass transit, the benefit must be provided in kind, in the form of a transit pass rather than in cash, except where transit passes may not be readily obtained by the employer for distribution.
 - (2) Free parking at or near the job site. This exclusion does not apply where an employer pays for an employee's cost of parking at or near his residence. The tax-free amount is limited to \$185 per month. To be nontaxable, these benefits must be offered as additional compensation to the employee. They

may not be offered in lieu of cash compensation. Thus, they may not be offered tax-free as part of a cafeteria plan under Code section 125.

c. **Examples of Benefits Includable in Gross Income:**

- (1) The value of the health insurance coverage provided to a non-spouse domestic partner, not a dependent of the employee, must be included as wages, subject to FICA, FUTA and income tax withholding. PLR 2001208010.
- (2) Scholarships given to children of employees for undergraduate expenses where the scholarship program fails to meet the "pattern of employment" criteria of Rev. Proc. 76-47, must be included as wages subject to FICA, FUTA and income tax withholding. PLR 200049007
- (3) Allowance paid for uniform cleaning and maintenance does not qualify as a working condition fringe benefit under § 132(d) where the employees are not required to verify to the employer that the allowance was actually used for such purposes. In such case, the allowance must be included as income. PLR 9443025 (July 27, 1994).
- (4) Tool rental payments made by an employer to an employee for the use of the employees' tools will generally be considered wages and subject to employment taxes. PLR 200006005

Line 8

a. Taxable Interest. - All taxable interest income must be reported on Part I of Schedule B, if:

- (1) The taxpayer has over \$1,500 in taxable interest, or
- (2) Any "special rules" apply, such as when the taxpayer:
 - (a) receives seller financed mortgage interest;
 - (b) receives a 1099-INT as a nominee;
 - (c) pays accrued interest on bonds;
 - (d) receives tax-exempt interest;
 - (e) reports OID interest different than the amount stated on Form 1099-OID;
 - (f) reduces interest income on a bond by the amount of amortizable bond premium.
- (3) The taxpayer is excluding interest from Series EE Bonds issued after 1989,
- (4) The taxpayer had over \$1,500 in dividends,
- (5) The taxpayer received dividends as a nominee, or
- (6) The taxpayer has a foreign account, or received a distribution from or was a grantor of, transferor to, a foreign trust.

Interest income from sales of real estate that are seller financed may require additional reporting. Real estate sold on a land contract or other form of seller financing results in reportable interest income to the seller. Additionally, if the real estate is used as the principal residence of the buyer, the seller is required to show the buyer's name, address and social security number on Schedule B. The

seller must also inform the buyer of his/her social security number. Failure to follow these requirements may result in a \$50 penalty for the seller.

Imputed Interest IRC §7872: If a lender does not charge interest at least equal to the AFR, the lender is considered to have imputed interest and is taxed on the difference between the AFR and the rate actually charged. The imputed interest is treated as a gift to the borrower. There are two exceptions to the imputed interest rules:

1. There will be no imputed interest if the aggregate outstanding balance of the loan(s) does not exceed \$10,000 on any given day. However, this exception does not apply if the loan proceeds were used to acquire investment property.

2. For loans between \$10,000 and \$100,000, the imputed interest is limited to the borrower's net investment income. If the borrower's net investment income is less than \$1,000, there will be no imputed interest. To qualify for this exception, the lender must have an annual statement that discloses the borrower's net investment income.

Walter made a \$15,000 demand loan to his brother Roger on October 1, 2002 with no interest. The imputed interest is computed using the short term AFR compounded semi-annually. Rev. Rul. 2002-61 sets this rate at 2.02%. Roger made no payments on the loan in 2002, therefore the imputed interest for 2002 is \$76.37. Additionally, Roger had \$1,200 of investment income in 2002. Therefore, the entire \$76 of imputed interest must be reported by Walter on Schedule B.

On the example tax return, the Burns have a total of \$1,517 of taxable interest. (See Schedule B, Part I).

- b. **Tax-exempt Interest** Taxpayers must show on their tax returns the amount of tax-exempt interest they received or accrued during the tax year if they are required to file an income tax return. § 6012(d).

On the example tax return, the Burns have \$120. of tax-exempt interest from the Iowa City Municipal Bond. (See Schedule B, Part I).

Line 9 Ordinary Dividends - Report all ordinary dividend income. Be sure to report the proper payer information on Line 5 of Schedule B. Also, remember the capital gain distributions reported on Form 1099-DIV go directly to Schedule D, line 13.

On the example tax return, the Burns have \$1,578 of dividend income. The capital gain distributions from the Pioneer Growth Fund of \$210 are reported directly to Schedule D, line 13. (See Schedule B, Part II and Schedule D, Line 13).

- Line 10 Taxable Refunds, Credits, Etc.** - Refunds from state and local income taxes are reportable as income when the taxpayer has taken that original state or local income tax liability as a deduction on their itemized deductions on previous years.

The attached state and local income tax refund worksheet shows that the Burns must report all of their \$1,688 Iowa refund from 2001 that they received in 2002.

State and Local Income Tax Refund Worksheet—Line 10

Keep for Your Records



1. Enter the income tax refund from Form(s) 1999-G (or similar statement). But do not enter more than the amount on your 2001 Schedule A (Form 1040), line 5	1	1,688
2. Enter your total allowable itemized deductions from your 2001 Schedule A (Form 1040), line 28	2	29,970
<p>Note: If the filing status on your 2001 Form 1040 was married filing separately and your spouse itemized deductions in 2001, skip lines 3, 4, and 5, and enter the amount from line 2 on line 6.</p>		
3. Enter the amount shown below for the filing status claimed on your 2001 Form 1040.	3.	7,500
<ul style="list-style-type: none"> • Single—\$4,550 • Married filing jointly or qualifying widower—\$7,600 • Married filing separately—\$3,800 • Head of household—\$6,650 		
4. Did you fill in line 55a on your 2001 Form 1040?	4.	0
<input checked="" type="checkbox"/> No. Enter -0-. <input type="checkbox"/> Yes. Multiply the number on line 55a of your 2001 Form 1040 by: \$900 if your 2001 filing status was married filing jointly or separately or qualifying widower; \$1,100 if your 2001 filing status was single or head of household		
5. Add lines 3 and 4	5.	7,500
6. Is the amount on line 5 less than the amount on line 2?	6.	22,370
<input type="checkbox"/> No. STOP None of your refund is taxable. <input checked="" type="checkbox"/> Yes. Subtract line 5 from line 2		
7. Taxable part of your refund. Enter the smaller of line 1 or line 6 here and on Form 1040, line 10	7.	1,688

Line 11 Alimony Received - Alimony received includes alimony and separate maintenance payments. The recipient of such payments must provide the payer with their social security number.

Line 12 Business Income or (loss)

a. Which Schedule? Beginning in 1992, certain sole proprietorships may report their income on Schedule C-EZ, a simplified version of Schedule C. The requirements are as follows:

- Gross receipts of \$25,000 or less.
- Business expenses of \$2,000 or less.
 - Use the cash method of accounting.
 - Did not have any inventory at any time during the year.
 - Did not have a net loss from the business.
 - Had only one business as a sole proprietor.
 - Had no employees during the year.
 - Are not required to file Form 4562 (depreciation and amortization).
 - Do not deduct expenses for business use of your home.
 - Do not have prior year unallowed passive activity losses from this business.

b. The §179 deduction allows part of the cost of business property to be expended in the year the property is put into use. This deduction is now limited to \$24,000 for 2002 and increase to \$25,000 for the year 2003 and beyond.

The §179 election must be made on an original or amended return, filed within the time period for filing the original return, including extensions. The §179 election may not be revoked without the consent of the commissioner. Patton v. Commissioner, 116 T.C. 206 (2001).

On the example tax return, Walter Burns has a consulting business he operates out of their home, therefore, he must complete the following:

- (1) Schedule C (Profit or Loss from Business) Walter can not use Schedule C-EZ because Walter needs to file Form 4562 and he is deducting expenses for business use of their home.*
- (2) Form 8829 (Home Office Expense)*
- (3) Form 4562 (Depreciation & Amortization) for the depreciation of the computers, office equipment, printer, that portion of the house he uses as his home office, and the 2002 Toyota Prius.*

Line 13 Capital Gain or (loss)

With the passage of the Taxpayer Relief Act of 1997, the top tax on long term capital gain was reduced from 28% to 20% (10% for taxpayers in the 15% bracket). As originally passed, the 1997 Act required an 18-month holding period for the lower rates. However, with the passage of the Internal Revenue Service Restructuring and Reform Act of 1998, the required holding period was reduced to 1 year.

Since 2001, the top tax rate for long-term capital gains is 18% (8% for taxpayers in the 15% bracket) if a 5-year holding period is met. The 18% rate (but not the 8% rate) will apply only if the holding period for the asset begins after December 31, 2000. (IRC §1(h)(2)(A) & (B))

The reduced capital gain rates apply for purposes of the regular tax and the Alternative Minimum Tax.

Long-term capital gain from the sale of collectibles continues to be taxed at a maximum rate of 28%.

All depreciation from §1250 property (depreciable residential or non-residential income producing or business real property) will be recaptured. The straight line depreciation recapture is taxed at 25%, while any additional depreciation recapture from the use of an accelerated method is ordinary income.

The IRS Restructuring and Reform Act of 1998 made a technical correction to IRC §1(h)(7)(B) to limit the amount of gain included in the 25% bracket to the net §1231 gain for the year.

Additionally under the 1997 Act, up to \$250,000 of home-sale profit is tax-free. The exclusion is doubled to \$500,000 for married persons filing jointly. This provision has replaced the home-sale rollover rules and the up to \$125,000 exclusion rules for home sellers age 55 and over. The IRS has recently issued proposed regulations in an attempt to clarify these §121 rules. (Prop. Reg. §§1.121-1-4 and 1.1398-3)

A taxpayer does not need to complete a Schedule D if:

1. The only amounts the taxpayer has to report on Schedule D are capital gain distributions from box 2a of Forms 1099-DIV or substitute statements;

2. None of the Forms 1099-DIV have an amount in box 2b (28% rate gain), box 2c (unrecaptured section 1250 gain), or box 2d (section 1202 gain); and

3. If the taxpayer is filing Form 4952 (relating to investment interest expense deduction), the amount on line 4e of that form is not more than zero.

If all three of the above conditions are met, these amounts are to be reported directly on line 13 of Form 1040, and the box to the left of that line needs to be checked. However, the taxpayer would still utilize the capital gain tax worksheet to compute the tax.

Page 2 of the Schedule D is no longer used to calculate tax if the taxpayer has income relating to §1250 gains and 28% gain on collectibles. Rather, the calculations are now in the instructions, and those affected taxpayers must turn to the worksheet in the instructions (page D-9) rather than Schedule D itself to calculate their tax. (See below).

On the example tax return, the Burns have capital gain and capital loss transactions, the capital gain distribution reported on a Form 1099-DIV and the gain on the sale of the stamp collection. Therefore, their tax return must include Schedule D (Capital Gains & Losses) and the use of the worksheet on page D-9 of the instructions .

Line 14 Other Gains or (Losses) - Generally these include the sale or exchange of assets used in the taxpayer's trade or business.

On the example tax return, Walter Burns had the sale of one of his business computers that is reported on Form 4797 and transferred to line 14.

Line 15 IRA Distributions - Distributions from an IRA are reported to the taxpayer on a 1099-R. The entire amount of the distribution is taxable, unless (1) the taxpayer had made nondeductible IRA contributions, or (2) the distribution was rolled over into another IRA. (The term IRA includes IRAs, SEPs and SIMPLE IRAs). If the taxpayer converts part or all of a traditional IRA to a Roth IRA, the taxpayer must fill out Form 8606 to calculate the proper amount reportable on line 15(b).

Line 16 Pensions and Annuities - Distributions from Pensions or Annuities are also reported to the taxpayer on a 1099-R. These distributions are fully taxable if (1) the taxpayer did not contribute to the cost of the pension or annuity, or (2) the taxpayer has already received all of the cost in prior distributions. If the pension or annuity is only partially taxable, the taxpayer will generally have to use the General Rule to compute the taxable portion. However, depending on the starting date of the annuity, the taxpayer may be able to use the Simplified Method. Alternatively, the taxpayer can ask the IRS to figure the taxable portion for a \$90 fee.

Line 17 Rental Real Estate, Etc. -

On the example tax return, the Burns have a three sources of rental income (loss) and must complete the following:

1. *Schedule E (Supplemental Income and Loss) to report the duplex, the limited partnership and the limited liability company information;*
2. *Form 8582 (Passive Activity Loss Limitations) to report the duplex, the limited partnership, and the limited liability company information.*

The passive activity loss is the amount by which the total losses from all passive activities for the tax year exceed the total income from all passive activities for the tax year. However, §469(k) requires the taxpayer to treat each publicly traded partnerships as a separate "activity" for purposes of the passive loss rules, so that the taxpayer will, in effect, be able to deduct losses from a publicly traded partnerships only against income from that same partnership.

Line 18 Farm Income or (Loss) - See "Country Mouse" outline.

Line 19 Unemployment Compensation - All unemployment compensation is taxable to the taxpayer receiving it. However, there is an exception if the taxpayer repaid some of the unemployment compensation received. The unemployment compensation is reported on Form 1099-G.

Line 20 Social Security Benefits - Social Security Benefits are reported to the taxpayer on Form SSA-1099. (Or the equivalent Railroad Retirement Benefits on Form RRB-1099). Up to 85% of Social Security Benefits may be taxable. Once the taxpayer has over \$32,000 (if married filing jointly) or \$25,000 (if single) of Modified Adjusted Gross Income, the Social Security Benefits start to become taxable. The taxable amount is figured on the Worksheet on page 28 of the 1040 instructions.

Effective for tax years ending after December 31, 1999, the earnings test for Social Security recipients between the ages of 65 and 69 has been abolished. Recipients between the ages of 62 and 64 are still under the test and for 2002, must repay \$1 for every \$2 over \$11,280 of earned income (increasing to \$11,520 for 2003).

Line 21 Other Income - Includes all taxable income not otherwise reportable on the Form 1040 lines 7 through 20. The Small Business Jobs Protection Act of 1996 expanded the inclusion of damage awards from personal injury and sickness cases. Generally, if the award, including punitive damages, is related to personal injury or sickness, it is includable in gross income. However, the rule does not apply to wrongful death cases.

Stacey's "other income" consists of \$6,500 of casino winning.

Proceeds from gambling winnings are reported on line 21. The taxpayer must report the total amount of winnings on line 21. All gambling losses, if any, are reported as an itemized deduction on Schedule A, line 27. The losses are reportable to the extent of gambling winnings.

The Job Creation and Worker Assistance Act of 2002 added Code Section 172(b)(1)(H) to provide a five-year carryback period for net operating losses for any taxable year ending during 2001 and 2002.

B. ADJUSTMENTS TO INCOME

Line 23 Educator Expenses - Beginning in 2002, EGTRAA created a new line on Form 1040. This new above-the-line deduction allows an educator to deduct up to \$250 (\$500 if married and both taxpayers are eligible educators) in qualified expenses that are unreimbursed by the employer and used in the classroom. Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment and other materials used in the classroom. The amount of qualified expenses must be reduced by:

- a. Excludable U.S. Series II and II savings bond interest from Form 8815.
- b. Nontaxable qualified state tuition program earnings.
- c. Nontaxable earnings from Coverdell Education Savings accounts, and
- d. Any reimbursements the taxpayer received for the expenses that were not reported in box 1 of their W-2.

Stacey had \$1,531 of qualified expenses, and thus is allowed to deduct \$250 on line 23. The balance is reported on Form 2106-EZ.

Line 24 IRA Deduction - With the passage of the Taxpayer Relief Act of 1997 and the "corrections" contained in the IRS Restructuring and Reform Act of 1998, there were substantial changes to the IRA rules. From increasing the eligibility to creating an entirely new form of Individual Retirement Account (the Roth IRA), these two acts dramatically changed the IRA landscape.

Generally, individuals can contribute up to the lesser of earned income or \$3,000 annually. Additionally, a spouse can contribute up to \$3,000 even if that spouse has no earned income. This is increased to \$3,500 if age 50 or older at the end of 2002. Contributions can continue until the taxpayer reaches 70½. At age 70½, the taxpayer must begin taking minimum distributions.

More individuals are able to make deductible IRA contributions. The modified adjusted gross income levels at which the IRA deduction begins to phase out for individuals who participate in an employer retirement plan were increased in 2002 by an additional \$1,000 over the 2001 levels. A spouse who isn't a retirement plan participant may be able to make a deductible IRA contribution even if the other spouse is a retirement plan participant. The following chart details the deductibility of IRA contributions and phase-out limitations:

	Single or Head of Household	Married Filing Joint		Married Filing Separate
	Taxpayer	Wife	Husband	Wife
Single and not covered by employer plan	Fully Deductible	N/A	N/A	N/A
Single and covered by plan	Fully Deductible with \$34,000 or less MAGI. Phase - out up to \$44,000	N/A	N/A	N/A
Married and neither covered by employer plan	N/A	Fully Deductible	Fully Deductible	Fully Deductible IF did not live with spouse
Married and wife covered by employer plan	N/A	Fully Deductible with \$54,000 or less MAGI. Phase-out up to 64,000	Fully Deductible with \$150,000 or less MAGI. Phase - out up to \$160,000	Partially Deductible. Phase - out up to \$10,000 MAGI
Married and both covered by employer plan	N/A	Fully Deductible with \$54,000 or less MAGI. Phase-out up to 64,000	Fully Deductible with \$54,000 or less MAGI. Phase-out up to 64,000	Partially Deductible. Phase - out up to \$10,000 MAGI

Even if the IRA contribution is not deductible, the taxpayer may still make a non-deductible IRA contribution of the lesser of earned income or \$3,000. The taxpayer MUST file Form 8606 for nondeductible IRA contributions. For more information see IRS Publication 923. (See later discussion of Roth IRA contributions and Form 8606).

The Form 1040 instructions contain the following helpful worksheet to calculate the deductible IRA contribution with these new restrictions and increased limitations:

IRA Deduction Worksheet—Line 24

Keep for Your Records

Before you begin:

- ✓ Complete Form 1040, lines 27 through 33a, if they apply to you.
- ✓ Figure any amount to be entered on the dotted line next to line 34 (see page 33).
- ✓ Be sure you have read the list beginning on page 29.



