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Tax Guide for Commercial Fishermen

For use in preparing

1995 Returns

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Important Changes for 1995

The following items highlight a number of administrative and tax law changes for 1995.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that could affect your 1995 tax return and 1996 estimated taxes. They include changes to:

1) Capital gains and losses, and
2) Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through the IRS bulletin board or via the Internet (see page 34 of the Form 1040 instructions).

Direct deposit of refund. If you are due a refund on your 1995 tax return, you can have it deposited directly into your bank account. Complete Form 8888, *Direct Deposit of Refund,* and attach it to your tax return (except Form 1040EZ). If you did not receive Form 8888 in your tax booklet, see *Ordering publications and forms,* later.

Higher earned income credit. The maximum earned income credit has been increased to $3,110 in 1995. To claim the credit, you must have earned income (including net earnings from self-employment) and adjusted gross income of less than $26,673 and meet certain other requirements. For more information, see Publication 596, *Earned Income Credit.*

Standard mileage rate. The standard mileage rate for 1995 is 30 cents a mile for all business miles put on a passenger automobile (including vans, pickups, or panel trucks). See chapter 5.

Depreciation of general asset account. You can elect to place assets subject to MACRS in one or more general asset accounts. After you have established the account, figure depreciation on the entire account by using the applicable depreciation method, recovery period, and convention for the assets in the account. See chapter 7.

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 1995 is $3,060. Your depreciation cannot exceed $4,900 for the second year of recovery, $2,950 for the third year, and $1,775 for each later tax year. See chapter 7.

Tax rates and maximum net earnings for self-employment taxes. In 1995, the maximum amount of net earnings from self-employment subject to the social security part (12.4%) of the self-employment tax is $61,200. There is no maximum limit on the amount subject to the Medicare part (2.9%).

For 1996, the maximum amount subject to the social security tax (12.4%) increases to $62,700. See chapter 11.

Wage limits for social security and Medicare taxes. The maximum amount of 1996 wages subject to the social security tax is $62,700. There is no wage base limit for the amount subject to Medicare tax. See chapter 12.

Federal unemployment (FUTA) tax rate. The gross FUTA tax rate remains at 6.2% through 1996.

Self-employed health insurance deduction. The deduction for health insurance costs for self-employed persons has been permanently extended for tax years beginning after 1993. If you were entitled to claim the 25% deduction for 1994 but did not, file Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your 1994 return. Do not use the worksheet in the 1995 Form 1040 instructions to figure your 1994 deduction. Instead, use the worksheet in the 1994 Form 1040 instructions or get the 1995 Publication 535, *Business Expenses.*

For tax years beginning after 1994, the deduction is increased to 30%. See chapter 5.

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.

Ordering publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms and Publications* at the end of this publication for details.

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 in resolving questions on bills, letters, and notices received from Internal Revenue Service Centers, as well as questions on the status of tax refunds. The publication also lists free taxpayer information publications. For each publication, it gives a brief description of the content along with a list of related tax forms and schedules.

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 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.

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 1–800–829–1040. 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.

Payment voucher for Form 1040. To help process tax payments more accurately and efficiently, the IRS is sending Form 1040–V, *Payment Voucher,* to most Form 1040 filers this year.

If you have a balance due on Form 1040, send the voucher with your payment. Follow the instructions that come with the voucher. There is no penalty for not using the payment voucher, but the IRS strongly encourages you to use it.

Payment voucher for Forms 940 and 940–EZ. 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.

Publication on employer identification numbers (EINs). 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,* earlier, for information on how to get the publication.

Electronic deposit of taxes. Employers can voluntarily enroll in TAXLINK, an electronic funds transfer system that allows tax deposits without coupons, paper checks, or visits to an authorized depositary. For more information, call 1–800–829–5469, or write to:

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

Form W–4 for 1996. You should make new Forms W–4 available to your employees and encourage them to check their income tax withholding for 1996. Those employees who owed a large amount of tax or received a large refund for 1995 may need to file a new Form W–4. See chapter 12.

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. 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.

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.

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.

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 a 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.

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 in order. 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.

Business codes for fishermen. You must enter on line B of Schedule C (Form 1040) a code that identifies your principal business. It is important to use the correct 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 Schedule C in chapter 16.

Rounding off 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.

Alternative ways of filing. IRS offers several alternatives to make filing your tax return easier. They are more convenient and accurate and will help us process your return faster.

Electronic filing. You can file your return electronically whether you prepare your own return or use a tax preparer. However, you must use an IRS-approved tax preparer or company to file an electronic return.

If you file a complete and accurate electronic return, your refund will be issued within 21 days. (Some refunds may be delayed as a result of compliance reviews to ensure the accuracy of the returns.) You can also choose the convenience and safety of direct deposit. IRS notifies your electronic return transmitter that your return has been received and accepted. Also, if you owe tax, you can file early and pay by April 15, 1996.

In many states, you can electronically file your state tax return with your federal return. Check with your tax return preparer or transmitter. Also, many companies offer electronic filing as a benefit for their employees. Check with your employer.

TeleFile. Single taxpayers who filed a 1994 Form 1040EZ may receive a TeleFile tax package that will allow them to file their 1995 tax return by phone. TeleFile is fast, easy, and free. It is available 24 hours a day and there is nothing to mail. IRS automatically sends the TeleFile package to persons eligible to use this method of filing, including students.

Other alternatives. If you have a computer, tax software, and a modem, you can file an electronic return with certain on-line services. Check with your on-line service.

More information. Call Tele-Tax and listen to topic 252 for more information. Check your tax package for information about Tele-Tax.

Important Dates

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 1996.* 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.

1996—Calendar Year

During January

Employers. Give each employee a Form W–2 showing income, social security, and Medicare information for 1995 as soon as possible. The due date for giving Form W–2 to your employees is *January 31, 1996.* Copy A of Form W–2 must be filed by *February 29, 1996.*

January 16

Fishermen. You may elect to pay your 1995 estimated tax in full. You can then file your 1995 income tax return (Form 1040) by *April 15.* If you do not pay your estimated tax at this time, your 1995 return will be due *March 1.*

Social security, Medicare, and withheld income tax. Deposit the tax for payments in December 1995 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 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 *February 12* to file the return.

Federal unemployment (FUTA) tax. File Form 940 (or 940–EZ) for 1995. 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 12* 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 for 1995. See also *February 28.*

February 12

Social security, Medicare, and withheld income tax. File Form 941 for the fourth 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 *January 31.*

Federal unemployment tax. File Form 940 (or 940–EZ) for 1995. 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 1995. Use Form 1096 to summarize and transmit the Forms 1099–MISC.

February 29

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 1995.

March 1

Fishermen. File your 1995 income tax return (Form 1040) and pay any tax due. However, you have until *April 15* if you paid your 1995 estimated tax by *January 16, 1996.*

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 15

Fishermen. File an income tax return (Form 1040) for 1995 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.

April 30

Social security, Medicare, and withheld income tax. File Form 941 for the first quarter of 1996. 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 1996. 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 *April 30.*

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 17

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

July 15

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 1996. 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 12* 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 12

Social security, Medicare, and withheld income tax. File Form 941 for the second quarter of 1996. 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 16

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

October 15

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 1996. 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 12* 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 12

Social security, Medicare, and withheld income tax. File Form 941 for the third quarter of 1996. 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 16

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

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, get:

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

Use this publication as a guide to figure your taxes and complete your tax return. If you need more information on any subject, get the specific IRS tax publication covering that subject. Many of these free publications are referred to throughout this publication. See the list of ''IRS Publications,'' which is located near the end of this publication, for other IRS publications you may need.

1. Filing Requirements and Return Forms

Important Reminders

Form 1099–MISC. Form 1099–MISC, *Miscellaneous Income,* is an information return used to report the amount of crew shares paid. 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.

Estimated tax. When you figure your estimated tax for 1996, 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
- ☐ **15-A** Employer's Supplemental Tax Guide

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 1995 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 ($2,500) plus the standard deduction for the filing status and age.

Who Must File

Filing Status Is:	Income At Least:
Single	
Under 65	$ 6,400
65 or older	7,350
Head of Household	
Under 65	$ 8,250
65 or older	9,200
Married, Joint Return	
Both under 65	$ 11,550
One spouse 65 or older	12,300
Both 65 or older	13,050
Not living with spouse at end of year (or on date spouse died)	2,500
Married, Separate Return	
All (regardless of age)	$ 2,500
Qualifying Widow(er) with Dependent Child	
Under 65	$ 9,050
65 or older	9,800

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 also 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 $3,900, or
2) Had only unearned income, such as interest and dividends, and the total is more than $650, or
3) Had both earned and unearned income, and the total is more than $650.

See the Form 1040 instructions for more information on who must file a return for 1995.

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 may not otherwise be 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, (SSN), 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. It usually takes about 2 weeks to get an SSN.

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 is not the same as total income*** shown on line 22 of Form 1040.

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 an income tax 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. (Divide your total income from fishing by your total gross income.)

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 or vegetable life.

You receive gross income from fishing if you conduct your fishing business for a profit. Your gross income from fishing 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, social security, and Medicare taxes 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 1994 or 1995 is from fishing, you have only one payment due date for estimated tax — January 16, 1996.

For your 1995 tax, you can either:

1) Pay all your estimated tax by January 16, 1996, and file your Form 1040 by April 15, 1996, or
2) File your Form 1040 by March 1, 1996, 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 16, 1996, and do not file your return or pay the tax by March 1, 1996, 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 15 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 1995 because less than two-thirds of your total gross income was from fishing and you do not expect to qualify in 1996, you do not qualify for the special estimated tax payment and return due dates. You generally must make quarterly estimated tax payments on April 15, June 17, and September 16, 1996, and on January 15, 1997. You must file your tax return by April 15, 1997.

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, 1996, the due date for your 1995 return will be April 15, 1996. 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, 1996. To get this extension, file Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* by April 15, 1996.

This extension ***does not*** extend the March 1, 1996, 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 16, 1996, and you file your tax return after March 1, 1996, 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 payments for rents, commissions, fees, prizes, and awards. Form 1099–MISC is used to report the amount of crew shares–(for any amount– the $600 general rule amount does not apply), that each crew member considered self-employed receives. 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.

Although fishermen use Form 1099–MISC most frequently,there are other forms in the 1099 series. Information on 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, 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 on or before the last day of January.

