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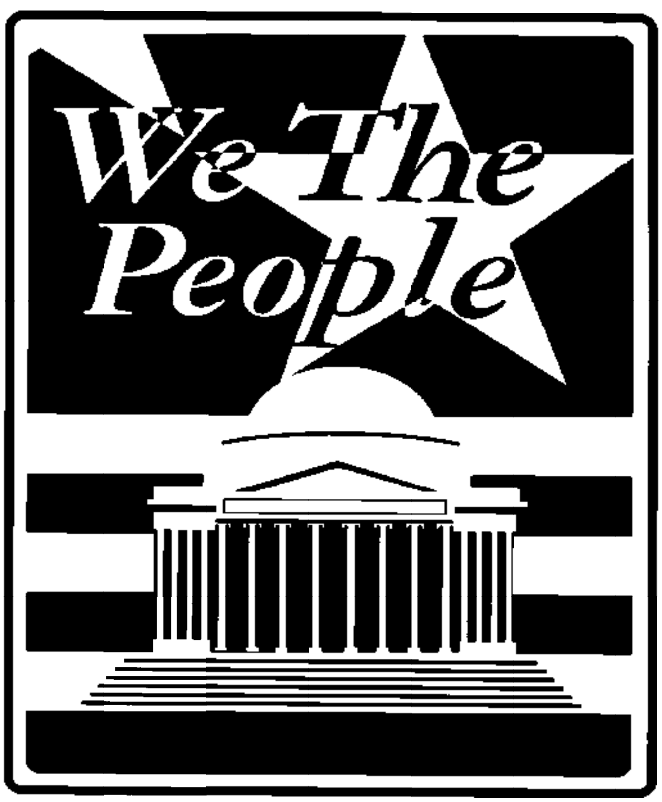
Tax Guide for Commercial Fishermen

For use in preparing

1994 Returns



Contents

Introduction

This publication explains how the federal tax laws apply to the fishing industry. It is written for the individual who is a sole proprietor and reports profit or loss from fishing on Schedule C (Form 1040).

The discussions in this publication do not cover the corporate or partnership form of business operation. If you have questions about corporations or partnerships, you should get:

- Publication 541, *Tax Information on Partnerships;*
- Publication 542, *Tax Information on Corporations;* or
- Publication 589, *Tax Information on S Corporations.*

You may use this publication as a guide to fill out your tax return. If you need more information on any subject, you should get the specific IRS publication that deals with that topic. Many of these publications are referred to at the beginning of each chapter. See the list of ''IRS Publications,'' which is located near the end of this publication, for other IRS publications you may need.

Ordering publications and forms. To order free publications and forms, call our toll-free telephone number 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you.

Telephone help. You can call the IRS with your tax question Monday through Friday during regular business hours. Check your income tax package or telephone book for the local number or you can call toll-free 1–800–829–1040.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call 1–800–829–4059 with your tax question or to order forms and publications. See your tax package for the hours of operation.

Important Changes for 1994

The following list highlights a number of administrative and tax law changes for 1994. A second list of items under *Important Reminders* contains information that may be helpful in preparing your tax return for 1994.

Legislation. For information on any legislative changes, see Publication 553, *Highlights of 1994 Tax Changes.*

Higher earned income credit. The maximum earned income credit has been increased from $2,364 in 1993 to $2,528 in 1994. To claim the credit, you must have earned income (including net earnings from self-employment) and adjusted gross income of less than $25,296 and meet certain other requirements.

Other earned income credit changes. The earned income credit has been expanded to include those who earn under $9,000 and do not have a qualifying child. The health insurance credit and the extra credit for a child born during the year are no longer available.

More information. For more information, see Publication 596, *Earned Income Credit.*

Payment voucher for Form 1040. To help modernize the federal tax payment system, the IRS is sending Form 1040–V, *Payment Voucher,* to certain taxpayers this year. IRS plans to eventually send preprinted vouchers to all Form 1040 filers in order to process payments more accurately and efficiently.

If you receive Form 1040–V and have a balance due on Form 1040, use the voucher to make your payment. Follow the instructions that come with the voucher.

Deferral of additional 1993 taxes. If you filed Form 8841, *Deferral of Additional 1993 Taxes,* with your 1993 tax return, the second installment is due April 17, 1995. If you are due a refund on your 1994 tax return, you can apply part or all of the refund to the second installment. See the Form 1040 instructions for more information.

Standard mileage rate. The standard mileage rate for 1994 is 29 cents a mile for all business miles put on a passenger automobile (including vans, pickups, or panel trucks). See Chapter 5.

Limits on depreciation of business cars. The total section 179 deduction and depreciation you can take on a car that you use in your business and first place in service in 1994 is $2,960. Your depreciation cannot exceed $4,700 for the second year of recovery, $2,850 for the third year of recovery, and $1,675 for each later tax year. See Chapter 7.

Electronic deposit of taxes. You may enroll in a system that will allow you to make tax deposits through direct electronic funds transfers, without the need for coupons, paper checks, or visits to an authorized depositary. For more information, call 1–800–829–5469, or write to:

IRS
Cash Management Site Office
Atlanta Service Center
P.O. Box 47669
Stop 295
Doraville, GA 30362

New publication on employer identification numbers (EIN). Publication 1635, *Understanding Your EIN,* provides general information on employer identification numbers. Topics include how to apply for an EIN and how to complete Form SS–4. See *Ordering publications and forms,* at the beginning of this publication.

New Form 1099–C. Beginning in 1994, certain financial entities, including financial institutions, credit unions, and federal government agencies, are required to report on Form 1099–C, *Cancellation of Debt,* any canceled debt of $600 or more. The form must be filed even though the debtor may not be subject to tax on the debt. For more information on canceled debt, see Chapter 7 in Publication 334.

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings from self-employment for 1994 is 15.3%. This rate is a total of 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance). In 1994, the maximum amount subject to the social security tax (12.4%) is $60,600. There is no maximum limit on the amount subject to the Medicare tax (2.9%).

For 1995, the tax rate will remain at 15.3%. However, the maximum amount subject to the social security part (12.4%) increases to $61,200. See Chapter 15.

Tax rates and wage maximums for social security and Medicare taxes. The tax rate for social security and Medicare taxes for 1994 is 7.65% for both the employee and the employer (a total of 15.3%). The 7.65% tax is a total of 6.2% for social security (old-age, survivors, and disability insurance) and 1.45% for Medicare (hospital insurance). In 1994, the maximum amount subject to the social security part (6.2%) is $60,600. There is no ceiling on the amount subject to the Medicare tax.

For 1995, the maximum wage amount subject to the social security tax (6.2%) is $61,200. All covered wages are subject to the Medicare tax. See Chapter 12.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1995.

Payment voucher for Forms 940 and 940–EZ. For 1994, if you are required to make a payment of federal unemployment tax with Form 940 or 940–EZ, use the payment voucher at the bottom of the form. For more information, see the form instructions.

Health insurance for self-employed persons. The 25% deduction for health insurance costs for self-employed persons expired for tax years beginning after 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend the provision. See Publication 553.

Waiver of estimated tax penalty. If you have an underpayment of tax for a period before April 16, 1994, any estimated tax penalty will be waived to the extent it was created or increased by any provision of the Revenue Reconciliation Act of 1993. See Publication 505.

Contributions to qualified retirement plan. The amount of a participant's compensation that can be taken into account for computing contributions to a Keogh or SEP plan is generally limited to $150,000 for plan years beginning on or after January 1, 1994. See Chapter 6.

General business credit. The following credits are part of the general business credit.

Targeted jobs credit. This credit cannot be claimed on wages paid to individuals hired after December 31, 1994.

Research credit. This credit has been extended from July 1, 1992, through June 30, 1995.

Low-income housing credit. This credit was permanently extended for all tax years ending after June 30, 1992.

See Form 3800, *General Business Credit,* and its instructions.

Important Reminders

The explanations and examples in this publication reflect the interpretation by the Internal Revenue Service of tax laws enacted by Congress, Treasury regulations, and court decisions. However, the information given does not cover every situation and is not intended to replace the law or change its meaning. This publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the Service.

Alternative minimum tax. Changes to alternative minimum tax for 1993 include:

Tax rates and exemption amounts. For tax years beginning after 1992, the alternative minimum tax rate for taxpayers other than corporations has been increased and graduated. The exemption amounts have also been increased.

Energy items. New alternative minimum tax rules for tax years beginning after 1992 apply to independent oil and gas owners or royalty owners.

Charitable contributions. The treatment of a charitable contribution of certain appreciated tangible personal property as a tax preference item was repealed for contributions of tangible personal property made after June 30, 1992, and for contributions of other property made after December 31, 1992.

See Form 6251 and its instructions for more information on alternative minimum tax.

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit. If your employees are eligible to receive advance payment of the earned income credit, have them complete Form W–5, *Earned Income Credit Advance Payment Certificate.* See Chapter 12.

Form W–4 for 1995. You should make new Forms W–4 available to your employees and encourage them to check their income tax withholding for 1995. Those employees who owed a large amount of tax or received a large refund for 1994 may need to file a new Form W–4. See Chapter 12.

Children employed by parents. Wages you pay to your children age 18 and older for services in your trade or business are subject to social security taxes. See Chapter 12.

Change of address. If you change your home or business address, you should use Form 8822, *Change of Address,* to notify IRS. Be sure to include your suite, room, or other unit number. Send the form to the Internal Revenue Service Center for your old address.

Form 1099–MISC. If you make total payments of $600 or more during the year to another person, other than an employee or a corporation, in the course of your fishing business, you must file information returns to report these payments. See Chapter 1.

Rounding off to whole dollars. You may round off cents to the nearest whole dollar on your return and schedules. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.49 becomes $1 and $2.50 becomes $3.

If you do round off, do so for all amounts. However, if you have to add two or more amounts to figure the total to enter on a line, include cents when adding the amounts and round off only the total.

Business codes for fishermen. You must enter on line B of Schedule C (Form 1040) a code that identifies your principal business or professional activity. It is important to use the correct business code, since this information will identify market segments of the public for IRS Taxpayer Education Programs. This information is also used by the U.S. Census Bureau for its economic census. See the sample records and forms in Chapter 16.

Depreciation. The recovery period for nonresidential real property placed in service after May 12, 1993, has been lengthened from 31.5 to 39 years. See Chapter 7.

Section 179 deduction. For property placed in service in tax years beginning after December 31, 1992, the limit on the section 179 deduction is increased from $10,000 to $17,500. See Chapter 7.

Deductions for clean-fuel vehicles and certain refueling property. Deductions are allowed for clean-fuel vehicles and certain clean-fuel vehicle refueling property placed in service after June 30, 1993. For more information, see Chapter 15 in Publication 535.

Credit for qualified electric vehicles. A tax credit is available for qualified electric vehicles placed in service after June 30, 1993. For more information, see Chapter 15 in Publication 535.

Penalties. There are various penalties you should be aware of when preparing your return. You may be subject to penalties if you:

1) Do not file your return by the due date. This penalty is 5% for each month or part of a month that your return is late, up to 25%.
2) Do not pay your tax on time. This penalty is ½ of 1% of your unpaid taxes for each month, or part of a month after the date the tax is due, up to 25%.
3) Substantially understate your tax. This penalty is 20% of the underpayment.
4) File a frivolous tax return. This penalty is $500.
5) Fail to supply your social security number. This penalty is $50 for each occurrence.

Tax shelter penalties. Tax shelters, their organizers, their sellers, or their investors may be subject to penalties for such actions as:

1) Failure to furnish tax shelter registration number. The penalty for the seller of the tax shelter is $100; the penalty for the investor in the tax shelter is $250.
2) Failing to register a tax shelter. The penalty for the organizer of the tax shelter is the greater of 1% of the amount invested in the tax shelter, or $500.
3) Not keeping lists of investors in potentially abusive tax shelters. The penalty for the tax shelter is $50 for each person required to be on the list, up to a maximum of $100,000.

Fraud penalty. The fraud penalty for underpayment of taxes is 75% of the part of the underpayment due to fraud.

Criminal penalties. You may be subject to criminal prosecution (brought to trial) for actions such as:

1) Tax evasion.
2) Willful failure to file a return, supply information, or pay any tax due.
3) Fraud and false statements.
4) Preparing and filing a fraudulent return.

Free tax help. Publication 910, *Guide to Free Tax Services,* provides information on where to get help in preparing tax returns. It describes the kind of year-round services available to resolve questions on bills, letters, and notices received from Internal Revenue Service Centers, as well as questions on the status of tax refunds. This publication lists free taxpayer information publications, with brief descriptions of their content along with a list of related tax forms and schedules that you may need to complete your returns. For information on how to order Publication 910, see *Ordering publications and forms,* at the beginning of this publication.

Written tax questions. You can send written tax questions to your IRS District Director. If you do not have the address, you can get it by calling the toll-free number. The IRS is working to decrease the time it takes to respond to your correspondence. If you write, the IRS can usually reply within approximately 30 days.

Tele-Tax. The IRS has a telephone service called Tele-Tax. This service provides recorded tax information on approximately 140 topics covering such areas as filing requirements, employment taxes, taxpayer identification numbers, and tax credits. Recorded tax information is available 24 hours a day, 7 days a week, to taxpayers using push-button telephones, and during regular working hours to those using dial telephones. The topics covered and telephone numbers for your area are listed in the Form 1040 instructions.

Unresolved tax problems. IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If you have a tax problem you have been unable to resolve through normal channels, write to your local IRS District Director or call your local IRS office and ask for Problem Resolution assistance.

Although the Problem Resolution Office cannot change the tax law or technical decisions, it can frequently clear up misunderstandings that resulted from previous contacts. For more information, see Publication 1546, *How to Use the Problem Resolution Program of the IRS.*

Hearing-impaired taxpayers who have access to TDD equipment may call 1–800–829–4059 to ask for help from Problem Resolution.

Overdue tax bill. If you receive a bill for overdue taxes, do not ignore the tax bill. If you owe the tax shown on the bill, you should make arrangements to pay it. If you believe it is incorrect, contact the IRS immediately to suspend action until the mistake is corrected. See Publication 594, *Understanding the Collection Process,* for more information.

Reminders—

Before you file your tax return, be sure to:

Use address label. Transfer the address label from the tax return package you received in the mail to your tax return, and make any necessary corrections.

Claim payments made. Be sure to include on the appropriate lines of your tax return any estimated tax payments and federal tax deposit payments you made during the tax year.

Also, you must file a return to claim a refund of any payments you made, even if no tax is due.

Attach all forms. Attach all forms and schedules in sequence number order. The sequence number is just below the year in the upper right corner of the schedule or form. Attach all other statements or attachments last, but in the same order as the forms or schedules they relate to. Do not attach these other statements to the related form or schedule.

Complete Schedule SE. Fill out Schedule SE (Form 1040) if you had net earnings from self-employment of $400 or more.

Use correct lines. List income, deductions, credits, and tax items on the correct lines.

Sign and date return. Make sure the tax return is signed and dated.

Submit payment. Enclose a check for any tax you owe. Write your social security number on the check. Also include the telephone number and area code where you can be reached during the day. If you receive a Form 1040–V, *Payment Voucher,* follow the instructions for completing and sending in the voucher.

Electronic filing. You may be able to have your tax return filed electronically instead of on a paper form. This method can be used by many tax return preparers and other professional filers who do not prepare returns but use this method to file returns already completed by taxpayers. These preparers and filers send tax return information over telephone lines to an Internal Revenue Service Center. They will charge you for this service. However, by filing electronically, you can have your refund deposited directly into your savings or checking account.

Electronic filing of federal tax returns is available to preparers in all 50 states. Also, in some states, preparers can file an electronic state tax return simultaneously with the federal return. Federal/state electronic filing is offered statewide in Colorado, Connecticut, Idaho, Indiana, Iowa, Kansas, Louisiana, Maine, Michigan, Mississippi, Missouri, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Utah, West Virginia, and Wisconsin. It is also offered in limited programs in Arizona, Arkansas, Delaware, Georgia, Kentucky, Montana, Nebraska, New Jersey, Rhode Island, and Virginia. In these states, check with your preparer to see if you can participate in the program.

Dates To Remember

You should take the action indicated on or before the date listed. Saturdays, Sundays, and legal holidays have been taken into account, but local banking holidays have not. A statewide legal holiday delays a due date only if the IRS office where you are required to file is located in that state.

Under the new deposit rules for withheld income taxes, social security taxes, and Medicare taxes, you generally deposit taxes monthly or semiweekly. The rules and due dates for each type of deposit are explained in detail in Publication 509, *Tax Calendars for 1995.* The dates listed here are for monthly deposits. See Publication 509 for the rules and due dates for semiweekly deposits.

Fiscal year taxpayers. Generally, the due dates listed apply to all taxpayers whether they use a calendar year or a fiscal year. However, fiscal year taxpayers should refer to Publication 509 for certain exceptions that apply to them.

1995—Calendar Year

During January

Employers. Give each employee a Form W–2 showing income, social security, and Medicare information for 1994 as soon as possible. The due date for giving Form W–2 to your employees is *January 31, 1995.* Copy A of Form W–2 must be filed by *February 28, 1995.*

January 17

Fishermen. You may elect to pay your 1994 estimated tax in full. You can then file your 1994 income tax return (Form 1040) by *April 17.* If you do not pay your estimated tax at this time, your 1994 return will be due *March 1.*

Social security, Medicare, and withheld income tax. Deposit the tax for payments in December 1994 if you are subject to the monthly deposit rule.

January 31

Social security, Medicare, and withheld income tax. File Form 941 for the fourth quarter of 1994. Deposit any undeposited tax. (If the total is less than $500 and not a shortfall, you can pay it with the return.) If you have deposited the tax in full and on time, you have until *February 10* to file the return.

Federal unemployment (FUTA) tax. File Form 940 (or 940–EZ) for 1994. If your undeposited tax is $100 or less, you can either pay it with your return or deposit it. If it is more than $100, you must deposit it. However, if you have deposited the tax for the year in full and on time, you have until *February 10* to file the return.

Fishing boat operators. Give every crew member who is considered self-employed a Form 1099–MISC showing information on crew shares. See also *February 28.*

February 10

Social security, Medicare, and withheld income tax. File Form 941 for the fourth quarter of 1994. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, the return was due *January 31.*

Federal unemployment tax. File Form 940 (or 940–EZ) for 1994. This due date applies only if you had deposited the tax for the year in full and on time. If not, the return was due *January 31.*

February 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in January if you are subject to the monthly deposit rule.

February 28

Fishing boat operators. File a Form 1099–MISC (Copy A) for each crew member considered self-employed. Form 1099–MISC is used to show the member's crew shares for 1994. Use Form 1096 to summarize and transmit the Forms 1099–MISC.

All employers. File Form W–3, *Transmittal of Wage and Tax Statements,* along with Copy A of all the Forms W–2 you issued for 1994.

March 1

Fishermen. File your 1994 income tax return (Form 1040) and pay any tax due. However, you have until *April 17* if you paid your 1994 estimated tax by *January 17, 1995.*

March 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in February if you are subject to the monthly deposit rule.

April 17

Fishermen. File an income tax return (Form 1040) for 1994 and pay any tax due. See Chapter 1.

Social security, Medicare, and withheld income tax. Deposit the tax for payments in March if you are subject to the monthly deposit rule.

May 1

Social security, Medicare, and withheld income tax. File Form 941 for the first quarter of 1995. Deposit any undeposited tax. (If the total is less than $500 and not a shortfall, you can pay it with the return.) If you have deposited the tax in full and on time, you have until *May 10* to file the return.

Federal unemployment tax. If you are liable for FUTA tax (see Chapter 12), deposit the tax owed through March. No deposit is necessary if the liability for the quarter does not exceed $100.

May 10

Social security and Medicare taxes and withheld income tax. File Form 941 for the first quarter of 1995. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, the return was due *May 1.*

May 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in

April if you are subject to the monthly deposit rule.

June 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in May if you are subject to the monthly deposit rule.

July 17

Social security, Medicare, and withheld income tax. Deposit the tax for payments in June if you are subject to the monthly deposit rule.

July 31

Social security, Medicare, and withheld income tax. File Form 941 for the second quarter of 1995. Deposit any undeposited tax. (If the total is less than $500 and not a shortfall, you can pay it with the return.) If you have deposited the tax in full and on time, you have until *August 10* to file the return.

Federal unemployment tax. If you are liable for FUTA tax, deposit the tax owed through June. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment tax for the first quarter, does not exceed $100.

August 10

Social security, Medicare, and withheld income tax. File Form 941 for the second quarter of 1995. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, the return was due *July 31.*

August 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in July if you are subject to the monthly deposit rule.

September 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in August if you are subject to the monthly deposit rule.

October 16

Social security, Medicare, and withheld income tax. Deposit the tax for payments in September if you are subject to the monthly deposit rule.

October 31

Social security, Medicare, and withheld income tax. File Form 941 for the third quarter of 1995. Deposit any undeposited tax. (If the total is less than $500 and not a shortfall, you can pay it with the return.) If you have deposited the tax in full and on time, you have until *November 13* to file the return.

Federal unemployment tax. If you are liable for FUTA tax, deposit the tax owed through September. No deposit is necessary if the liability for the quarter, plus undeposited federal unemployment tax for previous quarters, does not exceed $100.

November 13

Social security, Medicare, and withheld income tax. File Form 941 for the third quarter of 1995. This due date applies only if you had deposited the tax for the quarter in full and on time. If not, the return was due *October 31.*

November 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in October if you are subject to the monthly deposit rule.

December 15

Social security, Medicare, and withheld income tax. Deposit the tax for payments in November if you are subject to the monthly deposit rule.

1.

Filing Requirements and Return Forms

Important Reminders

Schedule C–EZ (Form 1040). You may be able to use Schedule C–EZ, *Net Profit From Business,* if you had gross receipts from your business of $25,000 or less and business expenses of $2,000 or less. Other requirements that must be met are listed on Schedule C–EZ.

Form 1099–MISC. If you make total payments of $600 or more during the year to another person, other than an employee or a corporation, in the course of your fishing business, you must file Form 1099–MISC to report these payments.

Estimated tax. When you figure your estimated tax for 1995, you must include any alternative minimum tax you expect to owe. See Publication 505, *Tax Withholding and Estimated Tax.*

Topics

This chapter discusses:

- Filing requirements
- Identification number
- Estimated tax and return due dates
- Other filing information
- Information returns
- Return forms

Useful Items

You may want to see:

Publication

- ❑ **505** Tax Withholding and Estimated Tax
- ❑ **937** Employment Taxes

Form (and Instructions)

This chapter discusses various forms you may have to file with the IRS. We have not listed them separately at the beginning of the chapter.

Filing Requirements

If you are a citizen or resident of the United States, single or married, and your gross income for the tax year is at least the amount shown in the category below that applies to you, you must file a 1994 federal income tax return even if no tax is due. This also applies to minor children. Gross income is discussed in Chapter 4.

The filing requirement amounts below are the exemption amount ($2,450) plus the standard deduction for the filing status and age.

Who Must File

Filing Status Is:	Income At Least:
Single	
Under 65	$ 6,250
65 or older	7,200
Head of Household	
Under 65	$ 8,050
65 or older	9,000
Married, Joint Return	
Both under 65	$ 11,250
One spouse 65 or older	12,000
Both 65 or older	12,750
Not living with spouse at end of year (or on date spouse died)	2,450
Married, Separate Return	
All (regardless of age)	$ 2,450
Qualifying Widow(er) with Dependent Child	
Under 65	$ 8,800
65 or older	9,550

Dependent's return. If you can claim someone as a dependent on your tax return (for example, your son or daughter), that person must generally file his or her own tax return if he or she:

1) Had only earned income, such as salary or wages, and the total is more than $3,800, or
2) Had only unearned income, such as interest and dividends, and the total is more than $600, or
3) Had both earned and unearned income, and the total is more than $600.

See the Form 1040 instructions for more information on who must file a return for 1994.

Self-employed. If you are self-employed, you must file a return if you had net earnings of $400 or more from self-employment, even though you are not otherwise required to file an income tax return. See Chapter 11.

Earned income credit refund. You must also file a return to receive a refund from the earned income credit. See the instructions for Form 1040.

Identification Number

You must show your taxpayer identification number (social security or employer identification number) on all returns, statements, or documents you are required to file. For example, it must be shown on your federal income tax return, your estimated tax payment voucher, and all information returns, such as Forms 1096 and 1099. A penalty of $50 may be levied for each failure to show the number.

Which number to use. If you have to file an excise, alcohol, tobacco, firearms, or employment tax return, you should have an employer identification number and use that number on Schedule C for your fishing business. Otherwise, use your social security number. On your individual income tax return (Form 1040), computation of self-employment tax (Schedule SE), and estimated tax payment voucher (Form 1040–ES), you should use your social security number regardless of the number used on your business returns.

If you are married, show social security numbers for both you and your spouse on your Form 1040, whether you file jointly or separately. If you are filing a joint return, list the social security numbers in the same order that you show your first names. Also show both social security numbers on your Form 1040–ES if you make joint estimated tax payments.

Application for identification number. To apply for a social security number, use Form SS–5. You can get this form from any social security office. If you are under 18 years of age, you must furnish evidence of age, identity, and U.S. citizenship with your Form SS–5. If you are 18 or older, you must appear in person with this evidence at a social security office.

To apply for an employer identification number, use Form SS–4. You can get this form from any social security or IRS office or by calling IRS at 1–800–829–3676.

Estimated Tax and Return Due Dates

When you must pay estimated tax and file your return depends on whether you qualify as a fisherman. To qualify as a fisherman you must receive at least two-thirds of your total gross income from fishing in the current or prior year.

Gross Income

Gross income is all income you receive in the form of money, property, and services that is not exempt from tax. It is the total income you receive before allowable deductions. For a business, gross income is total receipts minus cost of goods sold.

The amount of your gross income is used to determine if you must file a return. It is also used to determine if you qualify as a fisherman. To see if you qualify as a fisherman, figure the amount of your total gross income and then determine what percentage of this total is from fishing.

Joint return. On a joint return, you must add your spouse's gross income to your own gross income to determine if at least two-thirds of the total is from fishing.

More information. For more information about figuring gross income, see Publication 505.

Gross Income from Fishing

Gross income from fishing includes amounts you receive from catching, taking, harvesting, cultivating, or farming any kind of fish, shellfish (clam, mussel, etc.), crustacean (lobster, crab, shrimp, etc.), sponge, seaweed, or other aquatic form of animal and vegetable life.

You receive gross income from fishing if you conduct your fishing business for a profit. Your gross income from farming also includes your share of a partnership's or S corporation's gross income from fishing.

You receive gross income from fishing if you are an officer or crew member of a boat whose crew normally consists of fewer than 10 individuals and you do not receive any cash pay other than:

1) A share of the boat's catch, and
2) Your share depends on the amount of the catch.

Your share can be from the catch of more than one boat involved in a fishing operation, provided the crew of each boat in the operation normally consists of fewer than 10 individuals. For more information, see *Certain Crew Members Considered Self-Employed* in Chapter 12.

If you are an officer or member of a crew and meet these qualifications, you are treated as self-employed and must pay estimated income, social security, and Medicare taxes and report your income on Schedule C or Schedule C–EZ (Form 1040). Your fishing services include those ordinarily related to fishing, such as shore service that includes cleaning, icing, and packing fish.

If you are an officer or crew member, but do not meet these qualifications, you may be treated instead as an employee. Any wages you receive are then subject to income tax, social security, and Medicare tax withholding by your employer. It does not matter whether your wages depend upon the catch of a boat. You do not qualify as a fisherman because your income is from wages for the performance of services, not from the trade or business of fishing.

Qualified Fisherman Due Dates

If at least two-thirds of your total gross income for 1993 or 1994 is from fishing, you have only one payment due date for estimated tax — January 17, 1995.

For your 1994 tax, you can either:

1) Pay all your estimated tax by January 17, 1995, and file your Form 1040 by April 17, 1995, or
2) File your Form 1040 by March 1, 1995, and pay all the tax that is due. You are not required to make an estimated tax payment. If you pay all the tax due, you will not receive a penalty for not paying estimated tax.

Fiscal year. If you qualify as a fisherman but your tax year does not start on January 1, you can file your return and pay the tax on or before the first day of the 3rd month after the close of your tax year. Or you can pay your required estimated tax within 15 days after the end of your tax year. Then file your return and pay any balance due on or before the 15th day of the 4th month after the end of your tax year.

Penalty. If you do not pay all your required estimated tax by January 17, 1995, and do not file your return or pay the tax by March 1, 1995, use Form 2210–F, *Underpayment of Estimated Tax by Farmers and Fishermen,* to determine if you owe a penalty. If you owe a penalty but do not pay it and file Form 2210–F with your return, you will get a penalty notice from the IRS. You should pay the penalty as instructed by the notice.

If you file your return by April 17 and pay the bill within 10 days after the notice date, the IRS will not charge you interest.

Occasionally, you may get a penalty notice even though you filed your return on time, attached Form 2210–F, and met the gross income test. If you receive a penalty notice for underpaying estimated tax that you think is in error, write to the address on the notice and explain why you think the notice is in error. Include a computation showing that you meet the gross income test. Do not ignore a penalty notice even if you think it is in error.

Nonqualified Fisherman Due Dates

If you did not qualify as a fisherman in 1994 because less than two-thirds of your total gross income was from fishing and you do not expect to qualify in 1995, you do not qualify for the special estimated tax payment and return due dates. You generally must make quarterly estimated tax payments on April 17, June 15, and September 15, 1995, and on January 16, 1996. You must file your tax return by April 15, 1996.

Other Filing Information

Payment date on a holiday or weekend. If the last day for filing your return or making a payment falls on a Saturday, Sunday, or legal holiday, your return or payment will be on time if it is filed or made on the next business day.

Automatic extension of time to file Form 1040. If you do not choose to file your return on March 1, 1995, the due date for your 1994 return will be April 17, 1995. However, you can get an automatic 4-month extension of time to file your return. Your Form 1040 would then be due by August 15, 1995. To get this extension, file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* by April 17, 1995.

This extension ***does not*** extend the March 1, 1995, filing date for fishermen who did not make an estimated tax payment and who want to avoid an estimated tax penalty. Therefore, if you did not make an estimated tax payment by January 17, 1995, and you file your tax return after March 1, 1995, you will be subject to a penalty for underpaying your estimated tax, even if you filed Form 4868.

You must make a tentative estimate of tax for the year for which you file Form 4868. You can file Form 4868 and get an automatic 4-month extension even though you cannot pay the estimated tax in full. No filing penalty will be assessed under these circumstances. If the total tentative tax paid is less than the final tax shown on your Form 1040, interest from the original due date will apply on the amount of the difference.

The late payment penalty of one-half of 1% a month up to a maximum of 25% will apply unless there is reasonable cause for the delay. Reasonable cause will be presumed if the amount you owe on Form 1040 is no more than 10% of the total tax for the year and this amount is paid with Form 1040. For more information, see the instructions to Form 4868.

Form 9465. If you are unable to pay the tax owed on or before the end of the automatic 4-month extension period, you can attach Form 9465, *Installment Agreement Request*, to your income tax return. IRS encourages you to make installment payments as large as possible in order to reduce the interest and penalties required by law.

Where to file. File your return with the Internal Revenue Service Center for the place where you live. Use the envelope mailed to you or see the list of Service Center addresses in the instructions for your tax return.

Information Returns

If, in the course of your fishing business, you make payments of $600 or more during the calendar year to another person, other than a corporation, you generally must file Form 1099–MISC to report these payments. It is used to report the amount of crew shares each crew member considered self-employed receives, as well as payments for rents, commissions, fees, prizes, and awards. Form 1099–MISC is also used to report other payments and compensation, including payments to subcontractors and payment for services provided by nonemployees. Royalty payments of $10 or more are also reported on Form 1099–MISC.

Payments for merchandise, freight and similar charges, and for rental payments to real estate agents need not be reported. However, if you pay a contractor who is not a dealer in supplies for both supplies and services, include the payment for supplies used to perform the services as long as providing the supplies was incidental to providing the service.

Payments for compensation to employees are reported on Form W–2, not Form 1099–MISC.

Preparation of returns. You must prepare separate copies of Form 1099–MISC for each person. A statement showing the information reported on Copy A of Form 1099–MISC must be furnished to each crew member considered self-employed, and to each other person to whom you made a payment that must be reported. You must do this by January 31 following the end of the calendar year. Copy B of Form 1099–MISC can be used for this purpose.

Because these forms are read by machine, there are very specific instructions for their preparation and submission. You may be subject to a penalty for each incorrectly filed document. See the *Instructions for Forms 1099, 1098, 5498, and W–2G* for information on completing these forms.

Penalty. Information returns filed late, without all information required to be on the return, or with incorrect information may be subject to a penalty. See the *Instructions for Forms 1099, 1098, 5498, and W–2G* for information on the penalty.

Filing the returns. Copy A of Forms 1099 must be sent with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns,* to the IRS at the address shown in the Form 1096 instructions by February 28 following the end of the calendar year.

Return Forms

When filing your income tax return, arrange your forms and schedules in the correct order using the *Attachment Sequence Number* located in the upper right corner of each form or schedule. Attach all other statements last, arranged in the same order as the forms or schedules they support.

A fisherman may use the following forms when preparing a tax return.

Form 1040. List taxable income from all sources on Form 1040, including profit or loss from fishing operations as figured on Schedule C or Schedule C–EZ (Form 1040). Figure the tax on this form, also.

Schedule C. This schedule is used to list all income and deductions and determine net profit or loss from a business, including fishing.

Schedule C–EZ. This schedule can be used in place of Schedule C if gross receipts from a business are $25,000 or less and business expenses are $2,000 or less.

Schedule SE. This schedule is used to figure self-employment tax.

Other schedules for Form 1040. Use Schedule A to list nonbusiness itemized deductions and Schedule B to report interest and dividend income of over $400. Use Schedule D to report gains and losses from sales of capital assets. Use Schedule E to report income or loss from rents, royalties, partnerships, estates, trusts, and S corporations.

Form 1040–ES. This form is used to figure and pay estimated tax.

Form 2210–F. Form 2210–F, *Underpayment of Estimated Tax by Farmers and Fishermen,* is used to figure any underpayment of estimated tax and the underpayment penalty.

Form 4562. Form 4562, *Depreciation and Amortization,* is used to explain the deductions for depreciation and amortization.

Form 4797. Form 4797, *Sales of Business Property,* is used to report gains and losses from the sale or exchange of business property and from certain involuntary conversions. For example, gain or loss on the sale of a fishing boat is reported on Form 4797.

Other Forms

The following is a list of other forms a fisherman may use.

Form 8822. Form 8822, *Change of Address,* is used to notify IRS of a change in home or business address. The suite, room or other unit number should be included if it is required in the mailing address. The form must be sent to the Internal Revenue Service Center for the old address.

Form 1099–MISC. Form 1099–MISC, *Miscellaneous Income,* is an information return used to report the amount of crew shares received by each crew member considered self-employed, as discussed in Chapter 12. It is also used to report certain other payments made during the year in the course of business. See *Information Returns,* earlier. Form 1099–MISC is illustrated in Chapter 16.

Fishermen use Form 1099–MISC most frequently. However, there are other forms in the 1099 series. Information all Forms 1099 can be found in the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Form 1096. Form 1096, *Annual Summary and Transmittal of U.S. Information Returns,* is used to summarize and transmit Forms 1099 to the IRS.

Form 941. Form 941, *Employer's Quarterly Federal Tax Return,* must be filed quarterly if income tax is withheld from wages of employees or if you are liable for social security and Medicare taxes. The form is due one month after the calendar quarter ends. If you deposit the tax in full and on time, you have an additional 10 days to file the form.

Form W–2. Form W–2, *Wage and Tax Statement,* is prepared for each employee from whose wages income tax has been withheld or would have been withheld if the employee had claimed no more than one withholding exemption, or to whom you paid wages subject to social security and Medicare taxes. The Form W–2 must show the total wages and other compensation paid, whether or not they are subject to withholding, and the amounts deducted for income tax, social security, and Medicare taxes. In addition, the W–2 must show the value of any payment for services that was not made in cash.

Send Copy A of each Form W–2 to the Social Security Administration (SSA) with a completed Form W–3, *Transmittal of Income and Tax Statements,* by February 28. If the due date for filing a return falls on a Saturday, Sunday, or legal holiday, you can file the return on the next business day. The correct mailing address for your area's SSA office can be found in the instructions for Form W–3. Copies B and C of Form W–2 must be given to the employee by January 31.

2.

Importance of Good Records

Important Reminder

Recordkeeping requirements. IRS accepts certain financial account statements as proof of payment made by check, credit card, or electronic funds transfer. See *Financial account statements,* later.

Topics

This chapter discusses:

- How to keep records
- How long to keep records

Useful Items

You may want to see:

Publication

- ❏ **463** Travel, Entertainment, and Gift Expenses
- ❏ **534** Depreciation
- ❏ **917** Business Use of a Car
- ❏ **937** Employment Taxes
- ❏ **946** How To Begin Depreciating Your Property

Form (and Instructions)

- ❏ **W–2** Wage and Tax Statement
- ❏ **W–4** Employee's Withholding Allowance Certificate
- ❏ **8824** Like-Kind Exchanges

You must keep records to correctly figure your taxes. Your records must be permanent, accurate, complete, and clearly establish your income, deductions, credits, and employee information. The law does not require you to keep your records in any particular way. You can choose any system suited to your business that will clearly show your income.

Travel expenses. You are required to support your expenses for travel in connection with your business with adequate records or sufficient evidence to prove your own statements. This includes expenses for local travel, gifts, entertainment, and the business use of certain ***listed property.***

Adequate records include account books, diaries, trip sheets, or similar items. Records written at or near the time you have the expenses have more value than oral statements or written records reconstructed much later. See Publications 463 and 917 for more information.

Listed property includes all passenger automobiles; entertainment, amusement or recreation type property; and computer equipment not used exclusively at a regular business location. For more information on listed property, see Chapter 4 in Publication 534.