	Your IRA	Spouse's IRA
1a. Were you covered by a retirement plan (see page 31)?	1a. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
1b. If married filing jointly, was your spouse covered by a retirement plan? Next: If you checked "No" on line 1a, and, if married filing jointly, "No" on line 1b, skip lines 2–5, enter \$3,000 (\$3,500 if age 50 or older at the end of 2002) on line 7a (and 7b if applicable), and go to line 8. Otherwise, go to line 2.	1b. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	1b. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
2. Enter the amount shown below that applies to you: • Single, head of household, or married filing separately and you lived apart from your spouse for all of 2002, enter \$44,000 • Qualifying widower, enter \$64,000 • Married filing jointly, enter \$64,000 in both columns. But if you checked "No" on either line 1a or 1b, enter \$150,000 for the person who was not covered by a plan • Married filing separately and you lived with your spouse at any time in 2002, enter \$10,000	2a. <u>64,000</u>	2b. <u>64,000</u>
3. Enter the amount from Form 1040, line 22	3. <u>129,138</u>	
4. Add amounts on Form 1040, line 23, lines 27 through 33a, and any amount you entered on the dotted line next to line 34	4. <u>1,230</u>	
5. Subtract line 4 from line 3. Enter the result in both columns	5a. <u>127,908</u>	5b. <u>127,908</u>
6. Is the amount on line 5 less than the amount on line 2? <input checked="" type="checkbox"/> No. None of your IRA contributions are deductible. For details on nondeductible IRA contributions, see Form 8606. <input type="checkbox"/> Yes. Subtract line 5 from line 2 in each column. If the result is \$10,000 or more, enter \$3,000 (\$3,500 if age 50 or older at the end of 2002) on line 7 for that column and go to line 8.	6a. _____	6b. _____
7. Multiply lines 6a and 6b by 20% (.20) (or by 25% (.25) in the column for the IRA of an individual who is age 50 or older at the end of 2002). If the result is not a multiple of \$10, increase it to the next multiple of \$10 (for example, increase \$490.50 to \$500). If the result is \$200 or more, enter the result. But if it is less than \$200, enter \$200	7a. _____	7b. _____
8. Enter your wages, and your spouse's if filing jointly, and other earned income from Form 1040, minus any deductions on Form 1040, lines 29 and 31. Do not reduce wages by any loss from self employment	8. _____	
If married filing jointly and line 8 is less than \$6,000 (\$6,500 if one spouse is 50 or older at the end of 2002; \$7,000 if both spouses are 50 or older at the end of 2002), stop here and see Pub. 590 to figure your IRA deduction.		
9. Enter traditional IRA contributions made or that will be made by April 15, 2003, for 2002 to your IRA on line 9a and to your spouse's IRA on line 9b	9a. _____	9b. _____
10. On line 10a, enter the smallest of line 7a, 8, or 9a. On line 10b, enter the smallest of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040, line 24. Or, if you want, you may deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606)	10a. _____	10b. _____

Line 25 Student Loan Interest Deduction - The qualified student loan interest that may be deducted as an above-the-line deduction is \$2,500.

This deduction phases out ratably for single taxpayers with modified AGI between \$50,000 and \$65,000 and for married taxpayers with modified AGI between \$100,000 and \$130,000. Married taxpayers must file a joint return to utilize this deduction. The modified AGI is the taxpayer's AGI without regard to the deduction for student loan interest or the exclusion for U.S. Saving Bond interest, adoption benefits, foreign possession and Puerto Rico income. The taxpayer claiming the deduction cannot be claimed as a dependent on another's tax return.

Most significantly, the 60 month payment period limitation is repealed for 2002 and later tax years.


The qualifications for student loan interest deduction are as follows:

1. **Qualified Student Loan** - A loan to pay qualified higher education expenses for the taxpayer, spouse, or dependent when the loan was taken out. The proceeds must have been used for qualified higher education expenses and the loan cannot come from a related person or through a qualified employer plan.
2. **Qualified Higher Education Expense** - These include tuition, fees, room and board, books and supplies. The expenses must be incurred for a degree, certificate or similar program at an eligible educational institution. (Colleges, universities, and certain vocational schools).
3. **Eligible student** - A person who is enrolled in a degree, certificate, or other program approved for credit by the institution and must carry at least half the full-time work load for the course study.

The Burns paid a total of \$4,660 of student loan interest in 2002. Their deduction is reduced to \$175 because of the phase out limitations. (See worksheet below).

Student Loan Interest Deduction Worksheet—Line 25

Keep for Your Records

Before you begin:		<ul style="list-style-type: none"> ✓ Complete Form 1040, lines 27 through 33a, if they apply to you. ✓ Figure any amount to be entered on the dotted line next to line 34 (see page 33). ✓ See the instructions for line 25 that begin on this page. ✓ Be sure you have read the Exception above to see if you can use this worksheet instead of Pub. 970 to figure your deduction. 	
1. Enter the total interest you paid in 2002 on qualified student loans (defined above). Do not enter more than \$2,500		1.	2,500
2. Enter the amount from Form 1040, line 22	129,138	2.	
3. Enter the total of the amounts from Form 1040, line 23, line 24, lines 27 through 33a, plus any amount you entered on the dotted line next to line 34	1,230	3.	
4. Subtract line 3 from line 2	127,908	4.	
5. Enter the amount shown below for your filing status:		5.	
• Single, head of household, or qualifying widow(er) \$50,000			
• Married filing jointly \$100,000	100,000		
6. Is the amount on line 4 more than the amount on line 5?		6.	
<input type="checkbox"/> No. Skip lines 6 and 7, enter -0- on line 8, and go to line 9.			
<input checked="" type="checkbox"/> Yes. Subtract line 5 from line 4	27,908		
7. Divide line 6 by \$15,000 (\$30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000		7.	.930
8. Multiply line 1 by line 7		8.	2,325
9. Student loan interest deduction. Subtract line 8 from line 1. Enter the result here and on Form 1040, line 25. Do not include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.)		9.	175

Line 26 Tuition and Fees Deduction -

New for 2002, there is an above-the-line deduction for qualified higher education expenses. In 2002, the limit is \$3,000. The deduction is allowed for single taxpayers with modified AGI below \$65,000 and for married taxpayers with modified AGI below \$130,000.

This deduction is for qualified tuition and fees paid for the taxpayers, spouse or dependent. The deduction is not available for those married filing separate taxpayers. Additionally, the taxpayer can not be claimed as a dependent on another's tax return. This deduction can not be used for the same student for whom an education credit is being claimed.



The amount of qualified tuition fees must be reduced by:

- a. Excludable U.S. Series EE and I savings bond interest from Form 8815.
- b. Nontaxable qualified state tuition program earnings.
- c. Nontaxable earnings from Coverdell Education Savings accounts, and
- d. Any reimbursements the taxpayer received for the expenses that were not reported in box 1 of their W-2.

Line 27 Archer MSA Deduction - The CRTR 2000 extended the MSA program through 2002. No substantive portions of the MSA program were changed. Small employers, generally, those who employ no more than 50 employees (but can increase up to 200 employees), their employees and self-employed individuals

Tuition and Fees Deduction Worksheet—Line 26

Keep for Your Records

Before you begin:		<ul style="list-style-type: none"> ✓ Complete Form 1040, lines 27 through 33a, if they apply to you. ✓ Figure any amount to be entered on the dotted line next to line 34 (see page 35). ✓ See the instructions for line 26 above. ✓ Be sure you have read the Exception above to see if you can use this worksheet instead of Pub. 970 to figure your deduction. 	
1. Enter the amount from Form 1040, line 22	1.	129,138	
2. Enter the total of the amounts from Form 1040, lines 28 through 29, lines 31 through 33a, plus any amount you entered on the dotted line next to line 34	2.	1,405	
3. Subtract line 2 from line 1. If the result is more than \$3,000 (\$130,000 if married filing jointly),  You cannot take the deduction for tuition and fees	3.	127,733	
4. Tuition and fees deduction. Enter the total qualified tuition and fees (defined above) you paid in 2002. Do not enter more than \$3,000. Also, enter this amount on Form 1040, line 26. Do not include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.).	4.	1,205	

are eligible to participate in this program. These individuals are eligible for the MSA program if they are covered by a high deductible plan.

As increased for 2002 in Rev. Proc. 2001-59, a high deductible plan is a health plan that has an annual deductible of at least \$1,650 and no more than \$2,500 for individual coverage (\$3,300 to \$4,950 for family coverage). Additionally, the maximum out of pocket expense must not be more than \$3,500 for individual coverage (\$6,050 for family coverage). The participant can make annual contributions to the plan of not more than 65% of the deductible under the high deductible plan (75% for family coverage).

Excess contributions are subject to a 6% penalty tax. Contributions by an employee covered by a high-deductible health plan to an MSA are tax deductible, and contributions to an MSA by an employer are excludable from gross income. Additionally the earnings on an MSA are not currently taxable. The taxpayer can withdraw from an MSA for medical expenses for herself or her family. These withdrawals are tax-exempt. Distributions from an MSA account not used for medical expenses are taxable and subject to a 15% penalty tax, unless paid after the individual reached the age of 65, or on account of death or disability.

The advantages for self-employed individuals utilizing an MSA are: (1) 70% of the premiums for the insurance policy are deductible but the premium will normally be much lower as a high deductible health policy; (2) the contributions made into the MSA are tax deductible, these amounts are then used to pay the qualified medical expenses. This allows the self-employed person to circumvent the 7.5% of AGI limitation on Schedule A.

Line 28 Moving Expenses - If a taxpayer moves for employment reasons, either a transfer or new job, certain moving expenses are deductible. The first qualification is that the new work site must be at least 50 miles from the old residence. In 1994, moving expenses became an above-the-line deduction, but what qualifies as deductible moving expenses was greatly reduced.

Line 29 One-half of Self-employment Tax - A deduction consisting of one-half of self-employment tax is allowed as an above the line deduction. *See Form SE for further analysis, from Walter's business.*

Line 30 Self-employed Health Insurance Deduction - Under the Tax and Trade Relief Extension Act of 1998, self-employed individuals will be able to deduct 70% of medical insurance and qualified long term care insurance premiums paid in 2002 (increasing to 100% in 2003). (IRC §161(l)(1)(B)).

Walter paid premiums of \$340 for himself and \$310 for Stacey for qualified long-term care insurance policies. Because only Walter is self-employed, he can only include his premium of \$340 reduced to the allowable limit of \$240 (see limitations in Schedule A comments below) when figuring the self-employed health insurance deduction. ($\$240 \times 70\% = \168). (FORM 1040, LINE 28; SCHEDULE A, LINE 1).

Line 31 Self-Employment SEP, SIMPLE and Qualified Plans - A sole proprietor is capable of making contributions to a plan in a dual capacity as employer and employee. This is relevant under both defined benefit and profit sharing pension plans.

In general, the rules for establishing a retirement plan for a self-employed individual are the same as the rules for other employers. For retirement plan purposes a self-employed individual is treated as both an employee and employer. The individual's contributions are limited to a percentage of his or her "earned income". In calculating earned income, however, a deduction must be taken for the individual's contribution to the retirement plan. The maximum deduction for a contribution to a profit-sharing plan is 15% divided by 1.15, or 13.0435%.

As explained in IRS Notice 2001-84, EGTRRA reset many of the statutory dollar amounts previously adjusted on an annual basis under section 415 of the Code. Additionally, other new limitation amounts were added by EGTRRA. The limitation on the annual benefit under a defined benefit plan is increased

from \$140,000 to \$160,000. The limitation for defined contribution plans is increased from \$35,000 to \$40,000. The limitation on the exclusion for elective deferrals is increased from \$10,500 to \$11,000. This limitation affects elective deferrals to section 401(d) plans. The limitation regarding SIMPLE retirement accounts is increased from \$6,500 to \$7,000. The limitation on deferrals concerning deferred compensation plans of state and local governments and tax-exempt organizations is increased from \$8,500 to \$11,000. The dollar limitation concerning the definition of key employee in a top-heavy plan is \$130,000. The dollar limitation for catchup contributions to an applicable employer plan other than a plan described in section 401(k)(11) or 408(p) for individuals aged 50 or over is \$1,000. The dollar limitation for catch-up contributions to an applicable employer plan described in section 401(k)(11) or 408(p) for individuals aged 50 or over is \$500.

Line 32 Penalty on Early Withdrawal of Savings - These penalties that a taxpayer was charge for early withdrawal should be reported on Form 1099-INT or 1099-OID.

Line 33 Alimony Paid - Payments of alimony under a divorce or separation order are generally deductible. The issue to be decided is whether the payments are actually alimony or a disguised property settlement.

Line 34 Other Adjustments. The instructions to Form 1040 included the following other adjustments to AGI that are reported on line 34:

- a. Deduction for clean-fuel vehicles (“Clean-Fuel”).

The Clean-Fuel Vehicle Deduction (IRC §179A) from The Energy Policy Act of 1992 is available for taxpayers who purchase vehicles that utilize “clean fuels” such as natural gas, liquified natural gas, liquified petroleum gas, hydrogen, electricity and any other fuel that is 85% or more alcohol or ether. The deduction was scheduled to be phased out by 2005. Under the Job Creation and Worker Assistance Act of 2002, the deduction does not phase out until 2007. The deduction for vehicles placed in service in 2002 is as follows:

1. \$50,000 for truck with GVW over 26,000 pounds;
2. \$50,000 for a 20-plus passenger bus;
3. \$5,000 for truck with GVW between 10,000 and 26,000 pounds;
and
4. \$2,000 for any other vehicle.
- b. Performing-arts-related expenses (“QPA”).
- c. Jury duty pay given to your employer (“Jury Pay”).
- d. Deductible expenses related to income reported on line 21 from the rental of personal property engaged in for profit (“PPR”).
- e. Reforestation amortization (“RFST”).
- f. Repayment of supplemental unemployment benefits under the Trade Act of 1974 (“Sub-Pay TRA”).
- g. Contributions to section 501(c)(18) pension plans (“501(c)(18”).
- h. Contributions by certain chaplains to section 403(b) plans (“403(b”).
- i. Employee business expenses of fee-basis state or local government officials (“FBO”).

Walter purchased the 2002 Toyota Prius that qualifies for the clean fuel vehicle deduction.

Because he uses the vehicle 60% for his business, 60% of the \$2,000 deduction is on Schedule C, while the remaining \$800 is deducted on line 34.

Tax and Credits		36	Amount from line 26 (adjusted gross income)	36	126,528
37a <input type="checkbox"/> You were 55 or older, <input type="checkbox"/> blind, <input type="checkbox"/> Spouse was 65 or older, <input type="checkbox"/> blind. Add the number of boxes checked above and enter the total here		37a			
b If you are married filing separately and your spouse itemizes deductions, do you want to take a marital deduction on page 54 and check here		37b			
Standard Deduction for: <input type="checkbox"/> Person aged 65 or older, blind, or 65 or older with a dependent (see page 37) <input type="checkbox"/> All others: <input type="checkbox"/> Single (see 37c) <input type="checkbox"/> Head of household (see 37d) <input type="checkbox"/> Married filing jointly or Qualifying widow(er) (see 37e) <input type="checkbox"/> Married filing separately (see 37f)	38	Itemized deductions (from Schedule A) or your standard deduction (see 37b through 37f)	38	30,399	
	39	Subtract line 38 from line 36	39	96,129	
	40	Enter 36,310,000 or less (but not less than 0) by the total number of exemptions claimed on line 36. If line 26 is over \$125,000, see the worksheet on page 39	40	12,000	
	41	Taxable income. Subtract line 40 from line 39. Enter the result here (see page 39)	41	84,129	
	42	Tax (see page 39). Check if any tax is from: a <input type="checkbox"/> Form 9874 b <input type="checkbox"/> Form 4972	42	16,495	
	43	Alternative minimum tax (see page 37). Attach Form 1231	43	0	
	44	Add lines 42 and 43	44	16,495	
	45	Foreign tax credit. Attach Form 1118 (if required)	45		
	46	Credit for federal debt interest (see page 39). Attach Form 9447	46	320	
	47	Credit for the elderly or the disabled. Attach Schedule R	47		
48	Subject to credits. Attach Form 2013	48			
49	Retirement savings contributions credit. Attach Form 8880	49			
50	Child tax credit (see page 39)	50	350		
51	Adoption credit. Attach Form 8879	51			
52	Credits from: a <input type="checkbox"/> Form 9316 b <input type="checkbox"/> Form 9693	52			
53	Other credits. Check applicable boxes: a <input type="checkbox"/> Form 3300 b <input type="checkbox"/> Form 3301 c <input type="checkbox"/> Specify _____	53			
54	Add lines 45 through 53. This is your total credits	54	670		
55	Subtract line 54 from line 44. If line 54 is more than line 44, enter 0	55	15,815		
Other Taxes		56	Self-employment tax. Attach Schedule SE	56	23
57	Social Security and Medicare net equivalent taxable income. Attach Form 4137	57			
58	Tax on qualified plans, including IRAs, and other deferred payments. Attach Form 5498 (see line 58)	58			
59	Advance earned income credit payments from Form 940	59			
60	Household employment taxes. Attach Schedule I	60	599		
61	Add lines 56 through 60. This is your total tax	61	16,437		
Payments		62	Federal income tax withheld from Forms W-2 and 1099	62	17,119
63	2002 estimated tax payments and amount paid for 2001 return	63			
64	Limited income credit (LIC)	64			
65	Excess social security and tier 1 RRA tax withheld (see page 56)	65	497		
66	Additional child tax credit. Attach Form 8872	66			
67	Amount paid with respect to extension of time (see page 58)	67			
68	Other payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 2205	68			
69	Add lines 62 through 68. This is your total payments	69	17,606		
Refund		70	Enter the amount from line 69, column (b), from line 69. This is the amount you were paid	70	1,169
71a Amount of line 70 you want refunded to you		71a			
b Routing number		71b			
c Type <input type="checkbox"/> Checking <input type="checkbox"/> Savings		71c			
d Account number		71d			
72 Amount of line 70 you want applied to your 2003 estimated tax		72			
Amount You Owe		73	Amount you owe. Subtract line 69 from line 70. Enter the result here (see page 59)	73	
74 Estimated tax penalty (see page 59)		74			
Third Party Designee		Do you want to allow another person to discuss this return with the IRS (see page 60)? <input checked="" type="checkbox"/> Yes. Complete the following. <input type="checkbox"/> No			
Designee's name: PREPARED		Print name	Relationship to taxpayer	Taxpayer's identification number (9-0)	
Sign Here		Here is a table of people who can sign this tax return for you. Check the appropriate box, and to the best of my knowledge, the listed box is true, correct, and complete. Use a blue or black ink. Do not sign this page if it is based on information that is not true to the best of my knowledge.			
Joint return? See page 21. Applicable for joint returns	Your signature	Date	Your occupation	Taxpayer's phone number	
	Spouse's signature (if joint return, both must sign)	Date	Spouse's occupation		
Paid Preparer's Use Only		Preparer's signature	Date	Checked and employed <input checked="" type="checkbox"/>	Preparer's U.S. TIN
Print name for your Form 945 (see page 60)		SMITH PETERSON LAW FIRM, LLP		L.I. 42 0716999	
Address (see page 60)		P.O. BOX 248, COUNCIL BLUFFS, IA 51502		Phone no. : 712 328-1833	

I. **FORM 1040 (Page Two) AND COMMENTARY**

A. **DEDUCTIONS (Line 38)**

An individual may deduct the larger of (a) itemized deductions (Schedule A), or (b) the standard deduction. (See Code §63).

1. Standard Deduction. The Standard deduction for 2002 for the applicable filing status is as follows:

a.