2. Importance of Good Records

Topics

This chapter discusses:

- Why you should keep records
- What records to keep
- How long to keep records

Useful Items

You may want to see:

Publication

- ☐ **463** Travel, Entertainment, and Gift Expenses
- ☐ **917** Business Use of a Car
- ☐ **15** Circular E, Employer's Tax Guide

Why Keep Records?

Everyone in business, including fishermen, must keep records. Good records will help you do the following.

Monitor the progress of your fishing business. You need good records to monitor the progress of your fishing business. Records can show whether your business is improving, which items are selling, or what changes you need to make. Good records can increase the likelihood of business success.

Prepare your financial statements. You need good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help you in dealing with your bank or creditors.

Identify source of receipts. You will receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate fishing from nonfishing receipts and taxable from nontaxable income.

Keep track of deductible expenses. You may forget expenses when you prepare your tax return unless you record them when they occur.

Prepare your tax returns. You need good records to prepare your tax return. These records must document the income, expenses, and credits you report. Generally, these are the same records you use to monitor your fishing business and prepare your financial statements.

Support items reported on tax returns. You must keep your business records available at all times for inspection by the IRS. If the IRS examines any of your tax returns, you may be asked to explain the items reported. A complete set of records will speed up the examination.

Kinds of Records To Keep

Except in a few cases, the law does not require any special kind of records. You may choose any system suited to your fishing business that clearly shows your income.

You should set up your books using an accounting method that clearly shows your income for your tax year. See chapter 4. If you are in more than one business, you should keep a complete and separate set of books for each business.

Your books must show your gross income, as well as your deductions and credits. In addition, you must keep supporting documents. Purchases, sales, payroll, and other transactions you have in your business generate supporting documents such as invoices and receipts. These documents contain the information you need to record in your books.

It is important to keep these documents because they support the entries in your books and on your tax return. You should keep them in an orderly fashion and in a safe place.

Travel, transportation, entertainment, and gift expenses. Special recordkeeping rules apply to these expenses. For more information, see Publication 463, *Travel, Entertainment, and Gift Expenses,* and Publication 917, *Business Use of a Car.*

Employment taxes. There are specific employment tax records you must keep. For a list, see Publication 15.

Excise taxes. See chapter 14 for the specific records you must keep to verify your claim for credit or refund of excise taxes on certain fuels.

Assets. Assets are the property, such as machinery and furniture, that you own and use in your business. You must keep records to verify certain information about your business assets. You need records to figure the annual depreciation and the gain or loss when you sell the assets. Your records should show:

- When and how you acquired the asset
- The purchase price
- The cost of any improvements
- Section 179 deduction taken
- Deductions taken for depreciation
- Deductions taken for casualty losses, such as fires or storms
- How you used the asset
- When and how you disposed of the asset
- The selling price
- The expenses of sale

Examples of records that may show this information include:

- Purchase invoices
- Real estate closing statements
- Canceled checks

Financial account statements as proof of payment. If you do not have a canceled check, you may be able to prove payment with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institution by a third party. Acceptable account statements include:

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

These account statements must be highly legible and readable.

Proof of payment of an amount alone does not establish that you are entitled to a tax deduction. You should also keep other documents, such as credit card sales slips and invoices.

How Long To Keep Records

You must keep your records as long as they may be needed for the administration of any

provision of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out.

The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax. The period of time in which you can amend your return to claim a credit or refund is generally the later of:

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

Returns filed before the due date are treated as filed on the due date.

The IRS has 3 years from the date you file your return to assess any additional tax. If you file a fraudulent return or no return at all, the IRS has a longer period of time to assess additional tax.

Employment taxes. If you have employees, you must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

Assets. Keep records relating to property until the period of limitations expires for the year in which you dispose of the property in a taxable disposition. You must keep these records to figure any depreciation, amortization, or depletion deduction, and to figure your basis for computing gain or loss when you sell or otherwise dispose of the property.

Generally, if you received property in a nontaxable exchange, your basis in that property is the same as the basis of the property you gave up. You must keep the records on the old property, as well as on the new property, until the period of limitations expires for the year in which you dispose of the new property in a taxable disposition.

Tax returns. Keep copies of your filed tax returns. They help in preparing future tax returns and making computations if you later file an amended return.

Records for nontax purposes. When your records are no longer needed for tax purposes, do not discard them until you check to see if you have to keep them longer for other purposes. For example, your insurance company or creditors may require you to keep them longer than the IRS does.

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. Use the basis of property to figure the deductions for depreciation, amortization, depletion, and casualty losses. Also use it to figure gain or loss on the sale or other disposition of property. You must keep accurate records of all items that affect the basis of property so you can make these computations.

This chapter is divided into three sections:

- Cost Basis,
- Adjusted Basis, and
- Other Basis.

The basis of property you buy is usually its cost. In addition, if you use the asset in a trade or business or an activity conducted for profit, capitalize (add to basis) many direct and indirect costs.

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

You cannot determine your basis in some assets by cost. This includes property you receive as a gift or inheritance. It also applies to property received in an involuntary exchange, and certain other circumstances.

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. Some items that reduce the basis of your property are:

1) The section 179 deduction,
2) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
3) The credit for qualified electric vehicles,
4) The deduction for clean-fuel vehicles, and clean-fuel vehicle refueling property,
5) Exclusions from income of subsidies for energy conservation measures,
6) Investment credit (part or all of credit) taken,
7) Casualty and theft losses, and
8) 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 depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you took less depreciation than you could have under the method you selected, decrease the basis by the amount you could have taken under that method. 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. If a debt is canceled or forgiven, other than as a gift or bequest, the debtor generally must include the canceled amount in gross income for tax purposes. A debt includes any indebtedness for which the debtor is liable or which attaches to property the debtor holds. 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 you exclude canceled debt from income, you may have to reduce the basis of your 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.*

Adjusted basis example. In 1991, 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 1991. In July 1994, 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 1991 through 1994. The adjusted basis of the boat as of January 1, 1995, 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, 1995		$27,034

For more information about basis, see Publication 551. For more information about depreciation, see Publication 946.

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 used.

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. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Restricted property. Generally, 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.

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 with the following adjustments:

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. You cannot avoid this trade-in rule by using a subsidiary in the transaction.

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, and any gift tax paid on it.

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 property. 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 1995, 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. However, 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 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 regular 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 chapters 5 and 8.

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 26,

1995, you did not pick up the payment and the fish house ticket. You picked up the payment on January 3, 1996. The payment is included in your gross income for 1995 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, 1995, for a one-year period. You may deduct $500 in 1995, and $500 in 1996.

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 taxable distributions from cooperatives, 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. Patronage dividends should also be included in the gross receipts of the business operation.

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 1995

Standard mileage rate. The standard mileage rate for 1995 is 30 cents a mile for all business miles put on a light truck or car.

Self-employed health insurance deduction. The deduction for health insurance costs for self-employed persons has been permanently extended for tax years beginning after 1993. If you were entitled to claim the 25% deduction in 1994 but did not, file Form 1040X, *Amended U.S. Individual Income Tax Return,* to amend your 1994 tax return. Do not use the worksheet in the 1995 Form 1040 instructions to figure your deduction for 1994. Instead, use the worksheet in the 1994 Form 1040 instructions, or get the 1995 Publication 535, *Business Expenses.*

Beginning in 1995 the deduction is increased to 30%. See *Self-employed health insurance deduction,* later.

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 (Including Use by Day-Care Providers)
- ☐ **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
- ☐ **Sch C** (Form 1040) Profit or Loss From Business
- ☐ **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. 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).

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

Category 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.

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 of 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 including 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 you incur in the ordinary course of your fishing 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 generally can deduct all taxes imposed on real property you own and use in your fishing business (such as a gear shed or net loft). If your only business assets are personal property, such as a boat, see *Other taxes,* later. If you own your home 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 (FUTA) and the employer's part of social security and Medicare taxes (FICA) 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.

Sales tax you pay on a service or on the purchase or use of property is treated as part of the cost of the service or property. If the service or the cost or use of the property is a deductible business expense, you can deduct the tax as part of that service or cost. If the property purchased is merchandise for resale, the sales tax is part of the cost of the merchandise. If the property is depreciable, the sales tax is added to the basis for depreciation.

Do not deduct state and local sales taxes imposed on the buyer that you were required to collect and pay over to the state or local government. These taxes are not included in gross receipts or sales.

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 above requirements 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 employee's 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 may be able to use the standard mileage rate instead of deducting the actual expenses for your vehicle. The standard mileage rate for 1995 is 30 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 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, actual expenses for the business use of your car, and recordkeeping, see Publication 917.

Local transportation expenses. You can deduct car expenses for local business transportation if they are not commuting expenses. Local business transportation is traveling between two or more workplaces in the same day or between your home and a temporary work location.

Commuting. You cannot deduct the cost of travel between your home and your main or regular place of business. These costs are personal commuting expenses. You cannot deduct commuting expenses regardless of how far your home is from your regular place of work.

Temporary work location. If you have one or more regular places of business and commute to a temporary work location, you can deduct the expenses of the daily round-trip transportation between your home and the temporary location. The temporary work must be irregular or short term (generally a matter of days or weeks).

If you do not have a regular place of work, but you ordinarily work at different locations in the area where you live, you can deduct daily transportation costs between your home and a temporary work site **outside** your local area.

Example. You work at several clam flats in your local area. For two weeks in September you work at a flat in an area farther down the coast because the flats in your area are closed. The cost of travel to the flat outside your local area is deductible.

Two places of work. If you work at two places in a day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. If for some personal reason you do not go directly from one work location to the other, you can deduct only the amount it would have cost you to go directly from the first work location to the second. Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

For more information, see *Local Transportation Expenses* in Publication 463.

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 your duties require you to be absent from your home port substantially longer than an ordinary work day and you need to get sleep or rest to meet the demands of your work 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 ordinary 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 business 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), to the extent 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 ordinary and necessary cost of insurance premiums for your fishing business as a business expense.

Some deductible insurance premiums are:

1) Fire, theft, flood, or similar 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.

Self-employed health insurance deduction. If you are a self-employed individual, you can deduct, as an adjustment to income on your 1995 Form 1040, 30% of the amount paid for health insurance coverage for yourself, your spouse, and your dependents. Generally, this deduction cannot be more than the net profit from the business under which the plan was established.

