Ethics, Professional Responsibilities, and Federal Tax Procedures

Ethics and Responsibility in Tax Practice

Regulations Governing Practice Before the Internal Revenue Service

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Regulations Governing Practice Before the Internal Revenue Service

Introduction

Circular 230: IRS's rules of practice. The government may censure, fine, suspend, or disbar tax advisors from practice before the IRS if they violate Circular 230's standards of conduct.

Focus: Part B of Circular 230 which contains its substantive provisions; other portions contain procedural rules and potential punishments.

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Selected Substantive Provisions

Furnishing Information: A practitioner must promptly submit to the IRS any records or information that its agents and officers request properly and lawfully.

"Unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged."

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Selected Substantive Provisions

Client's Omission: Section 10.21 requires the practitioner, upon discovering an error or omission in a previous return, to promptly notify the client, but the practitioner need not notify the IRS of the error and may not without the client's permission.

Selected Substantive Provisions

Due Diligence and Reliance on Others: Practitioners must exercise due diligence in all aspects of their tax practice, including preparing tax returns and making representations to the IRS.

Selected Substantive Provisions

With the exception of situations involving aggressive tax shelters, **Section 10.22** allows a practitioner to rely upon the work product of others if the practitioner used reasonable care in engaging, supervising, training, and evaluating them.

Delays and Unconscionable Fees

- Practitioners may not **unreasonably** delay the prompt disposition of any matters before the Service (10.23).
- No practitioner may charge an **unconscionable** fee for representing a client before the IRS.

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Contingent Fees

A practitioner **may not** charge a contingent fee for providing services before the IRS, with three exceptions where substantive examination is likely and therefore it is unlikely the practitioner and client will play the "audit lottery."

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Contingent Fees

1. A contingent fee may be charged for services rendered in connection with an IRS **examination** of or **challenge** to either:
   a) An original tax return
   b) An amended return or claim for refund when they were filed within 120 days of receiving a written notice of examination or written challenge to the original exam

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Contingent Fees

2. Where a claim for refund is filed solely in connection with determination of statutory interest or penalties
3. When the accountant is representing the client in judicial proceedings

Return of Client Records

- Section 10.28 instructs the practitioner, upon the client's request, to promptly return any and all records needed for the client to comply with Federal tax obligations.
- If applicable state law permits retention in the case of a fee dispute, the practitioner need return only those records that **must be attached to the taxpayer's return.**

Conflicts of Interest

Section 10.29 provides that practitioners should not represent a client before the IRS if to do so would **create a conflict of interest.**

1. Such a conflict exists if the representation of one client would be adverse to that of another or if there is a significant risk that the representation of one client would be **materially limited** by the practitioner's responsibilities to another client

Conflicts of Interest

Section 10.20 provides that practitioners should not represent a client before the IRS if to do so would **create a conflict of interest.**

2. Notwithstanding the existence of a conflict of interest, however, practitioners may represent a client if they:
   a. Reasonably believe that they can provide competent and diligent representation to the client

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Conflicts of Interest

   b. The representation is not prohibited by **law**
   c. The affected client gives **informed** consent in writing

Note: Practitioners should keep the consents on file for at least three years.

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Best Practices

Section 10.33 sets forth best practices for tax advisors, including:

1. Communicating clearly with the client regarding the terms of the engagement, including the purpose, use, scope, and form of the advice

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Best Practices

2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of assumptions or representations, relating the applicable law to the relevant facts, and arriving at a conclusion supported by the law and the facts

Best Practices

3. Advising the client regarding the import of the conclusions reached, including whether taxpayers may avoid accuracy-related penalties if they rely on the advice
4. Acting fairly and with integrity when practicing before the IRS
5. Exercising any firm supervisory powers to ensure that firm employees act in accordance with best practices

Tax Return Standards

Section 10.34 instructs practitioners not to advise clients to take positions that are frivolous and to inform clients of any penalties that are reasonably likely to apply with positions taken on tax returns.

Internal Revenue Code and Regulations Related to Tax Return Preparers

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Internal Revenue Code and Regulation Related to Tax Return Preparers

Introduction

- The Internal Revenue Code (IRC) has many provisions that relate solely or largely to **T**ax **R**eturn **P**reparers (TRPs)
- This lesson surveys those provisions, both civil and criminal

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Who Is a Tax Return Preparer?

Any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any tax return or any claim for refund of tax under the Internal Revenue Code

Thus, people are TRPs if they:

1. Are paid
2. To prepare, or retain employees to prepare
3. A substantial portion
4. Of any federal tax return or refund claim

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Subtypes

- **Signing TRPs** are individual TRPs who bear "primary responsibility" for the overall accuracy of the return or claim for refund.
- **Nonsigning TRPs** are those other than the signing TRP who prepare all or a *substantial portion* of a return or claim for refund.

Substantial Portion

Nonsigning TRPs, who, for example, give advice regarding just one large deduction on a return, may be liable for a substantial portion unless the deduction involves either:

1. Less than $10,000
2. Less than $400,000, which is also less than 20% of the gross income indicated on the return

Safe Harbors

One is not a TRP merely because he or she:

1. Furnishes typing, reproducing, or other mechanical assistance
2. Prepares a return for his or her employer
3. Prepares as a fiduciary a return or claim for refund for any person

TRPs

1. A firm that employs a TRP is treated as the sole **signing** TRP.
2. When there are multiple people working on a return, the one who is primarily responsible for the position giving rise to an understatement is the TRP who will be punished.
3. If it is unclear who is responsible, the one with overall supervisory responsibility for the return or for the position will be the TRP.

IRC Code Civil Provisions

Understatement of Taxpayer's Liability.

Sec. 6694(a) imposes a penalty against a TRP when an unreasonable position causes an understatement of tax liability

Guidelines

- A position is unreasonable if there is no substantial authority (**<40%** chance of being sustained) for the position
- A position is unreasonable if it is disclosed yet there is no reasonable basis (**<20%** chance of being sustained) for it
- If the position relates to a tax shelter, it is unreasonable unless it is more likely than not (MLTN) (**<50%** chance) that the position will be sustained

Guidelines

Whereas Subsection A of 6694

- Focuses on **negligent** conduct,

Subsection B

- Imposes a larger penalty if the understatement is due to **willful or reckless** conduct

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Disclosure Provisions

Section 6695 punishes TRPS for, among other things:

1. Failure to furnish copy of return to taxpayer
2. Failure to sign return and show own identity
3. Failure to furnish preparer's identifying number to the IRS
4. Failure to keep copy of return

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Other Civil Provisions

Other civil provisions punish TRPs and others for:

1. Organizing and promoting abusive tax shelters
2. Aiding and abetting understatements of tax liability
3. Disclosing a client's confidential tax information or using it for any purpose other than to prepare a return

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IRC Code—Criminal Provisions

Tax Evasion. Sec. 7201 punishes tax evasion, including: failure to file a return, falsifying income, and falsifying amounts that reduce taxable income.

IRC Code — Criminal Provisions

Elements:

1. An affirmative act constituting an attempt to evade or defeat payment of a tax
2. Willfulness
3. Existence of a tax deficiency

Example: lottery ticket case

IRC Code — Criminal Provisions

Tax Fraud. Sec. 7206 punishes fraud and false statements, criminalizing:

1. Willfully making and subscribing to any document made under penalty of perjury, which the accountant does not believe to be true as to every material matter
2. Willfully aiding the preparation of any tax related matter which is fraudulent as to any material matter
3. Concealing client's property with intent to defeat taxes

IRC Code — Criminal Provisions

Other criminal provisions punish, among other acts:

1. Willful failure to file return, supply information, or pay tax
2. Willful failure to collect or pay over tax
3. Attempts to interfere with administration of the Internal Revenue laws, such as threatening IRS agents or misleading them
4. Willful disclosure or use of confidential information learned while preparing a tax return

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Licensing and Disciplinary Systems

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Licensing and Disciplinary Systems

State Boards of Accountancy

1. Authority: State boards of accountancy license CPAs and can prohibit non-CPAs from performing attest functions.

2. It is only state boards that can grant CPA licenses and only state boards that can take them away.

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State Boards of Accountancy

3. Licensing: To qualify to be licensed as a certified public accountant, one must meet several requirements. In most states, four steps are the key and may be accomplished in any order:

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State Boards of Accountancy

1. Education
2. "BA + 30" (150 hours of college education)
   - Professional ethics course (required by many states)
   - CPE: Once certification is gained, there are also continuing professional education requirements
3. Examination

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State Boards of Accountancy

4. Experience
   - How long? One year of professional experience (but at least 2,000 hours)
   - In what areas? In accounting, attest, management advisory, financial advisory, tax or consulting areas and may be while working for any employer (accounting firm, corporation, government agency, etc.)

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State Boards of Accountancy

- Any examination of prospective financial information to be performed in accordance with SSAE (Statements on Standards for Attest Engagements); and
- Any engagement to be performed in accordance with the standards of the PCAOB

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State Boards of Accountancy

One does not need a CPA license to perform such nonattest services as:

- Preparation of tax returns
- Management advisory services (consulting)
- Preparing financial statements without issuing a report thereon

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State Boards of Accountancy

Discipline: State boards may revoke CPA licenses and impose other penalties (such as fines) for such acts as:

- Fraud or deceit in obtaining a certificate
- Cancellation of a certificate in any other state for disciplinary reasons
- Failure to comply with requirements for renewal
- Revocation of the right to practice before any state or federal agency, including the PCAOB

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State Boards of Accountancy

- Dishonesty, fraud or gross negligence in performance of services or failure to file one's own income tax returns
- Violation of professional standards
- Conviction of a felony or any crime involving fraud or dishonesty

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AICPA Disciplinary Mechanisms

1. **Professional Ethics Division**: investigates violations and sanctions minor cases.
2. **Joint Trial Board** hears more serious cases and has power to admonish, suspend, or expel.

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AICPA Disciplinary Mechanisms

3. **J**oint **E**thics **E**nforcement **P**rogram (JEEP): AICPA and most state societies split ethics complaints where states handle many cases, but the AICPA handles matters:
   - Of national concern
   - Involving more than one state
   - In litigation

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AICPA Disciplinary Mechanisms

4. Remember: While the AICPA and state societies can punish CPAs in various ways, **only state accounting boards** can grant and take away the license to practice as a CPA.

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Substantiation and Disclosure of Tax Positions

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Substantiation and Disclosure of Tax Positions

Introduction

The IRC is long and complex.

The IRS seeks to punish bad behavior and reward good faith attempts at compliance.

Substantiation and disclosure play an important role.

Underpayment Penalty

Underpayment Penalty punishes, among others:

- Underpayments due to negligence or disregard of rules *and*
- Any substantial understatement of income tax.

Any Substantial Understatement of Income Tax

Understated amount is reduced by:

- Any item for which there was "substantial authority" (≥ 40% chance of being sustained) *and*
- Any disclosed item for which there was a "reasonable basis" (≥ 20% chance).

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Sec. 6664 Reasonable Cause/Good Faith Defense

Reasonable Cause

- Definition: The exercise of ordinary care
- Judged objectively
- Reliance on tax adviser
- Reliance on advice of IRS employee

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Sec. 6664 Reasonable Cause/Good Faith Defense

Good Faith

- Definition: Honesty of purpose
- Judged subjectively
- Reliance on erroneous advice of tax adviser where:
  - Adviser was given all facts and circumstances;
  - Advice was not based on unreasonable assumptions, *and*
  - If the advice was that a regulation was invalid, the position was adequately disclosed.

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Disclosure and Substantiation

Disclosure can help avoid liability by demonstrating that the taxpayer was acting in good faith and not trying to pull a fast one.

Substantiation can help avoid liability by establishing entitlement to a claimed position and also indicating good faith by a taxpayer who is trying to get things right.

Disclosure

Form 8275 or 8275-R

Lowers standard for "reasonable cause/good faith" challenge from ≥ 40% to ≥ 20%.

Substantiation

Accuracy-related penalties may be imposed for underpayments caused by negligence, which can include:

1. Failure to keep adequate books or records, *or*
2. Failure to substantiate items that gave rise to the understatement.

Failure to Keep Adequate Books or Records

In general, the law does not require any specific type of record.

Deductions that are often questioned include:

- Home office deductions
- Vehicle mileage
- Gifts to clients
- Food and entertainment

Failure to Keep Adequate Books or Records

Records that should be retained:

- All tax returns for the previous 7 years
- All records that pertain to a return for the previous 3 years
- Other records, no matter how old, that would be needed to support a tax position on a subsequent return

Failure to Substantiate Items That Gave Rise to the Understatement

Among others, taxpayers are required to substantiate:

Charitable contributions. The taxpayer must have a receipt for large donations to a charitable organization.

- Donations ≥ $250 must be documented with a receipt.
- Donations > $5,000 generally require a qualified appraisal.

Business use of an automobile. The taxpayer must track the miles driven for business use in a timely kept log.

Taxpayer Penalties

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Taxpayer Penalties

Late Filing Penalties

Late filing or failure to file:

- Penalty is 5% of the net tax due per month (up to 25% of unpaid taxes).
- Example: Mary files her income tax form two months after the deadline. She owes $10,000 in tax. She must now pay the $10,000 in tax plus a $1,000 penalty.
- If the failure to file is fraudulent, the penalty becomes 15% per month (up to 75% of unpaid taxes).

Late payment of tax:

- Penalty is 0.5% of the net tax due per month (up to 25%).

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Understatement Penalty = 20%

"Negligence or disregard of rules or regulations"

Examples:

- Failing to include on return income shown on W-2
- Filing at last minute and making many errors

Two foci:

- Taxpayer conduct
- Taxpayer positions

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"Substantial Understatement" of Tax

Individuals: One that exceeds the greater of:

- 10% of the tax, *or*
- $5,000.

Example: Ted's correct tax amount is $20,000, but Ted reported only $12,000. Ted's understatement of $8,000 exceeds the greater of the two standards [(10% of $20,000 =) $2,000 or $5,000) and therefore is a "substantial understatement." Ted must pay the missing tax of $8,000 and a 20% penalty of $1,600.

"Substantial Understatement" of Tax

Corporations: One that exceeds the lesser of:

- 10% of the tax (or, if greater, $10,000), *or*
- $10,000,000.

Example: ABC Corporation's correct tax amount is $200,000, but it reported only $140,000. ABC's understatement is $60,000. That understatement does not exceed $10,000,000, but it does exceed 10% of the tax ($20,000). Therefore, ABC owes the $60,000, plus a 20% penalty of $12,000.

"Substantial Understatement" of Tax

An understatement is reduced by the amount attributable to:

- Any item for which there is or was "substantial authority" for the claimed tax treatment, *or*
- "Substantial authority" = An objective standard requiring that the weight of authorities supporting the claimed position is substantial in relation to the weight of authorities opposing it
- ≥ 40% chance of being sustained

"Substantial Understatement" of Tax

An understatement is reduced by the amount attributable to:

Any item if:

- The relevant facts affecting the tax treatment are adequately disclosed (typically on a Form 8275 or 8275R), *and*
- There is a "reasonable basis" for the tax treatment.
  - ≥ 20% chance of being sustained.

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Reasonable Cause Defense

Definition: "The exercise of ordinary care and prudence"

Judged objectively

Examples:

- Reliance on a tax adviser
- Reliance on advice of an IRS employee
- Death or illness of taxpayer or close family member
- Unavoidable destruction of records

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Reasonable Cause Defense

Belief requirement for reasonable cause related to tax positions:

- Undisclosed position: "substantial authority" (≥ 40% chance)
- Disclosed position: "reasonable basis" (≥ 20% chance)
- Tax shelter position: "more likely than not" (> 50% chance)

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Example Question

A CPA prepared a tax return that involved a tax shelter transaction that was disclosed on the return. In which of the following situations would a tax return preparer penalty not be applicable?

A. There was substantial authority for the position.

B. It is reasonable to believe that the position would more likely than not be upheld.

C. There was a reasonable possibility of success for the position.

D. There was a reasonable basis for the position.

Good Faith Defense

Definition: Honesty of purpose

Judged subjectively

Examples:

- Reliance on erroneous W-2
- Reliance on erroneous advice of tax adviser, where:
  - Adviser was given all facts and circumstances
  - Advice not based on unreasonable assumptions, *and*
  - If the advice was that a regulation was invalid, the position was adequately disclosed.

Civil Fraud

There is a 75% penalty.

And, obviously, there is no reasonable cause/good faith defense.

Criminal Tax Culpability

Tax Evasion (26 USC 7201)

Punishes, among other wrongs:

- Failure to file a return
- Falsifying income
- Falsifying deductions

Government must prove:

- An affirmative act constituting an attempt to evade or defeat a tax
- Willfulness
- Existence of a tax deficiency

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Tax Evasion Example

Defendant (D) won $2.7 million in the lottery and began receiving $135,000 in annual payments. To offset those, he claimed gambling losses of $65,000 and filed for a $26,000 refund. When the IRS audited D, he produced 200,000 losing lottery tickets. He would have had to scratch 548 cards each day of the year to amass that many. Evidence showed he had "rented" the losing tickets from a "collector" for purposes of the audit. Convicted!

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Criminal Tax Culpability

Tax Fraud (26 USC 7206)

Punishes fraud and false statements

Criminalizes, for example:

- Willfully making and subscribing to any document made under penalty of perjury which the taxpayer does not believe to be true as to every material matter
- Willfully aiding the preparation of any tax-related matter which is fraudulent as to any material matter
- Removing or concealing property with intent to defeat taxes

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Tax Fraud Example

Defendant (D) was an officer of a company with an interest in hundreds of related real estate limited partnerships. The partnerships' tax returns were riddled with huge errors, including deductions for officers' personal expenses. D signed up to 800 returns a day. Though a CPA himself, D claimed that he relied on the firms' accountant's advice and was therefore only negligent. The jury and appellate court disagreed.

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Sources of Tax Authority and Research

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Sources of Tax Authority Research

Sources of Authority

Primary authority versus secondary authority

Sources of primary authority:

- Legislative authority
- Administrative authority
- Judicial authority
- Internal Revenue Code is the codification of the tax laws promulgated by Congress.

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Legislative Authority

Constitution

Internal Revenue Code (IRC § 351)

Committee reports

Barring certain exceptions (e.g., constitutional issues), Congress has the last word on what the federal tax law should be.

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Administrative Sources

Treasury Regulations (Treas. Reg. § 1.351-1)

- Legislative, interpretative, procedural
- Proposed, temporary, final

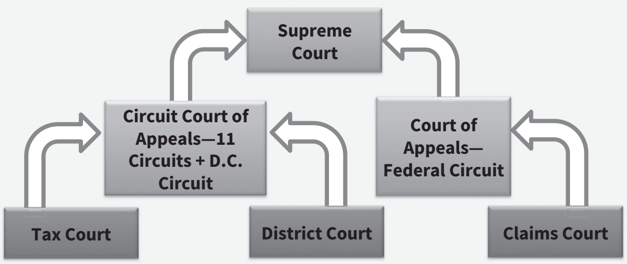
Revenue Rulings (Rev. Rul. 2009-12)

Private Letter Rulings (PLR 200948009)

Revenue Procedures (Rev. Proc. 2008-23)

Technical Advice Memoranda (TAM 201003016)

Judicial Sources



Courts of Original Jurisdiction

U.S. Tax Court—one court

- Hears only tax cases

U.S. District Court—many courts

- Jury trial possible
- Must pay deficiency first

U.S. Court of Federal Claims—one court

- Must pay deficiency first

U.S. Tax Court—Small Cases Division

- $50,000 or less
- No appeal

Precedents

Courts must follow previous decisions for future cases with the same controlling set of facts.

Tax court will follow previous decisions in the Circuit that will have jurisdiction on appeal.

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Weighting of Authority—Legislative

The highest source of tax authority is the U.S. Constitution.

The next highest source is the Internal Revenue Code.

Legislative regulations have almost as much weight as the IRC itself.

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Weighting of Authority—Administrative

Other types of regulations have very significant authority within the context of administrative authority.

Revenue Rulings are the next highest source of authority.

Private Letter Rulings apply only to the taxpayer who requested the ruling.

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Weighting of Authority—Judicial

The weighting of a judicial decision depends on:

- Level of court
- Legal residence of the taxpayer
- Whether IRS has acquiesced to the decision
- The date of the decision
- Whether later decisions have concurred with the opinion

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Review Question

In evaluating the hierarchy of authority in tax law, which of the following carries the greatest authoritative value for tax planning of transactions?

A. Internal Revenue Code

B. IRS regulations

C. Tax court decisions

D. IRS agents' reports

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Research Process

Identify all relevant facts.

Clearly state problem to be solved.

Locate applicable tax authority.

Evaluate the relevance of the authorities.

Determine alternative solutions.

Determine most appropriate solution.

Communicate results.

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Communicating Results

Document all relevant facts.

Clearly describe the issue investigated.

Report conclusions.

Summarize rationale and authorities that support conclusions.

Summarize key authorities used in research.

Tax Research TBS

26 U.S. Code § 351. Transfer to corporation controlled by transferor

(a) General rule No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) Receipt of property If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then—gain (if any) to such recipient shall be recognized, but not in excess of—(A)the amount of money received, plus (B) the fair market value of such other property received;

(2)no loss to such recipient shall be recognized.

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Tax Practice and Procedure

Audit Process

Audit process begins with review of returns for error and matching information from W-2s, 1099s, etc.

Each return is given a score from formulas that are part of the Discriminant Function System (DIF). The DIF score is used to determine which returns to review for possible audit.

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Audit Process

A taxpayer may appoint qualified individuals to represent her before the IRS, usually a CPA, attorney, or enrolled agent.

The IRS has the power to summon the taxpayer's records and witnesses to testify.

IRS reports findings in an Income Tax Examination Changes report.

Disagreements between the taxpayer and IRS may arise from questions of fact or from questions of law.

The IRS will take positions consistent with its administrative sources of the tax law.

The taxpayer and IRS can negotiate until the issues are resolved.

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Revenue Agent's Report

If the taxpayer agrees to the audit changes proposed in the Revenue Agent's Report, he cannot pursue tax relief through the appeals process or through the Tax Court.

A signed agreement binds the IRS and taxpayer with regard to only items in the agreement.

Nevertheless, once the deficiency is paid, the taxpayer can later pursue a claim for refund through the U.S. District Court or U.S. Claims Court.

30-Day Letter

If agreement is not reached through the audit process, the taxpayer will receive a copy of the Revenue Agent's Report and a 30-day letter.

The IRS encourages the taxpayer to agree to the RAR or request an appellate conference. However, the taxpayer is not required to respond.

If there is no response, a 90-day letter is issued, which includes a statutory notice of deficiency.

Appeals Process

To appeal, a written protest must be filed with the request for an appellate conference.

The protest must explain the taxpayer's position for each issue and provide the support on which the taxpayer is relying for questions of law.

The IRS is not required to grant an appeal in all cases.

Appeals Process

In general, new issues may not be raised by the IRS during the appeal.

If the case is settled, a Form 870-AD is signed, which means that the case will not be reopened unless there is a significant mathematical error or fraud.

If the IRS issues a "no change" report, the taxpayer still has the option to amend the return. However, the IRS cannot reopen the case unless fraud exists.

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90-Day Letter

If a taxpayer does not respond to the 30-day letter or does not reach agreement in the appeals process, a 90-day letter is issued.

The 90-day letter is significant in that this is the time that the taxpayer has to file a petition with the Tax Court. If the petition is not filed in a timely manner, then the taxpayer's only judicial recourse is through U.S. District Court or U.S. Claims Court, both of which require the deficiency to be paid before the judicial process can begin.

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Tax Court

Once a petition has been filed with the Tax Court, the IRS cannot enforce its assessment until the Tax Court's decision is finalized.

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Other IRS Procedures

An offer in compromise may be agreed to by the IRS, which allows a taxpayer to settle a tax liability for less than the actual amount owed.

The IRS may request the taxpayer to extend the statute of limitations period. While not required to do so, a refusal to extend will usually lead the IRS to assess a tax deficiency.

Privileged Communication

Any communication that would be privileged between a taxpayer and an attorney is also privileged between a taxpayer and any person who is authorized to practice before the IRS.

This privilege does not apply to criminal tax matters or to corporate tax shelters.

Signing a Return

A taxpayer must sign a tax return for it to be complete. Both spouses must sign a joint return. This creates joint and several liability for each spouse.

A taxpayer can use an electronic signature to sign a return that is e-filed.

A tax return is signed under the penalty of perjury. If a taxpayer knowingly signs a false tax return, the taxpayer can be subject to civil and/or criminal penalties.

Signing a Return

The tax preparer must also sign the tax return and provide a Personal Identification Number (PIN).

Circular 230

- IRS's rules of practice: The government may censure, fine, suspend, or disbar tax advisors from practice before the IRS if they violate Circular 230's standards of conduct.
- Subpart A: Rules Governing Authority to Practice
- Subpart B: Duties and Restrictions Relating to Practice before the IRS
- Subpart C: Sanctions for Violations

Who May Practice before the IRS

- Attorneys
- CPAs
- Enrolled agents
- Enrolled actuaries enrolled by the Joint Board for the Enrollment of Actuaries. Practice is limited to issues related to qualified retirement plans.
- Enrolled retirement plan agents. However, practice is limited to issues related to employee plans and to IRS forms in the 5300 and 5500 series.
- Registered Tax Return Preparers (RTRP).

Registration Requirements

Any individual who prepares tax returns for compensation has to be registered with the IRS and pay a registration fee.

This includes attorneys, CPAs, and enrolled agents.

Practice before the IRS

Practice before the IRS includes all matters connected with a presentation to the IRS or any of its officers or employees related to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS.

Practice before the IRS

A power of attorney (Form 2848, Power of Attorney and Declaration of Representative) is required for an individual to represent a taxpayer before the IRS.

Other Professional Standards

CPAs are also subject to:

- AICPA's Code of Professional Conduct
- AICPA's Statements on Standards for Tax Services

Compliance Responsibilities

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Compliance Responsibilities

Estimated Payments—Individuals

Taxpayers must make estimated payments (on the 15th of April, June, September, and January) if the amount of tax owed is at least $1,000 after subtracting withholding and credits.

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Payment Requirements—Individuals

There is no underpayment penalty if the total tax payments are at least equal to the lower of:

- 90% of the current year's tax.
- 100% of the prior year's tax.

Underpayment penalty is the applicable interest rate times the underpayment until the earlier of April 15 or the time the tax is paid.

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Payment Requirements—Corporations

Corporations must make estimated payments (on the 15th of April, June, September, and December) if the amount of tax owed is at least $500 after subtracting withholding and credits.

There is no underpayment penalty if the total tax payments are at least equal to the lower of:

- 100% of the current year's tax.
- 100% of the prior year's tax.

There is also an annualized income exception for corporations.

Payment Requirements—Corporations

A corporation with $1 million or more of taxable income in any of its three preceding tax years can use the preceding year's tax exception only for its first installment.

For all taxpayers, if there was no tax liability in the preceding year, the preceding-year exception method may not be used.

Annualization Exception

There is also an annualized income exception for individuals and corporations.

Amount due with an installment is:

- The tax due for the months ending before the due date of the installment, less
- The amount required to be paid for previous installments.

Different exceptions can be used for different installments.

Annualization Exception

If a taxpayer determines that the installment under the annualized income method is less than the required installment under the regular method, any reduction in a required installment is recaptured by increasing the amount of the next required installment by the amount of the reduction.

Failure to File Penalty

A nonfiling penalty is imposed on taxpayers if the return is not filed by the due date. The penalty for late filing is 5% per month of the tax due.

The maximum penalty is 25% of the tax due.

If the failure to file is fraudulent (intentional), the penalty is increased to 15% per month up to a maximum of 75% of the tax due with the return.

Failure to Pay Penalty

Any tax due must be paid at the time of filing, or else a penalty of 0.5% per month of the underpayment is imposed (up to 25% in total).

Interest on late payments starts on the due date for filing and is calculated using the federal short-term interest rate.

Does not apply if failure to file penalty is imposed for a given month.

Taxpayer Penalties

A 20% accuracy-related penalty applies to underpayments attributable to negligence or disregard of rules or regulations, substantial understatement of income tax, and substantial valuation overstatement.

An understatement is substantial if it exceeds the greater of 10% of the tax required to be shown on the return, or $5,000.

A 75% civil penalty, and possible criminal penalties, can be imposed for fraud.

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Taxpayer Penalties Problem

A taxpayer filed his income tax return after the due date but neglected to file an extension form.

The return indicated a tax liability of $50,000 and taxes withheld of $45,000.

On what amount would the penalties for late filing and late payment be computed?

$50,000 – $45,000 = $5,000

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Tax Forms

Form 1045 (Form 1139) is used by individuals (corporations) to claim refunds based on business credits or capital losses.

A claim for refund of erroneously paid income taxes must be submitted on Form 1040X.

Corporations file Form 1120X to amend a return.

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Tax Preparer Penalties

These penalties apply to all tax return preparers, including preparers for estate, gift, employment, excise, and exempt organization returns.

Tax preparers are required to make reasonable inquiries if the taxpayer's information appears to be incorrect or incomplete.

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Levels of Confidence for Tax Positions

Not frivolous = not patently improper

Reasonable basis = at least one authority that has not been overruled

Substantial authority = more than a reasonable basis

More likely than not = more than 50% chance of succeeding

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Tax Preparer Penalties

For an "unreasonable position," the preparer must pay a penalty equal to the greater of $1,000 or 50% of the income derived by the preparer for preparing the return. A position is unreasonable if there is not substantial authority for it.

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Tax Preparer Penalties

There is an exception to this rule if the position was disclosed and there is a reasonable basis for it. However, this exception applies to reportable transactions and tax shelters only if the position has a more-likely-than-not chance of being sustained.

Tax Preparer Penalties

If the understated tax liability is due to an unreasonable position and the preparer willfully attempts to understate the tax liability or recklessly or intentionally disregards rules or regulations, the penalty is the greater of $5,000 or 75% of the income earned by the tax preparer for preparing the return or claim.

Other Penalties

Additional penalties for preparers are:

- Not signing returns done for compensation
- Not providing a copy of the return for the taxpayer
- Not keeping a list of returns filed
- Endorsing or negotiating a refund check
- Disclosing information from a tax return, unless for quality or peer review, or under an administrative order by a regulatory agency

Tax Errors

A preparer should inform the taxpayer promptly (but not the IRS) upon becoming aware of an error in a previously filed return or of a taxpayer's failure to file a required return.

If a member is requested to prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer.

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Uncertain Tax Positions

Corporations that have at least $10 million of assets and uncertain tax positions have to file Schedule UTP if the corporation or a related party has issued audited financial statements.

Disclosure requirements include a concise description of each UTP ranked by the current year's relative magnitude based on the financial statement reserve.

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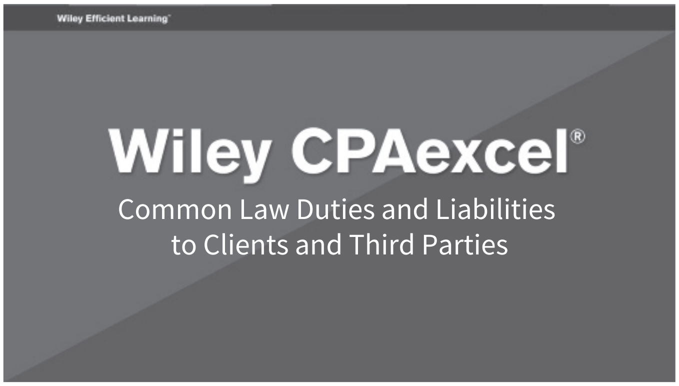
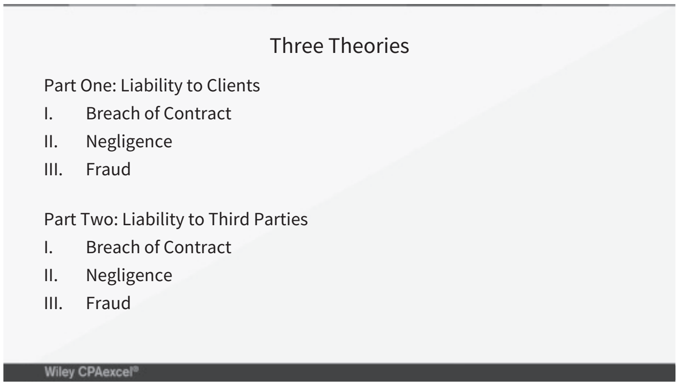
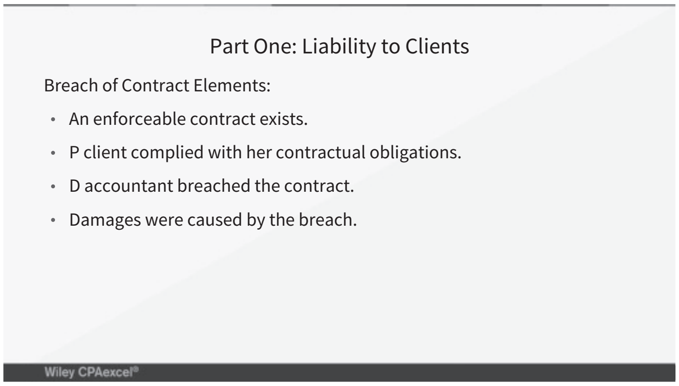
Legal Duties and Responsibilities

Common Law Duties and Liabilities to Clients and Third Parties







Breach of Contract Defenses

Statute of limitations

1. Oral: 2 yrs
2. Written: 4 yrs

Justifiable breach

Examples:

- Client refuses to provide accountant with the documents necessary to complete the tax return.
- Client provides accountant with incomplete, inaccurate, or misleading information.

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Negligence Elements

D accountant owed a duty of care to P.

D breached the duty of care.

- Carelessness is key, not intentional wrongdoing
- Standard: Skill & knowledge normally possessed by accountants in the area.

The breach proximately causes an injury:

- Factual ("but for") causation
- Legal (proximate) causation (reasonably foreseeable)

P client suffers damages.

- Compensatory damages are recoverable but punitive damages are not.

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Negligence Defenses

Statute of limitations

- Usually 2 yrs

Comparative negligence

- If P's carelessness contributed causally to the loss, P's recovery will generally be reduced and perhaps even barred altogether (if P's carelessness exceeds 50%).

<u>Not</u> Disclaimer in contract

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Fraud Elements

False representations of fact (or omission in face of duty to speak).

Misrepresented (or omitted) fact was material.

D knew or recklessly disregarded the falsity:

1. Knowledge = "actual fraud."
2. Recklessness = "constructive fraud."

D intended to and did induce reasonable reliance.

The false statements or omissions proximately caused damages.

- Fraudster can be hit with punitive damages.

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Fraud Defenses

Statute of limitations

Note: Fraud is also basis for criminal prosecution.

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Part Two: Liability to Third Parties

Breach of Contract:

Three types of third-party beneficiaries (3PBs):

1. Intended creditor beneficiaries (can sue)
2. Intended donee beneficiaries (can sue)
3. Incidental beneficiaries (can't sue)

Example: Jill sets up trust for Hal, hiring Ed to give tax advice. Ed gives erroneous advice in breach of contract, costing Hal money. Hal may sue Ed as 3PB.

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Negligence

Accountants are generally liable to one or a limited class of nonclients where D knows:

- The information supplied the client is for the benefit of this limited class, and
- The information will influence third parties in a specific transaction or type of transaction.

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Negligence Example

CPA Dolan carelessly recommended a tax position to his client, Fanny. Fanny told her neighbor, Dipson, about the tax strategy, and Dipson tried it on his own return. The IRS rejected the position as being without any reasonable basis, and Fanny and Dipson were hit with tax penalties.

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Fraud

General rule: Fraudsters are liable to all persons they can reasonably foresee will be injured by their false representations or omissions.

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Example Question

Able, CPA, was engaged by Wedge Corp. to audit Wedge's financial statements. Wedge intended to use the audit report to obtain a $10 million loan from Care Bank. Able and Wedge's president agreed that Able would give an unqualified opinion on Wedge's financial statements in the audit report even though there were material misstatements in the financial statements. Care refused to make the loan. Wedge then gave the audit report to Ranch to encourage Ranch to purchase $10 million worth of Wedge common stock. Ranch reviewed the audit report and relied on it to purchase the stock. After the purchase, Able's agreement with Wedge's president was revealed. As a result, Wedge stock lost half its value and Ranch sued Able for fraud. What will be the result of Ranch's suit?

Example Question

A. Ranch will win because Able intentionally gave an unqualified opinion on Wedge's materially misstated financial statements.

B. Ranch will win because Able is strictly liable for errors made in auditing Wedge's financial statements.

C. Ranch will lose because Ranch is not a foreseen user of Able's audit report.

D. Ranch will lose because Ranch is not in privity with Able.

Privileged Communications, Confidentiality, and Privacy Acts

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Privileged Communications, Confidentiality, and Privacy Acts

Privileged Communications, Confidentiality, and Privacy Acts

In today's high-tech information age, safeguarding client confidential information must be an extremely high priority for all CPAs.

This lesson examines three aspects of that subject matter:

1. Privileged communications
2. Confidentiality responsibilities
3. Privacy statutes

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Privileged Communications

- **Testimonial Privileges**: Classic privileged communications include attorney-client, doctor-patient, and priest-penitent.
- Where applicable the protected party (client, patient, penitent) can prevent the party who received the protected communications (attorney, doctor, priest) from testifying.
- Neither the federal courts nor the state courts at common law have recognized an accountant-client privilege.

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Privileged Communications

Nonetheless, approximately 15 states have statutorily recognized an accountant-client privilege. In those states, remember:

1. The privilege belongs to the client, not to the accountant.
2. The privilege can be waived by the client, either expressly or through voluntary and knowing disclosure of the relevant information.

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Privileged Communications

3. Waiver of the privilege as to part of the communication is waiver as to all.
4. The privilege applies only in state court, where state procedural rules apply.

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Privileged Communications

Additionally, Congress enacted the tax practitioner's privilege in 26 USC Sec. 7525. It extends a modest testimonial privilege to clients of **all** tax advisers (not just lawyers) authorized to practice before the IRS.

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Privileged Communications

However, 7525 applies only in noncriminal tax matters:

1. Before the IRS
2. In federal court in actions brought by or against the United States

And it exempts written advice in connection with promotion of a tax shelter

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Privileged Communications

Most courts have construed 7525 narrowly, holding:

1. It does not apply to information communicated to the practitioner solely for the purposes of facilitating tax return preparation.
2. It merely extends to tax practitioners the same privilege accorded in the attorney-client relationship.
3. Legal advice is protected, but not general accounting advice.

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Privacy Statutes

AICPA has proposed, but not yet adopted, **G**enerally **A**ccepted **P**rivacy **P**rinciples (GAPP)

Many states are enacting or considering statutes requiring professionals like accountants to:

- Protect clients' SSN #s
- Encrypt e-mails containing sensitive client info

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Business Law
Contracts
Introduction and Classification
Applicable Laws

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Applicable Laws

Sources of Contract Law

Common Law

- Real estate
- Services (employment)

Uniform Commercial Code (UCC) (Article 2)

- Sales of goods
- Goods and services combined: Intent and breakdown of cost of goods vs. cost of services

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Sources of Contract Law

CAUTION: Be sure to ask this question first:

Am I under UCC or am I under common law?

The answers are different on many issues!

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Law of Contracts

UCC	Common Law
Uniform Commercial Code	Restatement of contracts
Goods—tangible personal property	Real estate
	Services

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What Are the Differences between UCC and Common Law?

UCC is codified, and common law is body of cases decisions (majority view of the states is found in the Restatement of Contracts).

Common law requires much more detail for valid contracts.

UCC has goal of moving commerce along efficiently and quickly.

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Types of Contracts

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Types of Contracts

Types of Contracts

Express contracts

Implied or implied-in-fact contracts

Quasi-contracts

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Types of Contracts

Bilateral

"I promise to buy your house if you promise to sell your house."

Unilateral

"I promise to pay you $500 if you will drive my car from Los Angeles to New York."

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Types of Contracts

- Executed vs. executory contracts
- Valid contracts
- Void
- Voidable
- Unenforceable

Executed vs. Executory

Stages of a contract: negotiation, final contract, performance

Negotiation: No contract

Final contract: Executory – contract exists but no one has performed under its terms

Executed: Executory contract has been performed by both sides

Partially executed/partially executory: one side has completed performance and the other side has not.

- Executed for the party that has performed
- Executory for the party that has not yet performed

Valid Contracts

Final contracts

Negotiated without defenses

No illegal subject matter

In proper form (writing/record if required)

Void Contracts (More details in Defenses Lesson)

There is a final contract (could be oral or written)

Subject matter is illegal

One of the parties has been declared incompetent by a court (i.e., a guardian has been appointed to manage financial and other matters for the mentally incompetent individual)

Formation issues

- Duress that is actual physical force (a crime)

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Voidable Contracts (More details in Defenses Lesson)

- There is a final contract
- There is a problem with formation or the capacity of one of the parties
- Formation issues (Defenses)
  - Misrepresentation
  - Fraud
  - Duress (Economic duress, threats)

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Voidable Contracts Continued (More details in Defenses Lesson)

- Capacity
  - Intoxication (to the extent of mental incapacity)
  - Age (minor)
  - Mental incapacity (but not declared incompetent)
- One side has the choice of whether to honor the contract

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Formation

Offer and Acceptance

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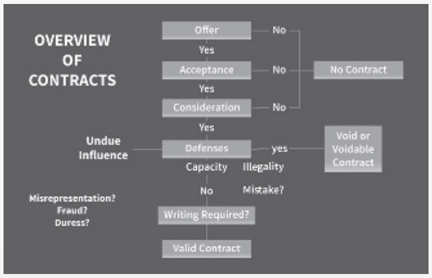
Offer and Acceptance

Contracting Steps



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Offer

	UCC	Common Law
1. Present intent	Objective basis	Objective basis
2. Language	Subject matter	All details

Need evidence of present intent to contract, not future promise.

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Review Question

Carson Corp., a retail chain, asked Alto Construction to fix a broken window at one Carson store. Alto offered to make the repairs within three days at a price to be agreed on after the work was completed. A contract based on Alto's offer would fail because of indefiniteness as to the:

A. Price involved.
B. Nature of the subject matter.
C. Parties to the contract.
D. Time for performance.

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Termination

1. Rejection*
2. Counteroffer*—Under common law the mirror image rule, but under UCC, see discussion of additional terms in acceptance
3. Revocation*

*Effective upon receipt

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Termination of Offers

Death of offeror

Bankruptcy

Illegality

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Types of Offers

Options

1. Paid-for offers
2. Consideration required
3. Irrevocable

Review Question

Dye sent Hill a written offer to sell a tract of land located in Newtown for $60,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 60 days if Hill would promise to refrain from suing Dye during this time. Hill promptly delivered a promise not to sue during the term of the offer and to forgo suit if Hill accepted the offer. Dye subsequently decided that the possible suit by Hill was groundless and phoned Hill, revoking the offer 15 days after making it. Hill mailed an acceptance on the 20th day. Dye did not reply. Under the circumstances,

Review Question

A. Dye's offer was supported by consideration and was not revocable when accepted.
B. Dye's written offer would be irrevocable even without consideration.
C. Dye's silence was an acceptance of Hill's promise.
D. Dye's revocation, not being in writing, was invalid.

Merchants' Firm Offers—UCC

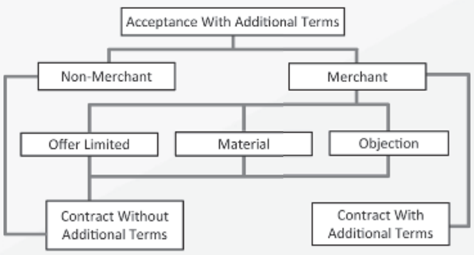
1. Some form of writing or record
2. Signed or authenticated
3. By a merchant: In the business of selling goods that are the subject matter of the contract
4. States that it will be kept open (maximum of three months)

Merchants Firm Offers—UCC

Nonmerchants—need option

Exceeds three months—need option

UCC Rules for Additional Terms in Acceptance*



*Not conditional acceptance

Acceptance–Conditional

Misnomer: Conditional acceptance is never acceptance

"I accept provided that . . . "

"I accept on the condition that . . . "

"I accept if . . . "

"I accept if and only if . . . "

"I accept but I must . . . "

Counteroffer and Rejection

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Additional Terms—Acceptance

A. "I'll sell you my Peugeot bicycle for $100."

B. "I'll take it. Include your tire pump."

Results

_______________Nonmerchants

_______________Merchants

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Additional Terms—Acceptance

A. "I'll sell you my 1974 white Ford Torino for $358. This offer is limited to these terms . . ."

B. "I'll take it. Furnish a history of repairs."

Results

_______________Nonmerchants

_______________Merchants

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Additional Terms—Acceptance

A. "I'll sell you my antique Coca-Cola sign."

B. "I'll take it if you will deliver it."

Results

_______________Nonmerchants

_______________Merchants

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Timing Rules for Acceptance

Type of Offer	UCC Method of Acceptance	Acceptance Effective?	Common Law Method of Acceptance
No means given	Same or faster method of communication	When properly mailed (dispatched) Mailbox Rule applies	Same method of comm.
No means given	Slower method of communication	When received if the offer is still open	Different method of communication
Specified means (stipulated)	Specified means used	Mailbox Rule	Specified means used
Specified means (stipulated)	Specified means not used	Counteroffer and rejection	Specified means not used
Prompt shipment	Proper goods shipped	Upon shipment	N/A
Prompt shipment	Improper goods shipped	Breach and acceptance	N/A

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Formation: Acceptance

Acceptance: Offeree's Response

- The Mailbox Rule
  - Timing rule in contract acceptances that provides that acceptance is effective upon mailing if properly done
- Acceptance by stipulated means
  - Mailbox rule applies
  - If offeree does not use means stipulated, then counteroffer and/or rejection

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Formation: Acceptance

Acceptance With No Stipulated Means

- Mailbox rule if same means or stipulated means used
- Arrival if different (slower) method used
- If non-stipulated means used, it is a counteroffer and a rejection

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Timing—Acceptance

1. February 1, 2016 - A mails an offer to B
   February 2, 2016 - B receives the offer
   February 3, 2016 - A mails a revocation
   February 4, 2016 - B mails acceptance
   February 5, 2016 - B receives revocation
   February 6, 2016 - A receives the acceptance

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Timing—Acceptance

2. February 1, 2016 - A mails an offer to B
   February 2, 2016 - B receives the offer
   February 3, 2016 - B wires acceptance
   February 4, 2016 - B wires a rejection
   February 4, 2016 (later) - A receives the acceptance
   February 5, 2016 - A receives rejection

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Timing - Acceptance

3. February 1, 2016 - A mails an offer to B
   February 2, 2016 - B receives the offer
   February 3, 2016 - A wires a revocation
   February 3, 2016 - B wires an acceptance
   February 4, 2016 - B receives the revocation
   February 5, 2016 - A receives the acceptance

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Timing - Acceptance

4. February 1, 2016 - A overnight expresses an offer to B
   February 2, 2016 - B receives the offer (before 10:30 a.m. no less)
   February 3, 2016 - A overnight expresses revocation to B
   February 4, 2016 - B phones acceptance
   A maintains the offer was revoked
   February 5, 2016 - B receives A's revocation (a major slip up in overnight delivery)

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Timing - Acceptance

5. February 1, 2016 - A mails an offer to B
   February 2, 2016 - B receives the offer
   February 3, 2016 - B mails an acceptance
   February 4, 2016 - B wires a rejection
   A receives the acceptance
   February 4, 2016 - A (later) receives the rejection

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Formation

Dec. 6, 1988	Dix letter offer to Anker: Building @ $75,000; Acceptance by certified mail
Dec. 10, 1988	Anker requests (via telephone) extension
Dec. 12, 1988	Dix mails extension until Dec. 20, 1988
Dec. 19, 1988	Anker accepts via private express mail courier
Dec. 20, 1988	Acceptance received

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Formation

Sept. 8, 1988	Crisp mail offer to Anker (50 pieces of furniture @ $9,500)
	To remain open until Dec. 20, 1988
	Crisp-furniture manufacturer
Dec. 5, 1988	Crisp mails revocation
Dec. 6, 1988	Anker received Crisp's revocation
Dec. 12, 1988	Anker mails acceptance
Dec. 13, 1988	Crisp receives acceptance

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Formation

On October 1, Baker, a wholesaler, sent Clark, a retailer, a written signed offer to sell 200 pinking shears at $9 each. The terms were Baker's warehouse, net 30, late payment subject to a 15% per annum interest charge. The offer indicated that it must be accepted no later than October 10, that acceptance would be effective upon receipt, and that the terms were not to be varied by the offeree.

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Formation

Clark sent a telegram which arrived on October 6, and accepted the offer expressly subject to a change of the payment terms to 2/10, net/30. Baker phoned Clark on October 7, rejecting the change of payment terms. Clark then indicated it would accept the October 1 offer in all respects, and expected delivery within 10 days. Baker did not accept Clark's oral acceptance of the original offer. Which of the following is a correct statement?