<u>Filing Status</u>	<u>Under 65 and not Blind</u>
Single	\$4,700 (up from \$4,550 in 2001)
Married Filing Joint	\$7,850 (up from \$7,600 in 2001)
Married Filing Separate	\$3,925 (up from \$3,800 in 2001)
Head of Household	\$6,900 (up from \$6,650 in 2001)

plus

- a. An additional amount will be allowed if the taxpayer is age 65 or older or is blind on the last day of the tax year.

For single/head of household filers, the amount is \$1,150, while for married filing joint, the amount is \$900.

2. Tax Planning Point: If your average itemized deductions approximately equal the standard deduction, the strategy of "bunching" should be implemented. This strategy allows you to take the standard deduction one year and itemize the next. An example demonstrates how bunching works.

Example: A single taxpayer with constant expenses from year to year as follows:

Mortgage Interest	\$1,900
Medical (Deductible portion)	\$800
State and local taxes	\$950
<u>Charitable Contributions</u>	<u>\$1,150</u>
TOTAL	\$4,800

That is enough to itemize, but the taxpayer loses the standard deduction, which is \$4,700 for 2002. Over two years the taxpayer would be entitled to deduct \$9,600, but that is it.

Bunching allows the taxpayer to adjust the timing of expenses so they are high in one year and low in the next. Following this strategy, the taxpayer can make the following adjustments:

- (1) In odd years prepay January interest in December.
- (2) See the doctor/dentist in January, June, and December in odd years and June in odd years.
- (3) In odd years prepay property taxes due in the following year.
- (4) Plan large charitable gifts for odd years.

Following this strategy, you end up with the following expenses:

	<u>EVEN</u>	<u>ODD</u>
Mortgage interest	\$1,700	\$2,100
Medical	400	1,200
State and local taxes	600	1,300
<u>Charitable contributions</u>	<u>550</u>	<u>1,750</u>
TOTAL	\$3,250	\$6,350

The total is the same: \$9,600 for two years, but by bunching the expenses, the taxpayer gets \$6,350 of itemized deductions in the odd year and at least a standard deduction for the even year (\$4,700 in 2002). Total: \$11,050. You can still have the standard deduction in the even year, but you have reduced the lost itemized deductions by moving some of them from the even year to the odd year.

Due to the 3% floor, another means of preserving itemized deductions would be to wait for a low income year. This can be an effective tax planning tool for individuals with fluctuating annual income. For example, if in 2002 you earn a \$1 million dollar salary, you will want to move itemized deductions into the following year when you expect to earn only an \$80,000 salary.

3. Itemized Deduction:

Substantiation of Deductions. The IRS has issued guidelines where substantiation other than by canceled check will be acceptable. Rev. Proc. 92-71, IRB 1992-35. They are as follows:

- a. Bank Statements, if they show: the check number; the amount of the check; the date the check amount was posted to the account by the financial institution; and the name of the payee.
- b. Electronic Funds Transfer (shown on bank statement), if they show: amount of the transfer; date the transfer was posted to the account by the financial institution; and the name of the payee.
- c. Credit Card Statements, if they show: the amount of the charge; the date of the charge (transaction date); and the name of the payee.

For examples of unacceptable substantiation, see Jones v. Comm'r, TC Memo 1992466 (8/18/92).

On the example tax return, the Burns will itemize their deductions. (See Schedule A.)

A. **EXEMPTIONS (Line 40)**

The deduction for personal exemptions has increased \$100 from last year, to \$3,000 for 2002. Children who can be claimed (whether or not they are) as dependents on the parents' returns cannot claim themselves on their own returns. See Code § 151(d).

If the taxpayer's AGI exceeds a threshold amount (based upon filing status) the deduction for exemptions is reduced by 2% for each \$2,500, (or each \$1,250 for married filing separately), or fraction thereof, by which the AGI exceeds the threshold amount. (See Code §151(d)(3)). The threshold amounts for 2002 are:

	<u>AGI Threshold</u>	<u>Exemptions Lost When AGI Equals</u>
Joint Returns and Surviving Spouse	\$206,000	\$328,500
Head of Household	171,650	294,150
Single Taxpayers	137,350	259,800
Married Filing Separately	103,000	164,250

On the example tax return, the Burns' AGI does not exceed the \$206,000 threshold and therefore their exemptions will not be reduced. The attached worksheet would be used for purposes of calculating a limitation:

The EGTRRA 2001 will phase out the AGI phase-outs of personal exemptions. Beginning in 2006, one-third of the phase out will be eliminated, increasing over the following four years until it is completely repealed in 2010.

Deduction for Exemptions Worksheet—Line 40

Keep for Your Records



<p>1. Is the amount on Form 1040, line 36, more than the amount shown on line 4 below for your filing status?</p> <p><input type="checkbox"/> No. STOP Multiply \$3,000 by the total number of exemptions claimed on Form 1040, line 6d, and enter the result on line 40.</p> <p><input type="checkbox"/> Yes. <i>Continue</i> </p>		
2. Multiply \$3,000 by the total number of exemptions claimed on Form 1040, line 6d	2	12,000
3. Enter the amount from Form 1040, line 36	3.	126,528
4. Enter the amount shown below for your filing status.	4.	206,000
<ul style="list-style-type: none"> • Single \$137,300 • Married filing jointly or qualifying widow(er)—\$206,000 • Married filing separately \$103,000 • Head of household—\$171,650 		
5. Subtract line 4 from line 3. If the result is more than \$122,500 (\$61,250 if married filing separately), STOP You cannot take a deduction for exemptions	5.	-
6. Divide line 5 by \$2,500 (\$1,250 if married filing separately). If the result is not a whole number, increase it to the next higher whole number (for example, increase 0.0001 to 1)	6.	-
7. Multiply line 6 by 3% (0.03) and enter the result as a decimal	7.	-
8. Multiply line 2 by line 7	8	-
9. Deduction for exemptions. Subtract line 8 from line 2. Enter the result here and on Form 1040, line 40	9	12,000

A. **TAX RATE (Line 42)**

As a result of EGTRRA 2001, the tax rates for 2002 have been reduced as follows:

MARRIED, FILING JOINTLY

<u>Taxable Income</u>		<u>Tax</u>
<u>Over</u>	<u>But Not Over</u>	
\$0	\$12,000	10%
\$12,000	\$46,700	\$1,200 + 15% of amount over \$12,000
\$46,700	\$112,850	\$6,405 + 27% of amount over \$46,700
\$112,850	\$171,950	\$24,265.50 + 30% of amount over \$112,850
\$171,950	\$307,050	\$41,995.50 + 35% of amount over \$171,950
\$307,050	_____	\$89,280.50 + 38.6% of amount over \$307,050

SINGLE

<u>Taxable Income</u>		<u>Tax</u>
\$0	\$6,000	10%
\$6,000	\$27,950	\$600 + 15% of amount over \$6,000
\$27,950	\$67,700	\$3,892.50 + 27% of amount over \$27,950
\$67,700	\$141,250	\$14,625 + 30% of amount over \$67,700
\$141,250	\$307,050	\$36,690 + 35% of amount over \$141,250
\$307,050	_____	\$94,720 + 38.6% of amount over \$307,050




On the example tax return, the Burns have capital gain income and will therefore calculate their federal income tax by using Part IV of Schedule D and the worksheet on page D-9 of the instructions.

A. ALTERNATIVE MINIMUM TAX (Line 43)

Based on the following worksheet, the Burns are not required to complete Form 6251 to determine if they will owe alternative minimum tax.

Worksheet To See If You Should Fill In Form 6251—Line 43

Keep for Your Records

Before you begin:		<input checked="" type="checkbox"/> Be sure you have read the Exception above to see if you must fill in Form 6251 instead of using this worksheet. <input checked="" type="checkbox"/> If you are claiming the foreign tax credit (see the instructions for Form 1040, line 45, on page 38), enter that credit on line 15.	
1. Are you filing Schedule A?			
<input checked="" type="checkbox"/> Yes. Enter the amount from Form 1040, line 39.			
<input type="checkbox"/> No. Enter the amount from Form 1040, line 38, and go to line 4.	1		98,129
2. Enter the smaller of the amount on Schedule A, line 4, or 2.5% (.025) of the amount on Form 1040, line 38.	2		0
3. Add lines 1 and 2 of Schedule A and enter the total.	3		10,350
4. Add lines 1 through 3 above.	4		108,479
5. Enter the amount shown below for your filing status.			
<ul style="list-style-type: none"> ◆ Single or head of household \$35,750 ◆ Married filing jointly or qualifying widow(er) \$49,000 ◆ Married filing separately \$24,500 	}		5
6. Is the amount on line 4 more than the amount on line 5?			57,479
<input type="checkbox"/> No.  You do not need to fill in Form 6251.			
<input checked="" type="checkbox"/> Yes. Subtract line 5 from line 4.	6		
7. Enter the amount shown below for your filing status.			
<ul style="list-style-type: none"> ◆ Single or head of household \$117,500 ◆ Married filing jointly or qualifying widow(er) \$150,000 ◆ Married filing separately—\$75,000 	}		7
8. Is the amount on line 4 more than the amount on line 7?			150,000
<input checked="" type="checkbox"/> No. Enter the amount from line 6 on line 10 and go to line 11.			
<input type="checkbox"/> Yes. Subtract line 7 from line 4.	8		
9. Multiply line 8 by 28% (.28) and enter the result but do not enter more than line 5 above.	9		
10. Add lines 6 and 9.	10		57,479
11. Is the amount on line 10 more than \$175,000 (\$87,500 if married filing separately)?			
<input type="checkbox"/> Yes.  Fill in Form 6251 to see if you owe the alternative minimum tax.			
<input checked="" type="checkbox"/> No. Multiply line 10 by 26% (.26).	11		14,945
12. Enter the amount from Form 1040, line 42, minus the total of any tax from Form 4972 and any amount on Form 1040, line 45.	12		16,485
Next: Is the amount on line 11 more than the amount on line 12?			
<input type="checkbox"/> Yes. Fill in Form 6251 to see if you owe the alternative minimum tax.			
<input checked="" type="checkbox"/> No. You do not need to fill in Form 6251.			

CREDITS (Lines 45-53)

1. Foreign Tax Credit (Line 45) This credit is based on taxes paid to foreign countries for income generated therefrom. The credit is computed on Form 1116.
2. Credit for Child and Dependent Care Expenses (Line 46) This credit is available for taxpayers who pay someone to care for their child or dependent, in order to be employed themselves, this credit is available. The child must be under age 13 or disabled. The credit is calculated on Form 2441. The credit is based on the number of qualifying children, amount of qualifying expenses paid, and the income earned by the parent(s). The

maximum credit with one qualifying child is \$720, and with two or more qualifying children is \$1,440.

The Burns have paid two individuals for child care expenses and must file Form 2441 to claim the credit.

Beginning in 2003, the maximum credit, which is currently 30%, is increased to 35%, the AGI phase-out threshold increases from \$10,000 to \$15,000 and the maximum eligible dependent care expenses will increase from \$2,400 to \$3,000 (for one child) and from \$4,800 to \$6,000 (for more than one child). (EGTRRA 2001 §204).

3. Credit for the Elderly or the Disabled (Line 47) For taxpayers that are, at the end of 2001 (a) 65 or older, or (b) retired on permanent and total disability and had taxable disability income, there is a credit allowed. AGI must be less than \$17,500; \$20,000 if married filing joint and only one spouse is eligible; \$25,000 if both are eligible; and \$12,500 if married filing separate. See Schedule R.
4. Education Credits. (Line 48) The education credit is equal to the sum of the Hope Scholarship Credit which is up to \$1,500 per year per student; and the Lifetime Learning Credit which is up to \$1,000 per year per taxpayer (\$2,000 for tax years after 2002). These credits are for expenses paid for higher education at accredited post secondary education institutions. These expenses may be incurred by the taxpayer, their spouse, or for a dependant.

The Hope Scholarship Credit is available for the first two years of undergraduate education. The Lifetime Learning Credit is for any post high school education at an eligible educational institution. Both of these credits cannot be claimed in the same year with respect to a single student. Married taxpayers must file jointly to be eligible for this credit.

For joint tax returns, these credits are phased out with modified adjusted gross income between \$82,000 and \$102,000, while in all other filers, the phase out range is \$41,000 to \$51,000.

Beginning in 2003, the taxpayer will be able to take an education credit the same year they received a distribution from an Education Savings Account.

Stacey continued her Masters program in 2002 and paid \$1,205 of tuition. However, because their AGI is more than \$102,000 she claimed the above-the-line deduction on Form 1040, Line 26.

5. Retirement Savings Contributions Credit. (Line 49) This new tax credit is computed using Form 8880. This is a credit for eligible taxpayers who made:
 - a. Contributions to a traditional or Roth IRA.
 - b. Elective deferrals to a 401(k), 403(b), 457, SEP, or SIMPLE plan.
 - c. Voluntary contributions to a qualified retirement plan.
 - d. Voluntary contributions to a 501(c)(18) plan.

To be eligible, the taxpayer must be 18 or older and not a student. The credit is phased out for single taxpayers at \$25,000 of AGI, and \$37,500 for

head of household and \$50,000 for married filing joint. The credit can be up to 50% of the lesser of \$2,000 or the amounts contributed by the taxpayer into the retirement savings discussed above. IRS Announcement 2001-106 contains the following chart to determine the credit:

Married filing joint	Head of household	All other filers	Credit
\$0-\$30,000	\$0-\$22,500	\$0-\$15,000	50% of contribution
\$30,001-\$32,500	\$22,501-\$24,375	\$15,001-\$16,250	20% of contribution
\$32,501-\$50,000	\$24,376-\$37,500	\$16,251-\$25,000	10% of contribution
Over \$50,000	Over \$37,500	Over \$25,000	credit not available

1. Child Tax Credit. (Line 50) Qualifying taxpayers can claim a \$600 tax credit for each qualifying child under the age of 17. The child tax credit is reduced by \$50 for each \$1,000 of modified AGI in excess of \$110,000 for joint filers, \$75,000 for single and head of household and \$55,000 for married filing separately. The phase out range depends upon the number of qualifying children.

In 2002, the additional child tax credit is a refundable credit to the extent that 10% of the taxable earned income exceeds \$10,350. (See Form 8812).

A qualifying child is a child who:

- a. is claimed as a dependent; and
- b. is under the age of 17; and
- c. is the taxpayer's son, daughter, adopted child, descendant of a child, stepchild, or foster child; and
- d. is a U.S. citizen or resident alien.

2. Adoption Credit. (Line 51) This credit was scheduled to end in 2001. However, EGTRAA 2001 revived and expanded the credit for 2002. The credit is allowed for qualified adoption expenses paid by the taxpayer during the tax year.

In 2002, the maximum credit has been increased to \$10,000 per child. However, this credit also has a phase out component for modified AGI's between \$150,000 and \$190,000.

- a. Domestic Adoption
 - (1) For expenses paid before the year the adoption becomes final, the credit is allowed in the year after the year the expenses were paid.
 - (2) When expenses were paid during or after the year the adoption becomes final, the credit is allowed for that year. If expenses are paid in an unsuccessful adoption attempt, the credit is allowed in the next taxable year.

- b. Foreign Adoption - The credit for expenses paid for a foreign adoption is allowed in the year the adoption becomes final.

The credit is a nonrefundable credit, however, the taxpayer may carry forward any unused credit through the succeeding five tax years after the year the credit arose.

The term "qualified adoption expenses" is defined as the reasonable and necessary expenses directly related to legally adopting an eligible child. These expenses do not include a surrogate parenting arrangement or the costs of adopting a spouse's child.

"An eligible child" is a child under 18 or one who is incapable of caring for himself or herself.

A "child with special needs" is defined as a U.S. citizen or resident who the State has determined cannot or should not be returned to his or her parents residents, and who probably will not be adopted without assistance.

- 3. Credits from Form 8396 or Form 8859 (Line 52) These credits include:
 - a. Mortgage interest credit (calculated on Form 8396); and
 - b. District of Columbia first time home buyer credit (calculated on Form 8859).
- 4. Other Credits (Line 53) Although the investment credit has been repealed, taxpayers may still use their carryover from previous years to offset tax liability in 2002. Taxpayers must still recapture any credit they took if property that qualified for the credit changes to property that does not qualify for the credit before the end of the recapture period.

For the years ending after July 1, 1987, any part of the general business credit and any carryover attributable to the regular investment credit must be reduced before they are used to offset tax liability.

Other credits available for taxpayers include:

- a. Alternative minimum tax credit (calculated on Form 8801);
- b. Qualified electric vehicle credit (calculated on Form 8834);
- c. General business credit (calculated on Form 3800);
- d. Empowerment zone employment credit (calculated on Form 8844);
- e. New York Liberty Zone business employee credit (calculated on Form 8884)
- f. Nonconventional Source Fuel Credit, check box "c"; enter "FNS"
- g. Qualified zone academy bond credit - for S-corporation shareholders (calculated on Form 8860)

B. **OTHER TAXES (Lines 56-60)**

1. Self-employment Tax (Line 56)

On the example tax return, the Burns must file a Schedule SE due to Walter's self-employment income.

2. Social Security and Medicare Tax on Tip Income (Line 57) See discussion earlier under Form 1040 Line 7.

3. Tax on Qualified Plans, Including IRAs, and other Tax Favored Accounts (Line 58) This tax may be due if the taxpayer:

- a. Received any early distributions from (i) an IRA or other qualified retirement plan, (ii) an annuity, or (iii) a modified endowment contract entered into after June 20, 1988.
- b. Excess contributions were made to IRAs, Coverdell education savings accounts (ESAs), or Archer MSAs.
- c. Received taxable distributions from Coverdell ESAs or qualified tuition programs.
- d. Was born before July 2, 1931, and did not take the minimum required distribution from IRA or other qualified retirement plan.
- e. Form 5329 is used to calculate this tax unless item a. above applies **and** distribution code 1 is correctly shown in box 7 of Form 1099R. Instead, multiply the taxable amount of the distribution by 10% (.10) and enter the result on line 58.

4. Advanced Earned Income Credit Payments (Line 59) The taxpayer receiving advanced earned income payments from an employer, reported in box 9 Form W-2, must report these amounts.

5. Household Employment Taxes (Line 60) This line was added to the 1040 in 1995. In addition, the IRS issued the Schedule H, for household employment taxes. A taxpayer who:
 - a. Pays any one household employee cash wages of \$1,300 or more in 2002; or
 - b. Withholds Federal Income Tax during 2002 at the request of a household employee; or
 - c. Pays total cash wages of \$1,000 or more in any calendar quarter of 2001 or 2002 to household employees

must file Schedule H along with their Form 1040, or by itself if they are not required to file a Form 1040.

On the example tax return, the Burns have a household employee who they paid more than \$1,300 in 2002, and must complete Schedule H.

C. **PAYMENTS (Lines 62-69)**

1. Federal Income Tax Withheld (Line 62). Using new Form W-4V, taxpayers may request voluntary withholding on amounts received after 1996 on the following types of payments: (a) social security benefits; (b) crop disaster payments; (c) commodity credit corporation loans; (d) state unemployment compensation benefits; and (e) other federal payments specified by the IRS. See Code § 3402(p).