If you are also an employee of another person, you cannot take the deduction for any month in which you are eligible to participate in a subsidized health plan maintained by your employer. This also applies if you are eligible to participate in a health plan maintained by your spouse's employer.

Use the worksheet in the Form 1040 instructions to figure your deduction. Include the remaining part of the insurance payment in your medical expenses on Schedule A, if you itemize your deductions.

Premiums paid in 1994. The deduction as an adjustment to income for 25% of health insurance premiums for self-employed persons and their spouses and dependents was retroactively extended for tax years beginning after December 31, 1993.

You may need to file an amended return, Form 1040X, for 1994 if you did not claim an adjustment to income for the health insurance premiums you paid in 1994. Do not use the worksheet in the 1995 Form 1040 instructions to figure your deduction for 1994. Instead, use the worksheet in the 1994 Form 1040 instructions, or get the 1995 Publication 535, *Business Expenses.*

Advance premiums. If you make an advance payment of a premium for an insurance policy that covers more than one tax year, you cannot deduct the entire premium in the year you make the payment. You can deduct only the part of the premium that applies to the current tax year. In each later tax year you deduct the part that applies to that tax year.

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 (1/4 of 1/3 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 1995, you leased moorage space for your fishing boat for 5 years beginning July 1, 1995, and ending June 30, 2000. You will pay a yearly rental of $360. You paid the first year's rent ($360) on June 1, 1995. On your income tax return for calendar year 1995, you can deduct only $\frac{6}{12}$ of $360, or $180, for the rent applicable to 1995.

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 the entire NOL to the earliest carryback year. If your NOL is not used up, you can carry the remainder to the next earliest carryback year, and so on.

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 apply an NOL to 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 use it up or 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 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. This statement must show you are choosing 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 generally cannot use an NOL. But partners or shareholders can use their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

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 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, see 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

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)
- ☐ **15** Employer's Tax Guide (Circular E)

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) Retirement 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 also 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 your contributions or by a mix of your contributions and employee contributions. Employee contributions do not have to satisfy the minimum funding requirements for your plan. For example, a retirement plan can require after-tax employee contributions that do not by themselves meet the minimum funding requirements. Employee contributions can be voluntary or mandatory.

Your plan can allow your employees to make ***elective deferrals,*** although they are considered ***employer contributions.*** 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. Your contributions as an employer to an employer-sponsored retirement plan generally are deductible as discussed later under *Deduction Limits.*

Kinds of plans. 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 generally can 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.

More than one job. If you are self-employed and also work for someone else, you can participate in retirement plans for both jobs. Generally, your participation in a retirement plan for one job does not affect your participation in a plan for the other job. However, if you have an IRA, you might not be permitted to deduct some or all of your IRA contributions.

Your deduction for IRA contributions might be limited if you also participate in a SEP-IRA. See Publication 560. In addition, your IRA deduction might be limited because you (or your spouse) are covered by an employer's retirement plan and your income is above a certain amount. See Publication 590.

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

Type of Plan	Last Date for Contribution	Maximum Contribution	When To Begin Distributions[1]
IRA	Due date of IRA owner's income tax return (NOT including extensions)	Smaller of $2,000 or taxable compensation	April 1 of year after year IRA owner reaches 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 participant reaches age 70½
Keogh	Due date of employer's return (plus extensions).[4]	**Defined Contribution Plans** **Employee** ***Money Purchase***–Smaller of $30,000 or 25% of employee's taxable compensation ***Profit-Sharing***–Smaller of $30,000 or 15% of employee's taxable compensation **Self-Employed Individual** ***Money Purchase***–Smaller of $30,000 or 20% of self-employed participant's taxable compensation[5] ***Profit-Sharing***–Smaller of $30,000 or 13.0435% of self-employed participant's taxable compensation[5] **Defined Benefit Plans** Amount needed to provide an annual retirement benefit no larger than the smaller of $120,000 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years	Generally, April 1 of year after year participant reaches age 70½[6]

[1] Distributions of at least the required minimum amount must be made each year if the entire balance is not distributed.
[2] 13.0435% of the self-employed participant's taxable compensation before adjustment for this contribution.
[3] Contributions are made to each participant's IRA (SEP-IRA) including that of any self-employed participant.
[4] The employer must set up the plan by the end of the employer's tax year.
[5] Compensation is before adjustment for this contribution.
[6] If the participant reached age 70½ before 1988, distributions must begin by the end of the year he or she retires.

Kinds of Qualified Plans

There are two basic kinds of qualified retirement plans:

1) Defined contribution plans, and
2) Defined benefit plans.

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 be set up only 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 do not have 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 generally are 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 generally can 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 limit on your deduction for your contributions to a Keogh plan depends on the kind of plan you have.

Defined contribution plans. The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. Your deduction for contributions to a profit-sharing plan cannot be more than ***15%*** of the compensation from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this 15% limit in figuring the deduction for contributions you make for your own account. See *Deduction of contributions for yourself,* later.

Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is limited to ***25%*** of the compensation from the business paid (or accrued) during the year to participating common-law employees. You must reduce this 25% limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure your deduction limit.

Note. In figuring the deduction for contributions, you cannot take into account any contributions or benefits that exceed the limits discussed under *Limits on Contributions and Benefits* in Publication 560.

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 about these plans, see *Kinds of Plans* in Publication 560.

Deduction of contributions for yourself. To take a deduction for contributions you make for yourself 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 in which your personal services are a material income-producing factor. 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 are 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 contributions you make for yourself. This reduction is made indirectly, as explained next.

Net earnings reduced by adjusting contribution rate. You must reduce net earnings by your deduction for contributions for yourself. The deduction and net earnings depend on each other. You can make this adjustment to your net earnings indirectly by reducing the contribution rate called for in the plan and using the reduced rate to figure your maximum deduction for contributions for yourself.

Annual compensation limit. You generally cannot take into account more than $150,000 of your compensation in figuring your contribution to a defined contribution plan.

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

Rate Worksheet for Self-Employed

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:

Deduction Worksheet for Self-Employed

Step 1 Enter the contribution rate shown in line 3 above	________
Step 2 Enter your net earnings (net profit) 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 self-employed fisherman and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, and 10½% of your common-law employees' compensation. Your

net earnings from line 31, Schedule C (Form 1040) are $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:

Rate Worksheet for Self-Employed

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

Deduction Worksheet for Self-Employed

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	$ 6,473
Step 4 Subtract step 3 from step 2 and enter the result	$193,527
Step 5 Multiply step 4 by step 1 and enter the result	$ 18,385
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. Additional information about retirement plans for the self-employed and on the reporting forms that must 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 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. See the sample Form 5305–SEP shown in this chapter.

Contribution limits. Contributions you make for a year to a common-law employee's SEP-IRA cannot exceed the smaller of 15% of the employee's compensation or $30,000. Compensation, for this purpose, does not include employer contributions to the SEP.

Annual compensation limit. You generally cannot consider the part of compensation of an employee that is over $150,000 when you figure your contributions limit for that employee.

Note. For employees in a collective bargaining unit for which the $150,000 limit is not effective, the compensation limit is $245,000.

More than one plan. If you also contribute to a defined contribution retirement plan, annual additions to an account are limited to the lesser of (1) $30,000 or (2) 25% of the participant's compensation. When you figure these limits, your contributions to more than one such plan must be added. Since a SEP is considered a defined contribution plan for purposes of these limits, your contributions to a SEP must be added to your contributions to defined contribution plans.

Reporting on Form W–2. Do not include SEP contributions on Form W–2, Wage and Tax Statement, unless there are contributions over the limit that applies or there are contributions under a salary reduction arrangement.

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when you figure your maximum deductible contribution. See *Deduction of contributions for yourself,* later.

Deduction limits. The most you can deduct for employer contributions for common-law employees is 15% of the compensation paid to them during the year from the business that has the plan.

Deduction of contributions for yourself. When figuring the deduction for employer contributions made to your own SEP-IRA, compensation is your net earnings from self-employment, which takes into account:

1) The deduction allowed to you for one-half of the self-employment tax, and
2) The deduction for contributions on behalf of yourself to the plan.

The deduction amount for (2), above, and your compensation (net earnings) are each dependent on the other. For this reason, the deduction amount for (2) is figured indirectly by reducing the contribution rate called for in your plan. This is done by using the *Rate Worksheet for Self-Employed,* shown earlier in the chapter.

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 income tax on the part contributed is deferred. This choice is called an elective deferral, which remains tax free until distributed (withdrawn). 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***). 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 $245,000.

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	28 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)

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 1995 is limited to the lesser of 15% of compensation or $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. Unless there are contributions above the limit that applies, 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 1995 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 15.

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 of 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.

Employee. 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).

Self-employed. 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 ***lesser*** 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 Changes for 1995

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 1995 is $3,060. Your depreciation cannot exceed $4,900 for the second year of recovery, $2,950 for the third year of recovery, and $1,775 for each later tax year. See Publication 917.

General asset account. You can elect to place assets subject to MACRS in one or more general asset accounts. After you have established a general asset account, figure depreciation on the entire account by using the applicable depreciation method, recovery period, and convention for the assets in the account.

For more information, see *General Asset Accounts* later.

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

- ☐ **535** Business Expenses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **551** Basis of Assets
- ☐ **587** Business Use of Your Home (Including Use by Day-Care Providers)
- ☐ **917** Business Use of a Car
- ☐ **946** How To Depreciate 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 in 1995,
2) You are claiming a section 179 deduction,
3) You are claiming amortization of costs that began during 1995,
4) You are claiming depreciation on any listed property,
5) You are filing a corporate tax return, or
6) You are claiming a deduction for any vehicle reported on a form other than Schedule C (Form 1040) or Schedule C–EZ.

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

You can depreciate many different kinds of property as, for example, machinery, buildings, vehicles, furniture, equipment, and certain patents and copyrights.

For property to be depreciable, it must first meet all of the following basic requirements:

1) The property must be used in business or held for the production of income,
2) The property 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.

Repairs and replacements. If a repair or replacement increases the value of your property, makes it more useful, or lengthens its life, your repair or replacement cost must be capitalized and depreciated. If the repair or replacement does not increase the value of your property, make it more useful, or lengthen its life, the cost of the repair or replacement is deductible in the same way as any other business expense.

Intangible Property

Intangible property is generally any property that has value but cannot be seen or touched. It includes items such as copyrights, franchises, patents, trademarks, and trade names.