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Formation

A. Baker's original offer is a firm offer, hence irrevocable.

B. There is no contract since Clark's modification effectively rejected the October 1 offer, and Baker never accepted either of Clark's proposals.

C. Clark actually created a contract on October 6, since the modifications were merely proposals and did not preclude acceptance.

D. The Statute of Frauds would preclude the formation of a contract in any event.

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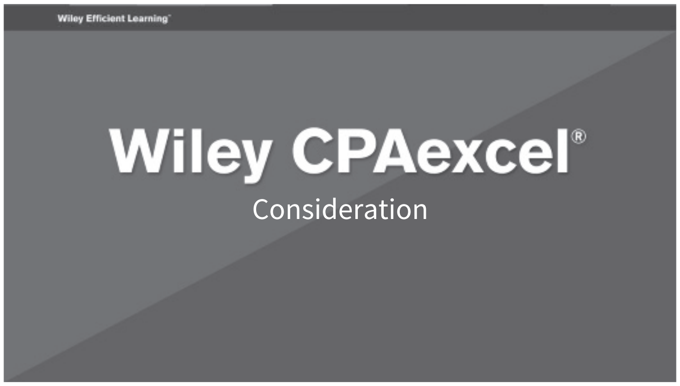
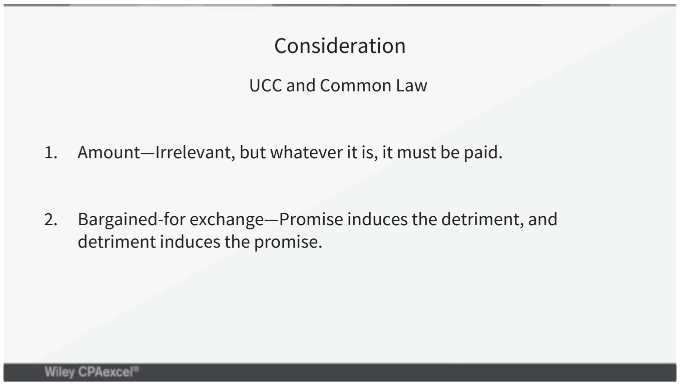
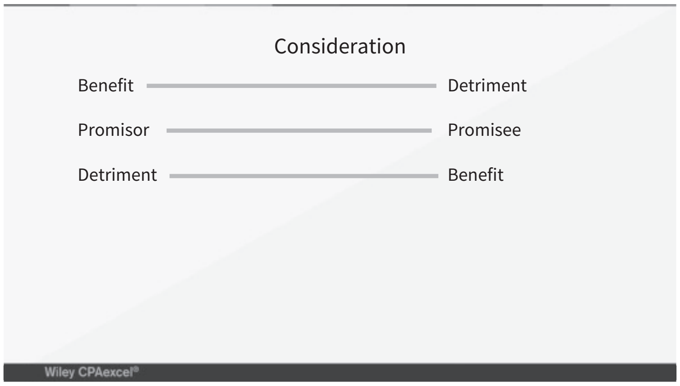
Consideration







Consideration

3. Definition—Doing what you're free not to do or not doing what you're free to do

Consideration Issues

1. Charitable subscriptions—Enforceable despite lack of detriment on one side

2. Preexisting obligation (antecedent debt)—Not sufficient consideration

3. Output/requirements (UCC)
   " I'll sell all my output."
   " I'll buy all I require."
   Enforceable in good faith

Consideration Issues

4. Modification
   - UCC—Good faith
   - Common law—Additional consideration

Consideration Issues

5. Liquidated vs. unliquidated accord and satisfaction
6. Statute of limitations—Promise to pay obligation discharged is enforceable if in writing
7. Discharge in bankruptcy—Promise to pay obligation discharged is enforceable if in writing

Consideration Issues

Which of the following requires consideration to be binding on the parties?

A. Material modification of a contract involving sale of real estate
B. Ratification of a contract by a person after reaching age of majority
C. Written promise signed by merchant to keep an offer to sell goods open for 10 days
D. Material modification of a sale of goods contract under the UCC

Review Question

Which of the following will be legally binding despite the lack of consideration?

A. Employer's promise to make cash payment to deceased employee's family in recognition of employee's years of service.
B. Promise to donate money to a charity on which the charity relied in incurring large expenditures.
C. Modification of a signed contract to purchase a parcel of land.
D. Merchant's oral promise to keep an offer open for 60 days.

Writing and Records: The Statute of Frauds

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Writing and Records: The Statute of Frauds

Statute of Frauds

I. Land
- Options
- Contracts
- Leases
- Mortgages
- Exception: Partial performance,
  - Possession and/or improvements and payment

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Land and Partial Performance

Jake and Juno have an oral contract for Jake to sell his cabin to Juno for $91,000. Juno has paid Jake a $10,000 deposit, is living in the cabin, and has put in new windows. Jake tries to evict Juno. Can he?

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Statute of Frauds

II. Promises to pay debts of another
- Original vs. collateral
- Surety
- Executor
- Bankruptcy discharge
- Statute of limitations

Statute of Frauds

III. Contracts not to be performed within one year, measured from time of agreement

October 2016—Oral contract for audit to run from January 2017 to November 15, 2017

Contract to teach entered into on April 4, 2016 for the coming academic year

IV. Sales—Contracts for sale of goods $500 or more must be in writing

Contracts and Statute of Frauds

Subject Matter	Required to Be in Writing?
Sale of golf cart for $750	**Yes**
Sale of 1/20 acre of land for $300	**Yes**
3-year advertising services contract	**Yes**
Manufacturer's sale of mobile home	**Depends**
Sale of a horse for $350	**No**
Sale of a painting for $1,000	**Yes**
Officer's guarantee of a corporate note	**Yes**
Sole proprietor's guarantee of business note	**No**

Contracts and Statute of Frauds

Sand orally promised Frost a $10,000 bonus, in addition to a monthly salary, if Frost would work two years. Will the Statute of Frauds prevent Frost from collecting the bonus?

A. No, because Frost fully performed.

B. No, because the contract did not involve an interest in real estate.

C. Yes, because the contract could not be performed within one year.

D. Yes, because the monthly salary was the consideration for the contract.

What Satisfies the Statute of Frauds?

Record

Signature/authentication of party to be held liable

Sufficient terms (refer to discussion of Contract Formation Requirements)

E-Sign Act

Federal law requiring that electronic signatures enjoy parity with written ones.

Must show underlying intent to contract (screen pop-ups and “You are about to contract”).

Must be able to reproduce the agreement.

No means for verification of identity of parties—done by state laws (verification).

First E-Sign Question

Joan Silver had viewed some land that she wished to purchase. It was offered for sale by Daniel Tweney over the Internet for $200,000. Silver believes this to be a good deal for her and thus wishes to purchase it. Silver and Tweney have communicated on-line and wish to make a contract for sale over the Internet. Which of the following statements is(are) correct?

E-sign answers

I. Because this contract is covered by the Statute of Frauds, this contract cannot be accomplished over the Internet.

II. Because of the parol evidence rule, this contract cannot be completed over the Internet.

III. Because this contract is covered by the Uniform Commercial Code, it may not be accomplished over the Internet.

A. Only I is correct
B. I and II only are correct
C. I and III only are correct
D. Neither I, II, nor III is correct

UCC Exceptions

A. Merchants' confirmation memo (two merchants required):
- Writing (record)
- Signed by one of the merchants
- Underlying oral agreement

B. Part performance:
- Goods actually accepted—buyer
- Payments actually received—seller

Merchant's Confirmation Memo

Radsbury, a shoe retailer, contacted Jerome, a manufacturer's rep for various tennis shoe manufacturers, by phone, and offered to buy 200 pairs of red Converse All-Star high-tops for $43 per pair. Jerome said, "When do you want them?" Radsbury replied, "ASAP." Jerome responded, "Okay." Radsbury's purchasing agent sent Jerome the following e-mail:

"Just confirming your shipment of 200 pairs of red Converse All-Star high-tops for $43 per pair. Thanks."

Jerome never responded and never sent the shoes. Explain Radsbury's rights.

UCC Exceptions

C. Specially manufactured

D. Admission—In any proceeding while under oath

Parol Evidence

If:

A. Complete contract

B. No ambiguities

C. Final written form

Then:

No outside/extrinsic evidence to contradict the contract

Parol Evidence Rule

- If what you talked about or agreed to is not written in the contract, and you sign it anyway, with an oral understanding, parol evidence prohibits the introduction of evidence to prove your oral, contemporaneous agreement.
- You cannot contradict the terms of a complete and unambiguous contract with extrinsic evidence of other oral agreements

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Exceptions to the Parol Evidence Rule

- Modifications post-contract execution
  - Remember consideration requirements - Common Law
  - Good Faith Requirements – UCC
- Proof of defenses: Fraud, misrepresentation, duress, illegality, lack of capacity
- Evidence of defenses and modifications is admissible

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Parol Evidence Question

Jill Stewart signed a lease agreement for an apartment. The apartment manager told Jill that she would receive her second month in the apartment for one-half the price. Before Jill signed her lease, she noticed that the lease did not contain the "half-off your second month" provision in it. The manager explained, "I know. All the leases are like that. We have to do some accounting changes and it will come through a refund of your deposit." Jill only paid one-half of her monthly rent for the second month, and the landlord has brought suit for forcible detainer (eviction). Jill will be able to:

A. Introduce evidence of the manager's promise in their signing session because there was fraud.

B. Introduce evidence of the manager's promise as a modification.

C. Introduce evidence because the statute of frauds does not apply to leases.

D. Not introduce evidence of the manager's promise in their signing session.

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Parol Evidence

Dunne and Cook signed a contract requiring Cook to rebind 500 of Dunne's books at 80 cents per book. Later, Dunne requested, in good faith, that the price be reduced to 70 cents per book. Cook agreed orally to reduce the price to 70 cents. Under the circumstances, the oral agreement is:

A. Enforceable, but proof of it is inadmissible into evidence.

B. Enforceable, and proof of it is admissible into evidence

C. Unenforceable, because Dunne failed to provide consideration, but proof of it is otherwise admissible into evidence.

D. Unenforceable, due to the statute of frauds, and proof of it is inadmissible into evidence.

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Defenses to Formation

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Defenses to Formation

Age

- Minors less than 18—Voidable
- Effect of misrepresentation of age—Irrelevant
- Disaffirm—Anytime during minority or for reasonable time after reaching majority (except necessaries [necessities])
- Returns only what consideration is left, if any
- Ratify—Upon reaching majority, by statement or conduct

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Mental

Declared insane—Void; need not return consideration

Run-of-the-mill Insane—Voidable; must return consideration

1. Did not understand nature of contracts
2. Did not understand effect of this contract

Drunk to extent of mental incapacity—Voidable

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Mistake

Unilateral mistake of fact—No defense

Unilateral mistake in computation—Defense if within range or offeree knows

Nolan Ryan Rookie baseball card

12 00

Mutual (bilateral) mistake of fact—Defense

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Misrepresentation Defenses

Misrepresentation—Innocent or negligent

- Termite report that is wrong

Fraudulent misrepresentation—Intent to defraud; calculated deceit

- The second termite report

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Innocent Misrepresentation

Basis of bargain

Fact or promise

Rescission is only remedy available

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Basis of the Bargain

Analyze the following statements and answer the question:
Could the opinion be the basis for misrepresentation?

"This stock has never decreased in value."

"These suits are 100% wool."

"These bicycle locks are theft-proof."

"This toothpaste reduces cavities by 20%."

"This car gets twenty-two miles to the gallon."

"This car has not been in an accident."

"This fabric is the finest money can buy."

"This house has no easements running through the backyard."

Defenses—Fraud

If these three points are established:

1. Material misstatement/basis of bargain
2. Must prove knowledge
3. Must prove intent to defraud

Then: Punitive damages awarded

Undue Influence

Confidential relationship—Need not be fiduciary relationship; relationship of dependence

Party deprived of meaningful choice

Duress

Subjective test

Deprived of meaningful choice

Does not require actual physical force—threat of force is enough

Threat of disclosure of information

Defenses—Illegality

Interest rates

- Usury—Charging of interest in excess of statutory maximum
- Public policy
- Consumer contracts
- Exculpatory/hold-harmless clauses

Licensing

- Revenue
- Qualification—Void

Defenses—Illegality

West, an Indiana real estate broker, misrepresented to Zimmer that West was licensed in Kansas under the Kansas statute that regulates real estate brokers and requires all brokers to be licensed. Zimmer signed a contract agreeing to pay West a 5% commission for selling Zimmer's home in Kansas. West did not sign the contract. West sold Zimmer's home. If West sued Zimmer for nonpayment of commission, Zimmer would be

A. liable to West only for the value of services rendered.

B. liable to West for the full commission

C. not liable to West for any amount because West did **not** sign the contract

D. not liable to West for any amount because West violated the Kansas licensing requirements.

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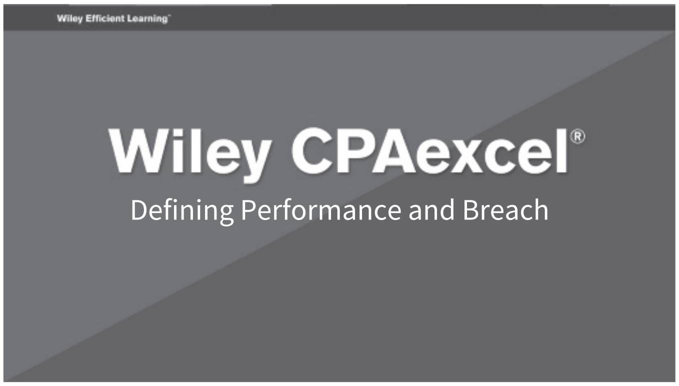
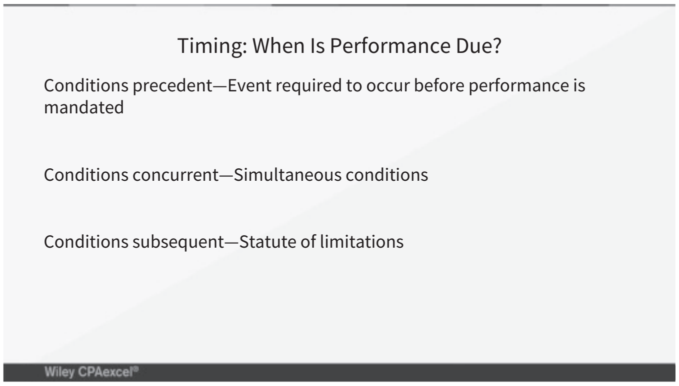
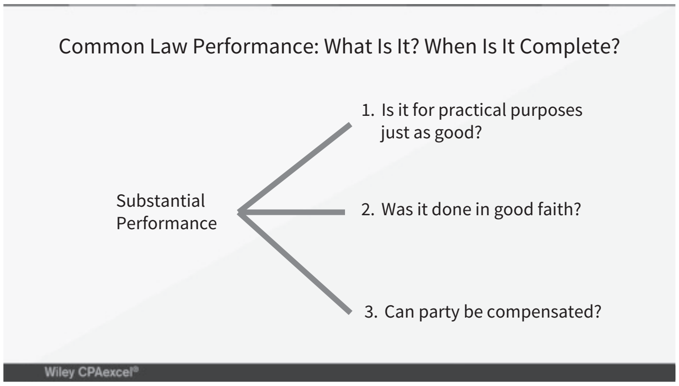
Performance

Defining Performance and Breach







Buyer's Rights in Goods

Buyer's Rights	When	How
Inspection	When goods arrive; before payment (unless COD, CF, CIF)	Examination; lab test; samples
Rejection	Single delivery—Fail to conform in any respect Installment—Substantially impairs value of installment or contract (if rejection in full) Must reject within reasonable time	Notification; nonuse
Acceptance	After inspection	Notification; use; failure to reject in reasonable time
Revocation of acceptance	After acceptance; must materially impair value *and either* a defect nondiscoverable or a promise of cure	Notification; reshipment or nonuse

UCC Right to Demand Assurances—Both
Right to Cure—Seller
Anticipatory Repudiation
Retraction of Anticipatory Repudiation

July 15	Aug 1	Sept 1	Oct 15	Dec 10
K signed	Angst and assurance	Anticipatory repudiation (breach)*	Retraction of repudiation	K due

*1. Breach: sue
2. Breach: substitute seller
3. Breach: wait

Right to Cure

Upon notification by buyer, prior to performance date, seller/buyer has the right to get conforming goods to the buyer or payment to the seller.

Review Question

Bibbeon Manufacturing shipped 300 designer navy blue blazers to Custom Clothing Emporium. The blazers arrived on Friday, earlier than Custom had anticipated and on an exceptionally busy day for its receiving department. The blazers were perfunctorily examined and sent to a nearby warehouse for storage until needed. On Monday of the following week, upon closer examination, it was discovered that the quality of the blazer linings was inferior to that specified in the sales contract. Which of the following is correct insofar as Custom's rights are concerned?

Review Question

A. Custom can reject the blazers upon subsequent discovery of the defects.
B. Custom must retain the blazers since it accepted them and had an opportunity to inspect them upon delivery.
C. Custom's only course of action is rescission.
D. Custom had no rights if the linings were merchantable quality.

Right of Rejection

Parker ordered 50 cartons of soap from Riddle Wholesale Company. Each carton contains 12 packages of soap. The terms were: $8 per carton 2/10, net/30, FOB buyer's delivery platform, delivery June 1.

During transit, approximately half the packages were damaged by the carrier. The delivery was made on May 28.

Review Question

1. Riddle had the risk of loss during transit.
2. If Parker elects to accept the undamaged part of the shipment, he will be deemed to have accepted the entire shipment.
3. To validly reject the goods, Parker must give timely notice of rejection to Riddle within a reasonable time after delivery.
4. If Riddle were notified of the rejection on May 28, Riddle could cure the defect by promptly notifying Parker of intention to do so and making a second delivery to Parker of conforming goods by June 1.
5. The Statute of Frauds is inapplicable to the transaction in the facts given above.

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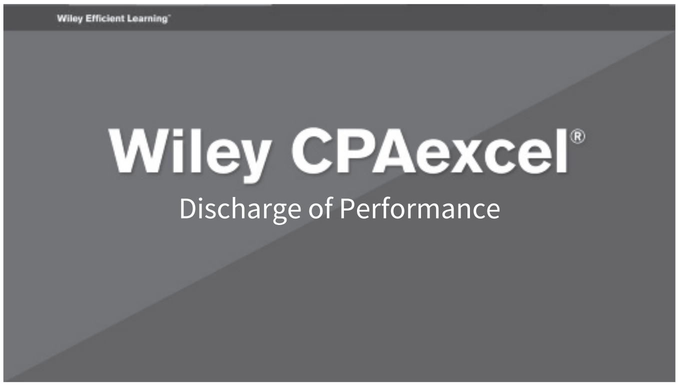
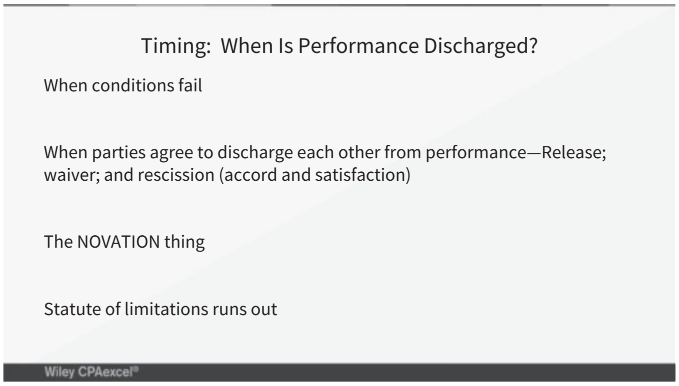
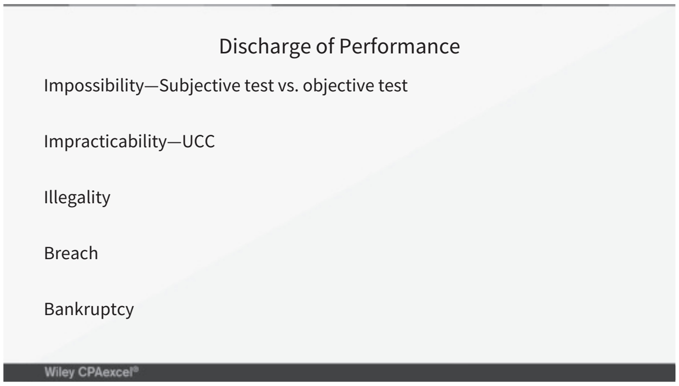
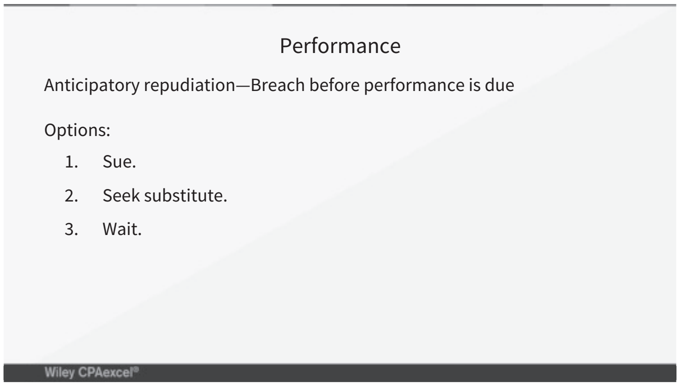
Discharge of Performance








Performance
Anticipatory repudiation—Breach before performance is due
Options:
1. Sue.
2. Seek substitute.
3. Wait.
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Issues of Passage of Title and Risk of Loss

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Issues of Passage of Title and Risk of Loss

Identification

Identification is a prerequisite for passage of title and risk of loss

On existing goods, occurs at the time of contracting

On future and fungible goods, occurs when the goods are shipped, marked, or otherwise designated for the buyer

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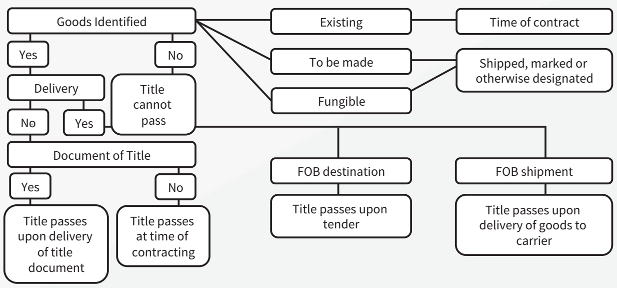
Passage of Title under Article 2



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Shipping Terms

COD

- Collect or cash on delivery (not shipment term, payment term)

CF: (cost and freight) or CIF (cost, insurance, and freight)

- Lump sum; cost and freight
  - Risk—Buyer upon delivery to carrier
  - Title—Buyer upon delivery to carrier
  - Expense—Seller includes cost of freight in contract price

Common Carrier Liability

- Strict liability except for natural disaster and improper packing

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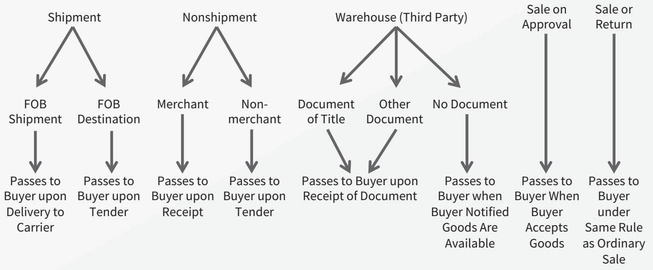
Risk of Loss Identification Must Come First



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Review Question

Wexford Furniture, Inc. is in the retail furniture business and has stores located in principal cities in the United States. Its designers created a unique cocktail table. After obtaining prices and schedules, Wexford ordered 2,000 tables to be made to its design and specifications for sale as a part of its annual spring sales promotion campaign.

Which of the following represents the earliest time Wexford will have an insurable interest in the tables?

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Review Question

A. At the time the goods are in Wexford's possession

B. Upon shipment of conforming goods by the seller

C. When the goods are marked or otherwise designated by the seller as the goods to which the contract refers

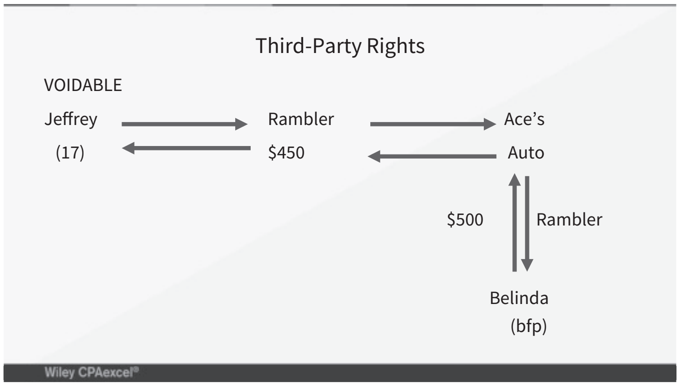
D. At the time the contract is made

Article 2. Sales Shipment Contracts

	Identification	Risk of Loss	Title	Shipping Costs
FOB place of shipment	1. Goods in existence at time of contract	Passes to buyer when delivered to carrier	Passes to buyer at time and place of shipment	Buyer
	2. Fungible goods–Shipped, marked, or otherwise designated			
FOB place of destination	3. Future goods–Shipped, marked, or otherwise designated	Passes to buyer at time of tender (effect of breach)	Passes at time and place of tender	Seller
Nonship-ment contracts	Marked or otherwise designated	Merchant seller–When buyer receives goods	With document of title–At time document is received	None
		Nonmerchant seller–When goods are tendered	Without document of title–At time of contracting	None

Article 2. Sales Shipment Contracts

	Identification	Risk of Loss	Title	Shipping Costs
Bailment/ Warehouse-man contract	Marked or otherwise designated	Passes to Buyer: 1. With receipt of negotiable document of title; 2. On acknowledgment By bailee; or 3. On receipt of nonnegotiable document	Same as nonshipment	None
Sale on approval	Marked or otherwise designated	Upon buyer's acceptance	Upon buyer's acceptance	Seller
Sale or return	Marked or otherwise designated	Same as actual sale	Same as actual sale (consignment exception)	Buyer


Third-Party Rights
VOIDABLE
Jeffrey
(17)
Rambler
$450
Ace's
Auto
$500
Rambler
Belinda
(bfp)
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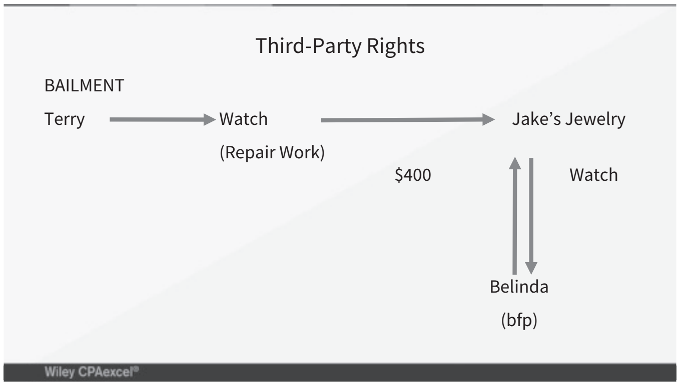
Third-Party Rights
BAILMENT
Terry
Watch
(Repair Work)
Jake's Jewelry
$400
Watch
Belinda
(bfp)
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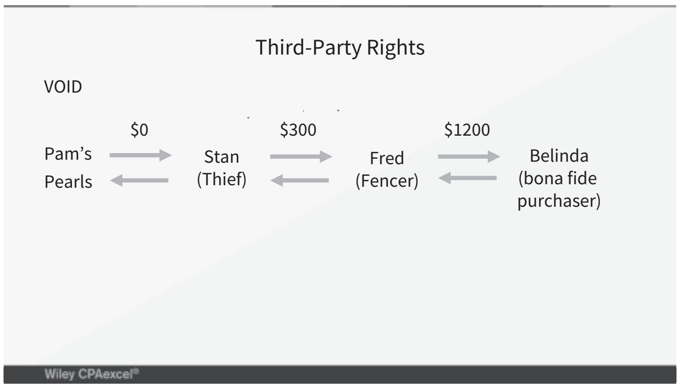
Third-Party Rights
VOID
$0
$300
$1200
Pam's
Pearls
Stan
(Thief)
Fred
(Fencer)
Belinda
(bona fide
purchaser)
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Remedies

Types of Remedies

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Types of Remedies

Damages—Types

Rescission—Used in misrepresentation; returns parties to original position

Nominal—Technical breach

Compensatory—Return parties to same positions as if there had been no breach

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Damages—Types

Incidental—Costs; lawyers' fees

Consequential—Damages to third party

Liquidated—Agreed-on-in-advance damages; alternative to compensatory damages

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Damages—Types

Punitive—Available in cases of fraud

Specific performance—Requires breaching party to perform; used against seller in land contracts

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Formulas for Damages

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Formulas for Damages

Sellers' Remedies Under Article 2

Name of Remedy	Stop Delivery	Resale Price	Market Price	Action for Price	Lost Profit
Section Number	2-702	2-706 2-710	2-708 2-710	2-709 2-708	2-708(2)
When available	Insolvency* Advance breach by buyer	Buyer fails to take goods	Buyer fails to take goods	Specially manufactured goods	Anticip. Repudiation
Nature of remedy	Stop delivery of any size shipment or recover goods if insolvent; stop delivery of large shipments for other reasons; reclaim*	K price – Resale price + Incidental damages – Expenses saved	K price – Market price + Incidental damages – Expenses saved	K price + Incidental damages – Expenses saved	Profits + Incidental damages – Salvage value

*Misrepresentation of insolvency (3 mos./10-day rules) (Revised UCC—any shipment. Anytime)

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Buyer's Remedies Under Article 2

Name of Remedy	Specific Performance (Replevin) (Identification)	Cover	Market
Section Number	2-711	2-712 2-715	2-713 2-715
When available	Rare, unique goods	Seller fails to deliver	Seller fails to deliver
Nature of remedy	Buyer gets goods (incidentals)	Cover price – K price + Incidentals + Consequential damages – Expenses saved	Market price – K price + Incidentals + Consequential damages – Expenses saved

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Third-Party Rights

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Third-Party Rights

Assignment of Benefits

Allied Construction owes Fred's Framing $7,000 for some subcontract work Fred did on Allied's townhouse project.

Fred owes its supplier $8,000 and tells Allied to pay the supplier directly.

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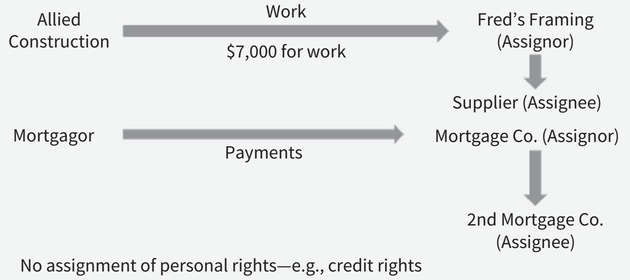
Assignment of Benefits



No assignment of personal rights—e.g., credit rights

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Assignment Rights and Obligation

Fred Farmer has just purchased a new combine for $300,000.

Fred will pay $2000/month over 30 years for the combine.

Harvest sells the contract to Ace Finance Co.

NOTE: These are nonpersonal rights!

Assignment Rights and Obligation

Fred Farmer (promisor)

Harvest Machines (assignor)

Ace Finance Co. (assignee)

Payment:

Fred pays Ace when Ace notifies

Fred is not liable to Ace for payment made to Harvest before he was notified of assignment.

Assignment Rights and Obligation

Defenses:

Assignee has no greater rights than assignor.

Ace is subject to Fred’s contract defenses,

e.g.: breach of warranty, misrepresentation.

Notification issues and payment.

Delegation of Duties

Ida's Ice Cream Factory, Inc. has a contract with Mr. Ice for supplying ice.

Mr. Ice has asked The Ice Man, Inc. to take over the supply contract.

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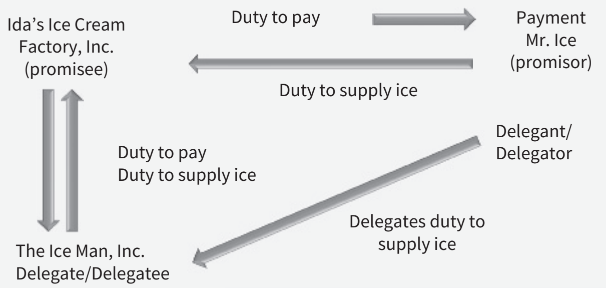
Delegation of Duties



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Review Question

On August 1, Neptune Fisheries contracted in writing with West Markets to deliver to West 3,000 pounds of lobsters at $4.00 a pound. Lobster delivery was due October 1 with payment due November 1. On August 4, Neptune entered into a contract with Deep Sea Lobster Farms, which provided as follows: "Neptune Fisheries assigns all the rights under the contract with West Markets dated August 1 to Deep Sea Lobster Farms." The best interpretation of the August 4 contract would be that it was:

A. Only an assignment of rights by Neptune

B. Only a delegation of duties by Neptune

C. An assignment of rights and a delegation of duties by Neptune

D. An unenforceable third-party beneficiary contract

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Rights of Parties: Third-Party Beneficiaries Donee Beneficiary

Insured (Promisee)	Life Insurance Company (Promisor)	Policy Beneficiary (Donee Beneficiary)
1.	Named beneficiary vs. life insurance Donee beneficiary vs. promisor	**Yes**
2.	Named beneficiary vs. insured Donee beneficiary vs. promisee	**No**
3.	Insured (estate) vs. life insurance Company promisee vs. promisor	**Yes**

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Rights of Parties: Third-Party Beneficiaries Creditor Beneficiary

Insured (Promisee)	Medical Insurance Company (Promisor)	Medical Care Providers (Creditor Beneficiaries)
1.	Medical care provider vs. medical insurance company Creditor beneficiaries vs. promisor	**Yes**
2.	Medical care provider vs. insured Creditor beneficiaries vs. promisee	**Yes**
3.	Insured vs. medical insurance company Promisee vs. promisor	**Yes**

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Review Question

Dan Freeburg went to his doctor for treatment of the flu. Dan signed an agreement that the doctor could bill his medical insurer, United Group, for any treatment received. Dan had a serious blood infection and not the flu. The doctor provided the treatment, including hospitalization, but United Group refused to pay because the doctor did not obtain pre-authorization for the hospitalization. Which of the following statements is correct about the doctor's rights?

a. The doctor can take steps to collect, but only from Dan.

b. The doctor cannot take steps to collect from United Group because Dan's contract limitations applied to him.

c. The doctor can take steps to collect from both Dan and/or United Group.

d. Dan is no longer liable because he delegated his duty to pay to United Group.

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Review Question

Saul is the sole beneficiary of his mother's life insurance policy. His mother has passed away and insurer has refused to pay unless Saul agrees to pay for an investigation into her death. The insurance policy does not cover the issue of post-mortem investigations. Which of the following statements is correct about Saul's rights?

a. Because Saul is a donee beneficiary only he must comply with the contract party's demands.
b. Because Saul is a creditor beneficiary, he is required to comply with the insurer's requirements.
c. Because Saul is just a done beneficiary, he will just have to turn to his mother's estate to collect the policy amount.
d. Saul can bring suit to collect the proceeds from the insurance company because only the contract terms apply to his rights as a done beneficiary.

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Rights of Parties

Third-Party Beneficiaries

Incidental beneficiary

No rights

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Rights of Parties

Ace contracted with Big City to train and employ handicapped, unemployed veterans residing in Big City. Ace breached the contract and Bell, a resident of Big City, who is a handicapped, unemployed veteran, sues Ace for damages. Under the circumstances, Bell will . . .

A. Lose, because Bell is merely an incidental beneficiary entitled to enforce the contract.
B. Win, because Bell is a third-party beneficiary entitled to enforce the contract.
C. Lose, because Big City did not assign its contract rights to Bell.
D. Win, because the contract intent was to confer a benefit on all handicapped, unemployed veterans residing in Big City.

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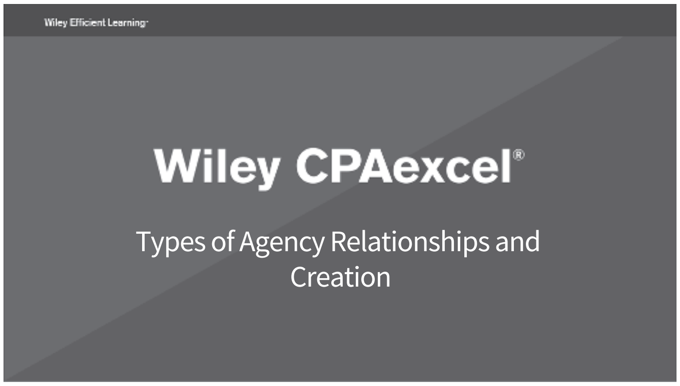
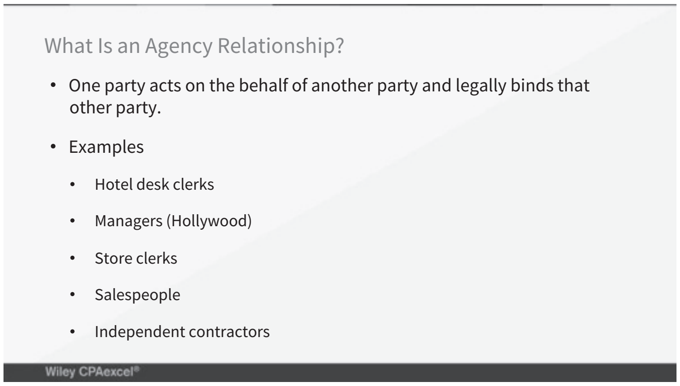
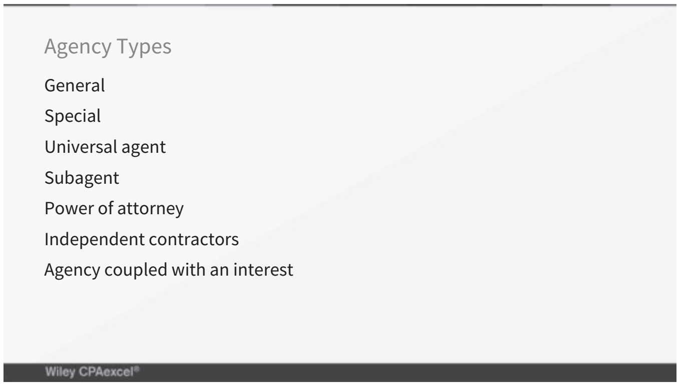
Agency

Types of Agency Relationships and Creation







Formation of Agency: Express Agency

General Requirements:

1. Writing/record, but only if agent's contracts must be in writing
2. Capacity of the principal

Not required:

1. Capacity of the agent
2. Consideration—can be a gratuitous agency

Express agency relationship includes implied agency authority—whatever is customary.

Formation of Apparent Agency Relationship

- Apparent Agency—carries the trappings of being an agent
- Lingering Apparent Agency—carries over after termination when there is no notice
- Agency by Estoppel or Ostensible Authority – for the exam, treat this as an apparent authority agency

Formation of an Agency Relationship by Ratification

- Done after the agent has entered into a relationship on behalf of the principal without authority
- The principal is NOT bound, unless the principal chooses to be bound.
- Must have full information about the terms
- Ratification takes authority back to the time of contracting, as if there were authority
- Ratify by action (oral or record agreement)
- Ratify by saying nothing and allowing performance

Duties of Agents and Principals

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Duties of Agents and Principals

Agency–Duties

Principal's Duties to Agent

- Compensation—Gratuitous agents
- Reimbursement—Expenses (Reasonable)
- To comply with the agency agreement
- Indemnification—See charts in "Contract Liability" lesson

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Duties of the Agent to the Principal

Fiduciary Duty—A duty to act in the best interest of the principal and not engage in self-dealing

- Duty of loyalty
- No conflicts of interest
- No appropriation of business opportunities
- No disclosure of confidential or proprietary information

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Duties of the Agent to the Principal

- Duty of obedience or the duty to follow instructions
- Duty of reasonable care
- Duty of accounting—for expenses and payments
- Duty of disclosure—letting principal know relevant information

Duties of the Parties upon Termination

How Termination Occurs

- By act of the parties
  - Fulfillment of the agreement
  - Lapse of time
  - Specified event
  - Mutual agreement
  - Unilateral act: "You're fired" or "I quit"
- Limitations: Agency coupled with an interest

What Is Terminated by Act of the Parties?

- Actual authority: Express and implied authority
- The problem of lingering apparent authority
  - Notice is required
    - Actual notice to those who have dealt with the agent in the past
    - Constructive notice for those who would not know of the termination (have not dealt with them before)
  - Be sure to take away the trappings of authority.

Termination of Agency by Operation of Law

- Death
- Insanity/lack of capacity
- Bankruptcy
- Breach of fiduciary duty
- Changes in the law
- Circumstances: Subject matter of the agency relationship no longer exists.

Effect: All types of authority are terminated automatically.

Review Question

Harris is a purchasing agent for Elkin, a sole proprietor. Harris has the express authority to place purchase orders with Elkin's suppliers. Harris typically conducts business through the mail and has very little contact with Elkin. Elkin was incapacitated by a stroke and was declared incompetent in a judicial proceeding. Subsequently, Harris placed an order with Ajax, Inc. on behalf of Elkin. Neither Ajax nor Harris was aware of Elkin's incapacity. With regard to the contract with Ajax, Elkin (or Elkin's legal representative) will:

Review Question

A. Not be liable because Harris was without authority to enter into the contract.

B. Not be liable provided that Harris had placed orders with Ajax in the past.

C. Be liable because Harris was acting within the scope of Harris's authority.

D. Be liable because Ajax was unaware of Elkin's incapacity.

Review Question

Susan Jackson is a real estate agent. She has a listing agreement with her cousin to sell his house. Susan agrees to take a 3% as opposed to the customary 6% commission she would receive if she sells the house. Susan is approached by Bell Brothers Homes to work with them in selling homes in their new subdivision. Susan explains that if her cousin could sell his home, he would be interested in a home in the Bell Brothers subdivision. The manager of the new subdivision agrees to buy Susan's cousin's home for a reduced price. Susan explains to her cousin that the offer is probably the best price for his home and that he is lucky to get that much. Susan does not disclose her relationship with Bell Brothers. Which of the following statements is correct?

Review Question

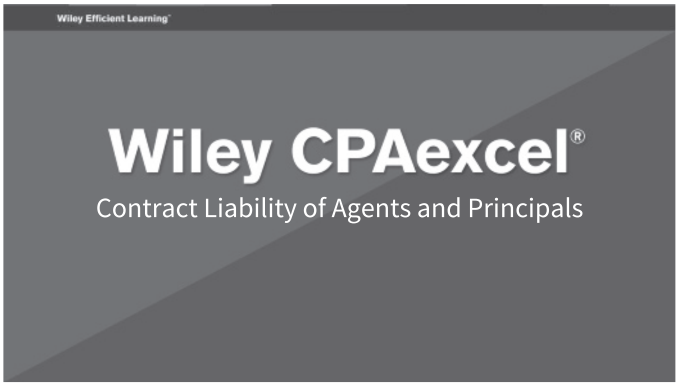
a. There is no breach of fiduciary duty because it was a family situation with a reduced commission.

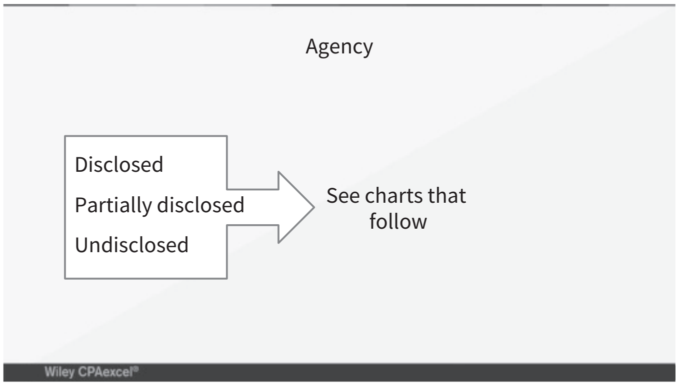
b. As long as the manager does not resell the cousin's home for more than he paid or transfer any proceeds to Susan, there is no breach of fiduciary duty.

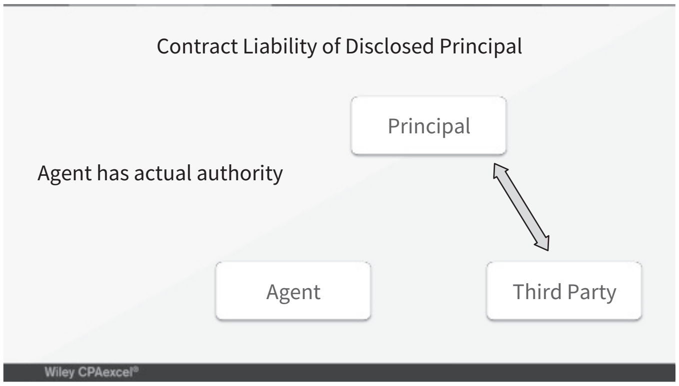
c. As long as the cousin does not buy a house in the Bell Brothers subdivision, there is no breach of fiduciary duty.

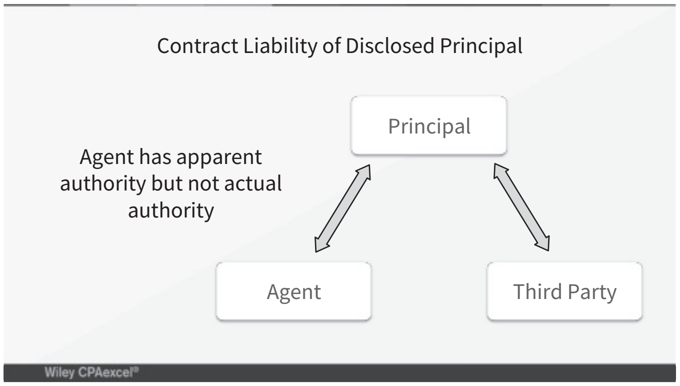
d. There is a breach of fiduciary duty.

Contract Liability of Agents and Principals








Contract Liability of Disclosed Principal
Principal
Agent has apparent authority but not actual authority
Agent
Third Party
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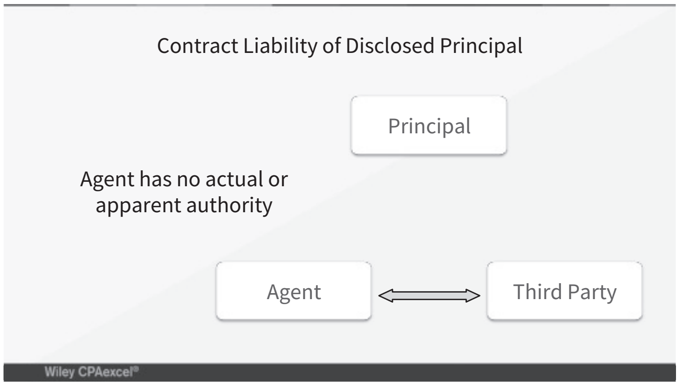
Contract Liability of Disclosed Principal
Principal
Agent has no actual or apparent authority
Agent
Third Party
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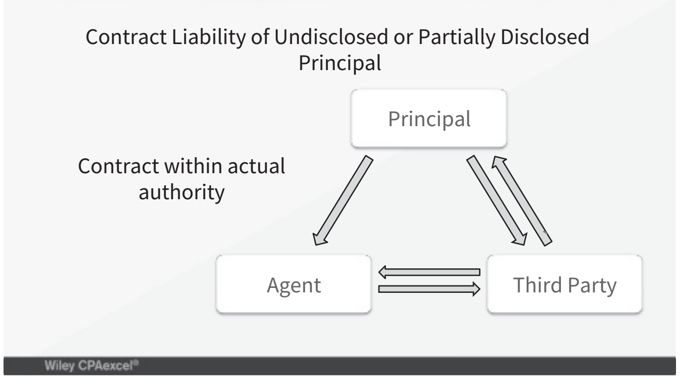
Contract Liability of Undisclosed or Partially Disclosed Principal
Principal
Contract within actual authority
Agent
Third Party
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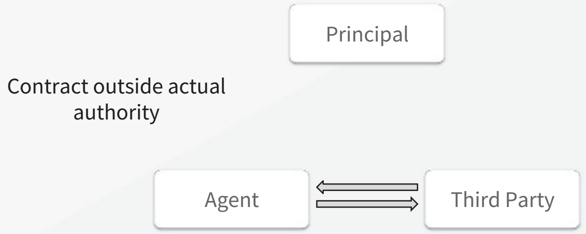
Contract Liability of Undisclosed or Partially Disclosed Principal



Review Question

Parc contracted with Furn Brothers Corp. to buy hotel furniture and fixtures on behalf of Global Motor House, a motel chain. Global instructed Parc to use Parc's own name and not to disclose to Furn that Parc was acting on Global's behalf. Who is liable to Furn on this contract?