Walter had \$12,550 withheld from his W-2's; Stacey had \$2,814 withheld from her W-2; and had \$1,755 withheld from her W-2G.

2. 2002 Estimated Tax Payments (Line 63): To Make or Not to Make. Due to the considerable complexity of some estimated tax computations, especially relating to high-income taxpayers, preparers may often be asked if it might be prudent to avoid paying the estimates altogether.

This may be especially true where the taxpayer is short of cash. In addition, because the estimated tax penalty is simply an interest calculation on the unpaid amount, it may be economically correct to avoid the payment where the IRS interest is no higher than the taxpayer's prospective loan rate. This is also true where the taxpayer can earn a rate higher than the IRS would charge by investing the estimate payment.

The danger with such an approach is the operation of Code Sec. 7203. This section makes it a misdemeanor for the taxpayer to willfully fail to make the required estimated tax payments, subject to a fine of up to \$25,000 and/or one year in prison.

While prosecution is certainly remote, it places the preparer in a rather precarious position of assenting to criminal conduct. Thus, every notification to the taxpayer of the potential liability should be made.

3. Earned Income Credit (Line 64). The earned income credit is a refundable credit which is available to taxpayers with or without qualifying children. For tax year 2002, the following table from Rev. Proc. 2001-59 sets the limits on the credit as follows:

<u>NUMBER OF CHILDREN</u>	<u>MAXIMUM AMOUNT OF THE CREDIT</u>	<u>EARNED INCOME AMOUNT</u>	<u>THRESHOLD PHASE-OUT AMOUNT</u>	<u>COMPLETED PHASE-OUT AMOUNT</u>
<u>1</u>	<u>\$2,506</u>	<u>\$7,370</u>	<u>\$13,520</u>	<u>\$29,201</u>
<u>2 or more</u>	<u>\$4,140</u>	<u>\$10,350</u>	<u>\$13,520</u>	<u>\$33,178</u>
<u>None</u>	<u>\$376</u>	<u>\$4,910</u>	<u>\$6,150</u>	<u>\$11,060</u>

The qualifying child for purposes of the earned income credit is different than that for the child tax credit. A qualifying child is one who:

- a. is the taxpayer's son, daughter, adopted child, grandchild, stepchild, or foster child; and
- b. was at the end of the tax year under age 19, or under age 24 and a student, or any age and permanent and totally disabled; and
- c. lived with the taxpayer in the United States for more than half of the year.

The exception to this qualification is if the child was:

- i. Born or died in 2002; and

- ii. The taxpayer's home was the only home for the child while alive during 2002.

The earned income credit qualifications, calculations and worksheets can be found on pages 43 through 49 of the instructions to Form 1040.

Additionally, the earned income tax credit is denied if certain investment income exceeds \$2,500.

1. Excess Social Security and RRTA Tax Withheld (Line 65). The maximum amount of Social Security tax that may be withheld in 2002 is \$5,263.80. If a taxpayer has more than one employer and combined they withhold more than this amount, the taxpayer is allowed to take the excess as a credit on line 65.

Walter had a total of \$5,751 withheld from two separate employers and thus receives a credit of \$487 on Line 65.

However, if a single employer withholds more than \$5,263.80 of Social Security tax, the employer must refund the excess, it cannot be claimed as a credit on the Form 1040.

2. Additional Child Tax Credit (Line 66). The additional Child Tax Credit is a refundable portion of the Child Tax Credit calculated on line 50 of Form 1040. This credit is calculated using Form 8812.
3. Amount Paid With Request for Extension to File (Line 67). When filing a request for extension, the IRS may reject the request if the taxpayer's estimate of tax liability is found to be unreasonable. Any amounts paid with the filing of Forms 4868, 2688 or 2350 should be included on this line.
4. Other Payments (Line 68). Other payments may come from Forms 2439, 4136 or 8885.

- B. **ESTIMATED TAX PENALTY (Line 74)** Individuals must pay a penalty on any underpayment of estimated tax. To avoid the underpayment of estimated tax penalty, individuals must pay 25% of a "required annual payment" of estimated tax by Apr. 15, June 15, Sept. 15, and Jan 15 (for calendar year taxpayers).

For tax years beginning after 1997, the estimated tax penalty is not imposed if the shortfall for the year is less than \$1,000 (up from \$500).

Underpayment penalties will not be imposed on individual taxpayers provided current year tax estimates are 100% of prior years tax and prior year's AGI was \$150,000 or less. As of January 1, 1994, if the prior year's AGI was more than \$150,000, a scheduled percentage of prior year's tax must be paid. (See chart below). The alternate method of paying 90% of the current years tax is also acceptable.

Under IRC §6654(d)(1)(C)(i) as amended by the Tax Relief Extensions Act of 1999, the required percentage of preceding tax year's tax that must be paid in a tax year to meet the safe harbor is as follows:

Tax year beginning in	Required percentage of prior-years tax
2002	112 %
2003 and thereafter	110%

1. **IRS Waiver of Penalty for Underpayment of Estimated Taxes.** The IRS may waive this penalty under Code Sec. 6654(e)(3)(A) where "by reason of casualty, disaster or other unusual circumstances the imposition of such addition to tax would be against equity and good conscience."

2. **Penalties.** With the continued increase in penalty exposure, the final regulations regarding the accuracy related penalties (negligence, substantial understatement valuation misstatement) and the preparer penalties should be reviewed.

Because the IRS often miscalculates penalty amounts, it is necessary to examine the calculations they make. The methods used are discussed in the Consolidated Penalty Handbook, new part E & I of the Internal Revenue Manual.

3. **Interest on Overpayments of Tax.** No interest is paid by the IRS on a Refund arising from an original income tax return if the refund is issued by the 45th day after the later of the due date for the return or the date the return is filed. Rev. Rul. 2002-59 sets the overpayment and underpayment interest rates at 6% beginning October 1, 2002. The rates were 6% for the 1st quarter, 6% for the 2nd quarter and 6% for the 3rd quarter of 2002. (See Rev. Rul. 2001-63, 2002-13 and 2002-33).

- B. **THIRD PARTY DESIGNATION.** The taxpayer designates a third party (but not necessarily the paid preparer) to discuss the return with the IRS. By checking the “yes” box, the taxpayer authorizes a designee to:

1. Give the IRS any information that is missing from the taxpayer’s return.
2. Call the IRS for information about the processing of the taxpayer’s return or the status of the refund or payments.
3. Respond to certain IRS notices that the taxpayer has shared with the designee about math errors, offsets, and return preparation. However the original notices will not be sent to the designee.

By checking this “yes” box, the taxpayer is not authorizing the designee to receive any refund check, bind the taxpayer to anything (including any additional tax liability), or otherwise represent the taxpayer before the IRS, a Form 2848 (IRS Power of Attorney) is still required for these matters.

This limited authorization automatically expires on the due date (April 15, 2004) of the taxpayer’s 2003 tax return.

- C. **PAID PREPARER’S RETENTION OF MANUALLY SIGNED RETURN COPIES**

Final treasury regulations have been issued giving paid preparers two alternatives to the requirement that they retain the manually signed return (or a copy of thereof). Treas. Reg. §1.6695-1(b)(4)(i) allows the paid preparer to:

1. retain a photocopy of the manually signed copy of the return or claim for refund; or
2. use an electronic storage system meeting the requirements of Rev. Proc. 97-22, Sec. 4, 1997-1 CB 652, or procedures subsequently prescribed by IRS, to store and produce a copy of the return or claim manually signed by the preparer.

SCHEDULES A&B
(Form 1040)

Schedule A—Itemized Deductions
(Schedule B is on back)

OMB No. 1545-0047

2002
Adjusted
Sequence No. **07**

Department of the Treasury
Internal Revenue Service 3298

▶ Attach to Form 1040. ▶ See instructions for Schedules A and B (Form 1040).

Name(s) shown on Form 1040

Your social security number
483 75 5777

WALTER AND STACEY BURNS

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others.				
1	Medical and dental expenses (see page A-2)	1	5,687		
2	Enter amount from Form 1070, line 33	2	126,528		
3	Multiply line 2 by 7.5% (0.075)	3	9,490		
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4			0
Taxes You Paid					
5	State and local income taxes	5	6,664		
6	Real estate taxes (see page A-2)	6	3,458		
7	Personal property taxes	7	228		
8	Other taxes. List type and amount ▶	8			
9	Add lines 5 through 8	9			10,350
Interest You Paid					
10	Home mortgage interest and points reported to you on Form 1098	10	8,569		
11	Home mortgage interest not reported to you on Form 1098, if paid to the purchaser from whom you bought the home, see page A-3 and enter that purchaser's name, date of purchase, or address ▶	11			
12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13	475		
14	Add lines 10 through 13	14			9,044
Gifts to Charity					
15	Gifts by cash or check. If you made any gift of \$250 or more, see page A-4.	15	5,165		
16	Other than by cash or check. If any gift of \$250 or more, see page A-4. You must attach Form 8283 if over \$500. Carryover from prior year	16	4,140		
17	Carryover from prior year	17			
18	Add lines 15 through 17	18			9,305
Casualty and Theft Losses					
19	Casualty or theft losses. Attach Form 4684. (See page A-5.)	19			
Job Expenses and Other Miscellaneous Deductions					
20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You must attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶	20	1,538		
21	Tax preparation fees	21	240		
22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22	35		
23	Add lines 20 through 22	23	1,813		
24	Enter amount from Form 1070, line 33	24	126,528		
25	Multiply line 24 by 2% (0.02)	25	2,531		
26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-	26			0
Other Miscellaneous Deductions					
27	Other from list on page A-6. List type and amount ▶	27			1,700
	GAMBLING LOSSES				
Total Itemized Deductions	Is Form 1040, line 36, over \$137,300 (over \$68,650 if married filing separately)?				
	<input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the right column for lines 4 through 27. Also, enter this amount on Form 990, line 38.	28			30,399
	<input type="checkbox"/> Yes. Your deduction may be limited. See page A-6 for the amount to enter.				

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 1-230X

Schedule A (Form 1040) 2002

II. ADDITIONAL FORMS & SCHEDULES WITH COMMENTARY
SCHEDULE A

1. Line 1 Medical and Dental Expenses

Taxpayers who itemized their deductions can deduct non-reimbursed medical and dental expenses, but the deduction is limited to the expenses that are more than 7.5% of the taxpayer's AGI.

Some applicable limitations on medical and dental expenses are: 1) standard mileage which has been increased for 2002 to \$.13 a mile; 2) \$50/night limitation on lodging while away from home that is essential to and primarily for medical care provided by a physician in a hospital; 3) meals are subject to a 50% limitation.

In Rev. Rul. 2000-24, the IRS determined that the cost of travel to and attendance to a medical conference pertaining to the taxpayer's child's illness was a deductible medical expense under IRC §213. However, the lodging costs were not deductible.

Amounts paid by taxpayers for participation in a weight-loss program as treatment for a specific disease or diseases (including obesity) diagnosed by a physician are expenses for medical care, subject to the 7.5 percent floor limitation. Rev. Rul. 2002-19.

Expenses of a nursing home, including meals and lodging, are deductible as a medical expense if they meet the requirements of Reg. 1.213-1(e)(1)(v). These include: (a) the individual is in the home because her condition is such that the availability of medical care is the principal reason for being in the nursing home; (b) meals and lodging are furnished as a necessary incident to the medical care; and (c) the meals and lodging are furnished to an individual who needs continual medical care.

Additionally, for tax years beginning after December 31, 1996, a taxpayer is allowed to deduct the costs of long-term care insurance. The limitations regarding long-term care premiums were changed for tax years beginning in 2002 in Rev. Proc. 2001-59 as follows:

<u>Age of Taxpayer</u>	<u>Deductible Limit</u>
0 to 40	240
41 to 50	450
51 to 60	900
61 to 70	2,390
71 +	2,990

The Burns had \$5,375 of non-reimbursed medical expenses plus the nondeductible 30% of Walter's self-employed health insurance (long term care insurance premiums) of \$72 plus Stacey's allowable long term care insurance premiums of \$240, for a total of \$5,687. However, because this falls below the 7½% of AGI floor, none of the unreimbursed medical expenses are deductible.

2. Lines 5-8 Taxes Paid

This deduction includes both state and local income taxes, taxes paid on the taxpayer's real estate not used in a trade or business, personal property taxes, and other miscellaneous taxes paid during the tax year.

The taxes paid by the Burns in 2002 are as follows:

2002 State Income Taxes (W-2's and W-2G)	\$6,664
Real Estate Taxes: The amount of real estate taxes paid, \$3,890, was reduced by \$432, the amount claimed on Form 8829 (Business Use of Your Home)	\$3,458
Personal Property Taxes (\$140 + 88)	<u>\$228</u>
TOTAL	\$10,350

The deductible amount of personal property taxes was \$228. This amount is from the license and registration fees the couple paid for their two cars.

(a) The deductible portion of the tax on vehicle registration consists of the amount of tax based on the vehicle's value, and not that portion based on the vehicle's weight. In Iowa, the registration fee is based on both value and weight. Iowa Code §321.109 computes the registration fee as follows:

(1) one percent of the value as fixed by the department, plus

(2) forty cents for each one hundred pounds or fraction thereof of weight of vehicle, as fixed by the department.

Stacey's car is valued at \$14,000 \times 1% = \$140
Stacey's car's weight is 2,750 lbs. / 100 \times .40 = \$11

Walter's car is valued at \$22,000 \times 1% = \$220
Walter's car's weight is 2,000 lbs. / 100 \times .40 = \$8

The portion of the registration fee based on value for the two vehicles is \$360 (140 + 220). However, Walter's car is used 60% for his business, therefore, $\$220 \times 40\% = \88 . The Schedule A portion therefore is \$228 (140 + 88).

3. Lines 10-11 Home Mortgage Interest

You may generally deduct all the interest on debt secured by your main or second home when:

(a) The debt, regardless of amount, was incurred on or before October 13, 1987, and was not increased after that date.

(b) The debt is not more than \$1,000,000 provided you used the proceeds to buy, build, or substantially improve your home.

(c) The debt was not used to buy, build, or substantially improve your home, but was equal to or less than \$100,000 and does not exceed the equity in home.

The home can be a house, condo, mobile home, boat, or house trailer, but it does not include vacant land used for camping, Garrison, TC Memo 1994-200 (5/5/94). Vacant land may qualify, however, if contiguous to the principal residence, PLR 8940061, or when the residence is under construction, Temp. Reg. 1.163-10T(p)(5)(i) and Notice 88-74.

On the example tax return, the following interest expense was calculated with respect to the Burns:

<i>Interest on Iowa City home</i>	<i>9,640</i>
<i>(less Form 8829 amount)</i>	<i><u>(1,071)</u></i>
<u>TOTAL</u>	<u>8,569</u>

For AMT purposes you may deduct only the interest on the amount of the refinanced mortgage that does not exceed your outstanding mortgage before refinancing. See Code § 163(h).

4. Line 12 Points not Reported on Form 1098

Points on a home mortgage loan for the purchase or improvement of your principal residence are currently deductible if the points are an established business practice in the area, the points that are paid do not exceed the number of points generally charged in the area, and the points are paid with funds other than those obtained from the mortgage. Thus, points withheld from loan proceeds are not fully deductible in the year withheld. Code § 461(g)(2). Points or service charges that are charged as compensation for services that the lender performs, such as appraisal or settlement fees, are not deductible as interest. FHA and VA loan points are not deductible as interest. See Rev. Rul. 67-297, 1967-2 C.B. 87; Rev. Rul. 69-188, 1969-1 C.B. 54; Wilkerson v. Commissioner, 70 T.C. 240 (1978), reversed on other grounds 655 F.2d 980 (9th Cir.1981). Points paid to refinance a home mortgage are not deductible in the year paid but must be deducted ratably over the period of the loan. Points paid on loans for other than a home mortgage are also to be deducted ratably over the terms of the loan. See Code §461(g). See also PLR 199905033.

In determining the deductibility of points paid in connection with the purchase of a principal residence, Rev. Proc. 94-27 notes the following requirements:

- a. The points must be clearly designated on the settlement statement (i.e., "loan origination fees", "loan discount", or "discount points").
- b. The points must be computed as a percentage of the amount borrowed.
- c. The points charged must conform to the usual bank practice of the area, i.e., they may not be a substitute for other types of fees.
- d. The points must be paid in connection with the acquisition of the principal residence and must be secured by the principal residence.
- e. The points must be paid directly by the borrower, not from the proceeds of the loan this also includes points that are paid by the seller of the property.

Delinquency charges for late payments of a home mortgage cannot be deducted as interest. If the terms of a mortgage assess a delinquency fee for late payment of a mortgage, this fee cannot be characterized as interest. The IRS disallowed the characterization of the delinquent payment as interest and the Tax Court agrees. According to the Tax Court, the purpose of the delinquency charge is to: (1) compensate the mortgagee bank for its costs, (2) penalize the borrower for the purpose of discouraging late payments, and (3) compensate the mortgagee for the lost earnings on the late payments.

5. Line 13 Investment Interest

Investment interest may be deducted up to the amount of net investment income. According to the Revenue Reconciliation Act of 1993, net investment income no longer includes net capital gain. "Net Capital Gain" is the excess of long-term capital gains over short term capital losses. This may significantly reduce the limitation on deductible investment interest. The amount of investment interest not deducted can be carried forward. See Code § 163(d). Investment income also does not include income from the

rental of property where the taxpayer materially participated in the rental activity. Ritter v. Commissioner, T.C. Summary Opinion 2001-57 (2001).

The Revenue Reconciliation Act of 1993 excludes long-term capital gains from the calculation of the investment income limit on deducting investment interest. Congress felt that it would be inappropriate for a taxpayer who realizes long-term capital gain taxable at the lower rate to use that gain to deduct otherwise nondeductible investment interest against ordinary income.

Section 163(d) provides that the amount of investment interest for any taxable year that is not allowed as a deduction is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year. Rev. Rul. 86-70 had held that a taxpayer may not carry over the disallowed investment interest to the extent that it exceeds the taxpayer's taxable income in the year the interest was paid or accrued. Since the Tax Court and four federal appellate courts have rejected that position, the IRS issued a new position in Rev. Rul. 95-16. Now it will allow the carryover of a taxpayer's disallowed investment interest to a succeeding taxable year. As a result, the deduction is not limited by the taxpayer's taxable income for the taxable year in which the interest is paid or accrued.

Walter and Stacey incurred \$475 of investment interest. They are not required to file Form 4952 because (1) their investment income is not more than their interest and ordinary dividends; (2) they have no other deductible investment expenses; and (3) they have no disallowed investment interest expense from 2001.

6. Lines 15-18 Gifts to Charity

Charitable contributions may only be claimed as an itemized deduction on Schedule A, Form 1040. Non-cash contributions can still be valued at their fair market value. See Code § 57(a)(6), see also Herman v. U.S., 99-2 USTC paragraph 50, 899.