How To Keep Records

Good records are needed for efficient management, to apply for credit, and to support all items of income and expense reported on your tax return. The following suggestions are provided to help you maintain good records and show you ways in which they may help.

Identify the source of income. The money or property you receive can come from many sources. Your records should identify the source of your income so you can show if the income is taxable or nontaxable.

Maintain a record of deductible expenses. You may forget your deductible expenses when you prepare your tax return unless you record them when they occur. You should also retain the invoice, paid receipt, or canceled check that supports the item of expense.

Figure depreciation. You should keep a permanent record of the depreciable assets used in your fishing business. Depreciation allows you to recover the cost of your business property by deducting part of it each year of its depreciable life on your tax return. You must keep a record of the cost and any other information about the basis of your assets. This information is needed to figure your depreciation deduction. See Chapter 7 for more information about depreciation. If you make capital improvements to your assets, only a permanent record will show how much of their cost you have recovered.

This information is also needed to correctly report the gain or loss from the sale or other disposition of an asset on your tax return. Also, if you exchange property for the same kind of property, these permanent records will help you complete and file Form 8824. You must file this form with your tax return to report the like-kind exchange of any business or investment property. For more information, see Chapter 8.

Figure earnings for self-employment tax. The self-employment tax is part of the system for providing social security coverage for people who work for themselves. The social security benefits you receive when you retire or become disabled, or the benefits your family receives in case of your death, depend on the amount you contributed to your social security account based on your net earnings. The self-employment tax also provides medical insurance (Medicare) benefits. Your records should show how much of your earnings are subject to self-employment tax.

Support items reported on tax return. If your income tax return is examined by the IRS, you may be asked to explain and support the items reported. Adequate and complete records should be supported by sales slips, invoices, receipts, canceled checks, certain financial account statements, and other documents.

Checkbook. Your business checkbook is the basic source for keeping a record of your business expenses. It is recommended that all daily receipts be recorded in your checkbook.

You should use a checkbook that provides enough space to enter sufficient information to determine later which receipts represent taxable income to be reported on your tax return and which represent nontaxable transfers of personal funds, reimbursements, or loans.

Deposits. You should deposit all business receipts in a business bank account and set up a petty cash fund for small expenses. All business expenses paid by cash should be supported by cash receipts, invoices marked ''paid,'' or other documents that clearly show the expenses incurred were for business purposes.

Pay by check. You should pay all business expenses by check. Do not write business checks payable to cash or to yourself unless they are drawn for personal reasons. If you must write a check for cash to pay a business expense, include the receipt for the payment in your records. If you cannot get a receipt for a cash payment, you should record an adequate explanation at the time of payment.

Financial account statements. If you cannot provide a canceled check to prove payment of an expense item, you may be able to prove it with certain financial account statements. This includes account statements prepared by a third party who is under contract to prepare statements for the financial institution.

To be acceptable, the statement must meet the following requirements:

1) An account statement showing a check clearing is accepted as proof if it shows the check number, amount, payee name, and the date the check amount was posted to the account by the financial institution.
2) An account statement prepared by a financial institution showing an electronic funds transfer is accepted as proof if it shows the amount transferred, payee name, and the date the transfer was posted to the account by the financial institution.
3) An account statement prepared by a financial institution showing a credit card charge (an increase to the cardholder's loan balance), is accepted as proof if it shows the amount charged, payee name, and the date charged (transaction date).

These account statements must show a high degree of legibility and readability. For this purpose, legibility is the quality of a letter or number enabling it to be identified positively excluding all other letters and numbers. Readability is the quality of a group of letters or numbers enabling it to be recognized as words or complete numbers. However, this does not mean the information must be typed or printed.

Proof of payment alone does not establish that you are entitled to a tax deduction. You should also keep other documents as discussed in *Support items reported on income tax return,* earlier.

Recordkeeping. You must keep the books and records of your business available at all times for inspection by the IRS. Your records must be kept as long as they may be needed in the administration of any Internal Revenue law.

Illustrated records. For an illustration of a sample recordkeeping system, see Chapter 16.

How Long To Keep Records

Keep records that support items of income or expenses reported on your tax return until the period of time for the statute of limitations for that tax return runs out. Usually, this is the later of:

1) 3 years after the date your return is due or filed, or
2) 2 years after the tax is paid.

Your permanent books must show your gross receipts, as well as your deductions and credits. In addition, you must keep other records and data you need to support the entries in your records and for all tax or information returns. Worksheets, logs, diaries, paid bills, canceled checks, etc., that support entries in your books should be maintained in a safe, well-organized file.

Employment taxes. If you are an employer, you must keep all your employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later. This includes copies of Form W–4, undelivered employee copies of Form W–2, and all payroll records. For more detailed information on employment tax records, see *Recordkeeping* in Publication 937.

Cost basis. Keep records that support your cost basis in property for as long as they are needed to figure the basis of the original or replacement property (including capital improvements).

Tax returns. Keep copies of your tax returns. They will help in preparing future tax returns and in making computations if you later file a claim for refund. They may also be helpful to the executor or administrator of your estate, or to the IRS, if your original return is not available.

3. Business Assets

Topics

This chapter discusses:

- Cost basis
- Adjusted basis
- Other basis

Useful Items

You may want to see:

Publication

- ❏ **504** Divorced or Separated Individuals
- ❏ **525** Taxable and Nontaxable Income
- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **551** Basis of Assets

An individual engaged in a business activity usually has property used in the business. This property contributes directly or indirectly toward earning the income of the business. Property used in a business is a business asset.

A business asset may be tangible property, such as a fishing vessel or fishing gear, or intangible property such as a franchise right. The amount paid for a business asset is usually a capital expenditure.

You may get business assets in several ways. These include, but are not limited to:

1) Purchase for cash, or for a cash down-payment plus your note for the rest of the purchase price,
2) Purchase as described in (1) except that you also trade in a used asset,
3) Inheritance,
4) Gift,
5) Conversion of property held for personal use to a business asset, and
6) Exchange of other assets.

Basis is the amount of your investment in property for tax purposes. The basis of property you buy is usually its cost to you. However, if you get the property in some other way, such as by gift or inheritance, you normally must use a basis other than cost. You must know the basis of the property to figure your depreciation on it and your gain or loss on its sale or other disposition.

While you own the property, various events may take place that change your original basis in the property. These events increase or decrease the original basis. The result is called ''adjusted basis.''

To figure depreciation, use ''unadjusted basis.'' For information on depreciation, see Chapter 7.

Cost Basis

The basis of property you buy is usually its cost. The cost usually is the amount you pay for it in cash, other property, or debt obligations. Your cost includes amounts you pay for:

1) Sales tax,
2) Freight,
3) Installation and testing charges,
4) Excise tax,
5) Legal fees (when required to be capitalized),
6) Revenue stamps,
7) Recording fees, and
8) Real estate taxes if assumed for the seller.

Settlement fees or closing costs. Legal and recording fees are some of the settlement fees or closing costs included in the basis of property.

Assumption of a mortgage. If you buy property and assume an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a fishing vessel for $20,000, and assume a mortgage of $80,000 on it, your basis is $100,000.

Constructing assets. If you construct real or tangible personal property for use in your business, you must add to the basis (capitalize) direct costs, such as labor and materials, and an allocable part of most indirect costs that benefit the property. Indirect costs include depreciation, taxes, interest, and general administrative costs. If property is produced (constructed, built, installed, etc.) for you under a contract, treat it as produced by you to the extent that you make payments or otherwise incur costs for the property.

More information. For more information, see *Business Assets* in Publication 551.

Adjusted Basis

Before figuring any gain or loss on a sale, exchange, or other disposition of property, or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to basis. Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than one year and amounts spent after a casualty to restore the damaged property. One of the items added to the basis of property is legal fees, such as the cost of defending and perfecting title.

If you make additions or improvements to business property, keep separate accounts for them. Also, depreciate the basis of each according to the depreciation rules in effect when you place the addition or improvement in service. For more information, see *Additions or improvements to property* in Chapter 3 of Publication 946.

Decreases to basis. Decrease the basis of your property by any items that represent a return of capital. These include:

1) The section 179 deduction,
2) Recognized losses on involuntary exchanges,
3) Casualty losses,
4) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
5) The credit for qualified electric vehicles,
6) The deduction for clean-fuel vehicles, and clean-fuel vehicle refueling property,
7) Exclusions from income of subsidies for energy conservation measures,
8) Investment credit (part or all of credit) taken,
9) Casualty and theft losses, and
10) Certain canceled debt excluded from income.

Section 179 deduction. If you take the section 179 deduction for any part of the cost of property, decrease the basis of the property by the amount of the section 179 deduction. For more information, see Chapter 7.

Casualties and thefts. If you have a casualty or theft loss, decrease the basis of your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis by amounts you spend after a casualty to restore the damaged property. For more information, see Chapter 9.

Depreciation. Decrease the basis of your property by the amount of depreciation you could have deducted for the property on your tax returns under the method of depreciation you selected. If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by an amount equal to the depreciation you should have deducted as well as by that part of the excess depreciation you deducted that actually reduced your tax liability for any year. If you did not deduct any depreciation that you could have taken, then decrease the basis for depreciation you could have taken as explained in Chapter 7.

Gas-guzzler tax. Decrease the basis in your car by the gas-guzzler (fuel-economy) tax if you begin using the car within 1 year of the date of its first sale for ultimate use. This rule applies to someone who later buys the car and begins using it not more than 1 year after the original sale for ultimate use. If the car is imported, the one-year period begins on the date of entry or withdrawal of the car from the warehouse if that date is later than the date of the first sale for ultimate use.

Diesel-powered vehicle. If you received an income tax credit or refund for buying a diesel-powered highway vehicle, reduce your basis in that vehicle by the credit or refund allowable. For more information about this credit or refund, see Publication 378.

Credit for qualified electric vehicles. If you claim the credit for qualified electric vehicles, you must reduce the basis of the property on which you claimed the credit. For more information on this credit, see Chapter 15 in Publication 535.

Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property. If you take either the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, or both, you must decrease the basis of the property by the amount of the deduction. For more information on these deductions, see Chapter 15 in Publication 535.

Exclusion from income of subsidies for energy conservation measures. If you received a subsidy from a public utility company for the purchase or installation of any energy conservation measure, you can exclude it from income. If you exclude the subsidy from income, reduce the basis of the property on which you received the subsidy, by the amount of the subsidy. For more information on this subsidy, see Publication 525.

Canceled debt excluded from income. You may be required to reduce the basis of your property if you exclude canceled debt from income. You can exclude your canceled debt from income if the debt is:

1) Canceled in a title 11 bankruptcy case or when you are insolvent,
2) Qualified farm debt, or
3) Qualified real property indebtedness (provided you are not a C corporation).

If your canceled debt exclusion relates to 1) or 2), you must apply the amount excluded to reduce, in a prescribed order, certain of your tax attributes (including the basis of property, which is 5th in order). However, you can choose to first reduce the basis of depreciable property.

If your canceled debt exclusion relates to 3), you must apply the amount excluded to reduce the basis of your depreciable real property.

For more information on canceled debt in a bankruptcy case or during insolvency, see Publication 908, *Tax Information on Bankruptcy.* For information on canceled debt that is qualified farm debt, see Chapter 4 in Publication 225, *Farmer's Tax Guide.* For information on the cancellation of qualified real property indebtedness, see Chapter 7 in Publication 334, *Tax Guide for Small Business.*

Adjusted basis example. In 1990, you paid $40,000 for a used fishing boat. You also paid commissions of $2,000 and transportation charges of $1,600 for a total cost of $43,600. You spent $14,200 to make the boat ready for sea and placed the boat in service in 1990. In July 1993, you had a $2,000 casualty loss on the boat from a fire. The loss was not covered by insurance and you claimed it as a deduction. You spent $2,500 to repair the fire damage. You were allowed depreciation of $31,266 for the years 1990 through 1993. The adjusted basis of the boat as of January 1, 1994, is figured as follows:

Original cost, including fees and transportation		$43,600
Adjustments to basis:		
Add:		
Improvements		14,200
Repair of fire damage		2,500
		$60,300
Subtract:		
Depreciation	$31,266	
Casualty loss	2,000	33,266
Adjusted basis January 1, 1994		$27,034

For more information about basis, see Publication 551. For more information about depreciation, see Publication 534.

Other Basis

There are many times when you cannot use cost as basis. In these cases, the fair market value of the property, or the adjusted basis of certain property may be important.

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

Property Received for Services

If you receive property for services, include its FMV in income. The amount you include in income becomes your basis.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. Property becomes substantially vested when you can transfer it or it is not subject to a substantial risk of forfeiture. For more information, see the discussion on *Restricted Property Received for Services* in Publication 525.

Taxable Exchanges

A taxable exchange is one on which the gain is taxable or the loss is deductible. If you received property in exchange for other property in a taxable exchange, the basis of the property you received is usually its FMV at the time of the exchange.

Involuntary Exchanges

If you acquire property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you acquire using the basis of the property exchanged.

Similar or related property. If you receive property that is similar or related in service or use to the property exchanged, the new property's basis is the same as the old property's basis on the date of the exchange with the following adjustments:

1) Decreased by—
   a) Any loss recognized on the exchange, and
   b) Any money received that was not spent on similar property.
2) Increased by—
   a) Any gain recognized on the exchange, and
   b) Any cost of acquiring replacement property.

Not similar or related property. If you receive money or other property not similar or related in service or use to the old property and you buy new property that is similar or related in service or use to the old property, the basis of the new property is its cost, decreased by the amount of gain not recognized on the exchange. See *Replacement Property* in Chapter 9.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged. This rule applies to exchanges of property used in a trade or business or held for investment for property of a like kind. Depreciable tangible personal property may be either "like kind" or "like class."

Example. You exchange real estate (adjusted basis $50,000, FMV $80,000) held for investment for other real estate (FMV $80,000) held for investment. Your basis in the new property is the same as the basis of the old property ($50,000).

For more information, see *Nontaxable Exchanges* in Publication 544.

Property plus cash. If you trade property in a nontaxable exchange and pay money, the basis of the property you receive is the same as the basis of the property you exchanged increased by the money you paid.

Example. You trade in a truck (adjusted basis $3,000) for another truck (FMV $7,500) and pay $4,000. Your basis in the new truck is $7,000 ($3,000 basis of old truck plus $4,000 paid).

Related parties. There are special rules for exchanges of like-kind property between related persons. See *Special rules for related persons* under *Nontaxable Exchanges* in Publication 551.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the same as the basis of the old property:

1) Decreased by—
   a) Any money received, and
   b) Any loss recognized on the exchange.
2) Increased by—
   a) Any additional costs incurred, and
   b) Any gain recognized on the exchange.

If the other party to the transaction assumes your liabilities (including a nonrecourse obligation), treat them as money transferred to you on the exchange.

Allocate the basis among the properties, other than money, you received in the exchange. In making this allocation, the basis of the unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example 1. You exchange a truck (adjusted basis $6,000) for a new, smaller truck (FMV $5,200) and $1,000. You have a recognized gain of $200 ($6,200 minus $6,000) and your basis in the new truck is:

Adjusted basis of old truck	$6,000
Minus: Cash you received	1,000
	$5,000
Plus: Gain recognized	200
Basis of new truck	$5,200

Example 2. You had an adjusted basis of $15,000 in real estate you held for investment. You exchange it for $1,000, other real estate to be held for investment with an FMV of $12,500, and a pleasure boat with an FMV of $3,000. You have a gain of $1,500 recognized on the exchange. The basis of the properties you received is:

Adjusted basis of real estate transferred	$15,000
Minus: Cash received	1,000
	$14,000
Plus: Gain recognized	1,500
Total basis of properties received	$15,500

Allocate the total basis of $15,500 between the boat and the real estate. The basis of the boat is its FMV, $3,000, and the basis of the real estate is the remainder, $12,500.

Trade-in or sale and purchase. If a sale and purchase are a single transaction, you cannot increase the basis for depreciation of property by selling your old property outright to a dealer and then buying the new property from the same dealer. If the sale to the dealer of your old property and your purchase from that dealer of the new property are dependent on each other, you are considered to have traded in your old property. Treat the transaction as an exchange no matter how it is carried out.

Exchange—loss not recognized. If you have an exchange that results in an unrecognized loss, the basis of the new property is the same as the basis of the old property, decreased by any money received. Allocate this basis among the properties, other than money, received in the exchange. In making this allocation, the basis of unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example. You exchanged a fishing boat (adjusted basis $18,000) used in your business for a smaller fishing boat (FMV $14,000) to be used in your business, a truck (FMV $2,500) for personal use, and $500. Do not recognize the loss of $1,000 ($17,000 minus $18,000) on the exchange. Your basis of the properties you received is:

Adjusted basis of your old boat	$18,000
Minus: Cash you received	500
Total basis of the properties you received	$17,500

Of the total basis of $17,500, $2,500 is for the truck you received and the remaining $15,000 is the basis of your new boat.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, any gift tax paid on it, and the date it was given to you.

FMV less than donor's adjusted basis. If the FMV of the property was less than the donor's adjusted basis, your basis for gain on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustment to basis during the period you held the property (see *Adjusted Basis,* earlier). Your basis for loss on its sale or other disposition is its FMV at the time of the gift plus or minus any required adjustment to basis during the period you held the property (see *Adjusted Basis,* earlier).

If you use the donor's adjusted basis for figuring a gain and get a loss, and then use the FMV for figuring a loss and get a gain, you have neither gain nor loss on its sale or other disposition.

Business assets. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property (see *Adjusted Basis,* earlier).

FMV equal to or greater than donor's adjusted basis. If the FMV of the property was equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of the gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property or figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property.

Gift received before 1977. If you received a gift before 1977, increase your basis in the gift by the gift tax paid on it. (Your basis in the gift is the donor's adjusted basis.) However, do not increase your basis above the FMV of the gift when it was given to you.

Example 1. You were given a fishing boat in 1976 that had an FMV of $21,000. The donor's adjusted basis was $20,000. The donor paid a gift tax of $500. Your basis is $20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. If, in Example 1, the gift tax paid had been $1,500, your basis would be $21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the boat at the time you received the gift.

Gift received after 1976. If you received a gift after 1976, increase your basis in the gift by the part of the gift tax paid that is due to the net increase in value of the gift. (Your basis in the gift is the donor's adjusted basis.) Figure the increase by multiplying the gift tax paid on the gift by a fraction, the numerator (top part) of which is the net increase in value of the gift, and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. In 1994, you received a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. She paid a gift tax of $9,000. Your basis, $25,400, is figured as follows:

Fair market value	$50,000
Minus: Adjusted basis	20,000
Net increase in value	$30,000
Gift tax paid	$ 9,000
Multiplied by ($30,000 ÷ $50,000)	.60
Gift tax due to net increase in value	$ 5,400
Adjusted basis of property to your mother	20,000
Your basis in the property	$25,400

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse, or former spouse if the transfer is incident to divorce, is the same as the transferor's adjusted basis.

Adjust your basis for any gain recognized by the transferor on a property transferred in trust. This rule applies only to a property transferred in trust in which the sum of the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

The transferor must supply you with records necessary to determine the adjusted basis and holding period of the property as of the date of transfer.

For more information, see Publication 504.

Inherited Property

Your basis in property you inherit is usually its FMV at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its FMV at the alternate valuation date, if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if elected for estate tax purposes.

For more information, see *Inherited Property* in Publication 551.

4. Determining Your Income

Topics

This chapter discusses:

- Accounting periods
- Accounting methods
- Gross income

Useful Items

You may want to see:

Publication

- ❏ **378** Fuel Tax Credits and Refunds
- ❏ **538** Accounting Periods and Methods
- ❏ **541** Tax Information on Partnerships
- ❏ **915** Social Security Benefits and Equivalent Railroad Retirement Benefits

Form (and Instructions)

- ❏ **Sch C (Form 1040)** Profit or Loss From Business
- ❏ **Sch C–EZ (Form 1040)** Net Profit From Business
- ❏ **1128** Application To Adopt, Change, or Retain a Tax Year
- ❏ **3115** Application for Change in Accounting Method

This chapter discusses accounting periods and methods, and how to figure gross income. Every person who is subject to federal income tax must have an accounting period and an established accounting method. After you have selected your accounting period and method, you must use them to figure your gross income. For more information on accounting periods and methods, see Publication 538.

Accounting Periods

Every taxpayer must figure taxable income, and file a tax return, on the basis of an annual accounting period called a tax year.

Calendar or fiscal year. A tax year is usually 12 consecutive months. It may be a calendar year or a fiscal year. A calendar year is 12 consecutive months ending on December 31. Most fishermen use the calendar year. A fiscal year is 12 consecutive months ending on the last day of any month other than December.

Partnerships. A partnership must conform its tax year to the tax year of either its majority partners, its principal partners, or a tax year that results in the ''least aggregate deferral of income'' to the partners. It must be in that order, unless the partnership can establish a business purpose for using a different tax year, or makes a section 444 election. See Publication 541.

Establishing the tax year. If you have never filed an income tax return before, you may adopt either a calendar or a fiscal year. In certain situations, however, you will have to adopt the calendar year as your tax year. For example, if you do not maintain a set of books and records, you must use the calendar year. You also must use the calendar year if you have no annual accounting period or the one you have does not qualify as a fiscal year. The first tax year must be adopted by the time set by law, not including extensions, for the filing of a return for that tax year.

Changing your tax year. You must, with certain exceptions, get the approval of the Internal Revenue Service (IRS) to change your tax year by filing Form 1128. This form must be filed by the 15th day of the second calendar month after the close of the short tax year. This short tax year begins with the first day after the end of your present tax year and ends on the day before the opening date of your new tax year. For more information, see the instructions to Form 1128.

If your application is approved, you must file an income tax return for the short tax year. There are special rules for figuring the tax for a short tax year caused by a change in your tax year. See *Tax for short tax year* under *Short Tax Year,* in Publication 538.

Accounting Methods

The purpose of an accounting method is to clearly show income and expenses accurately. If this is achieved, it is a satisfactory method of accounting for income tax purposes. You must file your tax return using the same method as you use in keeping your records. The most common accounting methods are:

1) The cash method, and
2) The accrual method.

You may also use any combination of these methods that meets the needs of your business as long as your income is clearly shown. However, if inventories are necessary in accounting for your income, you must use an accrual method for your sales and purchases. Only the cash method of accounting is discussed here. See *Accounting Methods* in Publication 538 for information on accrual methods and other accounting methods.

Choosing your accounting method. In filing your first return, you may adopt any permissible accounting method without the consent of the IRS. You must use the same method from year to year and figure your taxable income following the accounting method you use to keep your books if that method clearly shows your income.

Cash method. With the cash method, you include in your gross income all items of income you ***actually or constructively receive*** during the year. Usually, you must deduct expenses in the tax year in which you actually pay them. However, if you pay expenses in advance, see *Expenses paid in advance,* later. You may also have an expense that you may need to capitalize. For information on this and other business expenses, see Chapter 5.

You have constructive receipt of income when an amount is credited to your account or made available to you without restriction as to the time or manner of payment. You do not need to have possession of it.

Example. You sell fish daily to a local fish house and you receive the payment on Tuesday of each week. On Tuesday, December 27, 1994, you did not pick up the payment and the fish house ticket. You picked up the payment on January 3, 1995. The payment is included in your gross income for 1994 because it was available to you in that year.

Delaying receipt of income. You cannot hold checks or similar property from one tax year to another to avoid paying the tax on the income. You must report the income in the year the property is received or available to you without restriction. If you authorize someone to be your agent and receive income for you, you are treated as having received that income when your agent receives it.

Expenses paid in advance. Expenses you pay in advance can be deducted only in the year to which they apply.

Example. You are a calendar year taxpayer and you pay $1,000 for an insurance policy that is effective on July 1, 1994, for a one-year period. You may deduct $500 in 1994, and $500 in 1995.

Two or more businesses. If you own more than one business, you may use a different accounting method for each separate and distinct business if the method you use for each business clearly shows its income. No business will be considered separate and distinct if you do not keep a complete and separate set of books and records for that business.

Example. You operate a fishing vessel and a retail grocery. You may use the cash method for the fishing business, but you must use an accrual method for the grocery business because inventories are necessary in accounting for income in this kind of business.

Limits on use of cash method. Generally, the cash method of accounting may not be used by:

1) Corporations (other than S corporations),
2) Partnerships having a corporation (other than an S corporation) as a partner, and
3) Tax shelters.

Note: An exception allows entities, except tax shelters, with average annual gross receipts of $5,000,000 or less over the last 3 tax years to continue using the cash method. This exception does not apply to a tax shelter.

Changing your method of accounting. When you file your first return, you may, without the consent of the IRS, choose any appropriate method of accounting. The method you choose must clearly show your income and this same method must be used from year to year. After that, if you want to change your method of accounting, you must first get the consent of the IRS.

A change in the method of accounting includes a change not only in your overall system of accounting but also in the treatment of any material item. For examples of changes requiring consent and the rules on how to get consent, see Publication 538. Also, see Form 3115.

Gross Income

Any income you receive, regardless of its source or whether it is in the form of cash, property, or services, must be reported on your tax return (Form 1040), unless it is specifically excluded by law.

Trades and exchanges. If you exchange property for services, services for services, or services for property, you must report the fair market value of the property or services you receive. This is called ***barter income.*** It includes such exchanges as fish for services or groceries, or the exchange of your services for fish or the services of another.

Reporting income. Report on Form 1040 your net profit from your fishing business and any compensation received for services, interest, dividends, rents, or royalties. Also, report any income from partnerships, estates, or trusts, and profits from the sales or exchanges of property that you may have received. You may also have to include a refund of excise taxes in income, as discussed in Publication 378.

One important source of income for you is from your fishing business (net profit shown on Schedule C or C–EZ (Form 1040)). Your gross sales or gross receipts is the first figure you must determine for your fishing business. Usually the sales figure on your income tax return will be taken from your annual summary for Schedule C entries. See Chapter 16.

Gross income from fishing. Your gross income from fishing includes any income you receive from the catching, taking, harvesting, cultivating, or farming of any kind of fish, shellfish (such as clams and mussels), crustacea (such as lobsters, crabs, and shrimp), sponges, seaweeds, or other aquatic forms of animal and vegetable life.

Exclusions. Some items specifically excluded from gross income are:

1) The increase in the value of business assets, if no sale or exchange takes place, except for items included in inventories.
2) Interest on tax-exempt obligations of any state, possession of the United States, or any political subdivision of the United States, or of the District of Columbia. Private activity bonds, arbitrage bonds, and bonds not in registered form are not included as tax-exempt bonds. Interest on U.S. Savings Bonds is not tax-exempt.
3) Loans from banks or individuals and money, other than interest, that you receive from others in repayment of loans receivable. However, this does not apply if you previously charged off the loan and the charge-off resulted in a decrease in your tax for any year.
4) Social security benefits from the federal government or from a state under the federal social security program if they are under a certain amount. See Publication 915.

5) War veterans' pensions and certain kinds of compensation received for personal injuries or sickness. Retirement pay based on age or length of service is not excluded.

Payments for alleged negligence. Amounts paid to commercial fishing boat owners, operators, and crew members as compensation for losses suffered because of alleged negligence are included in gross income. They may also be subject to self-employment tax. For more information on self-employment tax, see Chapter 11.

5.

Business Expenses

Important Changes for 1994

Standard mileage rate. The standard mileage rate for 1994 is 29 cents a mile for all business miles put on a light truck or car.

Meal and entertainment expenses. Beginning in 1994, you can deduct only 50% of the cost of your business meal and entertainment expenses.

Health insurance for self-employed persons. The 25% deduction for health insurance costs for self-employed persons expired for tax years beginning after December 31, 1993.

Caution. At the time this publication was being prepared for print, Congress was considering legislation to extend this provision. See Publication 553, *Highlights of 1994 Tax Changes,* for information on late legislative changes.

Important Reminder

Amortization of goodwill and certain other intangibles. You may be able to amortize goodwill and certain other intangible property held in connection with your trade or business or income-producing activity. The amortization is taken over a period of 15 years.

Topics

This chapter discusses:

- Not-for-profit fishing
- Taxes
- Capital expenses
- Repairs
- Salaries, wages, etc.
- Truck and car expenses
- Travel expenses
- Insurance
- Interest
- Losses from a fishing business
- Nondeductible expenses

Useful Items

You may want to see:

Publication

- ❑ **463** Travel, Entertainment, and Gift Expenses
- ❑ **529** Miscellaneous Deductions
- ❑ **535** Business Expenses
- ❑ **536** Net Operating Losses
- ❑ **587** Business Use of Your Home
- ❑ **917** Business Use of a Car
- ❑ **925** Passive Activity and At-Risk Rules

Form (and Instructions)

- ❑ **1040** U.S. Individual Income Tax Return
- ❑ **1040X** Amended U.S. Individual Income Tax Return
- ❑ **Sch A** (Form 1040) Itemized Deductions
- ❑ **1045** Application for Tentative Refund
- ❑ **5884** Jobs Credit
- ❑ **8829** Expenses for Business Use of Your Home

A person who operates a fishing business for profit can deduct the ordinary and necessary expenses of carrying on the fishing business. ***Ordinary*** means the expense is a common and accepted practice in the commercial fishing industry. ***Necessary*** means the expense is appropriate and helpful in developing and maintaining your fishing business. Some of the most common business expenses for a fishing business are discussed later in this chapter. For a discussion of depreciation, see Chapter 7.

Whether a fishing business is being operated for profit must be determined from all the facts and circumstances in each case. However, you will not ordinarily be considered to operate a fishing business for profit if you fish mainly for personal consumption, but derive some income from incidental sales. If you do not engage in fishing for profit, you must still include any income you have from that activity on your return.

Not-for-Profit Fishing

If your fishing activity is not carried on to make a profit, the deductions you can take for it are limited and no loss is allowed to offset other income. In determining whether you carry on your fishing activity for profit, your intentions are important, but all factors relating to your activity must be taken into account. No one factor or group of factors is decisive.

If you do not fish for profit, take deductions only in the following order, subject to certain limits, and only if you itemize them on Schedule A (Form 1040).

1) Deductions you can take for personal as well as for business activities are allowed in full.

2) Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent your gross income from the activity is more than the deductions you take (or could take) for it under the first category.

3) Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity is more than deductions you take (or could take) for it under the first two categories.

See *Not-for-Profit Activities* in Chapter 1 of Publication 535 for more information.

Presumption an activity is for profit. Your fishing activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years. The 5-year period includes the current year. If your activity passes this test, the limits discussed here do not apply. You can deduct all your business expenses from the fishing activity, even for the years you have a loss. See *Presumption of Profit* in Chapter 1 of Publication 535 for more information.

Taxes

You can deduct various taxes imposed by federal, state (including certain Indian tribal governments), local, and foreign governments that:

1) You incur in the ordinary course of your fishing business, and

2) Are directly attributable to the business.

You can deduct other taxes not related to your fishing business only if you itemize deductions on Schedule A (Form 1040). If you use the cash method of accounting, deduct taxes only in the year you pay them.

Deductible taxes. Some taxes you can deduct are briefly discussed below.

Real property taxes. You can usually deduct all taxes imposed on real property you own (such as a gear shed or net loft). However, fishermen who have only personal property for business assets (a boat, etc.) pay no real property tax on business property. These fishermen cannot deduct real property taxes as a business expense. If you own your home, however, you can deduct the real estate taxes you pay on Schedule A (Form 1040) if you itemize your deductions.

State or local income taxes. If you operate your fishing business as a sole proprietorship, the state income taxes you pay are not deductible as business expenses. You can deduct them as itemized deductions on Schedule A (Form 1040).

However, you can deduct a state tax on gross income directly attributable to your fishing business as a business expense.

Employment taxes. You can deduct federal unemployment taxes and the employer's part of social security and Medicare taxes as business expenses. For more information on employment taxes, see Chapter 12.

Other taxes. A fisherman can deduct as a business expense any tax imposed by a state or local government on personal property used in the fishing business. Personal property taxes are based on the value of the property. However, they may be based on weight or some other measure and still be deducted as business expenses.

Although the itemized deduction for state and local sales taxes on Schedule A (Form 1040) has been eliminated, you can still deduct any sales tax you pay in your fishing activity to the extent you can deduct the expense itself. For example, you can deduct any sales tax paid on a business meal as part of the meal expense subject to limits, discussed later, on meals in general. Any sales tax you pay to buy or sell depreciable property must be either included in the basis of the property or deducted from the amount realized for the property.

Nondeductible taxes. Federal income, estate, and gift taxes and state inheritance, legacy, and succession taxes are not deductible.

Capital Expenses

The cost of repairing, replacing, or improving property used in your fishing business is either a deductible or capital expense. A capital expense is an investment of capital either to get property with a useful life of more than one year or to make permanent improvements that increase the value of the property or appreciably prolong its life. Included in capital expenses are such things as commissions paid to acquire property and court costs in perfecting title.

Example. You maintain a slip and dock for your ships. When it was built, the sides of the dock were riprapped. Later you discovered that because of the propeller action of the ships using the slip, the riprap did not stay in place, requiring substantial annual expenses for maintenance of the dock.

To correct the situation and to eliminate the annual maintenance costs, you had the slip on the dock side sheet piled. The cost of the sheet piling was three times the annual maintenance cost. The sheet piling was a permanent improvement to the dock and a capital expense, as distinguished from an annual maintenance cost. You recover the cost by annual depreciation allowances for real property. See Chapter 7.

Replacements. You cannot deduct the cost of a replacement that stops deterioration and adds to the life of your property. Capitalize and depreciate it.

Amounts you pay to replace parts of an engine to keep it in normal operating condition are deductible business expenses. However, if the engine has a major overhaul, capitalize and depreciate the expense.

Improvements. The costs of making improvements to a business asset are capital expenses if the improvements add to the value of property, lengthen its life, or adapt it to a different use. They cannot be deducted in full as current business expenses. Ordinarily, the cost of the improvement is added to the basis of the improved property and depreciated. Examples of improvements are a new refrigeration unit or a new engine for your boat.

Capitalize the cost of reconditioning, improving, or altering your property as part of a general restoration plan to make it suitable for your business. This applies even if some of the work would by itself be classified as repairs.

Example. You bought a fishing boat that needed extensive repairs. To meet safety requirements and to make the boat usable in your business, you spent $10,000 repairing or replacing old engine parts, worn-out equipment, and deteriorated sections of the hull. You must capitalize the $10,000.

Business motor vehicles. Capitalize the cost of a motor vehicle you buy to use in your business. You recover its cost through annual depreciation deductions, as discussed in Chapter 7.

You can deduct repairs you make to your business vehicles. However, amounts you pay for reconditioning and overhaul of business vehicles are capital expenses.

Tools. Unless the uniform capitalization rules apply, you can deduct amounts spent for tools used in your business as business expenses if the tools have a life expectancy of less than one year.

Repairs

Repairs neither add to the value or usefulness of property nor appreciably lengthen its life. They merely maintain the property in a normal efficient operating condition. You can deduct the cost of repairs, including labor, supplies, and certain other items, as a business expense. However, you ***cannot*** deduct the value of your own labor.

Examples of common repairs are the cost of material and labor to paint your boat, mend your nets, or replace a deck plank.

Salaries, Wages, Etc.

You can generally deduct salaries, wages, and other forms of compensation paid to employees as business expenses if they are all of the following.

1) Ordinary and necessary expenses of carrying on your fishing business.
2) Reasonable in amount.
3) For personal services performed.
4) Paid or incurred during the tax year.

As a sole proprietor, you cannot deduct your own salary or any other withdrawals you make for your personal use. However, wages paid to your relatives, including a minor child, are deductible if the four requirements above are met.

Reduce your deduction for salaries and wages by the jobs credit determined for the tax year. See Form 5884 for more information.

Noncash payments. You do not have to pay compensation in cash. It may be in the form of meals, lodging, or part of the catch. If your crew members receive part of the catch for their services, you can deduct the fair market value of the fish on the date given. Your crew members include this amount in their incomes. You also must include in your gross income the fair market value of the fish given to your crew members. If your crew members receive a part of the catch for their services, the value of their part may be subject to income tax withholding, FICA, and FUTA. See Chapter 12.

Meals and lodging. Generally, you can deduct all of the costs you incur in furnishing meals and lodging to your employees if the costs must be included in your employees' pay. However, if you reimburse your employees for the costs they incur for meals and entertainment, you can deduct only 50% of the reimbursement (see *Crew meals,* next), and only if the expense would otherwise be deductible as a trade or business expense.

Crew meals. The 50% limit does not apply to the expense for food or beverages an employer provides to crew members of certain commercial vessels if federal law requires the meals (or would require them if the vessel operated at sea). This exception does not apply to vessels usually used for luxury water transportation, such as cruise ships or passenger liners.

Exclusion from income. If the meals and lodging you furnish your employees without charge meet the following three special rules, you can exclude their value from your employee's gross income. The value is not subject to FICA, FUTA, and income tax withholding.

1) The meals or lodging are furnished on your business premises.
2) The meals or lodging are furnished for your convenience.
3) For lodging (but not meals), the employees must accept it as a condition of their employment. This means acceptance of the lodging is required to allow them to properly perform the duties of their employment, such as when they must be available for duty at all times.

Truck and Car Expenses

You can deduct the cost of operating a truck, van, or car in your fishing business. You can deduct only the expenses for business use, including gasoline, oil, repairs, license tags, insurance, and depreciation.

Standard mileage rate. You can use the standard mileage rate instead of deducting the actual expenses for your vehicle. The standard mileage rate for 1994 is 29 cents a mile for all business miles put on your light truck or car.

If you want to use the standard mileage rate for a car in any year, you must choose to use the standard mileage rate in the first year you place the car in service in your business. In later years, you can use the standard mileage rate or actual expenses.