	Parc	Global
A.	Yes	No
B.	No	Yes
C.	Yes	Yes
D.	No	No

Review Question

During your examination of the financial statements of Bonanza Development Corporation, you reviewed certain land transactions involving John Walters as agent for Bonanza. Bonanza feared the price of land would skyrocket if it became known that is was trying to purchase a large number of tracts of land to develop a shopping center. It therefore instructed Walters not to disclose to prospective sellers that he was acting as an agent on Bonanza's behalf. The agreement between Walters and Bonanza was in writing and signed by both parties.

Yes or No?

1. Bonanza is an undisclosed principal.
2. Unless Bonanza ratifies the contracts made by Walters, it has no liability thereon.
3. Walters has committed a fraud in failing to notify prospective buyers of the fact that he is acting as Bonanza's agent.
4. Bonanza cannot enforce the contracts made by Walters secretly on its behalf.

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Yes or No?

5. Walters will not be entitled to commissions agreed to by Bonanza in that he has entered into an illegal bargain.
6. If Walters gave the usual warranties in connection with the purchase of the land, Bonanza would be liable on them even though Walters was not authorized to make them.

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Review Question

Which of the following statements is (are) correct regarding the relationship between an agent and a nondisclosed principal?

I. The principal is required to indemnify the agent for any contract entered into by the agent within the scope of the agency agreement.

II. The agent has the same actual authority as if the principal has been disclosed.

A. I only
B. II only
C. Both I and II
D. Neither I nor II

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Tort Liability of Agents and Principals

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Tort Liability of Agents and Principals

Tort Liability – Agents and Principals

Issue: When do we hold the principal liable in addition to the agent's liability for tortious conduct?

- When the principal orders the agent to commit the tort ("Go to the hospital and collect the debt while you can find the debtor there.")
- Through choosing an agent without qualifications (unlicensed cosmetologist)
- Through negligent hiring (failure to do background check on a school bus driver)
- Through negligent supervision (employee with a history of violence) and failure to take action

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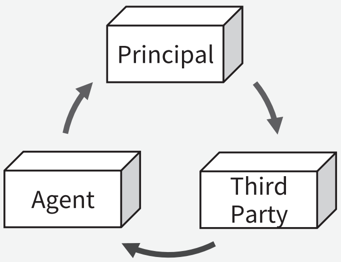
Agent Tort Authorized



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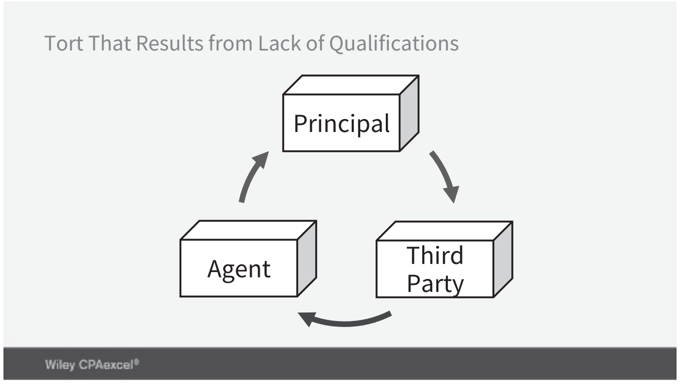
Tort That Results from Lack of Qualifications
Principal
Agent
Third Party
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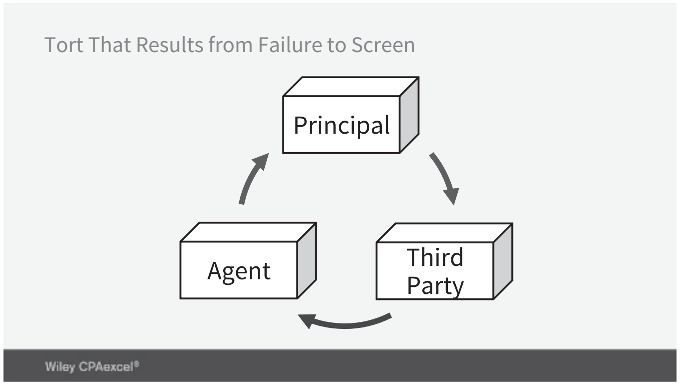
Tort That Results from Failure to Screen
Principal
Agent
Third Party
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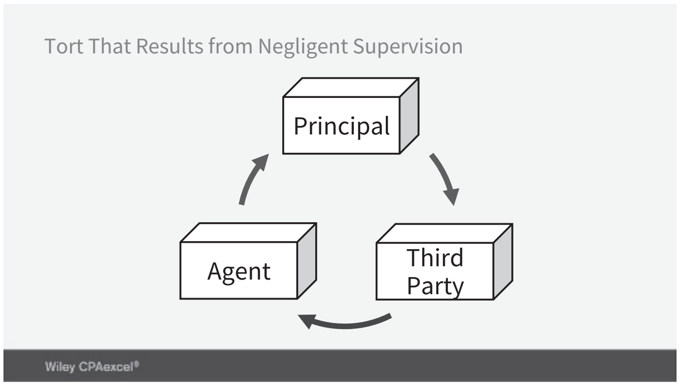
Tort That Results from Negligent Supervision
Principal
Agent
Third Party
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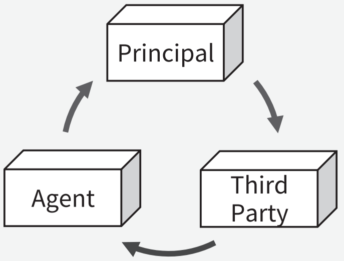
Tort Liability—Agents and Principals

- When the agent is negligent in performing work for the principal
  - Servant vs. Independent Contractor
  - Degree of control
- Doctrine of Respondeat Superior (vicarious liability)

  "Let the master answer" for the torts of the employee in the scope of employment

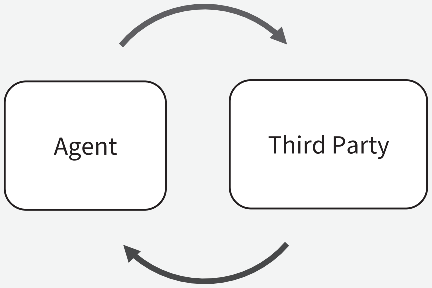
Torts That Result from Actions in Scope of Employment



Torts Outside the Scope of Employment

- Going beyond authority granted (bouncer – unless authorized)
- Scope of employment vs. frolic and detour
- Returns from frolic and detour

Torts Outside the Scope of Employment



Review Question

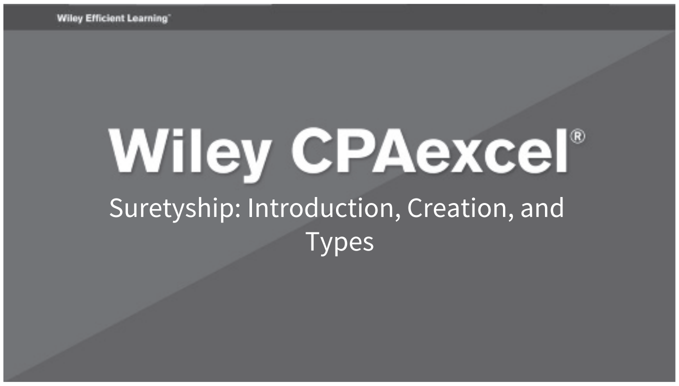
Your client, Sanitary Dairies, Inc., had employed Harold Stone as a milk truck driver. Stone negligently ran the truck into the car of Ronald Green, injuring Green and his wife and damaging Green's car. Stone was also injured in the collision.

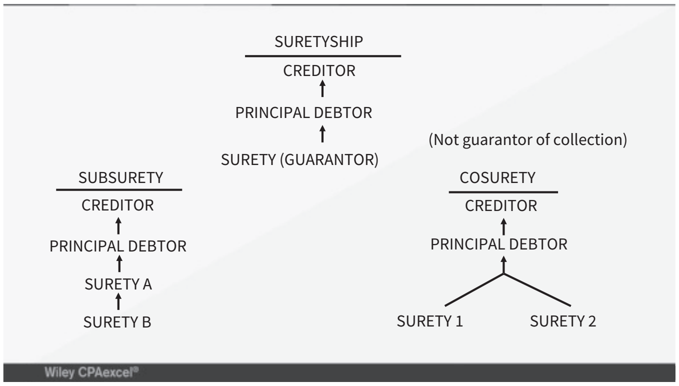
1. If Stone had never had a previous accident, Sanitary Dairies would not be liable.
2. Stone can avoid liability in that he was engaged in the performance of his principal's business.
3. If Green is shown to have been contributorily negligent, he cannot recover for his injuries or for the damage to the car.
4. Stone is entitled to receive worker's compensation.

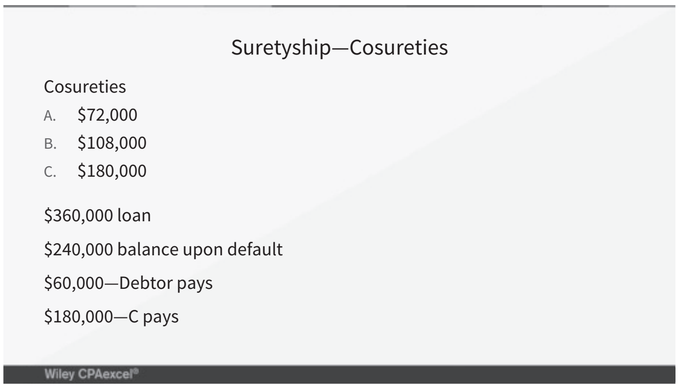
Debtor-Creditor Relationships

Rights, Duties, and Liabilities of Debtors, Creditors, and Guarantors

Suretyship—Introduction, Creation, and Types







Suretyship—Cosureties

$$\frac{\text{Amount Cosurety Guaranteed}}{\text{Total Surety Amount}}$$

$$A \quad \frac{72}{360} \times 180{,}000 = 36{,}000$$

$$B \quad \frac{108}{360} \times 180{,}000 = 54{,}000$$

Cosurety Liability and Bankruptcy

Suretyship—Cosureties

Maximum liability if solvent: $A = \frac{20}{90} \quad F = \frac{30}{90} \quad H = \frac{40}{90}$

If bankrupt:

Amount Cosurety Guaranteed

Total Surety Amount less Bankrupt Surety's Amount

Maximum liability if A is bankrupt: $F = \frac{30}{90-20} \quad H = \frac{40}{90-20}$

Maximum liability if F is bankrupt: $A = \frac{20}{90-30} \quad H = \frac{40}{90-30}$

Cosureties

Ivor borrowed $420,000 from Lear Bank. At Lear's request, Ivor entered into an agreement with Ash, Kane, and Queen for them to act as co-sureties on the loan. The agreement between Ivor and the co-sureties provided that the maximum liability of each co-surety was: Ash, $84,000; Kane, $126,000; and Queen, $210,000. After making several payments, Ivor defaulted on the loan. The balance was $280,000.

If Queen pays $210,000 and Ivor subsequently pays $70,000, what amounts may Queen recover from Ash and Kane?

A. $0 from Ash and $0 from Kane.
B. $42,000 from Ash and $63,000 from Kane.
C. $70,000 from Ash and $70,000 from Kane.
D. $56,000 from Ash and $84,000 from Kane.

Review Question

West promised to make Noll a loan of $180,000 if Noll obtained sureties to secure the loan. Noll entered into an agreement with Carr, Gray, and Pine to act as cosureties on the loan from West.

The agreement between Noll and the cosureties provided for compensation to be paid to each of the cosureties. It further indicated that the maximum liability of each cosurety would be as follows:

Review Question

Carr $180,000, Gray $60,000, and Pine $120,000

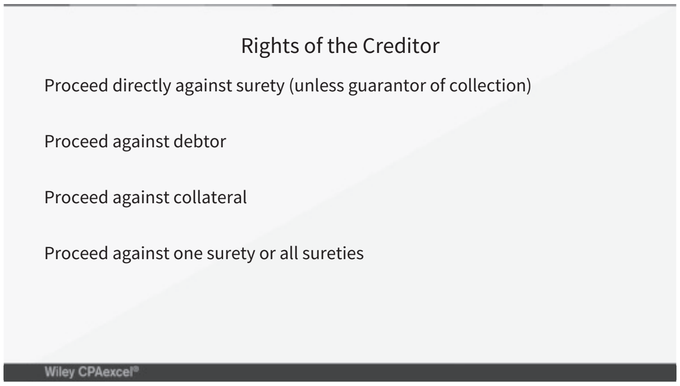
West accepted the commitment of the sureties and made the loan to Noll. After paying nine installments totaling $90,000, Noll defaulted. Gray's debts (including his surety obligation) are discharged in bankruptcy.

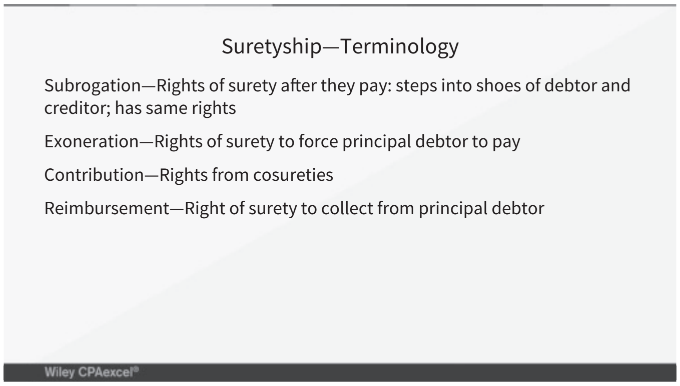
Subsequently, Carr properly paid the entire debt outstanding of $90,000.

What amounts may Carr recover from the cosureties?

	Gray	Pine
A.	$0	$30,000
B.	$0	$36,000
C.	$15,000	$30,000
D.	$30,000	$30,000

Suretyship—Rights of Parties





Suretyship—Terminology:

Indemnity contract
Suretyship contract
Surety
Third-party beneficiary
Cosurety
Statute of frauds
Right of contribution
Reimbursement
Subrogation
Exoneration

A. Relationship whereby one person agrees to answer for the debt or default of another.
B. Requires certain contracts to be in writing to be enforceable.
C. Jointly and severally liable to creditor.
D. Promises to pay debt on default of principal debtor.
E. One party promises to reimburse debtor for payment of debt or loss if it arises.
F. Receives intended benefits of a contract.
G. Right of surety to require the debtor to pay before surety pays.
H. Upon payment of more than his/her proportionate share, each cosurety may compel other cosureties to pay their shares.
I. Upon payment of debt, surety may recover payment from debtor.
J. Upon payment, surety obtains same rights against debtor that creditor had.

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Suretyship—No Release

- Fraud by debtor
- Misrepresentation by debtor
- Changes in loan terms (e.g., extension of payment) (compensated surety) unless it alters risk of surety
- Release of principal debtor
- Bankruptcy of principal debtor
- Insolvency of principal debtor
- Death of principal debtor
- Incapacity of principal debtor
- Lack of enforcement by creditor
- Creditor's failure to give notice of default
- Failure of creditor to resort to collateral

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Suretyship—Release

Release of Surety

- Proper performance by debtor
- Release, surrender, or destruction of collateral (to extent of value of collateral)
- Substitution of debtor
- Fraud/misrepresentation by creditor
- Refusal by creditor to accept payment from debtor
- Change in loan terms (uncompensated surety and must be material) (compensated—increase risk (collateral release))
- Statute of frauds
- Statute of limitations

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Review Question

Which of the following defenses would a surety be able to assert successfully to limit the surety's liability to a creditor?

A. Discharge in bankruptcy of the principal debtor

B. Personal defense the principal debtor has against the creditor

C. Incapacity of the surety

D. Incapacity of the principal debtor

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Article 9—UCC Secured Transactions

Introduction and Creation of Security Interests

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Introduction and Creation of Security Interests

Parties, Terms, and Purpose

Secured party/creditor

Debtor

Collateral

Security agreement

Security interest

Financing statement

Security for repayment, priority position

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Attachment of Security Interest

Security agreement

- Writing/record (exception is possession; electronic record is sufficient)
- Signed (*authenticated) by debtor
- Description of collateral—*"reasonably identify" OR POSSESSION OR CONTROL (is a substitute for a security agreement)

Interest in the collateral (identification)

Underlying debt

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Review Question

Under the Secured Transactions Article of the UCC, which of the following requirements is necessary to have a security interest attached?

	Debtor has rights in collateral	Proper filing of security agreement	Value given by creditor
A.	Yes	Yes	Yes
B.	Yes	Yes	No
C.	Yes	No	Yes
D.	No	Yes	Yes

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Review Question

Creditor A agreed to loan debtor D the money for the purchase of inventory. Debtor D signed a security agreement on October 1. Creditor A filed a financing statement on the goods on October 2. The inventory was shipped FOB place of shipment on October 5. When did the security interest attach?

A. October 1.

B. October 2.

C. October 5.

D. The interest has not attached until tender of the goods to D.

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Perfection of Security Interests

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Perfection of Security Interests

Methods of Perfection

Filing

Possession

Automatic

Temporary

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Types of Collateral

*ALL FILINGS CENTRAL WITH THE EXCEPTION OF REAL PROPERTY (local) (moving to electronic system)

- Tangible property
- Consumer goods
- Equipment
- Inventory
- Farm products
- Fixtures (local)

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Types of Collateral

Intangible Property

- Patents
- Copyrights
- Trademarks
- Royalties

Types of Collateral

Miscellaneous

- Proceeds
- Negotiable instruments
- Accounts
- Deposit accounts
- Commercial tort claims (not death or personal injury tort claims)
- Health care receivables

Period of Perfection

Five years for filing

Can renew any time within last six months

For perfection by possession, as long as possession continues

Must use care with collateral

Perfection

Possession

- Negotiable instruments
- Field warehousing
- Control of accounts

Review Question

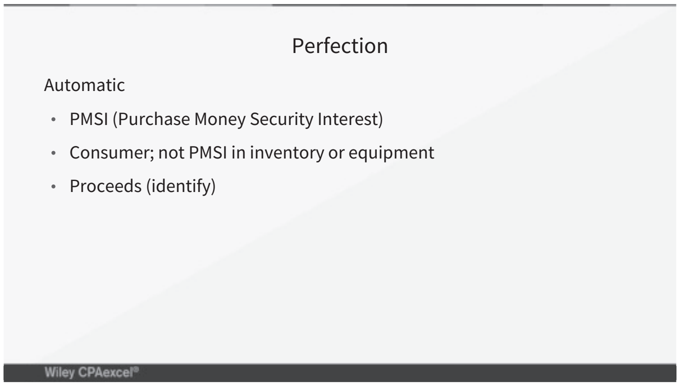
Under the UCC Secured Transactions Article, which of the following actions will best perfect a security interest in negotiable instrument against any other party?

A. Filing a security agreement
B. Taking possession of the instrument
C. Perfecting by attachment
D. Obtaining a duly executed financing statement

Perfection

Temporary

- 4-month rule—collateral moved to another state
- 21-day rule—negotiable instruments
- 20-day rule—see priorities discussion (old 10 days)


Perfection
Automatic
PMSI (Purchase Money Security Interest)
Consumer; not PMSI in inventory or equipment
Proceeds (identify)
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Priorities in Security Interests

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Priorities in Security Interests

Priority of Security Interests Under Article 9: General Rules

Conflict	Priority
Secured party vs. secured party	If the secured creditors are secured by the same collateral: first to attach. For remaining debt, treated as general creditors (pro rata)
Unsecured party vs. secured party	Secured party
Perfected secured party vs. secured party	Perfected secured party
Perfected secured party vs. perfected secured party	Party who is first to perfect
Perfected secured party vs. lienor	Party who filed (financing statement or lien) first

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Priority of Secured Interests Under Article 9: General Rules Review

1. Secured party vs. unsecured party
2. Secured party vs. secured party—first to attach
3. Unsecured party vs. unsecured party
4. Perfected secured party vs. unperfected secured party
5. Perfected secured party vs. perfected secured party—first in time, first in right

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Exceptions to General Priority Rules of Secured Creditors Under Article 9

Conflict	Priority
PMSI in fixtures vs. perfected secured party	PMSI creditor if perfected before annexation or within 20 days after annexation (PMSI will have priority even over prior perfected secured party)
PMSI in equipment vs. perfected secured party	PMSI if perfected within 20 days after delivery
PMSI in inventory vs. perfected secured party	PMSI if perfected before delivery and if perfected secured party gives notice to other secured creditors before delivery
PMSI in consumer goods vs. buyer	Buyer unless perfection is by filing before purchase
Perfected secured party vs. buyer	Buyers in ordinary course win even with knowledge

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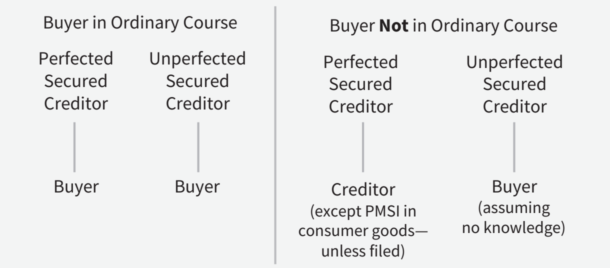
Buyers vs. Article 9 Secured Creditor



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Article 9—PMSI Buyer

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Article IX Priorities

Acorn Marina, Inc. sells and services boat motors. On April 1, 1989, Acorn financed the purchase of its entire inventory with GAC Finance Company. GAC required Acorn to execute a security agreement and financing statements covering the inventory and proceeds of sale. On April 14, 1989, GAC properly filed the financing statement pursuant to the UCC Secured Transaction Article. On April 27, 1989, Acorn sold one of the motors to Wilks for use in his charter business. Wilks, who had once worked for Acorn, knew that Acorn regularly financed its inventory with GAC. Acorn has defaulted on its obligations to GAC. The motor purchased by Wilks is:

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Article IX

a. Subject to the GAC security interest because Wilks should have known that GAC financed the inventory purchased by Acorn.
b. Subject to the GAC security interest because Wilks purchased the motor for a commercial use.
c. Not subject to the GAC security interest because Wilks is regarded as a buyer in the ordinary course of Acorn's business.
d. Not subject to the GAC security interest because GAC failed to file the financing statement until more than 10 days after April 1, 1989.

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Review Question

Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine's personal investments. Later, Wine sold the computer to Jacobs for Jacobs' family use. Jacobs was unaware of MJC's security interest. Wine now is in default under the MJC loan.

May MJC repossess the computer from Jacobs?

A. No, because Jacobs was unaware of the MJC security interest.
B. No, because Jacobs intended to use the computer for family or household purposes.
C. Yes, because MJC's security interest was perfected before Jacobs' purchase.
D. Yes, because Jacob's purchase of the computer made Jacobs personally liable to MJC.

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Review Question

Under the UCC Secured Transaction Article, what is the order of priority for the following security interests in store equipment?

I. Security interest perfected by filing on April 15, 2018.
II. Security interest attached on April 1, 2018.
III. Purchase money security interest attached April 11, 2018 and perfected by filing on April 20, 2018.

A. I, III, II.
B. II, I, III.
C. III, I, II.
D. III, II, I.

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Article IX

Fogel purchased a TV set for $900 from Hamilton Appliance Store. Hamilton took a promissory note signed by Fogel and a security interest for the $800 balance due on the set. It was Hamilton's policy not to file a financing statement until the purchaser defaulted. Fogel obtained a loan of $500 from Reliable Finance which took and recorded a security interest in the set. A month later, Fogel defaulted on several loans outstanding and one of his creditors, Harp, obtained a judgment against Fogel which was properly recorded. After making several payments, Fogel defaulted on a payment due to Hamilton, who then recorded a financing statement subsequent to Reliable's filing and the entry of the Harp judgment. Subsequently, at a garage sale, Fogel sold the set for $300 to Mobray. Which of the parties has the priority claim to the set?

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Article IX

a. Reliable

b. Hamilton

c. Harp

d. Mobray

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Rights of Secured Parties and Debtors

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Rights of Secured Parties and Debtors

Right of Release/Termination

On consumer goods, atermination statement must be filed within 30 days after the final payment is made or within 20 days of demand by the consumer.

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Article 9

Remedies

Creditor: Suit or repossession

Self-help: No court proceeding required before repossession

Breach of Peace issues: No violation of civil or criminal laws

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Review Question

Under the Secured Transactions Article of the UCC, which of the following remedies are available to a secured creditor when a debtor fails to make a payment when due?

	Proceed against the collateral	Obtain general judgment against debtor
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

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Article 9—Sale

1. 60% Rule: Creditor must sell collateral if debtor has paid 60% of cash price of collateral.
   - Consumer goods—can demand sale (90 days)
2. Requirements:
   - Notice to debtor
   - Notice to other secured parties
   - Public or private
   - Reasonable: price/practices
   - All security interests terminated

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Article 9—Sale

3. Distribution:
   - Expenses
   - First priority
   - Second priority, etc.
   - Debtor

After sale
All security interests in the property are terminated.

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Bankruptcy and Insolvency

Prebankruptcy Options, and Introduction to and Declaration of Bankruptcy

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Prebankruptcy Options and Introduction and Declaration of Bankruptcy

When the Debtor Does Not Pay

- Article 9 Secured Creditors
  - Repossess the collateral.
  - Bring suit to collect the debt.
- Sureties
  - Seek to collect from one or more of the sureties.
  - Cosurety proportionate liability for the remaining debt
- Common law or statutory lien rights

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Common Law or Statutory Lien Rights

- Bailee's lien
  - Lien for storage or transport fees
  - Common carriers, warehousemen, innkeepers, moving companies
  - Can sell the property to satisfy the storage or transport fees

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Common Law or Statutory Lien Rights (continued)

- Artisan or worker lien
  - Improvements to repairs to property by a bailee
  - Car repairs, jewelry repairs or refurnishing, reupholstering
  - Sale of property to satisfy the amount due for the improvements

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Priority of Statutory or Common Law Liens

- Possession is nine points of the law—he who possesses can sell and has first rights in the proceeds.
- These types of statutory and common law liens have priority over previously recorded liens or Article 9 perfected liens.
- The public policy goal of getting property repaired or improved

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Statutory Lien: Mechanic's Lien

- Interest in real property
- Created through a statutory process
- Usually dates back to the time that work began
- Secured creditor with right to foreclose on the property to satisfy the lien

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Collection—The Fair Debt Collections Practices Act (FDCPA)

- If the debtor has a lawyer, creditor must talk with the lawyer.
- Creditor can contact third parties in trying to locate the debtor, but cannot discuss the debt with the third party.
- Creditor can file suit for collection.
- Creditor is limited on times of day during which the debtor can be called.
- Creditor contact cannot reach the point of harassment (confronting hospitalized debtors).

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Reducing a Suit to a Judgment

- Once judgment is obtained, the court orders collection
- Attachment—court process for seizure of the debtor's non-exempt property (date judgment is filed is priority for creditor on liens place to collect judgment); homestead exemption for home equity
- Execution—court official takes the attached property—judicial sale
- Garnishment
  - Bank accounts
  - Wages (25% of take-home pay) (no termination due garnishment)
- Non-garnishment: Social Security

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Group of Creditors: Remedies

1. Composition—Discharges debts if debtor performs as to all creditors who agreed (does not bind creditors who do not agree to the composition)
2. Setting aside fraudulent conveyances (piercing the corporate veil)
3. Assignment
   - Debtor turns over certain property to a trustee or assignee.
   - Trustee or assignee gives pro rata share to creditors as full satisfaction of debt.
   - "Cram down"—take it or leave it—Creditors who do not take it cannot touch that property but can put debtor into bankruptcy.

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Changes in Bankruptcy Law and Exam Eligibility for Testing

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Bankruptcy—Chapter 7

Chapter 7 —Liquidation or Straight Bankruptcy

Voluntary/Involuntary

No involuntary for farmers and nonprofits

Eligibility: Individuals, partnerships, corporations

Individuals must satisfy the means test:

- Debtor's monthly income—allowable expenses (statutory) = means available for paying debts

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Bankruptcy—Chapter 7 (Continued)

Requirements

Exemptions (not covered): S&Ls; credit unions; SBA; RRs; municipalities; insurers; co-op banks

Trustee

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Bankruptcy—Chapter 9

Voluntary petitions by municipalities

Any governmental body with power to tax (counties)

Generally, no trustee

Pension defaults are usual reason for these bankruptcies.

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Bankruptcy—Chapter 11

Chapter 11—Reorganization

Voluntary/Involuntary

Generally, no trustee— Court-supervised process

Automatic stay

No involuntary for farmers, savings and loans, banks, insurance companies, stockbrokers, and nonprofits

RRs okay under Chapter 11

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Bankruptcy—Chapter 11 (Continued)

Eligibility: Individuals, partnerships, corporations

Requirements: Organization must have debts.

Approval of reorganization plan requires a vote of the creditors:

1/2 creditors or by sufficient creditors who together are owed 2/3 of the amount of claims

(by each class of creditor)

Review Question

Strong Corp. filed a voluntary petition in bankruptcy under the reorganization provisions of Chapter 11 of the Federal Bankruptcy Code. A reorganization plan was filed and agreed to by all necessary parties. The court confirmed the plans, and a final decree was entered.

Which of the following parties ordinarily must confirm the plan?

	1/2 of secured creditors	2/3 of shareholders
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

Bankruptcy—Chapter 12

Family farmer chapter (can be organized as a corporation, LLC, or partnership)

Only voluntary petitions

50/50 requirement: 50% of income from farm and 50% of debts due to farm

Total maximum debt:

2016-2019: $4,153,150 (upper limit—if higher, off to Chapter 7)

2019-2022: $4,411,400 (upper limit– if higher, off to Chapter 7)

Bankruptcy—Chapter 13

Consumer Debt Adjustment Plan

Voluntary only

- Eligibility:
  - Must have some source of income
  - 2016-2019 < $394,725 unsecured debts; 2019-2022<$419,275
  - 2016-2019 <$1,184,200 secured debts; 2019-2022<$1,257,850
- Limitations: Only individuals can file.

Trustee is required.

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Bankruptcy—Chapter 13 (continued)

Consumer Debt Adjustment Plan

- Hearing for approval of plan

After 3- or 5-year period, if debt plan met, court grants discharge, with exceptions.

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Forms of Bankruptcy

	Chapter 7	Chapter 11	Chapter 13
Trustee	Yes	No	Yes
Eligible Persons: Individuals Partnerships Corporations	 Yes Yes Yes	 Yes Yes Yes	 Yes No No
Voluntary	Yes	Yes	Yes
Involuntary	Yes, except for farmers and nonprofits	Yes, except for farmers and nonprofits	No
Exemptions	S&Ls, credit unions, SBA, RRs, municipalities	Same as Chapter 7 plus stockbrokers (RRs)	Only individuals allowed
Requirements—voluntary	Debts	Debts	Income < $394,725/ $419,725 unsecured < $1,184,200/$1,257,850 secured
Requirements—involuntary	< 12 = 1/$15,775/$16,750 ≥12 = 3/$15,775/$16,750	< 12 = 1/$15,775/$16,750 ≥12 = 3/$15,775/$16,750	N/A

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Bankruptcy—Declaration

Voluntary Petitions:

- Requirements: Petitioner has debts (consumer exceptions and the Chapter 13 path).
- Automatic relief: Order of relief
  - Some exceptions to relief (child support and alimony; divorce proceedings; eviction; divorce proceedings)

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Bankruptcy—Declaration (continued)

Involuntary Petitions:

- Liability for wrongful filling
- Requirements
  - < 12 creditors = 1/$15,775/$16,750
  - ≥ 12 creditors = 3/$15,775/$16,750

Entry of stay

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Effect of Bankruptcy Petition

Order for relief upon filing of petition

- Liens, foreclosures, etc., are stayed.
- There are exceptions (child support, alimony, divorce proceedings, eviction; driver's license suspensions)
- Payments are handled through the bankruptcy court.

Bankruptcy process begins.

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Bankruptcy—Wrongful Filing

- Damages for Wrongful Involuntary Filing
  - Court costs
  - Attorney fees
  - Compensatory damages
  - Punitive damages

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Review Question

A voluntary petition filed under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code:

A. Is not available to a corporation unless it has previously filed a petition under the reorganization provisions of Chapter 11 of the Federal Bankruptcy Code.

B. Automatically stays collection actions against the debtor except by secured creditors.

C. Will be dismissed unless the debtor has 12 or more unsecured creditors whose claims total at least $10,000.

D. Does not require debtor to show that the debtor's liabilities exceed the fair market value of assets.

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Bankruptcy Process

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Bankruptcy Process

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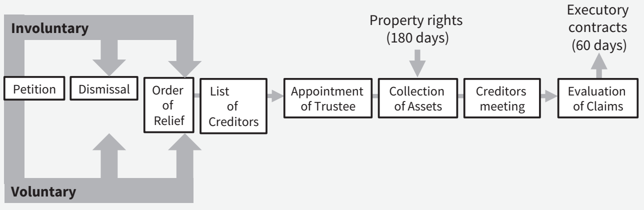
Anatomy of Bankruptcy Case



Bankruptcy—Test for Dismissal

Means Test

- Determines whether bankruptcy can proceed or whether debtor is involved in "substantial abuse" of the bankruptcy system
- Means Test: Calculation of debtor's monthly income averaged over the last 6 months less allowed expenses
- Monthly income x 12: If this figure exceeds state's median income by more than $6,325/$6,825, then substantial abuse is presumed
- Debtor can rebut by showing "special circumstances" or "adjustments" with no alternatives

Effect of Bankruptcy

- Automatic stay when petition is granted
- Judgments stop
- Liens stop
- Enforcement actions stop
- EXCEPTIONS: (1) Evictions; (2) Driver's License Suspension; and

  (3) Child Support and Divorce Proceedings; (4) Eviction

Duties of Trustee

1. Appointed by government (court)
2. Collect debtor's assets
3. Investigate debtor's financial affairs
4. Furnish reports to interested parties (Lehman bankruptcy)
5. Review debtor's materials
6. Be the representative for the debtor's estate

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Duties of Debtor

1. Schedule of all assets
2. List of all creditors
3. Schedule of current income and expenses
4. Certificate from approved credit counseling agency
5. Copy of most recent federal income tax return

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What Is Included in Debtor's Estate

Tangible and intangible property

All property acquired within 180 days following bankruptcy:

- Inheritances and gifts
- Property from divorce, separation, or property settlement
- Life insurance proceeds

Not included:

- Child Support and alimony
- Social Security payments
- Wages (earned after declaration of bankruptcy)

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Total Exemptions

Pensions and Retirement Savings

Wrongful death recovery for person upon whom you were dependent

Alimony and child support

Disability and unemployment income

Review Question

Under the liquidation provisions of Chapter 7 of the federal Bankruptcy Code, certain property acquired by the debtor after the filing of the petition becomes part of the bankruptcy estate. An example of such property is:

A. Inheritances received by debtor within 180 days after the filing of petition
B. Child support payments received by debtor within one year after filing petition
C. Social Security payments received by debtor within 180 days after filing of petition
D. Wages earned by debtor within one year after filing of petition

Homestead Exemptions

If homestead is acquired within 3.5 years of bankruptcy filing, homestead equity exempted is limited to $160,375 (April 2016-June 2019). $170,350 for July 2019-June 2022).

Must have lived in the state for two years.

Other Exemptions—Bankruptcy

1. State law: Can limit choice to state
2. Federal law: Control on homestead exemptions
3. Debtor's choice

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Exemptions (2016-2019)

Numbers for exams from July 2016 through September 2019

Motor vehicle	$ 3,775
Household furnishings	$12,625
Other property (wildcard)	$ 1,250 and up to $11,850 of unused home exemption
Tools of profession	$ 2,375
Life insurance	$12,625
Jewelry	$ 1,600
IRAs and ROTHs	$1,283,025
Personal injury claim up to	$23,675

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Exemptions (2019-2022)

Numbers for exams October 2019--September 2022

Motor vehicle	$ 4,000
Household furnishings	$ 13,400
Other property (wildcard)	$ 1,325 and up to $12,575 of unused home exemption
Tools of profession	$ 2,525
Life insurance	$13,400
Jewelry	$ 1,700
IRAs and ROTHs	$1,362,800
Personal injury claim up to	$25,150

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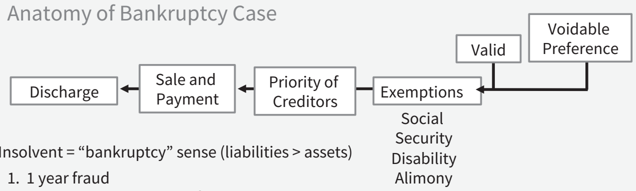
Anatomy of Bankruptcy Case



* Insolvent = "bankruptcy" sense (liabilities > assets)

1. 1 year fraud
2. 1 year insolvent* and unfair
3. 1 year insider
4. 90 days—presumed insolvent*—not ordinary course of business (presumed)
5. Security for antecedent debt

   OK (not voidable)

Limits on consumer debt/cash contemporaneous exchange; regular payments

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Voidable Preferences

1. Transfer for the benefit of a creditor
2. on an antecedent debt
3. while the debtor was insolvent (liabilities > assets) (presumption of insolvency when done within 90 days of filing the petition)
4. Paid

   a. within 90 days of the of filing of the petition for bankruptcy; OR

   b. Between 90 days and one year before the date of the filing of the petition for bankruptcy if the creditor was an insider
5. That allows the creditor to get more than a Chapter 7 distribution

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Exceptions for Voidable Preferences

- Contemporaneous exchanges
- Ordinary course of business payments between debtor and creditor and made under ordinary terms
- Creation of a PMSI-security interest for new value is okay (if creditor perfects within 30 days after debtor has possession of the collateral)

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Review Question

On May 1, 2018, Jane Fordham LLC declared Chapter 7 bankruptcy. Jane had $35,000 in unsecured debt and $900,000 in secured debt. One of the unsecured debtors was Jane's designer for her line of clothing. As her business struggled, Jane fully paid her designer his $1,600 fee on February 10, 2018. The fee was for services rendered on dress designs in September 2017. Regarding Jane's payment to her designer:

It is not a voidable preference because the debt was incurred in September 2017, more than 180 days before Jane's bankruptcy.

Is not a voidable preference because it is not for a secured debt.

Is not a voidable preference because the designer is an insider.

Is a voidable preference

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Bankruptcy—Voidable Transfers

A debtor may attempt to conceal or transfer property to prevent a creditor from satisfying a judgment. Which of the following actions will be considered an indication of fraudulent conveyance?

	Debtor remains in possession after transfer	Secret conveyance	Debtor retains equitable benefit in property conveyed
A.	Yes	No	Yes
B.	No	Yes	Yes
C.	Yes	Yes	No
D.	Yes	Yes	Yes

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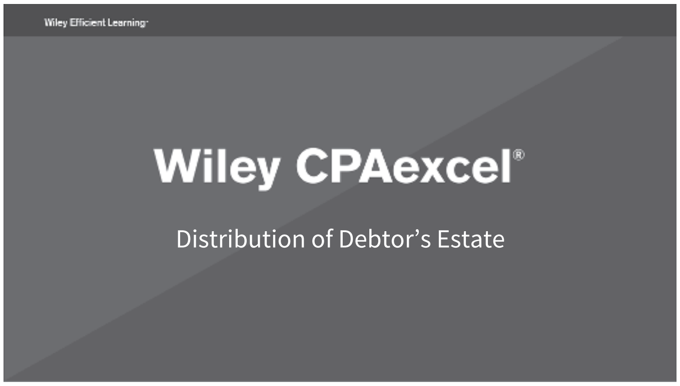
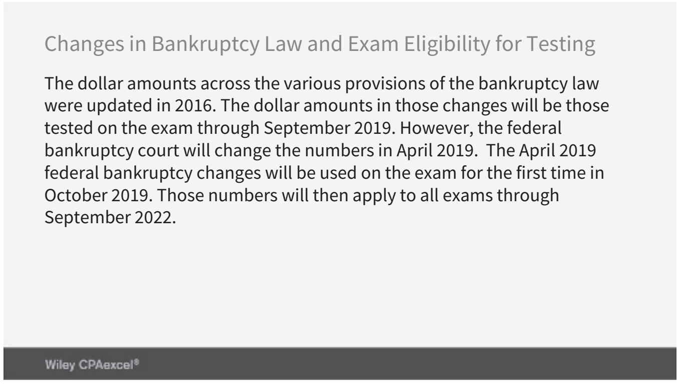
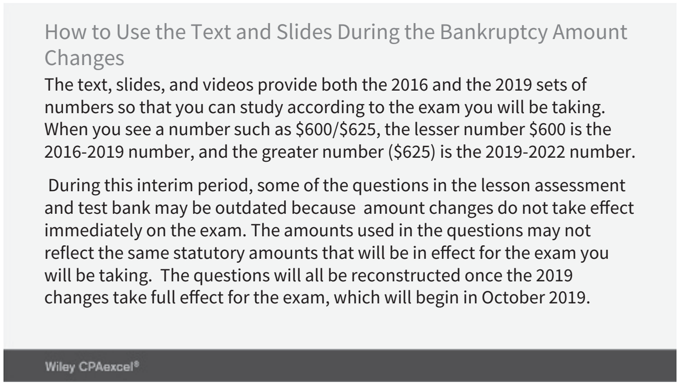
Distribution of Debtor's Estate







Bankruptcy—Distribution

Distribution priorities

1. Secured creditors (to the extent of repossession)

2. Claims for child support and alimony

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Bankruptcy—Distribution

3. Administration Costs
   - Attorneys, accountants, trustees, appraisers
4. Claims arising in ordinary course of business after bankruptcy petition is filed but before order of relief (interim creditors/involuntary)
5. Employee wages (not officers)
   - $12,475/ $13,650 maximum
   - 6 months preceding petition (180 days)

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Bankruptcy—Distribution

6. Contribution to Benefit Plans

$12,850/$13,650 maximum (reduced by wages received) 180 days preceding bankruptcy

7. Claims on raising or storage of grain ($6,325/$6,725)
8. Consumer deposits
   - $2,850/$3,025 maximum
9. Taxes (federal, state, and local)
10. Unsecured creditors

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The 2- and 3-Year Tax Priority Rules

1. The 3-Year Rule. Taxes must become due at least three years before you file for bankruptcy. Add three years to the tax due dates to determine the earliest date you can file for bankruptcy and still get your taxes discharged.

EXAMPLE: Your 2015 taxes would be due April 15, 2016. If you want your taxes for 2015 discharged, then you have to wait until April 15, 2019 to file for bankruptcy. (That is April 15, 2016 PLUS three years) (extensions bump the date later)

2. The 2-Year Rule. Your income tax returns must have been filed at least two years before you file your bankruptcy petition.

EXAMPLE: Taxes for 2017 were due on April 15, 2018. They are filed on September 15, 2018. No filing until bankruptcy UNTIL September 15, 2020. However, without an extension, the taxes were due April 15, 2018 -- which means that the bankruptcy petition could not be filed until April 15, 2021.

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Review Question

On July 1, 1986, Mix was petitioned by Able into bankruptcy under the liquidation provisions of the Bankruptcy Code. Able and Baker are unsecured creditors of Mix, owed $20,000 and $40,000 respectively. Mix also owed Carr $80,000, secured by a valid perfected security interest in bankruptcy on Mix's machinery, valued at $20,000. Mix has no other debts, except for 1986 federal income taxes ($6,000).

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Review Question

Shortly after the filing of the petition, Lang was appointed trustee in Mix's bankruptcy. In Lang's capacity as trustee, Lang: Engaged Ring & Co., CPAs, as the accountants for the bankruptcy estate. Included as part of the bankruptcy estate an inheritance that Mix became entitled to receive on December 15, 1986, and that Mix actually received on January 15, 1987.

Lang has sold the property in the estate (including selling Mix's machinery for $20,000, which Carr consented to), and now the sole asset of the estate is $60,000 cash. Lang wishes to distribute the $60,000 so as to satisfy the following claims and expenses of the estate:

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Review Question

Unsecured claim for 1986 federal income taxes	$ 6,000
Carr's claim	$ 80,000
Able's and Baker's claims	$ 60,000
Expenses necessary to maintain and sell the unsecured property of the estate	$ 1,000
Ring's fee for services rendered	$ 3,000

There are no other claims.

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Review Question
Order of Priorities and Amounts

1	Carr	$20,000
2	Expenses	$1,000 + $3,000
3	Taxes	$6,000
4	Able	$20,000
	Baker	$40,000
	Carr	$60,000

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Review Question

DISTRIBUTION OF CASH

$20,000 to Carr (from sale of the collateral)

$4,000 expenses

$6,000 taxes

TOTAL DISTRIBUTED SO FAR: $30,000 and we are at general unsecured creditors

$30,000 remaining is divided pro rata among Able, Baker, and Carr.

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Review Question

Total Owed

$60,000 Carr (amount owed after $20,000 from sale of collateral)
$20,000 Able
$40,000 Baker

$120,000 TOTAL OF ALL REMAINING CREDITORS

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Review Question

Carr 60,000/120,000 x 30,000 = $15,000

Able 20,000/120,000 x 30,000 = $ 5,000

Baker 40,000/120,000 x 30,000 = $10,000

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Review Question

Knox operates an electronics store as a sole proprietor. On April 5, 1988, Knox was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. On April 20, a trustee in bankruptcy was appointed and an order for relief was entered. Knox's nonexempt property has been converted to cash, which is available to satisfy the following claims and expenses as may be appropriate:

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Review Question

Claims and Expenses

Claims by Dart Corp. (one of Knox's suppliers) for computers ordered on April 6, 1988, and delivered on credit to Knox on April 10, 1988.	$20,000
Fee earned by the bankruptcy trustee	$15,000
Claim by Boyd for a deposit given to Knox on April 1, 1988, for a computer Boyd purchased for personal use but that had not yet been received by Boyd.	$ 1,500

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Review Question

Claim by Noll Co. for the delivery of stereos to Knox on credit. The stereos were delivered on March 4, 1988, and a financing statement was properly filed on March 5, 1988. These stereos were sold by the trustee with Noll's consent for $7,500 for their fair market value	$ 5,000
Fees earned by the attorneys for the bankruptcy estate	$ 10,000
Claims by unsecured general creditors	$ 1,000

Cash available for distribution **includes** proceeds from the sale of the stereos

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Bankruptcy – Distribution General Analysis

Noll - secured creditor - $5000

Trustee and lawyers - $25,000

Dart - interim creditor - $20,000

Consumer - $1,500

Unsecured - $1,000

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Bankruptcy Distribution: General Analysis

No wage claims

Boyd - consumer deposit

Unsecured creditors

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What amount will be distributed to the trustee as a fee if the cash available for distribution is $15,000?

a. $6,000
b. $9,000
c. $10,000
d. $15,000

$5,000 to Noll

$15,000/$25,000 X $10,000 for trustee or

$6,000 (Answer a)

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What amount will be distributed to Boyd if the cash available for distribution is $50,800?

a. $480
b. $800
c. $900
d. $1,500

$45,800-25,000=$20,800

$20,800-$20,000 (Dart)= $800 - Boyd

ANSWER:B

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What amount will be distributed to Dart if the cash available for distribution is $41,000?

a. $10,100
b. $11,000
c. $16,000
d. $20,000

$41,000-5,000=$36,000

$36,000-25,000=$11,000

Review Question

On July 15, 1988, White, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. White's nonexempt property has been converted to $13,000 cash, which is available to satisfy the following claims:

Unsecured claim for 1986 state income tax	$10,000
Fee owed to Best & Co., CPAs, for services rendered from April 1, 1988, through June 30, 1988	$ 6,000
Unsecured claim by Stieb for wages earned as an employee of White during March 1988	$ 3,000

There are no other claims.

Review Question

What is the maximum amount that will be distributed for the payment of the 1986 state income tax?

A. $ 4,000

B. $ 5,000

C. $ 7,000

D. $10,000

Review Question

In a voluntary bankruptcy proceeding under Chapter 7 of the federal Bankruptcy Code, which of the following claims incurred within 180 days prior to filing will be paid first?

A. Unsecured federal taxes

B. Utility bills up to $1,000

C. Voluntary contributions to employee benefit plans

D. Employee vacation and sick pay up to statutory amount per employee

Bankruptcy - Priorities

On April 15, 1992, Wren Corp., an appliance wholesaler, was petitioned involuntarily into bankruptcy under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code.

When the petition was filed, Wren's creditors included:

Secured Creditors	Amount Owed
Fifth Bank—1st mortgage on warehouse owned by Wren	$50,000
Hart Manufacturing Corp.—perfected purchase money security interest in inventory	30,000
TVN Computers, Inc.—perfected security interest in office computers	15,000

Bankruptcy - Priorities

Wren's creditors, continued:

Unsecured Creditors	Amount Owed
IRS—1990 federal income tax	$20,000
Acme Office Cleaners—service for January, February, and March 1992	750
Ted Smith (employee)—February and March 1992 wages	5450
Joan Sims (employee)—March 1992 commissions	1,500
Power Electric Co.—electricity charges for January, February, and March 1992	600
Soft Office Supplies—supplies purchased in 1991	2,000

Bankruptcy

The following transactions occurred before the bankruptcy petition was filed:

- On December 31, 1991, Wren paid off a $5,000 loan from Mary Lake, the sister of one of Wren's directors.
- On January 30, 1992, Wren donated $2,000 to Universal Charities.
- On February 1, 1992, Wren gave Young Finance Co. a security agreement covering Wren's office fixtures to secure a loan previously made by Young.
- On March 1, 1992, Wren made the final $1,000 monthly payment to Integral Appliance Corp. on a two-year note.
- On April 1, 1992, Wren purchased from Safety Co., a new burglar alarm system for its factory, for $5,000 cash.