In 2000, the IRS ruled in PLR 200004001 that a donor to a university that donated funds and in exchange received the right to purchase skybox tickets, use of the skybox, and parking was able to claim an 80% charitable contribution deduction for that donation under IRC §170(1)(2).

Charitable mileage is \$0.14 per mile. (See Rev. Proc. 2001-54).

On the example tax return, the Burns have made both cash and non cash contributions. For the noncash contributions, Form 8283 must be prepared.

7. Line 19 Casualty or Theft Loss

Nonbusiness casualty or theft losses may be deducted only to the extent that:

- (a) the amount of each separate loss is more than \$100, and
- (b) the total amount of all losses for the tax year is more than 10% of AGI,

8. Lines 20-26 Job Expenses & Other Miscellaneous Deductions

Most miscellaneous itemized deductions are subject to the 2% limitation. The amount deductible is limited to the total of these miscellaneous deductions that is more than 2% of AGI. Some of these expenses include: work clothes and uniforms, union dues and fees, safe deposit box rental, tax counsel and assistance, investment counsel fees, investment expenses, IRA fees, work-related supplies and tools, etc. See Code § 67.

Attorney fees. The deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim bears a sufficient nexus to the taxpayer's business. See Test v. Commissioner, 80 T.C.M. 776 (2000).

If an employee's business expenses are unreimbursed, the employee must use Form 2106 or 2106-EZ to figure the amount of unreimbursed business expenses that can be entered on Schedule A and claimed as a miscellaneous itemized deduction.

On the example tax return, the Burns are required to complete Form 2106-EZ for Stacey's unreimbursed expenses. Additionally, the Burns had \$240 non-business for tax preparation fees and a \$35 safe deposit box rental in 2002 that are deductible on Lines 21 and 22 respectively.

9. Line 27 Other Miscellaneous Deductions

On the example tax return, Walter and Stacey had gambling losses of \$1,700 during 2002, these are included on Line 27. (See Treas. Reg. §1.165-10 spouses' combined losses can offset combined winnings).

Gambling Losses. To provide adequate documentation for gambling losses, the taxpayer must keep an accurate record of all winnings and losses. See Rodriguez v. Commissioner, 81 T.C.M. 115 (2001). The record should contain the following:

- (a) Date and type of specific wager or wagering activity;
- (b) Name and location of the gambling establishment;
- (c) Names of others present while gambling;
- (d) Amounts won or lost.

More specifically, while playing slot machines, the taxpayer should keep a record of the machine number and all winnings by date and time the machine was played. While playing table games, the taxpayer should keep the number of the table at which they played, and casino credit card data indicating whether credit was issued in the pit or at a cashier's cage.

Unless the taxpayer is engaged in the trade or business of gambling, losses can only be utilized if the taxpayer itemizes. Torpie v. Commissioner, 79 T.C.M. 2064 (May 22, 2000).

10. Line 28 Limitation of Itemized Deduction

If the taxpayer's AGI exceeds \$137,300 (\$68,650 if married filing separately), IRC § 68 reduces your itemized deductions on a sliding scale. The sliding scale takes 3% of the excess AGI over \$137,300 (or \$68,650) and could eliminate as much as 80% of your itemized deductions. (See Code §68(b)(1)).

The Burns' AGI is below the \$137,300 threshold, and their itemized deductions will not be limited.

**SCHEDULE C
(Form 1040)**

Profit or Loss From Business

(Sole Proprietorship)

OMB No. 1545-0047

2002

Publication
Required by **09**

Department of the Treasury
Internal Revenue Service (99)

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

Name of proprietor
WALTER BURNS

Social security number (SSN)
483 73 5777

A Principal business or profession (including product or service) (see page C-1 of the instructions)
COMPUTER CONSULTING

B Other code from pages C-1, 6, & 9
5 4 1 5 1 0

C Business name (If it differs from the name above, give blank)

D Employer ID number (EIN), if any

F Address (including P.O. or mailing) _____
City, town or post office, state, and ZIP code _____

I Accounting method: (1) Cash (2) Accrual (3) Other (specify) _____

G Did you (or your family partner) materially participate in the operation of the business during 2002? (If "No," see page C-3 for further instructions.) Yes No

H If you started or acquired this business during 2002, check here: _____

Part I Income

1 Gross receipts or sales. Caution: If this income was reported to you on Form 1099-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here <input type="checkbox"/>	1	14,540
2 Return and allowances	2	
3 Subtract line 2 from line 1	3	14,540
4 Cost of goods sold (from line 42 on page C-1)	4	
5 Gross profit. Subtract line 4 from line 3	5	14,540
6 Other income (including Federal and state government job, as well as interest) (see page C-6)	6	
7 Gross income. Add lines 5 and 6	7	14,540

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

8 Advertising	8	78	19 Rent on and profit-sharing from	19	
9 Bad debts (from sales of services) (see page C-7)	9		20 Rent on lease (see page C-6):	20a	
10 Car and truck expenses (see page C-8)	10	1,422	a Vehicles, machinery, and equipment	20b	
11 Commissions and fees	11		b Other business property	21	
12 Depreciation	12		21 Expenses and maintenance	21	
13 Depreciation and section 179 expense (from depreciation table in Part I) (see page C-4)	13	7,052	22 Supplies (see instructions in Part II)	22	480
14 Employee benefit programs (other than on line 19)	14		23 Taxes and licenses	23	
15 Insurance (other than health)	15		24 Travel, meals, and entertainment:	24a	
16 Interest:	16a		a Travel	24b	
a Mortgage (paid to carry on)	16a		b Meals and entertainment	24c	
b Other	16b		c Other (see instructions on line 24c)	24d	
17 Legal and professional fees	17	240	d Substantive tax (see instructions 14c)	25	
18 Other expenses	18	297	25 Utilities	25	
20 Total expenses before expenses for business use of home. Add lines 8 through 18 and lines 19 through 25	20	11,259	26 Wages (less employment credits)	26	
29 Income (profit/loss). Subtract line 20 from line 7	29	3,281	27 Other expenses (from line 48 on page C-1)	27	1,890
30 Expenses for business use of your home. Attach Form 8829	30	2,410	31 Net profit or (loss). Subtract line 30 from line 29	31	871

31 Net profit or (loss). Subtract line 30 from line 29.

• If you entered on Form 1040, line 12, and also on Schedule SL, line 2 (statutory employees, see page C-3), estates and trusts, enter on Form 1041, line 3.

• If you are a partner, you must go to line 27.

32 If you have a loss, check the box that applies (see your instructions in the schedule) (see page C-6):

• If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SL, line 2 (statutory employees, see page C-3), estates and trusts, enter on Form 1041, line 3.

• If you checked 32b, you must attach Form 6198.

32a All investment is not tax-exempt.

32b Some investment is not tax-exempt.

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

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

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

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

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 10 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file.

43. When did you place your vehicle in service for business purposes? (month/day/year) ▶ _____/_____/_____

44. Of the total number of miles you drove your vehicle during 2002, enter the number of miles you used your vehicle for:

a. Business _____ b. Commuting _____ c. Other _____

45. Do you (or your spouse) have another vehicle available for personal use? Yes No

46. Was your vehicle available for personal use during off-duty hours? Yes No

47a. Do you have evidence to support your selection? Yes No

b. If "Yes," is the evidence written? Yes No

Part V Other Expenses. List below business expenses not included on lines 8-26 or line 30.

TELEPHONE	490
CLEAN FUEL VEHICLE DEDUCTION (80%)	1,200
48. Total other expenses. Enter here and on page 1, line 27	1,690



SCHEDULE C (PROFIT OR LOSS FROM BUSINESS)

The Revenue Reconciliation Act of 1993 has reduced or eliminated several business deductions effective 01/01/94:

Deductions for allowable meal and entertainment expenses reduced to 50% as of 1994. Meals that are furnished by the employer on the business premises for the convenience of the employer are fully deductible. §119(a). The IRS in Adv. Announcement 99-77 stated that they would be taking a relaxed stance with regard to what is considered the "employer's convenience". However, an employer cannot simply state that they have a "stay on premises policy" for meals. There must be some business reason for the policy.

Deduction barred for club dues as of 1994. This applies to clubs organized for business, pleasure, recreation, or other social purposes. Permissible organizations include professional organizations (bar association, medical associations, etc.) and civil or public service organizations (Kiwanis, Lions, Rotary, etc.).

Deduction now denied for travel expenses of taxpayer's spouse or dependents as of 1994 unless the spouse or dependent is an employee of the person paying or reimbursing the expenses.

Denial of trade or business expense deduction for certain lobbying expenses as of 1994.

In TAM 9409006 (11/12/93), the IRS concluded that the wife (a sole proprietor) was entitled to deduct the amounts paid to her husband and employee, as reimbursement of medical expenses under an employer-provided health plan under § 162(a). Likewise the IRS concluded that the reimbursement received by the husband was excluded from his gross income under § 105(b).

In 1998, the IRS required new Principal Business or Professional Activity Codes. Some of these codes have been changed and others added for 2002. The six digit codes can be found on pages 7 - 9 of the instructions to Schedule C.

Under Rev. Proc. 2000-22, a small business, defined as having average annual gross receipts of \$1,000,000 or less for the three prior tax years, is not required to account for inventories or use the accrual method of accounting for purchases and sales of merchandise. This Rev. Proc. was later modified by Rev. Proc. 2001-10 which, among other things, grants qualifying taxpayers the ability to use an automatic consent procedure to make a change in accounting method.

Name(s) shown or return filed after name and social security number (shown on other side)

Your social security number

WALTER AND STACEY BURNS

483 73 5777

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

Part II Income or Loss From Partnerships and S Corporations. Note: If you report a loss from a partnership, you must attach Form 990-B (or the 990-B schedule) for that partnership. See page 72 for more information. If you must file Form 9999.

27	(a) Name	(b) Partner for partnership, S or nonpartner	(c) Check for foreign partner	(d) Employer identification number	(e) Investment at Risk? (K-1 only) (Yes or No)
A	PTP LIMITED PARTNERSHIP	P		42-8546484	
B	NEWCO, LLC	P		42-1234567	✓
C					
D					
E					

Passive Income and Loss		Nonpassive Income and Loss		
(i) Passive deduction (attach Form 8582 if required)	(ii) Passive Income from Schedule K-1	(iii) Deductions from Schedule K-1	(iv) Section 179 expense deduction (on Form 4562)	(v) Nonpassive Income from Schedule K-1
A	PTP			
B	4,700			
C				
D				
E				
28a	Totals			
b	Totals	4,700		
29	Add columns (i) and (k) of line 28a			29
30	Add columns (j), (l), and (m) of line 28a			30 (4,700)
31	Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below.			31 4,700

Part III Income or Loss From Estates and Trusts

32	(a) Name	(b) Employer identification number
A		
B		

Passive Income and Loss		Nonpassive Income and Loss	
(i) Passive deduction or capital loss (attach Form 8582 if required)	(ii) Passive Income from Schedule K-1	(iii) Deduction or loss from Schedule K-1	(iv) Other income from Schedule K-1
A			
B			
33a	Totals		
b	Totals		
34	Add columns (i) and (j) of line 33a		34
35	Add columns (k) and (l) of line 33a		35 ()
36	Total estate and trust income or (loss). Combine lines 34 and 35. Enter the result here and include in the total on line 40 below.		36

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)- Residual Holder

37	(a) Name	(b) Employee identification number	(c) Project number from Schedules U, line 20 (see page 2-2)	(d) Taxable amount (see instructions on Schedules U, line 18)	(e) Amount from Schedules U, line 20
38	Combine columns (d) and (e) only. Enter the result here and include in the total on line 40 below.				38

Part V Summary

39	Net farm rental income or (loss) from Form 4835. Also, complete line 41 below.			39
40	Total income or (loss). Combine lines 29, 31, 36, 38, and 39. Enter the result here and on Form 1040, line 17.			40 (7,380)
41	Reconciliation of Farming and Fishing Income. Enter your gross farming and fishing income reported on Form 4835, line A; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 112055), line 25; and Schedule K-1 (Form 1041), line 14 (see page E-6).	41		
42	Reconciliation for Real Estate Professionals. If you were a real estate professional (see page 1-1), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules.	42		



SCHEDULE E (SUPPLEMENTAL INCOME OR LOSS.)

1. Vacation Homes.

The term "vacation home" is defined as a dwelling unit including a house, apartment, condominium, house trailer, boat, or similar property. It also includes any outbuildings, such as a garage, which relate to the use of the dwelling unit for living accommodations.

Specific limitations apply to the allowable business deductions that may be taken by a taxpayer who rents out a vacation home or other dwelling unit that he uses as his residence during the tax year. The purpose of the limitations is to curb the tax benefits that might otherwise be available to taxpayers who rent out homes in order to minimize their personal expenses rather than to make a profit from the rental. Limitations include minimal rental use and personal use.

The minimal rental use limitation provides that if the home is used by the taxpayer during the tax year as his residence and it is rented for less than 15 days during the taxable year, no deductions attributable to such rental are allowable and no income derived from such rental is includable in gross income. However, other allowable deductions in connection with the home, such as interest on a mortgage, state real estate taxes, and casualty losses, may still be deducted.

The personal use limitation provides that if the vacation home is rented for 15 or more days during the taxable year and it is used by the taxpayer for personal purposes for the greater of (a) more than 14 days or (b) more than 10% of the number of days during the year for which the home is rented, the deductions attributed to the rental activity are limited. In such case, the amount of the rental activity deductions may not exceed the amount by which the gross income derived from the rental activity exceeds the deductions otherwise allowable for the property (e.g., interest and taxes).

The order in which these deductions are to be taken in applying the limitation, however, is the same as that prescribed under Code § 183. This order is as follows: (1) taxes and interest allowable to rental use; (2) Operating expenses attributable to rental activities, except the expenses noted in (3) below; and (3) depreciation and other basis adjustment income.

If the taxpayer is engaged in repair and maintenance of the residence on a substantially full time basis for any day, such use will not constitute a personal use day. Twoheny, TC Memo. 1993-547 (11/22/93).

The personal use purposes stated above are those personal purposes by the following: (1) the taxpayer or any other person who owns an interest in the home, and relatives (spouses, brothers, sisters, ancestors, lineal descendants, and spouses of lineal descendants); (2) any individual who uses the home under a reciprocal arrangement, whether or not fair rental is charged; and (3) any other individual who uses the home during a day unless a fair rental is charged.

If a vacation home is owned by a partnership, estate, trust, or tax-option corporation, the number of days of personal use is determined by reference to the total number of days of personal use by the partners, beneficiaries, or stockholders, as the case may be.

The use of the dwelling unit by a relative will not be treated as "personal use" of the unit by the taxpayer if the unit is rented at a fair rental to such relative as that person's principal residence. The joint committee on "vacation homes" states that fair rental is to be determined by taking into account such factors as (1) comparable rentals in the area, and (2) whether substantial gifts were made by the taxpayer to the family member at or about the time of the lease or periodically during the year.

If the Burns' duplex in Iowa City had been used for personal use it would clearly fall under the definition of "vacation homes" set forth above. For example, let us assume that Walter and Stacey used the duplex for a total of 12 days, in 2001, and Walter's parents used it for a total of 18 days in 2001. Because Walter's parents are relatives of the Burns, their use of the duplex is added to the Burns use for the "personal use" test set forth above. If only Walter and Stacey's 12 days of use were counted for the "personal use" test, this total would be less than 15 days and all of their rental expenses would be deductible. However, their relative's use is added to their own use to total 30 days. Thus, "personal use" is greater than 14 days and they are subject to the deduction limitation. To compute the deduction limitation assume the gross rental income is \$9,000. This is reduced by the interest and taxes attributable to the rental use of the property. The resulting figure is the ceiling on the amount of rental expenses allowed. There has been much dispute as to what ratio is properly used to compute the portion of interest and taxes attributable to the rental use of the property. Where this issue has been litigated, the Commissioner has contended that the number of days of rental use over the total number of days used (rental and personal) is the proper ratio for allocating all expenses. The taxpayer's position has been that interest and taxes should be treated differently than the rest of the rental expenses because interest and tax expenses are being incurred 365 days of the year while other rental expenses such as utilities and repairs are only incurred when used. In the case of Bolton v. Commissioner, 694 F.2nd 556 (9th Cir. 1982), the taxpayer's view was accepted and the ratio using the 365 days as the denominator, was ruled to be the proper one.

The significance of this decision is that less of the interest and taxes, which are deductible in any event, will be attributed to rental use. Thus, the ceiling will be higher for allowing operating expenses and depreciation.

Because the Burns have received a Schedule K-1 from PTP, Limited Partnership, which is a publically traded partnership that has been assigned a tax shelter registration number, the Burns must report this number on Form 8271, and include the form with their 2002 tax return.

Form 8271 Department of the Treasury Internal Revenue Service		Investor Reporting of Tax Shelter Registration Number Attach to your tax return.		OVD No. 1646-0011
If you received this form from a partnership, S corporation, or trust, see the instructions.		Automatic Sequence No. 71		
Investor's name (street or P.O. box) WALTER AND STACEY BURNS		Investor's telephone number 483-73-5777		Investor's tax year ended 12/31/02
(a) Tax shelter name		(b) Tax shelter registration number (10 digit number)	(c) Tax shelter identifying number	
1	PTP LIMITED PARTNERSHIP	65465465464	42-6546464	
2				
3				
4				
5				
6				
7				
8				
9				
10				

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

Use Form 8271 to report the tax shelter registration number the IRS assigns to certain tax shelters required to be registered under section 6111 ("registration-required tax shelters") and to report the name and identifying number of the tax shelter. This information must be reported even if the particular interest is producing net income for the filer of Form 8271. Use additional forms to report more than 10 tax shelter registration numbers.

Note. A tax shelter registration number does not indicate that the tax shelter or its claimed tax benefits have been reviewed, examined, or approved by the IRS.

Who Must File

Any person claiming or reporting any deduction, loss, credit, or other tax benefit, or reporting any income on any tax return from an interest purchased or otherwise acquired in a registration-required tax shelter must file Form 8271. If you are an investor in a partnership or an S corporation, look at item C, Schedule K-1 (Form 1065) or item C, Schedule K-1 (Form 1120S). If a tax shelter registration number or the words "Applied for" appear there, then the entity is a registration-required tax shelter. If the interest is purchased or otherwise acquired by a pass-through entity, both the pass-through entity and its partners, shareholders, or beneficiaries must file Form 8271.

A pass-through entity that is the registration-required tax shelter does not have to prepare Form 8271 and give copies to its partners, shareholders, or beneficiaries unless the pass-through entity itself has invested in a registration-required tax shelter.

In certain cases, a tax shelter that does not expect to reduce the cumulative tax liability of any investor during the 6-year period ending after the date the investment is first offered for sale may be considered a "projected income investment." Such a tax shelter will not have to register and thus not have to furnish a tax shelter registration number to investors, unless and until it ceases to be a projected income investment. It is possible, therefore, that you may not be furnished a tax shelter registration number, and not have to report it, for several years after you purchase or otherwise acquire your interest in the tax shelter. If you are later furnished a tax shelter registration number because the tax shelter ceased to be a projected income investment, follow these instructions. However, you must file Form 8271 only for tax years ending on or after the date the tax shelter ceases to be a projected income investment.