Partial Business Use

If you use property for business or investment purposes and also for personal purposes, you can deduct only depreciation based on the business use and the use for the production of income. 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.

Property placed in service and disposed of in the same year. You cannot deduct depreciation on property placed in service and disposed of in the same taxable year. When property is considered placed in service is explained later.

Land. The cost of land can never be depreciated because land does not wear out or become obsolete and it cannot be used up. The cost of 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 946.

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 depreciable property 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 you are using to build your own capital improvements. You must add depreciation on this equipment used during the period of construction to the basis of the improvements. See *Uniform Capitalization Rules* in Publication 551.

Correct Depreciation Not Deducted

You cannot deduct unclaimed depreciation in any later tax year. However, you can claim the depreciation on a timely filed amended return for the year for which it should have been claimed. 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 you do not claim depreciation you are 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 any amount deducted.

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. They can do this instead of recovering the cost by 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 acquired 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 acquire for use in your business qualifies for the section 179 deduction. However, the cost of property acquired 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 1995, 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 1995. 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 1994, you bought a new car and used it entirely for personal purposes. In 1995, you begin to use the car in your business. You are not allowed a section 179 deduction for the car in 1995.

Business and nonbusiness 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. You must figure the part of the cost of the property that reflects only its business use. 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. Property does not qualify for the section 179 deduction if:

1) The property is acquired by one member of a controlled group from another member of the same controlled group,
2) The property's basis is either:
   - Determined in whole or in part by its adjusted basis in the hands of the person from whom you acquired it or
   - 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.

Electing the Deduction

The section 179 deduction is not automatic. If you want to take the deduction, you must elect to do so. See *How To Make the Election,* later.

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. You attach and file Form 4562 with:

1) Your original tax return (whether or not you file it timely) or
2) An amended return filed by the due date (including extensions) for your return for the tax year the property was placed in service.

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

The total business cost you can elect to deduct under section 179 for a tax year cannot be more than $17,500. This $17,500 maximum dollar limit applies to each taxpayer, not to each business. You do not have to claim the full $17,500. You can decide how much of the business cost of your qualifying property that you want to deduct under section 179. You may be able to depreciate any cost you do not deduct under section 179.

If you acquire and place in service more than one item of qualifying property during the year, you can divide the deduction between the items in any way, as long as the total deduction is not more than the limits. If you have only one item of qualifying property and that item costs less than $17,500 (for example $3,200), your deduction is limited to the lesser of:

1) Your taxable income from your trade or business (the taxable income limit is discussed later.), or
2) $3,200.

You must subtract the amount you elect to deduct under section 179 from the business/investment cost of the qualifying property. This result is called your 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

Your section 179 deduction cannot be more than the business cost of the qualifying property. In addition, 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 of section 179 property that you can elect to deduct for any year cannot be more than $17,500. This maximum dollar limit is reduced if you go over the investment limit (discussed later) in any tax year.

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 acquired the property or placed it in service.

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. 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. Jack Elm is married and he and his wife file separate returns for 1995. He bought and placed in service $200,000 of qualified machinery in 1995. 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 1995, 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. 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.

If your cost of section 179 property placed in service during a tax year is $217,500 or more, you cannot take a section 179 deduction and you are not allowed to carry over the cost that is more than $217,500.

Example. In 1995, James Smith placed in service machinery costing $207,000. Because this cost exceeds $200,000 by $7,000, he must reduce his maximum dollar limit of $17,500 by $7,000. If his taxable income is at least $10,500 or more, he can claim a $10,500 section 179 deduction for 1995.

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. Generally, you are considered to actively conduct a trade or business if you meaningfully participate in the management or operations of the trade or business.

Taxable income for this purpose is figured by totaling 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.

Carryover of disallowed deduction. The amount you carry over will be taken into account in determining the amount of your section 179 deduction in the next year. In the tax year you place property in service, you can select the properties for which costs will be carried forward and you can allocate the portion of the costs to these properties provided your decisions are shown in your books and records.

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 946 for information on figuring the carryover or figure your carryover using the *Section 179 Deduction Worksheet* also in chapter 2 of Publication 946.

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.

Neither the old nor the new owner can deduct any of the disallowed amount that is added to the basis of the property.

Example. In 1995, 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 1995. 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 1995. Your election of the $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. 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 1995, your total section 179 deduction and depreciation cannot exceed $3,060 in 1995. 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 and, in a year after you place it in service, you do not use it predominantly for business, you may have to recapture part of the deduction. This can occur in any tax year during the recovery period for the property. Recovery periods for property are discussed later.

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

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

How To Figure the Recapture

To figure the amount to include in income, you subtract 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 claimed.

Example. Paul Lamb, a calendar year taxpayer, bought and placed in service on August 1, 1993, an item of 3–year property costing $10,000. The property is not listed property. He used the property only for business in 1993 and 1994. He elected a section 179 deduction of $5,000 for this property. During 1995, he used the property 40% for business and 60% for personal use. He figures his recapture amount as follows:

Section 179 Deduction Claimed (1993)		$5,000.00
Allowable Depreciation (Instead of Section 179):		
1993 — $5,000 × 33.33%*	$1,666.50	
1994 — $5,000 × 44.45%*	2,222.50	
1995 — $5,000 × 14.81%* × 40% (Business)	296.20	4,185.20
1995 — Recapture Amount		$ 814.80

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

Paul must include $814.80 in income for 1995. This is $5,000 minus $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 for which you cannot use MACRS 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 *Election of 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.

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 placed in service by you or anyone (for any purpose) before 1987 (before August 1, 1986, if MACRS was elected). These rules apply to both personal and real property. However, the rules for personal property are more restrictive. 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 946.

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 18 of Part III of Form 4562 and attaching a statement as described in the Instructions for Form 4562.

How To Figure the Deduction Using Percentage Tables

Once you determine that your property can be depreciated under MACRS and whether it falls under GDS or ADS, you are ready to figure your deduction. To figure your MACRS deduction each year, you need to 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

In order to figure your depreciation deduction, you must determine the basis of your property. To determine basis, you need to know the cost or other basis of your property. If you bought the property, your basis is the amount you paid for the property plus any sales tax, freight charges, and installation and testing fees. Other basis refers to basis that is determined by the way you received the property. For example, you may have received the property through a taxable or nontaxable exchange, for services you performed, as a gift, or as an inheritance. If you received property in this or some other way, see chapter 3 for more information on how to figure basis.

Basis of property changed from personal use. If you held property for personal use and later change it to business use or use in the production of income, your basis is the lesser of:

1) The fair market value (FMV) on the date you change it from personal use, or
2) Your original cost or other basis adjusted as follows:
   a) Increased by the cost of any permanent improvements or additions and other costs that must be added to basis, and
   b) Decreased by any tax deductions you claimed for casualty losses and other charges to basis claimed on earlier years' income tax returns.

Property Classes and Recovery Periods

Under MACRS, property is assigned to one of several property classes. These property classes establish the recovery periods (number of years) over which you recover the basis of your property. The class your property is assigned to is generally determined by its class life. For example, property with a class life of 4 years or less is placed in the 3-year property class. The list of class lives and recovery periods for property is in the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946.

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 real property such as a rental home or structure (including a mobile home) if 80% or more of the gross rental income for the tax year is from dwelling units. If any part of the building or structure, is occupied by you for personal use, its 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 section 1250 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:

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

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

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, 1994, Donald Steep bought a boat for his business. It was delivered on December 7, 1994. However, it was not installed and operational until January 3, 1995. Since it was not operational until 1995, it is considered placed in service in 1995. If the boat had been ready for use when it was delivered in 1994, it would be considered placed in service in 1994 even if it was not actually used until 1995.

Conventions

To figure your depreciation deduction for both GDS and ADS, you use one of three conventions:

1) The half-year convention,
2) The mid-month convention, or
3) The mid-quarter convention.

Half-year convention. 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. 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. This convention can apply to your property (other than nonresidential real property and residential rental property) in certain circumstances. These circumstances occur if during any tax year when the total depreciable bases of your MACRS property placed in service during the last 3 months of that year are more than 40% of the total depreciable bases of all MACRS property placed in service during the entire year. When that happens, you must use this convention for all MACRS property placed in service during the year. To determine 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 basis multiplied by the percentage of business/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.

Mid-month convention. For residential rental and nonresidential real property, use the mid-month convention in all situations. 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

The depreciation methods you use depend on whether you use GDS or ADS, which class your property is in, and what type of property it is.

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

1) The 200% declining balance method over the GDS recovery period, which switches to the straight line method when that method provides a greater deduction,

2) The 150% declining balance method over the GDS recovery period, which switches to the straight line method when that method provides a greater deduction,

3) The straight line method over the GDS recovery period,

4) The 150% declining balance method over fixed ADS recovery periods, which switches to the straight line method when that method provides a greater deduction, or

5) The straight line method over fixed ADS recovery periods.

Note: If you use the MACRS percentage tables discussed in Publication 946 you do not need to determine in what year your deduction is greater using the straight line method. The tables have the switch to the straight line method built into their rates.

Before choosing a method, you may wish to consider the following:

1) The declining balance methods provide greater deductions during the earlier recovery years with the deductions getting smaller each year after the second year,

2) The straight line method generally provides equal yearly deductions throughout the recovery period (except for the first and last years), and

3) The GDS recovery periods for most classes of property are generally shorter than the ADS recovery periods.

150% election. Instead of using the 200% declining balance method over the GDS recovery period for nonfarm property in the 3–, 5–, 7–, and 10–year property classes, you can elect to use the 150% declining balance method over the ADS recovery period. Some of the ADS recovery periods are provided later in *ADS method.* For a list of ADS recovery periods, see the *Table of Class Lives and Recovery Periods* in Appendix B of Publication 946. If the property does not have an ADS recovery period specifically assigned to it, the recovery period is 12 years. If you elect this method, you change to the straight line method when it provides a larger deduction.

Make the election 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 year the property under the election is placed in service.

Note: 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. Once made, the election to use the 150% declining balance method cannot be changed.

Straight line election. Instead of using either the 200% or 150% declining balance methods over the GDS recovery period, you can elect to use the straight line method over the GDS recovery period.

Note: 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 tax year of the election. Once made, the election 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 946.