If you use the standard mileage rate in the first year, you have made an election not to use the modified accelerated cost recovery system (MACRS). You also cannot claim the section 179 deduction. If you change to the actual cost method in a later year, but before your car is considered fully depreciated, you have to estimate the useful life of the car and use straight line depreciation.

To use the standard mileage rate, you must:

1) Own the vehicle,
2) Not use the vehicle for hire (such as a taxi), and
3) Not use more than one vehicle at the same time for business.

Recordkeeping. You must prove your deductions for operating a vehicle by adequate records or by sufficient evidence that corroborates your own statement.

Your records must show when you started using your vehicle for business and the cost or other basis of the vehicle. Your records must show the business miles and total miles you drove your vehicle during the year. The level of detail for recording mileage may vary depending on the facts and circumstances.

For more information on the standard mileage rate, see Publication 917.

Commuting. You cannot deduct commuting expenses for travel between your home and the place where you regularly dock your boat.

Travel Expenses

You can deduct ordinary and necessary expenses you have in traveling away from home for your fishing business. However, you cannot deduct lavish or extravagant expenses. Your home, for tax purposes, is usually your home port where you begin and end your fishing trips. You are away from home if you are absent from your home port substantially longer than an ordinary work day and your duties require you to sleep or rest while away from home port.

If you meet these requirements and can prove the time, place, and business purpose of the travel, you can deduct your reasonable and necessary expenses for travel, meals, and lodging. See *Meals and lodging,* earlier, for limits on your deduction.

Travel expenses include:

1) Air, rail, bus, and car transportation.
2) Meals and lodging.
3) Cleaning and laundry expenses.
4) Telephone and telegraph expenses.
5) Transportation charges from where you obtain your meals and lodging to your boat.
6) Other similar ordinary and necessary expenses related to travel.
7) Tips incident to any of the above expenses.

Recordkeeping requirements. You must prove your deductions for travel, entertainment, and gift expenses. You should keep adequate records or have sufficient evidence to support your statement. Estimates or approximations are not proof of an expense.

Adequate records. You should keep the proof you need for travel, entertainment, and business gift expenses in an account book, diary, statement of expenses or similar record, and keep adequate documentary evidence that together support each element of an expense.

Instead of deducting the cost of meals and incidental expenses while traveling away from home for business, you can choose to deduct a standard meal allowance. If you choose this option, you do not have to keep records to prove the amount spent for meals. However, you must still prove the actual cost of other travel expenses as well as the time, place, and business purpose of your travel.

Reimbursements to employees. You can deduct as business expenses reimbursements and allowances to your employees for travel and transportation expenses they incur in the conduct of your business. If you require your employees to account to you and return any excess reimbursements, keep the records your employees give you to prove the expenses. In addition, you are subject to a 50% limit on the deduction for reimbursement of meals and entertainment expenses. For more information, see Chapter 16 of Publication 535.

Example. You take your boat and crew 200 miles from your home port to another port from which you intend to fish for 6 weeks. While in port, you and your crew stay in a motel and eat your meals in a restaurant. The crew members give you their receipts for meals and lodging. In this case you can deduct the meals, lodging, and other incidental expenses for yourself and amounts paid to your crew to cover these expenses as travel expenses (subject to the limits discussed earlier), if they are not lavish or extravagant.

Additional information. For additional information on travel and entertainment, including recordkeeping and the standard meal allowance amounts, see Publication 463.

Insurance

You can generally deduct the cost of insurance premiums for your fishing business as an expense.

Some deductible insurance premiums are:

1) Fire, theft, flood, and other casualty insurance on your business property (for example, hull insurance).
2) Liability insurance (protection and indemnity).
3) Workers' compensation insurance.
4) State unemployment insurance fund contributions.
5) Car and other vehicle insurance premiums on policies covering vehicles used in your fishing business. If you use the vehicles only partly for business, you can deduct only the part of your insurance premiums for the business use of the vehicle.

Business insurance premiums are ordinarily deducted in the tax year to which they apply. Premiums you pay in advance can be deducted only in the tax years to which they apply.

Example. You operate your own fishing boat and file your returns on a calendar year basis. You purchased a fire insurance policy on your boat effective October 1, and paid in advance a premium of $1,500 for 3 years. You can deduct $125 for the 3 months of insurance expense in the first year (¼ of ⅓ of $1,500), $500 in the 2nd year, $500 in the 3rd year, and $375 for the 9 months of insurance expense in the 4th year.

Interest

Interest is the amount you pay for the use of borrowed money. You can generally deduct all interest you pay or accrue during the tax year on debts related to your fishing business. The interest must be on a debt under which you have a legal obligation to pay a fixed or determinable sum of money. For more information, see Chapter 8 of Publication 535.

Prepaid interest. Under the cash method, you cannot generally deduct any interest paid before the year it is due. Charge interest you pay that is properly allocable to a later tax year to a capital account. Treat an advance payment as paid in the period covered by the prepaid interest.

Under the accrual method, if you pay interest in advance, deduct it only as it accrues. This rule also applies to the amount subtracted on a discounted loan.

Other Business Expenses

The following are some of the other business expenses you may have in your fishing business.

Business start-up costs. If you set up or acquire an active fishing business, you can choose to amortize certain amounts you spend in setting up the business or investigating the creation or acquisition of the business. You can amortize these costs over a period of 60 months or longer, starting with the month you begin the business. If you dispose of the entire fishing business before the end of the 60-month (or longer) period, you can deduct the unamortized costs to the extent they qualify as a business loss. See Chapter 12 of Publication 535 for more information.

Amortization of goodwill and certain other intangibles. You can amortize goodwill and certain other intangible property held in connection with your trade or business or income-producing activity. The amortization is taken over a period of 15 years. This rule applies to property acquired after August 10, 1993 (or earlier, if elected). This property is called section 197 property. For more information on section 197 intangible property, see Chapter 12 in Publication 535.

Business use of your home. If you use part of your home ***exclusively and regularly*** as the principal place of business for your trade or business or as a place where you meet or deal with clients or customers, you can deduct the expenses for the business part of your home.

A structure not attached to your home, such as a garage, may qualify if it is used exclusively and regularly for your business.

The deductions for operating expenses, depreciation, etc., for the business use of your home are limited. The total of your deductions for otherwise nondeductible expenses, such as utilities, insurance, and depreciation (with depreciation taken last), cannot be more than the gross income from the business use of your home minus the sum of:

1) The business percentage of the otherwise deductible mortgage interest, real estate taxes, and casualty and theft losses, and
2) The business expenses not attributable to the business use of your home (for example, salaries or supplies).

You do not have to use a particular method of recordkeeping. However, you must keep records that provide the information needed to figure your deduction for the business use of your home.

If you file as a sole proprietor and use part of your home for business, figure the deduction on Form 8829 and attach it to your Form 1040 along with the Schedule C (Form 1040). For additional information, see Publication 587.

Rent. Rent is an amount you pay for the use of property you do not own. You can generally deduct rent as an expense only for property you use in your business. If you pay rent in advance, you can deduct in the year paid only the amount that applies to your use of the rented property during that tax year. Deduct the remainder over the period it covers.

Example. In May 1994, you leased moorage space for your fishing boat for 5 years beginning July 1, 1994, and ending June 30, 1999. You will pay a yearly rental of $360. You paid the first year's rent ($360) on June 1, 1994. On your income tax return for calendar year 1994, you can deduct only $\frac{6}{12}$ of $360, or $180, for the rent applicable to 1994.

Legal and professional fees. You can deduct as business expenses legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses of operating your fishing business and directly related to your business. However, if the charges include payments for work of a personal nature, such as making a will, you can take a business deduction only for the part of the fee related to your business. Legal fees for producing or collecting taxable income, doing or keeping your job, or for tax advice may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529.

Tax preparation fees. You can deduct as a business expense on Schedule C (Form 1040) the cost of preparing that part of your tax return relating to your fishing business. The remaining cost is deductible on Schedule A (Form 1040) if you itemize your deductions.

You can also take a business deduction on Schedule C for the amount you pay or incur in resolving asserted tax deficiencies for your fishing business.

Miscellaneous expenses. Miscellaneous business expenses, such as galley supplies, bait, ice, and fuel for your boat, are deductible business expenses. Licenses and regulatory fees you pay annually to state or local governments also are deductible business expenses.

Losses From a Fishing Business

If you have a loss in the operation of your fishing business during the year, or you had a casualty or theft loss that was more than your income, you may have a net operating loss (NOL). You can use an NOL to reduce your income (and tax) in other years by carrying it to those years and deducting it from income. However, the at-risk limits, discussed later, may limit how much of your NOL you can carry to the other years.

Net operating losses. If your deductions for the year are more than your gross income, you may have an NOL. However, there are rules that limit what you can deduct when figuring an NOL. These rules are discussed under *How To Figure an NOL* in Publication 536.

It is important for you to determine whether you have an NOL. If you have an NOL this year, you may be able to get part or all of the income tax you paid for the past 3 tax years refunded or you may be able to reduce your tax in future years.

Carrybacks. You generally carry an NOL back to the 3 tax years before the NOL year and deduct it from income in those years. There are rules for figuring how much of the NOL you use in each tax year and how much you carry to the next tax year. These rules are explained under *When To Use an NOL* in Publication 536.

Unless you choose to forgo the carryback period (as discussed later), first carry your NOL to the third tax year before the NOL year. If it is not all used that year, carry the unused part to the next year, the second year before the NOL year. If it is not all used in the second year, carry the remaining unused part to the next tax year, the year before the NOL year.

Refigure your deductions, credits, and tax for each of the 3 carryback years to which you carried an NOL. If your refigured tax is less than the tax you originally paid, you can apply for a refund by filing Form 1040X for each year affected or by filing Form 1045. You will usually get a refund faster by filing Form 1045, and you can use one Form 1045 to figure the overpayment of tax for all 3 carryback years.

Carryovers. If you do not use the entire NOL in the 3 carryback years, carry what remains forward to the next 15 tax years following the NOL year. Carry it to the first tax year after the NOL year and continue to carry over any unused part of the NOL until you complete the 15-year carryforward period.

Forgoing the carryback period. You can choose not to carry back your NOL. If you make this choice, you may then use your NOL only in the 15-year carryforward period. To make this choice, attach a statement to your tax return for the year you have the NOL showing you choose to forgo the carryback period. For more information about making the choice, see *Forgoing the carryback period* under *When To Use an NOL* in Publication 536.

Partnerships and S corporations. Partnerships and S corporations cannot take an NOL deduction. Each partner or shareholder figures his or her individual NOL based on a separate share of the partnership's or S corporation's loss.

At-risk limits. Rules that limit your deduction for losses apply to most business or income-producing activities. Fishing is one of the activities covered. The at-risk rules limit the loss you can deduct when figuring your taxable income or an NOL. The deductible loss from an activity is limited to the amount you have at risk in the activity.

You are generally at risk up to the amount of money and property you contribute to an activity, plus certain amounts borrowed for use in the activity. You are at risk for amounts borrowed for use in the activity if you are personally liable for repayment of the amounts borrowed or if the amounts borrowed are secured by property not used in the activity. You are not at risk, however, for amounts borrowed for use in a fishing activity from a person who has an interest in the activity or a person related to someone (other than you) having such an interest. For more information, see Publication 925.

Passive activity limits. If you are involved in a passive activity, special rules limit the loss you can deduct in the tax year. Generally you cannot deduct losses from passive activities in the tax year that exceed income from all other passive activities. Credits are similarly limited.

A ***passive activity*** is generally any activity involving the conduct of any trade or business in which you do not materially participate. A rental activity is also a passive activity unless you materially participate in a real property trade or business and meet certain qualifications.

For more information, read Publication 925.

Nondeductible Expenses

You cannot deduct the following:

Fines and penalties. You cannot deduct fines and penalties for violating federal or state laws, even if they are called adjustments or any other name or if the violations are inadvertent. You also cannot deduct fines and penalties paid to a foreign government for violating its laws.

Bribes and kickbacks. You cannot deduct bribes, kickbacks, or similar payments if they are either of the following:

1) Payments made directly or indirectly to an official or employee of any government or an agency or instrumentality of any government in violation of the law. If the government is a foreign government, the payments are not deductible if they are unlawful under the Foreign Corrupt Practices Act of 1977.

2) Payments made directly or indirectly to a person in violation of any federal or state law (but only if that state law is generally enforced) that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

6. Retirement Plans

Important Change for 1994

New compensation limit. Compensation of a participant that can be taken into account for computing contributions to a Keogh or SEP plan is generally limited to $150,000 for plan years beginning on or after January 1, 1994. See *Deduction Limits* under *Keogh Plans* for more information.

Topics

This chapter discusses:

- Qualified plans
- Kinds of qualified plans
- Plans for the self-employed
- Keogh plans
- Simplified employee pensions (SEPs)
- Salary reduction arrangements
- Nonqualified plans
- Individual retirement arrangements (IRAs)

Useful Items

You may want to see:

Publication

- ❏ **533** Self-Employment Tax
- ❏ **560** Retirement Plans for the Self-Employed
- ❏ **590** Individual Retirement Arrangements (IRAs)
- ❏ **937** Employment Taxes

Form (and Instructions)

- ❏ **W–2** Wage and Tax Statement
- ❏ **5305–SEP** Simplified Employee Pension–Individual Retirement Accounts Contribution Agreement
- ❏ **5305A–SEP** Salary Reduction and Other Elective Simplified Employee Pension–Individual Retirement Accounts Contribution Agreement
- ❏ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Pension Benefit Plan

Retirement plans are savings plans that offer you tax advantages to set aside money for your own and your employees' retirement.

In general, ***a sole proprietor or a partner is considered an employee*** for purposes of participating in a retirement plan.

Funding the plan. A retirement plan you establish as an employer can be funded entirely by employer contributions or by a mix of employer and employee contributions. Employee contributions may not satisfy the minimum funding requirements for your plan. Employee contributions can be voluntary or mandatory. For example, a retirement plan can require after-tax employee contributions that do not by themselves meet the minimum funding requirements.

Although they are considered ***employer contributions,*** a plan can allow your employees to make ***elective deferrals.*** This allows employees (including yourself) to elect to have you contribute part of their current compensation (pay) to a retirement plan. Only the remaining portion of their pay is currently taxable. The income tax on the contributed pay (and earnings on it) is ***deferred.***

Employer contributions to an employer-sponsored retirement plan are generally deductible as discussed later under *Deduction Limits.*

Kinds of plans. Employer retirement plans are either:

- Qualified plans (includes retirement plans for the self-employed, such as HR–10 (Keogh) plans and simplified employee pensions (SEPs)), or
- Nonqualified plans.

Also, in general, individuals who are employed can set up and contribute to individual retirement arrangements (IRAs).

Qualified Plans

A qualified retirement plan is a written plan that you can establish for the exclusive benefit of your employees and their beneficiaries.

Contributions to the plan may be made by you, or by both you and your employees. If your plan meets the qualification requirements, you can generally deduct your contributions to the plan when you make them, except for any amount capitalized. For more information, get Publication 560.

Your employees generally are not taxed on your contributions or increases in the plan's assets until they are distributed to them. However, certain loans made from qualified employer plans are treated as taxable distributions. For more information, get Publication 575.

Qualification rules. To be a qualified plan, the plan must meet many requirements. Among these are rules concerning:

- Who must be covered by the plan,
- How contributions to the plan are to be invested,
- How contributions to the plan and benefits under the plan are to be determined, and
- How much of an employee's interest in the plan must be guaranteed (vested).

For more information, get Publication 560.

Nondiscrimination rules. To prevent discrimination in a plan caused by using separate businesses (and separate plans), all employees of certain related employers are treated as if employed by a single employer. For example, employees of commonly controlled businesses or affiliated service groups are treated as working for a single employer.

Kinds of Qualified Plans

There are two basic kinds of qualified retirement plans:

1) Defined contribution plans, and

2) Defined benefit plans.

Table 6-1. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution		Time Limit to Begin Distributions[1]
IRA	Due date of income tax return (NOT including extensions)	Smaller of $2,000 or taxable compensation		April 1 of year after year you reach age 70½
SEP–IRA	Due date of employer's return (Plus extensions)	Smaller of $30,000 or 15%[2] of participant's taxable compensation[3]		April 1 of year after year you reach age 70½
Keogh	Due date of employer's return (plus extensions). (To make contributions for a year to a new plan, the plan must be set up by the last day of the employer's tax year.)	**Defined Contribution Plans**		April 1 of year after year you reach age 70½ (unless the participant reached age 70½ before 1988, in which case the distributions must begin by the year he or she retires)
		Employee	**Self-Employed Individual**	
		Money Purchase–Smaller of $30,000 or 25% of employee's taxable compensation	***Money Purchase***–Smaller of $30,000 or 20% of self-employed participant's taxable compensation[4]	
		Profit-Sharing– Smaller of $30,000 or 15% of employee's taxable compensation	***Profit-Sharing***– Smaller of $30,000 or 13.0435% of self-employed participant's taxable compensation[4]	
		Defined Benefit Plans		
		Amount needed to provide an annual retirement benefit no larger than the smaller of $118,800 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years		

[1] Distributions of at least the required minimum amount must be made each year i f the entire balance is not distributed.
[2] 13.0435% of the self-employed participant's taxable compensation before adjust ment for this contribution.
[3] Contributions are made to each participant's IRA (SEP-IRA) including that of any self-employed participant.
[4] Compensation is before adjustment for this contribution.

Defined Contribution Plans

These are plans that provide for a separate account for each person covered by the plan. Benefits are based only on amounts contributed to or allocated to each account.

There are ***three types*** of defined contribution plans:

1) Profit-sharing plans,
2) Stock bonus plans, and
3) Money purchase pension plans.

Profit-sharing plan. This is a plan that lets your employees or their beneficiaries share in the profits of your business. The plan must have a definite formula for allocating the contributions to the plan among the participating employees and for distributing the funds in the plan.

Stock bonus plan. This plan is similar to a profit-sharing plan, but it can only be set up by a corporation. Benefits are payable in the form of the company's stock.

Money purchase pension plan. Under this plan, your contributions are a stated amount, or are based on a stated formula that is not subject to your discretion. For example, your formula could be 10% of each participating employee's compensation. Your contributions to the plan are not based on your profits.

Defined Benefit Plans

These are any plans that are not defined contribution plans. In general, a qualified defined benefit plan must provide for set benefits. Your contributions to the plan are based on actuarial assumptions. You may need continuing professional help to have a defined benefit plan.

Plan Approval

The Internal Revenue Service (IRS) will issue a determination or opinion letter regarding a plan's qualification. The determination or opinion of the IRS will be based on how the plan is written, not on how it operates.

You are not required to request a determination or opinion letter to get all the tax benefits of a plan. But, if your plan does not have a determination letter, you may want to request one to ensure that your plan meets the requirements for tax benefits.

Because requesting a determination, opinion, or ruling letter can be complex, you may need professional help. Also, the IRS charges a fee for issuing these letters. For more information, get Publication 1380, *User Fees.*

Master and prototype plans. It may be easier for you to adopt an existing IRS-approved master or prototype retirement plan than to set up your own original plan. Master and prototype plans can be provided by the following sponsoring organizations:

- Trade or professional organizations,
- Banks (including some savings and loan associations and federally insured credit unions),
- Insurance companies, or
- Mutual funds.

Adoption of a master or prototype plan does not mean that your plan is automatically qualified. It must still meet all of the qualification requirements stated in the tax law.

Retirement Plans for the Self-Employed

If you are a self-employed person, you can set up certain qualified retirement plans. See *Qualified Plans,* earlier. These plans are generally called HR–10 or Keogh plans. You can also set up a less complicated tax-advantaged retirement plan. See *Simplified Employee Pension (SEP),* later.

Keogh Plans

Only a sole proprietor or a partnership (not a partner) can set up a Keogh plan. For plan purposes, a self-employed person is both an employer and an employee. It is not necessary to have employees besides yourself to set up a Keogh plan. The plan must be for the exclusive benefit of employees or their beneficiaries. You can generally deduct contributions to the plan. Contributions are not taxed to your employees until plan benefits are distributed to them.

Certain boat crew members treated as self-employed. A crew member will be considered self-employed if he or she serves on a fishing boat under an arrangement providing pay only in the form of a share of the boat's catch. This also applies if the operation involves more than one boat's catch, or a share of the proceeds from the sale of the catch. The share must depend on the size of the boat's (or boats') catch. Also, the operating crew of the boat (or each boat from which the member gets a share) must normally be made up of fewer than 10 persons. See Chapter 12.

Deduction Limits

The limits differ depending on the kind of plan you have. If your plan is a ***defined contribution plan,*** the limit for each employee generally is the lesser of $30,000 or

- 15% of the employee's taxable compensation (pay) if your plan is a profit-sharing plan, or
- 25% of the employee's taxable compensation, if your plan is a money purchase pension plan.

The maximum compensation that can be taken into account for these limits is generally $150,000 for plan years beginning in 1994.

Note: For employees in a collective bargaining unit covered by a plan for which the $150,000 limit is not effective for the plan year beginning in 1994, the compensation limit is $242,280.

The deduction limit for contributions to a ***defined benefit plan*** may be greater than the defined contribution plan limits just described, but actuarial calculations are needed to determine the amount. For more information, see *Kinds of Plans* in Publication 560.

Deduction of contributions for yourself. To take a deduction for employer contributions made for your benefit to a plan, you must have ***net earnings*** from the trade or business for which the plan was established.

Limit on deduction. If the Keogh plan is a ***profit-sharing plan,*** your deduction of employer contributions for yourself is limited to the smaller of $30,000 or 13.0435% (15% reduced as discussed below) of your net earnings from the trade or business that has the plan. If the plan is a ***money purchase pension plan,*** the deduction is limited to the smaller of $30,000 or 20% (25% reduced as discussed below) of your net earnings.

Net earnings. Your net earnings must be from self-employment in a trade or business where your personal services are a material income-producing factor. Therefore, if you are a partner who only contributed capital, and who did not perform personal services, you cannot participate in the partnership's plan. Your net earnings do not take into account tax-exempt income (or deductions related to that income) other than foreign earned income and foreign housing cost amounts.

Your net earnings is your business gross income minus allowable deductions from that business. Allowable deductions include contributions to the plan for your common-law employees along with your other business expenses. If you are a partner, other than a limited partner, your net earnings include your distributive share of the partnership income or loss (other than separately computed items such as capital gains and losses) and any guaranteed payments you receive from the partnership. If you are a limited partner, your net earnings include only guaranteed payments you receive for services rendered to or for the partnership. For more information, see *Partners* under *Self-Employment Income,* in Publication 533.

Adjustments. You must reduce your net earnings by the income tax deduction you are allowed for one-half of the self-employment tax. Also, net earnings must be reduced by the deduction for employer contributions made for your benefit. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. To reduce net earnings by the employer deduction for contributions for yourself presents a problem. This is because the deduction and net earnings depend on each other. You can make this adjustment to your net earnings indirectly by, in figuring your maximum deduction, reducing the contribution rate called for in the plan.

Figuring your deduction. Use the following worksheet to find the reduced contribution rate. Make no reduction to the contribution rate for any common-law employees.

Self-Employed Person's Rate Worksheet

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	______
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	______
3) Self-employed rate as a decimal (divide line 1 by line 2)	______

Now that you have your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps:

Self-Employed Person's Deduction Worksheet

Step 1 Enter the contribution rate shown in line 3 above	______
Step 2 Enter your net earnings from: line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065).	$
Step 3 Enter your deduction for self-employment tax from line 25, Form 1040	$
Step 4 Subtract Step 3 from Step 2 and enter the result	$
Step 5 Multiply Step 4 by Step 1 and enter the result	$
Step 6 Multiply $150,000 by your plan contribution rate. Enter the result but not more than $30,000	$
Step 7 Enter the smaller of Step 5 or Step 6. This is your ***maximum deductible contribution.*** Enter your deduction on Line 27, Form 1040	$

Example. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation (defined earlier), and 10½% of your common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) is $200,000. In figuring this amount, you deducted your common-law employees' pay of $100,000 and contributions for them of $10,500 (10½% × $100,000). You figure your self-employed rate and maximum deduction for employer contributions for your benefit as follows:

Self-Employed Person's Rate Worksheet

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	0.105
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	1.105
3) Self-employed rate as a decimal (divide line 1 by line 2)	0.0950

Self-Employed Person's Deduction Worksheet

Step 1 Enter the contribution rate shown in line 3 above	0.0950
Step 2 Enter your net earnings from: line 31, Schedule C (Form 1040); line 3, Schedule C–EZ (Form 1040); line 36, Schedule F (Form 1040); or line 15a, Schedule K–1 (Form 1065).	$200,000
Step 3 Enter your deduction for self-employment tax from line 25, Form 1040	$ 6,435
Step 4 Subtract Step 3 from Step 2 and enter the result	$193,565

Step 5 Multiply Step 4 by Step 1 and enter the result	$ 18,389
Step 6 Multiply $150,000 by your plan contribution rate. Enter the result but not more than $30,000	$ 15,750
Step 7 Enter the smaller of Step 5 or Step 6. This is your ***maximum deductible contribution.*** Enter your deduction on Line 27, Form 1040	$ 15,750

When to make contributions. To take a deduction for contributions for a particular year, you must make the contributions not later than the due date (plus extensions) of your return for that year.

Additional information on retirement plans for the self-employed and on the reporting forms that must be filed for these plans can be found in Publication 560.

Simplified Employee Pension (SEP)

A simplified employee pension (SEP) is a written plan that allows you to make deductible contributions toward your own and your employees' retirement, without getting involved in more complex retirement plans. A corporation can have a SEP. But some advantages available to Keogh and other qualified plans, such as the special averaging treatment that may apply to lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to an individual retirement arrangement (called a SEP–IRA in this chapter), which is owned by you or your common-law employee.

SEP–IRAs are set up for, at a minimum, each ***qualifying employee.*** A SEP–IRA may have to be set up for a ***leased employee,*** but need not be set up for an ***excludable employee.*** For more information, get Publication 560.

You may be able to use ***Form 5305–SEP*** in setting up your SEP.

Employer contributions. You can contribute each year to each employee's SEP–IRA up to the smaller of $30,000 or 15% of the employee's ***compensation*** (determined without regard to your contributions to the employee's SEP–IRA). If you are self-employed, SEP contributions you make to ***your SEP–IRA,*** because a special computation is required, are limited to 13.0435% of your compensation. See *Figuring your deduction* under *Retirement Plans for the Self-Employed,* earlier. Make no reduction to the contribution rate for any common-law employees.

Your contributions are not included in a participant's income when contributed.

Your employees cannot take a deduction for your SEP contribution.

SEP and profit-sharing plans. If you also contributed to a qualified profit-sharing plan, you must reduce the 15% deductible limit for that plan by the allowable deduction for contributions to the SEP–IRAs of those participating in the profit-sharing plan.

SEP and other qualified plans. If you also contributed to any other type of qualified plan, treat the SEP as a separate profit-sharing plan for purposes of applying the overall 25% deduction limit described in section 404(h)(3) of the Internal Revenue Code.

Employee contributions. Participants can also make contributions of up to $2,000 to their SEP–IRAs independent of your SEP contributions. The portion of the contributions that is deductible may be reduced or eliminated because the participant is covered by an employer retirement plan (the SEP plan). See Publication 590 for details.

Salary Reduction Arrangement

A SEP can include a salary reduction (elective deferral) arrangement. Under the arrangement, employees can elect to have you contribute part of their pay to their SEP–IRAs. The tax on the part contributed is deferred. This choice is called an elective deferral. This election is available only if:

- At least 50% of your employees eligible to participate choose the salary reduction arrangement,
- You had no more than 25 employees who were eligible to participate in the SEP (or would have been eligible to participate if you had maintained a SEP) at any time during the preceding year, and
- The deferral each year by each eligible ***highly compensated employee*** (as defined in Publication 560) as a percentage of pay (deferral percentage) is no more than 125% of the average deferral percentage (ADP) of all nonhighly compensated employees eligible to participate (the ***ADP test***). For plan years beginning in 1994, you generally cannot consider compensation of an employee in excess of $150,000 in figuring an employee's deferral percentage.

Note: For employees in a collective bargaining unit covered by a SEP for which the $150,000 limit is not effective, the compensation limit is $242,280.

Limits on deferrals. In general, the total income an employee can defer under a salary reduction arrangement included in a SEP and certain other elective deferral arrangements for 1994 is limited to $9,240. This limit applies only to the amounts that represent a reduction from the employee's pay, not to any contributions from employer funds.

Employment taxes. Elective deferrals, not exceeding the ADP test, are not subject to income tax in the year of deferral, but are included in wages for social security, Medicare, and unemployment (FUTA) tax purposes.

Reporting SEP Contributions on Form W–2

Your SEP contributions are excluded from your employees' income. Therefore, unless there are contributions in excess of the applicable limit, or unless there are contributions under a salary reduction arrangement, do not include these contributions in your employees' wages on Form W–2 for income, social security or Medicare tax purposes. Your SEP contributions ***under a salary reduction arrangement*** are included in your employees' Form W–2 wages for social security and Medicare tax purposes only.

Example. In 1994, Jim chooses to have $4,500 taken out of his pay to fund employer contributions to his SEP–IRA. His compensation for the year is $30,000. On Jim's Form W–2, his employer will show total wages of $25,500 ($30,000 minus $4,500) for income tax and $30,000 for social security and Medicare wages. Jim will report $25,500 as wages on his tax return.

For more information on employer withholding requirements, get Publication 937.

For more information on SEPs, get Publication 560.

Nonqualified Plans

You can deduct contributions made to a nonexempt trust or premiums paid under a nonqualified annuity plan. Your employees generally must include the contributions or premiums in their gross income.

Deduct your contributions to the plan in the tax year in which any of your employees must include an amount attributable to the contributions in their gross income. You can deduct contributions only if you maintain separate accounts for each participating employee.

Transferable interest. When an employee's interest in your contributions or premiums for that employee is transferable, the employee must include those amounts in gross income for the tax year in which you make them. This rule also applies if the employee's interest is not subject to a substantial risk of forfeiture (that is, there is not much of a risk that the employee will lose his or her interest) when you make contributions or pay premiums for that employee.

Nontransferable interest. If, when you make the contributions, the employee's interest in the trust or in the value of the annuity contract is not transferable and is subject to a substantial risk of forfeiture, the employee does not include that interest in gross income until the tax year in which the interest becomes transferable or is no longer subject to a substantial risk of forfeiture.

Individual Retirement Arrangements (IRAs)

You can set up and make contributions to an individual retirement arrangement (IRA) if you received taxable ***compensation*** during the year and have not reached age 70½ by the end of the year. You can have an IRA whether or not you are covered by any other retirement plan. However, you may not be able to deduct any or some of your contributions if you or your spouse are covered by an employer's retirement plan.

Compensation. Compensation includes taxable wages, salaries, commissions, bonuses, tips, professional fees, self-employment income (subject to certain adjustments, discussed below, and providing your personal services are a material income-producing factor), other amounts received for personal services, and taxable alimony and separate maintenance payments.

If you are an employee, compensation includes any amount properly shown in box 1 (wages, tips, other compensation) of Form W–2, provided that amount is reduced by any amount shown in box 11 (nonqualified plans).

If you are self-employed (a sole proprietor or partner), compensation is the net earnings of your trade or business (self-employment income) reduced by the deduction for contributions on your behalf to retirement plans and the deduction allowed for one-half of your self-employment tax.

Compensation does ***not*** include:

- Income received from property, such as rental, interest, or dividend income, or
- Any amounts received as a pension or annuity, or as deferred compensation.

Foreign income. Foreign earned income and other amounts that are excluded from gross income are ***not*** compensation for IRA purposes.

Contributions. The most you can contribute for any year to your IRA is the ***smaller*** of:

- $2,000, or
- Your taxable compensation.

Deductible and nondeductible contributions. Generally, you can take a deduction for the contributions you are allowed to make to your IRA. However, if you or your spouse is covered by an employer retirement plan at any time during the year, your IRA deduction may be reduced or eliminated, depending on your filing status and the amount of your income. Whether or not your allowable contributions are deductible, you can choose to make nondeductible contributions to your IRA. For details on these and other rules, as well as general information on IRAs, get Publication 590.

7. Depreciation

Important Change for 1994

Limits on depreciation for business cars. The total section 179 deduction and depreciation you can take on a car that you use in your business and first place in service in 1994 is $2,960. Your depreciation cannot exceed $4,700 for the second year of recovery, $2,850 for the third year of recovery, and $1,675 for each later tax year. See Publication 917.

Important Reminders

Deductions for clean-fuel vehicles and certain refueling property. Deductions are allowable for clean-fuel vehicles and certain clean-fuel vehicle refueling property placed in service after June 30, 1993. For information on the deductions, see Chapter 15 in Publication 535.

Tax credit for qualified electric vehicles. An electric vehicle tax credit is available for qualified electric vehicles placed in service after June 30, 1993. For more information, see Chapter 15 in Publication 535.

Topics

This chapter discusses:

- General information on depreciation
- The section 179 deduction
- The Modified Accelerated Cost Recovery System (MACRS)
- Listed property

Useful Items

You may want to see:

Publication

- ❏ **534** Depreciation
- ❏ **535** Business Expenses
- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **551** Basis of Assets
- ❏ **587** Business Use of Your Home
- ❏ **917** Business Use of a Car
- ❏ **946** How To Begin Depreciating Your Property

Form (and Instructions)

- ❏ **1040X** Amended U.S. Individual Income Tax Return
- ❏ **4562** Depreciation and Amortization
- ❏ **4797** Sales of Business Property

If you buy business property that has a useful life of more than a year, you generally cannot deduct its entire cost in one year. Instead, you must spread the cost over more than one year and deduct a part of it each year. For most types of property, this is called ''depreciation.''

This chapter gives you basic information on depreciation, the section 179 deduction, the Modified Accelerated Cost Recovery System (MACRS), and the rules that apply to listed property. MACRS is the depreciation system that applies to property placed in service after 1986. If you need information on the depreciation methods for property used before 1987, see Publication 534.

Form 4562. Use Form 4562 to report your depreciation deduction, including the section 179 deduction.

File Form 4562 only if:

1) You are claiming depreciation on property placed in service this year,
2) You are claiming a section 179 deduction,
3) You are beginning to claim amortization this tax year,
4) You are claiming depreciation on any listed property, or
5) You are filing a corporate tax return.

If you do not have to file Form 4562, claim depreciation on the appropriate line of your tax return.

Dispositions. If you dispose of depreciable property at a profit, you may have to report, as ordinary income, all or part of the profit. See Chapter 8.

Alternative minimum tax. If you use accelerated depreciation, you may need to figure alternative minimum tax. For more information, see Form 6251, *Alternative Minimum Tax–Individuals.*

General Information on Depreciation

The first part of this chapter provides basic information on what property you can and cannot depreciate, and when to claim depreciation.

What Can Be Depreciated

Many different kinds of property can be depreciated. For example, machinery, buildings, vehicles, furniture, equipment, and certain patents and copyrights.

Property is depreciable if it meets these tests:

1) It must be used in business or held for the production of income (for example, to earn rent or royalty income),
2) It must have a determinable useful life longer than one year, and

3) It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

Depreciable property may be tangible or intangible.

Tangible Property

Tangible property can be seen or touched and includes both real and personal property. Personal property is property, such as machinery or equipment, that is not real estate. Real property is land and generally anything that is erected on, growing on, or attached to land. However, ***land itself is never depreciable.***

Pots, traps, and nets. You can depreciate pots, traps, and nets if they can be used for more than one year in your business. In most cases, you should capitalize and depreciate nets. Because the type and usage of pots and traps varies considerably from one fishery to another, no single rule can be made that will apply to all fishermen. You will have to use your own experience to determine if it is proper to capitalize and depreciate the cost of this equipment, or to deduct it as a business expense.

Intangible Property

Intangible property includes property such as a copyright or franchise that is not tangible. It may qualify for amortization. Amortization is a method that permits you to deduct certain capital expenditures in a way similar to depreciation. For more information on amortization, see Chapter 12 in Publication 535.

Partial Business/Investment Use

If you use property for business, investment, and personal purposes, you can only depreciate the business/investment part. If you use part of your home for business, you may be able to take a depreciation deduction for this use. For information on business use of your home, see Publication 587. For a discussion of car expenses, see Publication 917.

What Cannot Be Depreciated

To determine if you are entitled to depreciation, you must know not only what you can depreciate but what you cannot depreciate. Some property, although used in your business or held to produce income, can never be depreciated.

Land. Land can never be depreciated because it does not wear out or become obsolete and it cannot be used up. Land generally includes the cost of clearing, grading, planting, and landscaping because these expenses are all part of the cost of the land itself. Some land preparation costs, however, may be depreciable. For information on these costs, see Chapter 1 in Publication 534.

Inventory. You can never depreciate inventory. Inventory is any property held primarily for sale to customers in the ordinary course of business.

Rented property. Generally, a person who uses property subject to depreciation in a trade or business or holds it for producing income is entitled to the depreciation deduction for the property. Usually, this is the owner of the property. For rented property, this is usually the lessor. An owner or lessor is the person who generally bears the burden of exhaustion of capital investment in the property. This means the person who retains the incidents of ownership for the property. The incidents of ownership include:

1) The legal title,
2) The legal obligation to pay for it,
3) The responsibility to pay its maintenance and operating expenses,
4) The duty to pay any taxes, and
5) The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Equipment used to build capital improvements. You cannot deduct depreciation on equipment that you are using to build your own capital improvements. Depreciation on this equipment during the period of construction must be added to the basis of the improvements. See *Uniform Capitalization Rules* in Publication 551.

Repairs. You cannot deduct, in one tax year, the entire cost of repairs or replacements you make to depreciable property if it increases the value of the property, makes it more useful, or lengthens its life. You must capitalize these costs and depreciate them.

When To Claim Depreciation

You can only claim depreciation on a tax return for the tax year to which it applies. You cannot deduct unclaimed depreciation in the current year or any later tax year. However, you can claim the depreciation on a timely filed amended return for the earlier year. You must file an amended return within 3 years from the date you filed your original return, or within 2 years from the time you paid your tax, whichever is later. A return filed early is considered filed on the due date.