Note. Even if you have an interest in a registration-required tax shelter, you do not have to file Form 8271 if you did not claim or report any deduction, loss, credit, or other tax benefit, or report any income on your tax return from an interest in the registration-required tax shelter. This could occur, for example, if for a particular year you are unable to claim any portion of a loss because of the passive activity loss limitations, and that loss is the only tax item reported to you from the shelter.

Filing Form 8271

Attach Form 8271 to any return on which a deduction, loss, credit, or other tax benefit is claimed or reported, or any income reported, from an interest in a registration-required tax shelter. These returns include applications for tentative refunds (Forms 1043 and 1139) and amended returns (Forms 1040X and 1120X).

Furnishing Copies of Form 8271 to Investors

A pass-through entity that has invested in a registration-required tax shelter must furnish copies of its Form 8271 to its partners, shareholders, or beneficiaries.

However, in the case where (a) the pass-through entity acquired at least a 50% interest in one tax year in a registered tax shelter (and in which it had not held an interest in a prior year), and (b) the investment would not meet the definition of a tax shelter immediately following the acquisition if it had been offered for sale at that time, the pass-through entity need not distribute copies of Form 8271 to its investors. The pass-through entity alone is required to prepare Form 8271 and include it with the entity tax return.

Penalty For Not Including Registration Number on Return

A \$250 penalty will be charged for each failure to include a tax shelter registration number on a return on which it is required to be included unless the failure is due to reasonable cause.

Specific Instructions

Investor's Identifying Number

Enter the social security number or employer identification number shown on the return to which this Form 8271 is attached.

Investor's Tax Year Ended

Enter the date the tax year ended for the return to which this Form 8271 is attached.

**SCHEDULE H
(Form 1040)**

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

OMB No. 1545-0047

2002

Attachment
Schedule No. 44

Department of the Treasury
Internal Revenue Service (IRS)

▶ Attach to Form 1040, 1040NR, 1040-SS, or 1041.
▶ See separate instructions.

Name of employee:

WALTER BURNS

Social security number

483 | 73 | 5777

Employer identification number

4 | 2 | 8 | 9 | 8 | 9 | 8 | 1 | 1

A Did you pay **any one** household employee cash wages of \$1,600 or more in 2002? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions on page 3 before you answer this question.)

- Yes.** Skip lines B and C and go to line 1.
- No.** Go to line B.

B Did you withhold Federal income tax during 2002 for any household employee?

- Yes.** Skip line C and go to line 5.
- No.** Go to line C.

C Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2001 or 2002 to household employees? (**Do not** count cash wages paid in 2001 or 2002 to your spouse, your child under age 21, or your parent.)

- No. Stop.** Do not file this schedule.
- Yes.** Skip lines 1-9 and go to line 10 on the back.

Part I Social Security, Medicare, and Income Taxes

1	Total cash wages subject to social security taxes (see page 3)	1	3,915		
2	Social security taxes. Multiply line 1 by 12.1% (.121)	2		485	
3	Total cash wages subject to Medicare taxes (see page 3)	3	3,915		
4	Medicare taxes. Multiply line 3 by 2.9% (.029)	4		114	
5	Federal income tax withheld, if any	5			
6	Total social security, Medicare, and income taxes (add lines 2, 4, and 5)	6		599	
7	Advance earned income credit (EIC) payments, if any	7			
8	Net taxes (subtract line 7 from line 6)	8		599	

9 Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2001 or 2002 to household employees? (**Do not** count cash wages paid in 2001 or 2002 to your spouse, your child under age 21, or your parent.)

- No. Stop.** Enter the amount from line 8 above on Form 1040, line 60. If you are not required to file Form 1040, see the line 9 instructions on page 4.
- Yes.** Go to line 10 on the back.

SCHEDULE H (HOUSEHOLD EMPLOYMENT TAXES)

This tax, popularly referred to as the "Nanny tax" was expressly integrated into the Form 1040 in 1995. Also that year, a new schedule -- Schedule H -- was issued to report Social Security, Medicare, and Federal Unemployment taxes for household employees.

Household employers must include an employer identification number on their forms, including W-2s and the new Schedule H. (IRS Announcement 95-71). To apply for a EIN, household employers must complete and file a Form SS-4.

IRS Notice 95-18 further addresses the issues of this tax by a series of questions and answers. It clarifies that household employers no longer are required to file quarterly 942 forms, but rather include the information on the Form 1040 Schedule H.

Because the Burns have hired Esther to work in their home and have paid her more than \$1,300 in 2002, they must file the attached Schedule H with their 2002 return.

Additionally, the Burns will prepare the following W-2 for Esther:

2222		FORM 1040 USE ONLY OMB NO. 1545-0045	
Employer's name (do not check this box if the employer is a partnership) 42500000		1. Wages, salaries, tips \$3,915	
Employer's address (do not check this box if the employer is a partnership) WALTER BURNS 125 - 4TH STREET KWARA CITY, IA 62240		2. Federal income tax withheld \$240	
		3. Social Security tax withheld \$3,915	
		4. Medicare tax withheld \$57	
		5. Federal unemployment tax withheld \$	
Employer's identification number (EIN) 135-76-2488		6. State income tax withheld \$	
Employee's name (last, first, and middle) ESTHER SWANSON		7. State and local income tax withheld \$	
Employee's address 1842 DAKOTASTREET KWARA CITY, IA 62240		8. Social Security number 12-34-5678 9. State identification number \$ 10. State identification number \$ 11. State identification number \$	
Employer's state identification number IA		12. Total amount paid for Social Security tax \$	
Total amount paid for Social Security tax \$3,915		Total amount paid for Medicare tax \$	

W-2 Wage and Tax Statement 2002
 Copy A For Social Security Administration. (Do not file) 1099-MISC
 Copy B For State Department of Social Security Administration.
 Copy C For Employer's Records and Reporting Purposes.
 Copy D For Employee's Records and Reporting Purposes.
 Copy E For State Department of Social Security Administration.
 Copy F For Employee's Records and Reporting Purposes.

Name of partner or self-employment (do not list more than Form 1040)
WALTER BURNS

Social Security number of person with self-employment income ▶ **493 | 73 | 5777**

Section B- Long Schedule SE

Part I Self-Employment Tax

Note. If your only income subject to self-employment tax is **church employee income**, skip lines 1 through 4b. Enter -0- on line 4c and go to line 5a. Income from services you performed as a minister or a member of a religious order is **not** church employee income. See page SE-1.

A If you are a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361, but you had \$400 or more of other net earnings from self-employment, check here and continue with Part I. <input type="checkbox"/>			
1	Net farm profit or (loss) from Schedule F, line 3b, and farm partnerships, Schedule K-1 (Form 1065), line 15a. Note. Skip this line if you use the farm optional method. See page SE-3.		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-R), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report. Note. Skip this line if you use the nonfarm optional method. See page SE-4.		871
3	Combine lines 1 and 2.		871
4a	Line 3 is more than zero, multiply line 3 by 92.35% (92.35). Otherwise, enter amount from line 3.	4a	804
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here.	4b	
c	Combine lines 4a and 4b. If less than \$400, do not file this schedule; you do not owe self-employment tax. Exception. If less than \$400 and you had church employee income, enter -0- and continue ▶.	4c	804
5a	Enter your church employee income from Form W-2. Caution. See page SE-1 for definition of church employee income.	5a	
b	Multiply line 5a by 92.35% (92.35). If less than \$100, enter 0.	5b	
6	Net earnings from self-employment. Add lines 4c and 5b.	6	804
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2002.	7	81,800 00
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation.	8a	92,750
b	Unreported tips subject to social security tax (from Form 4137, line 6).	8b	
c	Add lines 8a and 8b.	8c	92,750
9	Subtract line 8c from line 7. If zero or less, enter 0 here and on line 10 and go to line 11. ▶	9	0
10	Multiply the smaller of line 6 or line 9 by 12.4% (12.4).	10	0
11	Multiply line 6 by 2.9% (2.9).	11	23
12	Self-employment tax. Add lines 10 and 11. Enter here and on Form 1040, line 56.	12	23
13	Deduction for one-half of self-employment tax. Multiply line 12 by 50% (1/2). Enter the result here and on Form 1040, line 20.	13	12

Part II Optional Methods To Figure Net Earnings (See page SE-3.)

Farm Optional Method. You may use this method only if: ♦ Your gross farm income ¹ was not more than \$2,400 or ♦ Your net farm profits ² were less than \$1,733.			
14	Maximum income for optional methods.	14	2,400 00
15	Enter the smaller of: two thirds (2/3) of gross farm income ¹ (not less than zero) or \$1,600. Also include this amount on line 4b above.	15	
Nonfarm Optional Method. You may use this method only if: ♦ Your net nonfarm profits ³ were less than \$1,733 and also less than 72.189% of your gross nonfarm income ⁴ and ♦ You had net earnings from self-employment of at least \$400 in 2 of the prior 3 years. Caution. You may use this method no more than five times.			
16	Subtract line 15 from line 14.	16	
17	Enter the smaller of: two thirds (2/3) of gross nonfarm income ⁴ (not less than zero) or the amount on line 16. Also include this amount on line 4b above.	17	

¹From Form F, line 11, and Sch. K-1 (Form 1065), line 15a. ²From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), line 15a; and Sch. K-1 (Form 1065-R), box 9. ³From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), line 15a; and Sch. K-1 (Form 1065-R), box 9. ⁴From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), line 15a; and Sch. K-1 (Form 1065-R), box 9.



SCHEDULE SE (SELF-EMPLOYMENT TAX)

The self-employment tax is imposed on self-employed persons for the purpose of providing social security benefits. It taxes self-employment income which is defined as "net earnings from self-employment". If the net earnings from self-employment is less than \$400, there is no self-employment tax due. In 2002, the maximum amount of taxable self-employment income for FICA purposes is \$84,900 and for Medicare purposes is unlimited. The total self-employment income is multiplied by 92.35%, and the resulting figure is taxed at the self-employment tax rate.

The tax rate for self-employment is 15.3% which consists of 12.4% for FICA and 2.9% for Medicare.

Walter's business had net earnings from self-employment of \$871. Therefore, he must file Form SE and pay self employment tax.

Unreimbursed Employee Business Expenses

2002

Attachment
Requirement No. **54A**

Department of the Treasury
Internal Revenue Service (IRS)

▶ Attach to Form 1040.

Your name STACEY BURN	Occupation (include your marital status) TEACHER	Social security number 169 36 5543
---------------------------------	--	--

You May Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2002.

Caution: You can use the standard mileage rate for 2002 **only if:** (a) you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service or (b) you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.

Part I Figure Your Expenses

1 Vehicle expenses using the standard mileage rate. Complete Part I and multiply line 1a by 56¢ (36¢)	1	257
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4	1,261
5 Meals and entertainment expenses: \$ _____ x 50% (50% if employees subject to Department of Transportation (DOT) hours of service limits. Multiply meal expenses by 65% (65% instead of 50%. For details, see instructions.)	5	
6 Total expenses. Add lines 1 through 5. Enter here and on line 20 of Schedule A (Form 1040). If on basis state or local government officials, qualified performing artists, and individuals with disabilities. See the instructions for special rules on where to enter this amount.	6	1,538

Part II Information on Your Vehicle. Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month/day/year) ▶ 04 / 01 / 2002	
8 Of the total number of miles you drove your vehicle during 2002, enter the number of miles you used your vehicle for: a Business 295 b Commuting 8,259 c Other 7,205	
9 Do you (or your spouse) have another vehicle available for personal use? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
10 Was your vehicle available for personal use during off-duty hours? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
11a Do you have evidence to support your deduction? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
b If "Yes," is the evidence written? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	

General Instructions

Section references are to the Internal Revenue Code.

Changes To Note

Standard mileage rate. The standard mileage rate has been increased to 31¢ per mile for each mile of business use in 2002.

Meal expenses. The percentage of meal expenses that may be deducted by an employee subject to DOT hours of service limits has been increased to 65% for 2002.

Purpose of Form

You may use Form 2106-EZ instead of Form 2106 only if you are claiming un-reimbursed employee business expenses. If you need all the requirements listed above than it.

Recordkeeping

You can't deduct expenses for travel and lodging, meals, unless you use the standard meal and travel/entertainment

rate instead of a reimbursement, property, unless you keep records to prove the time, place, business purpose, business relationship, and entertainment, gifts, and amounts of these expenses. Generally you must also have receipts for lodging expenses, regardless of the amount, and any other evidence of the expense.

Additional Information

- For more details about employee business expenses, see:
 - Pub. 463, Travel, Entertainment, Gift, and Car Expenses
 - Pub. 529, Miscellaneous Deductions
 - Pub. 507, Business Use of Your Home (Including Leasing by Independent Contractors)
 - Pub. 946, How To Deduct State Property

Specific Instructions

Part I—Figure Your Expenses

Line 2. See the line 2b instructions for the definition of commuting.

Line 3. Traveling and transportation expenses connected with overnight travel away from your tax home (public or home). You cannot deduct expenses for travel away from your tax home for a temporary or temporary assignment of more than 1 year. Do not include expenses for meals and entertainment. For meal and lodging limits, see Pub. 463.

Generally, your tax home is your main place of business or, if not, the regular place of where you maintain your family home. If you do not have a regular main place of business because of the nature of your work, then your tax home is the place where you regularly live. It should not fall either of these categories, you are considered an itinerant and your tax home is wherever you work. As an itinerant, you are never away from home and cannot claim any expenses deducted. For more details on your tax home, see P.J. 485.

Line 4. Enter other (or related) expenses not listed on lines 1 through 5, such as: expenses for business gifts, education, tuition and books, home check, travel publications,

FORM 2106 (EMPLOYEE BUSINESS EXPENSES)

If an employee's business expenses are unreimbursed, the employee must use Form 2106 or 2106-EZ to figure the amount of unreimbursed business expenses that can be entered on Schedule A and claimed as a miscellaneous itemized deduction.

Expenses are deemed paid or incurred under a reimbursement or expense allowance arrangement that requires the employee to substantiate the expenses to the employer, and requires the employee to return any amount in excess of the substantiated expenses. The employee covered by a reimbursement arrangement is entitled to an above-the-line deduction for expenses covered by the arrangement. The employee offsets any amounts received under the reimbursement arrangement against such expenses, rather than including the reimbursement in gross income and claiming the deduction from gross income. If the employee seeks to deduct expenses in excess of the reimbursed amounts, these excess expenses are computed on Form 2106 where the employee offsets expenses to the extent of the amounts paid under the arrangement and are included as miscellaneous itemized deductions subject to the 2% limitation.

The per diem rate for meals and lodging have been modified once again by Rev. Proc. 2001-47. The new Rev. Proc. also contains an updated list of the high cost localities.

Pursuant to Rev. Proc. 97-58 and revised by T.D. 8864, 2000-7 IRB 614, the IRS now allows the use of standard mileage deduction for automobiles which are leased as well as those which are owned. The business standard mileage rate for 2002 has been increased up to \$0.365 per mile for the year 2002 (up from \$0.345 in 2001). (See Rev. Proc. 2001-54).

On the example tax return, Stacey had the following unreimbursed employee expenses:

Standard Mileage 705 miles @ \$0.365 = \$257.33

Stacey had Instruction Materials \$240; Supplies \$510; Student Project Supplies \$705; and Prizes \$76; totaling \$1,531 of unreimbursed employee expenses. This total is reduced by the \$250 above the line deduction taken on Form 1040, Line 23.

Part III Dependent Care Benefits

12	Enter the total amount of dependent care benefits you received for 2002. This amount should be shown in box 10 of your W-2 form(s). Do not include amounts that were reported to you as wages in box 1 of Form(s) W-2	12	3,200
13	Enter the amount forfeited, if any (see the instructions)	13	
14	Subtract line 13 from line 12	14	3,200
15	Enter the total amount of qualified expenses incurred in 2002 for the care of the qualifying person(s)	15	5,155
16	Enter the smaller of line 14 or 15	16	3,200
17	Enter your earned income	17	93,609
18	Enter the amount shown below that applies to you: <ul style="list-style-type: none"> • If married filing jointly enter your spouse's earned income if your spouse was a student or was disabled. See the instructions for line 5. • If married filing separately see the instructions for the amount to enter. • All others enter the amount from line 17. 	18	26,790
19	Enter the smallest of line 16, 17, or 18	19	3,200
20	Excluded benefits. Enter here the smallest of the following: <ul style="list-style-type: none"> • The amount from line 19 or • \$3,000 (\$2,500 if married filing separately and you were required to enter your spouse's earned income on line 18). 	20	3,200
21	Taxable benefits. Subtract line 20 from line 14. Also, include this amount on Form 1040, line 7. On the dotted line next to line 7, enter "DCB"	21	0

To claim the child and dependent care credit, complete lines 22-26 below.

22	Enter \$2,400 (\$4,800 if two or more qualifying persons)	22	4,800
23	Enter the amount from line 20	23	3,200
24	Subtract line 23 from line 22. If zero or less, stop. You cannot take the credit. Exception. If you paid 2001 expenses in 2002, see the instructions for line 9	24	1,600
25	Complete line 2 on the front of this form. Do not include in column (c) any benefits shown on line 20 above. Then, add the amounts in column (c) and enter the total here	25	1,955
26	Enter the smaller of line 24 or 25. Also, enter this amount on line 8 on the front of this form and complete lines 4-11	26	1,600



Child and dependent care expenses are those paid for the care of a taxpayer's child or other qualified person which allows the taxpayer to work or look for work.

A qualifying person is: (1) a child under 13 years old claimed as a dependent; (2) disabled spouse; or (3) a disabled person whom the taxpayer can claim as a dependent (or could claim as a dependent except that the person had more than \$3,000 in gross income during the year).

The qualifying person must have shared the home with the taxpayer during 2002. There are exceptions for children of divorced or separated parents which allow a parent who does not claim the child as a dependent to nonetheless claim the child and dependent care expenses credit.

Qualified expenses are amounts paid for household services and care of the qualifying person while the taxpayer worked or looked for work. If married filing joint, both spouses must have worked during the time in which the dependent care expenses were incurred. However, if a spouse is a full-time student or disabled, they may be treated as if they worked during that period of enrollment or disability.

If a taxpayer received dependent care benefits from their employer either directly to the care provider or the taxpayer, or the employer provided a day care facility, the taxpayer must file Form 2441 to determine if any of these benefits must be included on Line 7 of Form 1040.

The credit is based on a number of qualifying persons, the amount of qualifying expenses paid, and the income earned by the parent(s). The maximum credit with one qualifying child is \$720, and with two or more qualifying children is \$1,440.

The Burns paid a total of \$5,155 in qualified expenses for the care of George and Grace. Stacey received dependent care benefits through her employer's cafeteria plan of \$3,200.

Part V Listed Property (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

Note: For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 24a, 24b, columns (a) through (f) of Section A, all of Section B, and Section C if applicable.