Election of ADS. Although your property may come under GDS, you can make an election to use ADS. ADS uses the straight line method of depreciation over fixed ADS recovery periods.

You make the election by completing line 16 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 to use 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. You must apply the percentages in the tables 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 *How To Figure the Deduction Using Percentage Tables* in chapter 3 of Publication 946.

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 946.

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 946 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, 1995, 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 1995 of $1,429 for this item of 7–year property. For 1996, 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 *How To Figure the Deduction Without Using the Tables* in chapter 3 of Publication 946.

General Asset Accounts

You can choose to put certain depreciable property subject to MACRS placed in one or more general asset accounts. After you have set up a general asset account, you generally figure the amount of depreciation for each general asset account by using the depreciation method, recovery period, and convention that applies to the property in the account. For each general asset account, record the depreciation allowance in a separate depreciation reserve account.

Property you cannot include. You cannot include property in a general asset account if you use it in both a trade or business (or for the production of income) and in a personal activity in the tax year in which you first place it in service.

How To Group Property in General Asset Accounts

Each general asset account must include only property that:

1) Has the same asset class,
2) Has the same recovery period,
3) Has the same depreciation method,
4) Has the same convention, and
5) You placed in service in the same tax year.

The following rules also apply when you establish a general asset account:

1) Property without an asset class, but with the same depreciation method, recovery period, and convention, that you place in service in the same tax year, can be grouped into the same general asset account;
2) Property subject to the mid-quarter convention can only be grouped into a general asset account with property that is placed in service in the same quarter of the taxable year;
3) Property subject to the mid-month convention can only be grouped into a general asset account with property that is placed in service in the same month of the taxable year; and
4) Passenger automobiles subject to the limits on passenger automobile depreciation must be grouped into a separate general asset account.

Dispositions and Conversions

When you transfer ownership of property in a general asset account or you permanently withdraw it from use in your trade or business or from the production of income, it is considered disposed of. A disposition also occurs when you transfer property to a supplies, scrap, or similar account. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of property; a disposition ***does not include,*** the retirement of a structural component of real property.

The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected by your disposition of property from the general asset account.

Property you change to personal use must be removed from the general asset account.

Unadjusted depreciable basis. The unadjusted depreciable basis of an item of property in a general asset account is the same amount you would use to figure gain on the sale of the property, but is figured without taking into account any depreciation taken in earlier years.

The unadjusted depreciable basis of a general asset account is the total of the unadjusted depreciable bases of all of the property in the account.

For more information on general asset accounts, see chapter 3 of Publication 946.

Listed Property

There are limits on the depreciation deductions you can claim on listed property. If listed property is not used predominantly (more than 50%) in a qualified business use, the section 179 deduction is not allowable and the property must be depreciated using ADS (the straight line method) over the ADS recovery period.

Limitations are also imposed on lessees that are similar to those imposed on owners. See chapter 4 of Publication 946.

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.

Listed property defined. Listed property is any of the following:

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 ***unless*** it is used only 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.

Passenger automobiles. For passenger automobiles placed in service in 1995, your total section 179 deduction and depreciation cannot exceed $3,060. For the second year, it cannot exceed $4,900. It cannot exceed $2,950 in the third year and $1,775 each later year. For more information, see Publication 917.

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 946.

8. Gains and Losses

Important Changes

Caution. As this publication was being prepared for print, Congress was considering tax law changes that would affect your 1995 tax return and 1996 estimated taxes. These changes include:

- Capital gains and losses, and
- Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

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.*

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

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. This chapter explains how to figure your gain or loss on the sale or exchange and determine the effect it has on your taxes.

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. For the tax treatment of destroyed or stolen property, see chapter 9. For information on condemned property, see Publication 544.

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.

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

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 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 and any liabilities to which the property you transferred is subject, 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.

Fair market value. Fair market value (FMV) is 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 has to buy or sell. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of FMV. If there is a stated price for services, this price is treated as the FMV, 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 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
FMV of property received		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. Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses are deductible 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 not taxable. 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:

1) Involve qualifying property, and
2) Involve like property.

These two requirements are discussed later. If the like-kind exchange includes the receipt of money or unlike property, you may have a taxable gain. (See *Partially nontaxable exchange,* later.)

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up. See *Deferred exchanges,* later.

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 have 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.

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.*

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 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 fishing boat for another fishing boat 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 can 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.

Partially nontaxable exchange. If you receive cash or unlike property in addition to like property, and the preceding conditions are met, you have a partially nontaxable exchange. 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 a fishing boat that has an adjusted basis of $8,000 for another fishing boat. The boat 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. The facts are the same as in the preceding example, except the property you transfer is subject to a $3,000 loan. Figure the gain realized and the amount of gain to be taxed as follows:

FMV of like property received	$10,000
Cash	1,000
Loan 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 taxed only to the extent of $4,000, the sum of the cash ($1,000) and the loan ($3,000).

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.

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 that 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.

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 by the day that is 45 days after the date you transfer the property given up in the exchange. Any property received by 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 by 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.

Some ***examples of capital assets*** are:

1) A home owned and occupied by you and your family.
2) Household furnishings.
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 that is more than 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. Gain or loss recognized on its sale, exchange, or involuntary conversion is 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. These 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.) If your section 1231 losses exceed your section 1231 gains, you have 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 taken in prior years. ***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

If you took depreciation on property, you may have to treat a gain on the property's 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 allowed or allowable 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) reflected in the adjusted basis. These include 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 1993, Don Smith bought and placed in service section 1245 property that cost $10,000 and had a 5-year life. By the end of 1995, he deducted $7,120 of depreciation using the MACRS method, 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 (less the amount of any recaptured deduction); and
5) The amount of any basis reduction for the investment credit (less the amount of any basis increase for any credit recapture).
6) The amount of any basis reduction for the qualified electric vehicle credit (less the amount of any basis increase for 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. For a list of items treated as depreciation adjustments, see *Depreciation and amortization* under *Section 1245 Gain,* earlier. If you hold section 1250 property for 1 year or less, all of the depreciation is additional depreciation.

You will 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, 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 do not have 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 transferred 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 decedent 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, 1993, you bought equipment for your boat for $1,500. You deducted $300 and $480 under MACRS on your 1993 and 1994 returns. On January 3, 1995, 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.

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. You increase your basis by any amounts spent to rebuild or restore the property after a casualty.

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 receive insurance or another type of reimbursement for your loss, you must subtract it from the loss when you figure your deduction. You cannot deduct the reimbursed part of a casualty or theft loss.

The amount you receive includes any money plus the value of any property you receive, minus any expenses you have in obtaining reimbursement. It also includes any reimbursement used to pay off a mortgage or other lien on the property that was damaged, destroyed, or lost by casualty or theft.

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 1994, 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, 1994, 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 1994. In January 1995, the court awards you a judgment of $4,000. In July 1995, you can show with reasonable certainty you cannot collect from the other driver. You can claim a $3,000 loss in 1995.

Example 2. In 1994, 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 1994 because the most you could possibly have collected from your claim was $18,000. In 1995, the insurance company offered to settle your claim for $15,000 and you accepted the offer. In 1995, 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 1994 ($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 a partnership or a corporation 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

1) did not acquire replacement property within the replacement period, or
2) the replacement property costs less than anticipated at the time you made the election, or
3) you decided not to replace the property.

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 replacement 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

Important Changes

Caution. As this publication was being prepared for print, Congress was considering tax law changes that would affect your 1995 tax return and 1996 estimated taxes. These changes include:

- Capital gains and losses, and
- Sale of your home.

See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

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
- ☐ **537** Installment Sales
- ☐ **550** Investment Income and Expenses

Form (and Instructions)

- ☐ **Schedule D (Form 1040)** Capital Gains and Losses
- ☐ **4684** Casualties and Thefts
- ☐ **4797** Sales of Business Property
- ☐ **6252** Installment Sale Income
- ☐ **8824** Like-Kind Exchanges

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).

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would affect capital gains and losses. The line numbers on Schedule D (Form 1040) could change for 1995. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

Other forms. Before completing Schedule D (Form 1040), you may have to complete other forms. For the sale of business property, complete Form 4797. Form 4797 is discussed later in this chapter.

You must complete Form 8824 in addition to Schedule D (Form 1040) or Form 4797 when you exchange property in a like-kind exchange. 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.*

Information returns. If you sell or exchange certain assets, you should receive an information return showing the proceeds of the sale. This information is also provided to the Internal Revenue Service.

Form 1099–B. If you sold stocks, bonds, commodities, etc., you should receive Form 1099–B or an equivalent statement.

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 as the Form 1099-S.

If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting does not have 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 or exchange on Schedule D (Form 1040) depends on how long you held (owned) the property.

Caution: As this publication was being prepared for print, Congress was considering tax law changes that would affect capital gains and losses. The line numbers on Schedule D (Form 1040) could change for 1995. See Publication 553, *Highlights of 1995 Tax Changes,* for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

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 carryover 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 any reduction for prior years' nonrecaptured net section 1231 losses, 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) Any long-term capital loss carryover.

The result from combining these items with 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 39.6% 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* (box c) 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	$56,550
Married filing jointly or qualifying widow(er)	94,250
Married filing separately	47,125
Head of household	80,750

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 either of the following situations applies to you.

1) Your excess capital loss is more than the yearly limit, or
2) The amount shown on line 35, Form 1040 (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you in 1995, 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 1996.

In 1996, 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 1996, and any excess capital loss will be subject to the limit for that year. Any loss not used in 1996 will be carried over to 1997.

Short-term and long-term losses. 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, combine your separate capital loss carryovers. However, if you and your spouse once filed jointly and are now filing separately, any capital loss carryover from the joint return 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 decedent's estate cannot deduct the excess or carry it 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 1995

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings for 1995 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 1995, the maximum amount subject to the social security part (12.4%) is $61,200. All earnings are subject to the Medicare part (2.9%).

The maximum amount subject to the social security part (12.4%) in 1996 increa ses to $62,700.

Important Reminders

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of SE 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 1995, you will receive a quarter of social security coverage, up to four quarters, for each $630 of income subject to social security. Therefore, for 1995, if you had income of $2,520 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 SE tax. If you do not have a number, see *Application for identification number* in chapter 1.

Estimated tax. If you estimate your income tax for 1996, you must also include an estimate of your SE tax. See *Estimated Tax and Return Due Dates* in chapter 1.