If, in an earlier year, you did not claim depreciation you were entitled to deduct, you must still reduce your property's basis by the amount of depreciation you were entitled to deduct. If you deduct more depreciation than you should, you must decrease your basis by the amount deducted to the extent of any benefit from excess depreciation claimed.

Section 179 Deduction

Section 179 of the Internal Revenue Code permits certain taxpayers to ***elect*** to deduct all or part of the cost of certain qualifying property in the year they place it in service, instead of taking depreciation deductions over a specified recovery period. There are limits, however, on the amount you can deduct in a tax year. These limits are discussed in *Deduction Limits* under *How To Figure the Deduction,* later.

What Costs Can and Cannot Be Deducted

You can claim the section 179 deduction only on qualifying property purchased for use in your trade or business. You cannot claim the deduction on property you hold only for the production of income.

Acquired by Purchase

Only the cost of property you purchase for use in your business qualifies for the section 179 deduction. However, the cost of property purchased from a related person or group may not qualify. See *Nonqualifying Property,* later.

Acquired by Trade

If you purchase an asset with cash and a trade-in, part of the basis of the asset you receive is the basis of the trade-in. You cannot claim the section 179 deduction on this part of the basis of the asset. For example, if you buy (for cash and a trade-in) a new truck to use in your business, your cost for the section 179 deduction does not include the adjusted basis of the truck you trade for the new vehicle. For more information on adjusted basis, see *Adjusted Basis* in Chapter 3.

Example. In 1994, Mr. Oak, who operates a fishing business named Oak Seafood, traded a used van with an adjusted basis of $4,500 for a new van costing $9,000. The new van was placed in service in 1994. Oak Seafood was given a $4,800 trade-in and paid $4,200 cash for the new van.

Oak Seafood's basis in the new property includes both the adjusted basis of the property traded and the cash paid. However, only the portion of the basis paid by cash qualifies for the section 179 deduction. The portion of the adjusted basis of the property traded that carries over to the basis of the new property is not treated as business cost for purposes of section 179. Oak Seafood has business costs that qualify for a section 179 deduction of $4,200, the part of the cost of the new property not determined by the property traded.

Qualifying Property

Property qualifying for the section 179 deduction is depreciable property and includes:

1) Tangible personal property,
2) Other tangible property (except most buildings and their structural components), used as:
   a) An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or
   b) A research facility used in connection with any of the activities in (a), or

c) A facility used in any of the activities in (a) for the bulk storage of fungible commodities.

3) Single purpose agricultural (livestock) or horticultural structures, and

4) Storage facilities (excluding buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

The determination of whether property is qualifying property is made in the first tax year the property is placed in service. Therefore, if you place property in service in a tax year and it does not qualify for the section 179 deduction, no section 179 deduction is ever allowed for it even though it becomes qualifying property in a later tax year.

Example. In 1993, you bought a new car and used it entirely for personal purposes. In 1994, you begin to use the car in your business. You are not allowed a section 179 deduction for the car in 1994.

Partial business use. When you use property for both business and nonbusiness, you can elect the section 179 deduction only if more than 50% of the property's use in the tax year it is placed in service is for trade or business purposes. You must allocate the cost of the property to reflect only the business use of the property. You do this by multiplying the cost of the property by the percentage of business use. You use this business cost to figure your section 179 deduction.

Nonqualifying Property

You cannot claim the section 179 deduction on:

1) Property held only for the production of income,

2) Real property including buildings and their structural components, and

3) Property acquired from certain groups or persons.

Acquired from certain groups or persons. The following property does not qualify for the section 179 deduction:

1) Property acquired by one member of a controlled group from another member of the same controlled group,

2) Property you acquire if the basis of the property is determined in whole or in part by its adjusted basis in the hands of the person from whom you acquired it or is determined under stepped-up basis rules for property acquired from a decedent (see Publication 448), or

3) Property you acquire from a related person.

For this purpose, a list of related persons is available in Chapter 2 of Publication 946 or Chapter 2 of Publication 534.

Electing the Deduction

You must make an election to take the section 179 deduction. You can make this election only in the first tax year the property is placed in service.

Placed in Service Rule

For the section 179 deduction, your property is considered placed in service in the tax year it is first made ready and available for a specific use. Such use can be in a trade or business, the production of income, a tax-exempt activity, or a personal activity. Property placed in service that does not qualify for the section 179 deduction cannot later qualify in another tax year even if its use changes to business.

How To Make the Election

You make the election by taking the deduction on Form 4562 filed with your original tax return (whether or not you file it timely) or on an amended return. You cannot make the election on an amended return filed after the due date (including extensions). Once made, the election can be revoked only with the consent of the Internal Revenue Service (IRS).

How To Figure the Deduction

For 1994, the maximum section 179 deduction is $17,500 of the business cost of property you buy for use in your trade or business. You decide how much of the cost of property you want to deduct under section 179. You do not have to claim the full $17,500. Any cost you do not deduct under section 179 can be depreciated.

If you purchase and place in service more than one item of qualifying property during the year, you can allocate the deduction between the items in any way, as long as the total is not more than the limits. If you have only one item of qualifying property and that item costs less than $17,500, such as $10,200, and you meet the taxable income limit (discussed later), your deduction is limited to the lesser of your taxable income or $10,200.

Subtract the amount you elect to deduct from the business/investment cost of the qualifying property. You use this unadjusted basis to compute your depreciation deduction.

Note: You cannot take depreciation to the extent that you elect to directly expense the cost of property under section 179.

Deduction Limits

In figuring your section 179 deduction, you must apply the following limits:

1) Maximum dollar limit,

2) Investment limit, and

3) Taxable income limit.

Maximum dollar limit. The total cost you can elect to deduct in 1994 cannot exceed $17,500. The $17,500 maximum dollar limit applies to you as a taxpayer and not to each business you operate.

While the maximum dollar amount that can be deducted is $17,500, there are certain rules that can reduce this amount.

Joint returns. A husband and wife who file a joint return are treated as one taxpayer in determining any reduction to the $17,500 maximum dollar limit, regardless of which spouse purchased the property or placed it in service.

Example 1. The Elms file a joint return. In 1994, Jack Elm bought and placed in service $200,000 of qualifying section 179 property. His wife placed in service $5,000 of qualifying property she bought. Their 1994 maximum dollar limit is $12,500 ($17,500 – $5,000) because they exceeded the $200,000 investment limit by $5,000. See *Investment limit,* later.

Married individuals filing separate returns. A husband and wife filing separate returns for a tax year are treated as one taxpayer for the $17,500 maximum dollar limit and the $200,000 investment limit that applies to the reduction of the maximum dollar limit. Unless they elect otherwise, 50% of the maximum dollar limit (after applying the investment limit) will be allocated to each spouse. If the percentages elected by each spouse do not total 100%, 50% will be allocated to each spouse.

Example 2. Jack Elm is married and he and his wife file separate returns for 1994. He bought and placed in service $200,000 of qualified machinery in 1994. His wife had her own business and she placed in service $5,000 of qualified business equipment. If Mr. and Mrs. Elm had filed a joint return for 1994, their maximum dollar limit would have been $12,500. This is because their $17,500 maximum dollar limit would have been reduced by $5,000 (the excess over the $200,000 investment limit). They elect to allocate $9,375 (75%) to Mr. Elm's machinery and $3,125 (25%) to Mrs. Elm's equipment. If they did not make an election to allocate their costs, they would be limited to the $12,500 multiplied by 50% or $6,250 each on their separate returns.

Joint return after filing separate returns. If a husband and wife elect to file a joint return after the due date for filing the return, the maximum dollar limit on the joint return is the lesser of:

1) The maximum dollar limit (after applying the investment limit), or

2) The total cost of section 179 property they elected to expense on their separate returns.

Example 3. Assume Jack Elm and his wife in Example 1 had filed separate returns. On their separate tax returns, Jack elected to expense $4,000 of section 179 property and his wife elected to expense $2,000. If they subsequently file a joint return after the due date for that return, their maximum dollar limit for section 179 is $6,000, the lesser of the maximum dollar limit after applying the investment limit or $6,000 (the total amount they elected to expense on their separate returns).

Investment limit. For each dollar of business cost over $200,000 for section 179 property placed in service in a tax year, the $17,500 maximum dollar limit is reduced (but not below zero) by one dollar.

Example. In 1994, James Smith placed in service machinery with a cost of $207,000. Since the cost of the machinery exceeds $200,000 by $7,000, he must reduce the maximum dollar limit ($17,500) by $7,000. Therefore, if he meets the taxable income limit, he is entitled to a section 179 deduction for 1994 of $10,500.

Taxable income limit. The total cost you can deduct each tax year is limited to your taxable income from the active conduct of any trade or business during the tax year.

Taxable income for this purpose is figured by aggregating the net income (or loss) from all trades and businesses you and your spouse (if filing a joint return) actively conducted during the tax year. Items of income derived from a trade or business actively conducted by you include section 1231 gains (or losses) as listed in the instructions to Form 4797, and interest from working capital of your trade or business. Also include in aggregate taxable income any wages, salaries, tips, or other compensation earned as an employee. When figuring taxable income, do not take into account any unreimbursed employee business expenses you may have as an employee.

In addition, you figure taxable income without regard to:

1) The section 179 expense deduction,
2) The self-employment tax deduction, and
3) Any net operating loss carryback or carryforward.

Example. Joyce Jones places in service in 1994 a machine that cost $8,000. The taxable income from her business for 1994 (determined without the cost of the machine or the deduction for half the self-employment tax) is $6,000. Her section 179 deduction is limited to $6,000. The $2,000 cost that is not allowed because of the taxable income limit can be carried to 1995.

Carryover of disallowed deduction. Any cost that is not deductible in one tax year under section 179 because of this limit can be carried to the next tax year.

The amount you carry over will be taken into account in determining the amount of your section 179 deduction in the next year. You can select the properties for which costs will be carried forward and you can allocate the portion of the costs to these properties.

If you do not make a selection, the total carryover will be allocated equally among the properties you elected to expense for the tax year. If you can deduct all or a portion of your total carryover in a subsequent year, you must deduct the costs being carried from the earliest tax year first.

See *Carryover of disallowed deduction* in Chapter 2 of Publication 534 for information on figuring the carryover or figure your carryover using the *Section 179 Deduction Worksheet* also in Chapter 2 of Publication 534.

Basis adjustment. Generally, upon a sale or other disposition of section 179 property, or a transfer of section 179 property involving a transaction whereby gain or loss is not recognized in whole or in part (including transfers at death), the adjusted basis of the property is increased before the sale or other disposition by the amount of disallowed section 179 deduction. This carryover of disallowed deduction is not available to the transferor or the transferee of the property.

Example. In 1994, you bought a $32,000 boat and a dinghy for $7,300 for use in your fishing business. You placed both items in service in 1994. If you meet the taxable income limit, you can elect to deduct the entire $7,300 for the dinghy and $10,200 for the boat, a total of $17,500. This is the most you can deduct in 1994. Your election of $7,300 deduction for the dinghy has completely recovered the cost of that item. Your election of $10,200 for the boat reduces the basis by this amount. Its unadjusted basis for depreciation is $21,800. This is figured by subtracting the amount of your section 179 deduction for the boat, $10,200, from its cost, $32,000.

Two different taxable income limits. As just discussed, the section 179 deduction is subject to a taxable income limit. You also may have to figure another deduction that has a limit based on taxable income. The limit for this other deduction may have to be figured taking into account the section 179 deduction. If so, complete the steps discussed next.

Step 1. Figure taxable income without either a section 179 deduction or the other deduction.

Step 2. Figure a hypothetical section 179 deduction using the taxable income figured in Step 1.

Step 3. Subtract the hypothetical section 179 deduction figured in Step 2 from the taxable income figured in Step 1.

Step 4. Figure a hypothetical amount for the other deduction using the amount figured in Step 3 as taxable income.

Step 5. Subtract the hypothetical other deduction figured in Step 4 from the taxable income figured in Step 1.

Step 6. Now figure your actual section 179 deduction using the taxable income figured in Step 5.

Step 7. Subtract your actual section 179 deduction figured in Step 6 from the taxable income figured in Step 1.

Step 8. Figure your actual other deduction using the taxable income figured in Step 7.

Passenger automobiles. For passenger automobiles placed in service in 1994, your total section 179 deduction and depreciation cannot exceed $2,960 in 1994. See Publication 917 for more information.

Recordkeeping requirements. You must keep records that show the specific identification of each piece of section 179 property. These records must show how the property was acquired, the person it was acquired from, and when it was placed in service. You must stay with your selection of section 179 property for which you claim a deduction when computing your taxable income for the tax year the election is made and for all later tax years.

When To Recapture the Deduction

If you claim a section 179 deduction for the cost of qualifying property placed in service ***after 1986*** and the property is not used more than 50% in a trade or business for any tax year before the end of the property's recovery period, you may have to recapture (include in income) part of the deduction.

If you elect the section 179 deduction, the amount deducted is treated as depreciation for purposes of the recapture rules. Thus, any gain you realize from a sale, exchange, or other disposition of property may have to be treated as ordinary income to the extent of the section 179 and depreciation deductions you claimed.

Report any recapture of the section 179 deduction on Form 4797.

You figure the amount to include in income by subtracting the depreciation that would have been allowable on the section 179 amount for prior tax years and the tax year of recapture from your section 179 deduction.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on August 1, 1992, an item of 3–year property costing $10,000. The property is not listed property. He used the property only for business in 1992 and 1993. He elected a section 179 deduction of $5,000 for this property. During 1994, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

Section 179 Deduction Claimed (1992)		$5,000.00
Allowable Depreciation (Instead of Section 179):		
1992 —		
$5,000 × 33.33%*	$1,666.50	
1993 —		
$5,000 × 44.45%*	2,222.50	
1994 —		
$5,000 × 14.81%* × 40% (Business)	296.20	4,185.20
1994 —		
Recapture Amount		$ 814.80

*Rates from 200% Table (3–Year Property), later.

Paul must include $814.80 in income for 1994, the excess of $5,000 over $4,185.20 ($1,666.50 + $2,222.50 + $296.20).

Dispositions. If you dispose of qualifying property, the amount you elected to deduct is subject to recapture as ordinary income. See Publication 544.

Modified Accelerated Cost Recovery System (MACRS)

The Modified Accelerated Cost Recovery System (MACRS) generally applies to all tangible property placed in service after 1986. MACRS provides two systems for depreciating property. The main system is called the General Depreciation System (GDS) and the second system is called the Alternative Depreciation System (ADS). Unless ADS is specifically required by law or you elect it, GDS is generally used to figure your depreciation deduction.

What Can Be Depreciated Under MACRS

MACRS applies to most tangible depreciable property placed in service after 1986. Property that you cannot use MACRS for is discussed in *What Cannot Be Depreciated Under MACRS.*

Use of real property changed. All real property acquired before 1987 that was changed from personal use to a business or income-producing use after 1986 must be depreciated under MACRS.

When To Use GDS

Most tangible depreciable property falls within the general rule of MACRS, also called the General Depreciation System (GDS). The major differences between GDS and ADS are the recovery period and method of depreciation you use to figure the deduction. Because GDS permits use of the declining balance method over a shorter recovery period, the deduction is greater in the earlier years.

However, the law requires the use of ADS for certain property as discussed under *When To Use ADS,* next.

Although your property may qualify for GDS, you can elect to use ADS. If you make this election, you can never revoke it. How to make this election is discussed later in *How to elect ADS,* under *Depreciation Methods.*

When To Use ADS

Under ADS, you determine your deduction by using the straight line method over a recovery period that generally is longer than the recovery period under GDS. This system is required for:

1) Any tangible property used predominantly outside the United States during the year,
2) Any tax-exempt use property,
3) Any tax-exempt bond-financed property,
4) Any imported property covered by an executive order of the President of the United States, and
5) Any property used predominantly in a farming business and placed in service during any tax year in which you make an election not to apply the uniform capitalization rules to certain farming costs.

What Cannot Be Depreciated Under MACRS

You cannot use MACRS for certain property because of special rules that exclude it from MACRS. You can elect to exclude certain property from being depreciated under MACRS.

No depreciation deduction is allowed for property placed in service and disposed of during the same tax year.

Property that you cannot depreciate using MACRS includes:

1) Intangible property,
2) Any motion picture film or video tape,
3) Any sound recording,
4) Certain real and personal property placed in service before 1987, and
5) Property you elect to exclude from MACRS that is properly depreciated under a method of depreciation that is not based on a term of years.

Property placed in service before 1987. There are special rules that prevent you from using MACRS for certain property originally placed in service before 1987 (before August 1, 1986, if a special election was made). If you have depreciable property that was placed in service (by anyone and for any purpose) before 1987, see *What Cannot Be Depreciated Under MACRS* in Chapter 3 of Publication 534.

Election to exclude property from MACRS. If you properly depreciate any property under a method not based on a term of years, such as the unit-of-production method, you can elect to exclude that property from MACRS. You must make this election by the tax return due date (including extensions) for the tax year your property is placed in service. You make it by reporting your depreciation for the property on Line 17 of Part III of Form 4562 and attaching a statement as described in the Instructions for Form 4562.

How To Figure the Deduction Under MACRS

Before figuring depreciation deductions, you must know the following information about your property:

1) Its basis,
2) Its property class and recovery period,
3) Its placed-in-service date,
4) What convention to use, and
5) Which method of depreciation to use.

Basis

Basis is a measure of your investment in property for tax purposes. When you depreciate property, a certain percentage of your basis in it is deducted each year.

For property that you buy, your original basis is usually its cost to you. For property that you acquire in some other way, such as by inheriting it, receiving it as a gift, building it yourself, or getting it in a tax-free exchange, you figure your original basis in some other way.

While you own the property, various events may take place that will change your basis. Some events, such as additions or permanent improvements to the property, increase basis. Others, such as casualty losses and the section 179 deduction, decrease basis. See Chapter 3 for more information on how to figure basis.

Nonbusiness property changed to business or investment use. When you change property that was not used for business or investment to a business or income-producing use, you must determine your basis in the property for figuring depreciation. You determine this amount as of the date of the change. It is the lesser of your property's fair market value or the adjusted basis of your property on that date.

Property Classes and Recovery Periods

Each item of property depreciated under GDS is assigned to a property class. The property class of an item of property establishes the number of years over which the basis of the property is recovered. This period of time is called the recovery period.

Under GDS, most tangible property that you place in service after 1986, or after July 31, 1986, if elected, falls into one of the following classes.

3–year property. This class includes tractor units for use over the road.

5–year property. This class includes trucks, computers and peripheral equipment, office machinery (typewriters, calculators, etc.), and any automobile.

7–year property. This class includes office furniture and fixtures (desks, files, etc.). This class also includes any property that does not have a class life and that has not been designated by law as being in any other class, such as nets, pots, traps, and boats used in commercial fishing.

10–year property. This class includes vessels, barges, tugs, and similar water transportation equipment.

15–year property. This class includes wharves and docks.

20–year property. This class includes any municipal sewer.

Residential rental property. This class includes any real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is rental income from dwelling units. If you occupy any part of the building or structure, the gross rental income includes the fair rental value of the part you occupy. The recovery period for this property is 27.5 years.

Nonresidential real property. This class includes any real property that is not:

a) Residential rental property, or

b) Property with a class life of less than 27.5 years.

The recovery period for nonresidential real property is:

31.5 years for property you placed in service ***before*** May 13, 1993, or

39 years for property you placed in service ***after*** May 12, 1993.

However, property you placed in service before January 1, 1994, will not be subject to the longer recovery period if you or a ''qualified person'' entered into a binding written contract to purchase or construct the property before May 13, 1994, or you (or a qualified person) began construction of the property before May 13, 1993. A ***qualified person*** is anyone who transfers a contract or property to you so long as the property was not placed in service by the transferor.

The class lives and recovery periods for most assets are listed in *The Table of Class Lives and Recovery Periods* in Appendix B of Publication 534.

Placed-in-Service Date

Depreciation begins when your property is placed in service in a trade or business or for the production of income. For example, if property is placed in service for personal use, depreciation is not allowable. If the property use changes to a business or income-producing activity, depreciation begins at the time of the change in use.

Example. On November 22, 1993, Donald Steep bought a boat for his business. It was delivered on December 7, 1993. However, it was not installed and operational until January 3, 1994. Since it was not operational until 1994, it is considered placed in service in 1994. If the boat had been ready for use when it was delivered in 1993, it would be considered placed in service in 1993 even if it was not actually used until 1994.

Conventions

Generally, you use the half-year convention to figure the deduction for property other than residential rental and nonresidential real property. Under a special rule, you may be required to use the mid-quarter convention. For residential rental and nonresidential real property, you use the mid-month convention in all situations.

Half-year convention. Under the half-year convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

Mid-quarter convention. If during any tax year the total depreciable bases of MACRS property placed in service during the last 3 months of that tax year exceeds 40% of the total depreciable bases of all MACRS property placed in service during that tax year, you use the mid-quarter convention. In determining the total bases of property, do not include the basis of:

Residential rental property,

Nonresidential real property, or

Property placed in service and disposed of in the same tax year.

To determine whether you must use the mid-quarter convention, the depreciable basis of property is your original basis multiplied by the percentage of business or investment use and then reduced by:

1) The amount of amortization taken on the property,

2) Any section 179 deduction claimed on the property, and

3) Any deduction claimed for clean-fuel vehicles or for clean-fuel vehicle refueling property.

Under the mid-quarter convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

To figure your MACRS deduction for property subject to the mid-quarter convention, first figure your depreciation for the full tax year. Then multiply by the following percentages for the quarter of the tax year the property is placed in service.

Quarter of tax year	Percentage
First	87.5%
Second	62.5%
Third	37.5%
Fourth	12.5%

See Chapter 3 of Publication 534 for more information, including percentage tables based on the mid-quarter convention.

Mid-month convention. Under the mid-month convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Depreciation Methods

Under MACRS, there are five ways to depreciate your property.

200% declining balance method. You use the 200% declining balance method for property in the 3–, 5–, 7–, or 10–year class over the GDS recovery period of 3, 5, 7, or 10 years and apply the half-year or mid-quarter convention.

150% declining balance method. You use the 150% declining balance method for property in the 15– or 20–year class over the GDS recovery period of 15 or 20 years and apply the half-year or mid-quarter convention.

For these classes of property, you change to the straight line method for the first tax year for which that method when applied to the adjusted basis at the beginning of such year will yield a larger deduction. You always use the straight line method for residential rental and nonresidential real property.

Election of straight line method. Instead of using the declining balance method, you can elect to use the straight line method with the half-year or mid-quarter convention over the GDS recovery period. The election to use the straight line method for one item in a property class applies to all property in that class placed in service in the year of the election. However, this election can be made each year for each property class.

The election is made by entering ''S/L'' in column (f) of Part II of Form 4562. The election must be made by the tax return due date (including extensions) for the tax year the property for which you make the election is placed in service.

Once made, the election to use the straight line method over the GDS recovery period cannot be changed (see also *How to elect ADS,* later).

Election of 150% declining balance method. Under MACRS, you can elect to use the 150% declining balance method over the ADS recovery period. If the property does not have a class life assigned to it, the ADS recovery period is 12 years. A half-year or mid-quarter convention is used, and there is a change to the straight line method when that method will give a larger deduction. The election to use the 150% declining balance method for one item in a property class applies to all property in that class placed in service in the tax year of the election.

The election is made by entering ''150 DB'' in column (f) of Part II of Form 4562. The election must be made by the tax return due date (including extensions) for the tax year the property for which you make the election is placed in service.

Once made, the election to use the 150% declining balance method over the ADS recovery period cannot be changed.

ADS method. Under MACRS, you can elect to use the ADS method for most property. Under the ADS method, you figure your depreciation deduction using the straight line method over the ADS recovery period. Some of the ADS recovery periods are as follows:

Property	Recovery Period
Nonresidential real and residential rental property	40 years
Automobiles and light duty trucks	5 years
Computers and peripheral equipment	5 years
Furniture and fixtures	10 years

The ADS recovery period for most types of property can be found in *The Table of Class Lives and Recovery Periods,* in Appendix B of Publication 534.

How to elect ADS. Although your property may qualify under GDS, you can elect to use the ADS method. You make the election to use the ADS method by completing line 15 of Part II of Form 4562. You must make the election by the tax return due date (including extensions) for the year the property is placed in service.

The election of the ADS method for one item in a property class generally applies to all property in that class placed in service in the tax year of the election. However, you can make the election on a property-by-property basis for residential rental and nonresidential real property.

The election to use the ADS method, once made, cannot be changed.

Depreciation methods chart. To help you determine the method to use for a specific property class, the following depreciation methods chart is provided. The declining balance method is abbreviated as DB and the straight line method is abbreviated as SL.

Depreciation Methods Chart

Property Class	Method-Recovery Period
3, 5, 7, 10–Year (Nonfarm)	200% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS*
3, 5, 7, 10–Year (Farm)	150% DB-GDS 150% DB-ADS* SL-GDS* SL-ADS*
15, 20–Year (Farm or Nonfarm)	150% DB-GDS SL-GDS* SL-ADS*
Nonresidential Real Property Residential Rental Property Trees or Vines Bearing Fruit or Nuts	SL-GDS SL-ADS*
Tax-Exempt Use Property Tax-Exempt Bond-Financed Property Imported Property Foreign Use Property (Used Outside U.S.)	SL-ADS

*Elective Method

MACRS Deductions

You may determine your MACRS depreciation deduction in one of two ways. You can use the percentage tables, or you can actually compute the deduction using the applicable depreciation method and convention over the recovery period. The deduction is the same under both methods.

Percentage tables. The percentage tables are based on the depreciation method, recovery period, and convention. The percentages in the tables are applied to the unadjusted basis of the property each year of the recovery period. ***Unadjusted basis*** is the same amount you would use to compute a gain on a sale but it is figured without taking into account any depreciation taken in earlier years. However, you do reduce your basis by:

1) The amount of amortization taken on the property,
2) Any section 179 deduction claimed, and
3) Any deduction claimed for clean-fuel vehicles and clean-fuel vehicle refueling property.

Also, if the business property is a vehicle, you must reduce the basis by any qualified electric vehicle credit.

However, you cannot continue to use the tables if there are any adjustments to the basis of your property for reasons other than:

1) Depreciation allowed or allowable, or
2) An addition or improvement to that property depreciated as a separate item of property.

For example, if the basis of your property is reduced as a result of a casualty, you cannot continue to use the tables. For the year of adjustment and the remainder of the recovery period, you must figure your depreciation based on the adjusted basis of the property at the end of the tax year of adjustment and the remaining recovery period. For more information, see *Figuring MACRS Deductions Without Tables* in Chapter 3 of Publication 534.

In addition, you cannot use the tables if you have a short tax year. If this occurs, see *MACRS Deduction in Short Tax Year* in Chapter 3 of Publication 534.

200% table. The following table has the percentages for 3–, 5–, and 7–year property. The percentages are based on the 200% declining balance method over GDS recovery periods and apply a half-year convention with a change to the straight line method. See Publication 534 for complete tables, including tables for the mid-quarter convention.

Year	3–Year	5–Year	7–Year
1	33.33%	20%	14.29%
2	44.45%	32%	24.49%
3	14.81%	19.2%	17.49%
4	7.41%	11.52%	12.49%
5		11.52%	8.93%
6		5.76%	8.92%
7			8.93%
8			4.46%

Example. You buy and place in service on August 11, 1994, an item of 7–year property that cost $10,000. You do not elect a section 179 deduction. The unadjusted basis of the property is $10,000. You use the percentages for 7–year property to figure your depreciation.

You multiply the property's unadjusted basis, $10,000, by 14.29% to get your depreciation for 1994 of $1,429 for this item of 7–year property. For 1995, you multiply $10,000 by 24.49% to get your depreciation deduction of $2,449. For later tax years, you multiply $10,000 each year by the applicable 7–year percentage to get your depreciation deduction.

Figuring deductions without the tables. Instead of using the percentage tables to figure depreciation, you can actually compute your depreciation deduction each year. For more information on this, see *Figuring MACRS Deductions Without Tables* in Chapter 3 of Publication 534.

Listed Property

There are limits on the depreciation deductions you can claim on listed property. If your listed property is not used more than 50% in business use during any tax year, the section 179 deduction is not allowable and you must depreciate the property using the ADS method.

ADS uses the straight line method and is discussed earlier. Limitations are also imposed on lessees that are similar to those imposed on owners. See Chapter 4 of Publication 534.

In addition to the rules for all listed property, there is a special dollar limit on the depreciation and section 179 deduction you can claim each year for passenger automobiles.

Passenger automobiles. For passenger automobiles placed in service in 1994, your total section 179 deduction and depreciation cannot exceed $2,960. For the second year, it cannot exceed $4,700. It cannot exceed $2,850 in the third year and $1,675 each later year. For more information, see Publication 917.

Listed property. Listed property includes:

1) Any passenger automobile.
2) Any other transportation vehicle (including boats).
3) Any property of a type generally used for entertainment, recreation, or amusement.
4) Any computer and related peripheral equipment (except computers used at a regular business establishment and owned or leased by the person operating the establishment).
5) Any cellular telephone (or similar telecommunication equipment) placed in service or leased in a tax year beginning after 1989.

What Records Must Be Kept

You cannot take any depreciation or section 179 deduction for the use of listed property (including passenger automobiles) unless you can prove business or investment use by adequate records or sufficient evidence to support your own statements.

Adequate Records

To meet the adequate records requirement, you must maintain an account book, diary, log, statement of expense, trip sheet, or similar record or other documentary evidence that, together with the receipt, is sufficient to establish each element of an expenditure or use. It is not necessary to record information in an account book, diary, or similar record if the information is already shown on the receipt. However, your records should back up your receipts in an orderly manner.

How Long To Keep Records

For listed property, records must be kept as far back as any tax year for which excess depreciation can be recaptured (included in income).

For property placed in service after 1986, recapture can occur in any tax year of the ADS recovery period.

For more information, see Publication 534.

8. Gains and Losses

Important Reminders

Investing in small business. Beginning in 1998, investments in certain small business stock held more than 5 years will qualify for a special tax benefit. If you sell or exchange the stock at a gain, only one-half of the gain will be subject to federal income tax. For information on qualifying stock, see Chapter 4 of Publication 550, *Investment Income and Expenses.*

Form 8824. If you exchange property in a like-kind transaction, you must file Form 8824 in addition to Schedule D (Form 1040) or Form 4797.

Topics

This chapter discusses:

- Sales and exchanges
- The treatment of gain or loss as ordinary or capital

Useful Items

You may want to see:

Publication

- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **547** Nonbusiness Disasters, Casualties, and Thefts
- ❏ **550** Investment Income and Expenses
- ❏ **537** Installment Sales

Form (and Instructions)

- ❏ **Sch D (Form 1040)** Capital Gains and Losses
- ❏ **4684** Casualties and Thefts
- ❏ **4797** Sales of Business Property
- ❏ **8824** Like-Kind Exchanges

During the year, you may have sold or exchanged some business assets. The rules for correctly reporting these transactions are discussed in this chapter.

Sales and Exchanges

Sales and exchanges of property generally result in taxable gains or deductible losses. However, some exchanges of property are nontaxable. An exchange of property for like property is the most common type of transaction in which no gain or loss is recognized.

Sale. A sale is a transfer of property for money or a mortgage, note, or other promise to pay money.

Exchange. An exchange is a transfer of property for other property or services, and may be taxed in the same way as a sale. However, see *Nontaxable Like-Kind Exchanges,* later.

Involuntary exchanges (conversions). These occur when your property is destroyed, stolen, condemned, or disposed of under threat of condemnation, and other property or money, such as insurance proceeds or a condemnation award, is received in payment.

Determining Gain or Loss

Gain or loss is usually realized when property is sold or exchanged. A ***gain*** is the excess of the amount you realize from a sale or exchange of property over its adjusted basis. A ***loss*** is the excess of the adjusted basis of the property over the amount you realize.

Basis. The cost or purchase price of property is usually its basis for figuring the gain or loss from its sale or other disposition.

Adjusted basis. The adjusted basis of property is your original cost or other basis, plus certain additions, such as improvements, and minus certain deductions, such as depreciation and casualty losses. See *Adjusted Basis* in Chapter 3. In determining gain or loss, the cost of transferring property to a new owner, such as selling expenses, is added to your adjusted basis.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value (FMV) of all property or services you receive. The amount you realize also includes any of your liabilities that are to be paid by the buyer, such as real estate taxes or a mortgage.

If the liabilities relate to an exchange of multiple properties, see *Multiple Property Exchanges,* and its discussion, *Treatment of liabilities,* in Chapter 1 of Publication 544.

Table 8-1. **How to Figure a Gain or Loss**

If:	**Then:**
Adjusted basis is more than amount realized	You have a loss
Amount realized is more than adjusted basis	You have a gain

Fair market value (FMV). The price at which the property would change hands between a buyer and a seller, when both are aware of all the necessary facts and neither is required to buy or sell, is the fair market value. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of fair market value. If there is a stated price for services, this price is treated as the fair market value, unless there is evidence to the contrary.

Example. In your fishing business, you used a boat that you bought for $30,000. You made certain permanent improvements at a cost of $10,000. Depreciation had been deducted in the amount of $31,600. You sold the boat for $20,000, plus other property having a fair market value of $2,000. The buyer assumed your note of $17,000. Your selling expenses were $1,000. Your gain on the sale is figured as follows:

Amount realized:		
Cash		$20,000
Other property (fair market value)		2,000
Note (assumed by buyer)		17,000
Amount realized		$39,000
Adjusted basis:		
Cost of boat	$30,000	
Improvements	10,000	
Total	$40,000	
Minus: Depreciation	31,600	
Adjusted basis	$ 8,400	
Plus: Selling expenses	1,000	9,400
Gain on sale		$29,600

Amount recognized. Generally, realized gains from the sale, exchange, or other disposition of the property must be recognized (included in gross income). Realized losses from these transactions are recognized (deducted from gross income). However, there are exceptions to this rule, as discussed next under *Nontaxable Like-Kind Exchanges.* For other exceptions, see *Other Nontaxable Exchanges* under *Nontaxable Exchanges* in Chapter 1 of Publication 544.

Nontaxable Like-Kind Exchanges

Certain exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even though you may realize a gain or loss on the exchange, it will not be recognized until you sell or otherwise dispose of the property you receive.

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must involve qualifying, like property.

Qualifying property. The property must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither property may be property used for personal purposes, such as your family car.

The property must not be property you primarily hold for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for use in your business and classified as a fixed asset or property held for investment. Fishing vessels, engines, radar, trucks, and rental houses are examples of property to which the rule applies.

The like-kind exchange rules do not apply to exchanges of accounts receivable, stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, or the exchange of partnership interests.

For the rules regarding the exchange of partnership interests, see Publication 541.

Like property. There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. For example, the trade of an apartment house for a store building or a panel truck for a pickup truck is a like-kind exchange. The exchanges of city real property for farm real property and improved real property for unimproved real property are exchanges of property for like property. An exchange of personal property for real property is not an exchange of like property.

Personal property. Depreciable tangible personal property may be either ''like kind'' or ''like class'' to qualify for nonrecognition treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class. ***General Asset Classes*** describe the types of property frequently used in many businesses. ***Product Classes*** include property listed in a 4-digit product class (except any ending in ''9,'' a miscellaneous category) in Division D of the Standard Industrial Classification codes of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (SIC Manual). For more information, see Chapter 1 of Publication 544.

Like-kind exchanges between related parties. Special rules apply to like-kind exchanges made between related parties. These rules affect both direct and indirect exchanges. Under these rules, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss on the original exchange must be recognized as of the date of that later disposition. The 2-year holding period begins on the date of the last transfer of property which was part of the like-kind exchange.

Related parties. Under these rules, related parties generally include you and a member of your family (spouse, brother, sister, parent, child, etc.), you and a corporation in which you have more than 50% ownership, you and a partnership in which you directly or indirectly own more than a 50% interest of the capital or profits, and two partnerships in which you directly or indirectly own more than 50% of the capital interests or profits interests. For more information on related parties, see *Nondeductible Loss,* under *Sales and Exchanges Between Related Parties* in Chapter 2 of Publication 544.

Money paid. If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible loss. See Chapter 3 to determine the basis of your new property.

Example. A fisherman trades an old fishing vessel for a new one. The new one costs $9,800. He is allowed $1,000 for the old fishing vessel and pays $8,800. He has no taxable gain or deductible loss on the transaction regardless of the adjusted basis of the old vessel. If the fisherman sold the old fishing vessel to a third party for $1,000 and bought a new one, he would have a recognized gain or loss on the sale of the old vessel, measured by the difference between the amount realized and the adjusted basis of the old fishing vessel.

Sale and purchase. If you sell property and buy similar property in two mutually dependent transactions, you may be required to treat the sale and purchase as a single nontaxable exchange.

Example. You used a pickup truck in your business for four years. Its adjusted basis is $500 and its trade-in value is $1,000. You are interested in a new truck that has a cash price of $10,500. Ordinarily, you would trade your old truck for the new one and pay the dealer an additional $9,500. Your basis for depreciation for the new truck would be $10,000 ($9,500 paid plus $500 basis for the old truck). However, you arrange to sell your old truck to the dealer for $1,000 and buy the new truck from the same dealer for $10,500. You will still be considered to have exchanged your old truck for the new one, because the sale and purchase were reciprocal and mutually dependent. Your basis for depreciation for the new truck is $10,000, the same as if you traded the old truck.

Unlike property given up. If you give up unlike property in addition to like property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Money or unlike property received. If you receive cash or unlike property in addition to like property, and the preceding conditions are met, you are taxed on the gain you realize, but only to the extent of the cash and the fair market value of the unlike property you receive. A loss is never deductible in a nontaxable exchange, even though you receive cash or unlike property. The basis of your new property is discussed in Chapter 3.