Section A- Depreciation and Other Information (Caution: See page 9 of the instructions for limits for passenger automobiles.)

24a Do you have evidence to support the business use claim? Yes No 24b If "Yes," is the evidence written? Yes No

(a) Type of property (list amount, if any)	(b) Date placed in service	(c) Business use percentage	(d) Cost or other basis	(e) Rate for calculating depreciation (see instructions)	(f) Recovery period	(g) Method of election	(h) Depreciation allowed	(i) Adjusted basis (see instructions)
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see page 7 of the instructions)						25	3,600	
26 Property used more than 50% in a qualified business use (see page 7 of the instructions):								
2002 TOYOTA	1/15/02	60 %	20,000	8,400	5.0	200DB HY	996	
PRIUS		9%						
		9%						
27 Property used 50% or less in a qualified business use (see page 7 of the instructions):								
		7%				R/T		
		9%				R/T		
		9%				R/L -		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1,						28	4,596	
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1,							20	0

Section B- Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner" or related person. Do not provide evidence to your employer (but answer the questions in Section C) unless you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
30 Total business-related miles driven during the year (do not include commuting miles (see page 9 of the instructions))												
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven												
33 Total miles driven during the year (add lines 30 through 32)												
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?												

Section C- Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons (see page 8 of the instructions).

	Yes	No
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use (such as, commutating) by your employees? (See page 8 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners)		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demerit program use? (See page 9 of the instructions)		

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Cost recovery period	(e) Amortization rate (see instructions)	(f) Amortization for this year
42 Amortization of costs that begins during your 2002 tax year (see page 9 of the instructions)					
43 Amortization of costs that began before your 2002 tax year					43
44 Total. Add amounts in column (f). See page 9 of the instructions for where to report					44



FORM 4562 (DEPRECIATION & AMORTIZATION)

RECOVERY CLASSES & RATES:

<u>Recovery Period</u>	<u>Examples</u>	<u>Rate</u>
3 years	Hogs, racehorses	200% D.B.
5 years	Cars, * general purpose trucks, beef & dairy cattle, sheep, goats, computers, solar & wind energy	200% D.B.
7 years	Equipment & Machinery, single-purpose agricultural structures, grain bins, fences, office furniture, breeding horses	200% D.B.
10 years	Assets used to manufacture grain, sugar products & vegetable oils, railroad tank cars, manufactured homes & coal utilization property	200% D.B.
15 years	Depreciable land improvements not otherwise listed	150% D.B.
20 years	Farm buildings	150% D.B.
27.5 years	Residential rental property	Strt. line
39 years	Non-residential real property	Strt. line

*The depreciation deduction for a passenger automobile placed in service in 2002 may not exceed \$3,060 for the first year. However, if the vehicle qualifies for the 30% additional depreciation and the taxpayer elects the additional 30% depreciation, this first year amount is increased by \$4,600 to a total of \$7,660.

STRAIGHT LINE DEPRECIATION LIVES:

Residential & non-residential real estate - 40 years.

Class life property over ADR midpoint:

5 years - Light trucks.

7 years - Breeding stock & dairy cattle.

10 years - Machinery, bins, fences.

15 years - Single-purpose structures.

20 years - Drainage facilities.

25 years - Farm buildings.

ONE-HALF YEAR CONVENTION:

For property in the 3, 5, 7, or 10 year class, the 200% declining balance method over these years and the half-year convention are used. For property in the 15 or 20-year class, the 150% declining balance method over these years is used with the half-year convention.

Depreciation is allowed for ½ year the first year and in the year of disposition. However, if the taxpayer purchases more than 40% of the new equipment in the last quarter, the property must be depreciated by quarter, using depreciation from the midpoint of each quarter.

30% Additional First Year Depreciation: The Job Creation and Worker Assistance Act of 2002 gave taxpayers the ability to take an additional amount of depreciation equal to 30% of the basis in the newly acquired asset. The property must be new property (not used) and must be acquired by the taxpayer on or after September 11, 2001 and before September 11, 2004. This additional depreciation amount applies for regular and alternative minimum tax. Taxpayers are treated as if they took advantage of this additional 30% depreciation unless they specifically elect out.

The 30% additional depreciation is taken after any §179 deductions and before regular depreciation. The ordering rules pertaining to the 30% additional depreciation are set forth in the following example:

Cost:	50,000	
§179	<u>(24,000)</u>	
Remaining Basis	26,000	
30% Add'l Depr.	<u>(7,800)</u>	
Remaining Basis	18,200	
1 st year MACRS	3,640	(assuming 20% first year rate)

The total available depreciation in first year on this \$50,000 asset is \$35,440.

Property qualifying for the 30% additional depreciation includes MACRS property with a 20 year or less recovery period, water utility property, computer software (not included under IRC §197) and qualified leasehold improvement property.

Because this provision came into being on March 9, 2002 (after many 2001 returns had been filed) the IRS issued Rev. Proc 2002-33, wherein relief was given to those taxpayers who had not taken advantage of the additional depreciation. Under this Rev. Proc., the taxpayer can:

- A. File an amended return (prior to the due date of the succeeding tax return, excluding extension), and claim the 30% additional depreciation;
- B. File a Form 3115, Application for Change in Accounting Method with the next year's return, and claim the 30% additional depreciation on the 2002 tax return (for the assets purchased between September 11, 2001 and December 31, 2001); or

- C. Opt to not take advantage of the 30% additional depreciation. As mentioned above, if the taxpayer does not elect out of the 30% additional depreciation, they are deemed to have taken it, and their basis would be reduced regardless of whether or not it was actually taken on a return. However, for the 2001 returns, the Rev. Proc. allows taxpayers who did not take the 30% additional depreciation, to be deemed to have elected out.
 WARNING: THIS IS ONLY AVAILABLE FOR TAX RETURNS FILED BEFORE JUNE 1, 2002.

On the example return, Walter purchased a new computer and a new Toyota Prius in 2002. Walter wants to take advantage of the 30% additional depreciation. His depreciation on these two items are calculated as follows:

<u>Computer</u>	Basis	3,205		
	§179		-0-	
	30% Depr.		(962)	
	Regular Depr.	Remaining Basis		2,243
		449		

Toyota Prius The allowable depreciation is the lesser of the following:

1. 30% Additional Depreciation Amount

30%
factor
30%

*Basis after c
Business use
Eligible bas*

PLUS
Regular Depreciation Amount

*Eligible bas
Less 30% de
Remaining b
First year de*

Total \$5,280

OR

2. Maximum Allowable Depreciation in first year of passenger automobile which qualifies for the 30% additional depreciation

\$7,600

*Normal first
Additional a*

Total

Business usc

Therefore, the total depreciation allowable is \$4,596. The ordering rules mandate that the 30% additional depreciation is allocated first (after any §179 deduction) which leaves [4,596 (total depreciation

allowable) - \$3,600 (additional 30% depreciation)] \$996 of regular depreciation.

4797

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts
Under Sections 179 and 280F(b)(2))

OMB No. 1545-0047

2002

Attachment
Sequence No. 27

Department of the Treasury
Internal Revenue Service (550)

Attach to your tax return. See separate instructions.

Name of the owner or return preparer
WALTER AND STACEY BURNS
Identifying number
483-73-5777

1 Enter the gross proceeds from sales or exchanges reported to you for 2002 on Form(s) 1099-B or 1099-S (do not include
through-the-middle sales including on-line and 210 or 215 (see instructions))
1

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

Table with 7 columns: (a) Description of property, (b) Date acquired, (c) Date sold, (d) Gross sales price, (e) Depreciation allowed, (f) Cost or other basis, (g) Gain or loss. Row 2: PENTIUM II COMPUTER, 6/15/98, 3/10/02, 165, 1,449, 2,000, (366)

- 3 Gain, carry from Form 1067, line 31
4 Section 179 gain from realty (see instructions for Form 4287, line 10 or 27)
5 Section 179 gain on depreciable personal property (see instructions for Form 8879)
6 Gain, carry from line 20, from other than casualty or theft

7 Combine lines 2 through 6. Enter the gain or loss from each of the appropriate lines for each:
Partnerships (except electing large partnerships) and S corporations. Report the gain or loss following the instructions for Form 1065, Schedule A, line 6, or Form 1120C, Schedule E, line 5. See lines 3, 4, 11, and 12 below.
All others. If there is one or more entries from line 2 on line 7 below and skip lines 8 and 9. If line 2 is a gain and you did not elect the partner exception (see instructions), do not enter amounts from an earlier year. Enter the gain from line 2 as a long-term capital gain on Schedule D and skip lines 8, 9, 11, and 12 below.

- 8 Nonrecourse debt on line 221 (see instructions for line 221)
9 Section 179 recapture from line 4. Enter the recapture amount from line 4 on line 12 below and enter the gain from line 4 as a capital gain on Schedule D (see instructions)

Part II Ordinary Gains and Losses

10 Ordinary gains and losses (see instructions for line 11 through 17) (do not include property held 1 year or less)

- 11 Loss, carry from line 7
12 Gain, carry from line 7, or amount from line 9, if applicable
13 Gain, carry from line 3
14 Net gain or (loss) from Form 4884, lines 21 and 22
15 Ordinary gain from line 10 (see instructions for Form 1065, line 26 or 18)
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824
17 Recapture of section 179 expense deduction for partnerships and S corporations (see instructions for section 179)
18 Combine lines 10 through 17. Enter the gain or (loss) from line 18 on the return being filed.

a For all except individual returns. Enter the gain or (loss) from line 18 on the return being filed.
b If or individual returns:
(i) If the loss on line 11 includes a loss from Form 4884, line 22, column (b)(1), enter the part of the loss from the sale of the loss from income-producing property of Schedule A, Form 1040, line 27, and the part of the loss from property of a partner or employee on Schedule A (Form 1040), line 27, identify as from Form 4797, line 10(c). See instructions.
(ii) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18(b)(1). Enter here and on Form 1040, line 14.

FORM 4797 (SALE OF BUSINESS PROPERTY)

Form 4797 is used to report:

1. The sale or exchange of (a) property used in your trade or business; (2) depreciable and amortizable property; (c) oil, gas, geothermal, or other mineral properties, and (d) § 126 property.
2. The involuntary conversion (from other than casualty or theft) of property used in your trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit.
3. The disposition of noncapital assets (other than inventory or property held primarily for sale to customers in the ordinary course of your trade or business).
4. The disposition of capital assets not reported on Schedule D.
5. The recapture of § 179 expense deductions for partners and S corporation shareholders from property dispositions by partnerships and S corporation.
6. The computation of recapture amounts under § 179 and § 280F(b)(2), when the business use of § 179 or listed property drops to 50% or less.

The condemnation of property, or the forced sale under the threat or imminence of condemnation is considered an involuntary conversion under § 1033(a)(2)(E)(ii). The amount realized from a condemnation equals the compensation or award received less the sum of the adjusted basis of the property plus any costs associated with the sale or the condemnation proceedings. The realized gain can however be deferred if the condemned property is replaced within the allowed time period and by the allowed type of property.

The time period within which condemned property must be replaced is the period beginning with the date of the disposition of the condemned property, or the earliest date of the threat or imminence of requisition or condemnation of the condemned property, whichever is the earlier, and ending

- (1) two years after the close of the first taxable year in which any part of the gain upon the conversion is realized,
- (2) three years after the close of the first taxable year in which any part of the gain upon the condemnation of real property held for productive use or for rental or investment is realized,
- (3) four years after the close of the first taxable year in which any part of the gain upon the conversion is realized on a principal residence converted due to presidentially declared disasters, or
- (4) at the close of such later date as the IRS may designate on application by the taxpayer.

The replacement property must be similar or related in service or use to the property it is replacing. However, the replacement of condemned real estate held for productive business use or for rental or investment need only be of like kind.

Walter sold the computer from his consulting business, and must complete Form 4797.

FORM 6251 (ALTERNATIVE MINIMUM TAX)

The Taxpayer Relief Act of 1997 changed how AMT is calculated. The tax rate for the taxpayer, other than a corporation, is 26% and a 28% AMT tax bracket is added to AMT incomes in excess \$175,000. The AMTI exemptions for 2002 are \$49,000 (married filing joint) or \$35,750 (single). See Code §§ 55, 56, & 57. The capital gains rates are applied to the AMT rules on Part IV of Form 6251.

A dubious Tax Court memorandum decision regarding alternative minimum tax came down in 1998. This case was affirmed by the 10th Circuit. Klaassen v. Commissioner, 99-1 USTC 50, 418 demonstrates a possibly unintentional but literal interpretation of the alternative minimum tax scheme. In this case, the taxpayer claimed 12 dependency deductions amounting to \$29,400 in personal exemptions. The taxpayer's itemized deductions had also included medical expenses of \$4,767 and state and local taxes of \$3,264. The taxpayers did not file Form 6251 nor report any alternative minimum tax liability. Because the personal exemptions are disallowed for AMT purposes, as are medical expenses and state and local taxes, the taxpayers wound up with \$1,085 of alternative minimum tax owed. The Court's rationale for its decision upholding the additional tax liability was that if Congress had intended to tax only tax preferences it would have defined alternative minimum income differently. Congress did act in the Tax Relief Extensions Act of 1999 which has alleviated this problem.

The following types of interest deductions are added back to the tax base for computing the alternative minimum tax:

1. The deduction for personal interest that is allowed under the five-year phase out;
2. The deduction for home mortgage interest to the extent that the mortgage loan was not incurred in acquiring, constructing, or substantially rehabilitating your home; and
3. The deduction for investment interest in excess of net investment income that is allowed under the five-year phase out. § 56(b)(1)(c).

The deduction for passive losses in excess of income from passive activities that is allowed under the phase-in rules of the Act must also be added back to the tax base to calculate alternative minimum tax.

If a taxpayer uses the standard deduction for regular tax purposes, the taxpayer cannot elect to use itemized deductions for the AMT calculation. PLR 200103073.

The exemption amounts shown on line 22 of Form 6251 are phased out by \$0.25 for each \$1.00 that alternative minimum taxable income exceeds the amounts shown, until the exemption amounts are completely phased out. §55(d)(3).

The alternative minimum tax rate is 26% on the first \$175,000 of AMTI (less exemptions) and 28% on any excess AMTI (less exemptions). §55(b).

As discussed above, the Burns are not required to file Form 6251.

Form **8283**

For calendar year

Department of the Treasury
Internal Revenue Service

Noncash Charitable Contributions

▶ Attach to your tax return if you claimed a total deduction of over \$500 for all contributed property.
▶ See separate instructions.

OMB No. 1545-0047

Attachment
Sequence No. **55**

Name(s) shown on your income tax return
WALTER AND STAGEY BURNS

Identifying number
483-73-5777

Note: Figure the amount of your contribution deduction before completing this form. See your tax return instructions.

Section A—List in this section **only** items (or groups of similar items) for which you claimed a deduction of \$5,000 or less. Also, list certain publicly traded securities (even if the deduction is over \$5,000 (see instructions)).

Part I Information on Donated Property—If you need more space, attach a statement.

	(A) Name and address of the donee organization	(B) Description of donated property
A	GOODWILL INDUSTRIES 988 S. 4TH STREET, IOWA CITY, IA 52240	CLOTHING
B	SALVATION ARMY 432 - 6TH AVENUE, IOWA CITY, IA 52240	CLOTHING AND FURNITURE
C	AMVETS 164 MAIN STREET, IOWA CITY, IA 52240	(50) SHARES NEWCO, INC. STOCK
D		
E		

Note: If the amount you claimed as a deduction for an item is \$500 or less, you do not have to complete columns (D), (E), and (F).

	(D) Date of the contribution	(E) Date acquired by donor (or, if none, yr)	(F) How acquired by donor	(G) Cost basis, or adjusted basis	(H) Fair market value	(I) Method used to determine fair market value
A	6/1/02	VARIOUS	PURCHASE	1,200	240	THRIFT STORE VALUE
B	9/1/02	VARIOUS	PURCHASE	7,200	1,200	THRIFT STORE VALUE
C	9/1/02	1/82	INHERITANCE	720	2,700	TRADED ON NYSE
D						
E						

Part II Other Information—Complete line 2 if you gave less than an entire interest in property listed in Part I. Complete line 3 if conditions were attached to a contribution listed in Part I.

2 If, during the year, you contributed less than the entire interest in the property, complete lines a-c.

a Enter the letter from Part I that identifies the property ▶ _____ If Part II applies to more than one property, attach a separate statement.

b Total amount claimed as a deduction for the property listed in Part I: (1) For this tax year ▶ _____ (2) 1 or any prior tax years ▶ _____

c Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):

Name of charitable organization (donor) _____
Address (number, street, and room or suite no.) _____
City, town, state, and ZIP code _____

d For tangible property, enter the place where the property is located or kept ▶ _____

e Name of any person, other than the donee organization, having actual possession of the property ▶ _____

3 If conditions were attached to any contribution listed in Part I, answer questions a-c and attach the required statement (see instructions).

	Yes	No
a Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property?		
b Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire?		
c Is there a restriction limiting the donated property for a particular use?		

FORM 8283 (NONCASH CHARITABLE CONTRIBUTION)

Tax planning point:

Consider giving away appreciated property, such as stocks or mutual fund shares, rather than cash. You get the same deduction, the charity gets the same amount, but the government gets less. Assuming you have owned the asset more than a year, you get to deduct the current value of the gift, but you do not have to pay tax on the appreciation that built up while you owned it.

Giving away appreciated assets can make sense even if you were not planning to get rid of the securities. Say you are planning a \$5,000 gift to your church's building fund. Instead of cash, you give \$5,000 worth of stock that, if you sold it, would produce a \$2,500 gain. You get a \$5,000 deduction (saving you \$1,350 in the 27% bracket) and avoid the \$500 (in the 20% capital gains rate bracket) tax on the gain. You can then use your \$5,000 cash to buy back the stock. Your basis will be \$5,000 and only future appreciation will be taxable.

The Revenue Reconciliation Act of 1993 permanently eliminated the appreciation as a preference item for the alternative minimum tax calculation. Also, in PLR 9321063 (March 2, 1993), the IRS agreed that a taxpayer with positive regular tax AGI but a much larger AMT AGI was entitled to a larger AMT charitable deduction using percentage limits based upon AMT AGI rather than regular AGI.

Quid Pro Quo Contributions. Charitable organizations will be required to inform donors in writing that quid pro quo contributions in excess of \$75 made on or after 1/1/94 are only deductible to the extent that the contributions are in excess of the goods or services received from the organization. The organization is required to give a good faith estimate of the goods or services furnished to the donor by the organization. Failure to comply with such disclosure is subject to penalties. (See § 6714)

Capital gain property donated to a "50% charitable entity" is limited to 30% of the taxpayer's AGI, while capital gain property donated to a "30% charitable entity" is limited to 20% of the taxpayer's AGI. Examples of 30% charitable entities are Veterans' Organizations, Fraternal Orders, Cemetery Companies and certain Private Nonoperating Foundations.