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Bankruptcy

All of Wren's assets were liquidated. The warehouse was sold for $75,000, the computers were sold for $12,000, and the inventory was sold for $25,000. After paying the bankruptcy administration expenses of $8,000, secured creditors, and priority general creditors, there was enough cash to pay each nonpriority general creditor 50 cents on the dollar.

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Bankruptcy - Voidable Transfers

a. Items 61 through 65 represent the transactions that occurred before the filing of the bankruptcy petition. For each transaction, determine if the transaction would be set aside as a preferential transfer by the bankruptcy court. On the Objective Answer Sheet, blacken Y if the transaction would be set aside, or N if the transaction would not be set aside.

61. Payment to Mary Lake
62. Donation to Universal Charities
63. Security agreement to Young Finance Co.
64. Payment to Integral Appliance Corp.
65. Purchase from Safety Co.

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Bankruptcy

1. Yes - insider
2. No -Not wise but okay
3. Yes - not for contemporaneous exchange
4. No - regular payments
5. No - dumb purchase but not fraud

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Bankruptcy - Priorities

b. Items 66 through 70 represent creditor claims against the bankruptcy estate. Select from List I the order of each of the creditors named in items 66 to 70, and blacken the corresponding oval on the Objective Answer Sheet.

	List I
66. Bankruptcy administration expense	A. First
67. Acme Office Cleaners	B. Second
68. Fifth Bank	C. Third
69. IRS	D. Fourth
70. Joan Sims	E. Fifth

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ANSWERS

66. B
67. E
68. A
69. D
70. C

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Bankruptcy - Priorities

c. Items 71 through 75 also represent creditor claims against the bankruptcy estate. For each of the creditors listed in Items 71 to 75, select from List II the amount that each creditor will receive and blacken the corresponding oval on the Objective Answer Sheet.

	List II		
71. TVN Computers, Inc.	A. $0	F. $5,450	K. $15,000
72. Hart Manufacturing Corp.	B. $300	G. $4,850	L. $25,000
73. Ted Smith	C. $600	H. $5,100	M. $27,500
74. Power Electric Co.	D. $1,000	I. $12,000	N. $30,000
75. Soft Office Supplies	E. $1,200	J. $13,500	

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ANSWERS

TVN -computers sold for $12,000 plus 1/2 of remaining $3,000 for total of $13,500 or **J**

Hart Manufac. - inventory sold for $25,000 plus 1/2 of remaining $5000 for 27,500 or **M**

Ted Smith - note change on dollar amount priorities ($4700) or **H**

Power Electric - 1/2 of $600 or $300 or **B**

Soft Office Supplies - 1/2 of $2000 or $1000 or **D**

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Discharge and Reaffirmation Agreements

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Discharge and Reaffirmation Agreements

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How to Use the Text and Slides During the Bankruptcy Amount Changes

The text, slides, and videos provide both the 2016 and the 2019 sets of numbers so that you can study according to the exam you will be taking. When you see a number such as $600/$625, the lesser number $600 is the 2016-2019 number, and the greater number ($625) is the 2019-2022 number.

During this interim period, some of the questions in the lesson assessment and test bank may be outdated because amount changes do not take effect immediately on the exam. The amounts used in the questions may not reflect the same statutory amounts that will be in effect for the exam you will be taking. The questions will all be reconstructed once the 2019 changes take full effect for the exam, which will begin in October 2019.

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Bankruptcy—Nondischarge

Nondischargeable Debts

1. Taxes within three years of filing bankruptcy petition
2. Liability for obtaining money or property by false pretenses
3. Willful and malicious injuries
4. Debts incurred by driving DWI
5. Alimony, maintenance or child support
6. Unscheduled debts (unless actual notice)
7. Debts resulting from fraud as a fiduciary (embezzlement)

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Bankruptcy—Nondischarge

Nondischargeable Debts

8. Government fines or penalties imposed within three years prior
9. Educational loans due within five prior years (unless hardship)
10. Prior bankruptcy debts in which debtor waived discharge
11. Mortgage issues
12. Sarbanes-Oxley—Bonuses; fraud
13. Consumer debt incurred within 90 days of filing—$650/$725 permitted (luxury goods); cash withdrawals on credit cards within 70 days ($950/$1,000)

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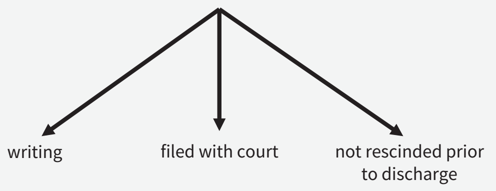
Bankruptcy—Nondischarge

14. Debts Under Reaffirmation agreements



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Bankruptcy—Discharge

Larson, an unemployed carpenter, filed for voluntary bankruptcy on August 14, 1990. Larson's liabilities are listed below.

Credit card charge due May 2, 1989: $3,000

Bank loan incurred June 1990: $5,000

Medical expenses incurred June 1983: $7,000

Alimony due during 1988: $1,000

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Bankruptcy—Discharge

Under the provisions of Chapter 7 of the federal Bankruptcy Code, Larson's discharge will not apply to the unpaid

A. Credit card charges.
B. Bank loan.
C. Medical expenses.
D. Alimony.

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Government Regulation of Business

Federal Securities Regulation

Defining a Security

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Defining a Security

Defining a Security

- The federal securities laws define *security* by example
- Common examples are: corporate stock, bonds, debentures, collateral trust certificates, puts, calls, straddles, options
- Catch-all categories include: investment contracts and **any interest or instrumentality commonly known as a security**

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Defining a Security

Elements of investment contract:

- Investment of money
- In a common enterprise
- With an expectation of profit
- To be earned primarily by the actions of others

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The Registration Process

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The Registration Process

Procedures

Issuer files a registration statement with the SEC and then waits 20 business days for the SEC to declare the registration statement effective:

- During the 20-day waiting period, the SEC theoretically reviews the registration statements

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Procedures

Three periods allow different activities; roughly:

1. Pre-filing: no offers and no sales
2. Waiting: oral offers and a few written offers, but no sales
3. Post-effective: offers and sales now okay

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Procedures

The primary written document allowed during the waiting period is the "red herring" prospectus, which is replaced by the final prospectus after the effective date.

Securities Offering Reform Package (SORP)

Shelf registration was enacted to allow the largest companies to file one registration statement to cover all shares it intended to issue during the next two years

In 2005, in the SORP, the SEC enacted "company registration" for very large firms and extended the two-year period to three years. Two primary things to remember are…

Securities Offering Reform Package (SORP)

WKSIs: The biggest companies are designated **W**ell-**K**nown **S**easoned **I**ssuers (WKSIs) and they can essentially offer their shares without regard to the rules mentioned before because the market is always well informed about them

Securities Offering Reform Package (SORP)

FWPs: WKSIs can freely use supplemental written literature called **F**ree **W**riting **P**rospectuses (FWPs) if they file them with the SEC

- Other issuers can also use FWPs under proper circumstances and at proper times

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Exempt Transactions and Securities

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Exempt Transactions and Securities

Exempt Securities Examples

Government Securities

- Ex. Municipal bonds

Bank and Saving & Loan Securities

Short-term notes (<9 months)

Non-profits' securities

Insurance and Annuity Policies

- However, the stock issued by insurance companies is not exempt.

Securities issues by Receivers or Trustees in Bankruptcy (with court approval)

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Exempt Transactions

The registration process is costly, time-consuming, and liability-laden, so naturally firms would like to avoid it.

In exchange for granting exemption from registration, the law usually restricts:

1. The amount that can be raised.
2. The methods by which offerings can occur.
3. The investors to whom securities may be marketed.

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Three Major Categories of Exempt Transactions

1. Small Offering Exemptions
   - Rule 504
   - Reg A
   - Crowdfunding
2. Private Placement Exemptions
   - Rule 506
3. Intrastate Offering Exemptions
   - Rule 147
   - Rule 147A

Three Key Concepts of Exempt Transactions

1. Accredited Investors (who can protect themselves without SEC help)
2. General Solicitation

   To avoid having a large-scale communication deemed a general solicitation, you need a *preexisting relationship* with the offerees.

3. Integration

   The law prohibits issuers from artificially separating one offering into two purported offerings for purposes of qualifying for an exemption.

Rule 504

Origin?

Small-offering exemption [Sec. 3(b) & Reg D]

Who can use?

Not blank check companies, investment companies, or "bad actors"

How much?

$5m in 12 months

General solicitation?

Only if one of the three criteria indicating adequate state protection applies

Rule 504 (continued)

Purchaser qualifications?

None

Information to investors?

None required

Filings with the SEC?

Form D

Resale restrictions?

None, if one of three state protection criteria applies

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Rule 504 (continued)

Integration?

Yes, but several major exceptions

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Reg A

Origin?

Small offering exemption [Sec. 3(b)] and known as the "mini-IPO"

Who can use?

Not reporting companies, investment companies, non-Canadian foreign companies, or bad actors

How much?

Tier 1: $20m/12/mo.

Tier 2: $50m/12mo.

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Reg A (continued)

General solicitation?

OK, and can "test the waters"

Purchaser qualifications?

Tier 1: None

Tier 2: Has cap on amount nonaccredited investors can buy

Reg A (continued)

Information to investors?

Offering circular with basic info about the company

Also 2 years balance sheets and income statements

Tier 2 F/S must be audited, but not Tier 1.

Filings with SEC?

Form 1-A (short-form registration form) and test-the-waters documents

Resale restrictions?

No

Reg A (continued)

Integration?

Yes, but many exceptions apply

Crowdfunding

Origin?

Small offering exemption [JOBS Act & Sec. 4(a)(6)]

How much?

$1m/12months

General solicitation?

Yes, but must sell thru intermediary

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Crowdfunding (continued)

Purchaser qualifications?

No, but strong limitations on how much a person can invest in crowdfunding in single year.

Resale restrictions?

Must hold for a year, unless selling to issuer, family, AIs, and a few others

Filings with SEC?

Investor disclosures must be filed with SEC, and reports as 50% and 100% of targets are collected.

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Rule 506

Origin?

Private placement exemption [Sec. 4(a)(2) & Reg D]

Who can use?

All but bad actors

How much?

Unlimited

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Rule 506 (continued)

General solicitation?

506(b): No

506(c): Yes, but with purchaser limitations

Purchaser qualifications?

506(b): can sell to unlimited # of AIs and up to 35 non-AIs, but they must all be "sophisticated" or acting thru Purchaser Reps (PRs)

596(c): can sell only to AIs or investors acting thru PRs

Rule 506 (continued)

Information to investors?

506(b): Basic financial information; the more money raised, the more disclosure

506(c): None

Filings with SEC?

Form D

Resale restrictions?

Can't sell for 6 months

Rule 506 (continued)

Integration?

Yes, but there are exceptions

Rule 147

Origin?

An Intrastate offering exemption [Sec. 3(a)(11)]

Who can use?

No investment companies

Others must be:

- Residents (incorporated and principal place of business), and
- Doing business (meeting any 1 of 4 tests)

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Rule 147 (continued)

How much?

Unlimited

General solicitation?

No; any offer to nonresident disqualifies

Purchaser qualifications?

Can offer and sell only to residents (reasonably believed)

Information to investors?

None

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Rule 147 (continued)

Filings with SEC?

None

Resale restrictions?

Can't sell to non-resident for 6 months

Integration?

Yes, but many exceptions

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Rule 147A

Origin?

Intrastate offering exemption [not 3(a)(11)]

Who can use?

No investment companies

Others must be:

- Residents (principal place of business), and
- Doing business (meeting any 1 of 4 tests)

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Rule 147A (continued)

How much?

Unlimited

General solicitation?

OK, but ads should indicate that sales will be made only to residents.

Purchaser qualifications?

Must be state residents (reasonably believed)

Information to investors?

None

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Rule 147A (continued)

Filings with SEC?

None

Resale restrictions?

Must wait 6 months to sell to non-resident

Integration?

Yes, but many exceptions apply

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Emerging Growth Companies (JOBS Act)

Provides an "IPO on-ramp" by delaying full regulation of companies going public for up to 5 years if they declare themselves to be EGCs.

Who can use?

Companies (even foreign) that:

- Have less than $1 billion in annual gross revenues during their most recently completed fiscal year.
- Have been publicly traded for less than five years.
- Have a public float of less than $700 million.
- Have not issued $1 billion in non-convertible debt in the prior three-year period.

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Benefits for EGCs

- Must include only 2 (instead of 3) years of audited F/S in IPO registration statement
- Reduced disclosure and other requirements regarding executives' compensation
- Right to submit to the SEC a draft registration statement for confidential review prior to a public filing

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Benefits for EGCs (continued)

Exempt for up to five years from complying with:

- Sec. 404(b) of SOX regarding auditor attestation report regarding the issuer's internal controls over financial reporting (still need SOX 404(a) certification by CEO and CFO)
- New PCAOB rules

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Liability Provisions—1933 Act

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Liability Provisions–1933 Act

Introduction

There are three key liability provisions under the 1933 Act:

1. Sec. 11
2. Sec. 12(a)(1)
3. Sec. 12(a)(2)

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Section 11

Essence: Section 11 remedies false statements or omissions in a registration statement as of the effective date

What a plaintiff must prove to win:

1. A false statement or omission in the RS on the effective date
2. Materiality
3. Tracing
4. Damages

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Section 11

Potential defendants:

1. The issuer
2. Officers and Directors
3. Underwriters
4. Experts

Defenses include:

1. Due diligence
2. Alternate causation
3. Statute of limitations

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Section 12(a)(1)

Essence: remedies violation of Section 5's registration provisions:

1. Sale of unregistered securities
2. Failure to deliver prospectus
3. Use of inadequate prospectus
4. Offer before RS is filed

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Section 12(a)(1)

What plaintiffs must show to win:

1. D violated Section 5
2. D was a seller
3. P lost money

Defenses:

1. Statute of limitations

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Section 12(a)(2)

Essence: remedies false statements and omissions in oral statements and in free writing

What a plaintiff must prove to win:

1. False statements or omissions
2. Materiality
3. D is a seller
4. Tracing
5. Damages

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Section 12(a)(2)

Defenses:

1. Due diligence
2. Alternative loss causation
3. Statute of limitations

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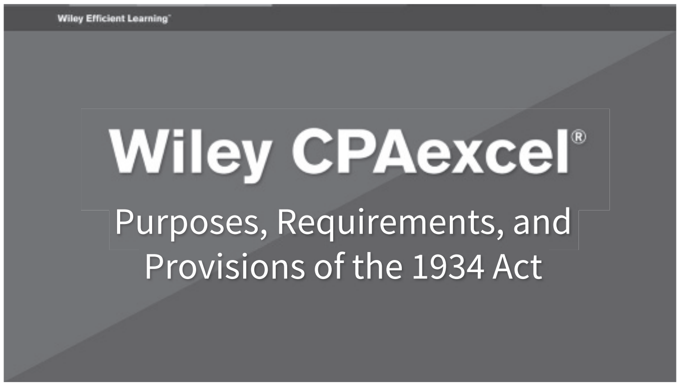
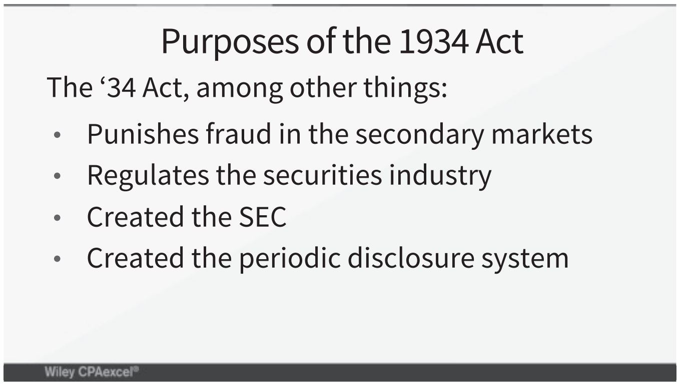
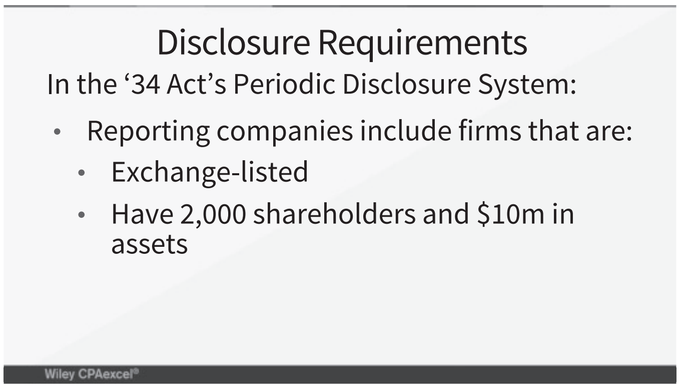
Purposes, Requirements, and Provisions of the 1934 Act







Disclosure Requirements

Must file:

- Form 10 (when they become reporting companies)
- Form 10-K (annually)
- Form 10-Q (quarterly)
- Form 8-K (between quarters if important developments occur)

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Key Provisions

There are two key provisions:

1. Section 10(b)
2. Section 18(a)

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Section 10(b)

Section 10(b) is the most significant securities law provision in the world

It punishes fraudulent statements and omissions in the purchase or sale of securities in virtually every setting:

- Public company or private company
- Primary market or secondary market
- Broad range of defendants, including accountants

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Section 10(b)

What a plaintiff must prove to win a 10(b) case:

- False statement or omission
- Materiality
- Reliance
- Causation
- Purchase or Sale
- Damages

Defenses:

- Statute of Limitations

Section 18(a) Provides:

“Any person who shall make or cause to be made any statement in any application, report, or **document filed** pursuant to [this Act], which statement was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, **in reliance upon such statement**, …

Section 18(a) Provides:

… shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, **unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.**”

Section 18(a)

Courts hold that plaintiffs establish a prima facie case for recovery by showing:

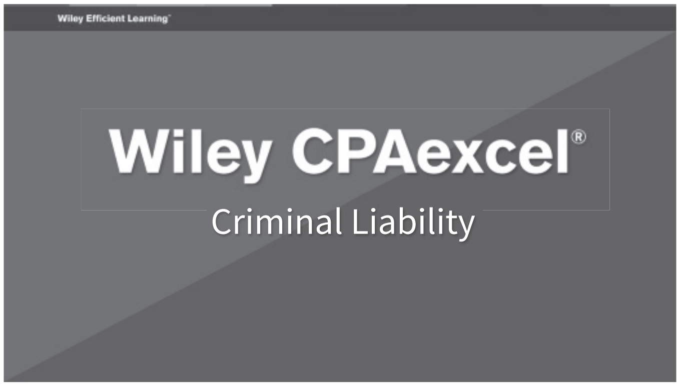
- Defendant made or caused to be made a false or misleading statement or omission
- In a filed document
- Materiality
- Plaintiff's purchase or sale of securities
- Plaintiff's "eyeball" reliance
- Causation
- Damages

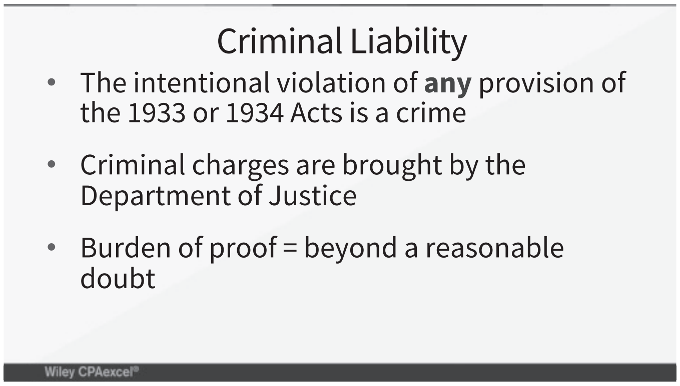
Section 18(a)

Defenses:

- D acted in good faith and without knowledge that the statement was false or misleading
- Statute of limitations (1-year/3-year)

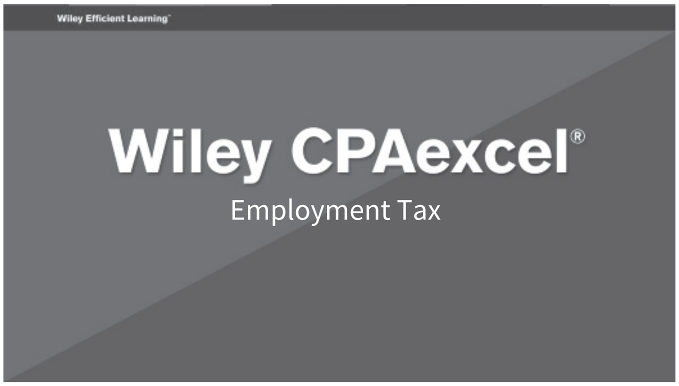
Criminal Liability

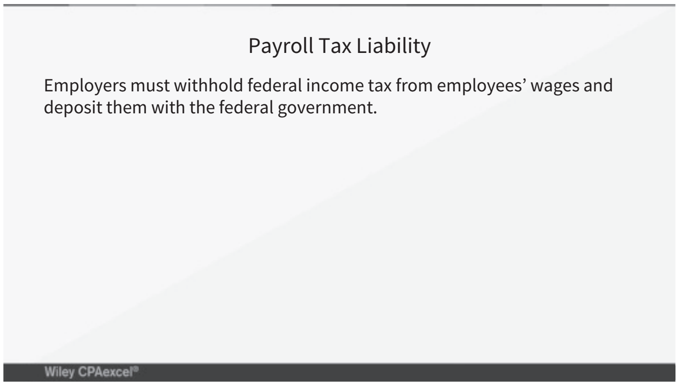


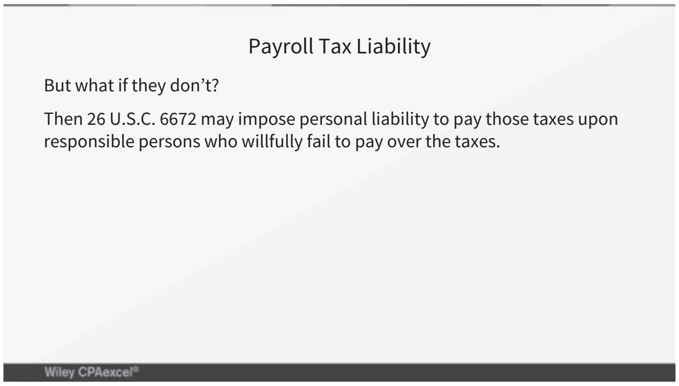


Other Federal Laws and Regulations

Employment Tax







Responsible Persons

Who is a "responsible person"?

One who was required to "collect, truthfully account for, and pay over" the tax.

Key question: Did the person have the discretion to decide which, when, and in what order debts or taxes would be paid?

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Responsible Persons

Accountants have been held to be "responsible persons" when they:

- Cosigned corporate employer's checks as representative of third parties
- Exercised a third party's authority to choose which creditors the corporation should pay.

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Responsible Persons

Accountants have been held not to be "responsible persons" when they:

- Were bookkeepers who did not manage day-to-day affairs of the firm *or*
- Had formal check-writing authority, but wrote checks only as directed by superiors.

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Responsible Persons

What is a “willful” failure to pay?

It does not require any desire to defraud the government, only that the person spent money in other ways while aware of the tax liability.

Federal Insurance Contributions Act (FICA)

Social Security Act

Purpose: To provide partial replacement of earnings when worker retires

Fully insured workers who contributed for at least 40 quarters (10 years) are entitled to full benefits.

Currently insured workers have not, but still qualify for some benefits.

Medicare

Purpose: provide a health care safety net for retired individuals.

Covers:

- Portion of medical costs of those 65 and older
- Some benefits for younger disabled workers

Social Security and Medicare

How do we pay for Social Security and Medicare?

FICA payroll taxes are imposed upon:

Employers

- Pay half and withhold other half from employee's salary

Employees

Note: FICA taxes do not pay for Medicaid.

FICA Tax

How much is the FICA tax in 2016?

Social Security = 6.2% from both employer and employee on first $118,500 of wages.

Medicare = 1.45% from both employer and employee on all wages.

So, 7.65% from each for a total of 15.3%.

Additional Medicare Tax (AMT)

What is the AMT?

The Affordable Care Act imposes a 0.9% Additional Medicare Tax (AMT) on wages and self-employment income above a certain amount (e.g., $200,000 for a single taxpayer, $250,000 for joint filers, and $125,000 for a married taxpayer filing separately). Employers are required to withhold this extra amount from employees' paychecks, but need not match it.

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Additional Medicare Tax (AMT)

How does the AMT work?

Bev works for XYZ Co., makes $350,000, and is a single filer. For the first $200,000 of this income, both XYZ and Bev must contribute a 1.45% Medicare tax. For the next $150,000, XYZ's tax remains the same, but Bev's is raised to 2.35%. XYZ must still withhold and pay over this amount.

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FICA

What sorts of income do FICA taxes apply to?

Only to wages, such as:

- Salary
- Commissions
- Bonuses
- Fringe benefits

Not to:

- Reimbursement for expenses
- Interest income

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Self-Employed Contributions Act (SECA)

The self-employed pay FICA taxes on their own self-employed taxable earnings:

- Pay as employer and as employee (15.3%)
- Only on active income
- Can deduct the share they pay as employer

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Affordable Care Act

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Affordable Care Act

Affordable Care Act (ACA)

Goal: Increase quantity and quality of medical care care coverage for Americans

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Affordable Care Act (ACA)

ACA Features

Coverage of preexisting conditions

No dropping of coverage because of illness

Eliminating gender and other discrimination

Extending coverage for adult children

Minimizing out-of-pocket expenses

Eliminating annual and lifetime limits for "essential health benefits"

Medicaid expansion

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Employer Mandate

What is the employer mandate?

The requirement that certain companies must either:

- Provide 95% of their full-time employees and dependents with "minimum essential coverage," *or*
- Pay a tax penalty (the "employer shared responsibility fee").

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Employer Mandate

Who must comply with the employer mandate?

"Applicable Large Employers" (ALEs), which are companies with at least 50 full-time equivalent employees (FTEs).

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Employer Mandate

How does a firm calculate FTEs?

Actual full-time employees + Full-time equivalent employees = FTEs

- Full-time employees = those working at least 30 hours/week
- Part-time (working less than 30 hours a week more than 120 days a year) employees' total # of hours worked in a week ÷ 30 = FTE

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Example

ABC Co. has 40 employees who work an average of at least 30 hours a week.

ABC Co. has 40 employees who work an average of 20 hours a week.

Actual Full-time employees =

FTE employees =

Employer Mandate

What is "minimum essential coverage"?

With few exceptions: a group plan

Affordable: must cost less than 9.5% of the employee's income

"Minimum value": employer covers at least 60% of the cost

Coverage must be equivalent of the Marketplace's Bronze benefit package.

Employer Mandate

What triggers the employer mandate penalty?

At least one employee does not receive qualifying coverage, shops on the ACA Health Insurance Exchange Marketplace, and is eligible for a federal premium subsidy.

Employer Mandate

How much is the employer mandate penalty?

If the employer did not offer coverage to workers as required, the penalty in 2016 was a flat $2,000 per full-time employee (excluding the first 30 employees).

If only a few workers were not covered, or if that coverage did not meet minimum value standards, the fine in 2016 was $3,000 per full-time employee who received cost assistance (but never more than $2,000 per full-time employee minus the first 30).

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Example

ABC Co. has 100 employees, 50 of whom work at least 30 hours per week. ABC does not offer health insurance coverage to any of its employees. At least one of ABC's full-time employees buys coverage on the ACA Marketplace and qualifies for federal support.

ABC would owe:

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Example

ABC has 200 employees, 100 of whom work at least 30 hours per week. ABC offers health insurance coverage to all its employees. Under ABC's plan, 20 full-time employees are asked to pay more than 9.5% of their income for coverage. All 20 go to the ACA Marketplace and qualify for federal subsidies.

ABC owes the lesser of:

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IRS Example

Jim is unmarried with no dependents and an income of $40,000 and has not purchased minimum essential coverage.

The maximum per-person fee is $695 in 2016.

Calculating percentage of income, $40,000 minus $10,150 (the tax filing threshold for individuals) leaves $29,850. When that number is multiplied by 2.5%, it yields $746.25. According to the IRS, the annual national average premium for a Bronze plan was $2,448. Because Jim's percentage-of-income fee is less than the national average, the latter does not apply.

Jim's percentage-of-income calculation, $746.25, is greater than $695, so that is his fee.

Affordable Care Act (ACA)

Nearly 90% of individuals who have purchased policies through the Healthcare Insurance Exchange Marketplace have qualified for federal subsidies. How is the ACA paying for this?

Affordable Care Act (ACA)

The ACA pays through:

- Employers' shared responsibility fees
- Individuals' shared responsibility fees
- Reduced medical care expense tax deductions
- Medical device excise tax of 2.3%
- The Cadillac tax (2020)
- The 0.9% Additional Medicare Tax (AMT)
- 3.8% Medicare surtax on net investment income (NII)

Affordable Care Act (ACA)

What is the AMT?

The ACA imposes a 0.9% Additional Medicare Tax (AMT) on wages and self-employment income above a certain amount

e.g., $200,000 for a single taxpayer,
$250,000 for joint filers, and
$125,000 for a married taxpayer filing separately

Employers are required to withhold this extra amount from employees' pay checks, paychecks but need not match it.

Affordable Care Act (ACA)

How is the AMT paid?

Sal works for ABC Co., makes $300,000 and is a single filer. For the first $200,000 of this income, both ABC and Sal must contribute a 1.45% Medicare tax. For the next $100,000, ABC's tax remains the same but Sal's is raised to 2.35%. ABC must still withhold and pay over this amount, but ABC need not match that last 0.9%.

Affordable Care Act (ACA)

What is the Medicare surtax on net investment income (NII)?

It is a 3.8% surtax on net investment income (NII) of certain estates and trusts and upon individuals making at least (in 2016):

- $200,000 for a single taxpayer
- $250,000 for joint filers
- $125,000 for a married taxpayer filing separately

Affordable Care Act (ACA)

What is "investment income" for the NII?

Yes:

- Capital gains
- Dividends from stocks
- Interest from bonds or loans
- Royalties
- Gains from the sale of investment real estate
- Rents

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Affordable Care Act (ACA)

What is "investment income" for the NII?

No:

- Wages
- Active trade or business income
- Social Security benefits
- Unemployment compensation
- Life insurance proceeds

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Affordable Care Act (ACA)

How is the Medicare surtax on NII calculated?

The taxable amount subject to the 3.8% surcharge is the lesser of:

- Net investment income *or*
- The excess of AGI over the AGI threshold.

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Example

Mary is a single filer with active income of $170,000 and net investment income (NII) of $100,000.

Her NII is, obviously, $100,000.

Her total income is $270,000, which exceeds the threshold for single filers by $70,000.

The 3.8% tax should be paid on:

Worker Classification Laws and Regulations

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Worker Classification Laws and Regulations

Worker Classification

Workers can be classified as either:

Employees, *or*

Independent contractors.

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Common Law Employee

If Sally is a common law employee:

Employer:

- Must withhold income tax and her portion of FICA (Social Security and Medicare) taxes.
- Is responsible for paying FICA and FUTA taxes on Sally's wages.
- Must give Sally a Form W-2, showing taxes withheld.

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Independent Contractor

If Sally is an independent contractor:

Her principal:

- May be required to give Sally a Form 1099-Misc (Miscellaneous Income) to report what it has paid to her.

Sally:

- Is responsible for paying her own income tax and self-employment (SE) tax (covering Social Security and Medicare).
- May need to make estimated tax payments during the year to cover her tax liabilities.
- May deduct business expenses on Schedule C of her tax return.

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Independent Contractor

Why would a principal be tempted to label an employee as an independent contractor?

- Not liable to withhold and pay over worker's income tax.
- Not liable to pay FUTA taxes.
- Not liable to pay its share and to withhold and pay over worker's share of FICA taxes.
- Not liable to pay overtime and minimum wages (FLSA).
- Not liable for employee discrimination under the Civil Rights Act of 1964.
- Not liable for failure to provide leave and reinstatement under the Family Medical Leave Act (FMLA).
- Less likely to be liable to third parties for injuries caused by for worker's torts.

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Employees vs. Independent Contractors

Many courts use an overarching "control test," asking whether the principal controlled the method and manner of the work.

- If so, the worker is an employee.
- If not, the worker is an independent contractor.

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Common Law "Control Test"

This common law "control test" is typically supplemented by many additional factors, such as whether or not the worker:

- Is generally on the job 40 hours a week;
- Works primarily for this principal;
- Uses the principal's tools; *and*
- Earns most of his or her income from this principal.

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Common Law "Control Test"

The IRS uses an 11-part version of the common law test that looks at:

- Two behavioral control factors,
- Five financial control factors, *and*
- Four relationship factors.

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Behavioral Control

Instructions

The more instructions given as to when and where to work, what tools or equipment to use, what assistants to hire, where to purchase supplies, what sequence to follow, etc., the more likely that control is being exercised and the worker is an employee.

Training

Independent contractors typically use their own methods. If they are trained in the principal's methods, workers are more likely to be employees.

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Financial Control

Unreimbursed Business Expenses

Principals usually reimburse an employee's business expenses, but not an independent contractor's.

Worker's Investment

Independent contractors usually have a significant investment in the tools or facilities they use; not so employees.

Availability to Market

Independent contractors often advertise and in other ways seek to provide services to others in the marketplace.

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Financial Control

Form of Payment

Employees are typically paid by the hour, week, or year. Independent contractors are more often paid a flat fee for the particular job.

Worker Profit or Loss

Independent contractors typically have a chance to make a profit (or loss) from a job. Employees generally do not.

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Type of Relationship

Written Contracts

If the parties have a written contract labeling the worker, this may be indicative in a close case, but will be ignored if the characterization is clearly inconsistent with other factors because substance is more important than form.

Benefits

Independent contractors tend to provide their own medical plan, disability insurance, pension plan, and related benefits. If the business provides these to the worker, the worker is more likely an employee.

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Type of Relationship

Permanency

Independent contractors are typically hired to complete a particular task. The longer a relationship lasts or is envisioned to last, the more likely it is an employer-employee relationship.

Regular Business of Company

If the worker provides services that are an integral part of the company's business, that worker is more likely an employee. If the services provided are more of a one-off for the company, that worker is more likely an independent contractor.

Penalties for Innocent Misclassification

- A $50 fine for each Form W-2 that should have been filed
- Penalties of 1.5% of wages for income taxes that were not withheld, plus 40% of the FICA taxes that should have been withheld from the employee and 100% of the employer's matching FICA contribution
- A 0.5% penalty on the unpaid tax liability for each month up to 25% of the total tax liability

Penalties for Intentional or Fraudulent Misclassification

- 20% of all wages paid
- 100% of both the employer's and the employees' FICA taxes
- Criminal penalties of up to $1,000 per misclassified worker and 1 year in jail also possibility.

"Reasonable Basis" Safe Harbor Defense

The classification is consistent with industry practice.

A previous IRS or court ruling found the workers to not be employees.

An IRS ruling or opinion letter supports the classification.

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Statutory Employees and Non-Employees

Sometimes the law treats employees as non-employees and non-employees as employees, ignoring these tests, so be sure to check out the materials on:

- Statutory employees *and*
- Statutory non-employees.

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Business Structure

Selection and Formation of Business Entity and Related Operation and Termination

Selection of a Business Entity

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Selection of a Business Entity

Introduction

There are numerous ways to organize a business enterprise.

Forms are often chosen because they minimize taxation or liability of the owners, or both.

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Sole Proprietorship

A single-owner business: the firm's assets and liabilities belong solely to its owner.

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General Partnership

An association of two or more persons to carry on as co-owners a business for profit

Profits are allocated and taxable directly to the partners.

The partnership is a legal entity for most purposes.

Joint Venture

A one-shot general partnership-type relationship

Governed by general partnership law, so any distinction between the two is generally unimportant for legal purposes

Limited Partnership

A partnership with at least one general partner and at least one limited partner

Limited partners give up certain of the general management rights that partners in a general partnership have in exchange for limited liability.

A limited partnership must have at least one general partner who will be generally liable for the firm's obligations.

Limited Liability Partnership (LLP)

Carries greater protection from liability than either general or limited partnerships

Created primarily to protect professionals from undue malpractice liability arising from errors of their partners

Limited Liability Partnership (LLP)

Liable only for:

1. Their own malpractice
2. The malpractice of those they directly supervise
   - Most states also protect partners from personal liability for LLP contractual obligations
   - Must carry minimum levels of malpractice insurance

Limited Liability Limited Partnership (LLLP)

Allows the general partner(s) of a limited partnership to enjoy limited liability, just like limited partners

Third-parties must protect themselves contractually.

LPs may become LLLPs merely by including a one-line statement to that effect in their certificate of limited partnership.

Limited Liability Limited Partnership (LLLP)

Both GPs and LPs will remain liable for the consequences of torts that they personally commit while carrying out partnership business.

Authorized in only 20 states or so

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Corporation

An artificial legal entity whose owners (shareholders) typically enjoy limited liability

Creation of the notion of an artificial legal entity in order to encourage people to invest in others' business ideas is one of the great advances in Western legal thought

On the other hand: Double taxation

By intelligent tax planning one may minimize the impact of double taxation.

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Subchapter S corporation

Can eliminate the double taxation that most corporations (called Subchapter C corporations) face by meeting certain requirements of Subchapter S of the Internal Revenue Code, including:

- No more than 100 shareholders
- Unanimous election
- Only certain types of shareholders

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Limited Liability Company (LLC)

Allows owners of businesses to gain the liability-limiting advantages of the corporate form while enjoying the single, pass-through tax benefits of the partnership form of business

Can operate like a general partnership (member-managed) or like a corporation (manager-managed)

Virtually all states allow single-member LLCs

Most popular form today

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Limited Liability Company (LLC)

Generally, LLCs will be the best form for most small businesses, LLPs for professional firms such as accounting firms and law firms, and corporations for very large entities, such as IBM or General Motors.

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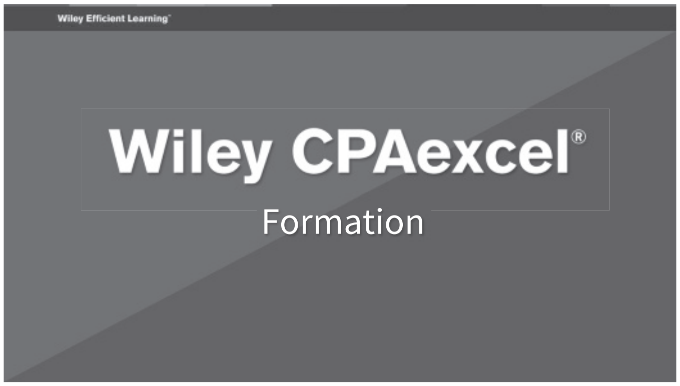
Formation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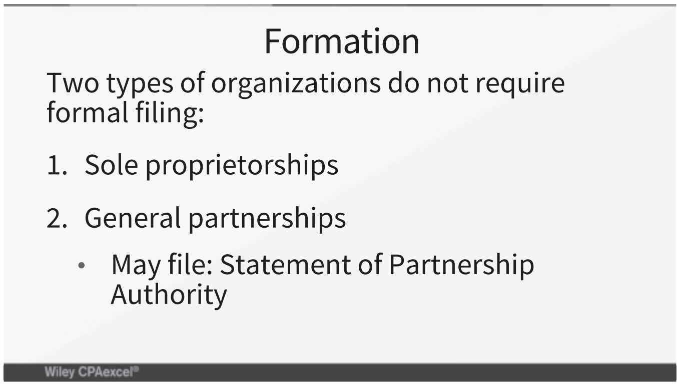
Formation


Formation
Two types of organizations do not require formal filing:
1. Sole proprietorships
2. General partnerships
• May file: Statement of Partnership Authority
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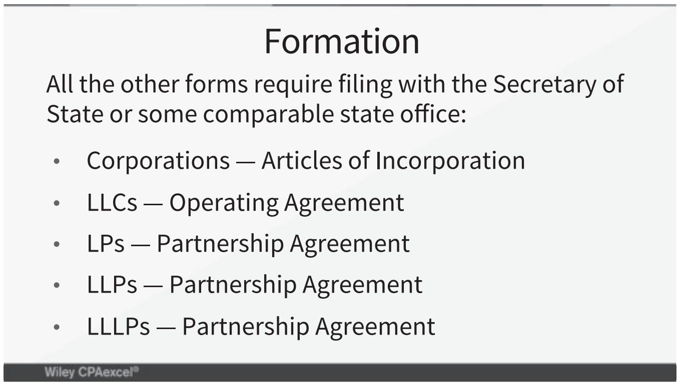
Formation
All the other forms require filing with the Secretary of State or some comparable state office:
• Corporations — Articles of Incorporation
• LLCs — Operating Agreement
• LPs — Partnership Agreement
• LLPs — Partnership Agreement
• LLLPs — Partnership Agreement
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Formation

Articles of Incorporation must include:

- Name (indicating corp. status: Corp., Inc., etc.)
- Number of authorized shares
- Address of registered office
- Name of registered agent at that office
- Names and addresses of incorporators

Basic Steps in Organizing a Corporation

1. Execute articles of incorporation and file with Sec. of State
2. Hold organizational meeting
   - Elect board of directors
   - Adopt promoters' contracts

Promoters and Liability

Definition: A person who takes the initiative in founding and organizing a corporation

Owes fiduciary duties to:

- The proposed corporation
- Other promoters
- Contemplated investors

Promoters and Liability

May profit in contracts with corporation, if:

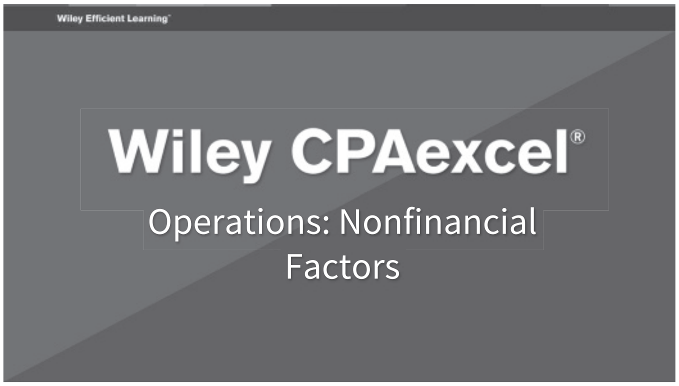
- Approval from a fully informed board
- Approval from fully informed original shareholders

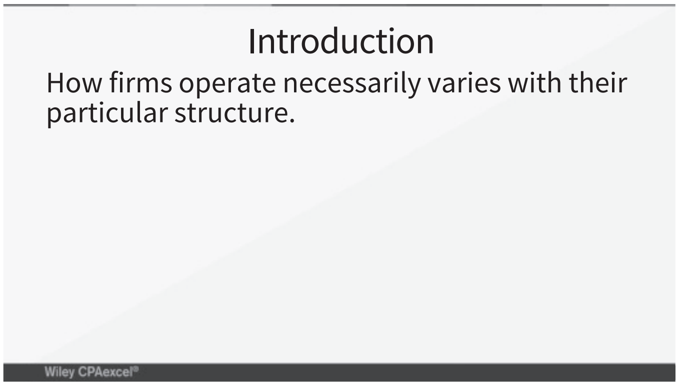
Promoters and Liability

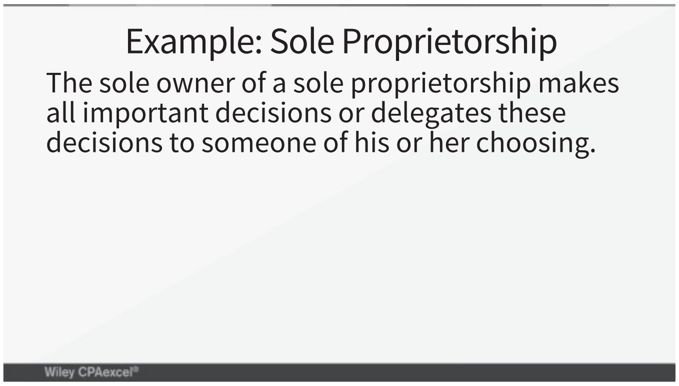
Firm is liable on promoters' contracts if board adopts them (expressly or impliedly).

These corporate rules are being applied to LLCs and LLPs that face similar situations.

Operations: Nonfinancial Factors







Example: GP and LLP

Absent agreement to the contrary, all partners have equal rights in the management and conduct of business affairs.

Absent agreement to the contrary, majority vote governs all ordinary course-of-business matters.

Example: GP and LLP

However, unanimity is needed to take actions contrary to the partnership agreement or to take action regarding **extraordinary matters**, which might include such actions as:

1. Admitting a new partner to the partnership
2. Assigning partnership property
3. Disposing of goodwill
4. Doing any other act which would make it impossible to carry on the ordinary business of the partnership

Example: LLP

An LLP is essentially a general partnership carrying limited liability.

LLPs are sometimes called limited liability general partnerships, and operate much as general partnerships.

Example: LP and LLLP

In these two forms of limited partnerships, one or more general partners make management decisions while limited partners generally sit on the sidelines playing the role of passive investors.

If limited partners in LPs (not LLLPs) leave the sidelines and become actively involved in control of the limited partnership, they may forfeit their limited liability as to creditors who rely upon their apparent role as general partners.

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Example: LLC

LLCs can operate in one of two ways:

1. **Owner-managed**: LLC members may choose to run the business themselves, as if they were general partners (enjoying limited liability).
2. **Manager-managed**: LLC members may choose, on the other hand, to delegate managerial powers to one or more members or non-members.

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Example: Corporation

General operations:

1. Shareholders elect directors.
2. Directors select officers.
3. Officers run things day-to-day.

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Piercing the Corporate Veil

Because corporations are distinct legal entities, their obligations are typically not visited upon their shareholders personally.

However, when small, closely-held corporations are involved, it is possible that courts might "pierce the corporate veil" and reach into shareholders' pockets to satisfy corporate obligations

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Piercing the Corporate Veil

Courts will not pierce the corporate veil of public corporations

Key reason to pierce: "to prevent the corporate form from being used to defeat public convenience, justify wrong, protect fraud, or defend crime"

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Piercing the Corporate Veil

The following considerations (usually in combination) may induce a court to pierce the corporate veil:

- Commingling of funds and other assets of the corporation with those of individual shareholders
- Diversion of the corporation's funds or assets to the personal use of shareholders
- Failure to maintain the necessary corporate formalities
- Failure to adequately capitalize the corporation for the reasonably foreseeable risks of the enterprise

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Piercing the Corporate Veil

Courts tend to apply comparable factors in deciding whether to pierce LLCs and LLPs.

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Financial Structure

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Financial Structure

Introduction

All the partnership forms (GPs, LPs, LLP, LLLPs) automatically allocate income to partners or members and can elect single (pass-through) taxation, so the more complicated financial issues tend to relate to corporations.

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Partnership Financial Matters

Capital Accounts — Under RUPA, each partner is deemed to have an account that is:

1. Credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership, and the partner's share of the partnership profits

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Partnership Financial Matters

Contribution
+ Share of Profits
– Liabilities

= Account Balance

Partnership Financial Matters

2. Account is charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of partnership losses.

Account Balance Reduced by Distributions
+
Share of Losses

Partnership Financial Matters

Partners are to be reimbursed for:

1. Payments made and indemnified for liabilities incurred in the ordinary course of the partnership business
2. Advances to the partnership made beyond agreed capital contributions

As noted elsewhere, absent agreement to the contrary, partners share profits and losses equally.