Example. You exchange real estate you held for investment that has an adjusted basis of $8,000, for other real estate to be held for investment. The real estate you receive has a fair market value of $10,000. You also receive $1,000 in cash. Although the total gain realized on the transaction is $3,000, only $1,000 (cash received) is recognized (included in your income).

Assumption of liabilities. You must treat the assumption of your liabilities by the other party or your transfer of property subject to a liability as the receipt of cash.

Example. If, in the preceding example, the property you transfer is subject to a $3,000 mortgage, figure the gain realized and the amount of gain to be taxed as follows:

FMV of like property received	$10,000
Cash	1,000
Mortgage assumed on property given up	3,000
Total received	$14,000
Less: Adjusted basis of property you transferred	8,000
Realized gain	$ 6,000

The realized gain is recognized (taxed) only to the extent of $4,000, the sum of the cash ($1,000) and the mortgage ($3,000).

Reporting the exchange. Report the exchange of like-kind property on **Form 8824.** The instructions for the form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

If you have any taxable gain because you received money or unlike property, report it on Schedule D (Form 1040) or Form 4797, whichever applies. You may also have to report ordinary income because of depreciation on Form 4797. See *Gain on Disposition of Depreciable Property,* later, and its discussion on like-kind exchanges or involuntary conversions under *Other Dispositions.*

Exchanges of multiple properties. Under the like-kind exchange rules, you must generally make a property-by-property comparison to figure your recognized gain and the basis of the property you receive in the exchange. However, for exchanges of multiple properties, you do not make a property-by-property comparison if you:

Transfer and receive properties in two or more exchange groups, or

Transfer or receive more than one property within a single exchange group.

In this situation, you figure your recognized gain and the basis of the property received by comparing the properties within each exchange group.

For more information, see *Multiple Property Exchanges* under *Like-Kind Exchanges* in Chapter 1 of Publication 544.

Deferred exchanges. A deferred exchange is one in which you transfer property you use in business or hold for investment and, at a later time, you receive like-kind property you will use in business or hold for investment. (The property you receive is ***replacement property.***) The transaction must be an exchange (that is, property for property) rather than a transfer of property for cash that is used to purchase replacement property. The exchange must meet the requirements discussed earlier and the property to be received must meet identification and receipt requirements.

For more information, see *Deferred Exchanges* under *Like-Kind Exchanges,* in Chapter 1 of Publication 544.

Identification requirement. The property must meet the identification requirement. The property to be received must be identified on or before the day that is 45 days after the date you transfer the property given up in the exchange. Any property received on or before that day is considered to have been identified. The identification requirement may be met by designating the property to be received in the contract between the parties.

Receipt requirement. The exchange must meet the receipt requirement. The property must be received on or before the earlier of:

- The 180th day after the date on which you transfer the property given up in the exchange, or
- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

You must receive substantially the same property that met the identification requirement, discussed earlier.

Ordinary or Capital Gain or Loss

If you have a taxable gain or a deductible loss from a sale or exchange of property, it may be either an ordinary gain or loss, or a capital gain or loss, or a combination of both. Usually, the full amount of an ordinary gain is taxable, and the full amount of an ordinary loss is deductible. The tax treatment of a capital gain or loss depends upon whether the gain or loss is short or long term and whether the taxpayer is an individual or a corporation.

For individuals, net capital gains may not be taxed at the same rate as ordinary income. Your deduction for capital losses may be limited. See Chapter 10.

Generally, you will have a capital gain or loss if you sell or exchange a capital asset. You may also have a capital gain or loss if you sell or exchange a noncapital asset that is section 1231 property, described later.

See Chapter 2 of Publication 544 for special rules that apply to:

Sales and exchanges between related parties,

Loss from an abandonment of property,

Sale of business, and

Dispositions of intangible property.

Capital Assets

All items you own and use for personal, pleasure, or investment purposes are capital assets. Following are some ***examples of capital assets:***

1) A dwelling owned and occupied by you and your family.

2) Household furnishings owned and used by you and your family.

3) An automobile used for pleasure or for commuting. (If your automobile is used both for pleasure or commuting and for business, it is partly a capital asset and partly a noncapital asset, as defined later.)

4) Stocks and bonds when held by individuals for investment. (You will find additional items listed in Publication 550.)

Personal use property. Property held for personal use is a capital asset. ***Gain*** from a sale or exchange of that property is a capital gain. ***Loss*** from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty or theft.

Personal casualty gains and losses. To figure your personal casualty (or theft) ***gain,*** subtract your adjusted basis in the property from any insurance or other reimbursements. To figure your personal casualty (or theft) ***loss,*** reduce each loss by any reimbursement and by $100. If your personal casualty gains for the tax year exceed your personal casualty losses, all of your personal casualty gains and losses are treated as sales and exchanges of capital assets. If your personal casualty losses for the tax year exceed your personal casualty gains, the excess is deductible on Schedule A (Form 1040) to the extent it exceeds 10% of your adjusted gross income. Use Section A of Form 4684 to report all personal casualty gains and losses. For more information, see Publication 547.

Noncapital Assets

An asset is a noncapital asset if it is excluded from the definition of capital assets. A list of properties excluded from the definition of capital assets appears in the Schedule D (Form 1040) instructions.

Property held for sale in the ordinary course of your fishing business. Property you hold mainly for sale, such as fish, lobsters, and crabs, are noncapital assets. Gain or loss from sales or other dispositions of such property is ordinary income or loss and is reported on Schedule C (Form 1040) and not on Form 4797.

Business assets. Business assets classified as real property or depreciable property used in your trade or business are noncapital assets, but may be treated as capital assets if held for more than 1 year. See *Section 1231 Property,* next. You report gain on depreciable property that you use in your trade or business and hold for more than 1 year in Part III, Form 4797. This part of Form 4797 is used to figure the part of gain, if any, that is subject to recapture as ordinary income due to depreciation, amortization, or depletion. Any gain in excess of the amount subject to recapture as ordinary gain is netted with other section 1231 gains and losses in Part I.

If you hold assets that you use in your trade or business for 1 year or less, any gain or loss on disposition is an ordinary gain or loss and is reported in Part II, Form 4797. Ordinary gains may be taxed at a higher rate of tax than capital gains, as discussed in Chapter 10.

Section 1231 Property

Real property and depreciable or amortizable personal property used in a trade or business or held for the production of rents or royalties and held for more than 1 year is section 1231 property and subject to section 1231 treatment. Capital assets held in connection with a trade or business or a transaction entered into for profit and subject to an involuntary conversion are also section 1231 property if held more than 1 year.

Sales or exchanges. Sales or exchanges of the following types of properties may result in gain or loss subject to section 1231 treatment:

1) Depreciable or amortizable property used in your business, such as a fishing vessel, refrigeration equipment, or a truck.

2) Real estate used in your business, such as your gear shed or net loft.

3) Property held for the production of rents or royalties.

Involuntary conversions. Section 1231 treatment applies to the gain or loss on business property and capital assets held in connection with a trade or business or a transaction entered into for profit, held for more than 1 year, resulting from condemnations or from casualties and thefts (whether insured or uninsured). These include casualty or theft to business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance payments or other reimbursement must be taken into account in arriving at the net gain or loss. However, if your casualty or theft losses exceed casualty or theft gains, neither the gains nor losses are taken into account in the section 1231 computation.

Treatment of gains and losses. Combine all the gains and losses from the sale or other disposition of section 1231 property for the tax year. Excess section 1231 gains over your section 1231 losses result in a net section 1231 gain. If you have a net section 1231 gain, your gains and losses are treated as long-term capital gains or long-term capital losses. (If you had net section 1231 losses in prior years, see the next discussion.) Excess section 1231 losses over section 1231 gains result in a net section 1231 loss. If you have a net section 1231 loss or your section 1231 gains and losses are equal, treat each item as an ordinary gain or loss.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent it does not exceed your nonrecaptured net section 1231 losses. ***Nonrecaptured losses*** are the total of your net section 1231 losses for your five most recent preceding tax years that have not yet been applied (recaptured) against any net section 1231 gains in those years. Your losses are recaptured beginning with the earliest year subject to recapture.

Form 4797. Section 1231 gains and losses are figured on Form 4797. See Chapter 10 for more information on Form 4797.

Gain on Disposition of Depreciable Property

Depreciation that you have taken on property may cause you to have to treat a gain on its disposition as ordinary income.

Section 1245 Gain

A gain on the disposition of section 1245 property (depreciable personal property) is treated as ordinary income to the extent of depreciation allowed or allowable on the property. Section 1245 property includes both tangible and intangible personal property. For more information on the types of section 1245 property, see *Depreciation Recapture on Personal Property* in Chapter 4 of Publication 544.

Treatment of gain. The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is limited to the ***lower*** of:

1) The depreciation and amortization taken on the property (the recomputed basis of the property minus the adjusted basis of the property), or
2) The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

For any other disposition of section 1245 property, ordinary income is the lower of (1) above or the amount by which its fair market value exceeds its adjusted basis. See *Other Dispositions,* later.

Recomputed basis. The recomputed basis of your section 1245 property is the total of its adjusted basis plus depreciation and amortization adjustments (allowed or allowable). This includes depreciation and amortization adjustments:

On property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion, and

Allowed or allowable to a previous owner, if your basis is determined with reference to that person's adjusted basis.

Example. In January 1992, Don Smith bought and placed in service section 1245 property that cost $10,000 and had a 5-year life. By the end of 1994, using the MACRS method, he deducted $7,120 of depreciation which reduced the asset's adjusted basis to $2,880. Since this adjusted basis reflects deductions for depreciation of $7,120, the recomputed basis of the property is $10,000.

Depreciation and amortization. Depreciation and amortization that must be recaptured as ordinary income include (but are not limited to) the following items:

1) Ordinary depreciation deductions;
2) Amortization deductions for–
   a) The cost of acquiring a lease,
   b) The cost of lessee improvements,
   c) Pollution control facilities,
   d) Reforestation expenses,
   e) Section 197 intangibles,
   f) Child care facility expenditures made before 1982, and
   g) Franchises, trademarks, and trade names acquired before August 10, 1993;
3) The section 179 expense deduction;
4) Deductions for–
   a) The cost of removing barriers to the disabled and the elderly,
   b) Tertiary injectant expenses, and
   c) Depreciable clean-fuel vehicles and refueling property; and
5) The amount of any basis reduction for the investment credit (less the amount of any basis increase for any credit recapture).

Depreciation allowed or allowable. The greater of depreciation allowed or allowable is generally the amount to use in figuring the part of the gain to report as ordinary income. If, in prior years, you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method.

This treatment applies only when figuring what part of the gain is treated as ordinary income under these rules.

Reporting gain. Gain from the sale, exchange, involuntary conversion, or other disposition of section 1245 property is figured in Part III of Form 4797. This gain may be ordinary income or a combination of ordinary income and capital gain income. See Chapter 10 for more information.

Section 1250 Gain

A gain on the disposition of section 1250 property (depreciable real property) is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. To determine the additional depreciation on section 1250 property, see *Additional depreciation,* later. Corporations may also have to treat an additional amount of the gain as ordinary income.

Generally, there is no additional depreciation (defined later) on the disposition of residential rental property or nonresidential real property placed in service after 1986 because these properties are depreciated using the straight line method.

Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property that is subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable.

If, because of a change in use, section 1250 property becomes section 1245 property in the hands of a taxpayer, it may never again be treated as section 1250 property by that taxpayer.

Treatment of gain. If you realize a gain on the disposition of section 1250 property and the depreciation you took under the depreciation method you used is more than the depreciation that would have been allowable under the straight line method for the same period, you must report part of your gain as ordinary income. Corporations may also have to report an additional amount as ordinary income. The balance is treated as a gain from a section 1231 transaction discussed earlier. However, if you held the property for more than 1 year and depreciated it exclusively on the straight line method, your gain is not subject to this treatment and you treat the entire gain as a gain from a section 1231 transaction. For more information, see Chapter 4 of Publication 544.

Additional depreciation. If you hold section 1250 property longer than 1 year, the additional depreciation is the excess of actual depreciation adjustments over the depreciation figured using the straight line method. Treat any basis reduction for investment credit as part of your actual depreciation adjustment. If you hold section 1250 property for 1 year or less, all of the depreciation is additional depreciation.

You have additional depreciation if you used the regular ACRS method, the declining balance method, the sum of the years-digits method, the units-of-production method, or any other method of rapid depreciation.

Reporting gain. Gain from the sale, exchange, involuntary conversion, or other disposition of section 1250 property is figured in Part III of Form 4797. This gain may be ordinary income or a combination of ordinary income and capital gain income. See Chapter 10 for more information.

Other Dispositions

This section discusses transfers of depreciable property by gift or at death, in like-kind exchanges, and in involuntary conversions. It also explains how to handle a single transaction involving a combination of depreciable property and other property.

Gifts. If you make a gift of depreciable personal or real property, you are not required to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property and this subsequent disposition is subject to recapture, the donee must take into account the depreciation that you deducted in figuring the gain to be reported as ordinary income.

Disposition part gift and part sale or exchange. If you transfer depreciable personal property or real property for less than its fair market value in a transaction considered to be partly a gift and partly a sale or exchange, and you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain realized) to recapture depreciation. If the depreciation (additional depreciation, if section 1250 property) is more than the gain, the balance is carried over to the transferee to be taken into account on any later disposition of the property.

Example. You transfer your fishing boat to your son for $20,000. The boat had an adjusted basis to you of $10,000 and a fair market value of $40,000, and your depreciation was $30,000. You are considered to have made a gift of $20,000, the difference between the $40,000 fair market value and the $20,000 sales price to your son. You have a taxable gain on the transfer of $10,000 ($20,000 sale price minus $10,000 adjusted basis) that must be reported as ordinary income due to depreciation. Since you report $10,000 of your $30,000 depreciation as ordinary income on the transfer of the boat, only the remaining $20,000 depreciation is carried over to your son and is to be taken into account by him on any later disposition of the property.

Transfers at death. When a taxpayer dies, no gain is reported on depreciable personal property or real property that is transferred to the taxpayer's estate or beneficiary. For more information, see Publication 559.

If the taxpayer disposed of the property before death and, because of his or her method of accounting or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported in the same way the decedent would have been required to report it if he or she were still alive.

Example. Jim Smith owned a fishing boat that, upon his death, was inherited by his son. No ordinary income because of depreciation is reportable on the transfer, even though the value used for estate tax purposes is more than the adjusted basis of the boat to Jim when he died. However, if Jim sold the boat before his death and realized a gain and if, because of his method of accounting, the proceeds from the sale are income in respect of a decedent reportable by his son, the son must report ordinary income because of depreciation.

Like-kind exchanges or involuntary conversions. A like-kind exchange of your depreciable personal property, or an involuntary conversion of the property into similar or related property, will not result in your having to report ordinary income because of depreciation unless money or property other than like-kind, similar, or related property is also received in the transaction.

If you must include gain as ordinary income because of depreciation, the amount to be included, figured under the rules explained earlier under *Section 1245 Gain,* is limited to the ***sum*** of:

1) The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions, ***plus***
2) The fair market value of the like-kind, similar, or related property other than depreciable personal property acquired in the transaction.

Example 1. You bought new equipment for your boat for $4,300 plus your old equipment for which you were allowed a $1,360 trade-in. The old equipment cost you $5,000 2 years ago. You took depreciation deductions of $3,950. Even though you deducted depreciation of $3,950, the $310 gain ($1,360 trade-in allowance minus $1,050 adjusted basis) is not reported because it is excluded under the rules for like-kind exchanges and you received only depreciable personal property in the exchange.

Example 2. On January 4, 1992, you bought equipment for your boat for $1,500. You deducted $300 and $480 under MACRS on your 1992 and 1993 returns. On January 3, 1994, a fire destroyed the equipment and you received $1,200 from your fire insurance realizing a gain of $480 ($1,200 minus $720 adjusted basis). You choose to postpone gain, but replacement equipment cost you only $1,000. Your taxable gain under the rules for involuntary conversions is limited to the remaining $200 insurance payment. Because all of your replacement property is depreciable personal property, your ordinary income because of depreciation is limited to $200.

Records. You must keep permanent records of the facts necessary to figure the depreciation allowed or allowable on your depreciable property in order to figure the gain to be reported as ordinary income. In general, the information needed will be the same as that required for other tax purposes including the dates of acquisition, cost or other basis, depreciation, and all other adjustments that affect basis.

On property you received as a nontaxable exchange or as a gift, your records must also indicate the following:

1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property, and
2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Form 4797. Form 4797, discussed in Chapter 10, is used to report the gain or loss from the preceding transactions.

9.

Casualties and Thefts

Topics

This chapter discusses:

- Casualties and thefts
- Proof of loss
- How to figure a loss
- When loss Is deductible
- How to figure a gain
- Postponing gain
- Reporting gains and losses

Useful Items

You may want to see:

Publication

- ❏ **544** Sales and Other Dispositions of Assets
- ❏ **547** Nonbusiness Disasters, Casualties, and Thefts

Form (and Instructions)

- ❏ **1040X** Amended U.S. Individual Income Tax Return
- ❏ **4684** Casualties and Thefts

A **casualty** occurs when property is damaged, destroyed, or lost due to a sudden, unexpected, or unusual event. A **theft** occurs when property is stolen. A casualty or theft may result in a deductible loss on your federal income tax return.

An involuntary conversion occurs when you receive money or other property, such as insurance proceeds, as reimbursement for a casualty or theft.

If an involuntary conversion results in a gain, you can postpone recognition of the gain on your income tax return if you receive or buy qualified replacement property within the specified replacement period. For more information, see *Postponing Gain,* later.

Casualties and Thefts

If your property is destroyed, damaged, or stolen, you may have a deductible loss. If the insurance or other reimbursement is more than the adjusted basis of the destroyed, damaged, or stolen property, you may have a gain. For information on casualties and thefts of personal-use property, see Publication 547.

Casualty

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.

- A ***sudden*** event is one that is swift, not gradual or progressive.
- An ***unexpected*** event is one ordinarily unanticipated and unintentional on the part of the one who has the loss.
- An ***unusual*** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

Events that may cause casualty damage, destruction, or loss include:

1) Earthquake, hurricane, tornado, flood, storm, volcanic eruption, shipwreck, mine cave-in, sonic boom, or vandalism.
2) Fire, but if you willfully set the fire, or pay someone else to set it, any resulting damage, destruction, or loss is not a casualty.
3) Car or boat accidents, but if your willful negligence or willful act caused the accident, or it was caused by the willful act or willful negligence of someone acting for you, the damage, destruction, or loss of your car or boat is not a casualty.

Gradual deterioration. Damage from gradual or progressive deterioration, such as from rust, corrosion, or termites, is not a casualty.

Related expenses. Expenses such as the care of personal injuries and rental of equipment are not deductible as part of a casualty loss. However, if you have these expenses for a casualty loss to your business property, you may be able to deduct them as business expenses. See also *Repair costs,* discussed later.

Theft

A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. Theft includes, but is not limited to, larceny, robbery, and embezzlement. Misrepresentation, however, is not a theft.

Mislaid or lost property. The mere disappearance of money or property in itself is not a theft. However, an accidental loss or disappearance of property may be a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Proof of Loss

To take a deduction for a casualty or theft loss, you must be able to show that there was a casualty or theft, and support your deduction.

Casualty. For a casualty loss, you should be able to show:

1) The type of casualty (car or boat accident, fire, storm, etc.) and when it occurred,
2) That the loss was a direct result of the casualty, and
3) That you were the owner of the property, or if you leased the property from someone else, that you were liable, under a contract, to the owner for the damage.

Theft. For a theft, you should be able to show:

1) When you discovered that your property was missing,
2) That your property was stolen, and
3) That you were the owner of the property.

How To Figure a Loss

How you figure the deductible casualty loss depends on whether the loss was to business or nonbusiness property, and whether the property was partly or completely destroyed.

Business property completely destroyed. If your business property is completely destroyed or stolen, your loss is the adjusted basis of your property minus any salvage, insurance, or other reimbursement you receive or expect to receive. This is true even though the fair market value of your property before the loss was less than its adjusted basis. For example, if you claimed the cost of wet gear as a business expense for the year of purchase rather than capitalizing its cost and claiming depreciation, you have no adjusted basis and thus no deductible loss.

If you have a casualty or theft loss that is from property you held for personal use, it is subject to the $100 and 10% limits, as discussed in Publication 547.

Amount received. The amount you receive includes the money plus the fair market value of unlike property you receive for the damaged, destroyed, or stolen property minus your expenses to collect them. It also includes any insurance or other reimbursement you receive or expect to receive.

Business property stolen. If your business property is stolen, your deductible loss is your adjusted basis in your property. Reduce the loss by any insurance or other reimbursement you receive or expect to receive.

Business property partly destroyed. The amount of a casualty loss of business property partly destroyed is the decrease in the fair market value of your property, or the adjusted basis of your property, whichever is less. Reduce this amount by any insurance or other reimbursement you receive or expect to receive.

Separate losses. Figure separately each individual property damaged or destroyed. For example, if casualty damage occurs to both your storage shed and dock, figure the loss separately for the shed and dock.

Decrease in fair market value. To figure the decrease in fair market value due to a casualty or theft, determine the fair market value of your property immediately before and after the loss. The decrease is the difference between the value of the property immediately before and immediately after the casualty. ***Fair market value*** is defined in Chapter 3.

Example 1. You owned a fishing boat used in your business. The boat had an adjusted basis of $30,000 when it was partly destroyed by a storm. The value immediately before the storm was $60,000 and the value immediately after was $40,000. The decrease in the fair market value is $20,000 ($60,000 minus $40,000). Since this is less than the adjusted basis, $30,000, your deductible loss is $20,000 minus any insurance or other reimbursement you receive or expect to receive.

Example 2. If, in Example 1, the value of the boat after the storm had been only $25,000, the adjusted basis, $30,000, would have been less than the value of the destroyed part ($60,000 minus $25,000, or $35,000). In this case, your deductible loss would be $30,000 minus any insurance or other reimbursement you receive or expect to receive.

Repair costs. You may use the cost of cleaning up and making repairs after a casualty as a measure of the decrease in fair market value of the property, if:

1) They are needed to restore the property to its condition before the casualty,
2) The cost of repairs is not excessive,
3) The repairs only take care of the damage, and
4) The value of the property after repairs is no more than its value before the casualty.

The cost of debris removal may be used, like the cost of repairs, as evidence of the amount of the casualty loss if these conditions are satisfied.

You cannot deduct the cost of repairing, replacing, or cleaning up after the casualty unless it is a business expense.

Appraisals. An experienced and reliable appraiser should make the appraisal. The appraiser's knowledge of sales of comparable property and familiarity with your property before and after the casualty, and the method used to determine the loss are important elements for proving a casualty loss.

Cars and trucks. You may find the books issued by various automobile organizations useful in figuring the value of your car or truck. You can use the wholesale or trade-in value given in these books, and modify it for such factors as the mileage and condition of your vehicle. A dealer's offer for your car or truck as a trade-in on a new car or truck is not usually a measure of its true value.

Basis of property damaged. Reduce the basis of property damaged or destroyed by a casualty by the allowable casualty loss deduction. Also reduce the basis by any insurance or other reimbursement you receive.

Example. Your business truck is involved in an accident. After appraisals, you determine the loss to be $2,000. You carry $250 deductible insurance. You receive $1,750 from the insurance company. Your deductible casualty loss is $250 ($2,000 minus $1,750 insurance). Reduce the basis of your truck by your casualty loss, $250, and the insurance received, $1,750.

When Loss Is Deductible

Casualty losses are generally deductible only in the year in which they occur. Theft losses are generally deductible only in the year in which they are discovered. However, see *Disaster area losses,* later.

Leased property. If you lease property from someone else, you may deduct a loss on the property in the year the liability is fixed, not the year in which it is paid. You are not entitled to a deduction until your liability under the lease is ascertainable with reasonable accuracy. This could include a settlement, adjudication, or abandonment of the claim.

Disaster area losses. If you have a deductible loss from a disaster in an area declared by the President of the United States to be eligible for federal disaster assistance, you can choose to deduct that loss on your return for the immediately ***preceding tax year.*** If you do this, consider this loss as occurring in the preceding year.

Make the election to deduct the loss in the preceding year by the later of:

1) The original due date of your tax return for the year the disaster occurred, or
2) The due date of the preceding year's return, including extensions.

Reimbursements. If you have a reasonable prospect of being reimbursed for part or all of your loss, subtract the expected reimbursement to figure your loss. Reduce your loss even if you do not receive payment until a later tax year. If you later receive less than the amount expected, you may deduct the difference when you determine that you cannot reasonably expect any more reimbursement.

Example 1. In 1993, a collision with another truck completely destroyed your business truck. The negligence of the other driver caused the accident. Your truck had a fair market value of $4,000 and an adjusted basis of $3,000. As of December 31, 1993, it was reasonable to believe you would recover the total damages from the owner of the other truck. You do not have a deductible loss in 1993. In January 1994, the court awards you a judgment of $4,000. In July 1994, you can show with reasonable certainty you cannot collect from the other driver. You can claim a $3,000 loss in 1994.

Example 2. In 1993, your fishing boat, with an adjusted basis of $25,000, was completely destroyed by fire. Your only claim for reimbursement was an insurance claim for $18,000. You can claim a casualty loss deduction of $7,000 in 1993 because the most you could possibly have collected from your claim was $18,000. In 1994, the insurance company offered to settle your claim for $15,000 and you accepted the offer. In 1994, you can claim an additional deduction of $3,000, the excess of your total loss of $10,000 ($25,000 minus $15,000) over the amount claimed in 1993 ($7,000).

Lump-sum reimbursements. If you have a casualty or theft loss of several assets at the same time, divide the lump-sum reimbursement among the assets according to the fair market value of each at the time of the loss. Figure the gain or loss separately for each asset that has a separate basis.

Reimbursement in a later year. If you receive more reimbursement than expected after deducting the loss in an earlier year, include the extra reimbursement in your income in the year you receive it. However, if any part of the deduction did not reduce your tax for the earlier year, do not include the extra reimbursement for that part of your deduction. Do not refigure the tax for the year you claimed the deduction.

Use and occupancy insurance. If insurance reimburses you for your loss of business income, it does not reduce your casualty or theft loss. However, the insurance reimbursement is income and taxed in the same manner as your business income.

How To Figure a Gain

You have a gain from a casualty or theft if your reimbursement is more than the adjusted basis of the property. Decrease your gain by any expenses you have to collect the reimbursement, such as legal fees. Increase your gain by any money you receive for salvage. You can postpone reporting the gain if you acquire qualified replacement property within the replacement period, as explained later.

Example. Your fishing boat was severely damaged in a storm. The adjusted basis of the boat was $52,000. Its fair market value before the storm was $65,000. The fair market value after the storm was $38,000. You sold some equipment on board as salvage for $1,000. Your insurance company reimbursed you $35,500 for your loss. Since your insurance reimbursement is more than the decrease in the fair market value of the boat, and is increased by the salvage money, you have a gain.

1) Adjusted basis	$52,000
2) Value before storm	$65,000
3) Value after storm	38,000
4) Decrease in value (2 minus 3)	$27,000
5) Amount of loss (1 or 4, whichever is less)	$27,000
6) Insurance reimbursement	35,500
7) Gain on insurance (6 minus 5)	$ 8,500
8) Salvage money	1,000
9) **Gain on casualty (7 plus 8)**	$ 9,500

Postponing Gain

You must ordinarily report the gain on your damaged, destroyed, or stolen property if you receive money or unlike property as reimbursement. However, you can choose to postpone reporting the gain if you acquire qualified replacement property that is similar or related in service or use to your involuntarily converted property within a specific replacement period.

If you are a member of a partnership or a shareholder in a corporation that owns the damaged, destroyed, or stolen property, only the partnership or corporation, and not you, can choose to postpone reporting the gain.

To postpone all the gain, the cost of your replacement property must be at least as much as the reimbursement you receive. If the cost of the replacement property is less than the reimbursement, include the gain in your income up to the amount of the unspent reimbursement.

Example. A fire totally destroyed a fishing boat used in your business. It had an adjusted basis of $9,000. During that year, you received $11,000 from the insurance company and immediately spent $9,500 to replace the destroyed boat. You realized a gain of $2,000 from the destruction of the old boat. Since $1,500 of the insurance reimbursement was not spent for its replacement, report $1,500 in your gross income. You can choose not to report the other $500 of gain. If you spent only $8,500, you would have to report the entire gain of $2,000.

Replacement Property

You must buy replacement property for the specific purpose of replacing your property. Your replacement property must be similar or related in service or use to the property it replaces. You do not have to use the actual reimbursement from your old property to acquire the replacement property. Property you receive by gift or inheritance does not qualify as replacement property.

Advance payment. You have not purchased replacement property if you pay a contractor in advance to build your replacement property, unless it is finished before the end of the replacement period.

Similar or related in service or use for an owner-user. If you are an owner-user, similar or related in service or use means the replacement property functions the same as the property it replaces. An example of replacement property that is similar or related in service is a business vehicle that replaces another business vehicle and the business uses it in the same way.

Substituting replacement property. Once you designate property as replacement property, you may not substitute other qualified replacement property. The designation is made by the statement with your return reporting that you acquired replacement property. However, if after you replace the property you discover it does not qualify as replacement property, you may, within the replacement period, substitute the other qualified replacement property.

Replacement Period

To postpone reporting your gain, you must buy replacement property within the replacement period.

The ***replacement period begins*** on the date your property was damaged, destroyed, or stolen.

The ***replacement period ends*** 2 years after the close of the first tax year in which you realize any part of your gain.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. Your application should contain all the details about your need for an extension. Make your application before the end of the replacement period. You may file an application within a reasonable time after the replacement period ends if you can show a good reason for the delay. You will get an extension of time if you can show reasonable cause for not making the replacement within the regular period.

How to postpone the gain. Report your election to postpone your gain, along with all necessary details, on your return for the tax year in which you realize the gain.

Replacement property acquired before return filed. If you acquire replacement property before you file your return for the year in which you realize gain, attach a statement to your return. Show in the statement the amount realized from the casualty or theft, how you figured the gain, and any gain you will report as income.

Replacement property acquired after return filed. If you intend to buy replacement property after you file your return for the year you realize gain, attach a statement to your return. Show in the statement all the facts relating to the casualty or theft. Also show how you figured the gain, and that you choose to replace the property within the required replacement period.

You then attach another statement to your return for the year in which you buy the replacement property. Show in this statement detailed information on the replacement property. If you acquire part of your replacement property in one year and part in another year, make a statement for each year. Show in the statement detailed information on the replacement property bought in each year.

Taxpayer's death. If a taxpayer dies in the year the gain is realized, but before replacement property is acquired, there can be no election to postpone the gain. Instead, report the gain on the decedent's final income tax return.

Amended return. File an amended return for the tax year in which the gain was realized if you made the election to postpone tax on the gain and later did not acquire replacement property within the replacement period, or the replacement property costs less than anticipated at the time you made the election.

Changing your mind. You can change your mind about whether to report or postpone your gain at any time before the end of the replacement period. However, see *Substituting property,* earlier.

Example. A fire destroyed your property. You had a gain of $5,000. You reported the gain on your return for the year you received it, and paid the tax due. You buy replacement property within the replacement period. You used all but $1,000 of your gain to buy the replacement property. You wish to change your election to postpone the tax on the $4,000 of gain spent for the replacement property.

File a claim for refund on Form 1040X. Attach an explanation to your Form 1040X showing that you previously reported the entire gain from the fire but you now want to change your election and report only the part of the gain ($1,000) not spent for replacement property.

Reporting Gains and Losses

Use Form 4684 to report gains and losses from casualties and thefts. On Form 4684, list each item or article for which you are reporting a casualty or theft and gain or loss.

10.

Reporting Gains and Losses

Topics

This chapter discusses:

- Schedule D (Form 1040)
- Form 4797
- Form 4684

Useful Items

You may want to see:

Publication

- ❑ **544** Sales and Other Dispositions of Assets
- ❑ **550** Investment Income and Expenses

Form (and Instructions)

- ❑ **1099–B** Proceeds From Broker and Barter Exchange Transactions
- ❑ **1099–S** Proceeds From Real Estate Transactions
- ❑ **8824** Like-Kind Exchanges
- ❑ **6252** Installment Sale Income

This chapter discusses the reporting of capital gains and losses and ordinary gains and losses from sales, exchanges, and other dispositions of property. It covers the use of Schedule D (Form 1040), Form 4684, and Form 4797.

Although this discussion refers to Schedule D (Form 1040), the rules discussed here also apply to taxpayers other than individuals. However, the rules for property held for personal use will usually not apply to taxpayers other than individuals.

Personal use property. Report gain on the sale or exchange of property held for personal use (such as your home) on Schedule D. Loss from the sale or exchange of property held for personal use is not deductible. But if you had a loss from the sale or exchange of real estate held for personal use (other than your main home), report the transaction on Schedule D even though the loss is not deductible. Complete columns (a) through (e) and write ''Personal loss'' across columns (f) and (g).

Other forms. Before completing Schedule D (Form 1040), you may have to complete other forms.

Form 4797. For the sale of business property, complete Form 4797. Form 4797 is discussed later in this chapter.

You must file Form 8824 in addition to Schedule D (Form 1040) or Form 4797 when you exchange property in a like-kind transaction. See *Reporting the exchange* under *Nontaxable Like-Kind Exchanges* in Chapter 8.

For an installment sale of business property, complete Form 6252. See Publication 537, *Installment Sales*.

Form 1099–B. If you sold stocks, bonds, commodities, etc., you should receive Form 1099–B or an equivalent statement from your broker. Use Form 1099–B or equivalent statement to fill out line 1 of Schedule D (Form 1040).

Whether or not you receive Form 1099–B, you must report all taxable sales of stocks, bonds, commodities, etc., on Schedule D. For more information about figuring gains and losses from these transactions, see Chapter 4 in Publication 550.

Form 1099–S. Information reporting must be provided on certain real estate transactions. Generally, the person responsible for closing the transaction must complete Form 1099–S. He or she is required to indicate on the form the sale or exchange of improved or unimproved land, a house, building, or other permanent structure, a condominium unit, or stock in a cooperative housing corporation.

If you have sold or exchanged any of the above types of property, the reporting person must give you a copy of the Form 1099–S or a statement containing the same information.

If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting is not required to value that property or those services. In that case, the gross proceeds reported on Form 1099–S will be less than the sales price of the property you sold. Figure any gain or loss according to the sales price, which is the total amount you realized on the transaction.

Schedule D

Where you report a sale on Schedule D depends on how long you held (owned) the property.

Short-term gains and losses. A gain or loss on the sale or exchange of a capital asset held 1 year or less is a short-term capital gain or loss. Report it in Part I.

Net short-term gain or loss. Combine your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries, with any short-term capital loss carryovers and your other short-term gains and losses to figure your net short-term capital gain or loss.

Long-term gains and losses. Gain or loss on the sale or exchange of a capital asset held more than 1 year is a long-term capital gain or loss. Report it in Part II.

Net long-term gain or loss. Net section 1231 gain from Part I of Form 4797, after reduction for prior years' nonrecaptured net section 1231 losses, if applicable, is long-term capital gain. See Chapter 8. Report this gain in Part II of Schedule D (Form 1040). The following are also reported in Part II:

1) Capital gain distributions from regulated investment companies, mutual funds, and real estate investment trusts,
2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries, and
3) Long-term capital loss carryovers.

The result of combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss.

Total net gain or loss. Figure your total net gain or loss by combining your net short-term capital gain or loss with your net long-term capital gain or loss. Enter the result on line 18, Part III. If losses are more than gains, see the later discussion on *Treatment of capital losses*.

Maximum tax rate on capital gains for individuals. The 31%, 36%, and 39% income tax rates for individuals do not apply to net capital gains. The maximum tax rate on net capital gain is 28%. Net capital gain is the excess of net long-term capital gain for the year over the net short-term capital loss for the year.

Figuring tax on net capital gains. If you file Schedule D and both lines 17 and 18 of Schedule D are gains, or if you reported capital gain distributions on line 13, Form 1040, you may need to use the *Capital Gain Tax Worksheet,* provided in the instructions for line 38 of Form 1040, to figure your tax. Be sure to check the box for *Capital Gain Tax Worksheet* on line 38, Form 1040, when you enter the amount of tax on that line. Use the *Capital Gain Tax Worksheet* if your taxable income (line 37, Form 1040) is more than the amount shown in the following table for your filing status.

Filing Status	Amount
Single	$55,100
Married filing jointly or qualifying widow(er)	91,850
Married filing separately	45,925
Head of household	78,700

Treatment of capital losses. If the total of your capital losses is more than the total of your capital gains, you must deduct the excess even if you do not have ordinary income to offset it. The yearly limit on the amount of the capital loss you can deduct is $3,000 ($1,500 if you are married and file a separate return).

Capital loss carryover. Generally, you have a capital loss carryover if the following situations apply to you.

1) Your excess capital loss is more than the yearly limit, or
2) The amount shown on line 35, Form 1040, is less than zero.

If these situations apply to you in 1994, complete the *Capital Loss Carryover Worksheet* provided in the instructions to Schedule D (Form 1040) to figure the amount of your loss that you can carry over to 1995.

In 1995, you will treat the carryover loss as if it occurred in that year. It will be combined with any capital gains and losses you have in 1995, and any excess capital loss will be subject to the limit for that year. Any loss not used in 1995 will be carried over to 1996.

When you carry over a loss, it retains its original character as either long term or short term. A short-term loss that you carry over to the next tax year is added to short-term losses occurring in that year. A long-term loss that you carry over is added to long-term losses occurring in that year.

For more information about the treatment of capital losses, see *Treatment of Capital Losses* in Chapter 3 of Publication 544.

Joint and separate returns. On a joint return, the capital gains and losses of a husband and wife are figured as the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to $1,500. Neither you nor your spouse may deduct any part of the other's loss.