The Burns had more than \$500 of noncash charitable contributions in 2002 and must file Form 8283. The gift of stock to AMVETS, would be limited to 20% of the Burn's AGI, however, their AGI is high enough that none of the \$2,700 gift will be limited.

WALTER AND STACEY BURNS

Part I 2002 Passive Activity Loss

Caution: See the instructions for Worksheets 1, 2, and 3 on page 9 before completing Part I.

Rental Real Estate Activities With Active Participation (For the definition of active participation see **Active Participation in a Rental Real Estate Activity** on page 9 of the instructions.)

1a Activities with net income (enter the amount from Worksheet 1, column (a)).			
1b Activities with net loss (enter the amount from Worksheet 1, column (b)).	(7,360)
1c Prior years unallowed losses (enter the amount from Worksheet 1, column (c)).			
1d Combine lines 1a, 1b, and 1c.	(7,360)

Commercial Revitalization Deductions From Rental Real Estate Activities

2a Commercial revitalization deductions from Worksheet 2, column (a).			
2b Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b).			
2c Add lines 2a and 2b.			

All Other Passive Activities

3a Activities with net income (enter the amount from Worksheet 3, column (a)).			
3b Activities with net loss (enter the amount from Worksheet 3, column (b)).			
3c Prior years unallowed losses (enter the amount from Worksheet 3, column (c)).			
3d Combine lines 3a, 3b, and 3c.			

4 Combine lines 1d, 2c, and 3d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Do not complete Form 8582. Report the losses on the forms and schedules normally used.	(7,360)
--	---	-------	---

- If line 4 is a loss, and:
- Line 1d is a loss, go to Part II.
 - Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
 - Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

Caution: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II or III. Instead, go to line 15.

Part II Special Allowance for Rental Real Estate With Active Participation

Note: Enter all numbers in Part II as positive amounts. See page 9 for examples.

5 Enter the smaller of (a) the loss on line 4 (reduced by the amount on line 2a) or (b) the loss on line 4.	(7,360)
6 Enter \$150,000. If married filing separately, see page 9.		150,000	
7 Enter the smaller of (a) the loss on line 5 and (b) the amount on line 6.		150,000	
8 Subtract line 7 from line 6.		10,100	
9 Multiply line 8 by 50% (.5). Do not enter more than \$25,000. If married filing separately, see page 9.		8,050	
10 Enter the smaller of line 5 or line 9.		7,360	

Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

Note: Enter all numbers in Part III as positive amounts. See page 9 for examples.

11 Enter \$25,000. If married filing separately, see instructions.			
12 Enter the amount, if any, from line 10.			
13 Subtract line 12 from line 11.			
14 Enter the smaller of line 2c or line 13.			

Part IV Total Losses Allowed

15 Add the income, if any, on lines 1a and 3a and enter the total.			
16 Total losses allowed from all passive activities for 2002. Add lines 10, 11, and 15. See page 11 to find out how to report the losses on your tax return.		7,360	

FORM 8582 (PASSIVE ACTIVITY LOSS LIMITATIONS)

The passive activity loss is the amount by which the total losses from all passive activities for the tax year exceeds the total income from all passive activities for the tax year.

Passive activity losses not allowed in the tax year may be carried forward to the next year. Any passive activity losses that have accumulated because of the annual limit will be allowed in the tax year in which the taxpayer disposes of the interest in the activity. The taxpayer must dispose of the entire interest in the activity in a transaction in which all realized gain or loss is recognized to an unrelated taxpayer.

No passive activity losses will be allowed to offset non-passive income. A special \$25,000 offset of non-passive income applies to individuals who "actively participate" in their rental real estate activities during the tax year. However, if a taxpayer rents property to a business in which the taxpayer materially participates, Treas. Reg. §1.469-2(f)(6) recharacterizes the rental income as non-passive. See Krukowski v. Commissioner, 114 T.C. No. 25 (May 22, 2000) and Fransen v. U.S., 99-2 USTC Paragraph 50,882.

The "active participation" standard is satisfied so long as the taxpayer participates in a significant and bona fide sense, such as by making management decisions or by arranging for others to provide services such as repairs. Relevant management decisions include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

The offset allows qualifying taxpayers to use up to \$25,000 of otherwise unallowable losses from rental real estate activities to offset other income (non-passive income). The special \$25,000 offset for rental real estate Activities is phased out for taxpayers with AGIs between \$100,000 and \$150,000.

The passive loss rules are contained in Code § 469. The \$25,000 offset for rental real estate activities is in § 469(i). Also useful is the Passive Activity Loss Audit Guide released by the IRS on 4/25/94.

Beginning in 1994, losses from a rental real estate activity meeting the requirements of Code § 469(c)(7) are no longer considered per se passive activities. An individual will satisfy the eligibility requirements when:

1. More than 50% of the individual's personal services during the tax year is performed in real property trades or businesses in which the individual materially participates, and

2. The individual performs more than 750 hours of service in the real property trades or businesses in which the individual materially participates. In the case of a joint return, the eligibility requirements are met only if either spouse separately satisfies all but the material participation requirements. In other words, the spouses cannot combine their respective personal services and hours of service to meet the requirements.

The Burns' AGI is not in excess of \$150,000 but is over \$100,000, therefore, they are entitled to deduct up to \$8,050 of rental real estate loss without any other offsetting passive activity income. Therefore, all \$7,360 of the loss they incurred is allowable in 2002.

The loss from PTP Limited Partnership (the publicly traded partnership) of \$210 is unallowed and added to the \$234 of unallowed loss from the 2001 tax year.

FORM 8606 (NONDEDUCTIBLE IRAs Contributions, Distributions, and Basis)

Roth IRA The Roth IRA does not create deductions upon contributions, but the distributions are tax-free if made after five years of the initial contribution to the Roth IRA, if the taxpayer is at least 59 ½, or because of death, disability, or to pay for certain first-time home buyer expenses.

The amount of allowable contributions to a Roth IRA is the lesser of \$3,000 or the annual compensation. However, the combined amount of contributions to a traditional IRA and a Roth IRA cannot exceed the \$3,000 ceiling. The allowable contributions are also subject to phase-out rules. The phase-out rules are as follows:

	<u>Full \$3,000 Contribution</u>	<u>Partial Contribution</u>	<u>No Contribution</u>
Married Filing Joint	AGI of \$150,000 or less	AGI between \$150,001 and \$160,000	AGI above \$160,000
Single or Head of Household	AGI of \$95,000 or less	AGI between \$95,001 and \$110,000	AGI above \$110,000
Married Filing Separate*	N/A	AGI between \$1 and \$10,000	AGI above \$10,000

* If the taxpayers did not live together during the entire tax year, they are treated as single.

EGTRRA 2001 also allows taxpayers, who have reached age 50 by the close of the tax year, to make an additional \$500 “catch-up” contribution. (See IRC §219(b)(5)(B)).

A taxpayer is allowed to continue making contributions to a Roth IRA even after reaching age 70 ½. Annual contributions can be made at any time up to the due date of the taxpayer’s return (not including extensions).

Rollover to a Roth IRA An existing traditional IRA can be rolled over or converted into a Roth IRA. There are three ways of rolling or converting a traditional IRA to a Roth IRA:

1. an ordinary distribution from the traditional IRA is contributed to a Roth IRA within 60 days after the distribution (normal withholding requirements will be required as for any ordinary distribution) (minimum required distributions do not qualify);
2. the traditional IRA can be transferred directly to a Roth IRA in a trustee to trustee transfer;
3. the trustee of the traditional IRA can directly transfer the amount to a Roth IRA.

The entire amount in the traditional IRA need not be transferred, partial transfers are acceptable. However, a taxpayer’s AGI must not exceed \$100,000 (not including minimum distributions from a traditional IRA or the taxable amount of the rollover / conversion) to be eligible to roll or convert these funds over. Additionally, married taxpayers filing separate returns are not eligible to roll or convert these funds over.

An inherited IRA cannot be converted to a Roth IRA because it cannot be rolled over. PLR 200013041.

The taxpayer must include in gross income any amount which would be included if the distribution had not been rolled or converted to a Roth IRA. There is no early withdrawal penalty, however upon a rollover or conversion.

Both Walter and Stacey made \$3,000 contributions to their Roth IRAs. These amounts contributed to a Roth IRA need not be reported on Form 8606.

Recharacterizing IRA Contributions and Conversions: A taxpayer that converts from an IRA to a Roth IRA during any tax year and then reconverts it back to a traditional IRA via recharacterization may not reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the tax year following the tax year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which the taxpayer transfers the amount from the Roth IRA back to a traditional IRA by means of recharacterization.

The useful application of this recharacterization provision is when a taxpayer who converted a traditional IRA to a Roth IRA now experiences a decline in the value of the assets held by the Roth IRA.

To make a recharacterization the taxpayer must follow the instructions in Form 8606.

Form **8829**

Expenses for Business Use of Your Home

OMB No. 1545-0046

Department of the Treasury
Internal Revenue Service

File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.
See separate instructions.

2002

OMB No. 1545-0046

Name of the taxpayer
WALTER BURNS

Your social security number
483 73 5777

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for day care, or for storage of inventory or product samples (see instructions)	1	200
2	Total area of home	2	1,800
3	Divide line 1 by line 2. Enter the result as a percentage	3	11.11%
<p>For day-care facilities not used exclusively for business, also complete lines 4-6. All others, skip lines 4-6 and enter the amount from line 3 on line 7.</p>			
4	Multiply days used for day care during year by hours used per day	4	hr.
5	Total hours available during year (365 days x 24 hours) (see instructions)	5	8,760 hrs.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	
7	Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7	11.11%

Part II Figure Your Allowable Deduction

8	Enter the amount from Schedule C, line 24, plus any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 709. If more than one piece of business, see instructions. See instructions for columns (a) and (b) before completing lines 9-20.	8	
9	Casualty losses (see instructions)	9	
10	Deductible mortgage interest (see instructions)	10	9,640
11	Real estate taxes (see instructions)	11	3,890
12	Add lines 9, 10, and 11	12	13,530
13	Multiply line 12, column (b) by line 7	13	1,503
14	Add line 12, column (a) and line 13	14	1,503
15	Subtract line 14 from line 8. If zero or less, enter -0-	15	
16	Excess mortgage interest (see instructions)	16	
17	Insurance	17	590
18	Repairs and maintenance	18	
19	Utilities	19	3,220
20	Other expenses (see instructions)	20	
21	Add lines 16 through 20	21	3,810
22	Multiply line 21, column (b) by line 7	22	423
23	Carryover of operating expenses from 2001 Form 8829, line 41	23	
24	Add line 21 in column (a), line 22, and line 23	24	423
25	Allowable operating expenses. Enter the smaller of line 15 or line 24	25	423
26	Limit on excess casualty losses and depreciation. Subtract line 25 from line 15	26	
27	Excess casualty losses (see instructions)	27	
28	Depreciation of your home from Part III below	28	484
29	Carryover of excess casualty losses and depreciation from 2001 Form 8829, line 42	29	
30	Add lines 27 through 29	30	484
31	Allowable excess casualty losses and depreciation. Enter the smaller of line 26 or line 30	31	484
32	Add lines 14, 25, and 31	32	2,410
33	Casualty loss portion, if any, from lines 14 and 31. Carry amount to Form 4684, Section B	33	
34	Allowable expenses for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions	34	2,410

Part III Depreciation of Your Home

35	Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	35	112,200
36	Value of land included on line 35	36	
37	Base of building. Subtract line 36 from line 35	37	112,200
38	Business basis of building. Multiply line 37 by line 7	38	18,833
39	Depreciation percentage (see instructions)	39	2.564%
40	Depreciation allowance (see instructions). Multiply line 38 by line 39. Enter here and on line 28 above	40	484

Part IV Carryover of Unallowed Expenses to 2003

41	Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0-	41	0
42	Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0-	42	0

For Paperwork Reduction Act Notice, see page 4 of separate instructions.

OMB No. 1545-0046

Form 8829 (2002)



FORM 8829 (HOME OFFICE EXPENSE)

A home office deduction is allowed for employees, self-employed individuals and investors for certain expenses for the use of the home as an office. As this is a non refundable credit, any unused credit can be carried forward for five years. The percentage of space within the residence that is used exclusively for the office, is the percentage by which many items, such as mortgage interest, real estate taxes, capital improvements and even depreciation may be taken as a deduction from the income of a trade or business operated from within the home. In addition, that same percentage of the utilities, insurance and other normally nondeductible household expenses are transformed into deductible expenses on the Form 8829.

The Small Business Jobs Protection Act of 1996 permits the deduction, for tax years beginning after December 31, 1995, for "home office" expenses relating to a storage unit within the taxpayer's home that is regularly used for inventory or product samples of the taxpayer's trade or business. The taxpayer's trade or business must be the retail or wholesale sales of those products, as long as the home is the sole location of the trade or business.

Additionally, with the passage of the Taxpayer's Relief Act of 1997, a taxpayer can now treat expenses related to a home office as deductible expenses if:

1. the office is used by the taxpayer to conduct administrative or management activities of a trade or business, and
2. there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

This change in the law overturns the infamous Soliman case law. This change is effective for tax years beginning after December 31, 1998.

Walter uses a portion of his home as a home office. His office is 200 sq. ft. while the total square footage of the home is 1,800 sq. ft. He can include the proportionate share of real estate taxes, mortgage interest, homeowner's insurance premiums and utilities that are attributable to his home office. Additionally, Walter will use the depreciation of his house as a business deduction.

The home office depreciation is made up of the house itself, with a basis of \$105,000, and \$7,200 of improvements that Walter made to his home office in 1998 ($\$105,000 \times 11.11\% = \$11,666$ plus $\$7,200 = 18,866$).

V. OTHER COMMENTARY

PRIVATE DELIVERY SERVICES

Under §7502(f), Congress authorized the IRS to designate certain Private Delivery Services. ("PDSs") Effective September 5, 2002, the list of designated PDSs is as follows:

1. Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service;
2. DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight;
3. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First; and
4. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

Only these specific delivery types by these specific Private Delivery Services will qualify for the "timely mailing as timely filing/paying" rule. (See Notice 2002-62). This notice also modifies what the "postmark date" is when using these services.

FORM W-7P PREPARER TAX IDENTIFICATION NUMBER

Tax preparers can apply for and obtain a Preparer Tax Identification Number ("PTIN"). This application is submitted on Form W-7P. The PTIN is used in place of the preparer's Social Security number, but not in place of an EIN. If a preparer received a PTIN in prior years it remains effective thereafter.

This is an elective procedure. Tax preparers can continue to include their Social Security numbers on the tax returns they prepare if they so choose. However, with the increase in the problems associated with "stolen identities", the acquisition and use of a PTIN is a good idea. The Form W-7P can be obtained through the IRS web site at "www.irs.gov". The form can then be faxed to the IRS and a notification, by mail, of your newly assigned PTIN will be sent within six weeks of submission.

COVERDELL EDUCATION SAVINGS ACCOUNTS

Beginning in 1998, taxpayers were given an opportunity to contribute up to \$500 per year into an Education IRA, renamed Coverdell Education Savings Accounts ("ESA") by the EGTRRA 2001, for a child under the age of 18. For 2002, anyone is allowed to make the contribution as long as the total amount contributed to any one child's ESA does not exceed \$2,000 (increased from \$500 in 2001). However, the amount that a person can contribute is ratably reduced for modified AGI's between \$190,000 and \$220,000 (married filing joint) and \$95,000 and \$110,000 (for all other filers). The instructions to Form 8606 contain a worksheet to assist in calculating the amount that an individual can contribute.

All earnings on the contributions accumulate tax free, and no tax is due on the distributions from the ESA as long as the distributions are for qualified higher education expenses.

In the event the child does not attend a post-secondary institution, the amounts in the ESA can be rolled over to another family member's ESA to be used for their qualified higher education expenses. Alternatively, the child can withdraw the amount in the ESA and pay income tax plus a 10% excise tax on the income earned thereon.

There is no tax deduction for the contribution to an ESA.

Beginning in 2002, EGTRRA 2001 repeals the 6% excise tax that was imposed on amounts contributed to an ESA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition plan (College Savings Iowa plan) on behalf of the same beneficiary.

"COLLEGE SAVINGS IOWA" PROGRAM (AN EXAMPLE OF A § 529 PLAN)

Walter and Stacey contributed \$2,180 to each of their children's College Savings Iowa accounts in 2002. While there is no federal tax consequence to these contributions, the following contains excerpts from this program's web page at "www.treasurer.state.ia.us/saving/college_saving1.htm".

College Savings Iowa is administered by the Treasurer of State and is designed to encourage adults to save for the future educational expenses of young people.

Contributions are tax deductible at the state level and the earnings are exempt from state taxes altogether. Beginning in 2002, withdrawals for higher education area also exempt from federal income tax.

Plan benefits can be used at all accredited public and private institutions of higher learning. Citizens can even use it for schools located out of state. The participant or beneficiary is not required to be an Iowa resident.

Each adult (the "Participant") may save a minimum of \$50 per year per child (the "Beneficiary") up to a maximum of \$2,180 per year per child. The maximum amount is adjusted annually for inflation. Parents can save for children. Grandparents can save for grandchildren. Aunts and uncles can save for nieces and nephews. Stepparents can save for stepchildren. In fact, friends can save for friends; there is no relationship required.

More than one Participant can save on behalf of a Beneficiary. Mom and Dad, as well as other adults, can each invest up to the maximum per child per year.

College Savings Iowa, pursuant to IRS rules, establishes an account balance limit (based upon five years of undergraduate enrollment at the highest cost eligible institution) which has been recently increased to \$239,000. Once the aggregate account balance for all accounts held on behalf of a Beneficiary exceed the applicable account balance limit, future contribution to any of the accounts are barred.

A single Participant may save on behalf of more than one Beneficiary up to the annual maximum for each Beneficiary.

All of a Participant's contributions are tax deductible for state income tax purposes and the earnings are exempt from state taxation altogether so long as the funds are spent for the "qualified higher education expenses" of a Beneficiary. The College Savings Iowa account statements for January 2003 will include or verify the amount you may deduct on line 24 of the 2002 IA 1040 - Iowa Individual Income Tax Long Form. The form will refer you to the instructions.

A Participant must: 1) be a resident of any state, 2) be age 18 or older, 3) have a valid social security number, 4) have a desire to save for the future educational expenses of a young person, and 5) complete a Participation Agreement.

A Beneficiary must: 1) be a resident of any state, 2) be under age 18 on the date a participation agreement is submitted, and 3) have a valid social security number. A Participant must submit with a Participation Agreement the Beneficiary's valid social security number and proof that the Beneficiary is under age 18.

If the original Beneficiary doesn't go to college, a Participant may substitute one Beneficiary for another as long as: 1) the original Beneficiary has not been admitted to an eligible institution, 2) the substitute Beneficiary is eligible, and 3) the substitute Beneficiary is a member of the original Beneficiary's family.

If another Beneficiary does not exist, a refund will be made to the Participant. However, if a refund is made to the Participant for any reason other than the Beneficiary's death, disability or receipt of a scholarship, the Participant will be penalized 10% on the earnings (after December 31, 2001, this is called a 10% federal tax).