Corporate Financial Structure

Issuing Shares: Corporate shares should not be issued unless two tests are met:

1. **Quality tests**: shares can be issued in exchange for cash, promissory notes, or any other items of tangible or intangible value to the corporation
2. **Quantity tests**: must be issued for at least par (face value) or amount authorized by board

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Corporate Financial Structure

If shares are issued for less than amount authorized, then the following may be liable to creditors and other shareholders:

1. Directors who allowed the sale
2. Buyers who paid too little
3. Transferees of original buyer who both know that he paid too little and who pay too little themselves

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Corporate Financial Structure

Dividends and other distributions

1. Authorized by Board of Directors
2. Must:
   - Be consistent with shareholders' rights
   - Not render corp. unable to meet its bills as they come due (bankruptcy insolvency)
   - Not leave corp. with fewer assets than liabilities (equity insolvency)

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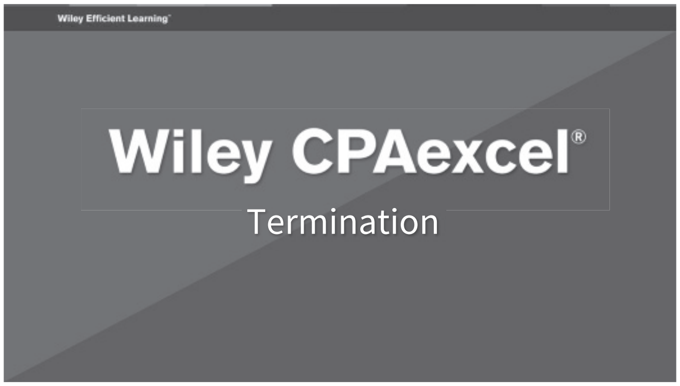
LLC Financial Structure

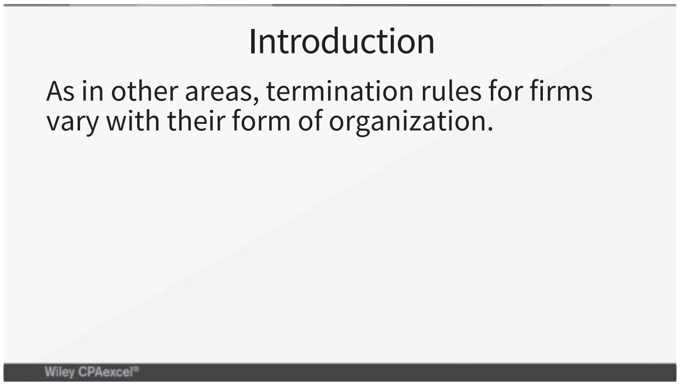
The key LLC financial provisions tend to reflect comparable corporate (or, occasionally, partnership) provisions.

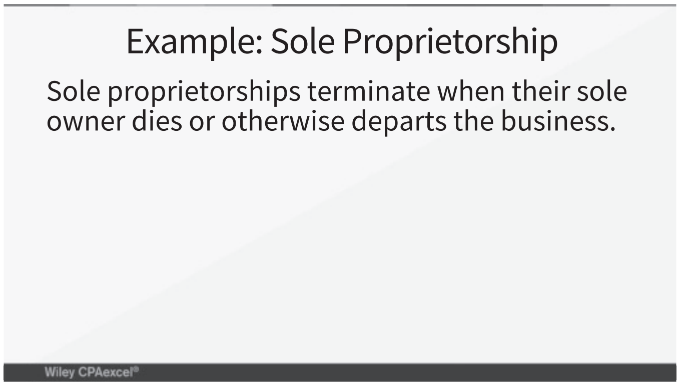
Contributions to an LLC, as with a corporation or partnership, may be made in cash, property or services.

Like corporations, LLCs may not make distributions to members if after doing so the firm would be insolvent.

Termination







Example: Partnership

Detailed rules are set out in RUPA regarding termination of general partnerships. Practices regarding LPs, LLPs, LLLPs, and even LLCs are quite similar.

Under RUPA, addition or subtraction of partners does not automatically lead to dissolution of the partnership (as was formerly the case).

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Example: Partnership

Rather, causes of dissociation of a partner from the partnership include:

1. Notice of a partner's express will to dissolve the partnership
2. Death of a partner
3. Bankruptcy of a partner
4. Expulsion of a partner

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Example: Partnership

After a partner dissociates, one of two things must happen. Either:

1. The partnership dissolves and is wound up;
2. The departing partner is bought out

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Example: Partnership

Buy-out formula:

Value of account on day of dissociation* – Damages caused (if dissociation was wrongful)

* Valued by greater of liquidation value or going-concern value

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Example: Partnership

Waiting Period: 90-day "cooling off" period between dissociation and liquidation

Priorities in winding up the partnership business

1. Creditors (including partners) are paid first.
2. If there's not enough money to pay creditors, partners will have to contribute
3. If funds are left over after paying creditors, then the partnership shall make a distribution to partners

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Example: Corporation

Corporations may be voluntarily dissolved upon approval of their directors and shareholders.

Typically, a majority of directors vote to propose dissolution and a majority of shareholders vote to approve the proposal

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Example: Corporation

Corporations may be involuntarily dissolved administratively by the Secretary of State for such reasons as:

- Failure to pay franchise taxes
- Failure to file annual reports
- Failure to properly establish and maintain a registered agent or office

Example: Corporation

Corporations may be involuntarily dissolved judicially in:

1. An action by the attorney general, where:
   - The corporation fraudulently obtained approval for its articles of incorporation.
   - The corporation has abused its legal authority.

Example: Corporation

Corporations may be involuntarily dissolved judicially in:

2. An action by shareholders:
   - If management is deadlocked
   - If those controlling the corporation are acting in an illegal or oppressive way, such as by looting the corporation or wasting its assets
   - If the shareholders are deadlocked and cannot elect directors

Example: Corporation

An action by creditors if a judgment creditor's claim is unsatisfied and the corporation is insolvent or if the corporation admits in writing that the creditor's claim is due and owing and that it is insolvent.

Other major organic changes (in addition to dissolution) include:

1. Sale of all or substantially all of a corporation's assets (not in the ordinary course of business)
2. Mergers or consolidations with other corporations

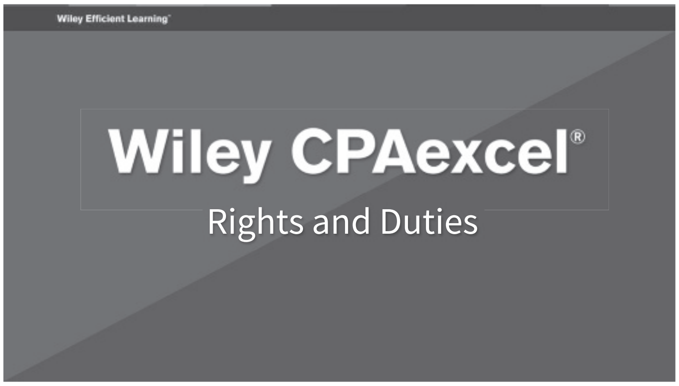
Example: Corporation

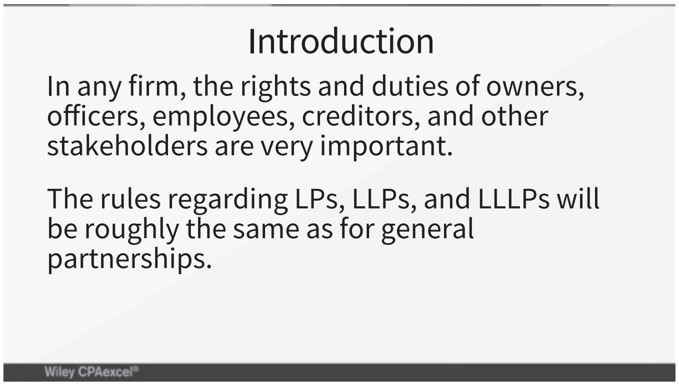
Shareholder interests are protected in such transactions that can so fundamentally alter their interests by:

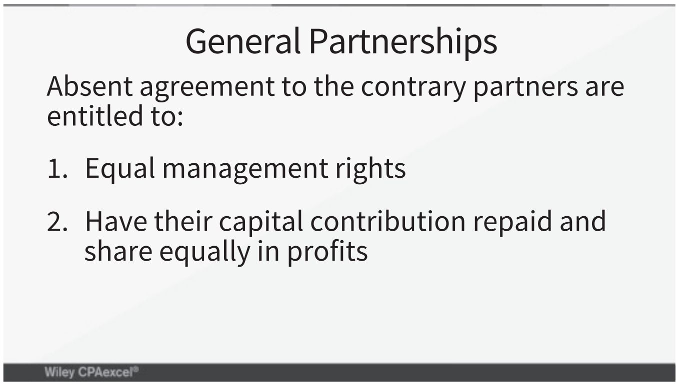
1. **Procedures**: Directors owing a fiduciary duty must propose and shareholders must approve in a vote.
2. **Appraisal rights**: Dissenting shareholders may request that their shares be purchased at a court-valued rate pursuant to their appraisal rights (also called dissenters' rights).

Rights, Duties, Legal Obligations, and Authority of Owners and Management

Rights and Duties







General Partnerships

Property rights:

1. Partnership property belongs to the partnership.
2. Partners are entitled to use or possess partnership property, but only on behalf of the partnership.

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General Partnerships

Charging orders:

1. Creditors of individual partners may not seize partnership property to satisfy individual debts of partners.
2. Rather, they may go to court to obtain a charging order in which the judge orders the other partners to pay any distribution due to the debtor partner to that partner's creditor instead.

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General Partnerships

Compensation: Partners are not entitled to compensation for work performed for the partnership, except for "reasonable compensation" rendered in winding up the business of the partnership.

Delectus Personae: Partners may veto admission of potential new partners, because new partners may be added only upon unanimous consent of existing partners.

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General Partnerships

Information rights:

1. Partners and their agents are entitled to access to partnership books and records during ordinary business hours.
2. Each partner and the partnership shall furnish to partners and their legal representatives:
   - Without demand: any information concerning the partnership's business and affairs reasonably required for proper exercise of partners' rights
   - Upon demand: any other partnership information reasonably requested

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General Partnerships

Standards of conduct — The only fiduciary duties a partner owes to the partnership and other partners are the:

Duty of Loyalty, which includes:

1. Accounting for any benefit derived
2. Avoiding conflicts of interest
3. Refraining from competing with the partnership business

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General Partnerships

Duty of Care, which includes refraining from engaging in:

1. Grossly negligent or reckless conduct
2. Intentional misconduct
3. Knowing violation of the law

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Corporations

Shareholders have few duties, but several important rights:

1. To vote for corporate directors
2. To inspect corporate records for proper purposes at proper times and in proper locations
3. To have their financial priorities respected; e.g., if they hold preferred shares

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Corporations

Shareholders have few duties, but several important rights:

4. To exercise appraisal rights when they dissent from major organic changes
5. To file derivative lawsuits against officers, directors and others who have committed wrongful acts that have injured the corporation

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Corporations

Directors (and officers) have several important duties, including:

1. **Duty of Attention**. Directors must direct. They must not be mere figureheads; at a minimum they must:
   - Attend most board meetings
   - Gain a basic familiarity with the company's business
   - Study the company's F/S

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Corporations

2. Duty of Care — Directors are not expected to be perfect, but must act:

- In good faith
- With the care of an ordinarily prudent person in a like position
- In a manner reasonably believed to be in the best interests of the corporation

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Corporations

3. Duty of Loyalty — Directors owe a fiduciary duty of loyalty to the corporation and its shareholders, meaning:

- They should avoid conflicts of interest
- Transactions between a director and the corporation are not automatically void, but will be scrutinized carefully. Such transactions are permitted if:
  - They are approved by an affirmative majority of disinterested directors

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Corporations

- They are approved by a majority of knowledgeable shareholders
- They are "fair" to the corporation

3. Directors should respect the corporate opportunity doctrine by not appropriating for themselves business opportunities that rightfully belong to the corporation.

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Corporations

Directors' Rights:

1. **Right to Rely**—Directors have the right to rely upon the reports of officers and other directors unless they have some reason to be suspicious.
2. **Business Judgment Rule**—Courts are not business experts, so they normally do not second-guess business decisions of directors or officers. Rather, they apply the business judgment rule which states:

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Corporations

"In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion, the business judgment of the directors will not be interfered with by the courts. The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation, and a minority stockholder who challenges their bona fides of purpose has the burden of proof."

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Corporations

Officers:

1. Run the corporation day-to-day (under the supervision of the board of directors), and are very powerful and have the opportunity to abuse that power
2. Are constrained by the same duties of care and loyalty that constrain directors

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LLCs

Whether an LLC is member-managed or manager-managed, managers owe duties of care and loyalty to the (other) members.

An operating agreement may limit, but not totally eliminate fiduciary duties.

RULLCA also provides: members shall discharge their duties consistently with contractual obligations of "good faith and fair dealing".

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LLCs

Additionally, courts protect members by:

1. Allowing them to escape an operating agreement by convincing a court that its provisions are "manifestly unreasonable"
2. Providing judicial dissolution if those managing the firm are guilty of "oppressive conduct"

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Authority of Owners and Managers

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Authority of Owners and Managers

Introduction

Agency law provides the basic rules for the authority of owners and managers of various forms of business to bind their firms.

As in other areas, the rules for general partnerships are nearly identical to those for LPs, LLPs, and LLLPs.

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General Partnerships

General Principles: As a general rule, agency law provides:

1. An act of a partner for apparently carrying on in the ordinary course the partnership business binds the partnership, unless:
   - The person with whom the partner was dealing knew or had received notification that the partner lacked authority
   - The partner had no authority to act for the partnership in the particular matter

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General Partnerships

2. An act of a partner which is not apparently for carrying on in the ordinary course the partnership's business binds the partnership only if the act was authorized by the other partners.

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General Partnerships

A partner binds both the partnership and the other partners if he or she acts with:

1. Actual authority (expressed or implied)
2. Apparent authority, which cannot exist where:
   - The third party knows of a partner's lack of authority
   - The partner's action is one that requires unanimity, such as an agreement to admit a new partner

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General Partnerships

Ratification — An act lacking both actual and apparent authority may still bind a partnership that ratifies the action expressly or by knowingly accepting the benefits of the agreement

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General Partnerships

Tort liability — Consistent with agency law, partnerships are generally liable for the torts committed by their partners or other agents within the scope of their employment.

1. **Intentional torts**: A partnership is usually liable if a partner commits an intentional tort while trying to advance partnership interests, even if he or she does so in a wrongful way.
2. **Misapplication of funds**: RUPA imposes virtually strict liability on a partnership for the misapplication of money received by the partnership in the course of its business.

General Partnerships

Joint and Several Liability: Under RUPA, contract and tort liability are typically joint and several, meaning that a creditor may sue any general partner and hold that partner completely liable without suing the others.

However, RUPA provides that the assets of the partnership must be exhausted before the partnership creditor proceeds against the individual assets of the general partners.

General Partnerships

Late Arrivers: If a general partner joins an existing partnership, he or she is personally liable for all subsequently-incurred debts, but is liable for preexisting debts only out of his or her partnership contribution.

Corporation

The Corporate Pyramid: The corporation is typically viewed as a pyramid.

Shareholders are passive investors whose input into corporate management is their vote for directors. Directors then set overall corporate policy and select officers. Officers are at the top of the pyramid, making the day-to-day decisions that bind the firm.

Corporation

Directors: Most state corporate codes provide that "the business and affairs of a corporation shall be managed under the supervision of a board of directors." Directors have broad authority to:

1. Borrow money
2. Sell corporate property
3. Hire and fire officers and other employees
4. Declare or refuse to declare dividends

Corporation

5. Make or refuse to make other distributions to shareholders'
6. Set the salaries of employees, officers, and even themselves
7. Propose for shareholder approval:
   - Sale of major corporate assets
   - Mergers or consolidations with other firms
   - Dissolution
   - Amendments to the articles of incorporation

Corporation

Officers — run the firm day-to-day and typically have various types of authority to bind the firm, including:

Express authority, derived from:

- Articles of incorporation
- By-laws
- Directors' resolutions
- Statutes

Corporation

Implied authority: Derived by virtue of their offices. The general trend is to find broad authority inherent in the offices of CEO, CFO, etc., but in questionable situations the other party may always demand a board of directors resolution.

Ratification: Even if an officer acts without either express or implied authority, the board of directors could always bind the corporation by ratifying the contracts.

LLCs

The operating agreement should indicate whether the LLC will be member-managed or manager-managed.

Absent provision to the contrary, it is assumed that an LLC will be member-managed.

LLCs

If member-managed, an LLC will operate much like a general partnership:

1. Each member has equal rights in management.
2. Ordinary business issues are decided by majority vote.
3. Acts outside the ordinary course of business require unanimous approval.
4. The operating agreement may be amended only with the consent of all members.

LLCs

If manager-managed, an LLC will operate much like a limited partnership, with the managers assuming the role of the general partner:

1. Except as otherwise provided in RULLCA, matters related to the activities of the company will be decided exclusively by the managers.
2. Managers have equal rights in management and conduct of the firm.

LLCs

3. Issues arising in the ordinary course of business are decided by majority vote of the managers.
4. Consent of all managers is required to engage in extraordinary transactions, such as sale of all or substantially all firm property, approval of a merger, or amending the operating agreement.
5. Managers may be removed at any time, with or without cause, by a majority vote of the members.

LLCs

Partnership law generally provides for statutory apparent authority, indicating that a partnership will generally be bound whenever a general partner acts to carry on the business of the partnership in the usual way.

The RULLCA provides to the contrary — that "a member is not an agent of the limited liability company solely by reason of being a member."

Introduction to Tax Review

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Introduction to Tax Review

Structure of Regulation

Format:

- Two multiple-choice question (MCQ) testlets consisting of a total of 76 questions
- Three testlets containing of a total of 8–9 short task-based simulations (TBS) or document review simulations (DRS)
- No written communication tasks

Grading:

- Multiple-choice questions: 50%
- Task-based simulations: 50%

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Regulation Exam Content

% OF EXAM	CONTENTS
10–20%	Ethics, Professional Responsibilities and Federal Tax Procedures
10–20%	Business Law
12–22%	Federal Taxation of Property Transactions
15–25%	Federal Taxation of Individuals
28–38%	Federal Taxation of Entities

Source: CPA Exam Blueprints effective 1/1/18. www.aicpa.org

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Regulation Exam: High-Order Cognitive Skills

SKILL LEVELS	WEIGHT	
Evaluation	-	The examination or assessment of problems, and use of judgment to draw conclusions.
Analysis	25-35%	The examination and study of the interrelationships of separate areas in order to identify causes and find evidence to support inferences.
Application	35-45%	The use or demonstration of knowledge, concepts or techniques.
Remembering and understanding	25-35%	The perception and comprehension of the significance of an area utilizing knowledge gained.

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Tax Law Coverage in Material

The CPA Exam is a closed exam; only a limited number of questions are released each year.

However, we can predict based on our expertise what is likely to be tested.

Preparing for MCQ versus TBS

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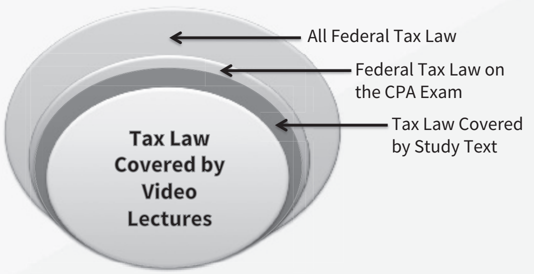
Tax Law Content on Exam



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Tax Law Coverage in Material

Material does not focus on detailed exceptions that are not likely to be tested.

Do not focus on phase-outs or inflation-adjusted items.

Two main types of tax law material to master:

- Review and recognize (do not need to memorize long lists of specific tax items).
- Learn and apply (problem-solving and critical thinking skills).

Study Tips

Video, study text, questions, TBS

Tax forms

Multiple short study sessions are more productive than marathon sessions.

When you take the exam you will not be reading solutions, you will be creating them, so prepare by doing the same.

Perseverance—one lesson at a time

Test-Taking Tips

Learn the basics very well. That will take care of 90% of the problems.

If you are not sure of the correct answer, try to rule out alternatives you believe are incorrect.

Answer all multiple-choice questions.

Use keyword searches for research questions.

Don’t worry about the few questions you do not know; they could be pretest questions.

If you have to guess, choose the answer that is worse for the taxpayer.

Summary

Review! Review! Review!

Work problems.

Focus on breadth, not depth.

One step (lesson) at a time.

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Recent Developments in Tax Law

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Recent Developments in Tax Law
(for January 1, 2019)

Tax Cuts and Jobs Act of 2017

House and Senate passed bill on December 20, 2017 and President signed it on December 22.

The final bill is 509 pages.

Individual provisions expire after 2025 if no future Congressional action.

Corporate tax changes are permanent.

Very few items are retroactive; a few take effect late in December 2017.

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Tax Cuts and Jobs Act

When will these changes be tested on the CPA Exam?

BEGINNING JANUARY 1, 2019

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Property Transactions

Property Transactions

Bonus depreciation increased to 100% and applies to used property also; begins phasing out in 2023

Luxury auto limits increased:

- $10,000 for the first year,
- $16,000 for the second year,
- $9,600 for the third year, and
- $5,760 for the fourth and later years.

Section 179:

- Increased to $1,000,000 and phase-out to $2,500,000.
- Now applies to nonresidential real property such as roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Property Transactions

The following assets held by the taxpayer who created them are NOT capital assets:

- Patents
- Inventions
- Models and designs
- Secret formulas and processes.

Like-Kind Exchange rules no longer apply to personalty.

Cost Recovery

Machinery and equipment used in farming is now 5-year property (changed from 7-year).

3-, 5-, 7-, and 10 year property used in farming can be depreciated using 200% declining balance method (changed from 150%).

Qualified improvement property (i.e., an improvement to the interior portion of nonresidential real property after the building has been placed in service), is recovered over a 15-year recovery period using the straight-line method and half-year convention (unless the mid-quarter convention applies).

Capital Gain Rates for 2019

Long-Term Capital Gains Tax Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately
0%	$0-$39,375	$0-$78,750 (12% bracket ends at $78,950)	$0-$52,750	$0-$39,375
15%	$39,376-$434,550	$78,751-$488,850 (35% bracket ends at $408,201)	$52,751-$461,700	$39,376-$244,425
20%	$434,551 or more	$488,851 or more	$461,701 or more	$244,426 or more

Ordinary income brackets are:

10%

12%

22%

24%

32%

35%

37%

Income and Deductions

Accounting Methods and Periods

Corporations with average annual gross receipts of $25 million or less in the three prior tax years:

- can use the cash basis
- can account for inventory as non-incidental materials and supplies or conform to their financial accounting treatment
- do not need to use UNICAP rules for inventories.

Taxpayers must recognize income no later than the year in which the income is included on an applicable financial statement.

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Income

For any divorce after 2018, alimony is not deductible by the payer spouse, and is not includible in income by the payee spouse.

Exclusion of $20 per month for employer reimbursements of bicycle commuting expenses is repealed.

Clarifies that the exclusion of $400/$1,600 for nonqualified/qualified employee achievement awards does not include cash, gift cards, gift coupons and certificates, vacations, meals, lodging, tickets for theatre/ sporting events, stocks, or bonds.

Student loans forgiven because of the death or disability of the student is excluded from income.

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Deductions

Moving expense deduction is repealed, except for members of Armed Forces.

Deduction of business entertainment repealed.

Deduction for qualified transportation fringe benefits (parking and mass transit) is repealed

Net interest expense is limited to business interest income plus 30% of adjusted taxable income. Any disallowed interest is carried forward indefinitely. The limitation does not apply to businesses that meet the $25 million gross receipts test.

Settlements or payments, including attorney's fees, related to sexual harassment or sexual abuse are not deductible if subject to a non-disclosure disagreement.

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Deductions

Limits NOL deductions to 80 percent of taxable income

Taxpayers are allowed to carry NOLs forward indefinitely; no carryback.

Any payment to a governmental entity in relation to a violation or potential violation is not deductible. This provision does not apply to payments that are restitution for damage caused by the taxpayer or payments for taxes paid.

Deduction for local lobbying expenses is eliminated.

The $1,000,000 deduction for PEO, and PFO, and three other highest compensated officers now includes commissions and performance-based compensation unless these amounts were part of a contract as of November 2, 2017 and there have been no material modifications to it.

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Individual Provisions—Itemized Deductions

Medical expenses threshold is reduced to 7.5 percent of AGI for 2017 and 2018.

State and Local Taxes for individuals are limited to $10,000 ($5,000 for MFS).

Mortgage interest deduction modified to reduce the limit on acquisition indebtedness to $750,000 (from $1 million). Not apply if incurred before December 15, 2017.

Home-equity loan interest deduction is repealed.

Taxpayers can take a deduction for casualty losses only if the loss is attributable to a presidentially declared disaster.

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Itemized Deductions

Gambling Losses limited to gambling income; losses include any otherwise allowable deduction incurred in carrying on a wagering transaction.

Increases the limit of cash contributions to public charities to 60 percent of AGI.

Denies a charitable deduction for payments made for college athletic event seating rights.

Repeals all deductions subject to the 2 percent floor.

Repealed the overall limitation on itemized deductions.

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2% Miscellaneous Expenses Disallowed

- Appraisal fees for a casualty loss or charitable contribution
- Clerical help and office rent related to investments
- Depreciation on home computers used for investments
- Hobby expenses
- Indirect miscellaneous deductions from pass-through entities;
- Investment fees and expenses
- Tax return preparation and advising fees
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;
- Safe deposit box rental fees
- Service charges on dividend reinvestment plans
- Trustee's fees for an IRA, if separately billed and paid

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2% Miscellaneous Expenses Disallowed for Employees

- Dues to professional societies
- Home office expenses
- Job search expenses in the taxpayer's present occupation
- Legal fees related to the taxpayer's job
- Licenses and regulatory fees
- Subscriptions to professional journals related to the taxpayer's work
- Tools and supplies used in the taxpayer's work
- Travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work
- Union dues and expenses
- Work clothes and uniforms if required and not suitable for everyday use
- Work-related education

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Individual Tax Provisions

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Individual Tax Provisions

New Rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%

Increased Standard Deduction:

- $24,000 for married filing jointly,
- $18,000 for head of households, and
- $12,000 for all other individuals

No deduction for personal and dependency exemptions

Unearned income for those subject to “kiddie tax” is taxed at the rates for trusts and estates, rather than parent’s rate.

The due diligence requirements for preparers related to the earned income credit, child tax credit, and American Opportunity Tax Credit are extended to Head of Household filing. ($520 (2018) penalty per violation.)

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Personal Tax Credits

Child Tax Credit

- Increased to $2,000 per qualifying child
- Maximum refundable amount is increased to $1,400
- Phaseout threshold increased to $400,000 for married filing joint taxpayers and $200,000 for other taxpayers
- Earned Income threshold for refundability is decreased from $3,000 to $2,500

New nonrefundable $500 credit for qualifying dependents who are not qualifying children

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Other Individual Provisions

Section 529 Plans now allowed to distribute up to $10,000 in expenses for tuition incurred at elementary and secondary schools.

Basic exclusion from estate tax per individual is doubled to $11,200,000.

Alternative Minimum Tax:

- AMT exemption amount increases to $109,400 for MFJ and to $70,300 for individuals
- Phaseout thresholds increases to $1 million for MFJ and $500,000 for individuals.

The ACA penalty for individuals without minimum essential coverage is reduced to zero.

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Business Entities

Corporations

These provisions are permanent.

Corporate tax rate reduced to flat rate of 21%.

Corporate AMT is repealed.

Domestic production activity deduction repealed.

Dividends received deduction is reduced:

- From 80% to 65%
- From 70% to 50%

Tax-Exempt Organizations

Taxed at the corporate rate of 21% on the sum of

- compensation to a covered employee in excess of $1,000,000, and
- any excess parachute payment.
- A covered employee is one of the five highest compensated employees during the tax year. If one is a covered employee for 2017 or later, then the employee is always a covered employee.

1.4% excise tax is imposed on investment income of private colleges and universities with at least 500 students and with assets of at least $500,000 per student.

Unrelated business taxable income must now be computed separately for each trade or business.

Qualified Business Income

Beginning in 2018, individual can deduct 20% of qualified business income (QBI) that is received from partnerships, S corporations, or sole proprietorships.

The 20% is allowed as a deduction reducing taxable income and is not allowed to reduce AGI.

The deduction is allowed only for Federal income tax purposes and does not reduce self-employment income.

The deduction is limited to the greater of:

1. 50% of the W-2 wages relating to the qualified trade or business, or
2. the sum of a) 25% of the W-2 wages relating to the business, and b) 2.5% percent of the unadjusted basis immediately after acquisition of all qualified property.

Qualified Business Income

The wage limitation does not apply if the business owner's income is less than $157,500 ($315,000 if married filing joint). The full wage limitation applies once taxable income reaches $207,500 ($415,000 if married filing joint).

The deduction with respect to specified service activities is allowed if taxable income is less than $207,500 ($415,000 married filing joint) in 2018.

A qualified trade or business does not include the trade or business of being an employee, and the following specified service activities:

- Health, Law, Accounting, Actuarial Science, Performing Arts, Consulting, Athletics, Financial Services, Brokerage Services

Partnerships

Technical termination rules are repealed.

If a partnership interest is received in exchange for services, it must be held for three years before sold to qualify for long-term capital gain treatment. Otherwise, the gain is short-term capital gain.

S Corporations

A nonresident alien can now be a current beneficiary of an electing small business trust (ESBT).

Charitable contribution rules for individuals apply to ESBT.

Business Credits

Rehabilitation credit for pre-1936 buildings is repealed. 20% credit for other certified historic structures must be amortized over five years.

Credit for employer paid family and medical leave

- Credit for 12.5% of wages paid to employees while on FML as long as employer continues to pay at least 50% of normal wages.
- All qualifying employees must be given at least two weeks of paid FML.
- The credit increases as a higher percentage of wages is paid, but capped at 25%.
- For tax years beginning only in 2018 and 2019.

Taxation of Foreign Income

The system of taxing U.S. corporations on the earnings of their foreign subsidiaries when they are distributed was repealed.

The new system provides for deemed repatriation. U.S. shareholders owning at least 10% of a foreign subsidiary must include in income the shareholder's share of post 1986 Earnings and Profits if not previously taxed in U.S. This is included for the subsidiary's last tax year beginning before 2018.

The E&P is taxed at 8% except the portion due to cash is taxed at 15.5%. The tax can be paid in over 8 years with most of it paid in the last three years.

Taxation of Foreign Income

The new system provides a 100 percent deduction for foreign-source portion of dividends received from specified 10 percent owned foreign corporations by domestic corporations that are U.S. shareholders of those foreign corporations. This deduction completely offsets the income from the foreign subsidiary.

No foreign tax credit or deduction will be allowed for any taxes paid or accrued with respect to a dividend that qualifies for the deduction.

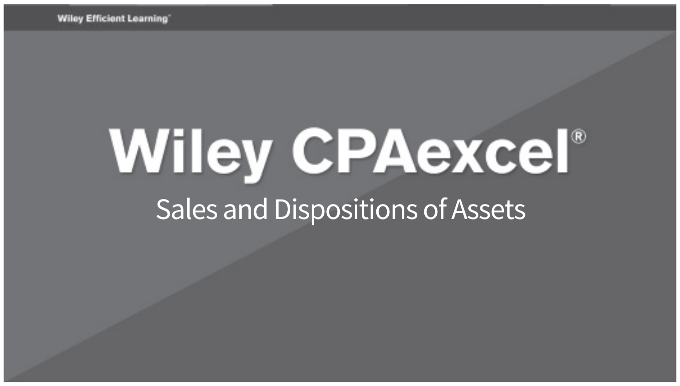
A domestic corporation will not be permitted a deduction for dividends related to stock that is held for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.

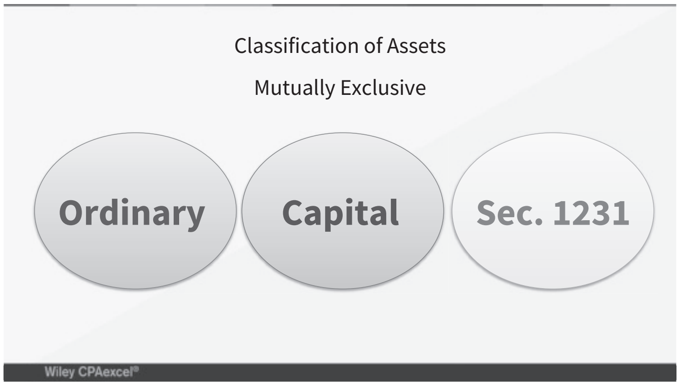
Recent Developments in Tax Law

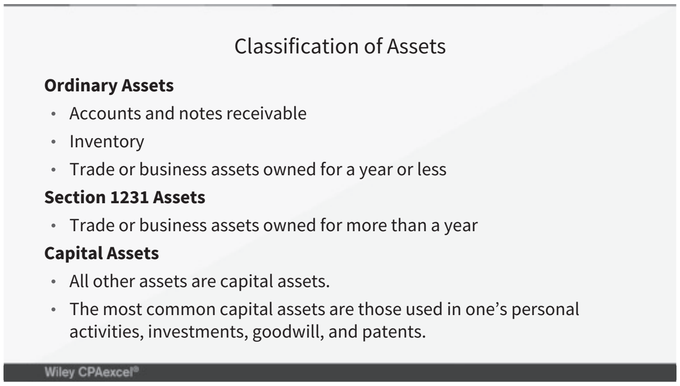
From July 1 through December 31, 2018 the CPA Exam will test the 2018 law as it would have applied if the Tax Cuts and Jobs Act had not been passed.

Property Transactions

Sales and Dispositions of Assets







Classification of Assets Example

Platt owns land that is operated as a parking lot. A shed was erected on the lot for the related transactions with customers.

With regard to capital assets and Section 1231 assets, how would these assets be classified?

Property Transaction

Any time that a property transaction occurs, the taxpayer must compute a realized gain or loss. Property transactions include sales or disposition of assets.

The term **sale or disposition** includes sales, exchanges, trade-ins, casualties, condemnations, thefts, and retirements.

Realized Gains and Losses

Realized gain or loss is computed as follows:

Amount Realized
– Adjusted Basis
Realized Gain/Loss

Realized Gains and Losses

Amount realized includes:

- Cash received
- Fair market value of any property received
- Liabilities assumed by the buyer
- Less selling expenses

Adjusted basis equals the cost or other acquisition basis of the property

- Cost includes any liabilities or expenses connected with the acquisition
- Minus depreciation, amortization, and depletion
- Plus capital improvements

Basis Rules

Basis in an asset is usually determined by its cost, which includes all of the expenditures required to place an asset in service, including:

- Transportation
- Installation
- Testing
- Taxes

Review Question

Ralph Birch purchased land and a building which will be used in connection with Birch's business. The costs associated with this purchase are as follows:

Cash down payment	$ 40,000
Mortgage on property	350,000
Survey costs	2,000
Title and transfer taxes	2,500
Charges for hookup of gas, water, and sewer lines	3,000
Back property taxes owed by the seller that were paid by Birch	5,000
What is Birch's tax basis for the land and building?	

Recognized Gains and Losses

You should assume that all realized gains and losses should be recognized unless you are aware of a tax rule that excludes or defers the gain or loss.

Note that in general, losses from the sale or disposition of all personal use assets are not recognized.

Gifts and Inheritances

Two major exceptions to the cost basis rules are for:

1. Gifts
2. Inheritances

Gifts—Basis Rules

If property is gifted to a taxpayer, the donee's basis is:

1. Gain basis = Adjusted basis of the donor
2. Loss basis = Lower of
   - FMV at date of gift, or
   - Adjusted basis of the donor
3. Depreciable basis = Gain basis
4. The basis is increased for the portion of any gift tax paid by the donor due to appreciation in the property:

$$\text{Adjustment} = \frac{\text{(Unrealized Appreciation)}}{\text{FMV at Date of Gift} - \text{Annual Exclusion}} \times \text{Gift Tax Paid}$$

Gifts—Basis Rules Example

Farr made a gift of stock to her child, Pat. At the date of gift, Farr's stock basis was $10,000 and the stock's fair market value was $15,000. No gift taxes were paid.

What is Pat's basis in the stock for computing gain?

Gain

Loss

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Gifts—Basis Rules Example—Solution

Gain Basis

Gain if sold for more than gain basis

No gain or loss if amount realized is in between gain and loss basis

Loss if sold for less than loss basis

Loss Basis

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Inheritances—Basis Rules

Basis to the beneficiary is the fair market value of the asset on the **date of death** of the taxpayer, or the alternate valuation date (six months after the date of death) if that is elected by the estate's executor.

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Holding Period—Gifts and Inheritances

Does the holding period of the donor/decedent carry over to the new owner?

Gifts:

- If the property is sold for a gain, the holding period carries over.
- If the property is sold for a loss, the holding period does not carry over.

Inheritances:

- Holding period is always long term.

Property Transactions Fundamentals

Five items to know for every property transaction:

1. Realized gain or loss
2. Recognized gain or loss
3. Character of the gain or loss
4. Holding period of the retained asset (could be zero)
5. Basis in the retained asset, if any (could be zero)

Capital Gains and Losses

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Capital Gains and Losses

Capital Gains and Losses

The most common capital assets are those used in one's personal activities and in investment activities.

- Long term if held more than one year
- Short term if held one year or less

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Capital Gains and Losses

Four categories:

1. Long-term capital gain—preferential rates (individuals only)
2. Long-term capital loss
3. Short-term capital gain—ordinary rates
4. Short-term capital loss

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Netting Capital Gains/Losses Example

Baker Corp., a calendar-year C corporation, realized taxable income of $36,000 from its regular business operations for Year 1.

In addition, Baker had the following capital gains and losses this year…

Netting Capital Gains/Losses Example

Short-term capital gain	$8,500
Short-term capital loss	(4,000)
Long-term capital gain	1,500
Long-term capital loss	(3,500)

Baker did not realize any other capital gains or losses since it began operations. What is Baker's total taxable income this year?

Capital Losses—Individuals

If the combination of net short-term and net long-term gains and losses is negative, then individuals can deduct this net capital loss up to $3,000 per year.

The deduction is for AGI and is limited to taxable income (any excess loss carries forward).

Capital Losses—Corporations

Corporations can only use a **net capital loss** to offset capital gain net income.

Unused net capital losses are short-term capital losses, and they can be carried back three years and forward five years.

There is no preferential rate for long-term capital gains.

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Long-Term Capital Gains—Individuals

For most taxpayers, net long-term capital gain is taxed at a maximum rate of 15%. If the taxpayer's regular tax rate is in the lowest tax brackets, then the maximum tax rate is reduced to 0%.

The LTCG rate is 20% for taxpayers whose ordinary incomes are taxed in the higher tax brackets.

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Capital Gain Rates for 2019

Long-Term Capital Gains Tax Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately
0%	\$0-\$39,375	\$0-\$78,750 (12% bracket ends at \$78,950)	\$0-\$52,750	\$0-\$39,375
15%	\$39,376-\$434,550	\$78,751-\$488,850 (35% bracket ends at \$408,201)	\$52,751-\$461,700	\$39,376-\$244,425
20%	\$434,551 or more	\$488,851 or more	\$461,701 or more	\$244,426 or more

Ordinary income brackets are:
10%
12%
22%
24%
32%
35%
37%

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Long-Term Capital Gains—Individuals

A 3.8% surtax is added for:

- Joint filers with modified AGI > $250,000
- Single and head-of-household filers with MAGI >$200,000
- The 3.8% tax applies to the lesser of (a) net investment income, or (b) the excess of AGI over the AGI thresholds.
- The 3.8% surtax also applies to qualified dividends, passive interest, rents, royalties, and flow-through income that is passive.

Long-Term Capital Gains—Individuals

Those subject to the 20% LTCG rate will have a total rate on LTCG income of 23.8%. Those subject to the 15% LTCG rate could have a total rate on LTCG income of 18.8%.

Net capital gain attributable to **straight-line depreciation** claimed on real estate is taxed at a maximum rate of 25%.

Net capital gain from collectibles is taxed at a maximum rate of 28%.

Netting Capital Gains/Losses

A net short-term or long-term loss is applied against a net long-term gain.

The group of long-term gains taxed at the highest rate is offset first.

Netting Capital Gains/Losses

Example: TP has net short-term capital loss of $20,000. He has also realized a net long-term gain of $50,000 comprised of the following net gains and losses:

$10,000 gain on the sale of coins held three years

$25,000 gain on the sale of securities held three years

$15,000 gain on the sale of realty (attributable to depreciation)

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Solution

Capital Loss	20,000
28%—coins	(10,000)
25%—recapture	(10,000)

- $10,000 gain on the sale of coins held 3 years
- $25,000 gain on the sale of securities held 3 years
- $15,000 gain on the sale of realty taxable gain

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Personal Casualty and Theft Gains and Losses

Gains and losses from casualties of property held for personal use are separately netted.

If gains exceed losses (after the $100 floor for each loss), then all gains and losses are treated as capital gains and losses, short term or long term depending upon holding period.

If losses (after the $100 floor for each loss) exceed gains, the losses (1) offset gains, and (2) are an ordinary deduction from AGI to the extent in excess of 10% of AGI.

Net losses are deductible only if the loss was incurred as part of federally declared disaster.

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Stocks and Bonds

The date of purchase/sale for stocks and bonds is the **trade date**, not the **settlement date.**

The **trade date** is the day that the purchase or sale actually occurs.

The **settlement date** is the day that the stock is delivered or that payment is actually made.

Mutual Funds

Capital gain distributions from mutual funds are reported as long-term gains on Schedule D.

If a mutual fund distributes short-term capital gain, that is shown as dividend income on Form 1099-DIV.

Section 1244 Losses

The first $50,000 of losses ($100,000 for married filing joint) from the sale of Section 1244 stock will be treated as an **ordinary loss**.

The individual selling the stock must be the **original holder** of the stock.

To qualify as Section 1244 stock, the total capitalization of the corporation cannot exceed $1,000,000 at the time the stock is issued.

Qualifying Small Business Stock

QSBS is stock of a small business corporation (less than $50 million in capital) held for more than five years.

The maximum gain eligible for the exclusion (100%) is the greater of 10 times the taxpayer's basis in the stock or $10 million.

Exclusion percentage is:

- 50%: purchased before February 18, 2009
- 75%: purchased after February 17, 2009, and before September 28, 2010

Qualifying Small Business Stock

QSBS rules apply to corporations only in certain specified industries (manufacturing, technology, retail, and wholesale).

Section 1231 Assets

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Section 1231 Assets

Definition

Section 1231 assets are assets that are used in a trade or business and have been owned for more than one year.

Segment asset sales for the year into Section 1231 gains and Section 1231 losses.

Casualty Gains and Losses

Netting Section. 1231 gains and losses is accomplished in two steps. First, net all casualty and theft gains and losses on property held for more than one year.

1. If the losses exceed gains, treat them all as ordinary losses and gains and do not net them with other Section. 1231 gains and losses.
2. If the gains exceed losses, the net gain is combined with other Section. 1231 gains and losses.

Section 1231 Netting

To the extent Section 1231 gains exceed Section 1231 losses, the net gain is treated as a long-term capital gain (subject to a lookback limit for losses during the previous five years).

If Section 1231 losses exceed Section 1231 gains, the loss is deductible as an ordinary loss.

The lookback provision states that the net Section 1231 gains must be offset by net Section 1231 losses from the five preceding tax years that have not previously been recaptured.

To the extent of these losses, the net Section 1231 gain is treated as ordinary income.

Lookback Rule Example

The results of Digimatic Corporation's first three years of operations are presented below:

Year	Results of Operations
1	Sec. 1231 losses of $10,000
2	Sec. 1231 losses of $15,000
3	Sec. 1231 gain of $75,000

Digimatic Corporation's Year 3 Section. 1231 gain can best be characterized as . . .

Lookback Rule Solution

Year 3 gain	75,000
Year 1 loss	
Year 2 loss	
Taxed as LTCG	
Taxed as ordinary income	

Recapture Rules

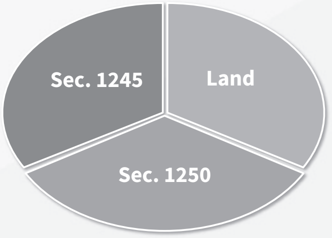
Recapture applies only to Section 1231 assets because only assets used in a business are depreciable

Section 1250 recapture — Realty (land and assets permanently attached to land)

Section 1245 recapture — Personalty (assets other than realty)

Assets Subject to Recapture

Section 1231 Assets



Section 1245 Recapture

If the Section 1231 property was depreciable, the gain from the sale is subject to recapture as ordinary income.

The amount not recaptured is categorized as Section 1231 gains.

Depreciable personalty is Section 1245 property. All depreciation taken on Section 1245 property is subject to being recaptured as ordinary income.

Recapture Example

Mr. Monopoly sold equipment used in his business for $11,000. The equipment cost $10,000 and Monopoly had properly claimed MACRS deductions totaling $4,000.

Straight-line depreciation, if it had been used, would have been $2,500. What is the amount of gain that should be reported under Section. 1231 and 1245?

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Recapture Example—Solution

Amount realized

Adjusted basis

Realized/recognized gain

Section 1245 ordinary income Section 1231 gain

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Section 1250 Recapture

Depreciable realty is Section 1250 property.

Only the excess of actual depreciation over straight-line depreciation is subject to recapture as ordinary income.

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25% Recapture Rate

For Section 1250 property, the portion of the gain that would be recaptured if all depreciation taken was subject to recapture under Section 1245 over the regular Section 1250 recapture is taxed at 25%, rather than as a Section 1231 gain.

The amount subject to the 25% rate is usually the straight-line depreciation on the asset.

Recapture Solution

Gain 5,000

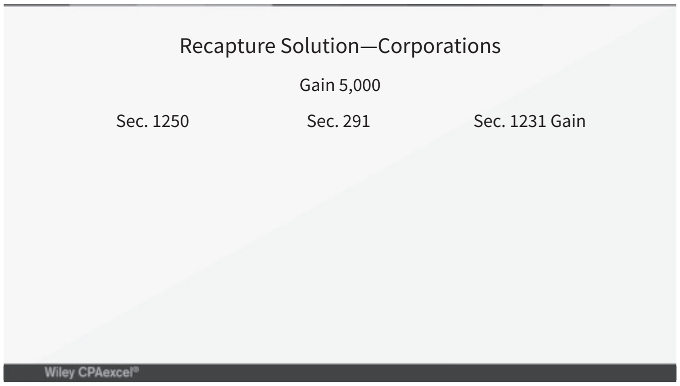
Sec. 1250	25%	Sec. 1231 Gain

Section 1250 Recapture—Corporations

Rules are the same as for individuals, except:

1. Straight-line depreciation is not taxed at a 25% rate.
2. Additional depreciation is recaptured to the extent of 20% multiplied by:
    - Recapture if the property was Section. 1245 property
    - Less: Section 1250 depreciation recapture

This additional amount is Section. 291 recapture.


Recapture Solution—Corporations
Gain 5,000
Sec. 1250
Sec. 291
Sec. 1231 Gain
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Section 1231 Assets—Cost Recovery

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Section 1231 Assets—Cost Recovery

MACRS—Personalty

200% declining-balance method with a half-year convention; taxpayer gets one-half-year depreciation in the year of acquisition and one-half-year in the year of disposal.

5-year property includes light trucks, automobiles, computers and peripheral equipment, office equipment (e.g., calculators, copiers), most new farm equipment and machinery, appliance, carpets, and furniture used in residential rental property.

7-year property includes office furniture and fixtures, used farm equipment and machinery, equipment other than 5-year property.

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Personalty

Applicable Depreciation Method: 200% Declining Balance Switching to Straight Line
Applicable Recovery Periods: 3, 5, 7 years
Applicable Convention: Half-year

If the Recovery Year is:	And the Recovery Period is: 3-year	5-year	7-year
	The Depreciation Rate is:		
1	33.33	20.00	14.29
2	44.45	32.00	24.49
3	14.81	19.20	17.49
4	7.41	11.52	12.49
5		11.52	8.93
6		5.76	8.92
7			8.93

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Half-Year Convention Computation

Assume that business furniture of $10,000 is purchased on March 10 of Year 1.

Compute the depreciation allowed on the furniture for Year 1:

10,000

Compute the depreciation allowed on the furniture if it is sold in Year 3:

10,000

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MACRS—Personalty

Taxpayers can elect to use the straight-line method.

A mid-quarter convention is used if more than 40% of all personalty is placed in service during the last quarter of the taxable year.

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Review Question

Data Corp., a calendar-year corporation, purchased and placed into service office equipment during November Year 1 costing $100,000. No other equipment was placed into service during Year 1.

Under the general MACRS depreciation system, what convention must Data use?

A. Full year

B. Half year

C. Mid-quarter

D. Mid-month

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Mid-Quarter Computation

Compute the depreciation allowed on the office equipment for Year 1:

100,000

Compute the depreciation allowed on the office equipment if it sold on January 27, Year 3:

100,000

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Personalty

Applicable Depreciation Method: 200% Declining Balance Switching to Straight Line
Applicable Recovery Periods: 3, 5, 7 years
Applicable Convention: Mid-quarter (property placed in service in first quarter)

If the Recovery Year is:	**And the Recovery Period is:** 3-year	5-year	7-year
	The Depreciation Rate is:		
1	58.33	35.00	25.00
2	27.78	26.00	21.43
3	12.35	15.60	15.31
4	1.54	11.01	10.93
5		11.01	8.75
6		1.38	8.74
7			8.75
8			1.09

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Personalty

Applicable Depreciation Method: 200% Declining Balance Switching to Straight Line
Applicable Recovery Periods: 3, 5, 7 years
Applicable Convention: Mid-quarter (property placed in service in fourth quarter)

If the Recovery Year is:	**And the Recovery Period is:** 3-year	5-year	7-year
	The Depreciation Rate is:		
1	8.33	5.00	3.57
2	61.11	38.00	27.55
3	20.37	22.80	19.68
4	10.19	13.68	14.06
5		10.94	10.04
6		9.58	8.73
7			8.73
8			7.64

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MACRS—Realty

Straight-line depreciation with mid-month convention; taxpayer gets one-half month depreciation in the month of acquisition and one-half month in the month of disposal

Residential realty is depreciated over 27.5 years.