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

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The capital loss limit discussed earlier still applies in this situation. Even if the loss is greater than the limit, the excess cannot be deducted by the decedent's estate or carried over to following years.

Form 4797

Use Form 4797 to report gain or loss from a sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties.

Section 1231 gains and losses. Any section 1231 gains and losses are shown in Part I. A net gain is carried to Schedule D (Form 1040) as a long-term capital gain. A net loss is carried to Part II of Form 4797 as an ordinary loss.

If you had any nonrecaptured net section 1231 losses from the preceding 5 tax years, reduce your net gain by those losses and report the amount of the reduction as an ordinary gain in Part II. Report any remaining gain on Schedule D. See *Section 1231 Property,* in Chapter 8.

Ordinary gains and losses. Any ordinary gains and losses are shown in Part II. This includes a net loss or a recapture of losses from prior years figured in Part I of Form 4797. It also includes ordinary gain figured in Part III.

Ordinary income due to depreciation recapture. The ordinary income due to the recapture of depreciation on personal property (as discussed in Chapter 8) is figured in Part III. The ordinary income is carried to Part II of Form 4797 as an ordinary gain. Any remaining gain is carried to Part I as a section 1231 gain, unless it is from a casualty or theft. Any remaining gain that is from a casualty or theft is carried to Form 4684.

Form 4684

Use Form 4684 to figure and report casualty and theft losses and gains. Section B, Part I, has space to figure a gain or loss on four items of business or income-producing property. List each item or article for which you are claiming a casualty or theft loss. If more than four items of property were damaged or stolen in a single casualty or theft, use additional sheets following the format of Section B, Part I, through line 27.

If you had more than one casualty or theft during the year, fill out a separate Form 4684 for each casualty or theft.

Section B, Part II is used to summarize all your gains and losses from casualties and thefts of business or income-producing property during the tax year. Your net gain or loss is then carried to other tax forms. Short-term gains and losses are listed separately from long-term gains and losses. Part II also separates losses by the type of property. Losses on business property and property that earns rent or royalty income are listed in column (b)(i). Losses on income-producing property are listed in column (b)(ii). Gains are listed in column (c).

11. Self-Employment Tax

Important Change for 1994

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings for 1994 is 15.3%. This rate is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance). For 1994, the maximum amount subject to the social security part (12.4%) is $60,600. All earnings are subject to the Medicare part (2.9%).

The maximum amount subject to the social security part (12.4%) in 1995 will be published in the 1994 revision of Publication 533, *Self-Employment Tax,* and Publication 553, *Highlights of 1994 Tax Changes.*

Topics

This chapter discusses:

- Who must pay self-employment tax
- Self-employment income
- Figuring the tax

Useful Items

You may want to see:

Publication

❑ **533** Self-Employment Tax

Form (and Instructions)

❑ **1040** U.S. Individual Income Tax Return

❑ **Sch SE (Form 1040)** Self-Employment Tax

The self-employment tax is a social security and Medicare tax for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of wage earners.

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, and medical insurance (Medicare) benefits.

You must be *insured* under the social security system before you begin receiving social security benefits (described above). You are insured if you have the required number of quarters of coverage. A ''quarter of coverage'' means a period of 3 calendar months during which you were paid a certain amount of income subject to social security tax.

For 1994, you will receive a quarter of social security coverage, up to four quarters, for each $620 of income subject to social security. Therefore, for 1994, if you had income of $2,480 that was subject to social security taxes (self-employment and wages), you will receive four quarters of coverage.

For an explanation of the number of quarters of coverage you must have to be insured, and of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Social security number. You must have a social security number to pay the self-employment tax. If you do not have a number, see *Application for identification number* in Chapter 1.

Who Must Pay Self-Employment Tax

If you carry on a ***trade or business*** as a sole proprietor, a member of a partnership, or as an independent contractor, you probably have to pay self-employment tax on your self-employment income.

Fishing crew members. If you are a crew member on a boat that is engaged in the catching of fish or other forms of water life, you may have to pay self-employment tax. See the discussion on *Certain Crew Members Considered Self-Employed* in Chapter 12.

Income limits. You must pay self-employment tax if you have net earnings from self-employment of $400 or more.

For 1994, the maximum amount subject to the social security part of the self-employment tax (12.4%) is $60,600. All earnings are subject to the Medicare part of the self-employment tax (2.9%).

Estimated tax. If you estimate your income tax for 1994, you must also include an estimate of your self-employment tax. See *Estimated Tax and Return Due Dates* in Chapter 1.

Self-Employment Income

You are probably self-employed if you are a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself. Certain fishing crew members are also considered to be self-employed.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do on the side in addition to your regular job, may also be self-employment.

Some types of income, such as interest, may or may not be self-employment income. The source from which your income is received and your involvement in the activity from which your income is received will determine whether it is self-employment income.

Some common types of income are listed here. For a more complete discussion about self-employment income, see *Self-Employment Income* in Publication 533.

Real estate rent. Rent from real estate and personal property leased with real estate is not self-employment income. However, if you receive rent as a real estate dealer, the rental income and related deductions are included in figuring self-employment income.

Interest. Interest is not self-employment income unless you receive it in your trade or business, such as interest on accounts receivable.

Dividends. Dividends on securities are not self-employment income unless you are a dealer in securities.

Gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of depreciable property or other fixed assets used in your trade or business are not included.

However, any amounts for depreciation, including any section 179 deduction, recaptured because the business use of certain property was reduced to 50% or less are taken into account in figuring your net earnings from self-employment. This does not include amounts recaptured on the disposition of property.

Wages and salaries. Wages that are received for services performed as an employee and that are covered by social security and Medicare taxes or by railroad retirement tax are not self-employment income. Also, tips received for work done as an employee are excluded from self-employment income.

Lost income payments. If you are self-employed and reduce or stop your fishing activities, any payment you receive for the lost income of your fishing business from insurance or other sources is self-employment income. If you are not working when you receive the payment, it still relates to your fishing business (even though it is temporarily inactive) and is self-employment income.

If there is a connection between any payment you receive and your trade or business, the payment is self-employment income. A connection exists if it is clear that the payment would not have been made but for your conduct of the trade or business.

Net Self-Employment Income

Net self-employment income normally includes all of the items of business income and takes into account business deductions allowed for income tax purposes. Net self-employment income is determined using the same accounting method as used for income tax purposes.

If you have more than one trade or business, your net self-employment income is the combined earnings from all of your businesses. A loss in one business will reduce the income earned in another. You must claim all allowable deductions, including depreciation, when figuring your net earnings from self-employment. Your net self-employment income is reduced by 7.65%, as explained later, to determine your net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

Deductions and exemptions. Your self-employment income should not be reduced by certain deductions that are used when figuring income tax. Specifically, do not use:

1) Deductions for personal exemptions for yourself, your spouse, or dependents,
2) The standard deduction or itemized deductions,
3) The net operating loss deduction,
4) Nonbusiness deductions including contributions on your behalf to a pension, profit-sharing, annuity, Keogh, or SEP plan, and
5) The self-employed health insurance deduction.

Caution: The self-employed health insurance deduction expired for tax years beginning after 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend this deduction. For information on late legislative changes, see Publication 553, *Highlights of 1994 Tax Changes.*

Example. You own a fishing boat and for the year your business had the following items:

Gross profit on sales	$32,500
Salaries	9,000
Fuel	2,700
Repairs	1,400
Other expenses	900
Gain on sale of equipment	350
Fire loss on boat	1,200
Net operating loss carryover	1,000

To figure taxable income, consider all the above items. But to figure ***net self-employment income,*** use only the following:

Gross profit on sales		$32,500
Expenses:		
Salaries	$9,000	
Fuel	2,700	
Repairs	1,400	
Other expenses	900	
Total expenses		14,000
Net operating profit		$18,500

The $18,500 is your net self-employment income. The sale of the equipment, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation. For other excluded income and deductions, see *Self-Employment Income* in Publication 533.

Figuring Self-Employment Tax

There are three ways to determine net earnings for figuring self-employment tax. They are the regular method, the nonfarm optional method, and the farm optional method. The optional methods allow you to continue social security coverage when you have a loss or small amount of net income from self-employment. The regular and the nonfarm optional methods apply to the fishing industry. For a discussion of all the methods, see Publication 533.

The regular method and the nonfarm optional method differ in the way you determine net earnings. However, the tax rates are the same for each method. You will find the general rules for figuring self-employment tax in the discussion of Schedule SE.

The optional method may be used only to figure your self-employment tax. To figure your income tax, include your actual self-employment income in gross income, regardless of which method you use to figure self-employment tax.

Tax rates. The self-employment tax rate for 1994 is 15.3% (12.4% social security tax plus 2.9% Medicare tax). However, you can take a deduction of 7.65% of your net self-employment income when you figure your net earnings from self-employment. You are allowed this deduction only in figuring self-employment tax, and you figure it on line 4 of your 1994 Schedule SE. This is ***not*** the same as the deduction for one-half of self-employment tax taken on Form 1040, line 25.

Who should use optional method. You should use the nonfarm optional method if your net self-employment income is less than $1,733 and less than 72.189% of your gross nonfarm income, or if you had a loss, and:

1) You want to receive credit for social security benefit coverage,
2) You incurred child or dependent care expenses for which you could claim a credit (this method will increase your earned income which could increase your credit), or
3) You are entitled to the earned income credit (this method will increase your earned income which could increase your credit).

If you use the optional method, you must figure and pay the self-employment tax due under that method, even if you would have had a smaller tax or no tax under the regular method.

Example. Your gross nonfarm income is $900 and your net nonfarm earnings are $200. You use the nonfarm optional method to get a larger earned income credit. Your net earnings using the optional method are $600. You must pay self-employment tax.

Schedule SE (Form 1040) is used to compute self-employment tax. This form is illustrated in Publication 533.

Forms. Use Schedule SE (Form 1040) to figure your self-employment tax. Report the self-employment tax on line 47 of Form 1040. If you have to pay self-employment tax, you must file a Form 1040 (with Schedule SE attached), even if you are not otherwise required to file a federal income tax return.

Joint returns. You cannot file a joint Schedule SE (Form 1040), even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, it is independently subject to self-employment tax. If you both have self-employment income, each of you must file a separate Schedule SE (Form 1040).

Schedule SE

You must file Schedule SE if:

1) You were self-employed, and your net earnings from self-employment from other

than church employee income were $400 or more, or

2) You had church employee income of $108.28 or more.

Even if you are not required to file Schedule SE, it may be to your benefit to file it and use the nonfarm optional method in Part II of Section B.

Most taxpayers can use the *Short Schedule SE* (Section A) to figure self-employment tax. However, the following taxpayers must use *Long Schedule SE* (Section B):

1) Individuals whose total wages and tips subject to social security (or railroad retirement) tax plus net earnings from self-employment are more than $60,600,
2) Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS consent), who owe self-employment tax on other earnings,
3) Employees who earned wages reported on Form W–2 of $108.28 or more working for a church or church-controlled organization that elected exemption from social security and Medicare taxes,
4) Individuals with tip income subject to social security (or railroad retirement) and Medicare taxes that was not reported to their employers, and
5) Individuals who use one of the optional methods to figure self-employment tax.

Regular Method

Use the following steps to figure your tax under the regular method:

Step 1. Figure your net self-employment income. Under the regular method, the net profit from your business or profession is generally your net self-employment income. Net income is figured by subtracting all allowable business expenses and deductions from gross business income.

Step 2. After you have figured your net self-employment income, determine how much is subject to self-employment tax. Your net income is reduced by the 7.65% deduction to get your net earnings from self-employment.

7.65% deduction. Multiply your net income by 0.9235 for the 7.65% deduction (100% – 7.65% = 92.35% or 0.9235). This is your net earnings from self-employment.

Minimum income. You must have $433.13 or more of net earnings from self-employment before reduction by the 7.65% deduction to be subject to the tax (.9235 × $433.13 = $400). If your net income is less than $433.13 before the 7.65% reduction, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you choose to use the optional method.

Maximum income. No more than $60,600 of your combined wages, tips, and net earnings in 1994 is subject to any combination of the 12.4% social security part of self-employment tax, social security tax, or railroad retirement tax.

All of your combined wages, tips, and net earnings in 1994 are subject to any combination of the 2.9% Medicare part of self-employment tax, social security tax, or railroad retirement tax.

If your wages and tips are subject to either social security or railroad retirement tax, or both, and total at least $60,600, you do not have to pay the 12.4% social security part of the self-employment tax. However, you must pay the 2.9% Medicare part of the self-employment tax on all of your net earnings.

Step 3. Figure your self-employment tax as follows:

1) If your net earnings from self-employment plus any wages and tips are not more than $60,600, and you do not have to use *Long Schedule SE,* use *Short Schedule SE.* On line 5, multiply your net earnings by the 1994 tax rate of 15.3% (.153). The result is the amount of your self-employment tax.
2) If you had no wages, your net earnings from self-employment are more than $60,600, and you do not have to use *Long Schedule SE,* use *Short Schedule SE.* On line 5, multiply the line 4 net earnings by the 2.9% (.029) Medicare tax and add the result to $7,514.40 (12.4% of $60,600). The total is the amount of your self-employment tax.
3) If your net earnings from self-employment plus any wages and tips are more than $60,600, you must use *Long Schedule SE.* Subtract your total wages and tips from $60,600 to find the maximum amount of earnings subject to the 12.4% social security part of the tax. If more than zero, multiply the amount by 12.4% (.124). The result is the social security tax amount. Then multiply your net earnings from self-employment by 2.9% (.029). The result is the Medicare tax amount. The total of the social security tax amount and the Medicare tax amount is your self-employment tax.

Example 1. During 1994, you have $30,000 in net self-employment income, and receive no wages subject to social security and Medicare taxes. You multiply the $30,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction (100% – 7.65% =92.35%), and the result is $27,705. Your self-employment tax is 15.3% (.153) of $27,705, or $4,238.87.

Example 2. During 1994, you have $20,000 in net self-employment income, and receive $15,000 in wages subject to social security and Medicare taxes. You multiply the $20,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction, and the result is $18,470. Your self-employment tax is 15.3% (.153) of $18,470, or $2,825.91.

Example 3. During 1994, you have $70,000 in net self-employment income, and receive no wages subject to social security and Medicare taxes. You multiply the $70,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction, and the result is $64,645. Since only $60,600 of your earnings is subject to the social security part of the self-employment tax, your tax for this part is $7,514.40 (12.4% of $60,600).

Since all of your earnings are subject to the Medicare part of the self-employment tax, multiply $64,645 by 2.9% (.029) on *Short Schedule SE* for the Medicare part, and the result is $1,874.71. Add this to the $7,514.40 figured above for total self-employment tax of $9,389.11.

Example 4. During 1994, you have $70,000 in net self-employment income, and receive $10,000 in wages subject to social security and Medicare taxes. You multiply the $70,000 by 0.9235 on *Long Schedule SE* for the 7.65% deduction, and the result is $64,645. Next, you subtract your wages of $10,000 from $60,600, the maximum income subject to the social security part of the self-employment tax. The result is $50,600. Since only $50,600 of your earnings is subject to the social security part of the self-employment tax, your tax for this part is 12.4% (.124) ×$50,600, or $6,274.40.

Since all of your net earnings are subject to the Medicare part of the self-employment tax, you multiply all of your net earnings from self-employment, $64,645, by 2.9% (.029) on *Long Schedule SE* for the Medicare part, and the result is $1,874.71. Add this to the $6,274.40 figured above for total self-employment tax of $8,149.11.

Nonfarm Optional Method

The nonfarm optional method is figured on *Long Schedule SE* (Section B). By using the nonfarm optional method, you can continue your self-employment tax coverage when your net profit for the year is small or you have a loss. But you may not use this method to report an amount less than your actual net earnings from self-employment.

Use the nonfarm optional method only for self-employment income that does not come from farming. You may use this method if you meet all the following tests:

1) Your net nonfarm profits, as shown on line 31 of Schedule C (Form 1040), line 3 of Schedule C–EZ (Form 1040), and line 15a of Schedule K–1 (Form 1065), are less than $1,733 (.9235 × $1,733 = $1,600.43).
2) Your net nonfarm profits are less than 72.189% of your gross nonfarm income.
3) You are self-employed on a regular basis. Self-employment on a regular basis means that your actual net earnings from self-employment were $400 or more in at least 2 of the 3 tax years before the one for which you use this method.
4) You have not previously used this method more than 4 years (there is a 5-year lifetime limit). The years do not have to be one after another.

For more information on the nonfarm optional method, see Publication 533.

Self-Employment Tax Deduction

You can deduct one-half of your self-employment tax as a business expense in figuring your adjusted gross income. This is an income tax adjustment only. It does not affect either your net earnings from self-employment or your self-employment tax. You deduct it on line 25 of Form 1040.

12. Employment Taxes

Important Changes for 1994

Tax rates and maximum wages. The social security tax and Medicare tax rates remain the same for 1994 and 1995. The social security tax is 6.2% for both the employer and the employee (12.4% total). The Medicare tax is 1.45% for both the employer and the employee (2.9% total). The wage base for social security for 1994 is $60,600. For 1995, the wage base for social security is $61,200. For 1994 and 1995, there is no wage base limitation for Medicare tax; all covered wages are subject to Medicare tax.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains 6.2% through 1995.

Important Reminders

Earned income credit. You, as an employer, must notify employees who worked for you and from whom you did not withhold income tax about the earned income credit.

Form W–4 for 1995. You should make new Forms W–4 available to your employees and encourage them to check their income tax withholding for 1995. Those employees who owed a large amount of tax or received a large refund for 1994 may need to file a new Form W–4.

Children employed by parents. Wages you pay to your children age 18 and older for services in your trade or business are subject to social security taxes.

Topics

This chapter discusses:

- Who are employees?
- Certain crew members considered self-employed
- Income tax withholding
- Social security and Medicare taxes
- Paying social security, Medicare, and withheld income taxes
- Federal unemployment tax
- Family members
- Advance payment of earned income credit

Useful Items

You may want to see:

Publication

- ❏ **15** Circular E, Employer's Tax Guide
- ❏ **937** Employment Taxes

Form (and Instructions)

- ❏ **W–2** Wage and Tax Statement
- ❏ **W–4** Employee's Withholding Allowance Certificate
- ❏ **W–5** Earned Income Credit Advance Payment Certificate
- ❏ **W–9** Request for Taxpayer Identification Number and Certification
- ❏ **940 and 940–EZ** Employer's Annual Federal Unemployment (FUTA) Tax Return
- ❏ **941** Employer's Quarterly Federal Tax Return

If you have employees, you may be required to withhold, report, and deposit employment taxes. You may have to withhold federal income tax from their wages. You may also be subject to social security and Medicare taxes under the Federal Insurance Contributions Act (FICA) and unemployment tax under the Federal Unemployment Tax Act (FUTA).

However, no withholding is required for crew members who are treated as self-employed individuals. You may be required only to file a Form 1099–MISC, *Miscellaneous Income,* to report the payments made to these crew members. See *Certain Crew Members Considered Self-Employed,* later in this chapter.

Every employer subject to employment taxes must have an employer identification number. If you do not have one, you should get Form SS–4, *Application for Employer Identification Number,* from the Internal Revenue Service. You should file the completed application form with the Internal Revenue Service Center where you file your federal tax returns.

New employees. You must ask each new employee to complete the employee part of Immigration and Naturalization Service (INS) Form I–9, *Employment Eligibility Verification.* You must then complete the employer part of the form to verify the employee's identity and eligibility to work. You can get M–274, *Handbook for Employers,* which contains Forms I–9 and instructions, from INS regional and district offices.

Who Are Employees?

Common-law rules are used to determine whether a person working for you is an employee for purposes of social security and Medicare taxes (FICA taxes), federal unemployment tax (FUTA tax), and federal income tax withholding. Under the common-law rules, anyone who performs services that are subject to the will and control of an employer, as to both what must be done and how it must be done, is an employee. It does not matter whether the employer allows the employee discretion and freedom of action, as long as the employer has the legal right to control both the method and the result of the services. Two of the usual characteristics of an employer-employee relationship are that the employer supplies the employee with tools and a place to work and the employer has the right to discharge the employee.

If you have an employer-employee relationship, it makes no difference how it is described. It does not matter if the employee is called an employee, partner, co-adventurer, agent, or independent contractor. It does not matter how the payments are measured, how they are made, or what they are called. Also, it does not matter whether the individual is employed full or part time.

For employment tax purposes, no distinction is made among classes of employees. Superintendents, managers, and other supervisory personnel are all employees.

In doubtful cases, the facts will determine whether or not there is an actual employer-employee relationship. If you want the IRS to determine whether a worker is an employee, file Form SS–8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding,* with your District Director.

Example 1. The Pan Fishing Co. engaged Mike Rose to captain one of its fishing trawlers. The trawler is a United States vessel of more than 10 net tons. The Pan Fishing Co. and Mike Rose entered into a contract of service within the United States. Mike hires a crew of 15 to operate the vessel. He offers to pay each crew member on the ''lay'' (sharing of the profit) basis. He and the crew members, except the engineer who is paid a straight fee, are jointly liable for any losses resulting from a voyage.

After the voyage, Mike sells the catch through a fish exchange, which deducts its fees from the proceeds. After deducting certain specified expenses (such as fuel, oil, etc.), he turns one-fourth of the proceeds over to Pan Fishing Co., less 5% which he keeps as his commission. From the remaining three-fourths, the expenses of food, bait, etc., are deducted. The remainder is then equally divided among the members of the crew and Mike.

The members of a fishing crew are generally employees either of the captain (if he is not an agent of the owner of the vessel) or of the vessel owner. Amounts paid to crew members on the ''lay'' basis are considered wages, and the agreements under which the crews are hired in these circumstances are contracts of hire.

In this example, Mike is acting as an agent of Pan Fishing Co.; therefore, the company is the employer. As an employer of a crew working on an American vessel under a contract entered into in the U.S., the company must withhold income tax and social security and Medicare taxes from the entire crew's wages, including Mike's and the engineer's. The company also must pay the employer's portion of the social security and Medicare taxes. Because the trawler is a vessel of more than 10 net tons with a crew of more than nine members, the company also must pay federal unemployment tax on these wages.

The value of meals and lodging furnished to the crew is not subject to income tax withholding, social security and Medicare taxes, and federal unemployment taxes, however, because the company must furnish meals and lodging to the employees on board the vessel so that they can perform their services.

Example 2. Assume the same facts as in Example 1, except that Mike Rose is the owner-operator of the vessel and is in no way associated with Pan Fishing Co. In this situation, Mike is the employer for purposes of withholding income tax and FICA taxes from the wages of the crew. He also must pay the employer's part of the social security tax and Medicare taxes. Because the vessel is more than 10 net tons with a crew of more than nine members, Mike must also pay federal unemployment tax on these wages.

Additional information. For more information on the employer-employee relationship, see *Who Are Employees?* in Publication 937.

Certain Crew Members Considered Self-Employed

Wages paid to members of a crew on a fishing boat are not subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax if all the following conditions are met:

1) The members do not get and are not entitled to get any money for their work (other than as provided in condition (2), below);
2) The members get a share of the catch or a share of the proceeds from the sale of the catch;
3) Each member's share depends on the size of the catch; and
4) The operating crew of the boat (or each boat from which a member gets a share for a fishing operation involving more than one boat) is normally fewer than 10 persons.

Each member of the crew who meets these conditions is considered self-employed. The earnings of these crew members are considered trade or business income, and therefore are subject to self-employment tax. See Chapter 11, *Self-Employment Tax.*

Example 1. Mike Jones, an owner of a fishing boat of more than 10 net tons, employs a captain and eight others to work as crew members on the boat. The proceeds from the sale of the catch offset boat operating expenses, including bait, ice, and fuel. 60% of the balance is divided among the captain and the crew members and 40% between Mike and the captain.

Between voyages, the crew members do not receive any additional compensation, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch. However, the mate, the engineer, and the cook get an additional payment from Mike of $100 each. The payment does not depend upon the boat's catch. Since the mate, the engineer, and the cook get this additional payment that does not depend on the amount of the catch, they are not considered self-employed. The $100 payment and their share of the proceeds from the catch are subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax.

Since the other six crew members, including the captain, do not get any additional pay and are members of an operating crew of fewer than 10 members, they are considered self-employed. Mike does not have to withhold federal income tax or social security and Medicare taxes from their pay. They must pay self-employment tax on their earnings.

Example 2. The facts are the same as in Example 1, except that, in addition to receiving a share of the catch, the captain and the other crew members are entitled to get $10 per hour for repairing nets, constructing new nets, splicing cable, and other incidental work while in port. Since the crew members are entitled to receive payment other than a share of the catch, they are not considered self-employed. The $10 per hour payment plus their share of the proceeds from the catch are subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax.

Reporting requirements. The operator of a boat must file with the IRS a completed Form 1099–MISC, *Miscellaneous Income,* if any of the crew members work as self-employed individuals. All amounts must be reported. The $600 or more general rule for Form 1099–MISC does not apply.

Form 1099–MISC must be filed with the IRS by February 28 following the calendar year in which the crew member was paid.

Statement to crew members. Every operator who is required to file Form 1099–MISC must also furnish a statement to each crew member. You may use Copy B of Form 1099–MISC for this purpose. This statement must be furnished to all crew members by January 31 of the year following the calendar year in which the crew members were paid.

Unemployment tax. Self-employed crew members do not have to pay federal unemployment tax on their earnings. However, the operator of the boat may be subject to federal unemployment tax on the earnings of crew members who perform services that come under the exceptions stated later in this chapter under *Federal Unemployment Tax.*

Record requirement. The operator must keep a record of each catch. These records must be kept for 3 years after the tax year in which the catch occurred.

Income Tax Withholding

Generally, you must withhold income tax from wages that you pay an employee if the wages (whether paid in cash or in fish) are more than the dollar value of withholding allowances for that pay period. You should not withhold income tax from the wages of an employee who, by filing Form W–4, certifies that he or she had no income tax liability last year and anticipates no income tax liability for the current year.

The amount to withhold is figured on gross wages without taking out social security and Medicare taxes, union dues, insurance, etc. Several methods may be used to determine the amount of withholding. They are described in Circular E.

Form W–4 for 1995. You should make new 1995 Forms W–4 available to your employees, and encourage them to check their income tax withholding situation for 1995. Those employees who owed a large amount of tax or received a large refund for 1994 may need to file a new 1995 Form W–4.

Effective date of Form W–4. You must put a new Form W–4 into effect no later than the start of the first payroll period ending on or after the 30th day from the date that you receive the new form. If you pay wages without regard to a payroll period, you must put the new Form W–4 into effect no later than the first payment of wages on or after the 30th day from the date that you receive the new Form W–4.

Meals and lodging. Meals are not subject to income tax withholding if furnished for the employer's convenience and on the employer's premises. Lodging is not subject to withholding if furnished for the employer's convenience, on the employer's premises, and as a condition of employment.

Backup withholding. In certain cases, the law requires you to withhold income tax at 31% (backup withholding) on payments of commissions, nonemployee compensation, and other payments for services that you make in the course of commercial fishing or other business activities. The backup withholding rules do not apply to wages.

The payer must withhold 31% of the payment if:

1) The payee does not furnish a taxpayer identification number to the payer; or

2) The IRS notifies the payer that the payee furnished an incorrect taxpayer identification number.

Backup withholding applies to payments by fishing boat operators made in cash which represent a share of the catch. It also applies to other payments for services reportable on Form 1099–MISC in any of the following situations:

1) The amount you receive from any one payer is $600 or more.
2) The payer was required to give you a Form 1099–MISC last year.
3) The payer made payments to you last year that were subject to backup withholding.

Backup withholding is generally not required for a payment of less than $10.

Other types of reportable payments are subject to backup withholding under these rules. Payments of interest and dividends may be subject to backup withholding for other reasons. See Publication 505, *Tax Withholding and Estimated Tax,* for more information.

Amounts withheld under the backup withholding provisions are reported on Form 945. Also, these amounts are shown on information returns in the 1099 series reporting payments for the year. For more information on information returns and backup withholding, see *1994 Instructions for Forms 1099, 1098, 5498, and W–2G.*

Form W–9 may be used by payers to request payees to furnish a taxpayer identification number and to certify that the number furnished is correct.

Social Security and Medicare Taxes

The Federal Insurance Contributions Act (FICA) provides for a federal system of old-age, survivors, disability, and hospital insurance. This system is financed through social security and Medicare taxes. Social security and Medicare taxes (FICA taxes) are paid by you and your employees. You, as an employer, must collect and pay the employee's share, and you must pay your own share of this tax. You must withhold it from your employee's wages, whether paid in cash or in fish, in much the same way as income tax, discussed earlier.

Payments in kind. Generally, payments in kind are subject to social security taxes in the same way as wages paid in cash. However, the value of meals that are exempt from income tax withholding because they are furnished for the employer's convenience and on the employer's premises are also exempt from social security and Medicare taxes. Similarly, lodging that is exempt from income tax withholding because it is furnished for the employer's convenience, on the employer's premises, and as a condition of employment, is also exempt from these taxes.

Withholding tables for social security and Medicare taxes. Tables showing the amount to be withheld from the employee are provided in Circular E. The employer's tax rate for 1994 is 7.65% and the employee's tax rate is also 7.65% (a total of 15.3%). The 7.65% tax is a total of 6.2% for social security (old-age, survivors, and disability insurance), and 1.45% for Medicare (hospital insurance). No withholding allowances are allowed for social security and Medicare taxes.

Wage base limit. For 1994, the maximum amount subject to the social security part (6.2%) is $60,600. For 1995, the maximum amount subject to the social security part is $61,200. For 1994 and 1995, there is no wage base limitation for Medicare tax; all covered wages are subject to Medicare tax.

Paying Social Security, Medicare, and Withheld Income Taxes

You must deduct and withhold income, social security, and Medicare taxes from the salaries and wages of your employees. You are liable for the payment of these taxes to the federal government whether or not you collect them from your employees. If, for example, you deduct less than the correct tax from your employees' wages, you are still liable for the full amount.

If you must withhold income tax from wages or are liable for social security and Medicare taxes, you must file Form 941. A return may never cover a period of more than one calendar quarter. Fill in all the information requested on the return, including your employer identification number.

Deposits of taxes. Your total liability for social security and Medicare taxes and federal income tax withholding will determine whether deposits are necessary and, if so, how often they must be made. To help ensure proper crediting to your account when depositing taxes, write your employer identification number, ''Form 941,'' and the tax period the deposit applies to on your check or money order. See Circular E for information on depositing social security and Medicare taxes, withheld income taxes, and use of authorized depositaries.

If you must make deposits of taxes and you make timely deposits in full payment of the taxes due, you can file your quarterly return on or before the 10th day of the second month following the period for which it is made. In this case, the due dates for 1995 are as follows:

Quarter	*Due date*
January-February-March	May 10
April-May-June	Aug. 10
July-August-September	Nov. 13
October-November-December	Feb. 12, 1996

Seasonal or intermittent employers. If you are a seasonal or intermittent employer, you do not have to file Form 941 when you have paid no wages during a quarter. However, you must check the seasonal filer box on Form 941 on each return you file so the IRS will not expect a return each quarter.

Penalties. If you do not deposit social security, Medicare, and withheld income taxes on time with an authorized financial institution or a Federal Reserve bank, you may have to pay a penalty. In addition, the IRS can require you to file monthly returns for these taxes on Form 941–M, *Employer's Monthly Federal Tax Return.* The penalty will not apply if the failure to meet the deposit requirements was due to reasonable cause and not to willful neglect.

Federal tax deposit penalties. The penalty for a late tax deposit is based on the length of time the deposit is late. The following penalties apply for late deposits:

1) If the deposit is not more than 5 days late, the penalty is 2% of the underpayment.
2) If the deposit is more than 5 days late but not more than 15 days late, the penalty is 5% of the underpayment.
3) If the deposit is more than 15 days late, the penalty is 10% of the underpayment.
4) If the deposit is not made within 10 days after the IRS issues the first notice demanding payment or by the day that notice and demand for immediate payment is given, the penalty is 15% of the underpayment.

Trust fund recovery penalty. If you are a person responsible for withholding, accounting for, or depositing or paying withholding taxes and willfully fail to do so, you can be held liable for a penalty equal to the tax not paid, plus interest. A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. A trustee or agent with authority over the funds of the business can also be held responsible for the penalty.

''Willfully'' in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered to be acting willfully.

Forms for employees. You must furnish copies of Form W–2 to each employee from whom income or social security and Medicare taxes have been withheld. You must also furnish it to employees from whom income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W–4. The Form W–2 must show the total wages and other compensation paid (whether or not they are subject to withholding), and the amounts deducted for income, social security, and Medicare taxes.

Fill in all the information required on the form. More detailed information for preparing Form W–2 is contained in the *Instructions for Form W–2.*

Form W–3. Employers must file Form W–3, *Transmittal of Income and Tax Statements,* annually to transmit Forms W–2 that were issued for the preceding year. Form W–3 and its attachments must be filed with the Social Security Administration on or before the last day of February following the calendar year for which the Forms W–2 are prepared.

Additional information. Circular E contains tables for withholding income, social security, and Medicare taxes. It also contains more information about employment taxes. You can get Circular E from the IRS Forms Distribution Center for your state.

Federal Unemployment Tax

You are subject to federal unemployment tax (FUTA) if during the current or preceding calendar year, you:

1) Paid total wages of $1,500 or more in any calendar quarter; or
2) Employed one or more employees for some part of at least 1 day during each of 20 different calendar weeks. The 20 weeks do not have to be consecutive. Nor does it have to be the same employee each week. Individuals on vacation and sick leave are counted as employees in determining your status.

These rules apply to federal unemployment tax, but not to social security and Medicare taxes or withholding of income tax. Also, they do not apply to your spouse, parents, or children under age 21. See *Family Members,* later.

Catching fish. Services performed in catching fish are exempt from federal unemployment tax except for:

1) Work related to catching salmon or halibut for commercial purposes; or
2) Work performed on or in connection with a vessel of more than 10 net tons.

However, work that is not exempt under this rule may qualify as exempt if the four conditions discussed earlier under *Certain Crew Members Considered Self-Employed* are met.

Meals and lodging. Meals and lodging are not subject to federal unemployment tax if certain conditions, discussed earlier in *Payments in kind* under *Social Security and Medicare Taxes,* are met.

Figuring the tax. The gross federal unemployment tax rate for 1994 and 1995 is 6.2% of the first $7,000 in wages paid to each employee. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. The net tax rate, therefore, can be as low as 0.8% in 1994 if your state is not subject to a credit reduction, discussed below. If your state tax rate (experience rate) is less than 5.4%, you are still allowed the full 5.4% credit. However, you cannot take the credit for any state taxes you fail to pay. If for any reason you are exempt from state unemployment tax, the full 6.2% rate applies.

Credit reduction. The 5.4% credit may be reduced for employers in some states. A credit reduction is required if a state's unemployment fund borrows from the federal government and keeps an outstanding balance for 2 or more years. For 1994, no state is subject to a credit reduction.

Form 940. If you are liable for the federal unemployment tax, an annual return must be filed on Form 940 by January 31 following the close of the calendar year for which the tax is due. Any tax still due on that date is payable with the return. If you mail the tax payment with your return, complete the Payment Voucher on the return but do not detach it. Mail the return with the payment to the address shown for "Return with payment" in the instructions.

For more information about the federal unemployment tax, including the deposit rules, see the instructions on Form 940.

Form 940–EZ. Form 940–EZ, a simplified version of Form 940, can be used by employers:

1) Who paid state unemployment taxes to only one state;
2) Who paid the state taxes by the due date of Form 940 or Form 940–EZ;
3) Whose wages taxable for FUTA tax were also taxable for state unemployment tax; and
4) Who paid no wages subject to the unemployment compensation laws of a credit reduction state.

Family Members

Child of employer. The services of a child under the age of 18 who works for his or her parent in a trade or business, or a partnership consisting only of the child's parents, are not covered by social security and Medicare. If these services are for work other than in a trade or business, such as domestic work in the parent's private home, they are not covered by social security and Medicare until the child reaches 21.

Federal unemployment does not cover the services of a child under the age of 21 who works for his or her parent (whether or not in a trade or business), or for a partnership consisting only of the child's parents.

The above rules apply even if the child is paid regular wages. The wages for these services are not subject to social security and Medicare or federal unemployment taxes. But the wages may still be subject to income tax withholding.

One spouse employed by another. The wages for the services of an individual who works for his or her spouse in a trade or business are covered by social security and Medicare taxes, but not by federal unemployment taxes. However, the services of one spouse employed by another in other than a trade or business, such as domestic service in a private home, are not subject to social security and Medicare taxes or federal unemployment taxes.

Covered services of a child or spouse. The wages for the services of a child or spouse are covered by social security, Medicare, and federal unemployment, if he or she works for:

1) A corporation, even if it is controlled by the child's parent or the individual's spouse;
2) A partnership, even if the child's parent is a partner, unless each partner is a parent of the child;
3) A partnership, even if the individual's spouse is a partner; or
4) An estate, even if it is the estate of a deceased parent.

Under these conditions, a child is not considered to work for his or her parent. Nor is a married individual considered to work for his or her spouse.

Advance Payment of the Earned Income Credit

Employers are generally required to make payments to employees who have filed with them a Form W–5 to receive advance payments of part of their earned income credit. This allows those employees to receive the benefit of part of their credit each payday rather than having a single amount credited to them later on their tax return.

The payment is added to the pay of the employees each payday. It is figured from tables in Circular E. Employers reduce their liability for income tax withholding and social security and Medicare taxes by the total amount of the advance earned income credit payments made. For more information, see *Advance Payment of Earned Income Credit* in Publication 937.

Earned income credit notification. You must notify each employee who worked for you at any time during the year and from whom you did not withhold any income tax about the earned income credit (EIC). However, you do not have to notify employees who claim exemption from withholding on Form W–4.