Reporting self-employment tax. Figure your SE tax on Schedule SE. Then report the tax on line 47 of Form 1040, and attach Schedule SE to Form 1040.

Self-employment tax deduction. You can deduct one-half of your SE 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 SE tax.

To deduct the tax, enter on Form 1040, line 25, the amount shown on the "Deduction for one-half of self-employment tax" line of the Schedule SE.

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

Who Must Pay Self-Employment Tax

The SE 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.

You must pay SE tax if you were self-employed and your net earnings from self-employment were $400 or more.

You are self-employed if you carry on your own trade or business as a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself. A ***trade or business*** is generally an activity carried on for a livelihood or in good faith to make a profit.

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.

The SE tax rules apply even if you are fully insured under social security or are now receiving benefits.

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 SE tax. See *Certain Crew Members Considered Self-Employed* in chapter 12 to find out if you have to pay the tax.

Self-Employment Income

Different types of income can be SE income. The source of your income and your involvement in the activity from which your income is received will determine whether it is SE income.

Some common types of income are listed here. For a more complete discussion about SE income, see *Self-Employment Income* in Publication 533.

Real estate rent. Rent from real estate and personal property leased with real estate is not SE income. However, if you receive rent as a real estate dealer, the rental income and related deductions are included in figuring SE income.

Interest. Interest is not SE income unless you receive it in your trade or business, such as interest on accounts receivable.

Dividends. Dividends on securities are not SE 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 SE 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 the following types of property are not included:

1) Investment property.
2) Depreciable property or other fixed assets used in your trade or business.

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 self-employment income. 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 SE income. Also, tips received for work done as an employee are excluded from SE 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 SE 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 SE income.

If there is a connection between any payment you receive and your trade or business, the payment is SE 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 SE income usually includes all of the items of business income minus all business deductions allowed for income tax purposes. Net SE 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 SE income is the combined incomes from all of your businesses. A loss in one business will reduce the income earned in another. You must claim all allowable deductions when figuring your net SE income. Your net SE income is used to figure 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 SE 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.

Example. You own a fishing boat and for the year your business had the following items:

Item	Amount
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:

Item		
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 SE 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 *Net Self-Employment Income* in Publication 533.

Figuring Self-Employment Tax

There are three steps to figure the amount of tax you owe.

1) Determine your net earnings from self-employment.
2) Determine the amount that is subject to the tax.
3) Multiply that amount by the tax rate.

There are two ways for fishermen to figure net earnings from self-employment.

1) The regular method, and
2) The nonfarm optional method

Tax rates. The SE tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). It is the same for net earnings figured under each method.

Net earnings subject to SE tax. Whether you have to pay SE tax on any part of your net earnings from self-employment generally depends on the total amount of your net earnings for the year, and on the total amount of any wages or tips you earn for the year.

Minimum amount. You must have $400 or more of net earnings from self-employment to be subject to the tax. For this purpose, net earnings are figured on line 4 of Schedule SE, Section A or line 4c of Schedule SE, Section B. If your net earnings are less than $400, you do not have to file Schedule SE (Form 1040) or pay the tax unless you had church employee income of $108.28 or more.

Maximum amount. No more than $61,200 of your combined wages, tips, and net earnings in 1995 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All of your combined wages, tips, and net earnings in 1995 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

If your wages and tips are subject to either social security or railroad retirement (tier 1) tax, or both, and total at least $61,200, you do not have to pay the 12.4% social security part of the SE tax any of your net earnings. However, you must pay the 2.9% Medicare part of the SE tax on all of your net earnings.

Optional method. You can generally use the nonfarm optional method (discussed later) when you have a loss or small amount of net income from self-employment 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 SE tax due under that method, even if you would have had a smaller tax or no tax under the regular method.

The optional method may be used only to figure your SE tax. To figure your income tax, include your actual income in gross income.

Forms. Use Schedule SE (Form 1040) to figure your SE tax. Report the SE tax on line 47 of Form 1040. If you have to pay SE 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 SE income, it is independently subject to SE tax. If you both have SE income, each of you must file a separate Schedule SE (Form 1040). Attach both schedules to the joint return.

Community income. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to SE tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

Schedule SE

You must file Schedule SE if:

1) You were self-employed, and your net earnings from self-employment (excluding 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 SE 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 (tier 1)) tax plus net earnings from self-employment are more than $61,200,
2) Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS consent), who owe SE 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 and Medicare taxes that was not reported to their employers, and
5) Individuals who use the optional method to figure SE tax.

Regular Method

Use the following steps to figure your tax under the regular method:

Step 1. Figure your net SE income. The net profit from your business or profession is generally your net SE income.

Step 2. After you have figured your net SE income, determine how much is subject to SE tax. The amount subject to SE tax is called net earnings from self-employment. It is figured on *Short Schedule SE,* line 4, or *Long Schedule SE,* line 4a.

Step 3. Figure your SE tax as follows:

1) If your net earnings from self-employment plus any wages and tips are not more than $61,200, and you do not have to use *Long Schedule SE,* use *Short Schedule SE.* On line 5, multiply your net earnings by 15.3% (.153). The result is the amount of your SE tax.
2) If you had no wages, your net earnings from self-employment are more than $61,200, 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 $7,588.80 (12.4% of $61,200). The total is the amount of your SE tax.
3) If your net earnings from self-employment plus any wages and tips are more than $61,200, you must use *Long Schedule SE.* Subtract your total wages and tips from $61,200 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 SE tax.

Example 1. During 1995, you have $30,000 in net SE income, and receive no wages subject to social security and Medicare taxes. You multiply the $30,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of $27,705. Your SE tax is 15.3% (.153) of $27,705, or $4,238.87.

Example 2. During 1995, you have $20,000 in net SE 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* to get your net earnings from self-employment of $18,470. Your SE tax is 15.3% (.153) of $18,470, or $2,825.91.

Example 3. During 1995, you have $70,000 in net SE income, and receive no wages subject to social security and Medicare taxes. You multiply the $70,000 by 0.9235 on *Short Schedule SE* to get your net earnings of $64,645. Since only $61,200 of your earnings is subject to the social security part of the SE tax, your tax for this part is $7,588.80 (12.4% of $61,200).

Since all of your earnings are subject to the Medicare part of the SE 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 $7,588.80 figured above for total SE tax of $9,463.51.

Example 4. During 1995, you have $70,000 in net SE income, and receive $10,000 in wages subject to social security and Medicare taxes. You figure your net earnings on *Long Schedule SE,* line 4a to be $64,645. Next, you subtract your wages of $10,000 from $61,200, the maximum income subject to the social security part of the SE tax. The result is $51,200. Since only $51,200 of your earnings is subject to the social security part of the SE tax, your tax for this part is 12.4% (.124) × $51,200, or $6,348.80.

Since all of your net earnings are subject to the Medicare part of the SE 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 $6,348.80 figured above for total SE tax of $8,223.51.

Nonfarm Optional Method

The nonfarm optional method is figured on *Long Schedule SE* (Section B). By using the nonfarm optional method, you can continue paying SE tax for your social security 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 SE 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.
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.

12. Employment Taxes

Important Changes for 1996

Social security and Medicare taxes. For 1996, the employer and the employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. The maximum amount of 1996 wages subject to the social security tax is $62,700. There is no wage base limit for the Medicare tax (1.45%). All covered wages are subject to the tax.

Federal unemployment (FUTA) tax. The gross FUTA tax rate remains at 6.2% through 1996. The maximum amount of wages subject to FUTA tax remains at $7,000.

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. However, you do not have to notify employees who claim exempt from withholding on Form W–4.

Form W–4 for 1996. You should make 1996 Forms W–4 available to your employees and encourage them to check their income tax withholding for 1996. Those employees who owed a large amount of tax or received a large refund for 1995 may need to file a new Form W–4.

Employer's child. Wages you pay to your child who is 18 or older for services in your trade or business are subject to social security and Medicare taxes.

Introduction

You are generally required to withhold federal income tax from the wages of your employees. 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 payments to crew members who are treated as self-employed individuals. You are required to file Form 1099–MISC, *Miscellaneous Income,* to report the payments made to these crew members. See *Certain Crew Members Considered Self-Employed,* later.

Note. See Table 12–1 for information on the employment tax treatment of fishing and related activities.

Employer identification number. Every employer subject to employment taxes must have an employer identification number (EIN). You can apply for an EIN either by mail or by telephone. You can get an EIN immediately by

Table 12-1. **Employment Tax Treatment of Fishing and Related Activities**

Activity	Income Tax Withholding	Social Security and Medicare Taxes	Federal Unemployment Tax (FUTA)
a. Catching salmon or hailbut.	Withhold unless *c.* applies.	Taxable unless *c.* applies.	Taxable unless *c.* applies.
b. Catching other fish, sponges, etc.	Withhold unless *c.* applies.	Taxable unless *c.* applies.	Taxable if vessel is more than 10 net tons and *c.* does not apply.
c. Individual is paid a share of the catch (or proceeds from sale of the catch), rather than cash remuneration, under an arrangement with the owner or operator of a boat. The share depends on the boat's catch and the operating crew of the boat is normally fewer than 10 individuals.	Exempt	Exempt	Exempt
d. Native Americans exercising fishing rights.	Exempt	Exempt	Exempt

calling the Tele-TIN phone number for the service center for your state, or you can send a completed SS–4, *Application for Employer Identification Number,* directly to the service center to receive your EIN in the mail. See the instructions for Form SS–4 for more information.

INS Form I–9. You must ask each new employee to complete the employee section of an Immigration and Naturalization Service (INS) Form I–9, *Employment Eligibility Verification.* You must then complete the employer section 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.

Topics

This chapter discusses:

- Who are employees?
- Certain crew members considered self-employed
- Income tax withholding
- Social security and Medicare taxes
- Reporting and paying employment taxes
- Federal unemployment tax (FUTA)
- Family members
- Earned income credit (EIC)

Useful Items

You may want to see:

Publication

- ☐ **15** Employer's Tax Guide (Circular E)
- ☐ **15–A** Employer's Supplemental Tax Guide

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

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 subject to the will and control of a payer, as to both what must be done and how it must be done, is an employee. It does not matter that 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:

1) The employer supplies tools and a place to work, and
2) 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, coadventurer, 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. A superintendent, manager, or other type of supervisor is an employee.