Nonresidential realty is depreciated over 39 years.

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Review Question

On August 2 Graham purchased and placed into service an office building costing $264,000 including $30,000 for the land. What was Graham's MACRS deduction for the office building this year?

Total cost	264,000
Land	______
Depreciable basis	

Modified from assess.AICPA.101108REG

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Realty: Residential

Applicable Depreciation Method: Straight Line

Applicable Recovery Period: 27.5 years

Applicable Convention: Mid month

If the Recovery Year is:	**And the Month in the First Recovery Year the Property is Placed in Service is:** 1	2	3	4
	The Depreciation Rate is:			
1	3.485	3.182	2.879	2.576
2	3.636	3.636	3.636	3.636
3	3.636	3.636	3.636	3.636

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Residential Realty Depreciation

Assume that an apartment building is purchased on April 30 for $500,000.

Compute the depreciation allowed on the apartment building for Year 1:

500,000 × 2.576% = 12,880

Compute the depreciation allowed on the apartment building if it sold on February 12 of Year 3:

500,000 × 3.636% × 1.5/12 = 2,273

Qualified Improvement Property

Qualified improvement property is improvements to the interior portion of nonresidential real property after a building has been placed in service).

Recovered over a 15-year recovery period using the straight-line method and half-year convention (unless the mid-quarter convention applies).

QIP includes leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Section 179

Taxpayers can elect to expense a certain amount of tangible personalty used in a trade or business. Qualified Improvement Property is also eligible.

The following improvements to nonresidential real property also qualify if made after the property is first placed in service: roofs, heating and air conditioning, fire protection, and security systems.

Property used in investment activities is not eligible.

New or used property is eligible.

Maximum deduction for 2019 is $1,020,000.

Section 179

There are two limitations on this deduction:

- The annual limit is reduced dollar for dollar for personalty placed in service during the year that exceeds $2,550,000 (2019). This reduction does not create a carryforward to future tax years.
- The Section 179 expense cannot exceed the taxable income from the business. Any excess is carried forward to future taxable years.

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Section 179

The basis of the property for cost recovery purposes is reduced by the Section 179 amount, even if the deduction is limited by the taxable income rule.

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Section 179 Recapture

If in any tax year that is part of the MACRS recovery period the property is not used predominantly for business, part of the deduction may need to be recaptured.

After the recapture, the net depreciation expense claimed will be the same as if Section 179 had never been elected.

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Section 179 Recapture Example

Assume that Donald properly elected early expensing for a 5-year asset that cost $200,000 in Year 1. The property was used 100% for business in Years 1 and 2. In Year 3 the property was used 100% for personal purposes. The recapture amount is:

- S. 179 claimed in Year 1
- Regular Year 1 depreciation
- Regular Year 2 depreciation
- Year 3 recapture
- Net depreciation claimed

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Bonus Depreciation

Beginning September 27, 2017, taxpayers can elect to immediately depreciate 100% of many types of personalty.

Bonus Depreciation applies to new and used property.

AMT adjustments are not required for property for which bonus depreciation has been elected.

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Alternatives to MACRS

Straight-line depreciation can be elected over the regular MACRS life of the asset.

The alternate depreciation system (ADS) can be elected. Straight-line depreciation is used over a recovery period longer than MACRS. 150% declining-balance or straight-line can be used tangible personalty.

ADS must be used for listed property and for computing earnings and profits.

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Luxury Auto Limits

Special rules limit the amount of depreciation that can be claimed on a passenger automobile (GVW of 6,000 pounds or less).

These assume 100% business/investment use. For mixed-use autos, the limit is multiplied by the percentage of business/investment use.

For autos purchased in 2018, the limit is $10,000. If business/investment use was 70%, the limit is:

For heavy SUVs (over 6,000 pounds), the limit is $25,000 for the first year.

Listed Property

Listed property rules apply to vehicles that can be used for both business and personal purposes. Note that cell phones and computers are no longer defined as listed property.

To use accelerated cost recovery, the business use of listed assets must exceed 50% of total use. Investment use is not considered.

Both business and investment use are depreciated.

Intangible Assets

Intangible assets that are acquired, not created, can be amortized on a straight-line basis over 15 years.

Examples include goodwill, franchises, trademarks, etc.

Other assets (covenants not to compete, computer software, film, sound recordings, videotapes, patents, and copyrights) qualify if acquired in connection with the acquisition of a trade or business.

Like-Kind Exchanges and Involuntary Conversions

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Like-Kind Exchanges and Involuntary Conversions

Like-Kind Exchanges

Losses are never recognized from a like-kind exchange.

Recognized gain is the lesser of

- Realized gain, or
- Boot received.

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Like-Kind Exchanges

Boot is any non-like-kind property received as part of the exchange. Liabilities assumed by the other party to the exchange are considered boot.

Realty for realty is like-kind. (Realty is land and buildings.)

The like-kind exchange rules no longer apply after 2017 to exchanges of personalty.

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Like-Kind Exchanges

The like-kind exchange rules:

- Do not apply to personal-use property.
- Apply only to business and investment property.

Business property can be exchanged for investment property.

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Nonqualifying Property

Nonqualifying property includes the following:

- Inventory
- Partnership interests
- Stocks, bonds, and notes
- Other securities or evidence of indebtedness or interest
- Personalty

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Review Question

A owns investment land with an adjusted basis of $50,000, FMV of $70,000, subject to a mortgage of $15,000. B owns investment land with an adjusted basis of $60,000, FMV of $65,000, subject to a mortgage of $10,000. A and B exchange real estate investments with A assuming B's $10,000 mortgage and B assuming A's $15,000 mortgage. The computation of gain and basis for the acquired real estate for both A and B is as follows:

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Review Question—Solution for Taxpayer A—Gain

FMV of real estate received
+ Liability assumed by other party (boot received)
– Liability assumed on new real estate (boot given)
Amount realized on the exchange
– Adjusted basis of old real estate transferred
Gain realized

Gain recognized

Review Question—Solution for Taxpayer A—Basis

Basis of old real estate transferred
+ Liability assumed by taxpayer (boot given)
+ Gain recognized
– Liability assumed by other party (boot received)
Basis of new real estate acquired

Review Question—Solution for Taxpayer B—Gain

FMV of real estate received
+ Liability assumed by other party (boot received)
– Liability assumed on new real estate (boot given)
Amount realized on the exchange
– Adjusted basis of old real estate transferred
Gain realized

Gain recognized

Review Question—Solution for Taxpayer B—Basis

Basis of old real estate transferred
+ Liability assumed by taxpayer (boot given)
+ Gain recognized
– Liability assumed by other party (boot received)

Basis of new real estate acquired

Review Question

Leker exchanged land (plot A) that was used exclusively for business and had an adjusted tax basis of $20,000 for a different plot of land (plot B). Plot B had a fair market value of $10,000, and Leker also received $3,000 in cash.

What was Leker's tax basis in Plot B?

Review Question—Solution

Amount Realized:

Plot B
Cash ________

Adjusted Basis ________
Realized Loss ________
Recognized Loss ________

Like-Kind Exchanges—Basis

The basis of like-kind property received can be computed as follows:

FMV of property received

– Postponed gain

+ Postponed loss

Like-Kind Exchanges

Basis of non-like-kind property received is the property's FMV, since gain has been recognized to that extent.

Holding period of like-kind property surrendered tacks on to the holding period of like-kind property received.

Involuntary Conversions

An involuntary conversion includes destruction, theft, seizure, and condemnation of property.

Replacement property must be "similar or related in service or use" to the involuntarily converted property.

Property must be replaced within two years after the close of the taxable year in which the conversion took place (three years for condemned business or investment real property).

Involuntary Conversions

Amount realized from conversion
– Adjusted basis of old property
Realized gain/loss

Amount realized from conversion
– Cost of replacement property
Recognized gain, limited to realized gain

Losses are **never** deferred under these rules.

Review Question

Mr. N's business building was destroyed by a hurricane. The building had an adjusted basis to Mr. N of $200,000 and a fair market value immediately before the hurricane of $300,000.

Mr. N received a reimbursement of $270,000 from his insurance company and immediately spent $268,000 for a new business building.

What amount must Mr. N include in his gross income?

Review Question—Solution

Amount realized from conversion	270,000
– Adjusted basis of old property	(200,000)
Realized gain/loss	70,000
Amount realized from conversion	270,000
– Cost of replacement property	(268,000)
Recognized gain (limited to realized gain)	2,000

Involuntary Conversion—Basis

The basis of new property received is computed as follows:

FMV of property received	268,000
– Postponed gain	(68,000)
+ Postponed loss	0
Basis of new property	200,000

If a gain is deferred, the holding period of the converted property tacks on to the holding period of the replacement property.

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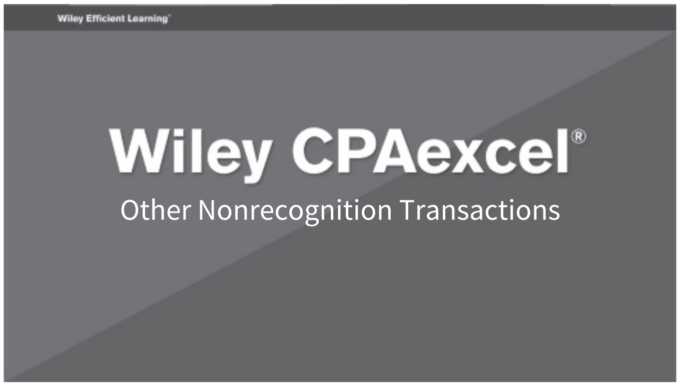
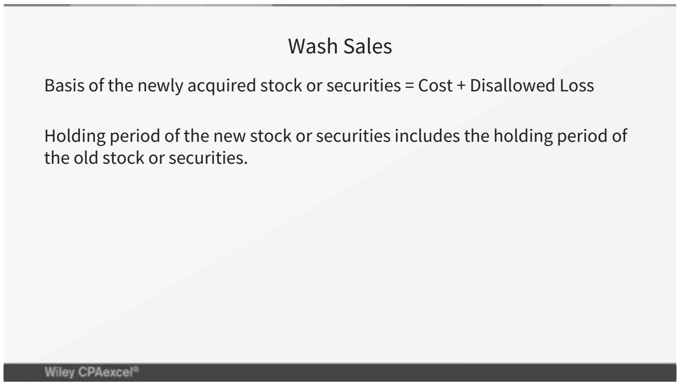
Other Nonrecognition Transactions





Wash Sale Example

Smith, an individual calendar-year taxpayer, purchased 100 shares of Core Co. common stock for $15,000 on December 15, Year 1, and an additional 100 shares for $13,000 on December 30, Year 1.

On December 31, Year 1, Smith sold the shares purchased on December 15, Year 1, for $13,000.

What amount of loss from the sale of Core's stock is deductible on Smith's Year 1 income tax return?

Wash Sale Example—Solution

	Shares	Basis
12/15		
12/30		
12/31		
Amount Realized		
Adjusted Basis		
Realized Loss		
Recognized Loss		
Basis in remaining shares:		
Cash		
+ Disallowed Loss		

Related-Party Losses

Realized losses from sales or dispositions of property between related taxpayers are not recognized.

Related parties include:

- Spouse
- Descendants—children, grandchildren, great-grandchildren, etc.
- Ancestors—parents, grandparents, great-grandparents, etc.
- Siblings—brothers and sisters, including half brothers and sisters

Related-Party Losses

In-laws are not considered related parties, although they are eligible to be claimed as a dependent.

Aunts and uncles and cousins are not related parties.

The amount of disallowed loss is called a **right of offset**.

The right of offset can be used to offset any gain recognized when the current owner disposes of the property in the future (unless the property was personal use property to the original seller).

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Related-Party Losses

The right of offset can only reduce a gain to zero; it cannot create a loss.

Holding period of original buyer does not include holding period of the seller. Begins on date of purchase of property from related party.

Related parties also include:

- A corporation and a more than 50% shareholder
- A partnership and a partner that owns more than 50% of the capital or profits interest of the partnership

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Related-Party Loss Problem

Fay sold 100 shares of Gym Co. stock to her son, Martin, for $11,000. Fay had paid $15,000 for the stock in 1990.

Two years later Martin sold the stock to an unrelated third party for $16,000.

What amount of gain from the sale of the stock to the third party should Martin report on his income tax return?

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Related-Party Loss Problem—Solution

	Fay	Martin
Amount realized		
Adjusted basis		
Realized gain/loss		
Right of offset		
Recognized gain/loss		

Sale of a Principal Residence

An individual can exclude up to **$250,000** of gain from the sale or exchange of a **principal residence.**

The individual must have **owned** and **occupied** the residence as a principal residence for at least two of the five years before the disposition.

This restriction does not apply in the event of a change in employment (exclusion is prorated).

Sale of a Principal Residence

Married couples filing jointly can exclude up to **$500,000** if:

- At least one meets the ownership requirement
- Both meet the use requirement

Frequency test: The exclusion applies to only one sale or exchange every two years.

Federal Taxation of Individuals

Income

Gross Income—General Concepts and Interest

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Gross Income—General Concepts and Interest

Gross Income

Gross income is **broadly defined**. All income is considered to be taxable unless the income is specifically excluded by the tax law.

Taxable income differs from accounting income.

Income is not limited to cash receipts.

Bartering can also produce income.

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Income Principles

Constructive Receipt: Constructive receipt requires a **cash-basis** taxpayer to include the value of property in income in the period in which the right to the property is acquired.

Income has been constructively received if:

- The amount is **readily available** to the taxpayer, and
- Actual receipt is **not** subject to substantial restrictions.

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Review Question

Dowd, a cash-basis engineering consultant, wanted to defer income to Year 2. A client who was in Dowd's office on December 31, Year 1, offered to pay his $2,000 bill immediately, but Dowd told him to pay $2,000 in January. A check for $5,000 from another client arrived in the mail on December 29 and Dowd told his office manager not to deposit it until January. Dowd also told his office manager not to send a client a bill for $3,000 for services performed in Year 1 until January. **How much income from these transactions should Dowd report in Year 2?**

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Income Principles

Assignment of Income: Income is taxed to the individual who earned the income. Income cannot be assigned to others.

Tax Benefit Rule: The tax benefit rule requires a taxpayer to include an expense reimbursement in income if the expense was deducted in a prior period and the deduction reduced the taxpayer's taxable income.

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Tax Benefit Rule Problem

Clark filed Form 1040 for the Year 1 taxable year and did not itemize his deductions. In July Year 2, Clark received a state income tax refund of $900, plus interest of $10, for overpayment of Year 1 state income tax.

What amount of the state tax refund and interest is taxable in Clark's Year 2 federal income tax return?

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Income Principles

Claim of Right Doctrine: The claim of right rule requires the taxpayer to include property in income in the period in which an apparent claim to the property materializes.

A later repayment of the property generates a deduction but does not influence the earlier recognition of the income.

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Interest Income

In general, all interest income is taxable except for **municipal interest**, which is interest paid on bonds owned by state and local governments.

Interest earned from mutual funds is also tax-free to the extent that the funds own municipal bonds.

However, gain from the sale of municipal bonds is taxable.

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Interest Income

Prepaid interest income is always taxed when received.

Common sources of taxable interest that individuals often have are:

- United States Treasury notes and bonds.
- Federal and state tax refunds.
- Mortgages.

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Series EE Bonds

Interest is paid and taxed at maturity.

Taxpayer can elect to tax annually.

Interest at maturity or redemption can be excluded if:

- Owner of the bond is at least 24 years old.
- Proceeds used to pay **higher education expenses (tuition and fees)** in the year of redemption.
- Higher education expenses are for taxpayer, spouse, or dependents.
- Exclusion is phased out at higher income levels.

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Interest Income Example

Charles and Marcia are married cash-basis taxpayers. This year they had interest income as follows:

√$ 500 interest on federal income tax refund

√$ 600 interest on state income tax refund

√$ 800 interest on federal government obligations

$1,000 interest on state government obligations

What amount of interest income is taxable on Charles and Marcia's joint income tax return? $1,900

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Bond Premium Amortization

If a taxpayer buys a taxable bond at a **premium**:

- An election can be made to amortize the premium.
- The amortization reduces the basis of the bond.
- The amortization offsets the interest income from the bond.
- The amortized bond premium is computed using the **constant yield to maturity method**.

Premiums on tax-exempt bonds must be amortized, but the amortization cannot be deducted.

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Bond Discount Amortization

Bond **discounts** are amortized using the **effective interest rate** method.

The amortization increases interest income.

For short-term bonds, the discount is taxed at maturity as ordinary income for cash-basis taxpayers. It is reported as earned for accrual-basis taxpayers.

Short-term bonds: maturity of one year or less.

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Interest-Free and Below-Market Loans

If interest rate is not at least equal to the applicable federal rate, it is assumed that the borrower pays the current market rate of interest to the lender.

Results in:

- Compensation income if the borrower is an employee.
- Dividend income if the borrower is a shareholder.
- A gift in most other circumstances.

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Interest-Free and Below-Market Loans

Exceptions:

- Less than $10,000
- If less than $100,000, deemed interest is limited to the borrower's investment income on the loan proceeds. The investment income is deemed to be zero if $1,000 or less.

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Gross Income—Other Inclusions

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Gross Income—Other Inclusions

Alimony

- Divorces finalized after 2018:
  - Alimony is not tax to recipient
  - Alimony is not deductible by payor
- Divorces finalized before 2019:
  - Alimony is taxed to the recipient
  - The payor is granted a deduction (for AGI).
- Child support is not taxed to the recipient and is not deductible by the payor.
- Property transfers between spouses are not taxable, and basis stays the same.

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To Qualify as Alimony

- The payment must be in cash or via expense payment (such as a mortgage payment).
- The payment must be contingent upon the life of the recipient (payments cease upon the recipient's death).
- The payment must be required by a written agreement or decree.
- The payment is not child support or specifically identified as non-alimony.

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Alimony Example

Ed and Ann Ross were divorced in January Year 2 (before 2019). In accordance with the divorce decree, Ed transferred the title in their home to Ann in Year 2.

The home, which had a fair market value of $150,000, was subject to a $50,000 mortgage that had 20 more years to run.

Monthly mortgage payments amount to $1,000.

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Alimony Example

Under the terms of settlement, Ed is obligated to make the mortgage payments on the home for the full remaining 20-year term of the indebtedness, regardless of how long Ann lives. Ed made 12 mortgage payments in Year 2.

What amount is taxable as alimony in Ann's Year 2 return?

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Damages and Insurance Benefits

Payments for **physical injury or physical sickness are excluded,** as is worker's compensation.

Unemployment compensation is taxable.

Benefits from accident and health policies are generally excluded from income.

Benefits from disability plans are excluded unless premiums were paid by employer and not taxed to employee.

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Damages and Insurance Benefits

Medical insurance premiums paid by the employer are excluded from income.

Damages received for emotional distress, employment or age discrimination, or injury to reputation must be included in gross income.

Benefits received under long-term care insurance are excludible from income.

Punitive damages in general must be included in gross income.

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Other Income

Jury duty pay is includible in income.

If the jury pay is given to the juror's employer, then a deduction for AGI is received to offset this income.

Unemployment compensation is included in income.

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Gross Income—Exclusions

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Gross Income—Exclusions

Prizes and Awards

The fair market value of these items must be included in income.

Prizes or awards can be excluded if they are for civic, artistic, educational, scientific, or literary achievement and the recipient is:

- Selected without action on her part.
- Not required to perform services.
- The amount is paid directly to a tax-exempt or governmental organization.

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Prizes and Awards Example

Joan accepted and received a $10,000 award for outstanding civic achievement. Joan was selected without any action on her part, and no future services are expected of her as a condition of receiving the award.

What amount should Joan include in her adjusted gross income in connection with this award?

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Scholarships

Amounts received as scholarships by a degree-seeking student can be excluded from income to the extent that the funds are used for **tuition, fees, books, supplies, and equipment required** for courses.

Amounts received for **room and board** are treated as **earned income**.

Scholarship Example

Klein, a master's degree candidate at Briar University, was awarded a $12,000 scholarship from Briar in Year 3. The scholarship was used to pay Klein's Year 3 university tuition and fees. Also in Year 3, Klein received $5,000 wages for teaching two courses at a nearby college.

What amount is includible in Klein's Year 3 gross income?

Life Insurance

Proceeds of life insurance received due to the **death** of the insured are excluded from income.

Accelerated death benefits from a life insurance policy can be excluded from income if the insured taxpayer is terminally or chronically ill.

Gifts and Inheritances

Gifts/inheritances are excluded from the income of the recipient; **intent of the donor** determines if the transaction is a gift.

No such thing as a gift between employer and employee (except for de minimis rules).

Income accrued up to time of gift is still taxed to the donor whereas income accruing after the gift is taxed to recipient (donee).

Social Security Benefits

Generally, SSB are not included in income. However, if the taxpayer's provisional income (PI) exceeds a specified amount, up to 85% of the benefits may be included in income

PI = AGI + Tax-Exempt Interest + 50% (SSB)

Social Security Benefits

PI is compared to the following base amounts (BA):

	BA1		BA2
Married filing joint	$32,000		$44,000
	Not Taxed	50% May Be Taxed	**85% May Be Taxed**
Single	$25,000		$34,000

Forgiveness of Debt

Generally, the forgiveness of debt results in income to the borrower unless the forgiveness is a gift.

A taxpayer that is insolvent, but not bankrupt, can exclude forgiveness of debt **only to the extent of the insolvency**.

If the taxpayer is **bankrupt or insolvent**:

- The debt forgiveness is not taxable.
- The taxpayer must reduce tax attributes such as NOLs, credit carryovers, and the basis of property.

Student loans that are discharged because of the death or disability (total and permanent) are excluded from income.

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Taxation of Income from Business Entities

Qualified Dividends Tax Rate

Qualified dividend income is not taxed (0%) if the taxpayer is in lower tax brackets.

For higher tax brackets, qualified dividend income is taxed at 15% or 20%. The 3.8% net investment income tax could also apply.

To qualify for this lower rate, the dividend must be received from a domestic corporation or a foreign corporation whose stock is tradable on an established U.S. securities market.

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Qualified Dividends Tax Rate

To qualify for this lower rate, the dividend must be received from a domestic corporation or a foreign corporation whose stock is tradable on an established U.S. securities market.

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Dividend Income

Dividends received by a taxpayer are taxed in the following order:

- Dividend income to extent of E&P
- Reduction of basis in stock
- Capital gain

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Dividend Income Problem

How much income does the taxpayer have if:

Distribution to shareholder = $10,000

Shareholder's share of E&P = $ 4,000

Stock basis = $5,000

Capital gain

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Dividend Income

Stock dividends on common stock are not taxable.

Stock dividends on preferred stock are taxable.

The taxpayer's basis in the stock is spread over all shares owned after the dividend.

Stock dividend is taxable:

- If the dividend is not proportionate, or
- If the shareholder has the option of receiving some of the dividend in cash.

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Dividend Income Example

Greller owns 100 shares of Arden Corp., a publicly traded company, which Greller purchased on January 1, Year 1, for $10,000. On January 1, Year 3, Arden declared a 2-for-1 stock split when the fair market value (FMV) of the stock was $120 per share. Immediately following the split, the FMV of Arden stock was $62 per share. On February 1, Year 3, Greller had his broker specifically sell the 100 shares of Arden stock received in the split when the FMV of the stock was $65 per share.

What is the basis of the 100 shares Greller sold?

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Dividend Income Solution

Pre-split basis

$10,000 / 100 shares = $100

Post-split basis

$10,000 / 200 shares = $50

Basis in shares sold

100 shares × $50 = $5,000

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Rents and Royalties

Deductions include depreciation, taxes, insurance, and other ordinary and necessary expenses.

If the taxpayer occupies a portion of the rental property, only the portion of costs applicable to the portion rented can be deducted in arriving at net rental income.

The costs related to the owner-occupied portion are not deductible as rental expenses but may qualify as itemized deductions (e.g., property taxes, mortgage interest).

Reported on Schedule E, page 1.

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Partnerships/LLCs

A partner's share of income from a partnership is reported on Form K-1.

The partner's share of ordinary income is reported by the partner on Schedule E, page 2, of Form 1040.

The partnership's ordinary income, capital gains, deductions, and credits retain their separate character when they flow from the entity to the owner.

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S Corporations

A stockholder's share of S corporation earnings is reported to the shareholder on Form K-1.

The shareholder's share of ordinary income is reported by the shareholder on Schedule E, page 2, of Form 1040.

The corporation's ordinary income, capital gains, deductions, and credits retain their separate character when they flow from the entity to the owner.

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Sole Proprietorship

Business income includes:

Gross profit (gross sales receipts – cost of goods sold).

Professional fees, such as a CPA or an attorney performing professional services.

Board of directors' fees are also considered self-employment income.

Business income is reduced by business expenses and expenses for business use of home to arrive at net profit or loss on Schedule C.

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Farming Tax Rules

Generally rules are the same for other businesses.

All harvested products held for resale, feed, or seed must be included in inventory.

Livestock held for resale must be included in inventory.

Livestock held for breeding or dairy are business assets that can be depreciated.

Cost can be computed under the unit-livestock-price method (animals are grouped based on type and/or age).

Growing crops are not usually included in inventory.

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Farming Tax Rules

Income and expenses for sole proprietors who own farms are reported on Schedule F and Schedule SE.

An individual engaged in farming can elect to determine current-year tax liability by averaging, over the previous three years, all or part current-year income.

Income from the sale of a crop is normally reported in the year of sale.

Exception if insurance proceeds received as a result of the destruction or damage to crops.

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Farming Tax Rules

The cost of most machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business and purchased after 2017 is recovered using the MACRS 150% declining balance method over a 5-year recovery period.

Cash-basis farmers can generally deduct prepaid feed costs in the year of payment if the deduction does not materially distort income.

However, no deduction is allowed for advance payments for feed, seed, fertilizer, or other supplies to the extent such prepayments exceed 50% of total deductible farming expenses (excluding the prepaid items).

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Qualified Business Income

Individuals can deduct 20% of qualified business income (QBI) that is received from partnerships, S corporations, or sole proprietorships.

The 20% is allowed as a deduction reducing taxable income and is not allowed to reduce AGI.

The deduction is allowed only for Federal income tax purposes and does not reduce self-employment income.

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Qualified Business Income

QBI is reduced by 50% of the self-employment tax, the self-employed health insurance deduction, and retirement plan contributions.

If a taxpayer has more than one QBI activity, the QBI deduction is computed separately for each activity. A loss activity will have a negative QBI that will reduce the total deduction (but not below zero).

The QBI deduction reported on the tax return is the lower of:

1) the sum of the QBI from all activities, or

2) 20% x the taxpayer's modified taxable income.

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Qualified Business Income – Wage Limitation

The QBI deduction for each activity is limited to the greater of:

1. 50% of the W-2 wages relating to the qualified trade or business, or
2. the sum of
   a) 25% of the W-2 wages relating to the business, and
   b) 2.5% percent of the unadjusted basis immediately after acquisition of all qualified property.

This limitation does not apply depending on the taxpayer's modified taxable income.

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Qualified Business Income – Specified Services Limitation

Income earned in a specified services activity is not eligible for a QBI deduction unless the taxpayer's modified taxable income is below a certain threshold.

The following are subject to the specified service activities limitation:

- Health, Law, Accounting, Actuarial Science, Performing Arts, Consulting, Athletics, Financial Services, Brokerage Service

Those engaged in the trade or business of being an employee are not eligible for a QBI deduction for income earned as an employee.

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Qualified Business Income – Income Limitations

	QBI Limitations		
Filing Status	2019 Modified Taxable Income		
Married Filing Jointly	<= $321,400	> $321,400 and < $421,400	>= $421,400
Married Filing Separate	<= $160,725	> $160,725 and < $210,725	>= $210,725
Other	<= $160,700	> $160,700 and < $210,700	>= $210,700
Wage/Asset Limitation	Limitation does not apply	Limitation phased-in; partially applies	Wage limitation fully phased-in
Specified Services Limitation	Limitation does not apply; QBI deduction allowed	QBI deduction partially allowed	QBI deduction not allowed
20% of Taxable Income Limitation Applies?	Yes	Yes	Yes

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Qualified Business Income Example

Kaitlin, a married taxpayer, operates a business as a sole proprietor. The business has one employee, who is paid $90,000 during 2019. Assume that the business has no significant assets. During 2019, the net income of Kaitlin's business [as reported on Schedule C (Form 1040)] amounts to $230,000 and her modified taxable income is $275,000.

Kaitlin's QBI deduction is $46,000 ($230,000 x 20%).

$46,000 does not exceed Kaitlin's modified taxable income ($275,000) x 20%, or $55,000.

If Kaitlin's modified taxable income was $200,000, the QBI deduction would be limited to $40,000 ($200,0000 x 20%).

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Qualified Business Income

Assume the same facts except that the net income from Kaitlin's proprietorship amounts to $500,000 and her modified taxable income is $560,000. As Kaitlin's modified taxable income exceeds $421,400, her QBI deduction for this activity is $45,000, the lower of:

- $100,000 (20% x $500,000), or
- $45,000 (50% of W–2 wages of $90,000).

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Qualified Business Income

Assume the same facts except that Kaitlin's modified taxable income is $381,400. Because Kaitlin's modified taxable income exceeds $321,400 but is less than $421,400, the W–2 limit is partially phased in. Her modified taxable income exceeds $321,400 by $60,000. So Kaitlin must reduce her "normal" QBI deduction ($100,000) by 60% ($60,000/$100,000) of the difference between the normal QBI deduction ($100,000) and the limited QBI deduction (based on W–2 wages; $45,000). So Kaitlin's QBI deduction is $67,000, computed as follows:

Normal QBI deduction	$100,000
Less: 60% x ($100,000 − $45,000)	(33,000)
QBI deduction	$ 67,000

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Accounting Methods and Periods—Individuals

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Accounting Methods and Periods—Individuals

Sole Proprietorships

An individual's business income is reported on Schedule C.

Methods of accounting available are cash, accrual, and hybrid.

Individuals always report on the calendar year-end.

Cash Basis

Under the cash basis, a taxpayer has **no accounts receivable** because no accounting entry is made for sales on account (no property has been received).

Accrual Basis—Exceptions

Unearned income is usually recognized in the year received, rather than the year earned.

Taxpayers may elect to defer recognition of **service income** into the next year if the service is to be provided within the following year.

Taxpayers may elect to defer recognition of **advance payments for goods** if the method of accounting for sales is the same for tax and financial reporting purposes.

Taxpayers must recognize income no later than the year in which the income is included on an applicable financial statement.

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Applicable Financial Statement

An applicable financial statement is a statement which conforms to GAAP and is,

1. reported in a 10-K, or
2. an audited financial statement used for a non-tax purpose, or
3. filed with a federal agency (but not for tax purposes).

Also includes a financial statement that conforms to IFRS.

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Rental Income

Prepaid rent is taxed when received.

Lease deposits are not income when received if they can be returned to the lessee at the end of the lease term. They are taxed when the lessor receives an unrestricted right to them.

The fair value of **leasehold improvements** is income to the landlord if the improvements are made in **lieu of rent**.

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Rental Income—Problem

Nare, an accrual-basis taxpayer, owns a building which was rented to Mott under a 10-year lease expiring August 31, Year 8. On January 2, Year 5, Mott paid $30,000 as consideration for canceling the lease. On November 1, Year 5, Nare leased the building to Pine under a five-year lease. Pine paid Nare $10,000 rent for the two months of November and December and an additional $5,000 for the last month's rent.

What amount of rental income should Nare report in its Year 5 income tax return?

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Cash vs. Accrual

In general, corporations and partnerships with corporate partners must use the accrual method of accounting.

The taxpayers listed above whose average annual gross receipts (for past three tax years) do not exceed $25 million can also use the cash method. These taxpayers can:

1. Treat inventory as a non-incidental material and supply, or
2. Treat inventory in the same manner as on an applicable financial statement.

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Cash vs. Accrual

The $25 million test has to be met only for the preceding three tax years.

Notwithstanding any other rules, a taxpayer that is classified as a tax shelter must use the accrual method of accounting.

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Inventory Accounting

LIFO can be used only if it is also used for financial reporting.

When prices are rising, LIFO results in:

- Higher cost of goods sold
- Lower taxable income

Taxpayers can value inventory at the lower of cost or market unless they are using LIFO (in which case cost must be used).

Market is defined as replacement cost or reproduction cost.

Uniform Capitalization Method

Manufacturers and certain retailers and wholesalers are required to use the uniform capitalization method to capitalize all the **direct** and **indirect** costs allocable to property they produce and for property bought for resale.

Virtually all indirect production costs must be capitalized for tax purposes.

The uniform capitalization rules do not apply to taxpayers with average gross receipts (for the last three years) of less than $25 million. This applies to both producers and resellers.

Uniform Capitalization Method

Included costs:

- Storage costs if off-site
- Quality control
- Taxes (except income taxes)
- Utilities, repairs, rent, depreciation

Uniform Capitalization Method

Costs not included:

- Marketing and selling
- Research
- Advertising
- Distributions
- General and administrative expenses

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Changes in Accounting Method

Any adjustment to income required due to a **voluntary change** in accounting method is spread over **four years** beginning with the year of change. A voluntary change includes changing from an incorrect to a correct method. If the adjustment is less than $25,000, the taxpayer can include all income in the year of change.

If the change in accounting method is initiated due to an IRS examination, any positive adjustment to income is included in the earliest tax year under examination.

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Installment Sales

The gross profit from the sale is recognized as cash is received.

Contract price is the amount of cash or property to be received as payment. It is the amount realized reduced for debt relief and increased by selling expenses.

Amount realized (including any debt relief)

(Adjusted basis)

Gross Profit

$$\text{Recognized Gain} = \text{Cash Received} \times \frac{\text{Gross Profit}}{\text{Contract Price}}$$

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Review Problem

In year 1, a taxpayer sold real property for $200,000, receiving $100,000 at closing and $100,000 plus accrued interest at the prime rate in the next year. The buyer also assumed a $50,000 mortgage on the property. The taxpayer's adjusted basis was $75,000, and the taxpayer incurred $10,000 of selling expenses.

If this transaction qualifies for installment sale treatment, what is the gross profit on the sale?

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Review Problem—Solution

Cash
Liability relief
Selling expenses

Amount realized
Adjusted basis
Gross profit
Gross profit % =
Gross profit/contract price =

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Installment Sales

- Does not apply to losses.
- Dealers cannot use installment method for sales of inventory.
- All depreciation recapture must be recognized in the year of sale.
- The entire gain will be recognized immediately if the installment note is sold.
- The installment obligation must have a market interest rate or a portion of the gain will be treated as imputed interest.
- Can elect to recognize gains currently.

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Installment Sales Problem

Assume an asset is sold for $100 on the installment basis. The asset is equipment which is Section 1245 property.

Other information is as follows:

A. Adjusted basis = $40
B. Depreciation claimed on the asset is $35.
C. The $100 will be paid in two installments of $60 in Year 1 and $40 in Year 2.

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Installment Sales Problem—Solution

Amount Realized
Adjusted Basis
Realized Gain

Year 1 recapture:
Year 1 installment income:

Year 2 installment income:

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Prepaid Expenses

For prepaid expenses under the cash method, an immediate deduction can be taken when paid as long as the benefits from the expenditure do not extend beyond the earlier of:

- 12 months after benefits first begin, **or**
- The end of the year after the year in which the payment was made.

If the **12-month rule** is not met, then the expenses are amortized over the benefit period.
Prepaid interest must always be amortized over the life of the loan.

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Accrual Method Exceptions

The taxpayer can deduct refunds, rebates, awards, prizes, provision of warranty work or service contracts, taxes, and insurance premiums when actually paid.

Capitalization Rules

The cost of a unit of property (UOP) includes all related expenditures incurred before the date the asset is placed in service, even repairs.

A single UOP includes all components that are functionally interdependent.

The taxpayer can elect to capitalize employee compensation and overhead costs.

Safe Harbor—Lower-Cost Items

This safe harbor applies if the taxpayer:

A. Has written procedures in place that provide for the expensing of amounts below a specified dollar amount, or that have a useful life of 12 months or less.

B. Expenses the items for its accounting/book records.

C. Insures that items costing more than $5,000 are capitalized ($2,500 if the company does not have acceptable [generally meaning audited] financial statements).

Routine Maintenance

Routine maintenance to keep UOPs operating efficiently is expensed, such as testing, cleaning, inspecting, and replacing parts.

For an expenditure to be routine, it must be expected that the expenditure will be needed more than once during the asset's life.

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Routine Maintenance

An expense cannot be treated as routine maintenance if:

- It improves a UOP (treated as a betterment);
- A loss has been deducted against the property's basis, or the basis has been reduced as part of a sale/exchange;
- The asset has deteriorated and the expenditures restore the UOP to an operating condition;
- It adapts a UOP to a new or different use; or
- It is for maintenance, improvement, or repair of network assets or certain spare parts.

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Qualifying Small Taxpayers

Qualifying small taxpayers are those with $10 million or less average annual gross receipts in the three preceding tax years.

They can deduct improvements made to an eligible building property (one with an unadjusted basis of $1 million or less).

This new safe harbor election applies only if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of $10,000 or 2% of the building's unadjusted basis.

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Taxation of Employee Benefits

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Taxation of Employee Benefits

Employee Business Reimbursements

Reimbursements of employee business expenses are included in income of the employee.

However, note that reimbursements under an **accountable plan** are not required to be reported on the W-2.

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Discrimination Rules

Employee benefits are generally excluded from income as long as the benefit plans do not **discriminate** in favor of highly compensated employees.

If they do discriminate, highly compensated employees must include these benefits in income, but in general other employees do not.

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Life Insurance

The limit on this exclusion is the amount of premiums necessary for a **group term** policy of **$50,000** face value.

For amounts over $50,000, the insurance benefits are taxable based on the rates in an IRS table. The rates are based on the age of the taxpayer.

If an employer pays premiums on a **whole-life insurance policy** for an employee the value of those premiums are included in income.

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Insurance Premiums

Health insurance premiums paid by an employer are **excluded from income**.

Employer-paid premiums **for long-term care policies** are also excluded from income.

Employer-paid premiums for **wage continuation insurance** are included in income.

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Disability Insurance Summary

Premiums paid by taxpayer—**not** deductible

Premiums paid by taxpayer's employer—**excluded** from taxpayer's income; deductible by employer

Benefits received by the taxpayer from a policy paid for by the taxpayer—**excluded** from income

Benefits received by the taxpayer from a policy paid for by the employer—**included** in income

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Meals and Lodging

Meals and lodging are excluded if:

- Furnished for convenience of employer
- On employer's premises
- Meals must be in kind
- Lodging must be a condition of employment

Employee Benefits

Following are excluded from income:

- No-additional-cost **services**, employee discounts (limited to gross profit percentage; 20% for services), working condition fringes, deminimis fringes, nominal gifts (up to $25), payments for transportation, and parking.
- Employer-provided retirement planning advice.
- Payments from an employer for expenses that would be deductible as moving expenses must be included in income, unless the move is for a member of the Armed Services related to a military order.

Employee Benefits Example

Mr. T has been a night watchman at Y Company for 10 years. This year he received the following payments from Y Company:

Salary	$ 15,000
Hospitalization insurance premiums	3,600
Required lodging on Y's premises for Y's convenience as a condition to T's employment	2,400
Reward for preventing a break-in	1,000
Christmas ham (value)	15
What amount is includable in Mr. T's gross income?	16,000

Other Employee Benefits

Employees can exclude (up to $5,000; $2,500 if married filing separately) from gross income the value of **child and dependent care services** provided by the employer, if the services are provided so that the employee can work.

Employees can exclude (up to $5,250) from gross income the value of assistance provided by the employer **for undergraduate and graduate tuition, fees, books, and supplies**.

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Tuition Waivers

Employees of **nonprofit educational institutions** can exclude **undergraduate tuition** waivers for themselves, their spouse, and dependent children from gross income if the institution has a qualified tuition reduction plan.

Graduate tuition waivers are excluded from income only for **graduate teaching/research assistants**.

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Other Employee Benefits

Employees can exclude from gross income **expenses incurred to adopt a child**, if these expenses are reimbursed by the employer.

The exclusion is phased out at higher AGI levels.

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Cafeteria Plans

Under a cafeteria plan, an employee can choose between cash and certain "qualified benefits."

Cash is treated as wages.

Qualified benefits are tax-free benefits if they would have been tax-free if not offered through a cafeteria plan.

Cafeteria Plans

Qualified benefits include:

- Benefits/coverage under accident or health plans
- Long-term or short-term disability coverage
- Group term life insurance coverage
- Dependent care assistance programs
- Section 401(k) plans
- Contributions through health savings accounts
- Adoption assistance

Stock Options

	Incentive Stock Option	Nonqualified Stock Option
Grant Date	None	None
Exercise Date	None (except amt.)	Ordinary Income
Sale Date	Ordinary Income/Capital Gain (amt. adj. reverses)	Capital Gain

Corporation receives deduction for ordinary income portion only.

Nonqualified Stock Options

On the exercise date, the employee recognizes ordinary income equal to:

(FMV of stock – Exercise price)
×
# of shares exercised

Nonqualified Stock Options Example

Greg received 100 nonqualified stock options to purchase E.com stock on October 17, Year 4. At the grant date the stock had a fair market value of $10 and an option price of $6. On December 12, Year 4, Greg exercised the stock options. The FMV of the stock was $14 at that time On January 5, Year 5, Greg sold the 100 shares for $15 per share.

How much income should Greg report on his Year 4 tax return?

Non-Qualified Stock Options—Solution

Year 4:

(FMV of stock – Exercise price) × # of shares exercised

Year 5:

Amount realized

Adjusted basis

Short-term capital gain

Incentive Stock Options

The gain on sale is LTCG if acquired stock is:

- Held more than one year
- Not sold until after two years from the date the option was granted

Incentive Stock Options

If these requirements are not met, the option is treated like a nonqualified stock option:

1. The gain on the stock sale is ordinary income, and the employer receives a deduction equal to the stock's FMV on the exercise date over the exercise price.
2. The difference in the FMV on the sale date and the FMV on the exercise date is capital gain or loss.

Incentive Stock Options Example

In Year 1 Jan received an incentive stock option from her employer with an exercise price of $10. The fair market value of the stock at that time was $10.

Jan exercised the option on December 30, Year 1, when the fair market value of the stock was $13. Jan sold the stock on May 15, Year 4, for $20.

How much income should Jan report on her Year 1 tax return?

Incentive Stock Options—Solution (Sold in Year 4)

Grant date	> 2yr	YR 1	
Exercise date		12/30/1	> 1yr
Sale date		05/15/4	

<u>Year 4</u>

Amount realized	20
Adjusted basis	(10)
Long-term capital gain	10

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Incentive Stock Options—Solution (Sold in Year 2)

<u>Year 2</u>

Ordinary income =

(FMV of stock – Exercise price) × # of shares exercised

(13 – 10) = $3 OI

Amount realized	20
Adjusted basis	(13)
Short-term capital gain	7

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Qualified Equity Grants

Private company employees can elect to defer for up to five years the recognition of income from private company stock acquired due to the exercise of a stock option or the settlement of an Restricted Stock Unit (RSU), provided the employee received the stock as part of a qualified equity grant.

Applies with respect to stock received due to options exercised or RSUs settled after Dec. 31, 2017.

The grant must provide all eligible employees the same rights and privileges to receive qualified stock, and not less than 80% of all U.S.-based employees who provide services to such corporation must receive grants of stock options or RSUs.

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Qualified Equity Grants

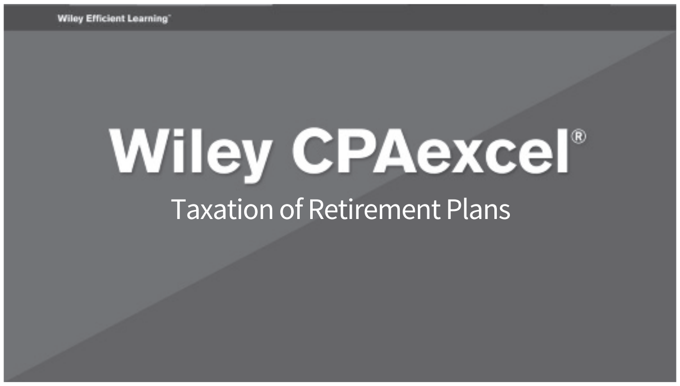
If election is made, income taxes are due upon the earliest of:

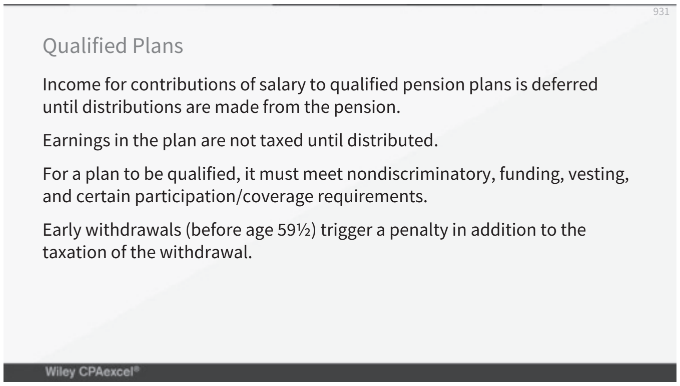
- When the stock becomes transferable, including to the employer;
- Five years after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier; or
- The date the employee revokes his or her election.

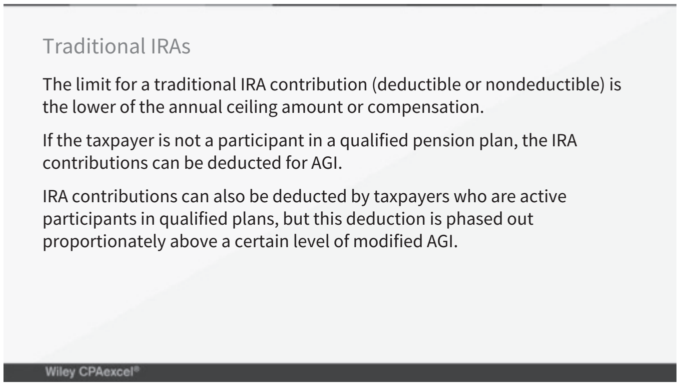
Election must be made within 30 days of the date the five-year period begins.

The deferral of taxes does not apply to FICA taxes.

Taxation of Retirement Plans







Traditional IRAs

A married taxpayer who is not an active participant can deduct contributions even if the taxpayer's spouse is an active participant. However, this deduction is phased out proportionately above a certain level of modified AGI.

All phase-outs are prorated over the phase-out range (usually $10,000 or $20,000 range).

Taxpayers who cannot deduct IRA contributions can nonetheless defer the income earned by **nondeductible IRA contributions** to traditional IRAs.

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Traditional IRAs

IRA contributions must be made by the original due date of the return (April 15) to be deductible for the previous tax year.

Nondeductible contributions to traditional IRAs are reported on **Form 8606.**

Withdrawals from a traditional IRA must begin when the taxpayer reaches age 70½.

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Roth IRAs

Contributions are **not deductible** but can only be made if modified AGI does not exceed certain levels.

Withdrawals of income accumulated in a Roth IRA are not taxed as income if the distribution:

- Occurred five years or more from the date of the initial contribution
- Is made on or after an individual attains age 59½

Withdrawals are not required once the taxpayer reaches age 70½.

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Withdrawals—IRAs

Withdrawals from an IRA may be subject to a **penalty tax of 10%**. This tax is not imposed if the taxpayer is disabled, age 59½, separated from service after age 55, or has died.

Also if:

- Made in the form of certain periodic payments,
- For first-time homebuyers (up to $10,000),
- Used to pay qualified higher education expenses,
- Used to pay health insurance premiums if unemployed, **or**
- Used to pay medical expenses in excess of the AGI floor.

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IRA Conversions

Taxpayers can convert a traditional IRA to a Roth IRA.

The taxpayer must recognize gain at the time of the conversion to the extent that the conversion amount exceeds the tax basis in the IRA.

This same rule applies to conversions of 401(k) plans into Roth plans.

These conversions are reported on Form 8606.

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Distributions

Payments from retirement plans are included in income, except to the extent that the employee has basis in the plan.

An employee has **basis** to the extent that the employee made **nondeductible contributions** to the plan.