You can meet the notification requirement by giving each employee the official IRS Form W–2, which contains the notification on the back of Copy C, or you can give each employee Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC).* You can also use your own written statement as long as it has the exact wording of Notice 797, or you can furnish substitute Forms W–2 containing the exact wording shown on the back of Copy C of the official Form W–2.

You must so notify each employee, either in person or by First Class Mail, with his or her 1994 Form W–2 or within 1 week before or after that time, unless you use a substitute Form W–2 as the notice. If you do not furnish Form W–2 on time, you must notify the employee about the EIC by the date Form W–2 was required to be furnished. If Form W–2 is not required, you must notify the employee about the EIC by February 7, 1995.

You may request supplies of Notice 797 by calling the IRS toll-free telephone number 1–800–TAX–FORM (1–800–829–3676).

13. Capital Construction Fund

Topics

This chapter discusses:

- Qualifying vessels
- Deduction for contributions
- Tax treatment of withdrawals

Useful Items

You may want to see:

Publication

❏ **542** Tax Information on Corporations

Form (and Instructions)

❏ **Sch C** (Form 1040) Profit or Loss From Business

❏ **Sch SE** Self-Employment Tax

The Capital Construction Fund (CCF) is a special investment program administered by the National Marine Fisheries Service (NMFS). This program allows you, as a commercial fisherman, to enter into an agreement with the Secretary of Commerce to invest part of your income in an interest-bearing trust fund (savings accounts, stocks, bonds, etc.). These funds are to be used to acquire or construct a new fishing vessel or to reconstruct or recondition one you already own. You can establish a fund for any or all vessels you own.

Qualifying vessels. If you are a citizen of the United States who owns or leases an eligible vessel, you may enter into an agreement to establish a CCF. To be eligible, a vessel must:

1) Be built or rebuilt in the United States,
2) Have a home port in the United States if it weighs between 2 and 5 net tons,
3) Be documented under the laws of the United States if the vessel weighs 5 net tons or more, and
4) Be operated in the foreign or domestic commerce of the United States or the fisheries of the United States.

Note: Any vessel constructed outside the United States but documented under the laws of the United States on April 15, 1970, or any vessel constructed outside the United States for use in United States foreign trade in accordance with a contract entered into before April 15, 1970, is both eligible and qualifying for purposes of establishing a CCF.

CCF Accounts

Each CCF fund has three separate bookkeeping accounts. These accounts are:

1) The capital account,
2) The capital gain account, and
3) The ordinary income account.

CCF Contributions

You can exclude from taxable income any amounts you deposit in your CCF account coming from the following sources:

1) Earnings attributable to the operation of the agreement vessels,
2) Net proceeds from sales or other dispositions of, or from insurance on, agreement vessels (if the net proceeds from the transaction are deposited in the fund), and
3) Earnings of the fund.

A deposit to the capital account does not generate a CCF tax deduction. A deposit to a capital gain account defers tax on the capital gain part of a sale or other disposition if the net proceeds from the transaction are deposited in the fund. A deposit to the ordinary income account creates an immediate income tax reduction.

Alternative minimum tax. Contributions made by a corporation to a CCF are treated as an adjustment used in figuring alternative minimum taxable income. For information on the alternative minimum tax for corporations, see Publication 542.

Dispositions. Gain on the disposition of a vessel covered by an agreement is excluded from income tax if the net proceeds from the sale or other disposition of, or from insurance on, the vessel is deposited into the fund. Ordinary income from depreciation recapture is also excluded from tax.

Investment earnings. Earnings from investment and reinvestment of amounts held in the fund are excluded from gross income. Report any amounts earned as interest or dividends, that are held in your CCF account, on the appropriate form or schedule for the tax return you file. Identify the amounts as ***CCF earnings.*** Then subtract the same amounts and identify them as ***CCF deposits.***

Deduction for CCF Contributions

If you enter into a CCF agreement, you can take a deduction for the investment when figuring your taxable income. For income tax purposes, you reduce taxable income by the amount contributed to the fund up to the lesser of:

1) Your taxable income for the year, or
2) Your taxable income from fishing operations.

This limit is not affected by a net operating loss (NOL) carryback or net capital loss.

How To Take the Deduction

How to take the deduction for a CCF investment depends on how you file your tax return.

Individuals. The deduction for a CCF investment is not taken on Schedule C or C–EZ (Form 1040). To take the deduction, you subtract the deduction from the amount that would normally be entered as taxable income on line 37 (Form 1040). In the margin to the left of line 37, write ''CCF'' and the amount of the deduction.

Note: If you take a deduction for a CCF contribution and must complete other forms such as Form 6251 or the worksheets for Schedule D, you will need to make an extra computation. When the other form tells you to use an amount from line 35, Form 1040, do not use that amount. Instead, add lines 36 and 37, Form 1040, and use that amount.

Partnerships. The deduction for contributions to a CCF for a partnership is separately stated on Schedule K (Form 1065), Line 11 and allocated to the partners on Schedule K-1 (Form 1065), line 11.

S Corporations. The deduction for contributions to a CCF for an S corporation is separately stated on Schedule K (Form 1120S), line 10 and allocated to the shareholders on Schedule K-1 (Form 1120S), line 10.

Corporations. The deduction for contributions to a CCF for a corporation is made by subtracting the amount of the deduction from the amount that would normally be entered on line 30 of Form 1120. On the dotted line next to line 30, write ''CCF'' and enter the amount of the deduction. For information on computing taxable income, see Publication 542.

Self-employment tax. You must figure your self-employment tax by transferring your net profit or loss from line 31, Schedule C (Form 1040) to line 2, Schedule SE (Form 1040). Do ***not*** reduce the net profit or loss from your fishing business by the amount deposited in the CCF.

CCF Withdrawals

Withdrawals from a CCF account, approved by the NMFS for payment towards fishing vessels you will construct, reconstruct, or acquire with the money in your CCF account, are qualified withdrawals. Any other withdrawal is a nonqualified withdrawal.

Note: The ''acquisition, construction, or reconstruction of a qualified vessel'' includes acquiring a vessel through either purchase or lease of a vessel for a period of five years or more.

Tax Treatment of Qualified Withdrawals

A qualified withdrawal from either the ordinary income account or the capital gain account reduces the depreciable basis of your fishing vessel by 100% of the withdrawal.

Qualified withdrawals from a CCF shall be treated as:

1) First, as made from the capital account,
2) Second, as made from the capital gain account, and
3) Third, as made from the ordinary income account.

Tax Treatment of Nonqualified Withdrawals

Nonqualified withdrawals made from either the ordinary income account or the capital gain account of a CCF are taxed separately from other gross income at the highest marginal tax rate. You treat any nonqualified withdrawal you make in the following order:

1) First, as made from the ordinary income account,
2) Second, as made from the capital gain account, and
3) Third, as made from the capital account.

In any tax year in which you make a nonqualified withdrawal, you figure the tax on the amount of the nonqualified withdrawal separately from other gross income. The amount of the withdrawal is excluded from your gross income. To figure the tax on the nonqualified withdrawal, you multiply the withdrawal amount by the highest rate of tax.

Interest. Interest is assessed on the additional tax due to a nonqualified withdrawal. The period for the interest begins from the last date for paying tax for the tax year in which you deposited the amount in the CCF to the last date for paying tax for the tax year in which you make the nonqualified withdrawal. The interest rate on the nonqualified withdrawal is simple interest. The interest rate is subject to change annually to reflect the investment yields and money rates after 1971. For more information on computing the interest, see Regulation 3.7(e).

Attach a statement to your tax return that shows the computation of both the tax and interest for the nonqualified withdrawal.

Interest deduction. Interest paid on a nonqualified withdrawal is allowable as an interest deduction as a trade or business expense.

Individuals. Include the tax and interest for the nonqualified withdrawal on line 53 of Form 1040. To the left of line 53, write the amount of tax and interest and ''CCF.''

Partnerships. The partners in a partnership are taxed at their highest marginal rate for nonqualified withdrawals from a CCF made by the partnership. The partnership reports the nonqualified withdrawal on a statement attached to Schedule K (Form 1065) explaining line 22 and allocates this amount to the partners on Schedule K–1, line 23.

S Corporations. The shareholders of an S corporation are taxed at their highest marginal rate for nonqualified withdrawals from a CCF made by the corporation. However, the amount of the withdrawal taxed to the shareholders is reduced by a proportionate share of the tax paid by the corporation on the amount of each withdrawal that was included in:

1) The net capital gain taxed to the corporation under section 1374 of the Internal Revenue Code (as in effect prior to the enactment of the Tax Reform Act of 1986),
2) The net recognized built-in gains taxed to the corporation under section 1374 of the Internal Revenue Code, or
3) The net passive income taxed to the corporation under section 1375 of the Internal Revenue Code.

The S corporation reports the nonqualified withdrawal (after reducing for its share of the above taxes) on a statement attached to Schedule K (Form 1120S) explaining line 21 and allocates this amount to the shareholders on Schedule K–1 (Form 1120S), line 23.

Corporations. Corporations are taxed on nonqualified withdrawals made from a CCF. Corporations must figure the tax and interest for a nonqualified withdrawal separately and include this tax and interest on Schedule J (Form 1120), Line 10. On the dotted line next to line 10, they must write ''CCF'' and the amounts of tax and interest. A nonqualified withdrawal is subject to the highest tax rate for corporations.

Estates. An estate must figure the tax for a nonqualified withdrawal on Schedule G (Form 1041).

Tax benefit rule. If any portion of your nonqualified withdrawal is properly attributable to contributions (not earnings on the contributions) you made to the fund and they did not reduce your tax liability for any tax year prior to the withdrawal year, the tax treatment is as follows:

1) The portion that did not reduce your tax liability for any year prior to the withdrawal year is not taxed, and
2) An amount equal to that portion is allowed as a net operating loss deduction.

Amounts not withdrawn from fund after 25 years. Amounts not withdrawn from a fund after 25 years from the date deposited are taxed as nonqualified withdrawals. There are percentages beginning with year 26 and later that determine the amount of the nonqualified withdrawal.

More information. This chapter briefly discusses the CCF program. For more detailed information, see section 607 of the Merchant Marine Act of 1936 as amended (46 USC 1177), section 7518 of the Internal Revenue Code and the regulations for each. You may also obtain a free question and answer type publication about the CCF program from:

National Marine Fisheries Service
Capital Construction Fund Program
1335 East-West Highway, 5th Floor
Silver Spring, MD 20910
Telephone: (301) 713–2393

14. Excise Taxes

Important Reminder

Diesel fuel. The excise tax applies to diesel fuel used in boats. Certain uses will qualify for a credit or refund of the tax. Dyed diesel fuel used in a nontaxable use (such as commercial fishing) is not taxed.

Topics

This chapter discusses:

- Fuels used in boats
- Fuels used in off-highway business use
- How to buy fuel tax free
- Diesel-powered highway vehicles
- How to claim a credit or refund
- Including the credit or refund in gross income

Useful Items

You may want to see:

Publication

- ❏ **378** Fuel Tax Credits and Refunds
- ❏ **510** Excise Taxes for 1995

Form (and Instructions)

- ❏ **4136** Credit for Federal Tax Paid on Fuels

❏ **8849** Claim for Refund of Excise Taxes

You may be eligible to claim a credit on your 1994 income tax return for federal excise tax paid on certain fuels. You may also be eligible to claim a quarterly refund of the fuel taxes during 1995, instead of waiting to claim a credit on your 1995 income tax return.

Also, you may be eligible to claim a credit or refund as the original purchaser of a diesel-powered car, van, or light truck. This applies even if the vehicle is not used in a trade or business. See *Diesel-Powered Highway Vehicles,* later.

You may be able to buy certain fuel tax free instead of buying the fuel tax paid and then filing for a credit or refund. See *How To Buy Fuel Tax Free,* later.

For information about credits and refunds for fuels used for nontaxable purposes not discussed in this chapter, see Publication 378.

Fuel Used In Boats

You may be eligible to claim a credit or refund of excise tax included in the price of fuel you use in a vessel employed in the fisheries or whaling business.

Boats used in fishing include only watercraft used in taking, catching, processing, or transporting fish, shellfish, or other aquatic life for commercial purposes, such as selling or processing the catch, on a specific trip basis. It includes boats used in both fresh and salt water fisheries. It does not include watercraft used on a specific trip for both sport fishing and commercial fishing.

Aircraft. Fuel used in aircraft to locate fish is not fuel used in commercial fishing.

Diesel fuel. You may be eligible to claim a credit or refund of the excise tax on undyed diesel fuel if you use the fuel in the boat in the active conduct of:

- A trade or business of commercial fishing or transporting persons or property for compensation or hire, or
- Any other trade or business, unless the boat is used predominantly for entertainment, amusement, or recreation.

No credit or refund is allowed on dyed diesel fuel.

Fuels Used In Off-Highway Business Use

You may be eligible to claim a credit or refund of excise tax included in the price of fuels used in off-highway business use.

Off-highway business use. Off-highway business use is any use of fuel in a trade or business or in any income-producing activity. The use must not be in a highway vehicle registered for use on public highways.

Highway vehicle. A highway vehicle includes any self-propelled vehicle designed to carry a load over public highways, whether or not also designed to perform other functions. Examples of vehicles designed to carry a load over public highways are passenger automobiles, motorcycles, buses, highway-type trucks, and truck tractors. It does not matter if:

1) The vehicle's design allows it to perform a highway transportation function for only
   a) A particular type of load, such as passenger, furnishings, and personal effects (as in a house, office, or utility trailer), or
   b) A special kind of cargo, goods, supplies, or materials, or
2) Machinery or equipment is designed (and permanently mounted) to perform some off-highway task unrelated to highway transportation except as discussed next.

Vehicles not considered highway vehicles. Generally, the following kinds of vehicles are not considered highway vehicles:

- Specially designed mobile machinery for nontransportation functions. A self-propelled vehicle is not a highway vehicle if the chassis—
  a) Has permanently mounted to it machinery or equipment used to perform certain operations (construction, manufacturing, drilling, mining, timbering, processing, farming, or similar operations) if the operation of the machinery or equipment is unrelated to transportation on or off the public highways,
  b) Has been specially designed to serve only as a mobile carriage and mount for the machinery or equipment, whether or not the machinery or equipment is in operation, and
  c) Because of its special design, could not, without substantial structural modification, be used as part of a vehicle designed to carry any other load.
- Vehicles designed for off-highway transportation. A self-propelled vehicle is not a highway vehicle if—
  a) The vehicle is designed primarily to carry a specific kind of load other than over the public highway for certain operations (construction, manufacturing, mining, processing, farming, drilling, timbering, or similar operations), and
  b) The vehicle's use of carrying this load over public highways is substantially limited or impaired because of its design. To determine if the vehicle is substantially limited or impaired, you may take into account whether the vehicle may travel at regular highway speeds, requires a special permit for highway use, or is overweight, overheight, or overwidth for regular highway use.

A ***public highway*** includes any road in the United States that is not a private roadway. This includes federal, state, county, and city roads and streets.

Registered. A vehicle is considered registered when it is registered or required to be registered for highway use under the law of any state, the District of Columbia, or any foreign country in which it is operated or situated. Any highway vehicle operated under a dealer's tag, license, or permit is considered registered. A highway vehicle is not considered registered solely because a special permit allows the vehicle to be operated at particular times and under specified conditions.

Fuel used for power take-offs. You cannot take a credit or refund for fuel used in the motor (for propulsion) of a highway vehicle that also operates special equipment by means of a power take-off or power transfer. It does not matter if the special equipment is mounted on the vehicle.

Separate motor. The fuel you use in a separate motor to operate special equipment, such as a refrigeration unit, pump, generator, or mixing unit, may qualify for a credit or a refund. If you draw fuel from the same tank to operate both of the motors, you must figure the quantity used in the separate motor operating the special equipment. You may make a reasonable estimate based on your operating experience and supported by your records.

You can use devices that measure the miles the vehicle has traveled (such as hubometers) to figure the gallons of fuel used to propel the vehicle. Add to this amount the fuel consumed while idling or warming up the motor before propelling the vehicle. The difference between your total fuel used and the fuel used to propel the vehicle is the fuel used in the separate motor.

Diesel fuel. Undyed diesel fuel used other than as a fuel in the propulsion engine of a diesel-powered highway vehicle or boat qualifies for a credit or refund. No credit or refund is allowed for any use of dyed diesel fuel.

Fuel lost or destroyed. You cannot treat fuel lost or destroyed through spillage, fire, or other casualty as fuel used in an off-highway business use.

Examples. Off-highway business use in a trade or business or income-producing activity includes fuels used:

1) In stationary machines such as generators, compressors, power saws, and similar equipment;
2) For cleaning purposes;
3) In forklift trucks and bulldozers; and
4) In vehicles operating off the highway in construction, mining, or timbering activities, if the vehicles are neither registered nor required to be registered.

How To Buy Fuel Tax Free

Instead of buying fuel tax paid and then filing a claim for credit or refund when the fuel is used for a nontaxable use, you may be eligible to buy it tax free.

Diesel fuel. You buy dyed diesel fuel tax free for use for a nontaxable purpose, such as in a boat used in commercial fishing. You must buy the fuel from a person who is registered with the IRS. However, if you use the dyed diesel fuel for a taxable purpose, you could be subject to the excise tax and a penalty.

Gasoline. Your supplier may be able to sell you gasoline at a tax-excluded price only for use in a ***vessel employed in the fisheries or whaling business.*** You may not buy gasoline for any other purpose at a tax-excluded price.

Your supplier may be eligible to claim a credit or refund of the excise tax on the gasoline sold to you at a tax-excluded price. Refer your supplier to Publication 510, for details.

In order to buy gasoline at a tax-excluded price, give your supplier a signed certificate identifying you and stating how you will use the gasoline. You do not need to renew the certificate as long as the information it contains continues to be correct.

Exemption certificate. The following is an acceptable exemption certificate:

Date__________________________________
The undersigned (''Buyer'') hereby certifies that Buyer bought or will buy for use in a vessel employed in the fisheries or whaling business
(Check the applicable type of certificate)
______The (quantity)_________ of gasoline, or
______ALL the gasoline it buys
at a price that does not include the excise tax from:
Name of seller:___________________________
Address of seller:___________________________
If the gasoline is not used as specified above, Buyer will so notify the person to whom Buyer gives this certificate. Buyer has not and will not claim a refund or credit under section 6421 of the Internal Revenue Code for the excise tax on this gasoline.
Buyer understands that Buyer or any other party may, for fraudulent use of this certificate, be subject to a fine or imprisonment, together with the costs of prosecution.
Signature___________________________
Title___________________________________
TIN_____________________________________
Address____________________________

Diesel-Powered Highway Vehicles

If you buy a qualified diesel-powered car, van, or light truck you may be eligible for a one-time credit or refund. You can purchase the vehicle for either business or personal use. You generally claim the credit on the tax return for the year of purchase. However, if you can claim a refund for certain excise taxes, you may be able to use Form 8849 to claim a refund for the purchase of a vehicle. See *How to claim a refund,* later.

Original purchaser. You must be the original purchaser to be eligible for the credit or refund. An original purchaser is the first person to buy a new qualified diesel-powered vehicle for use other than resale. Treat the lease or rental of a vehicle as a use other than resale.

If you buy and register a qualified diesel-powered vehicle subject to a lien (even if the lienholder holds title to the vehicle), you can claim the credit or refund.

The following do not qualify as original purchasers:

1) State and local governments,
2) Nonprofit educational organizations,
3) Dealers who use the vehicle as a demonstrator vehicle. However, the first person to buy the demonstrator vehicle for use other than resale qualifies as the vehicle's original purchaser.

Qualified diesel-powered highway vehicle. A qualified diesel-powered highway vehicle is one that:

1) Has at least four wheels;
2) Has a gross vehicle weight rating of 10,000 pounds or less; and
3) Is registered for highway use in the United States under the laws of any state.

Amount of credit or refund. You can claim a credit or refund of $102 for a car, and $198 for a light truck or van. A van is a vehicle with no body sections protruding more than 30 inches ahead of the leading edge of the windshield.

Basis reduction. Reduce the basis of any qualified diesel-powered highway vehicle by the credit or refund payable for such vehicle. Consider the basis reduction to occur on the date of purchase.

Example. David purchased a new diesel-powered car to use in his business. He claimed the $102 credit ***only*** for the tax year in which he purchased the car (1994). He reduced his basis in the car by $102 on the date he purchased it.

How to claim a credit. You claim the credit for the purchase of a qualified diesel-powered vehicle on Form 4136. Complete Parts I and III and attach Form 4136 to your income tax return.

If you are not required to file an income tax return, you should do so to take advantage of this refundable credit. If you do not file a return, you cannot claim the credit. Do not claim a credit for any tax for which you have filed a refund claim.

How to claim a refund. You may be eligible to use Form 8849 to claim the refund available to you as the original purchaser of a qualifying diesel-powered highway vehicle. Use Form 8849 only if you qualify to file a quarterly refund claim, as discussed under *Claiming a Refund,* later.

How To Claim a Credit or Refund

You generally can claim a credit or refund of the excise taxes included in the price of fuels you use for nontaxable purposes. No credit or refund is allowed for any fuel, such as dyed diesel fuel, purchased tax free.

Taxpayer identification number. To file a claim for credit or refund, you MUST have a taxpayer identification number — either a social security number or an employer identification number. See *Identification number* in Chapter 11.

Records. Keep at your principal place of business all records needed to enable the IRS to verify the amount you claimed. No special form is required, but the records should establish:

1) The total number of gallons purchased and used during the period covered by your claim,
2) The dates of the purchases,
3) The names and addresses of suppliers and amounts purchased from each during the period covered by your claim,
4) The purpose for which you purchased and used the fuel, and
5) The number of gallons used for each purpose.

It is important that your records show separately the number of gallons used for each purpose that qualifies as a claim.

Claiming a Credit

You make a claim for credit on Form 4136 and attach it your income tax return. Do not claim a credit on Form 4136 for any excise tax for which you have already filed a refund claim on Form 8849.

How to claim a credit. How you claim a credit depends on whether you are an individual, partnership, corporation, S corporation, or trust.

Individuals. Individuals claim the credit on line 59 and check box b of the 1994 Form 1040. Even though you may not otherwise have to file an income tax return, you must do so to obtain a fuel tax credit. See instructions accompanying Form 1040.

Partnerships. The partnership itself cannot claim the credit on Form 1065, *U.S. Partnership Return of Income.* The partnership must attach a statement to Form 1065, showing the number of gallons of each fuel allocated to each partner and the applicable tax rates. Each partner claims the credit on his or her income tax return for his or her share of the fuel used by the partnership.

Corporations. To claim the credit, corporations use either line 32g of Form 1120, *U.S. Corporation Income Tax Return*, or line 28g of Form 1120–A, *U.S. Corporation Short-Form Income Tax Return.*

S corporations. To claim the credit, S corporations use line 23c of Form 1120S, *U.S. Income Tax Return for an S Corporation.*

Trusts. Trusts required to file Form 1041, *U.S. Income Tax Return for Estates and Trusts,* use line 24g to claim the credit.

When to claim a credit. You can claim a fuel tax credit on your income tax return for the year you used the fuels or on an amended return for that year filed within the time prescribed by law. Ordinarily, you must file an amended return by the later of 3 years from the date you filed your original return or within 2 years from the time you paid the tax.

Claiming a Refund

You may be eligible to claim a refund during 1995 rather than waiting until you file your 1995 income tax return to claim a credit. File a claim for refund on Form 8849.

Quarterly refund claim. You can file a quarterly refund claim for any of the first three quarters of your tax year for which you qualify. To qualify for a quarterly refund, you must claim the following amounts for fuel used during the quarter:

1) At least $1,000 for gasoline used for nontaxable purposes such as off-highway business use.
2) At least $1,000 for special motor fuel and compressed natural gas used for nontaxable purposes, such as off-highway business use, and the refund available to the original purchaser of diesel-powered highway vehicles.
3) At least $750 for undyed diesel fuel and aviation fuel used for nontaxable purposes.

A special rule for diesel fuel and aviation fuel allows you to aggregate the amount of fuel used in each quarter. You may file a claim for the quarter for which the combined total is at least $750.

Fourth quarter claims. You cannot file a quarterly claim for refund for the fourth quarter of your tax year. You file claims for the fourth quarter as a credit on your income tax return.

When. You must file a quarterly claim by the last day of the quarter following the end of the quarter for which the claim is being filed. If you file your claim late, you are not allowed a refund. Instead, you add the amount of disallowed refund to any claim for credit and claim it on your income tax return by attaching Form 4136. Do not claim a credit against your income tax for any excise tax for which you filed a claim for refund.

Generally, you file Form 8849 with the same IRS Service Center where you file your income tax return. A partnership files a claim for refund in the name of the partnership and one of the partners must sign it. A corporation files the claim in the name of the corporation and one of its officers must sign it.

Example. Pearl Steele used 15,000 gallons of undyed diesel fuel on her boat for commercial fishing purposes in April of 1994. She filed Form 8849 for the second quarter and claimed a $3,660 refund. When Pearl files her 1994 income tax return, she cannot claim a credit for the tax on this fuel.

Including the Credit or Refund in Income

You include any credit or refund of excise taxes on fuels you receive in your gross income if you claimed the taxes as an expense deduction that reduced your income tax liability. Do not include as income any credit or refund related to the purchase of a qualified diesel-powered highway vehicle.

The year you include a credit or refund in gross income depends on whether you use the cash or accrual method of accounting.

Cash method. If you use the cash method and file a claim for **refund,** include the refund in your gross income for the tax year in which you receive the refund. If you claim a **credit** on your income tax return, include the credit in gross income for the tax year in which you file Form 4136. If you file an **amended return** and claim a credit, include the credit in gross income for the tax year in which you receive it.

Example. Ed Brown, a cash-basis fisherman, filed his 1994 Form 1040 on March 1, 1995. On Schedule C, he deducted the total cost of gasoline (including $100 of excise taxes) used in his commercial fishing vessels. Then, on Form 4136, Ed claimed the $100 of excise tax paid on the gasoline as a credit. Ed reports the $100 as additional income on his 1995 Schedule C.

Accrual method. If you use an accrual method, include the entire claim in gross income for the tax year in which the qualifying use occurred. It does not matter if an accrual-basis taxpayer filed for a quarterly refund or claimed the entire amount as a credit.

Example. Todd Green, an accrual-basis fisherman, filed his 1994 return on April 2, 1995. On Schedule C, he deducted the total cost of gasoline (including $155 of excise taxes) used in his commercial fishing vessels during 1994. On Form 4136, Todd claimed the $155 excise tax he paid on the gasoline as a credit. He must report the $155 as additional income on his 1994 Schedule C.

15. The Examination and Appeals Process

Topics

This chapter discusses:

- Examination of returns
- Appealing the examination findings

Useful Items

You may want to see:

Publication

- ❑ **1** Your Rights as a Taxpayer
- ❑ **5** Appeal Rights and Preparation of Protests for Unagreed Cases
- ❑ **556** Examination of Returns, Appeal Rights, and Claims for Refund

We examine returns for correctness of income, exemptions, credits, and deductions. After the examination, if we propose any changes to your tax, you may either agree with those changes and pay any additional tax, or you may disagree with the changes and appeal the decision.

Fairness If Your Return Is Examined

Most taxpayers' returns are accepted as filed. But if your return is selected for examination, it does not suggest that you are dishonest. The examination may or may not result in more tax. Your case may be closed without change. Or, you may receive a refund.

Courtesy and consideration. You are entitled to courteous and considerate treatment from IRS employees at all times. If you ever feel that you are not being treated with fairness, courtesy, and consideration by an IRS employee, you should tell the employee's supervisor. Publication 1 explains the many rights you have as a taxpayer. You can get free publications by calling our toll-free number.

Pay only the required tax. You have the right to plan your business and personal finances in such a way that you will pay the least tax that is due under the law. You are liable only for the correct amount of tax. Our purpose is to apply the law consistently and fairly to all taxpayers.

Privacy and confidentiality. You have the right to have your tax case kept confidential. Under the law, the IRS must protect the privacy of your tax information. However, if a lien or a lawsuit is filed, certain aspects of your tax case will become public record. People who prepare your return or represent you must also keep your information confidential.

You also have the right to know why we are asking you for the information, exactly how we will use it, and what might happen if you do not give it.

Examination of Returns

An examination usually begins when we notify you that your return has been selected. We will tell you which records you will need. If you gather your records before the examination, it can be completed with the least amount of effort.

How returns are selected. We select returns for examination by several methods. A computer program called the Discriminant Function System (DIF) is used to select most returns. In this method, the computer uses historical data to give parts of the return a score. IRS personnel then screen the return. Returns most likely to have mistakes are selected for examination.

Some returns are selected at random. We use these examination results to update and improve our selection process.

We also select returns by examining claims for credit or refund and by matching information documents, such as Forms W–2 and the 1099 series, with returns.

Arranging the examination. Many examinations are handled by mail. However, if we notify you that your examination is to be conducted through a personal interview, or if you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. If the time or place we suggest is not convenient, the examiner will try to work out something more suitable. However, we will make the final determination on how, when, and where an examination takes place.

Transfers to another district. Generally, your individual return is examined in the IRS district office nearest your home. However, not all offices have examination facilities. Your business return is examined where your books and records are maintained. If the place of examination is not convenient, you may ask to have the examination done in another office or transferred to a different district.

Representation. Throughout the examination, you may represent yourself, have someone else accompany you, or, with proper written authorization, have someone represent you in your absence. If you want to consult an attorney, a C.P.A., an enrolled agent, or any other person permitted to represent a taxpayer during an examination, we will stop and reschedule the interview. We cannot suspend the interview if you are there because of an administrative summons.

Recordings. You can generally make an audio recording of an interview with an IRS Examination officer. Your request to record the interview should be made in writing. You must notify us at least 10 days before the meeting and bring your own recording equipment. We also can record an interview. If we initiate the recording, we will notify you 10 days before the meeting and you can get a copy of the recording at your expense.

Repeat examinations. We try to avoid repeat examinations of the same items, but sometimes this happens. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so that we can see if we should discontinue the examination.

Explanation of Changes

If we propose any changes to your return, we will explain the reasons for the changes. It is important that you understand the reasons for any proposed change. You should not hesitate to ask about anything that is unclear to you.

Agreement with changes. If you agree with the proposed changes, you may sign an agreement form and pay any additional tax you may owe. You must pay interest on any additional tax. If you pay when you sign the agreement, the interest is generally figured from the due date of your return to the date you paid.

If you do not pay the additional tax when you sign the agreement, you will receive a bill. The interest on the additional tax is figured from the due date of your return to the billing date. However, you will not be billed for more than 30 days additional interest, even if the bill is delayed. Also, you will not have to pay any more interest or penalties if you pay the amount due within 10 days of the billing date.

If you are due a refund, we can refund your money more quickly if you sign the agreement form. You will be paid interest on the refund.

Appealing the Examination Findings

If you do not agree with the examiner's report, you may meet with the examiner's supervisor to discuss your case further. If you still don't agree after receiving the examiner's findings, you have the right to appeal them. The examiner will explain your appeal rights and give you a copy of Publication 5. This publication explains your appeal rights in detail and tells you exactly what to do if you want to appeal. You can also get a free copy by calling us at our toll-free number.

Appeals Office. You can appeal the findings of an examination within the IRS through our Appeals Office. The Appeals Office is independent of your examiner and IRS District Director or Service Center Director. Most differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled to your satisfaction in Appeals, you can take your case to court.

Appeals to the courts. Depending on whether you first pay the disputed tax, you can take your case to the U.S. Tax Court, the U.S. Court of Federal Claims, or your U.S. District Court. These courts are entirely independent of the IRS. However, a U.S. Tax Court case is generally reviewed by our Appeals Office before it is heard by the Tax Court. As always, you can represent yourself or have someone admitted to practice before the court represent you.

If you did not yet pay the additional tax and you disagree about whether you owe it, you generally have the right to take your case to the Tax Court. We will mail you a formal notice (called a "notice of deficiency") telling you that you owe additional tax. You ordinarily have 90 days to file a petition with the Tax Court.

If you have already paid the disputed tax in full and filed a claim for refund (discussed later) for it that we disallowed (or on which we did not take action within 6 months), you may take your case to the U.S. District Court or U.S. Court of Federal Claims.

Court decisions. We follow Supreme Court decisions. However, we can lose cases in other courts involving taxpayers with the same issue and still apply our interpretation of the law to your situation. You have the right to appeal our decision to do so.

Recovering litigation expenses. If the court agrees with you on most of the issues in your case, and finds the IRS's position to be largely unjustified, you may be able to recover some of your litigation expenses from us. But to do this, you must have used up all the administrative remedies available to you within the IRS, including going through our Appeals system. You may also be able to recover administrative expenses from the IRS.

Publication 556 will help you more fully understand your appeal rights. You can get it free by calling our toll-free number.

Other Remedies

If you believe that tax, penalty, or interest was unjustly charged, you have rights that can remedy the situation.

Claims for refund. Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax is too much. You may claim a credit or refund by filing Form 1040X, *Amended U.S. Individual Income Tax Return.*

You should file your claim by mailing it to the Internal Revenue Service Center where you filed your original return. File a separate form for each year or period involved.

Time for filing a claim. Generally, claims for a credit or refund must be filed within 3 years from the date you filed your original return or 2 years from the date you paid the tax, whichever is later. (A return filed early is considered filed on the date it was due.) There are exceptions to this time period if your claim is based on certain carryback items, foreign taxes, bad debts, worthless securities, or if you and the Service have agreed to extend the tax assessment period.

Cancellation of penalties. You have the right to ask that certain penalties (but not interest, as discussed later) be canceled (abated) if you can show reasonable cause for the failure that led to the penalty (or can show that you exercised due diligence, if that is the standard for the penalty).

If you relied on wrong advice given to you by IRS employees on the toll-free telephone system, we will cancel certain penalties that may result. But you have to show that your reliance on the advice was reasonable.

Reduction of interest. If our error caused a delay in your case, and this is grossly unfair, you may be entitled to a reduction of the interest that would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify. If you think we caused such a delay, please discuss it with the examiner and file a claim.

Business Taxpayers

If you are in an individual business, the rights covered in this discussion generally apply to you. If you are a member of a partnership or a shareholder in a small business corporation, special rules (which may be different from those described here) may apply to the examination of your partnership or corporation items. The examination of these items is discussed in Publication 556. You can get this publication free by calling us at our toll-free number.

16. Sample Records and Forms

This chapter discusses a sample record-keeping system and several commonly used tax forms. You are not required to use this system. It is only an example of a simple system of keeping business records. The records and forms discussed are illustrated at the end of the chapter.

Sample Record System

The first part of this chapter is a discussion of the records of a good bookkeeping system. These records might include a:

1) Daily Cash Receipts and Expenses Diary
2) Fishhouse Ticket
3) Monthly Summary of Receipts and Expenses
4) Annual Summary for Schedule C Entries
5) Depreciation Worksheet
6) Crew Share Compensation Record

Frank Carter owns and operates a 32-foot fishing boat, the *Salem.* He uses a single-entry bookkeeping system and the cash method of accounting. He has two crew members, Bill Brown and Joe Green, who are considered self-employed for social security tax (FICA) and federal income tax withholding purposes. The boat's catch is divided: 76% to Frank and 12% to each crew member. Frank is not required to pay federal unemployment tax on the crew members' wages.

See the discussions in Chapter 12 under *Certain Crew Members Considered Self-Employed* and *Federal Unemployment Tax* for more information on these topics.

Single-entry bookkeeping. A single-entry bookkeeping system is based on the income statement. This system is simple and very practical if you are starting a small business. For tax purposes, the system records the flow of income and expenses through the use of a daily cash receipts and expenses diary, fishhouse tickets, and a monthly summary of receipts and expenses.

Books. Frank is not required to keep his records in bound books. Records are adequate if they show current income on the basis of an annual accounting period, such as a calendar year.

1) Daily Cash Receipts and Expenses Diary

This diary is used to record daily receipts and out-of-pocket expenses. Frank uses this diary to record expenses he cannot pay by check. For example, Frank records expenses he pays while in a foreign port. Frank also records miscellaneous cash sales such as the sale of fish to tourists at the dock. He keeps the diary on the boat to record these transactions as they occur.

Income and expenses. Frank transfers the income and expense figures to his accounting records on a weekly or monthly basis depending on how often he fishes. He might record other daily activities in his diary, such as those shown in the sample diary for January 4 and 5. Frank also deposits all daily receipts (cash and checks) in his business bank account and pays all his bills by check. He enters checks in the *Monthly Summary of Receipts and Expenses,* discussed later.

Cash receipts and expenses. The cash receipts ($50.00) and the cash payment ($9.04) for January 4, 1994, are taken from Frank's *Daily Cash Receipts and Expenses Diary.* Frank enters the items in the proper columns of the *Monthly Summary of Receipts and Expenses.*

2) Fishhouse Ticket

Frank sells his daily catch to a fishhouse and receives a fishhouse ticket as a record of sales. Each ticket usually covers a specific period (for example, one week). It shows the receipts and expenses for each day that Frank sells to the fishhouse. The fishhouse charges for items such as ice and oil are included on the ticket and Frank receives the net payment (income minus expenses). The ticket also shows the share of the catch due each crew member. The fishhouse tickets become part of Frank's accounting records and he retains them with his other records.

3) Monthly Summary of Receipts and Expenses

Frank carries the weekly gross receipts ($1,254.60) as shown on each fishhouse ticket and cash receipt to the *Monthly Summary of Receipts and Expenses* to determine his gross receipts for the month of January. He also transfers the weekly expenses ($356.05) to determine his total expenses for the month. Frank carries the amount of the crew shares ($107.83 each to Bill Brown and Joe Green) to determine his expenses and crew shares for the month of January.

Checks. Frank enters the checks he draws on his business checking account daily. All of his checks are prenumbered and every number is accounted for in the column provided for check numbers.