Employee or independent contractor? In doubtful cases, the facts will determine whether a worker is your employee. 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. Mike and the fishing company 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 any 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% that he keeps as his commission. From the remaining three-fourths, the expenses of food, bait, etc., are deducted. The remainder is then equally divided between Mike and the members of the crew.

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 agreement under which the crew is hired in these circumstances is a contract of hire.

Mike is the agent of Pan Fishing Co. and the company is the employer. As an employer of a crew working on an American vessel under a contract entered into in the United States, 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 FUTA 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 FUTA 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 Example 1 except that Mike Rose is the owner-operator of the vessel and associated in no way 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 FUTA tax on these wages.

Additional information. For more information on the employer-employee relationship, see *Who Are Employees?* in Publication 15 (Circular E).

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 FUTA 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.
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.

Crew members who meet these conditions are considered self-employed. Their earnings are considered income from a trade or business and are subject to self-employment tax. See chapter 11 for information on self-employment tax.

Example 1. Mike Jones owns a fishing boat of more than 10 net tons. He 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 between the captain and the

crew members and 40% between Mike and the captain.

The crew members do not receive any additional compensation between voyages, 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 FUTA 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 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 FUTA tax.

Reporting requirements. The boat operator must send to the IRS a completed Form 1099–MISC, *Miscellaneous Income,* for each crew member who is considered self-employed. All amounts must be reported. The rule for reporting only payments of $600 or more on 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 member. 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 each crew member by January 31 of the year following the calendar year in which the crew member was 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 (FUTA).*

Recordkeeping requirement. The operator must keep a record of each catch. These records must be kept for 3 years after the year of the catch.

Income Tax Withholding

Generally, you must withhold income tax and social security and Medicare tax from wages you pay an employee if the wages (whether paid in cash or in fish) are more than the dollar value of withholding allowances the employee claimed 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 a right to a refund of all income tax withheld last year because of no income tax liability, and because he or she expects the same situation to exist this year.

The amount to withhold is figured on gross wages before any deductions for social security and Medicare taxes, union dues, insurance, etc. Several methods may be used to determine the amount of withholding. They are described in Publications 15 and 15–A.

Form W–4 for 1996. You should make 1996 Forms W–4 available to your employees and encourage them to check their income tax withholding situation for 1996. Those employees who owed a large amount of tax or received a large refund for 1995 may need to file a new 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 it. 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 it. A Form W–4 that makes a change for the next calendar year will not take effect in the current year.

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, you must withhold income tax at 31% (backup withholding) on commissions, nonemployee compensation, and other payments for services you make in the course of your commercial fishing or other business activities. The backup withholding rules do not apply to wages.

You must withhold 31% of the payment if:

1) The recipient does not furnish a taxpayer identification number to you, or
2) The IRS notifies you that the recipient furnished an incorrect taxpayer identification number.

See Form W–9 and the *Instructions for Forms 1099, 1098, 5498, and W–2G* for more information.

Social Security and Medicare Taxes

The Federal Insurance Contributions Act (FICA) provides for the federal system of old-age, survivors, disability, and hospital insurance. This system is financed through social security and Medicare taxes paid by you and your employees. You, as an employer, must collect and pay the employee's part and you must pay a matching amount. You must withhold the taxes 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.

Tax rates and social security wage limits. For 1996, the employer and the employee will continue to pay:

1) 6.2% each for social security tax (old-age, survivors, and disability insurance), and
2) 1.45% each for Medicare tax (hospital insurance).

Wage limits. The maximum amount of 1996 wages subject to the social security tax is $62,700. There is no wage base limit for the Medicare tax (1.45%). All covered wages are subject to the tax.

Reporting and Paying Employment Taxes

You must withhold income, social security, and Medicare taxes that are required to be withheld 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 withhold less than the correct tax from your employees' wages, you are still liable for the full amount.

Form 941. If you must withhold income tax from your employees' wages or are liable for social security and Medicare taxes, you must file Form 941. It is a quarterly return due one month after the end of each calendar quarter. However, if you must deposit the employment taxes and you deposit them on time and in full, you are given an extra 10 days to file the return. Fill in all the information requested on the return, including your employer identification number.

Deposits. 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 to which the deposit applies on your check or money order. See Publication 15, (Circular E) for information on deposits, including deposit rules and penalties for late deposits.

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 employer box on Form 941 on each return you file so the IRS will not expect a return each quarter.

Penalties. If you pay your taxes late, you may have to pay a penalty as well as interest on any overdue amounts. There are also civil and criminal penalties for intentionally not paying taxes, and for intentionally filing a false tax return or filing no return at all.

Trust fund recovery penalty. If you are 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.

More information. See Publication 15 (Circular E) for more information about penalties for tax deposits.

Form W–2. Form W–2 must show the total wages and other compensation paid (whether or not they are subject to withholding), the amounts deducted for income, social security, and Medicare taxes, and any other information required on the statement.

More detailed information for preparing, filing, and correcting Form W–2, and for giving copies to employees, is contained in the *Instructions for Form W–2.*

Additional information. Publication 15 (Circular E) contains more information about employment taxes. You can get Circular E from the IRS Forms Distribution Center for your state. See *Ordering publications and forms* at the beginning of this publication.

Federal Unemployment Tax (FUTA)

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.

Exceptions. 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 not exempt from FUTA tax under this rule may be 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 FUTA tax rate is 6.2% of the first $7,000 in wages paid annually 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% 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 two or more years.

If your state is subject to a credit reduction for 1996, the state's name and the amount of the credit reduction will be shown on the 1996 Form 940.

Form 940. If you are liable for FUTA 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. However, you may have to make deposits of the tax before filing the return. If you deposit the tax on time and in full, you have an extra 10 days to file — until February 10.

You can use Form 940–EZ, a simplified version of Form 940, if all of the following apply:

1) You paid state unemployment taxes to only one state.
2) You paid the state taxes by the due date of Form 940 or Form 940–EZ.
3) All of your wages taxable for FUTA tax were also taxable for state unemployment tax.
4) You did not pay wages subject to the unemployment compensation laws of a credit reduction state.

Deposits. If at the end of any calendar quarter you owe, but have not yet deposited, more than $100 in FUTA tax for the year, you must make a deposit by the end of the next month.

If the undeposited tax is $100 or less at the end of a quarter, you do not have to deposit it. You must add it to the tax for the next quarter. If the total undeposited tax is more than $100 in the next quarter, a deposit will be required. If the undeposited tax for the 4th quarter (plus any undeposited tax for an earlier quarter) is less than $100, you can either make a deposit or pay it with your return by the January 31 due date.

More information. For more information on FUTA tax, including figuring the tax, the amount to deposit, and due dates of deposits, see Publication 15 (Circular E).

Earned Income Credit (EIC)

The EIC is a special credit for certain employees that reduces the tax they owe. Even if they do not owe any tax, the credit may give them a refund. Eligible employees can choose to receive advance payment of the EIC from you. To ensure that certain employees are aware of the EIC, you must notify them about the credit.

Advance payment. You must pay part of the EIC in advance to eligible employees who have filed a Form W–5 with you. This allows those employees to receive part of the benefit 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 employee's pay each payday. It is figured from tables in Publication 15 (Circular E). You reduce your liability for income tax withholding and social security taxes by the total amount of the advance EIC payments made. For more information, see Publication 15 (Circular E).

Employees not eligible. Employees whose wages are exempt from withholding of income, social security, or Medicare tax are not eligible to receive advance EIC payments.

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 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 one of the following:

1) Form W–2, which contains the notification on the back of Copy C.
2) A substitute Form W–2 with the exact EIC wording shown on the back of copy C of Form W–2.
3) Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC).*
4) Your own written statement with the exact wording of Notice 797.

For more information about notification requirements and claiming the EIC, see Notice 1015, *Employers—Have You Told Your Employees About the Earned Income Credit (EIC)?*

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) and the Internal Revenue Service (IRS). 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 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 which taxpayers must maintain. These accounts are:

1) The capital account,
2) The capital gain account, and
3) The ordinary income account.

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 portion 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 generates a deduction by reducing your taxable income.

Capital account. The capital account includes:

1) Amounts attributable to your depreciation deduction for the agreement vessels,
2) Amounts attributable to the net proceeds from the sale or disposition of the agreement vessels, or any insurance or indemnity proceeds, (not including the portion that represents gain), and
3) Amounts representing tax exempt interest on CCF investments in state and local bonds.

Capital gain account. The capital gain account consists of:

1) Amounts representing capital gains, on assets held in the fund for more than 6 months from the sale or disposition of any agreement vessel, or the insurance or indemnity proceeds attributable to an agreement vessel, or
2) The gains from fund investments held in the fund, ***less***
3) Amounts representing capital losses on assets held in the fund for more than six months.

Ordinary income account. The ordinary income account consists of:

1) Amounts attributable to the taxable income from the agreement vessel operations, without regard to any net operating loss carryback or net capital loss;
2) Amounts representing capital gains on assets held in the fund six months or less from:
   a) The sale or disposition of agreement vessels, insurance or indemnity proceeds, and fund investments, ***less***
   b) Amounts representing capital losses on assets held in the fund for six months or less;
3) Interest (not including tax-exempt interest from state and local bonds) and other ordinary income received, and
4) Ordinary income (depreciation recapture), if any, from the sale or other disposition of any agreement vessel or insurance or indemnity proceeds attributable to any agreement vessel.

CCF Contributions

You can exclude from taxable income any amounts you deposit in your CCF account coming from the following sources:

1) Earnings from the operation of the agreement vessels,
2) Gain 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.

Earnings from vessel operations. You can reduce the portion of your taxable income for the tax year (without regard to the carryback of any net operating loss or net capital loss) attributable to the operation of the agreement vessel in the fisheries of the United States.

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.***

Contribution Ceilings

The amount that you can deposit, for any tax year, cannot exceed the sum of:

1) The taxable income from your fishing vessel operations (without regard to any net

operating loss (NOL) carryback or net capital loss),

2) The deduction for depreciation allowable on your fishing vessel,
3) Any net proceeds (not included in 1 above) from the sale or disposition of an agreement vessel or insurance or indemnity received on the vessel, and
4) The receipts from the investment or reinvestment of the fund assets.

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.

Examples of nonqualified withdrawals are amounts remaining in a CCF upon termination of the fund and payments against indebtedness in excess of basis. If NMFS determines that the balance in your CCF exceeds the amount that is appropriate to meet the objectives of the vessel construction program, the excess will be treated as a nonqualified withdrawal unless you develop appropriate program objectives within three years to dissipate the excess.