The following do not create basis:

- Contributions made by employers
- Tax deductible employee contributions
- Tax-free earnings inside the plan

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Distribution Problem

John invested $5,000 a year into his retirement plan from his taxable earnings. His employer contributed $8,000 a year to John's retirement fund. After 20 years of contributions, John retires and receives a distribution, which is not tax-free, of $750,000, the balance in his retirement fund. John must include what amount in gross income?

Distribution	$750,000
Basis 20 × $5,000	(100,000)
Income	$650,000

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Tax on Excess Accumulations

Distributions from qualified plans must begin by the required beginning date, and the payment each year must be at least equal to the required minimum distribution.

If the required distribution is not made a tax equal to 50% of the required distribution not made must be paid.

Distributions must begin by April 1 of the later of:

- The year the taxpayer reaches age 70½, **or**
- The year the employee retires.

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Keogh Plans

Keogh plans are for **self-employed taxpayers**. Contributions are limited to the lesser of the annual limitation or 25% of earned income.

Earned income equals net earnings from self-employment less 50% of the self-employment tax less the allowable Keogh contribution.

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Section 401(k) Plans

A 401(k) plan allows voluntary employee contributions to reduce taxable salary up to an annual limit, plus a catch-up amount for those age 50 and over.

Employers often match a certain percentage of employee contributions to these plans.

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Simplified Employee Pension Plan (SEP)

A SEP is an individual retirement plan established by an employer.

Employer contributions for a year must be made to each SEP of each employee who has:

- Reached age 21
- Performed service for the employer during at least three of the immediately preceding five years
- Has received a certain level of compensation

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Simplified Employee Pension Plan (SEP)

Maximum allowable contributions made by an employer to a SEP cannot exceed the lower of:

- 25% of compensation, **or**
- The dollar limitation for defined contribution plans.

Contributions can be made up to the **extended due date of the return**.

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Section 529 Plans

These plans are used to save for education expenses through a vehicle that allows the earnings to be excluded from gross income.

Contributions are not deductible, and a beneficiary must be specified for the plan.

States typically allow lifetime contributions to the plan of as much as $250,000.

Earnings in the plan are tax deferred.

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Section 529 Plans

Distributions from the plans are excluded from income to the extent the distribution is used to pay for college/university tuition, fees, books, etc., and reasonable room and board costs.

Distributions not used for a qualified purpose are subject to income taxation and a 10% penalty.

For distributions after 2017, qualified expenses include tuition at elementary or secondary public, private, or religious schools. Exclusion is limited to $10,000 per year.

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Deductions

Deductions—Basic Principles

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Deductions—Basic Principles

Individual Deductions

Deductions can be divided into two broad categories:

- Deductions for AGI
- Deductions from AGI (i.e., itemized deductions)

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Activities for Tax Purposes

Activities/transactions can be divided into three mutually exclusive categories:

- Trade or business
- Investment
- Personal

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Types of Deductions

Expenses related to one's personal activities cannot be deducted unless specifically provided for in the IRC (e.g., charitable contributions, mortgage interest).

Expenses related to trade or business activities are deductible if they are related to the business operations and are ordinary, necessary, and reasonable.

Expenses related to investment activities or other activities that produce income are deductible if ordinary, necessary, and reasonable.

Types of Deductions

Expenses related to the management or maintenance of property and in connection with the determination of any tax are deductible.

Definition: "Ordinary" "and necessary" are usually interpreted to mean the nature of the expenditure is customary and appropriate under the circumstances.

The expenditure must be reasonable in amount.

Review Question

Rich is a cash-basis self-employed air-conditioning repairman with Year 5 gross business receipts of $20,000. Rich's cash disbursements were as follows:

Air conditioning parts	$2,500 ✓
Yellow Pages listing	2,000 ✓
Estimated federal income taxes on self-employment	1,000
Business long-distance telephone calls	400 ✓
Charitable contributions	200

What amount should Rich report as net self-employment income?
20,000 – 4,900 = $15,100

Disallowed Deductions

Executive compensation for the CEO and the four other most highly compensated officers that exceeds $1 million per person is not deductible. After 2017 income that is based on a performance-based compensation plan is also included in this restriction (unless part of a contract in effect on November 2, 2017).

Lobbying expenses at the local, state, and federal level cannot be deducted.

No expenses can be deducted if the expense is used to generate tax-exempt income.

Political contributions are disallowed.

Disallowed Deductions

No deduction is allowed for a settlement or attorney's fees related to sexual harassment or sexual abuse if the payments are subject to a nondisclosure agreement.

Members of Congress cannot deduct living expenses when away from home.

Domestic production activities deduction is no longer allowed.

Expenses Against Public Policy

No expenses can be deducted if the expenditure is against public policy (e.g., illegal). Examples include bribes, fines, penalties, and expenses of operating an illegal drug business.

However, cost of goods sold can be deducted for an illegal drug business.

Note that the ordinary, necessary, and reasonable expenses of operating other illegal businesses are permitted (as long as the expense itself is not against public policy).

No deduction is allowed for amounts paid/incurred to a government entity or specified nongovernmental entity related to the violation of any law. An exception is made for payments for restitution or remediation, and for taxes due.

Business Interest

Businesses cannot deduct net interest expense in excess of 30% of the business's adjusted taxable income.

Determination is made at partnership level and S corporation level for pass-through entities.

Adjusted taxable income does not include depreciation, amortization, or depletion.

Disallowed interest may be carried forward indefinitely.

Does not apply to taxpayers with average annual gross receipts (three years) that does not exceed $25 million.

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Business Interest

Real property trade/businesses can elect out if they use ADS to depreciate real property.

Farming businesses can elect out if they use ADS to depreciate property with a recovery period of 10 years or more.

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Deductions for AGI

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Deductions for AGI

Business and Rental Expenses

Income from sole proprietorships is reported on Schedule C net of business deductions.

The net income is transferred to Form 1040 so these deductions are for AGI.

Similarly, deductions from rental property reported on Schedule E are also deductions for AGI; and for farming operations on Schedule F.

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Moving Expenses

Moving expenses are no longer deductible beginning in 2018.

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Interest on Education Loans

Individuals can deduct interest paid on education loans.

The maximum deduction is $2,500.

An education loan is defined as a loan to pay higher education expenses for the taxpayer and the taxpayer's spouse and dependents.

The deduction is phased out for certain higher-income taxpayers.

A taxpayer will not be allowed a deduction if she can be declared as a dependent by someone else.

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Alimony

Alimony is deductible by the payor as a deduction for AGI through 2018.

For divorces or separation agreements after 2018, alimony is no longer deductible, and alimony is not income to the recipient.

The current rules continue to apply for divorces and separations that are/were executed *before* 2019.

If an agreement executed before 2019 is later modified, the new rules will apply to it only if the modified agreement explicitly states that the new provisions apply.

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Alimony Example

Rick and Stacy were divorced in February of 2017. Requirements of the divorce decree and Stacy's performance follow:

Transfer title to their residence to Rick. Stacy's basis was $95,000. The fair market value was $105,000, and the residence was subject to a mortgage of $90,000.

Make the mortgage payments of $1,000 per month (beginning in March) for the remaining 20 years or until Rick dies, if sooner.

Pay Rick $500 per month (beginning in March) for 6 years or until Rick dies, if sooner. Of this amount, $200 is designated as child support.

How much is Stacy's alimony deduction in the current tax year?

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Other Deductions for AGI

One-half of self-employment taxes as computed on Schedule SE is allowed as a deduction for AGI.

100% of the costs of health insurance premiums are deductible by self-employed workers as long as the amount does not exceed the taxpayer's net earnings from self-employment.

IRA and other retirement plan contributions.

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Other Deductions for AGI

Penalty on early withdrawal of savings

Repayment of jury duty fees to employer

Educator expense

- Deductible up to $250 for teachers in grades kindergarten – 12th
- Books, equipment, and supplies qualify; and professional development

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Health Savings Account

Taxpayers can contribute funds to a health savings account and receive a deduction for AGI in the year the contributions are made.

Amounts distributed from an HSA to pay qualified medical expenses of the account beneficiary are not includible in income.

Nonqualified distributions are included in gross income and subject to a 20% penalty. Medicine and drugs are qualified only if they are prescription drugs or insulin.

To qualify, a taxpayer must be covered only under a high-deductible health plan and may not be entitled to benefits under Medicare.

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Itemized Deductions—Medical, Taxes, Interest

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Itemized Deductions—Medical, Taxes, Interest

Standard Deduction

Individuals deduct the greater of the standard deduction or itemized deductions.

Standard deduction amounts vary according to filing status. For 2019 the amounts are:

• Single	$12,200
• Head of Household	$18,350
• Married–jointly	$24,400
• Married–separate	$12,200

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Medical Expenses

Deductible for taxpayer, spouse, and dependent (gross income and joint return tests do not apply for this purpose).

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Deductible Items

- Dental, medical, and hospital care
- Prescription drugs
- Equipment such as wheelchairs, crutches, eyeglasses, hearing aids, contacts
- Transportation for medical care
- Medical insurance premiums
- Qualified long-term care expenses and insurance
- Alcohol and drug rehabilitation
- Weight-reduction programs if as part of medical treatment

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Nondeductible Items

- Funeral, burial, and cremation expenses
- Nonprescription drugs (except insulin)
- Bottled water
- Toiletries
- Cosmetics
- Health spas
- Unnecessary cosmetic surgery

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Formula for Medical Expenses

Qualified Medical Expenses
– Reimbursements from Insurance
– 10% of AGI

Deductible Medical Expenses

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Medical Expenses Problem

Smith paid the following unreimbursed medical expenses:

Dentist and eye doctor fees	$ 5,000
Contact lenses	500
Facial cosmetic surgery to improve Smith's personal appearance (surgery is unrelated to personal injury or congenital deformity)	10,000
Premium on disability insurance policy to pay him if he is injured and unable to work	2,000

What is the total amount of Smith's tax-deductible medical expenses before the adjusted gross income limitation?

Real Estate Taxes

Real estate taxes on property used for personal purposes are itemized deductions.

State and local taxes on real property are deductible, but only by the person legally liable for the tax.

Foreign real property taxes are no longer deductible after 2017.

Income Taxes

Foreign, state, and local income taxes are itemized deductions, even if partially due to business income.

An individual can elect to deduct sales taxes instead of state income taxes.

Actual receipts can be used for sales taxes or an IRS table can be used that uses income, number of exemptions, and state residence as input factors.

Taxes

Personal property taxes based on the value of the property (ad valorem) are deductible.

Other property taxes are not deductible.

Special assessments are not deductible.

Fees and licenses (dog, automobile, hunting and fishing, etc.) are not deductible.

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Overall Limitation on Personal Taxes

The overall deduction for taxes related to one's personal life cannot exceed $10,000 ($5,000 for MFS).

The $10,000 limit applies to the total of the following state and local taxes:

- Real property
- Personal property
- Income/Sales

This does not apply to taxes deductible on Schedule C, E, or F.

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Taxes Example

George Burke, a salaried taxpayer, paid the following taxes, which were not incurred in connection with a business:

Federal income tax (withheld by employer)	$1,500
State income tax (withheld by employer)	1,000
FICA tax (withheld by employer)	700
State sales taxes	900
Federal auto gasoline taxes	200
Federal excise tax on telephone bills	50

What taxes are allowable deductions from Burke's adjusted gross income?

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Nondeductible Taxes

The following taxes are not deductible for individuals:

- Federal income taxes
- Federal, state, or local estate or gift taxes
- Social security and other federal employment taxes paid by employee (including self-employment taxes)
- Foreign real property taxes

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Interest Expense

Personal interest: Credit card interest, car loan interest, and interest on income tax underpayments is not deductible.

Investment interest expense is limited to net investment income (investment income less investment expenses).

Election is available to include long-term capital gain and qualified dividend income in investment income; if so, these items are taxed as ordinary income.

Investment expenses reduce NII only to the extent they are deductible.

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Investment Interest Example

For the current year, David Roth, a married taxpayer filing a joint return, reported the following:

Investment income from interest	$24,000
LTCG on stock held for investment	25,000
Investment expenses	4,000
Interest expense on funds borrowed to purchase investment property	70,000

Assuming that David elects to treat the gain as investment income, what amount can he deduct as investment interest expense?

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Investment Interest Example

Net investment income = Inv Inc – Inv Exp

Deduction =

Carryforward =

Mortgage Interest Expense

Interest paid or incurred on acquisition indebtedness secured by a qualified residence (principal residence plus one other residence) is deductible. Debt is limited to $750,000.

The $1,000,000 debt limit (pre-2018) will continue to apply to acquisition indebtedness incurred before December 15, 2017. Also to refinancing of debt to the extent the $1,000,000 limit applied to the original debt.

After 2017, home equity indebtedness is no longer deductible.

Mortgage Interest Example

On January 2 of the current year, the Philipses paid $50,000 cash and obtained a $200,000 mortgage to purchase a home.

This year they borrowed $15,000 secured by their home and used the cash to add a new room to their residence.

They also took out a $5,000 auto loan.

Mortgage Interest Example

The following information pertains to interest paid in the current year:

Mortgage interest	$ 17,000
Interest on room construction loan	1,500
Auto loan interest	500

How much interest is deductible, prior to any itemized deduction limitations?

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Itemized Deductions—Other

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Itemized Deductions—Other

Charitable Contributions

- Must be made to a qualified charitable organization.
- Payments to individuals do not qualify.
- No deduction is allowed for a contribution of services.
- A taxpayer who makes a payment to a college or university and is entitled to purchase tickets to athletic events cannot deduct the payment as a charitable contribution.
- Cash contributions can be deducted up to 60% of AGI. Contributions of other property are limited to 50% of AGI.
- Carryover is 5 years—no carryback.

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Charitable Contributions

LTCG property: FMV is deductible, but deduction is limited to 30% of AGI.

All other property: The deduction is the fair market value of the property, reduced by any STCG or ordinary income that would be recognized if the property had been sold.

Ordinary income property includes ordinary income due to depreciation recapture.

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Charitable Contributions—Example

Moore, a single taxpayer, had $50,000 in adjusted gross income this year. During the current year she contributed $23,000 to her church. She had a $10,000 charitable contribution carryover from her previous year church contribution.

What is the maximum amount of properly substantiated charitable contributions that Moore could claim as an itemized deduction for this year?

Modified from assess.AICPA.950507REG-AR

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Charitable Contributions—Solution

AGI

Limitation × 60%

Contributions:

Current

Carryover

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Charitable Contribution Ordering Rules

The limitations on charitable contribution deduction are applied in the following order:

Cash contributions – 60% of AGI

Contributions to 50% charities (public) – 50% of AGI

Contributions to 30% charities (certain private foundations, fraternal orders, cemetery companies, etc.) – 30% of AGI

Contributions of long-term capital gain property to 50% charities – 30% of AGI

Contributions of long-term capital gain property to 30% charities – 20% of AGI

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Charitable Contribution Ordering Example

Genevieve has adjusted gross income of $100,000 and contributes $28,000 cash and stock owned for three years to a qualified public charity. The stock had a fair market value of $60,000 and adjusted basis of $40,000. Compute her charitable contribution deduction and carryforward?

Cash contribution to 50% charity (limited to $100,000 x 50%)

LTCG contribution is deductible to the extent of the lower of:

1) ($100,000 x 50%) less =

2) $100,000 x =

Carryforward of 30% contribution is

Nondeductible Contributions

- Civic leagues, social clubs
- Foreign organizations
- Chambers of commerce, labor unions
- The value of the taxpayer's time or services
- The use of property, or less than an entire interest in property
- Tuition or amounts in place of tuition
- Payments to a hospital for care of particular patients
- Raffles, bingo, etc. (but may qualify as gambling loss)
- Political organizations

Casualty Losses

Casualties must be sudden and unexpected.

Typical casualties include natural disasters, thefts, and automobile accidents.

Damage caused from erosion is not sudden and does not qualify as a casualty.

After 2017, a casualty of personal use property must be part of a federally declared disaster to be deductible.

If a taxpayer has casualty gains, casualty losses (even if not federally declared disaster) can be used to offset the gains.

Not Qualifying as Casualties

- Losses from the breakage of china or glassware through handling or by a family pet
- Disease, termite, or moth damage
- Expenses incident to casualty (temporary housing, etc.)
- Losses from nearby disaster (property value reduced due to location near a disaster area)
- Loss of future profits

Casualty Losses

For personal casualty losses, the deduction is computed as follows:

Lower of decline in FMV or AB of property

– Insurance reimbursements

– Casualty floor

– 10% × AGI

Casualty Loss Deduction

Casualty Losses Example

The next two items are based on the following selected information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the current calendar year.

The Hoyts had adjusted gross income of $34,000 and itemized their deductions this year. The Hoyts' cash expenditures follow.

Casualty Losses Example

$2,500 repairs in connection with fire damage to the Hoyt residence

This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1999 for nonpayment of premium.

$800 appraisal fee to determine amount of fire loss

What amount of fire loss were the Hoyts entitled to deduct as an itemized deduction on their return, assuming the fire was part of a federally declared disaster?

Casualty Losses—Solution

Lower of decline in FMV

or AB of property

– Insurance Reimbursements

– Casualty Floor

– 10% × AGI 34,000

Casualty loss deduction

Casualty Gains

If a gain results from the casualty (insurance reimbursement exceeds property's adjusted basis), then all casualty gains and losses are netted.

This netting is done before the 10% of AGI reduction.

A net casualty gain is treated as a capital gain.

2% Miscellaneous Itemized Deductions

Beginning in 2018, 2% miscellaneous itemized deductions are no longer deductible. The following items are **not** deductible:

- Unreimbursed employee expenses and expenses reimbursed but not under an accountable plan
- Expenses relating to tax planning and return preparation (for all taxes)
- Investment expenses, including:
  - Fees paid for investment advice
  - Safe deposit box rental fees

Other Disallowed Deductions

Appraisal fees for a casualty loss or charitable contribution

Hobby expenses

Dues to professional societies; union dues and expenses

Home office expenses

Job search expenses in the taxpayer's present occupation

Subscriptions to professional journals related to the taxpayer's work

Work clothes and uniforms if required and not suitable for everyday use

Work-related education

Other Miscellaneous Deductions

Certain miscellaneous expenses are not subject to the 2% rules, including:

- Gambling losses, including expenses incurred, to the extent of gambling winnings
- Certain expenses of short sales
- Unrecovered annuity costs

2% Miscellaneous Itemized Deductions Example

Mr. G, a construction worker, had adjusted gross income of $30,000. He incurred the following employment-related and investment-related miscellaneous expenses. He was not reimbursed for any of the employment-related expenses.

What is the amount of his miscellaneous expense deduction after any limitations?

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2% Miscellaneous Itemized Deductions Example

Safety shoes	$ 100
Union initiation fees	2,000
Union dues	300
Life insurance	800
Jeans and flannel shirts for work	200
Management fees on investments producing taxable income	1,200
Legal expenses for drafting a will	200

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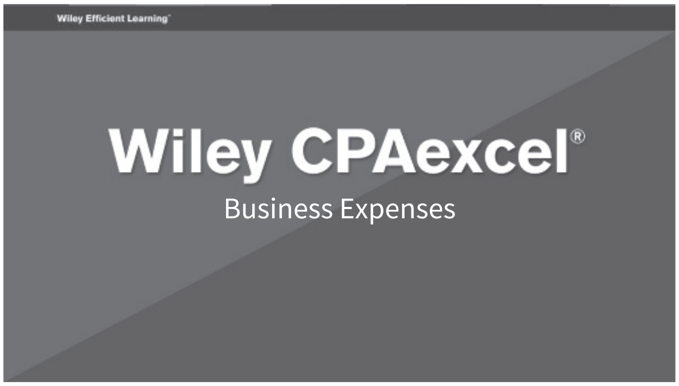
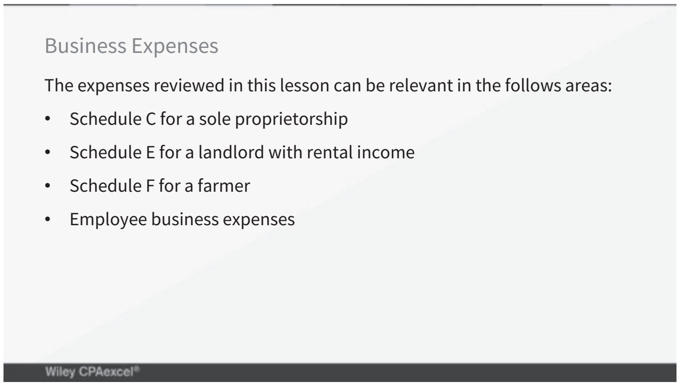
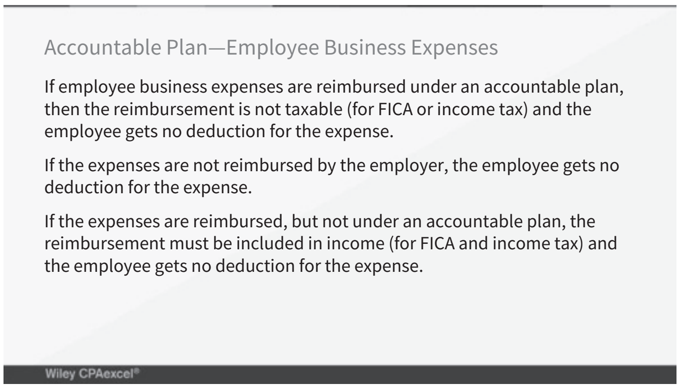
Business Expenses







Accountable Plan

For a plan to be accountable:

- Employees must substantiate all expenses to be reimbursed.
- All excess reimbursements must be returned to the employer.

Review Question

Easel Co. has elected to reimburse employees for business expenses under a nonaccountable plan. Easel does not require employees to provide proof of expenses and allows employees to keep any amount not spent. Under the plan, Mel, an Easel employee for a full year, gets $400 per month for business automobile expenses. At the end of the year, Mel informs Easel that the only business expense incurred was for business mileage of 12,000 at a rate of 30 cents per mile, the IRS standard mileage rate at the time. Mel encloses a check for $1,200 to refund the overpayment to Easel.

What amounts should be reported in Mel's gross income for the year?

assess.AICPA.101122REG

Transportation Expenses

Commuting between the taxpayer's residence and the place of business is never deductible.

However, travel from one job or work area to a second job or work area is deductible.

Also, travel from home to a temporary work location is deductible if the assignment is short term in nature.

Transportation costs include direct costs (airfare, tolls, gas, depreciation of a vehicle, insurance, etc.), or a mileage rate can be claimed for auto use.

Employer cannot deduct qualified transportation fringe benefits.

Travel Expenses

If the mileage rate is used, the only costs added to this amount are for parking and tolls.

Travel expenses include transportation expenses and meals and lodging while away from your business home

"Away from home" means that the taxpayer must be gone overnight.

If the taxpayer is assigned to a new location for an indefinite period of time or for more than a year, the tax home shifts to the new location. Thus, there would be no travel expenses.

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Travel Expenses

The cost of meals is reduced by 50%.

For business travel that is mixed with personal travel, the transportation to the location is deductible only if greater than 50% of the total days are business days.

If the 50% test is met, all of the transportation costs to the location are deductible. If not met, then none of the transportation costs are deductible.

If Friday and Monday are both business days, then the weekend can be counted as business days also.

No deduction is allowed for travel to investment seminars.

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Review Question

Baker, a sole proprietor CPA, has several clients that do business in Spain. While on a four-week vacation in Spain, Baker took a five-day seminar on Spanish business practices that cost $700. Baker's round-trip airfare to Spain was $600. While in Spain, Baker spent an average of $100 per day on accommodations, local travel, and other incidental expenses, for total expenses of $2,800.

What amount of educational expense can Baker deduct on Form 1040 Schedule C, Profit or Loss from Business?

assess.AICPA.990506REG-AR

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Review Question—Solution

Business days/total days:

Airfare

Deductible expenses:

Seminar costs

Daily travel expenses

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Entertainment Expenses

Entertainment expenses are no longer deductible.

50% of business meals is still deductible if provided to a current or potential business customer or client. If the meal is related to an entertainment activity the cost of the meal must be stated separately on the receipt.

50% of meals related to deductible business travel are still deductible.

50% limit also applies to employer-owned eating facilities.

Dues to clubs organized for pleasure or recreation are not deductible. Dues for public service clubs (e.g., Kiwanis), professional organizations, and trade associations are deductible.

Business gifts are limited to $25 per donee per year.

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Education Expenses

Education expenses **are not** deductible if they are :

- To meet minimum standards of current job, or
- To qualify taxpayer for a new trade or business.

Education expenses **are** deductible if:

- To maintain or improve existing skills required in current job, or
- To meet requirements of employer or imposed by law to retain employment status.

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Deductions—Losses and Bad Debts

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Deductions—Losses and Bad Debts

Bad Debts

Bad debts are deductible only for accrual basis taxpayers that have previously recognized income and therefore have basis in the receivable.

The specific charge-off method must be used (financial institutions can use the reserve method).

A business bad debt is deducted against ordinary income in the year that partial or total worthlessness occurs.

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Nonbusiness Bad Debts

Nonbusiness bad debts include debts provided by a lender that is not in the business of lending money (e.g., loans to relatives and friends) and loans that are not directly related to a taxpayer's trade or business.

An NBD is always treated as a short-term capital loss.

No deduction is allowed until the debt becomes totally worthless.

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Bad Debts Problem

Jason Budd, CPA, reports on the cash basis. In April Year 4, Budd billed a client $3,500 for the following professional services:

Personal estate planning	$ 2,000
Personal tax return preparation	1,000
Compilation of business financial statements	500

No part of the $3,500 was ever paid. In April Year 5, the client declared bankruptcy, and the $3,500 obligation became totally uncollectible.

What loss can Budd deduct on his tax return for this bad debt?

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Worthless Securities

A worthless asset is treated as being sold for no consideration on the last day of the year.

This rule applies to stocks and bonds.

In general, the security must be totally worthless.

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NOLs Post 2017

Beginning in 2018, NOLs can no longer be carried back. However, they can now be carried forward indefinitely.

Certain losses from farming can be carried back two years.

Fiscal year taxpayers will apply this rules for first tax year ending in 2018.

NOLs are limited to 80% of taxable income determine without regard to the NOL.

NOLs are only allowed for business losses and casualty losses. Any nonbusiness losses or expenses must be added back to the taxable loss to determine the NOL.

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NOL Computation

The following adjustments are made to the taxable loss:

+ Standard deduction or itemized deductions (except for casualty loss), and other nonbusiness deductions in excess of nonbusiness income
+ Excess of nonbusiness capital losses over nonbusiness capital gains (limited to $3,000)
+ An NOL deduction from another year

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NOL—Problem

Destry, a single taxpayer, reported the following on his U.S. Individual Income Tax Return Form 1040:

Income:	
Wages	$5,000
Interest on savings account	1,000
Net rental income	4,000
Deductions:	
Standard deduction (assume $12,000)	12,000
Net business loss	16,000
Net short-term capital loss	2,000

What is Destry's net operating loss that is available for carryback or carryforward?

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NOL Solution Method One

The following adjustments are made to the taxable loss:

+ Standard deduction or itemized deductions (except for casualty loss), and other nonbusiness deductions in excess of nonbusiness income. ($12,000 – $1,000)
+ Excess of nonbusiness capital losses over nonbusiness capital gains (limited to $3,000) ($2,000 - $0)
+ An NOL deduction from another year

Net Operating Loss

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NOLs Pre-2018

Pre-2018 NOLs can be carried back to the two preceding tax years (beginning with the second prior year) unless an election is made in the year of the NOL to forgo the carryback.

The carryover period is 20 years.

100% of NOLS can be used to offset taxable income.

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NOL Solution Method Two

Wages

Nonbusiness Income Less Nonbusiness Deductions (standard deduction)

Rental Income

Business Losses

Net Operating Loss

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Excess Business Losses

- After 2017, no deduction is allowed for:
  - A noncorporate taxpayer's,
  - Excess business loss,
  - That exceeds $500,000/$250,000 (married filing joint/other).
- The disallowed amount is added to the taxpayer's NOL carryforward.
- This limitation applies after application of the passive loss rules.
- The limit applies to the aggregate net loss from all of the taxpayer's trade and businesses.
- For flow-through entities, the limitation applies at the owner level.

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Excess Business Losses - Problem

Santanu is single and has the following results from his trades and businesses:

Schedule C consulting business	($350,000)
Partnership distributive share	$ 70,000

How should this be reported on his tax return?

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Limitations on Business Deductions

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Limitations on Business Deductions

Hobby Losses

Losses from hobbies are personal expenses that are not deductible.

If the taxpayer clearly has a profit motive, then the activity is not a hobby.

Profit-seeking is presumed if profit in three of last five years.

Otherwise is presumed to be a hobby.

Expenses from a hobby are deductible only to the extent of income.

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Hobby Loss Deductions

Expenses related to the hobby are deducted in the following order:

- Items that would have been deductible anyway
- Other cash expenses
- Depreciation

Revenue from a hobby is reported on Form 1040.

Since 2% miscellaneous itemized deductions are not deductible after 2017, the taxpayer receives no incremental benefit from any of these expenses.

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Home Office Expenses

Expenses for a home office are deductible if it is used exclusively (i.e., solely) on a regular basis as either:

- The principal place of business for a trade/business of the taxpayer, or
- A place of business used by clients, patients, or customers, and
- The use is for the convenience of the employer (if employed).

Home Office Expenses

Home office expense deduction is limited to income from the business less all other business expenses.

Expenses are deducted in the same order as for hobby losses.

Any disallowed expenses are carried forward to future years (indefinitely) and used when there is sufficient business income.

Since 2% miscellaneous itemized deductions are not deductible after 2017, an employee no longer receives a deduction for home office expenses.

Self-employed individuals can still benefit from the home office deduction.

Safe Harbor—Home Office

The IRS provides a simplified method for computing the home office deduction.

Multiply the allowable square footage by $5.

The maximum square footage under this method is 300, limiting the deduction to $1,500.

Vacation Homes

If rented for less than 15 days a year, it is treated as a personal residence.

Rent income is excluded.

Mortgage interest and property taxes are deductible on Schedule A.

It is treated as rental property if rented for 15 days or more, and if it is not used for personal purposes for more than the greater of:

- 14 days or
- 10% of the total days rented.

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Vacation Homes

All rent is taxable, net of all regular rental expenses, prorated for the percentage of rental days only.

A rental loss is allowable.

It is treated as a personal/rental property if rented for 15 days or more and if it is used for personal purposes for more than the greater of:

- 14 days or
- 10% of the total days rented

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Vacation Homes

All regular expenses are prorated as above for rental days, but a rental loss is not allowed.

Expenses must be deducted in the same order as for a hobby.

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Vacation Home—Problem

Adam owns a second residence that is used for both personal and rental purposes. This year, Jackson used the second residence for 50 days and rented the residence for 200 days.

Which of the following statements is correct?

Rental days: > = 15?

Personal days: more than the greater of:

- 14 days or
- 10% of the total days rented?

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Vacation Home—Problem

Depreciation may not be deducted on the property under any circumstances.

A rental loss may be deducted if rental-related expenses exceed rental income.

Utilities and maintenance on the property must be divided between personal and rental use.

All mortgage interest and taxes on the property will be deducted to determine the property's net income or loss.

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Passive Losses

Losses from passive activities cannot offset earned income or portfolio income (i.e., investment income).

A passive activity is one in which the taxpayer does not "materially participate," most rental activities, and any limited partnership interest.

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Passive Losses

Passive Basket | Active Basket | Portfolio Basket

Can passive losses offset income from this basket?

Material Participation

Two specific ways to meet this requirement are to work more than 500 hours in the activity or to work more than 100 hours if no other individual works more than 100 hours.

All limited partners and many rental activities are considered passive without regard to the taxpayer's participation.

Passive Losses

If the taxpayer åctively participates in a rental real estate activity, $25,000 of losses from such activities can offset active and portfolio income.

This deduction phases out between modified AGI of $100,000 and $150,000.

Disallowed passive losses can be carried forward to offset passive income in future years and to offset any gain or to increase the loss when the passive activity is disposed of in a fully taxable transaction.

Real Estate Professionals

Real estate professionals may be able to deduct rental real estate losses against other income.

To qualify, a real estate professional must:

- Perform more than 50% of his or her personal services in trades or businesses involving real property.
- Perform more than 750 hours of services in real property trades or businesses in which he or she materially participates.

At-Risk Limitations

Loss deductions are also limited to the amount a taxpayer has "at risk."

Applies to individuals and closely held regular corporations.

Amount "at risk" includes

- The cash and adjusted basis of property contributed by the taxpayer.
- Liabilities for which the taxpayer is personally liable; excludes nonrecourse debt.

Individual Tax Issues

Tax Dependents

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Tax Dependents

Personal and Dependency Exemptions

Deductions for personal and dependency exemptions are no longer allowed.

Correctly identifying qualifying dependents is still important because having a dependent is still relevant for provisions such as:

- Head of Household status
- Earned Income Tax Credit
- Child Tax Credit

One can qualify as a dependent as either a qualifying child or qualifying relative.

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Qualifying Child

A qualifying child can be claimed as a dependent if the following tests are met:

1. Relationship test: natural child, stepchild, adopted child, foster child, sibling, step-sibling, or a descendant of any of these.

   Note that this definition includes brothers, sisters, nieces, and nephews.

2. Residence test: The dependent must have the same principal place of abode as the taxpayer for more than one half of the tax year. One could live with several individuals at the same time who potentially qualify to claim the individual as a dependent (mother, aunt, grandfather).

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Qualifying Child

3. Age test: Must be less than 19 at the end of the tax year, or less than 24 if a full-time student for at least five months of the tax year. There is no age limitation if the individual is permanently and totally disabled.
4. Joint return test: If the individual is married, he cannot be claimed as a dependent by another if he files a joint return with his spouse, unless there is no tax liability on the return.
5. Citizenship/residency test: The individual must be a U.S. citizen or resident, or a resident of Canada or Mexico.
6. Not self-supporting test: To be claimed as a dependent, the individual must not have provided more than 50% of her own support.

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Qualifying Relative

The qualifying relative rule defines relative very broadly, including all common relatives except for cousins.

The term also includes any person who lives in the taxpayer's home for the entire tax year.

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Qualifying Relative

The following tests must be met to claim a qualifying relative as a dependent:

1. Relationship test
2. Support test: The taxpayer must provide more than 50% of the dependent's total support.
3. Joint return test
4. Citizenship/residency test
5. Gross income test: The dependent's gross income must be less than the exemption amount for the year. Gross income is defined as only income that is taxable.

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Qualifying Relative

There are two exceptions to the gross income test. These apply for a child/stepchild (adopted and foster also):

- who is less than 19 at the end of the tax year, or
- who is less than 24 at the end of the tax year and is a full-time student for at least five months during the tax year.

Support Test

Support includes food, clothing, value of lodging, medical, education, recreation, and certain capital expenses.

Excludes services provided by the taxpayer, life insurance premiums, funeral expenses, nontaxable scholarships, unused sources of funds of dependent.

Dependents—Problem

Jim and Kay Ross contributed to the support of their two children, Dale and Kim, and Jim's widowed parent, Grant. Dale, a 19-year-old full-time college student, earned $4,500 as a baby-sitter. Kim, a 23-year-old bank teller, earned $12,000. Grant received $5,000 in dividend income and $4,000 in nontaxable Social Security benefits. Grant, Dale, and Kim are U.S. citizens and were over one-half supported by Jim and Kay.

How many dependents can Jim and Kay claim on their joint income tax return?

Multiple Support Agreement

If no one person provides more than 50% of an individual's support, but a group of individuals does, the group can file a multiple support agreement designating which person will claim the individual as a dependent.

The person designated must:

- Provide more than 10% of the support for the individual and
- Meet the other dependency tests.

Divorced Parents

The parent with custody (over half the year) is entitled to dependency exemption in the absence of any written agreement.

The custodial parent can waive the exemption to other parent by signing Form 8332.

The noncustodial parent must attach this form to the return to claim the exemption.

Filing Status

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Filing Status

Filing Status

Marital status is determined on the last day of the taxable year.

If one spouse dies, a joint return can be filed for the year of death.

A surviving spouse (i.e., qualifying widow[er]) may continue to use the rates for married filing joint for two years after the year of the spouse's death, if…

…the spouse provides more than half of the cost of maintaining the household, for a dependent child (also step, adopted),who uses the home as a principal residence.

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Filing Status

Maintaining the household includes rent, mortgage interest, taxes, home insurance, repairs, food consumed in the house, utilities, etc.

Maintaining the household does not include clothing, education, medical, vacations, and transportation.

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Filing Status

Head of Household status is used by:

- An unmarried person
- That provides more than half of the cost of maintaining the household
- For a qualifying child or a qualifying relative (a nonrelative living in the home for the entire tax year does not qualify)
- Who uses the home as a principal residence for more than half the tax year.

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Head of Household

Two exceptions to these rules:

1. If the qualifying child is an unmarried child the child, need not qualify as a dependent.
2. If the qualifying relative is a parent, the parent need not live with the taxpayer, but the taxpayer must provide more than 50% of the cost of maintaining the parent's home.

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Head of Household Exceptions

	Dependent	Live in Home
Child	No	Yes
Parent	Yes	No

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Same-Sex Marriages

Individuals of the same sex who are legally married in a state that permits same-sex marriages can file married filing joint.

This is the case even if the couple is domiciled in a state that does not allow same-sex marriages.

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Dependents' Returns

If someone is a dependent on another return but is required to file his own return, then for the dependent's return the standard deduction is limited to the greater of $1,100 or earned income plus $350 (limited to the regular standard deduction).

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Review Question

Nell Brown's husband died in Year 4. Nell did not remarry, and continued to maintain a home for herself and her dependent infant child during Year 5, Year 6, and Year 7, providing full support for herself and her child during these three years. For Year 4, Nell properly filed a joint return. What is Nell's filing status for Year 7?

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Kiddie Tax

The kiddie tax includes all children who are under 18.

It also includes children who are 18, or between 19 and 23 who are full-time students, if their earned income does not exceed 50% of their total support for the year.

Net unearned income in excess of a statutory amount is taxed at the rates for trusts and estates, while the remaining taxable income is taxed at child's tax rate.

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Kiddie Tax Problem

	One	Two	Three
Unearned Income	$2,250	$500	$3,000
Earned Income	250	800	11,850
	2,500	1,300	14,850
Standard Deduction	(1,100)	(1,150)	(12,200)
Taxable Income	$1,400	$150	$2,650
Taxed at Estate/Trust Rate (Unearned Income > $2,200)	$50	0	$800
Taxed at Child's Rate	$1,350	$150	$1,850

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Standard Deduction

Standard deduction amounts are provided for each filing status and are indexed for inflation.

The standard deduction can be increased if the taxpayer (or spouse if filing jointly) is blind at year-end or is at least age 65.

These additions do not apply to dependents.

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Alternative Minimum Tax and Other Taxes

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Alternative Minimum Tax and Other Taxes

Alternative Minimum Tax

Must pay the greater of the regular tax or the tentative minimum tax.

An AMT exemption is provided, which prevents many taxpayers from being impacted by the AMT.

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Formula for Computing AMT

Regular taxable income	
+/–	Adjustments
+	Preferences
	AMT Income
–	Exemption
	AMT Base
×	Rate
Tentative Minimum Tax before Credits	
–	Certain Credits
	Tentative Minimum Tax
–	Regular Tax Liability
	AMT (if positive)

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AMT Credits

Nonrefundable personal credits can offset the sum of the regular tax and the AMT, including:

- Child and dependent care credit
- Adoption credit
- Credit for the elderly and disabled
- Child tax credit
- Education credits
- IRA credit
- Foreign tax credit

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AMT Adjustment Items

The AMT adjustment applies only to MACRS 3-, 5-, 7-, and 10-year property that is depreciated using the 200% declining-balance method.

For AMT, the 150% declining-balance method is used over the MACRS life.

No AMT adjustment is required for property that is eligible to use bonus depreciation.

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AMT Adjustment Items

For itemized deductions:

- No deduction is allowed for taxes (so must be added back to taxable income).
- Standard deduction (if used) is added back.
- The compensation element on the exercise date for an incentive stock option.

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Tax Preference Items

For real property and leased personalty purchased before 1987, excess of accelerated over straight-line depreciation

Tax-exempt interest on private activity bonds (less related expenses)

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AMT Credit

The AMT credit is limited to the amount of AMT generated from timing differences, and this credit is available in a year in which the tentative tax is less than regular tax.

The AMT credit may be carried forward indefinitely.

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AMT—Problem

Robert had adjusted gross income of $100,000 and potential itemized deductions as follows:

Medical expenses (before percentage limitations)	$12,000
State income taxes	4,000
Real estate taxes	3,500
Qualified housing and residence mortgage interest	10,000
Home equity mortgage interest (used to consolidate personal debts)	4,500
Charitable contributions (cash)	5,000

What are Robert's itemized deductions that are allowable for alternative minimum tax purposes?

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Computing AMT Income

Self-Employment Tax

Self-employment income is gross income from self-employment less deductions associated with the activity.

The last step in calculating the tax is to multiply self-employment income by 92.35%.

Self-employment income × 92.35% must exceed $400 for the SE tax to be assessed.

Self-Employment Tax

Self employment income includes:

- Gross income from self employment less deductions associated with the activity
- Director's fees
- Allocations of income to general partners (but not limited partners)
- Guaranteed payments paid to both general and limited partners

Self-employment tax is not due on allocations to S corporation shareholders.

Self-Employment Tax—Problem

Freeman, a single individual, reported the following income in the current year:

Guaranteed payment from services rendered to a partnership	\$50,000
Ordinary income from a S corporation	\$20,000

What amount of Freeman's income is subject to self-employment tax?

Payroll Taxes

FICA taxes are levied on the earned income of taxpayers.

Social security is 6.2% of earned income up to an annual limit.

Medicare is 1.45% on all earned income.

These amounts are matched by the employer.

Medicare Surtax

An additional .9% hospital insurance tax applies:

- Joint filers with wages > \$250,000
- Single and HofH filers with wages > \$200,000
- To self-employment income above these limits

Tax on Net Investment Income

Applies to the lower of:

(1) net investment income or (2)modified AGI in excess of certain thresholds

$200,000/$250,000 (single/married filing jointly)

MAGI = AGI + foreign earned income exclusion

Taxed at 3.8 % on excess

Applies to

- Individuals
- Trusts
- Estates

Net Investment Income Inclusions

Interest, dividends, annuities, rents, royalties; net of allowed expenses

Net income derived from a passive activity or a business of trading in financial instruments or commodities

Net gain from the disposition of property not held in a trade or business

Exclusions from NII Tax

Earned compensation/wages

Excluded capital gains from the sale of a residence

Gains from the sale of a business where the taxpayer actively participate.

Qualified retirement plan distributions and IRA distributions

Tax-exempt income

Review Problem

John and Lisa file married filing jointly with $275,000 of earned income and $75,000 net investment income. Modified AGI is $300,000.

Compute the net investment income tax.

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Solution

(1) Net Investment Income, or

(2) Modified AGI in excess of $250,000

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Review Problem

G Corporation, an S corporation, is engaged in a trade or business. Toysan owns 100 % of the stock. G sells property used in the trade or business for a gain. If Toysan materially participates in the business, the pass-through gain is not subject to the NII tax.

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Review Problem

Felipe rents out his boat in a passive activity for $50,000 per year. He sells the boat for a $200,000 profit. The net gain is subject to NII tax because it is from a passive activity.

Tax Planning Strategies for Individuals

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Tax Planning Strategies for Individuals

Marginal Tax Rate

Marginal tax rate is the rate that should be used for decision making.

Marginal tax rate is the amount of taxes that would be paid on the next dollar of taxable income or that would be saved on the next dollar of deduction.

Cash Flows

Income taxes must be considered in analyzing cash flows. The marginal tax rate must be used when determining the after-tax cash flow from revenues or expenses.

E.g.: $1,000 charitable contribution; MTR = 24%

$1,000	$1,000
× ______	______

The tax effect must also be considered when determining the cash flow from the sale or disposition of an asset.

Tax Rates

Difference in tax rates over time:

- Moving between tax brackets
- Statutory changes in rates

If rates are increasing in the future, accelerate income and defer deductions.

If rates are decreasing in the future, accelerate deductions and defer income.

Tax Rates

Shift income to lower-bracket taxpayers.

Differences based on character of income (e.g., long-term capital gain vs. ordinary income).

Differences based on jurisdiction (e.g., U.S. tax rates versus foreign tax rates).

Tax-Exempt Rate

The relationship between the rate on tax-free bonds to the rate on taxable bonds is:

- Taxable rate × (1 – marginal tax rate) = Tax-exempt rate
- A 10% taxable bond is equivalent to a tax-free bond that yields 6.3% for a taxpayer at the 37% marginal tax rate.
- [10% × (1 – 0.37) = 6.3%]

Tax Strategies—Timing

Installment sales

Itemized deductions/Medical expenses

AMT

Tax Strategies—Timing

Capital gains/losses

Estimated taxes

Insure that carryforward amounts are used before they expire (e.g., charitable contributions)

Tax Strategies—Shifting

Children—Investment income

Children—Business income

Gift Tax

Section 529 plans

Tax Strategies—Conversion

Qualified dividends

Ordinary income vs. Capital gain

Passive losses

Nontaxable fringe benefits vs. Salary

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Other Tax Strategies

Defer income by meeting rules such as like-kind exchange rules.

Maximize contributions to retirement plans.

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Alternative Minimum Tax

Taxpayers adopt planning strategies to avoid the individual AMT.

If the individual AMT cannot be avoided, it may be advantageous to accelerate income into the AMT year since it will be taxed at a maximum rate of 28%.

Recall that several itemized deductions are not allowed for AMT purposes.

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Charitable Contributions

Gifting appreciated property to a charity avoids recognizing the appreciation as income.

Depreciated property should not be gifted because the loss is not recognized.

Rather, the asset should be sold so the loss can be recognized. The cash from the sale can then be contributed to a charity.

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Loss Limitations

Capital losses

Bad debts

NOLs

Related party losses

Worthless securities

Section 1244 losses

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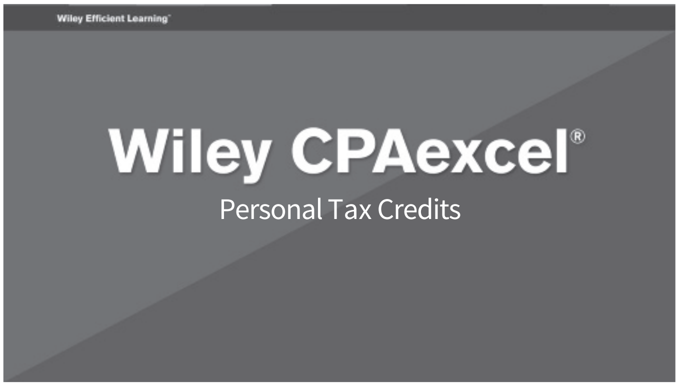
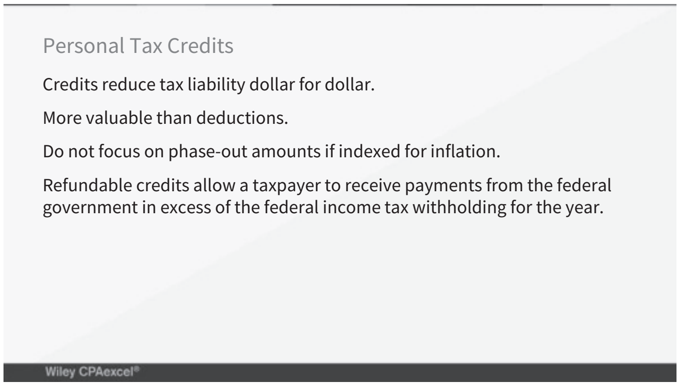
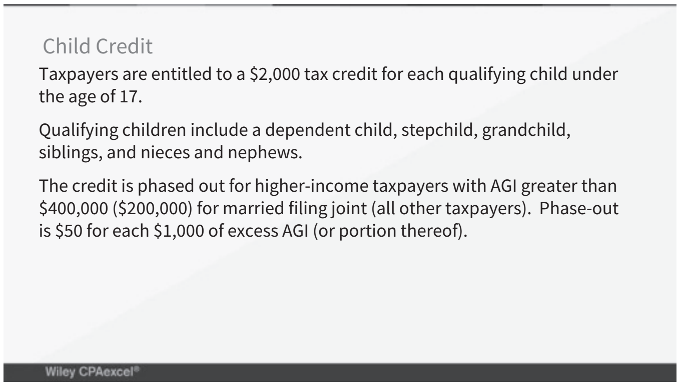
Tax Credits

Personal Tax Credits







Child Credit

A portion of the credit may be refundable (up to $1,400) for some taxpayers that have earned income of $2,500 or more, computed as 15% of the earned income in excess of $2,500.

The child's social security number must be provided for the credit to be allowed.