Kinds of expenses. The more common expenses have their own headings across the sheet. Frank enters the expenses that normally require numerous entries, such as repairs, fuel, and galley supplies in a separate account column. He enters the expenses or other items that normally have only one or two monthly payments in the ''Other'' column.

Monthly total of receipts. Frank carries the monthly total of receipts ($3,789.10) for January to his *Annual Summary for Schedule C Entries.* Similarly, Frank enters his monthly expenses for galley supplies, fuel, bait, ice, crew shares, etc., in the appropriate columns of the annual summary.

4) Annual Summary for Schedule C Entries

Frank's annual summary of the monthly income and expense totals provides the final annual amounts that Frank will enter on his tax return. The entries on his annual summary are the totals from his monthly summary. As in the case of his *Monthly Summary of Receipts and Expenses,* there are separate columns for each major expense and for his cash receipts.

Schedule C, Part I. Frank enters the total gross receipts from the annual summary on line 1 of Schedule C.

Schedule C, Part II. Frank enters the annual totals for rent, wages, taxes, interest, etc., on the appropriate lines of Schedule C (Form

1040). He carries the annual expense total for repairs from his annual summary and enters it under ''Repairs'' on line 21.

Schedule C, Part V. He enters the annual expense for boat fuel as a separate item on line 46 and carries it to page 1, line 27.

5) Depreciation Worksheet

Another major item entered on Schedule C is the depreciation allowed on the assets used in the fishing business. Frank figures his deduction on the *Depreciation Worksheet*. It shows an item sold in 1994 that was placed in service before 1981 and depreciated using the straight-line method. The sale is reported on *Form 4797,* discussed later. The *Depreciation Worksheet* also shows items placed in service after 1986 that are depreciated using the Modified Accelerated Cost Recovery System (MACRS).

Year depreciation taken. Frank maintains a depreciation record (not shown) over the entire period he depreciates an item. Depreciation must be taken in the year it is allowable. He cannot deduct in the current year depreciation he did not claim in a prior year. The depreciation Frank can claim for the tax year is shown on the *Depreciation Worksheet.*

Section 179 deduction. Frank can choose to deduct part of the cost of certain depreciable property bought and placed in service in his trade or business during the tax year. This is referred to as the ''section 179 deduction.'' For more information on depreciation and the section 179 deduction, see Chapter 7.

Frank purchased a new pickup truck and placed it in service in August 1994. Frank must use MACRS to depreciate the truck. Frank uses the truck 80% in his fishing business. The truck is listed property and is subject to the rules for listed property. Since the truck's gross vehicle weight is less than 6,000 pounds, it is treated as a passenger automobile and is subject to the special deduction limits that apply to passenger automobiles. For a discussion of these limits, see Publication 917, *Business Use of a Car.*

Frank's total depreciation and section 179 deduction for the truck cannot exceed $2,368. This is the $2,960 limit adjusted to reflect Frank's 80% business use. He takes a $2,368 section 179 deduction and reduces his basis in the truck by the deduction ($8,000 − $2,368). The depreciable basis of Frank's truck is $5,632. Frank has taken the maximum deduction for the truck in 1994 and he cannot take a depreciation deduction.

Depreciation. Frank enters the amounts from the *Depreciation Worksheet* on the appropriate lines of Form 4562, *Depreciation and Amortization.* Frank must complete Part V of the form because his truck is listed property. He enters the amount of the depreciation on his truck (the section 179 deduction) on line 23 of Section A because he used the truck more than 50% for business. Then he answers the questions in Section B regarding the use of his truck. He enters the total depreciation ($6,928) from Form 4562 on line 13 of Schedule C (Form 1040).

6) Crew Share Compensation Record

This record is kept for each crew member regardless of whether the crew member is considered an employee or self-employed for purposes of the social security tax (FICA) and federal income tax withholding. To determine if a crew member is considered self-employed, see the discussion under *Certain Crew Members Considered Self-Employed* in Chapter 12. If the crew member does not qualify under those rules, see the discussions under *Income Tax Withholding* and *Social Security and Medicare Taxes* in that chapter.

Crew members not considered self-employed. If the crew members are not considered self-employed, your records for each pay period should show for each employee:

1) Whether the employee is full- or part-time.
2) The total wages received.
3) The withholding deductions (to show the computation of the employee's net pay).

You then use this information to prepare Form 941, *Employer's Quarterly Federal Tax Return.*

Crew members considered self-employed. For this sample record system, both crew members are considered self-employed. However, only Bill Brown's *Crew Share Compensation Record* is shown. It shows:

1) Bill's share of the proceeds from the sale of the catches.
2) Bill's percentage of or proceeds from each catch.
3) Frank's (the operator-owner) percentage of each catch.

Since Bill received cash from the sale of each catch, the items for recording the estimated value of Bill's share, the type of catch, and the total weight of each catch do not apply.

Shares paid in cash. Each month Frank transfers the amounts for the shares paid in cash to his *Monthly Summary of Receipts and Expenses.*

7) Form 1099–MISC

A fishing boat operator must file Form 1099–MISC with the IRS for each crew member considered self-employed whether the crew member was paid in kind (fish) or received proceeds from the sale of the catch.

Frank enters his address and employer identification number and Bill's address and social security number in the appropriate boxes. Frank enters $5,495.81 (Bill's total share of the catch for the year) in box 5, *Fishing boat proceeds.*

Frank must send Copy A of Form 1099–MISC with Form 1096 to the IRS by February 28, 1995. Frank is required to give Bill a statement showing the information reported on Copy A by January 31, 1995. He can use Copy B for this purpose.

For more information, see the *Instructions for Forms 1099, 1098, 5498, and W–2G* and the instructions for Form 1096.

Tax Forms

Schedule C (Form 1040) and Form 4797 are discussed next.

When Frank completes his return, he attaches the schedules and forms in the correct order, using the *Attachment Sequence Number* shown in the upper right corner of each schedule or form. He attaches any supporting statements last, assembled in the same order as the forms and schedules they support.

Schedule C

Frank Carter is a sole proprietor who owns and operates a fishing boat. He shows his business income and expenses on Schedule C (Form 1040). Frank reports the net profit or loss from his business on ***line 12, Form 1040.***

If Frank has more than one business, he must prepare a separate Schedule C (Form 1040) for each business and attach them to his tax return. If he does not, he may have to pay a penalty for not properly reporting his income and deductions.

Frank pays self-employment tax because he operates his business as a sole proprietor. See Chapter 11 for information on self-employment tax.

The Schedule C shown is based on information taken from Frank's illustrated sample records.

Line A. He enters his principal business activity of *Fishing* on line A.

Line B. He enters his principal business code of *2246* (which he finds in the instructions) on line B.

Line C. Frank puts the name of his business on line C.

Line D. He enters his employer identification number (EIN) on Line D.

Line E. Frank enters his business address on line E.

Line F. Since Frank uses the cash method of accounting, he checks box 1 on line F.

Line G. Frank checks box 4 on line G since he has no inventory in his business.

Line H. Because Frank checked box 4 on line G, no entry is required for line H.

Line I. Frank checks ''Yes'' on line I because he materially participated in the operation of his fishing business.

Line J. Frank does not check this box because this is not his first Schedule C.

Part I. Frank enters his income in Part I.

Line 1. Frank's total sales of $60,288 include all the fish he caught and sold during the year. Since there were no returns and allowances (line 2), Frank carries the gross receipts or sales of $60,288 to line 3.

Line 5. Frank's gross profit is $60,288 since there is no entry on line 4.

Line 7. Frank's gross income on Schedule C is the same as the gross sales from his business.

Part II. Frank enters his business expenses for the year in Part II.

Line 10. Frank's total truck expenses are $505. Since he uses the truck 80% for business, he can deduct only $404 (80% × $505) as a business expense.

Line 13. Frank figures his depreciation deduction on Form 4562. He uses information from his depreciation record (not shown) to complete the *Depreciation Worksheet* and Form 4562. Frank attaches Form 4562 to his tax return to report his purchase of the truck in 1994 and the section 179 deduction he elects for the truck.

Line 15. The insurance expense of $3,291 represents the 1994 premiums on insurance policies covering his business property.

Line 16b. Frank enters the $800 interest he paid in 1994 on the loan for the boat he uses in his business.

Line 20b. Frank rents his mooring space. He enters the $72 he paid in 1994 for the space.

Line 21. Frank's entry of $4,593 represents $3,600 for vessel repairs and $993 for gear repairs during the year.

Line 22. Frank enters the $1,713 he paid for galley supplies and the $4,751 he paid for bait and ice during 1994.

Line 23. Frank enters the $35 state fee he paid for his 1994 license.

Line 26. Frank paid total crew shares of $10,992 to his crew members. He enters this amount on line 26. (He does not qualify for any employment credits.) He does not include any amount he draws for personal use on this line.

Line 27. Other business expenses not listed elsewhere on Schedule C are listed separately in Part V, line 46, and the total is carried to line 27. Frank lists the fuel expense for his fishing boat here. He does not include the fuel expense for his truck, which he has deducted on line 10.

Line 28. His total expenses shown on Schedule C are $39,946.

Line 29. Frank enters his tentative profit of $20,422 on line 29. He makes no entry on line 30.

Line 31. He enters his net profit, $20,342, on line 31 and carries that amount to line 12 of Form 1040. He then figures his self-employment tax on Schedule SE (Form 1040), which is not shown.

Form 4797

On January 3, 1994, Frank sold one of his fishing boats for $25,000. The boat, *Chatham,* cost $50,000 and was placed in service in his business on January 3, 1980. The boat had an estimated useful life of 16 years and a salvage value of $10,000. The adjusted basis of the boat on January 3, 1994, was $15,000. Since the boat was depreciable business property held over one year and was sold at a gain, Frank completes Part III of Form 4797 first.

Part III. Frank completes lines 21(a) through 21(c) by providing a description of the property sold and the dates of acquisition and disposition. He then figures the ordinary gain from depreciation on lines 22 through 27b. In this example, the total gain of $10,000 (from line 26) is compared with the total depreciation allowed or allowable ($35,000) on line 24 and the smaller of the two amounts ($10,000) is entered on line 27b. All of Frank's gain from depreciation is ordinary. He has no capital gain from the sale of his fishing boat.

Since he has no other transactions to include in Part III, Frank goes to the *Summary of Part III Gains.* The total gain from the sale is ordinary gain due to depreciation. Frank enters $10,000 on lines 32 and 33.

Part I. Frank has no figure on line 34 to carry to line 6. He has no other section 1231 transactions so he does not complete Part I.

Part II. Frank enters the $10,000 ordinary gain on line 14. Since this is the only entry in Part II, Frank enters $10,000 on lines 19, 20, and 20b(2) of Part II and also on line 14 of Form 1040.

Table 6-2. Form 5305-SEP

Form **5305-SEP**
(Rev. March 1994)
Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499
Expires 2-28-97

DO NOT File with the Internal Revenue Service

____________________________ makes the following agreement under section 408(k) of the
(Name of employer)
Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see **Specific Instructions.**)

The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least ________ years old (not to exceed 21 years old) and have performed services for the employer in at least ________ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) ☐ includes ☐ does not include employees covered under a collective bargaining agreement. ☐ includes ☐ does not include certain nonresident aliens, and ☐ includes ☐ does not include employees whose total compensation during the year is less than $396*.

Article II—SEP Requirements (See **Specific Instructions.**)

The employer agrees that contributions made on behalf of each eligible employee will be:

A. Based only on the first $150,000 of compensation.
B. Made in an amount that is the same percentage of total compensation for every employee.
C. Limited annually to the smaller of $30,000* or 15% of compensation.
D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

Employer's signature and date

Name and title

Paperwork Reduction Act Notice

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

Recordkeeping	7 min.
Learning about the law or the form	26 min.
Preparing the form	20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the **Internal Revenue Service,** Attention: Reports Clearance Officer, PC:FP, Washington, DC 20224; and the **Office of Management and Budget,** Paperwork Reduction Project (1545-0499), Washington, DC 20503. **DO NOT** send this form to either of these addresses. Instead, keep it for your records.

A Change To Note

For years beginning after December 31, 1993, the Revenue Reconciliation Act of 1993 (the Act) reduced to $150,000 the annual compensation of each employee to be taken into account in making contributions to a SEP. The $150,000 amount will be indexed for inflation after 1994 in increments of $10,000 that will be rounded to the next lowest multiple of $10,000. See Act section 13212 for different effective dates and the transition rules that apply to governmental plans and plans under a collective bargaining agreement.

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form.—Form 5305-SEP (Model SEP) is used by an employer to make an agreement to provide benefits to all eligible employees under a SEP described in section 408(k). **Do not** file this form with the IRS. **See Pub. 560,** Retirement Plans for the Self-Employed, and **Pub. 590,** Individual Retirement Arrangements (IRAs).

Specific Instructions

Instructions to the Employer

Simplified Employee Pension.—A SEP is a written arrangement (a plan) that provides you with a simplified way to make contributions toward your employees' retirement income. Under a SEP, you can contribute to an employee's individual retirement account or annuity (IRA). You make contributions directly to an IRA set up by or for each employee with a bank, insurance company, or other qualified financial institution. When using Form 5305-SEP to establish a SEP, the IRA must be a Model IRA established on an IRS form or a master or prototype IRA for which the IRS has issued a favorable opinion letter. Making the agreement on Form 5305-SEP does not establish an employer IRA described in section 408(c).

When Not To Use Form 5305-SEP.—Do not use this form if you:

1. Currently maintain any other qualified retirement plan. This does not prevent you from also maintaining a Model Elective SEP (Form 5305A-SEP) or other SEP to which either elective or nonelective contributions are made.

2. Previously maintained a defined benefit plan that is now terminated.

3. Have any eligible employees for whom IRAs have not been established.

4. Use the services of leased employees (described in section 414(n)).

5. Are a member of an affiliated service group (described in section 414(m)), a controlled group of corporations (described in section 414(b)), or trades or businesses under common control (described in sections 414(c) and 414(o)), unless all eligible employees of all the members of such groups, trades, or businesses, participate in the SEP.

6. Will not pay the cost of the SEP contributions. Do not use Form 5305-SEP for a SEP that provides for elective employee contributions even if the contributions are made under a salary reduction agreement.

Use Form 5305A-SEP, or a nonmodel SEP if you permit elective deferrals to a SEP.

Eligible Employees.—All eligible employees must be allowed to participate in the SEP. An eligible employee is any employee who: (1) is at least 21 years old, and (2) has performed "service" for you in at least 3 of the immediately preceding 5 years. **Note:** *You can establish less restrictive eligibility requirements, but not more restrictive ones.*

Service is any work performed for you for any period of time, however short. If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, service includes any work performed for any period of time for any other member of such group, trades, or businesses.

Excludable Employees.—The following employees do not have to be covered by the SEP: (1) employees covered by a collective bargaining agreement whose retirement benefits were bargained for in good faith by you and their union, (2) nonresident alien employees who did not earn U.S. source income from you, and (3) employees who received less than $396* in compensation during the year.

Contribution Limits.—The SEP rules permit you to make an annual contribution of up to 15% of the employee's total compensation or $30,000*, whichever is less. Compensation, for this purpose, does not include employer contributions to the SEP or the employee's compensation in excess of $150,000. If you also maintain a Model Elective SEP or any other SEP that permits employees to make elective deferrals, contributions to the two SEPs together may not exceed the smaller of $30,000* or 15% of compensation for any employee.

Contributions cannot discriminate in favor of highly compensated employees. You are not required to make contributions every year. But you must contribute to the SEP-IRAs of all of the eligible employees who actually performed services during the year of the contribution. This includes eligible employees who die or quit working before the contribution is made.

**This amount reflects the cost-of-living increase under section 408(k)(8), effective January 1, 1994. The amount is adjusted annually. Each January, the IRS announces the increase, if any, in a news release and in the Internal Revenue Bulletin.*

Cat. No. 11825J Form **5305-SEP** (Rev. 3-94)

1) Daily Cash Receipts and Expenses Diary

Date	Item
1/4	Sold 50 fish to tourists at dock - $50.00
1/4	Paid for bait at Bob's Bait and Ice - $9.04
1/5	Winch broke down early morning - Went looking for parts
1/5	Talked fish prices with Joe Smith - looks like $1.07/lb.

2) Fishhouse Ticket

Humble Seafood Co.

Boat: Salem		Date: 1-7-94
Catch:	208 lbs. @ 1.05	$218.40
	432 lbs. @ 1.10	475.20
	510 lbs. @ 1.10	561.00

Expenses:		Gross:	$1,254.60
Oil	$179.65	Expenses:	356.05
Ice	176.40	Net:	$ 898.55
Total:	$ 356.05	Crew share:	$ 107.83
		Crew share:	107.83

3) Monthly Summary of

1994 Date		Descriptions	Ck. No.	Amount: Receipts		Amount: Expenses		Galley Supplies		Fuel		Moorage	
Jan	3	Marine Supply Co.	75			300							
	4	Sold fish-dock		50									
	4	Bob's Bait & Ice				9	04						
	4	Frank Carter	76			200							
	7	Shark Oil Co.	77			27	58			27	58		
	7	White's Grocery	78			92	90	92	90				
	7	Humble Seafood Co.		1,254	60								
	7	Humble Seafood Co.				356	05			179	65		
	7	Bill Brown				107	83						
	7	Joe Green				107	83						
	7	Frank Carter	79			200							
	14	National Bank (boat loan)	80			250							
	14	Peter's Pier	81			6						6	
	14	Frank Carter	82			200							
	14	Humble Seafood Co.		1,321	80								
	14	Humble Seafood Co.				401	49			201	84		
	14	Bill Brown				110	44						
	14	Joe Green				110	44						
	21	Bass Insurance (boat)	83			241	75						
	21	Joe's Garage	84			21	03						
	21	Frank Carter	85			200							
	28	Humble Seafood Co.		1,162	70								
	28	Humble Seafood Co.				339	71			168	41		
	28	Bill Brown				98	76						
	28	Joe Green				98	76						
		Totals		3,789	10	3,479	61	92	90	577	48	6	

Receipts and Expenses

Bait and Ice		Truck/Auto Expenses		Insurance		Repairs		Crew Shares		Interest		Other		Personal	
						300									
9	04														
														200	
176	40														
								107	83						
								107	83						
														200	
										75		(principal) 175			
														200	
199	65														
								110	44						
								110	44						
				241	75										
		21	03												
														200	
171	30														
								98	76						
								98	76						
556	39	21	03	241	75	300		634	06	75		175		800	

4) Annual Summary for

Month	Monthly Cash Receipts	Galley Supplies	Fuel	Moorage	Bait & Ice
January	3789 10	92 90	577 48	6	556 39
February	4415 43	104 15	481 20	6	441 26
March	4247 32	60 43	220 87	6	389 70
April	5204 71	151 03	621 49	6	411 79
May	6304 16	147 09	500 65	6	360 97
June	6122 47	159 60	562 31	6	341 26
July	6714 12	180 82	610 37	6	489 70
August	5872 87	175 35	643 27	6	402 30
September	5037 32	168 50	500 77	6	355 75
October	4728 61	152 90	590 61	6	390 47
November	3695 80	164 63	538 44	6	339 60
December	4153 94	155 60	519 73	6	271 31
Totals	60287 85	1713 00	6367 19	72	4750 50

5) Depreciation

Description of Property	Date Placed in Service	Cost or Other Basis	Business/ Investment Use %	Section 179 Deduction
Fishing boat (Chatham)	1.3.80	50,000	100%	
Pots and traps	7.2.88	7,000	"	1,000
Gill net	7.2.88	1,500	"	
Fishing boat (Salem)	1.3.89	38,000	"	
Pots and traps	1.3.91	6,000	"	2,000
Truck (USA Rover) *	8.1.94	10,000	80%	2,368
1994 totals:				2,368

Monthly Expenses

Truck/Auto Expenses	Insurance	Repairs	Crew Shares	Taxes/Other	Interest
21.03	241.75	300	634.06		75
18.32	241.75	250	814.25		72.23
29.50	241.75	150	836.82		70.18
16.04	241.75	600	950.33		70.09
39.07	241.75	400	1206.85		69.84
43.21	241.75	310	1177.89		73.13
52.98	306.75	574	1227.37	STATE LICENSE FEE 35	62.10
98.60	306.75	250	1074.55		65.90
92.50	306.75	325	914.59		64.30
39.68	306.75	350	815.41		62.95
28.70	306.75	494	597.26		60.03
25.37	306.75	590	747.23		54.25
505.00	3291.00	4593	10991.61	35	800.00

Worksheet

Depreciation Prior Years	Basis for Depreciation	Method/ Convention	Recovery Period	Rate or Table %	Depreciation Deduction
35,000	Sold 1.3.94	SL	16		-0-
5,196	6,000	200DB/HY	7	8.93	536
1,298	1,500	200DB/HY	7	8.93	134
29,521	38,000	200DB/HY	7	8.92	3,390
2,252	4,000	200DB/HY	7	12.49	500
-0-	5,632	200DB/HY	5	20.0	-0- *
					4,560
* Listed property – limited deduction					

Form **4562**

Department of the Treasury
Internal Revenue Service (T)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172

1994

Attachment Sequence No. 67

Name(s) shown on return: Frank Carter

Identifying number: 111-00-1111

Business or activity to which this form relates: Fishing

Part I Election To Expense Certain Tangible Property (Section 179) (Note: *If you have any "Listed Property," complete Part V before you complete Part I.)*

1	Maximum dollar limitation (If an enterprise zone business, see instructions.)	1	$17,500
2	Total cost of section 179 property placed in service during the tax year (see instructions)	2	8,000
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	-0-
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. (If married filing separately, see instructions.)	5	17,500

	(a) Description of property	(b) Cost	(c) Elected cost
6			
7	Listed property. Enter amount from line 26	7	2,368

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	2,368
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	2,368
10	Carryover of disallowed deduction from 1993 (see instructions)	10	-0-
11	Taxable income limitation. Enter the smaller of taxable income (not less than zero) or line 5 (see instructions)	11	17,500
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	2,368
13	Carryover of disallowed deduction to 1995. Add lines 9 and 10, less line 12 ▶	13	-0-

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

Part II MACRS Depreciation For Assets Placed in Service ONLY During Your 1994 Tax Year (Do Not Include Listed Property)

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
Section A—General Depreciation System (GDS) (see instructions)						
14a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
h Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	
Section B—Alternative Depreciation System (ADS) (see instructions)						
15a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III Other Depreciation (Do Not Include Listed Property)

16	GDS and ADS deductions for assets placed in service in tax years beginning before 1994 (see instructions)	16	4,560
17	Property subject to section 168(f)(1) election (see instructions)	17	
18	ACRS and other depreciation (see instructions)	18	

Part IV Summary

19	Listed property. Enter amount from line 25	19	-0-
20	**Total.** Add deductions on line 12, lines 14 and 15 in column (g), and lines 16 through 19. Enter here and on the appropriate lines of your return. (Partnerships and S corporations—see instructions)	20	6,928
21	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs (see instructions)	21	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions. Cat. No. 12906N Form **4562** (1994)

Part V **Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement**

*For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 22a, 22b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See instructions for limitations for automobiles.*)

22a Do you have evidence to support the business/investment use claimed? ☑ Yes ☐ No | 22b If "Yes," is the evidence written? ☑ Yes ☐ No

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost
23 Property used more than 50% in a qualified business use (see instructions):								
94 Truck (DEA Ranger)	8.1.94	80 %	10,000	5,632	5	200DB/HY	-0-	2,368
		%						
		%						
24 Property used 50% or less in a qualified business use (see instructions):								
		%				S/L –		
		%				S/L –		
		%				S/L –		

25 Add amounts in column (h). Enter the total here and on line 19, page 1 . . . . 25 -0-

26 Add amounts in column (i). Enter the total here and on line 7, page 1 . . . . 26 2,368

Section B—Information on Use of Vehicles—*If you deduct expenses for vehicles:*

- *Always complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.*
- *If you provided vehicles to your employees, first answer the questions in Section C to see if 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	
27 Total business/investment miles driven during the year (DO NOT include commuting miles)	4,480											
28 Total commuting miles driven during the year	-0-											
29 Total other personal (noncommuting) miles driven	1,120											
30 Total miles driven during the year. Add lines 27 through 29	5,600											
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
31 Was the vehicle available for personal use during off-duty hours?	✓											
32 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
33 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. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.*

	Yes	No
34 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
35 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
36 Do you treat all use of vehicles by employees as personal use?		
37 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
38 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)? . .		

Note: *If your answer to 34, 35, 36, 37, or 38 is "Yes," you need not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
39 Amortization of costs that begins during your 1994 tax year:					
40 Amortization of costs that began before 1994				40	
41 **Total.** Enter here and on "Other Deductions" or "Other Expenses" line of your return . . .				41	

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SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (T)

Profit or Loss From Business

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065.

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

OMB No. 1545-0074

1994

Attachment Sequence No. 09

Name of proprietor: Frank Carter

Social security number (SSN): 111 : 00 : 1111

A Principal business or profession, including product or service (see page C-1): Fishing

B Enter principal business code (see page C-6) ▶ 2246

C Business name. If no separate business name, leave blank.: Cap'n Frank's

D Employer ID number (EIN), if any: 10 9999999

E Business address (including suite or room no.) ▶ 215 Seagull Drive
City, town or post office, state, and ZIP code: Hometown, OR 97331

F Accounting method: (1) ☑ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Method(s) used to value closing inventory: (1) ☐ Cost (2) ☐ Lower of cost or market (3) ☐ Other (attach explanation) (4) ☑ Does not apply (if checked, skip line H)

	Yes	No
H Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation		
I Did you "materially participate" in the operation of this business during 1994? If "No," see page C-2 for limit on losses.	✓	

J If you started or acquired this business during 1994, check here ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here* ▶ ☐	1	60,288
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	60,288
4	Cost of goods sold (from line 40 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	60,288
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-2)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	60,288

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

8	Advertising	8		19	Pension and profit-sharing plans	19	
9	Bad debts from sales or services (see page C-3)	9		20	Rent or lease (see page C-4):		
					a Vehicles, machinery, and equipment	20a	
10	Car and truck expenses (see page C-3)	10	404		b Other business property	20b	72
				21	Repairs and maintenance	21	4,593
11	Commissions and fees	11		22	Supplies (not included in Part III)	22	6,464
12	Depletion	12		23	Taxes and licenses	23	35
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	6,928	24	Travel, meals, and entertainment:		
					a Travel	24a	
					b Meals and entertainment		
14	Employee benefit programs (other than on line 19)	14			c Enter 50% of line 24b subject to limitations (see page C-4)		
15	Insurance (other than health)	15	3,291				
16	Interest:						
a	Mortgage (paid to banks, etc.)	16a			d Subtract line 24c from line 24b	24d	
b	Other	16b	800	25	Utilities	25	
17	Legal and professional services	17		26	Wages (less employment credits) Crew	26	10,992
18	Office expense	18		27	Other expenses (from line 46 on page 2)	27	6,367

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	39,946
29	Tentative profit (loss). Subtract line 28 from line 7	29	20,342
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3. • If a loss, you MUST go on to line 32.	31	20,342

32 If you have a loss, check the box that describes your investment in this activity (see page C-5).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you MUST attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 Instructions. Cat. No. 11334P **Schedule C (Form 1040) 1994**

Part III **Cost of Goods Sold** (see page C-5)

33	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	33	
34	Purchases less cost of items withdrawn for personal use	34	
35	Cost of labor. Do not include salary paid to yourself	35	
36	Materials and supplies	36	
37	Other costs	37	
38	Add lines 33 through 37	38	
39	Inventory at end of year	39	
40	**Cost of goods sold.** Subtract line 39 from line 38. Enter the result here and on page 1, line 4	40	

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-3 to find out if you must file.

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

42 Of the total number of miles you drove your vehicle during 1994, enter the number of miles you used your vehicle for:

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

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

44 Was your vehicle available for use during off-duty hours? ☐ Yes ☐ No

45a Do you have evidence to support your deduction? ☐ 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.

Fuel for fishing boat		6,367
46 **Total other expenses.** Enter here and on page 1, line 27	46	6,367

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Form **4797**

Department of the Treasury
Internal Revenue Service (T)

Sales of Business Property

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

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

OMB No. 1545-0184

1994

Attachment Sequence No. 27

Name(s) shown on return: Frank Carter

Identifying number: 111-00-1111

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1994 on Form(s) 1099-S (or a substitute statement) that you will be including on line 2, 11, or 22 1

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

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

Line	Description		(g)	(h)
3	Gain, if any, from Form 4684, line 39	3		
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4		
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5		
6	Gain, if any, from line 34, from other than casualty or theft	6		-0-
7	Add lines 2 through 6 in columns (g) and (h)	7	( )	

8 Combine columns (g) and (h) of line 7. Enter gain or (loss) here, and on the appropriate line as follows: 8

Partnerships—Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 9, 10, 12, and 13 below.

S corporations—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 9, 10, 12, and 13 below, unless line 8 is a gain and the S corporation is subject to the capital gains tax.

All others—If line 8 is zero or a loss, enter the amount on line 12 below and skip lines 9 and 10. If line 8 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 9, 10, and 13 below.

9 Nonrecaptured net section 1231 losses from prior years (see instructions) 9

10 Subtract line 9 from line 8. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions): 10

S corporations—Enter this amount (if more than zero) on Schedule D (Form 1120S), line 13, and skip lines 12 and 13 below.

All others—If line 10 is zero, enter the amount from line 8 on line 13 below. If line 10 is more than zero, enter the amount from line 9 on line 13 below, and enter the amount from line 10 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

11 Ordinary gains and losses not included on lines 12 through 18 (include property held 1 year or less):

Line	Description		(g)	(h)
12	Loss, if any, from line 8	12		
13	Gain, if any, from line 8, or amount from line 9 if applicable	13		
14	Gain, if any, from line 33	14		10,000
15	Net gain or (loss) from Form 4684, lines 31 and 38a	15		
16	Ordinary gain from installment sales from Form 6252, line 25 or 36	16		
17	Ordinary gain or (loss) from like-kind exchanges from Form 8824	17		
18	Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)	18		
19	Add lines 11 through 18 in columns (g) and (h)	19	( )	10,000

20 Combine columns (g) and (h) of line 19. Enter gain or (loss) here, and on the appropriate line as follows: . . . 20 10,000

a For all except individual returns: Enter the gain or (loss) from line 20 on the return being filed.

b For individual returns:

(1) If the loss on line 12 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here and on line 22 of Schedule A (Form 1040). Identify as from "Form 4797, line 20b(1)." See instructions . . . . 20b(1)

(2) Redetermine the gain or (loss) on line 20, excluding the loss, if any, on line 20b(1). Enter here and on Form 1040, line 14 . . 20b(2) 10,000

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 13086I Form **4797** (1994)

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

21 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Fishing boat (Chatham)	1.3.80	1.3.94
B		
C		
D		

Relate lines 21A through 21D to these columns	▶	Property A	Property B	Property C	Property D
22 Gross sales price (**Note:** *See line 1 before completing.*)	22	25,000			
23 Cost or other basis plus expense of sale	23	50,000			
24 Depreciation (or depletion) allowed or allowable	24	35,000			
25 Adjusted basis. Subtract line 24 from line 23	25	15,000			
26 Total gain. Subtract line 25 from line 22	26	10,000			
27 **If section 1245 property:**					
a Depreciation allowed or allowable from line 24	27a	35,000			
b Enter the **smaller** of line 26 or 27a	27b	10,000			
28 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 28g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	28a				
b Applicable percentage multiplied by the **smaller** of line 26 or line 28a (see instructions)	28b				
c Subtract line 28a from line 26. If residential rental property or line 26 is not more than line 28a, skip lines 28d and 28e	28c				
d Additional depreciation after 1969 and before 1976	28d				
e Enter the **smaller** of line 28c or 28d	28e				
f Section 291 amount (corporations only)	28f				
g Add lines 28b, 28e, and 28f	28g				
29 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	29a				
b Line 29a multiplied by applicable percentage (see instructions)	29b				
c Enter the **smaller** of line 26 or 29b	29c				
30 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	30a				
b Enter the **smaller** of line 26 or 30a	30b				
31 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	31a				
b Enter the **smaller** of line 26 or 31a	31b				

Summary of Part III Gains. Complete property columns A through D, through line 31b before going to line 32.

32 Total gains for all properties. Add columns A through D, line 26	32	10,000
33 Add columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14	33	10,000
34 Subtract line 33 from line 32. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	34	-0-

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

		(a) Section 179	(b) Section 280F(b)(2)
35 Section 179 expense deduction or depreciation allowable in prior years	35		
36 Recomputed depreciation. See instructions	36		
37 Recapture amount. Subtract line 36 from line 35. See the instructions for where to report	37		

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6) Crew Share — Compensation Record

Name	Address	Social Security No.	Phone
Bill Brown	1116 Ocean Drive Hometown, Oregon 97331	444-00-5555	370-1121

Self-Employed Crewmember

Date	Member's Share	Member's Percentage of Catch or Proceeds	Operator's Percentage of Catch or Proceeds	Estimated Value of Shares	Type of Catch	Total Weight
1-7	107.83	12	76			
1-14	110.44	12	76			
1-28	98.76	12	76			
Monthly Totals.....	317.03					
2-4	118.33	12	76			
2-11	122.60	12	76			
2-18	166.20	12	76			
Monthly Totals.....	407.13					
3-4	121.40	12	76			
3-11	140.90	12	76			
3-18	122.79	12	76			
Yearly Totals.....	5,495.81	12	76			

Employee

☐ Full-Time ☐ Part-Time

Number of Exemptions

Pay Period Ending	Total Wages	Deduction: Social Security	Deduction: Federal Income Tax	Deduction: State Income Tax	Deduction: Other	Net Pay
Quarterly Totals...						

Notes

9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code: Frank Carter 215 Seagull Drive Hometown, OR 97331	1 Rents $ 2 Royalties $ 3 Other income $	OMB No. 1545-0115 **1994**	**Miscellaneous Income**
PAYER'S Federal identification number: 10-9999999 · RECIPIENT'S identification number: 444-00-5555	4 Federal income tax withheld $	5 Fishing boat proceeds $ 5,495.81	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name: Bill Brown	6 Medical and health care payments $	7 Nonemployee compensation $	File with Form 1096.
Street address (including apt. no.): 1116 Ocean Drive	8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code: Hometown, OR 97331	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional) · 2nd TIN Not. ☐	12 State/Payer's state number		

Form **1099-MISC** Cat. No. 14425J Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

IRS Publications

Listed below are selected IRS tax publications. The list includes all the publications referred to in the chapters of this book, as well as others that might interest you. A full list can be found in Publication 910, *Guide to Free Tax Services.* If you only need to order ***tax forms and publications*** and do not have any tax questions, please call 1–800–TAX–FORM (1–800–829–3676).

General Guides

1
Your Rights as a Taxpayer

17
Your Federal Income Tax (For Individuals)

225
Farmer's Tax Guide

334
Tax Guide for Small Business

509
Tax Calendars for 1995

553
Highlights of 1994 Tax Changes

910
Guide to Free Tax Services

Employer's Guides

15
Circular E, Employer's Tax Guide

51
Circular A, Agricultural Employer's Tax Guide

80
Circular SS, Federal Tax Guide for Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands

Specialized Publications

349
Federal Highway Use Tax on Heavy Vehicles

378
Fuel Tax Credits and Refunds

448
Federal Estate and Gift Taxes

463
Travel, Entertainment, and Gift Expenses

501
Exemptions, Standard Deduction, and Filing Information

502
Medical and Dental Expenses

503
Child and Dependent Care Expenses

504
Divorced or Separated Individuals

505
Tax Withholding and Estimated Tax

510
Excise Taxes for 1995

521
Moving Expenses

523
Selling Your Home

524
Credit for the Elderly or the Disabled

525
Taxable and Nontaxable Income

526
Charitable Contributions

527
Residential Rental Property

529
Miscellaneous Deductions

530
Tax Information for First-Time Homeowners

533
Self-Employment Tax

534
Depreciation

535
Business Expenses

536
Net Operating Losses

537
Installment Sales

538
Accounting Periods and Methods

541
Tax Information on Partnerships

542
Tax Information on Corporations

544
Sales and Other Dispositions of Assets

547
Nonbusiness Disasters, Casualties, and Thefts

550
Investment Income and Expenses

551
Basis of Assets

554
Tax Information for Older Americans

555
Federal Tax Information on Community Property

556
Examination of Returns, Appeal Rights, and Claims for Refund

559
Survivors, Executors, and Administrators

560
Retirement Plans for the Self-Employed

561
Determining the Value of Donated Property

575
Pension and Annuity Income

583
Taxpayers Starting a Business

584
Nonbusiness Disaster, Casualty, and Theft Loss Workbook

587
Business Use of Your Home

589
Tax Information on S Corporations

590
Individual Retirement Arrangements (IRAs)

594
Understanding The Collection Process

596
Earned Income Credit

597
Information on the United States– Canada Income Tax Treaty

907
Tax Highlights for Persons With Disabilities

908
Tax Information on Bankruptcy

911
Tax Information for Direct Sellers

915
Social Security Benefits and Equivalent Railroad Retirement Benefits

917
Business Use of a Car

925
Passive Activity and At-Risk Rules

926
Employment Taxes for Household Employers

929
Tax Rules for Children and Dependents

936
Home Mortgage Interest Deduction

937
Employment Taxes

946
How To Begin Depreciating Your Property

1544
Reporting Cash Payments of Over $10,000

1635
Understanding Your EIN

Spanish Language Publications:

1SP
Derechos del Contribuyente

556SP
Revisiâon de las Declaraciones de Impuesto, Derecho de Apelaciâon y Reclamaciones de Reembolsos

579SP
Câomo Preparar la Declaraciâon de Impuesto Federal

594SP
Comprendiendo el Proceso de Cobro

596SP
Crâedito por Ingreso del Trabajo