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). The current interest rate can also be obtained by calling National Marine Fisheries Service at (301) 713-2393.

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 54 of Form 1040. To the left of line 54, 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 24 and allocates this amount to the partners on Schedule K–1, line 25.

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 Code of Federal Regulations, 26 C.F.R. Part 3 and 50 C.F.R. Part 259. 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. ExciseTaxes

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 1996

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 1995 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 1996, instead of waiting to claim a credit on your 1996 income tax return. The form you use to claim your credit or refund shows the rate that applies to the fuel.

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 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.

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 (1995). 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 1.

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 to 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 60 and check box b of the 1995 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 rate that applies. 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 1996 rather than waiting until you file your 1996 income tax return to claim a credit. File a claim for refund on Form 8849. However, you must meet the quarterly amount requirements (discussed next) to use Form 8849 for claiming a refund.

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 1995. She filed Form 8849 for the second quarter and claimed a $3,660 refund. When Pearl files her 1995 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 1995 Form 1040 on March 1, 1996. 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 1996 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 1995 return on April 2, 1996. On Schedule C, he deducted the total cost of gasoline (including $155 of excise taxes) used in his commercial fishing vessels during 1995. 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 1995 Schedule C.

15.

The Examination and Appeals Process

Introduction

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.

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

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 us at 1-800-829-3676.

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 can ask to have the examination done in another office or transferred to a different district.

Representation. Throughout the examination, you can 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 can 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 can 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 1-800-829-3676.

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 can 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 us.

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 can 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 from IRS employees, given to you by phone, 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 1-800-829-3676.

16. Sample Records and Forms

This chapter discusses a sample recordkeeping 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, 1995, 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 1995 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 1995. 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 $2,448. This is the $3,060 limit adjusted to reflect Frank's 80% business use. He takes a $2,448 section 179 deduction and reduces his basis in the truck by the deduction ($8,000 − $2,448). The depreciable basis of Frank's truck is $5,552. Frank has taken the maximum deduction for the truck in 1995 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 24 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 ($6,534) 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

29, 1996. Frank is required to give Bill a statement showing the information reported on Copy A by January 31, 1996. 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 1995 and the section 179 deduction he elects for the truck.

Line 15. The insurance expense of $3,291 represents the 1995 premiums on insurance policies covering his business property.

Line 16b. Frank enters the $800 interest he paid in 1995 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 1995 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 1995.

Line 23. Frank enters the $35 state fee he paid for his 1995 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 $39,552.

Line 29. Frank enters his tentative profit of $20,736 on line 29. He makes no entry on line 30.

Line 31. He enters his net profit, $20,736, 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, 1995, 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, 1995, was $12,500. 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 $12,500 (from line 26) is compared with the total depreciation allowed or allowable ($37,500) on line 24 and the smaller of the two amounts ($12,500) 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 $12,500 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 $12,500 ordinary gain on line 14. Since this is the only entry in Part II, Frank enters $12,500 on lines 19, 20, and 20b(2) of Part II and also on line 14 of Form 1040.

Notes

1)Daily Cash Receipts and Expenses Diary

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 Ben'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: 1-7-95
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

1995 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 and 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	3784.10	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	387.70
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	337.60
December	4155.94	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	7-1-88	1,500	"	
Fishing boat (Salem)	1-3-89	38,000	"	
Pots and traps	1-3-91	6,000	"	2,000
Truck (USA Rover) *	8-1-95	10,000	80%	2,448
1995 totals:				2,448

Schedule C Entries

Monthly Expenses

Truck/Auto Expenses	Insurance	Repairs	Crew Shares	Taxes/Other	Interest
21.03	241.75	300	634.06		75
18.22	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
48.60	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	592.26		60.03
25.37	306.75	590	747.23		54.25
505.00	3291.00	4593.00	10991.61	35	800.00

Worksheet

Depreciation Prior Years	Basis for Depreciation	Method/ Convention	Recovery Period	Rate or Table %	Depreciation Deduction
37,500	Sold 1-3-95	SL	16		-0-
5,732	6,000	200DB/HY	7	4.46	268
1,432	1,500	200DB/HY	7	4.46	67
32,911	38,000	200DB/HY	7	8.93	3,394
2,752	4,000	200DB/HY	7	8.93	357
-0-	5,552	200DB/HY	5	20.0	-0- *
					4,086

* Listed property – limited deduction

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach this form to your return.

OMB No. 1545-0172

1995

Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Frank Carter	Fishing	111-00-1111

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 page 1 of the instructions	1	$17,500
2	Total cost of section 179 property placed in service during the tax year. See page 2 of the 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 page 2 of the instructions	5	17,500

	(a) Description of property	(b) Cost	(c) Elected cost
6			
7	Listed property. Enter amount from line 27	7	2,448

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	2,448
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	2,448
10	Carryover of disallowed deduction from 1994. See page 2 of the 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	2,448
13	Carryover of disallowed deduction to 1996. 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 1995 Tax Year (Do Not Include Listed Property.)**

Section A—General Asset Account Election

14 If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 2 of the instructions ▶ ☐

(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 B—General Depreciation System (GDS) (See page 2 of the instructions.)						
15a 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 C—Alternative Depreciation System (ADS) (See page 4 of the instructions.)						
16a 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.) (See page 4 of the instructions.)**

17	GDS and ADS deductions for assets placed in service in tax years beginning before 1995	17	4,086
18	Property subject to section 168(f)(1) election	18	
19	ACRS and other depreciation	19	

Part IV **Summary (See page 4 of the instructions.)**

20	Listed property. Enter amount from line 26	20	
21	**Total.** Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	21	6,534
22	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	22	

For Paperwork Reduction Act Notice, see page 1 of the separate instructions. Cat. No. 12906N Form **4562** (1995)

Part V Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete only 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See page 5 of the instructions for limitations for automobiles.)*

23a Do you have evidence to support the business/investment use claimed? ☑ Yes ☐ No 23b 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
24 Property used more than 50% in a qualified business use (See page 5 of the instructions.):								
95 Truck (USA Rover)	8-1-95	80 %	10,000	5,552	5	200DB/HY	-0-	2,448
		%						
		%						
25 Property used 50% or less in a qualified business use (See page 5 of the instructions.):								
		%				S/L –		
		%				S/L –		
		%				S/L –		

26 Add amounts in column (h). Enter the total here and on line 20, page 1 . . . . . . 26 -0-

27 Add amounts in column (i). Enter the total here and on line 7, page 1 . . . . 27 2,448

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.
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	
28 Total business/investment miles driven during the year (DO NOT include commuting miles)	4,480											
29 Total commuting miles driven during the year	-0-											
30 Total other personal (noncommuting) miles driven	1,120											
31 Total miles driven during the year. Add lines 28 through 30.	5,600											
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
32 Was the vehicle available for personal use during off-duty hours?	✓											
33 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
34 Is another vehicle available for personal use?	✓											

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

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who are not more than 5% owners or related persons.

	Yes	No
35 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
36 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 6 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
37 Do you treat all use of vehicles by employees as personal use?		
38 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
39 Do you meet the requirements concerning qualified automobile demonstration use? See page 6 of the instructions . .		

Note: *If your answer to 35, 36, 37, 38, or 39 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
40 Amortization of costs that begins during your 1995 tax year:					

41 Amortization of costs that began before 1995 41

42 **Total.** Enter here and on "Other Deductions" or "Other Expenses" line of your return 42

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SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service

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

1995

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 1995? If "No," see page C-2 for limit on losses.	✓	

J If you started or acquired this business during 1995, check here ▶ ☐

Part I Income

Line	Description		Amount
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.

Line	Description		Amount
8	Advertising	8	
9	Bad debts from sales or services (see page C-3)	9	
10	Car and truck expenses (see page C-3)	10	404
11	Commissions and fees	11	
12	Depletion	12	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	6,534
14	Employee benefit programs (other than on line 19)	14	
15	Insurance (other than health)	15	3,291
16	Interest:		
a	Mortgage (paid to banks, etc.)	16a	
b	Other	16b	800
17	Legal and professional services	17	
18	Office expense	18	
19	Pension and profit-sharing plans	19	
20	Rent or lease (see page C-4):		
a	Vehicles, machinery, and equipment	20a	
b	Other business property	20b	72
21	Repairs and maintenance	21	4,593
22	Supplies (not included in Part III)	22	6,464
23	Taxes and licenses	23	35
24	Travel, meals, and entertainment:		
a	Travel	24a	
b	Meals and entertainment		
c	Enter 50% of line 24b subject to limitations (see page C-4)		
d	Subtract line 24c from line 24b	24d	
25	Utilities	25	
26	Wages (less employment credits) Crew	26	10,992
27	Other expenses (from line 46 on page 2)	27	6,367

Line	Description		Amount
28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶	28	39,552
29	Tentative profit (loss). Subtract line 28 from line 7	29	20,736
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	20,736

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) 1995**

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 1995, 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

Form **4797**

Department of the Treasury
Internal Revenue Service

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

1995

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 1995 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	(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 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):

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)

		Line	(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		12,500
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	( )	12,500

20 Combine columns (g) and (h) of line 19. Enter gain or (loss) here, and on the appropriate line as follows: . . . 20 12,500

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) 12,500

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 13086I Form **4797** (1995)

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	1-3-95
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	37,500			
25 Adjusted basis. Subtract line 24 from line 23	25	12,500			
26 Total gain. Subtract line 25 from line 22	26	12,500			
27 **If section 1245 property:**					
a Depreciation allowed or allowable from line 24	27a	37,500			
b Enter the **smaller** of line 26 or 27a	27b	12,500			
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 (see instructions)	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 property columns A through D, line 26	32	12,500
33 Add property columns A through D, lines 27b, 28g, 29c, 30b, and 31b. Enter here and on line 14	33	12,500
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	

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		

6)Crew Share Compensation Record

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

Form 1099-MISC

☐ CORRECTED (if checked)

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 1995 Form 1099-MISC	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 B For Recipient
RECIPIENT'S name Bill Brown	6 Medical and health care payments $	7 Nonemployee compensation $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) 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 ► ☐	
City, state, and ZIP code Hometown, OR 97331	10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional)	12 State/Payer's state number		

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