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Additional "Family Credit"

A $500 non-refundable credit is allowed for dependents who are not "qualifying children" for purposes of the $2,000 child tax credit.

Examples of individuals that may qualify taxpayers for a $500 credit are:

- A parent who is a qualifying relative
- Other dependents who are qualifying relatives
- Children that are older than 17 and less than 19
- Children less than age 24 that are full-time college students

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American Opportunity Tax Credit

If enrolled in one of the first four years of postsecondary education, a credit of $2,500 is allowable:

- A 100% credit is allowed for the first $2,000 of tuition, fees, and course materials paid.
- A 25% credit is allowed for the next $2,000 paid.
- The expenses must relate to an academic period beginning in the current tax year or the first three months of the next tax year.

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American Opportunity Tax Credit

Student must be enrolled in a degree program.

The credit is phased out for higher-income taxpayers.

The $2,500 credit is allowed for each eligible student.

Credit applies for tuition paid for the taxpayer, taxpayer's spouse, and taxpayer's dependents carrying at least one-half of the normal load of a full time-student.

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Lifetime Learning Credit

The lifetime learning credit allows a credit of 20% of qualified tuition expenses for years for which the American Opportunity credit is not available.

The maximum credit is $2,000 per taxpayer (regardless of the number of students for which tuition is paid). Student does not need to be at least half-time for expenses to qualify.

Credit applies for tuition paid for the taxpayer, taxpayer's spouse, and taxpayer's dependents.

The credit is phased out for higher-income taxpayers.

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Education Credit

The American opportunity credit, the lifetime learning credit, and other tax benefits for higher education are mutually exclusive in that an educational expenditure can never simultaneously qualify for more than one benefit (e.g., no "double dipping").

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Child and Dependent Care Credit

Credit is a specified percentage (between 20% and 35%) of qualified expenses incurred for care for a qualified individual to enable the taxpayer to work.

A qualified individual is:

- A qualifying child (as defined for dependency rules) under age 13.
- A dependent or spouse who is physically or mentally incapacitated and has the same abode as the taxpayer for more than half the tax year.

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Child and Dependent Care Credit

Qualified expenses are limited to the lower of:

- Earned income of the lowest paid spouse, or
- $3,000 ($6,000 for two or more qualified individuals).

Credit percentage is 35% if AGI is $15,000 or less. It is reduced by 1% for each $2,000 (or portion thereof) of AGI in excess of $15,000 (but not below 20%).

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Child and Dependent Care Credit Problem

Robert and Mary Jason, filing a joint tax return, had a tax liability of $9,000 based on their tax table income and three exemptions. Robert and Mary had earned income of $20,000 and $12,000, respectively.

In order for Mary to be gainfully employed, the Jasons incurred the following employment-related expenses for their four-year-old son, John:

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Child and Dependent Care Credit Problem

Payee	Amount
Union Day Care Center	$ 2,500
Acme Home Cleaning Service	500
Wilma Jason, babysitter (Robert Jason's mother)	1,000

Assuming that the Jasons do not claim any other credits against their tax, what is the amount of the child care tax credit they should report on their tax return?

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Child and Dependent Care Credit Solution

Lowest of: Qualified expenses	3,500	3,000
Statutory limits		3,000
Earned income of lowest paid spouse		12,000
		× 26%
		780
AGI	32,000	
Phase-out threshold	(15,000)	
	17,000 / 2,000 = 8.5 = 9%	
Allowable %	35% – 9% = 26%	

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Earned Income Credit

The credit is generated by earning income.

The credit percentage increases if the taxpayer maintains a home with qualifying children.

The credit is phased out based on earned income or AGI (if greater) exceeding a threshold that also depends upon the number of qualifying children.

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EIC—Earned Income

The most common sources of earned income that qualify for the credit are wages, salaries, tips, and earnings from self-employment.

Combat pay can also be included as earned income.

Taxable disability payments from an employer plan qualify as earned income until the taxpayer reaches normal retirement age.

Earned Income Credit

The credit is disallowed if disqualified income, such as interest, dividends, tax-exempt interest, and other investment income, exceeds a threshold.

Taxpayers between the ages of 25 through 64 without qualifying children are also eligible if they are not claimed as a dependent on another's return.

EIC—Qualifying Children

Qualifying child is defined as it is for the dependency exemption rules—a natural child, stepchild, adopted child, foster child, sibling, stepsibling, or descendants of these.

The descendants must be under the age of 19, students under 24, or permanently disabled dependents.

The qualifying child must also be younger than the taxpayer.

Information on qualifying children is reported on Form 1040 Schedule EIC.

EIC—Qualifying Children

The qualifying child also must have lived in the taxpayer's home for more than half of the tax year in the United States.

A qualifying child can only be used by one taxpayer to claim the EIC. If more than one person qualifies to claim the qualifying child, the tie-breaker rules are similar to those used for dependency exemptions.

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EIC—Form 8867

A paid preparer must also complete Form 8867, which provides a checklist to insure that the preparer met all due diligence requirements for taking the EIC on the return.

There is a penalty for each failure to meet these requirements.

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Health Care—Individual Mandate

As of 2019, taxpayers must no longer pay a penalty if they do not maintain minimum essential health care coverage.

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Health Care Credit

The credit is available for those whose income is between 100% and 400% of the federal poverty level and who do not otherwise have access to coverage.

The credit is advanceable, meaning that it can be used to reduce the monthly health care premium during the year. The credit is also refundable.

Employer Mandate—No Coverage Penalty

A large employer (generally, at least 50 employees) not offering coverage for all its full-time employees and their dependents, offering minimum essential coverage that is unaffordable, or offering minimum essential coverage of less than 60% of medical expenses is required to pay a penalty.

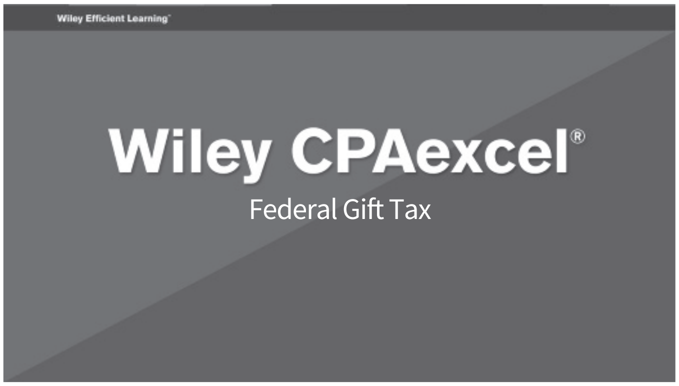
The annual tax penalty is $2,000 per full-time worker.

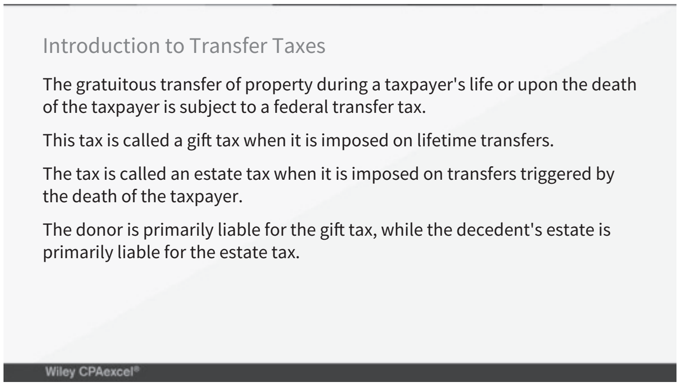
Employer Mandate—Assessable Penalty

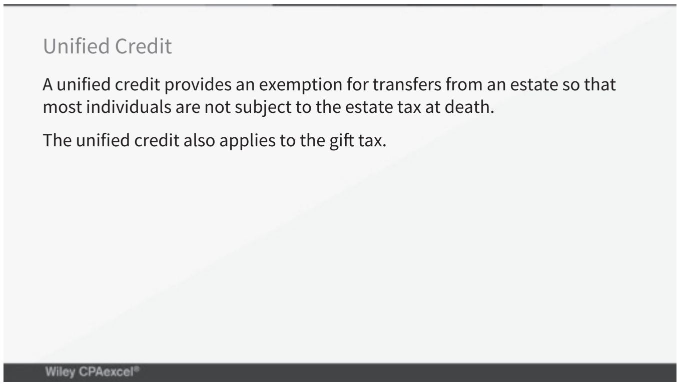
Even if the employer offers health insurance, if any full-time employee is certified as having purchased health insurance through a state exchange involving a tax credit or cost-sharing reduction paid to the employee, such employer must then pay $3,000 per employee per year tax penalty.

Estate and Gift Taxation

Federal Gift Tax







Trusts

When a taxpayer transfers property to a trust, the taxpayer has made two gifts, the income interest and the remainder interest.

The beneficiary of the income interest receives the income from the trust each year.

The beneficiary of the remainder interest receives the property (corpus) of the trust when the trust terminates.

The income and remainder interests are valued using actuarial tables provided by the IRS.

The rate used in the valuation is 120% of the applicable federal midterm rate for the month in which the transfer is made.

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Federal Gift Tax

Value of gifts for gift tax purposes is fair market value.

Each individual can give away an amount up to the annual exclusion, per donee, without having to pay any gift tax. Gift must be of a present interest for exclusion to apply.

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Gift Splitting

Spouses can elect gift splitting, which means that they could give away an amount up to twice the annual exclusion a year to a donee and pay no gift tax, regardless of which spouse actually made the gift.

A gift tax return must be filed to elect gift splitting.

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Gift Splitting—Problem

Steve and Kay Briar, U.S. citizens, were married for the entire Year 5 calendar year. In Year 5, Steve gave a $40,000 cash gift to his sister. The Briars made no other gifts in Year 5. They each signed a timely election to treat the $40,000 gift as made one-half by each spouse.

Disregarding the unified credit and estate tax consequences, what amount of the Year 5 gift is taxable to the Briars, assuming the annual exclusion is $15,000?

Gift Splitting—Solution

$40,000

	Steve	Kay
Exclusion		
Taxable Gift		

Includible Gifts

Cash and property transfers

Debt forgiveness to family members

Sales at bargain prices to family members

Loans to family members at a bargain (below-market interest rates)

Transfers of property into trust for the benefit of others

Purchases of jointly owned real estate or securities if one co-owner contributes more than a fair proportionate share

Gift Tax Exclusions

An unlimited exclusion exists for gifts to spouses, charities, and political organizations.

An unlimited exclusion exists for educational tuition and medical expenses paid on behalf of an individual if and only if the amounts are paid directly to the educational institution or medical provider.

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More Exclusions

Donations of personal services

Transfers that can be revoked

Payments to minor family members for food, shelter, clothing, and other reasonable support needs

Payments to an employee that in substance are compensation for personal services

Property settlements incident to divorce

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Annual Exclusion—Problem

In Year 2, Blum, who is single, gave an outright gift of $50,000 to a friend, Gould, who needed the money to pay medical expenses.

In filing the Year 2 gift tax return, Blum was entitled to a maximum exclusion of how much?

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Gift Tax—Problem

Which of the following requires filing a gift tax return, if the transfer exceeds the available annual gift tax exclusion?

A. Medical expenses paid directly to a physician on behalf of an individual unrelated to the donor.

B. Tuition paid directly to an accredited university on behalf of an individual unrelated to the donor.

C. Payments for college books, supplies, and dormitory fees on behalf of an individual unrelated to the donor.

D. Campaign expenses paid to a political organization.

Gift Tax Formula

	Taxable gifts for current year
+	Taxable gifts for all prior years
	Total lifetime gifts
×	Unified tax rates
	Total gift tax
–	Gift tax paid in prior years (at current rates)
–	Unified tax credit (if elected)
	Gift tax due for current year

Unified Credit

Under the unified rate schedule:

A. Lifetime taxable gifts are taxed on a noncumulative basis.

B. Transfers at death are taxed on a noncumulative basis.

C. Lifetime taxable gifts and transfers at death are taxed on a cumulative basis.

D. The gift tax rates are 5% higher than the estate tax rates.

Gift Tax—Problem

Mr. C made the following gifts during the current year:

- $1,000 each month to a university to pay tuition costs for his niece.
- An undeveloped tract of land to his sister that had an adjusted basis to Mr. C of $4,000 and a fair market value of $25,000.
- Various shares of stock to his wife that had an adjusted basis to Mr. C of $15,000 and a fair market value of $40,000. Mr. C did not consent to gift splitting

What is the total amount of taxable gifts for this year?

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Gift Tax—Solution

Niece—tuition

Sister—land

Wife—stock

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Federal Estate Tax

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Federal Estate Tax

Federal Estate Tax

	Gross estate
–	Deductions
	Taxable estate
+	Taxable gifts made after 1976
	Total taxable transfers
×	Unified tax rates
	Tentative transfer tax
–	Gift tax paid after 1976 (at current rates)
–	Unified credit and other credits
	Estate tax due

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Gross Estate

The gross estate includes the FMV of all property owned at the date of death.

An executor can elect to value certain realty used in farming or in connection with a closely held business at a special use valuation. The farm or business must continue to be used in that capacity for at least five years during the eight year period after the date of death.

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Alternate Valuation Date

The FMV is measured at the date of death, unless the executor elects the alternate valuation date, which is six months after the date of death.

AVD can be elected only if the value of the gross estate will be less than the date of death value.

If the AVD is elected and the property is distributed before the AVD, the FMV is determined on the distribution date.

Jointly Owned Property

Husband and Wife: 50% of the property owned jointly by husband and wife goes into the estate of the first spouse to die. A tenancy by the entirety is a joint tenancy between husband and wife.

Joint-tenancy: property owned with a right-of-survivorship, meaning that at death the property immediately passes to the other owner that is still living.

For tax purposes, 100% of the property is included in the estate of the first owner to die, unless it can be proven that the surviving owner contributed to the purchase of the asset.

Jointly Owned Property

Tenancy in common—There is no right of survivorship.

The decedent’s share of property passes into the probate estate and its distribution is controlled by the decedent’s will.

The decedent’s share of the property is included in the gross estate for tax purposes.

Life Insurance

Proceeds are included in the gross estate under either of two conditions:

- The decedent had incidents of ownership (e.g., the right to designate the beneficiary).
- The decedent's estate is the beneficiary of the insurance policy.

Review Question

Following are the fair market values of Wald's assets at the date of death:

Personal effects and jewelry	$ 150,000
Land bought by Wald with Wald's funds five years prior to death and held with Wald's sister as joint tenants with right of survivorship	800,000

The executor of Wald's estate did not elect the alternate valuation date. The amount includible as Wald's gross estate in the federal estate tax return is?

$ 950,000

Review Question

Which of the following items of property would be included in the gross estate of a decedent who died in the current year?

- Clothes and jewelry of the decedent. ✓
- Cash of $400,000 given to decedent's friend in Year 1. No gift tax was paid on the transfer.
- Land purchased by decedent and held as joint tenants with rights of survivorship with decedent's brother. ✓

Life Insurance

Life insurance proceeds from buy-sell agreements are generally excluded from the gross estate.

Retained Interests

A retained life estate or the retention of a power to alter, amend, or revoke a transfer are retained interests that cause the property subject to the power to be included in the gross estate.

The power to designate possession or enjoyment of property or income (including power created by another that can be exercised in the decedent's favor) will also cause the property to be included in the gross estate.

Transfers Within Three Years of Death

Transfers involving retained interests and revocable transfers where the retention or right to revoke was terminated within three years of death are included in the gross estate.

Transfers of life insurance are included in the decedent's gross estate if the transfer was made within three years of death.

Gift tax paid on transfers made within three years of death is included in the gross estate.

Deductions

- Marital deduction
- Debts of the estate
- Funeral and administrative expenses
- Charitable contributions
- Casualty losses

Medical Expenses

Medical expenses incurred prior to the death of the taxpayer that are paid within one year of death have a special rule.

These expenses can be deducted either on the decedent's final Form 1040 or the estate tax return (Form 706).

Review Question

Bell, a cash basis calendar year taxpayer, died on June 1, Year 3. In Year 3, prior to her death, Bell incurred $2,000 in medical expenses. The executor of the estate paid the medical expenses, which were a claim against the estate, on July 1, Year 3. If the executor files the appropriate waiver, the medical expenses are deductible on:

A. The estate tax return
B. Bell's final income tax return
C. The estate income tax return
D. The executor's income tax return

Unified Credit

The unified credit will offset a net estate of $11,400,000 in 2019.

Any unused credit from a spouse dying after 2010 may be used in the future by the surviving spouse.

Review Question

Henry died in 2013 with a taxable estate of $2 million. An election is made on Henry's estate tax return to permit his wife, Wilma, to use his unused exclusion of $3.25 million. Wilma, who had not made any lifetime taxable gifts, dies in 2019 (exclusion amount is $11,400,000) with a taxable estate of $20 million. How much is her total exclusion?

Generation-Skipping Tax

The generation-skipping tax, which is similar to the estate tax, is imposed on an estate when a bequest skips a generation (e.g., from grandfather to grandson).

If the grandson's parents were deceased, the GST would not apply.

The tax rates and unified credit for the GST are the same as for the estate tax.

Federal Taxation of Entities

Corporate Taxation

Formation of a Corporation

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Formation of a Corporation

Formation of a Corporation

No gain or loss is recognized to the shareholder or corporation if the following conditions are met:

- The only property received from the corporation is stock (stock does not include stock rights, stock warrants, or debt).
- The stock is received in exchange for property or cash (i.e., not services).
- The group (can include more than one person) transferring property and receiving stock as part of this exchange collectively own at least 80% of (a) the voting power and (b) each nonvoting class of stock.

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Stock for Services

If stock is received in exchange for services:

- The transferor has wage income equal to the fair market value of the stock received (and basis in the stock equal to that amount).
- The corporation has a salary expense deduction (unless the services rendered were an organizational expense).

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Boot Received

If anything other than stock is received, it is called boot.

If boot is received, the gain recognized to the shareholder is the lower of:

- Realized gain, or
- The fair market value of the boot received.

Review Question

Dole, the sole owner of Enson Corp., transferred a building to Enson. The building had an adjusted tax basis of $35,000 and a fair market value of $100,000.

In exchange for the building, Dole received $40,000 cash and Enson common stock with a fair market value of $60,000.

What amount of gain did Dole recognize?

Review Question

Amount realized: Cash
Stock

Adjusted basis

Realized gain

Recognized gain is the lower of:
1. Realized gain, or
2. Boot received

Liability Assumption

If the total liabilities assumed by the corporation exceed the total adjusted basis of property transferred by the shareholder, then gain must be recognized as follows:

Gain recognized = Liabilities assumed – Basis of property transferred

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Review Question

Anna transferred land with an adjusted basis to her of $20,000 and a fair market value of $56,000 to Elm Corporation in exchange for 100% of Elm Corporation's only class of stock.

The land was subject to a liability of $26,000, which Elm assumed for legitimate business purposes. The fair market value of Elm's stock at the time of the transfer was $30,000.

What is the amount of Anna's recognized gain?

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Review Question—Solution

Amount realized

Adjusted basis

Realized gain

Debt assumed

Adj. basis of assets contributed

Recognized gain

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Shareholder's Basis

The shareholder's basis in the stock received from the corporation is:

Basis of all property transferred to the corporation	20,000
+ Gain recognized by shareholder	6,000
– Boot received by shareholder	
– Liabilities assumed by corporation	(26,000)
	0

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Corporation's Basis

The corporation's basis in the property received is:

Shareholder's basis in the property	20,000
+ Gain recognized by the shareholder	6,000
	26,000

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Holding Period

The shareholder's holding period for the stock is determined as follows:

- Capital asset or Section 1231 asset transferred to corporation—property holding period is tacked on to stock holding period.
- All other property—holding period of property does not tack on. Holding period for stock begins on the day after the transfer.
- The corporation's holding period in the property received always includes the period that the transferor held the property before the exchange.

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Property Contributions

- If property is contributed to a corporation but no stock is received:
- By shareholders—There is no gain or loss to a corporation when shareholders contribute property. Shareholder's basis in stock is increased by basis of property contributed.
- By nonshareholders—Corporation recognizes gain equal to the fair market value of the property and has a fair market value basis in the property.

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Corporate Income

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Corporate Income

Corporate Income Computation

The general income and deduction rules for corporations are the same as those for individuals.

The corporate tax rate is a flat rate of 21%.

The corporate Alternative Minimum Tax does not apply after 2017.

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Capital Losses

Deductible capital losses are offset against recognized capital gains, but there is no deduction for a net capital loss.

Rather, a net capital loss is carried back three years/forward five years to offset against capital gains in other years.

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Definitions

A personal service corporation is a corporation whose principal activity is the performance of personal services performed by employees who own substantially all of the stock.

A corporation is a closely held corporation if at any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

Passive Losses

Passive loss limits do not apply to corporations.

Closely held corporations can use passive losses to offset active corporate income but not portfolio income.

Personal service corporations cannot offset passive losses against either active income or portfolio income.

Book/Tax Income Reconciliation

Schedule M-1 is a reconciliation of book income to taxable income.

Nondeductible expenses are added to book income (federal tax expense, net capital loss, expenses in excess of limits, etc.).

Income that is taxable but not included in book income is added to book income (e.g., prepaid income included in taxable income).

Book/Tax Income Reconciliation

Nontaxable income that is included in book income is subtracted from book income (municipal interest, life insurance proceeds, etc.).

Deductions not expensed from book income are subtracted from tax income (dividends received deduction, Section 179 election to expense, etc.).

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Review Question

Starke Corp., an accrual-basis calendar-year corporation, reported book income of $380,000. Included in that amount was $50,000 municipal bond interest income, $170,000 for federal income tax expense, and $2,000 interest expense on the debt incurred to carry the municipal bonds.

What amount should Starke's taxable income be as reconciled on Starke's Schedule M-1 of Form 1120, U.S. Corporation Income Tax Return?

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Review Question—Solution

Book income	
Municipal interest	
Federal income tax	+
Interest expense	+
Taxable income	

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Schedule M-3 Requirement

Corporations that report total assets of $10 million or more must complete and file Schedule M-3 instead of Schedule M-1.

Schedule M-3 provides much more detail than Schedule M-1.

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NOLs Post 2017

Beginning in 2018, NOLs can no longer be carried back. However, they can now be carried forward indefinitely.

Certain losses from farming can be carried back two years.

Fiscal year taxpayers will apply this rules for first tax year ending in 2018.

NOLs are limited to 80% of taxable income determine without regard to the NOL.

NOLs are only allowed for business losses and casualty losses. Any nonbusiness losses or expenses must be added back to the taxable loss to determine the NOL.

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NOLs Pre-2018

Pre-2018 NOLs can be carried back to the two preceding tax years (beginning with the second prior year) unless an election is made in the year of the NOL to forgo the carryback.

The carryover period is 20 years.

100% of NOLS can be used to offset taxable income.

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Accounting Methods and Periods—Corporations

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Accounting Methods and Periods — Corporations

Tax Year

C corporation: any taxable year

Personal service corporation: generally must adopt a calendar year.

Partnership: generally must use the same tax year as that used by its partners owning more than 50% of partnership income and capital.

S corporation: generally must adopt a calendar year.

Estate: any taxable year.

Trust (other than charitable and tax-exempt trusts): must adopt a calendar year.

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Changing Tax Year

Business purpose test: Taxpayer receives at least 25% of its gross receipts in the last two months of the selected year for three consecutive years.

Taxpayers can request permission to change a year by filing Form 1128, Application for Change in Accounting Period, by the 15th day of the second month after the close of a short period.

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Method of Accounting

The following entities cannot use the cash method of accounting:

- Regular C corporations
- Partnerships that have regular C corporations as partners
- Tax shelters

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Method of Accounting

The following entities (but not tax shelters) can use the cash method of accounting:

- Any corporation, or partnership with a corporate partner, whose annual gross receipts do not exceed $25 million. The test is satisfied for a given year if the average annual gross receipts for the previous three-year period do not exceed $25 million. Once the test is failed, the entity must use the accrual method for all future tax years.
- Certain farming businesses.
- Qualified personal service corporations.

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Review Question

Which of the following taxpayers may use the cash basis as its method of accounting for tax purposes?

A. Partnership that is designated as a tax shelter.

B. Retail store with average annual revenue of $30 million.

C. An international accounting firm that is a limited liability company.

D. Office cleaning business with average annual income of $80 million.

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Inventory Accounting

In general, businesses with inventories must use the accrual method to report purchases (cost of goods sold) and sales.

LIFO can be used only if it is also used for financial reporting.

Taxpayers can value inventory at the lower of cost or market unless they are using LIFO (in which case cost must be used).

Market is defined as replacement cost or reproduction cost.

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Long-Term Contracts

Special rules apply for production projects that generally take more than one year to complete. The general rule is that the percentage-of-completion method (PCM) must be used to recognize income.

For contracts entered into after Dec. 31, 2017 in tax years ending after that date, small construction contracts can use the completed contract method. A small construction project is a contract for the construction or improvement of real property if the contract:

- is expected to be completed within two years of commencement of the contract, *and*
- is performed by a taxpayer that meets the $25 million gross receipts test.

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S Corporation Converted to C Corporation

If an S election is terminated after December 21, 2017, the Code§481(a) adjustment is taken into account ratably over the six-year period beginning with the year of change.

This is a transition rule that applies only to entities that were:

- S corporations on December 21, 2017,
- Revokes its S election on or before December 21, 2019, and
- The ownership structure has not changed from December 21, 2017 to the revocation date.

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Special Corporate Deductions

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Special Corporate Deductions

Corporate Tax Formula—Special Deductions

Gross Income

Less: Deductions (except charitable, dividends received, and capital loss carryback)

Taxable income for charitable limitation

Less: **Charitable contributions** (<= 10% of above)

Taxable income for Div. Rec'd deduction (however, note that NOL carryforwards are not allowed for computing the DRD limit)

Less: **Dividends received deduction**

Taxable income before carrybacks

Less: **Capital loss carryback**

Taxable income

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Charitable Contributions

Charitable contribution rules are the same as for individuals, with the following exceptions:

- A contribution of inventory, by corporations only, to charities that use the property in a manner related to the exempt purpose and solely for the care of the ill, needy, or infants, or where the property is used for research purposes under specified conditions, is subject to special rules.
- The deduction is the lower of:
  AB of property + 50% × (FMV – AB), or 2 × AB

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Charitable Contributions

The corporation can elect to deduct accrued contributions if the contributions are actually paid in first 3½ months following the year-end (first 2½ months for June 30 year-end corporations).

The limit on the deduction is 10% of taxable income (before special deductions for charity, dividends received, and capital loss carrybacks).

Any excess charitable contribution (above the 10% limit) carries forward for five years (there is no carryback).

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Dividends-Received Deduction

The dividends-received deduction (DRD) is a percentage (%) of domestic dividends.

If the corporation owns less than 20% of the stock of another corporation, then the dividends-received deduction (DRD) is 50% of the dividends received.

If the corporation owns 80% or more, then the DRD is 100% of the dividends received.

All ownership levels between these two extremes are entitled to a 65% DRD.

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Dividends-Received Deduction

The DRD is limited to:

Taxable income multiplied by the same percentage used to compute the DRD.

This limitation is not required if the full dividends-received deduction would create or add to a net operating loss.

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Review Question

Best Corp., an accrual-basis calendar-year C corporation, received $100,000 in dividend income from the 5% common stock interest that it held in an unrelated domestic corporation. The stock was not debt financed, and was held for over a year.

Best recorded the following information:

Loss from Best's operations	($ 10,000)
Dividends received	100,000
Taxable income (before dividends received deduction)	$ 90,000

Review Question—Solution

Best's dividends-received deduction was:

Step 1: Full DRD

Step 2: Taxable income limitation

Step 3: Income/Loss with full DRD

Organization Expenses

Typical organizational expenses are legal services incident to organization, accounting services, organizational meetings of directors and shareholders, and fees paid to incorporate.

$5,000 of these expenses may be deducted, but the $5,000 is reduced by the amount of expenditures incurred that exceed $50,000.

Expenses not deducted must be capitalized and amortized over 180 months, beginning with the month that the corporation begins its business operations (unless an election is made to not do so).

Organization Expenses

They must be incurred before the end of the taxable year that business begins (but they do not have to be paid, even if on the cash basis).

Costs of issuing and selling stock (syndication expenses) must also be capitalized, but they cannot be amortized.

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Review Question

Brown Corp., a calendar-year taxpayer, was organized and actively began operations on July 1, Year 4, and incurred the following costs:

Legal fees to obtain corporate charter	\$40,000
Commission paid to underwriter	\$25,000
Other stock issue costs	\$10,000

Brown wishes to amortize its organizational costs over the shortest period allowed for tax purposes. In Year 4, what amount should Brown deduct for organizational expenses?

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Review Question—Solution

Current-year expense:

Legal Fees	40,000
Expense	(5,000)

Current-year amortization:

35,000 ÷ 180 months =	194.44
	× 6 months
Total	1,167

Total expense is 5,000 + 1,167 = 6,167

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Start-up Costs

Same rules apply for start-up costs.

Start-up costs are expenditures that would be deductible as trade or business expenses (ordinary, necessary, and reasonable) except that the corporation has not yet started its trade or business operation.

Insurance Premiums

A corporation may deduct insurance premiums paid for casualty insurance, employee health or accident insurance, and life insurance coverage for its employees and their beneficiaries.

Premiums paid on life insurance policies in which the corporation itself is the beneficiary are not deductible.

Research or Experimentation Expenses

Research and Experimentation expenses can be recovered through one of three methods:

- Current deduction
- Recover ratably over a period of at least 60 months
- Recover over a period of 10 years

Penalty Taxes

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Penalty Taxes

Penalty Taxes—Corporations

Accumulated earnings tax: ATI represents earnings that are retained in the business for which there is no reasonable business need to retain the earnings for the future.

Personal holding company tax: PHC tax for a previous year can be avoided by paying a deficiency dividend within 90 days after a determination by the IRS that the tax applied.

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Penalty Taxes—Corporations

Both penalty taxes operate to force corporations to distribute dividend income to shareholders.

The rate of the penalty tax is the current top tax rate on dividend income (20%).

The two penalty taxes are mutually exclusive—only one will apply in any year.

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Accumulated Taxable Income

Taxable income
\+ Dividends received deduction
\+ NOL deduction
– Federal income taxes
– Excess charitable contributions
\- Net capital loss
\- Net short term capital gain
– Net capital gain (net of tax)

Adjusted taxable income
– Dividends paid
– Accumulated earnings credit

Accumulated taxable income
× Tax rate on dividend income

Accumulated earnings tax

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Accumulated Earnings Tax Credit

A credit is allowed which represents the amount of earnings that can be accumulated for reasonable business needs.

The accumulated earnings credit is the greater of:

- Earnings needed for reasonable business needs, or
- Minimum credit of $250,000 ($150,000 for service corporations) less accumulated earnings and profits at the beginning of the year.

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Review Question

Daystar Corp., which is not a mere holding or investment company, derives its income from retail sales. Daystar had accumulated earnings and profits of $145,000 at December 31, Year 2. For the year ended December 31, Year 3, it had earnings and profits of $115,000 and a dividends-paid deduction of $15,000 for a dividend paid in June Year 3. It has been determined that $20,000 of the current and accumulated earnings and profits for Year 3 is required for the reasonable needs of the business.

How much is the allowable accumulated earnings credit at December 31, Year 3?

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Review Question

Greater than:

- Earnings needed for reasonable business needs, or $20,000
- $250,000 less accumulated earnings and profits at the beginning of the year $250,000 – $145,000 = $105,000

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Dividends

The AET can be eliminated by paying dividends within 3½ months after year-end or by paying a consent dividend.

Consent dividends are hypothetical dividends that are treated as if they were paid on the last day of the corporation's taxable year.

Shareholders increase their stock basis by the amount of consent dividends included in their gross income.

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Personal Holding Company Tax

Two tests must be met for a corporation to fall within the PHC provisions:

1. More than 50% of the value of the outstanding stock must be owned directly or indirectly by five or fewer individuals at any time during the last half of the tax year.
2. A substantial portion (60% or more) of the corporate income must consist of income such as dividends, interest, rents, and royalties.

Rents are not included in this definition if a) more than 50% of the corporation's gross income is from rents, and b) personal holding company income less dividends paid during the year is 10% or less of ordinary gross income.

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Personal Holding Company Tax

An individual indirectly owns stock if it is owned by the individual's family.

Family includes the individual's brothers, sisters, spouse, and lineal descendants and ancestors.

An individual will not be considered to be the constructive owner of the stock owned by nephews, cousins, uncles, aunts, and any of his/her spouse's relatives.

Constructive ownership also may exist if the individual is a partner in a partnership or the beneficiary of an estate that is a shareholder.

Personal Holding Company Tax Formula

Taxable income
plus or minus adjustments:
– Corporate income tax
– Excess charitable contributions
– Net capital gain (after tax)
+ Dividends received deduction
+ Net operating loss carryover
Adjusted taxable income
– Dividends paid or deemed paid
Undistributed PHC income

Dividends

The PHC tax can be eliminated by paying dividends within 3½ months after year-end, a consent dividend, or a deficiency dividend.

A deficiency dividend is a dividend expressly declared to avoid the tax and is paid within 90 days of the finding of a deficiency due to the PHC tax.

Review Question

The following information pertains to Hull, Inc., a personal holding company, for the current year:

Undistributed personal holding company income	$100,000
Dividends paid during the current year	20,000
Consent dividends reported in the current year's individual income tax returns of the holders of Hull's common stock, but **not** paid by Hull to its shareholders	10,000

In computing its personal holding company tax, what amount should Hull deduct for dividends paid?

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Taxation of Related Corporations

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Taxation of Related Corporations

Taxation of Related Corporations

There is a tax incentive to create multiple corporations to avoid the limits placed on individual corporations.

Congress created limits on related corporations to mitigate these incentives and create a mechanism for identifying and taxing related economic entities.

These related corporations are known as controlled groups.

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Controlled Groups

Controlled groups are parent-subsidiary corporations, brother-sister groups, and certain insurance companies.

A controlled group of corporations is entitled to one $250,000 accumulated earnings tax.

A group also receives only one Section 179 expense deduction.

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Parent-Subsidiary Group

A parent-subsidiary controlled group exists if:

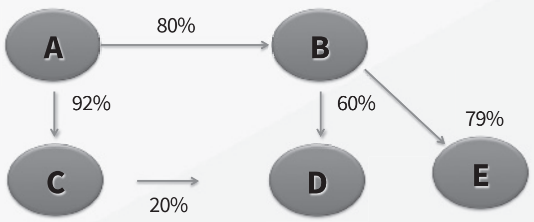
- Stock possessing at least 80% of the voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of each of the corporations, except the common parent, is owned by one or more of the other corporations.
- The common parent owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of at least one of the other corporations.

Review Question

Ape Corporation owns 80% of Bear Corporation and 92% of Cat Corporation. Bear Corporation owns 79% of Eel Corporation and 60% of Dog Corporation. Cat Corporation owns 20% of Dog Corporation. All corporations are domestic C corporations having a single class of stock outstanding.

Which corporations form a controlled group?

Review Question—Solution



Brother-Sister Controlled Group

A brother-sister controlled group exists if:

- Two or more corporations are owned by five or fewer persons (individuals, estates, or trusts), who have a common ownership of more than 50% of the total combined voting powers of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation, and
- Who possess stock representing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of each corporation.

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Brother-Sister Controlled Group

The 80% test does not apply for determining brother-sister corporations in the following circumstances:

- Corporate tax brackets
- The accumulated earnings credit
- The minimum tax exemption

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Brother-Sister Controlled Group—Problem

The only class of outstanding stock of Corporations N, O, P, Q, and R is owned by the following unrelated individuals:

Corporations/Percentage of Stock Owned

Individual	N	O	P	Q	R	50%
V	40%	40%	40%	40%	40%	40%
W	20%	-0-	10%	20%	30%	-0-
X	10%	10%	20%	20%	10%	10%
Y	30%	-0-	30%	10%	-0-	-0-
Z	-0-	50%	-0-	10%	-0-	-0-

Failed 50%

Which corporations are members of a brother-sister controlled group?

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Solution to the Brother-Sister Controlled Group—Problem

The only class of outstanding stock of Corporations N, O, P, Q, and R is owned by the following unrelated individuals:

	Corporations/Percentage of Stock Owned			
Individual	N	P	Q	50%
V	40%	40%	40%	40%
W	20%	10%	20%	10%
X	10%	20%	20%	10%
Y	30%	30%	10%	10%
Z	-0-	-0-	10%	-0-
	100%	100%	90%	70%

Which corporations are members of a brother-sister controlled group?

Affiliated Groups

An affiliated group exists when one corporation owns at least 80% of the voting power of another corporation and holds shares representing at least 80% of its value.

This test must be met on every day of the year.

An affiliated group can elect to file a consolidated tax return (insurance companies, S corporations, and foreign corporations are not eligible).

Affiliated Groups

Dividends between the affiliated corporations are eliminated on the consolidated tax return.

Gains and losses on intercompany sales are deferred until disposition outside the group.

The parent adjusts the basis of the stock of a consolidated subsidiary for allocable portion of income, losses, and dividends.

The members of the group must conform their tax year to the parent's tax year.

Affiliated Groups—Problem

Potter Corp. and Sly Corp. file consolidated tax returns. In January Year 1, Potter sold land, with a basis of $60,000 and a fair value of $75,000, to Sly for $100,000. Sly sold the land in December Year 2 for $125,000.

In its Year 1 and Year 2 tax returns, what amount of gain should be reported for these transactions in the consolidated return?

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Affiliated Groups—Solution

	Year 1	Year 2
Amount Realized		
Adjusted Basis		
Realized Gain		
Recognized Gain		

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Controlled vs. Affiliated Groups

While the rules for parent-subsidiary controlled groups are similar to those for affiliated groups, there are two important differences:

1. The affiliated group rules must be met every day of the year, while the P-S rules must be met only on the last day of the tax year.
2. The 80% test for affiliated groups is for voting power AND value, whereas the 80% test for P-S is for voting power or value.

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Distributions from a Corporation

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Distributions from a Corporation

Ordinary Distributions

Step 1: Taxable as dividend income to extent of the shareholder's pro rata share of E&P.

Step 2: Excess is tax-free to extent of shareholder's basis in stock (and reduces the basis).

Step 3: Remaining distribution amount is taxed as a capital gain.

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Ordinary Distributions: Example

If Pat receives a corporate distribution of $10,000 and has the following tax characteristics:

Earnings and profits	$3,000
Basis in stock	4,000

The tax consequences would be as follows:

Distribution	
E&P (dividend income)	
Basis in stock (tax-free)	
Capital gain	

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Property Distributions

Amount distributed = FMV – Liabilities on property

Basis of the property to the shareholder is the fair market value.

Earnings and Profits

Conceptually, E&P measures the corporation's economic ability to pay a dividend.

Computed by making adjustments to taxable income.

E&P is increased for all items of income, including tax-exempt income, and is decreased for both deductible and nondeductible expenses and losses.

The alternative depreciation system (straight-line) must be used for E&P purposes.

E&P—Reduction for Dividends

The E&P of the distributing corporation is reduced by:

- For cash distributions—the amount of money distributed
- For property distributions—by
  - The greater of the fair market value or the adjusted basis of the property distributed
  - Less the amount of any liability on the property

E&P—Property Distributions

If Corporation Mouse distributes property with an FMV of $1,000 and a basis of $1,200 to shareholder Cat, and Cat assumes a liability attached to the property of $300:

Earnings and Profits

Current	Accumulated	Results
+	+	Dividend = both
–	–	Not a dividend
+	–	Dividend = current
–	+	Net first

Earnings and Profits—Problem

On January 1, Year 4, Kee Corp., a C corporation, had a $50,000 deficit in earnings and profits.

For Year 4, Kee had current earnings and profits of $10,000 and made a $30,000 cash distribution to its stockholders.

What amount of the distribution is taxable as dividend income to Kee's stockholders?

Earnings and Profits—Solution

Amount of Distribution: $30,000

Earnings and Profits	
Current	Accumulated
$10,000	($50,000)

Corporate Gain

Gain but not loss is recognized to a corporation that distributes property as a dividend, as if the property were sold to the shareholder at its fair market value.

Corporate Gain—Problem

Dahl Corp. was organized and commenced operations in Year 1. At December 31, Year 5, Dahl had accumulated earnings and profits of $9,000 before dividend declaration and distribution. On December 31, Year 5, Dahl distributed cash of $9,000 and a vacant parcel of land to Green, Dahls' only stockholder. At the date of distribution, the land had a basis of $5,000 and a fair market value of $40,000.

What was Green's taxable dividend income in Year 5 from these distributions?

Corporate Gain—Solution

Amount of Distribution:
- Cash
- Land

Gain from Distribution:
- FMV
- Adjusted Basis

Earnings and Profits:
- Accumulated
- Gain
- Dividend Income

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Allocating Current E&P

A deficit in current E&P is allocated ratably during the year based on time, even if there is only one distribution for the year.

If more than one distribution is made during the year, a positive current E&P balance is prorated among the distributions based on the amount of the distributions.

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Corporate Redemptions and Liquidations

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Corporate Redemptions and Liquidations

Redemptions

A redemption is a sale of stock back to the issuing corporation.

The redemption qualifies for sale or exchange treatment (i.e., capital gain treatment) if the shareholder owns:

- After the distribution, less than 80% of his or her total interest in the corporation before the distribution.
- Less than 50% of the total combined voting power of all classes of stock entitled to vote.

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Redemptions

Bill owns 60% of Buc Corporation before a redemption and 49% after a redemption. Does the redemption qualify for sale or exchange treatment?

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Review Question

Elm Corp. is an accrual-basis calendar-year C corporation with 100,000 shares of voting common stock issued and outstanding as of December 28, Year 2. On Friday, December 29, Year 2, Hall surrendered 2,000 shares of Elm stock to Elm in exchange for $33,000. Hall had no direct or indirect interest in Elm after the stock surrender.

Hall's adjusted basis in 2,000 shares of Elm on December 29, Year 2 ($8 per share)	$16,000
Elm's accumulated earnings and profits at January 1, Year 2	25,000
Elm's Year 2 net operating loss	(7,000)

What amount of income did Hall recognize from the stock surrender?

Review Question—Solution

Amount realized

Adjusted basis

Capital gain

Redemptions

A redemption also qualifies as a sale or exchange if:

- It is not essentially equivalent to a dividend.
- Complete termination of interest (family attribution rules are waived).
- Partial liquidation:
  - At least two active businesses for last five years and one is liquidated.
- Redemption used to pay death taxes (stock must be at least 35% of adjusted gross estate).

Liquidations

A liquidation occurs when an entity ceases to be a going concern, and it distributes its assets.

Expenses incurred in the liquidation are deducted on the last corporate return.

Consequences to corporation:

- Gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation.

For purposes of computing gain/loss, the fair market value of the property will not be less than any liability that is attached to the property.

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Liquidations

Losses may not be recognized if:

- The property had been contributed in last five years, or
- The property is distributed to a related party.

Consequences to shareholder:

- Shareholders treat the distribution as a sale/exchange; capital gain or loss is recognized.
- The basis of assets received by the shareholder will be the fair market value on date of distribution.

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Review Question

Under a plan of complete liquidation, Len Corporation distributed land, having an adjusted basis to Len of $26,000, to its sole shareholder.

The land was subject to a liability of $38,000, which the shareholder assumed for legitimate business purposes. The fair market value of the land on the date of distribution was $35,000.

What is the amount of Len Corporation’s recognized gain or (loss)?

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Review Question—Solution

Liability > FMV of property

Amount realized

Adjusted basis

Sec. 1231 gain

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Review Question

Mintee, Corp., an accrual-basis calendar-year C corporation, had no corporate shareholders when it liquidated. In cancellation of all their Mintee stock, each Mintee shareholder received a liquidating distribution of $2,000 cash and land with a tax basis of $5,000 and a fair market value of $10,500. Before the distribution, each shareholder's tax basis in Mintee stock was $6,500.

What amount of gain should each Mintee shareholder recognize on the liquidating distribution?

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Review Question—Solution

Amount Realized:

Cash

Land

Adjusted Basis

Capital Gain

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Liquidation of Subsidiary

When a corporation liquidates a subsidiary, in general no gain or loss is recognized on the liquidation.

Basis in the subsidiary's assets will stay the same.

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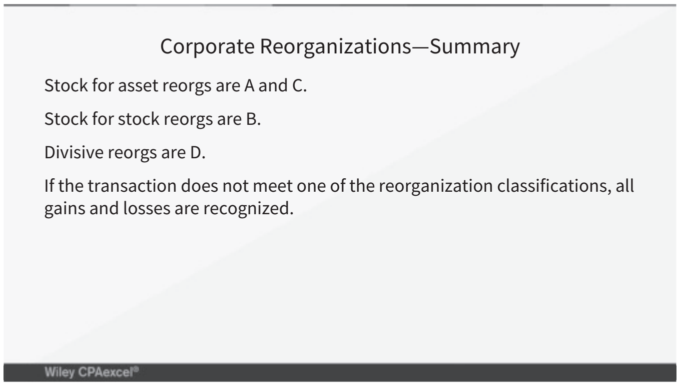
Corporate Reorganizations



A Reorganization

- Stock for asset.
- Known as a statutory merger since the requirements of state law must be met.
- Target corporation must dissolve.
- Voting or nonvoting stock can be used by Acquiring.
- At least 50% of the consideration given to Target by Acquiring must be stock.

B Reorganization

- Stock for stock.
- Acquiring must own at least 80% of Target after the transaction.
- Only voting stock can be used by Acquiring.
- No boot is allowed.

C Reorganization

- Stock for asset.
- Does not have to be a statutory merger.
- Only voting stock can be used by Acquiring.
- Boot is allowed, but it cannot exceed 20% of the consideration provided by Acquiring.
- Acquiring must acquire substantially all of Target's assets (90% of net asset value and 70% of gross asset value).

Consequences to Shareholders

No gain or loss is recognized to the shareholders of the corporations involved in a tax-free reorganization if they receive only stock in exchange for property of the acquiring organization.

If they receive other property in addition to stock, it is treated as boot and gain is recognized equal to the lower of:

- Boot received, or
- Realized gain.

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Consequences to Corporations

Gain or loss generally is not recognized to the corporations involved in the reorganization.

If the acquiring corporation transfers appreciated property to the target corporation, gain (but not loss) will be recognized.

If the target corporation transfers appreciated property to its shareholders, gain (but not loss) will be recognized.

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Basis in Stock

The basis to the shareholder in the stock received is:

Basis in stock surrendered
\+ Gain recognized
– Boot received

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Corporate Basis

The basis for the acquiring corporation in the transferor's assets is:

Transferor's basis in asset
\+ Gain recognized by Transferor

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Reorganization—Problem

In connection with a recapitalization of Yorktown Corporation, Robert Moore exchanged 1,000 shares of stock which cost him $95,000 for 1,000 shares of new stock worth $108,000 and bonds in the principal amount of $10,000 with a fair market value of $10,500.

What is the amount of Moore's recognized gain?

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Reorganization—Solution

Amount Realized:
Stock
Bonds—Boot
Adjusted Basis
Realized Gain

Recognized Gain—Lower of:
1. Realized gain 23,500
2. Boot received 10,500

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Basis in Stock—Solution

The basis to the shareholder in the stock received is:

Basis in stock surrendered

+ Gain recognized

– Boot received

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Reorganization—Problem

Jaxson Corp. has 200,000 shares of voting common stock issued and outstanding. King Corp. has decided to acquire 90% of Jaxson's voting common stock solely in exchange for 50% of its voting common stock and retain Jaxson as a subsidiary after the transaction. Which of the following statements is true?

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Reorganization—Problem

- King must acquire 100% of Jaxson stock for the transaction to be a tax-free reorganization.
- The transaction will qualify as a tax-free reorganization.
- King must issue at least 60% of its voting common stock for the transaction to qualify as a tax-free reorganization.
- Jaxson must surrender assets for the transaction to qualify as a tax-free reorganization.

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Tax Attributes

The tax attributes of Target normally carryover to Acquiring, including adjusted basis of assets, E&P, carryovers (including net operating loss, capital loss, and excess charitable contributions), accounting methods (including depreciation methods), and tax credit carryovers.

Same rules apply to the tax-free liquidation of a subsidiary.

Limitations may be placed on the use of Target's NOLS and negative E&P by Acquiring.

Multijurisdictional Tax Issues

State and Local Taxation

Types of SALT

State income taxes—Starting point is usually federal taxable income and then adjustments are made.

Sales taxes—Levied on tangible personal property and some services; exemptions vary by state but usually include items bought for resale and that are used in manufacturing.

Use taxes—Levied on the use of tangible personal property that was not purchased in the state.

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Types of SALT

Property taxes—Ad valorem taxes based on value of real property (realty taxes) and personal property (personalty taxes). There are usually many exemptions for property such as inventory. A few states also tax intangible property. Usually levied for property owned at a specific date.

Franchise tax—Levied on the privilege of doing business in a state. Based on the value of the capital used in the jurisdiction (common stock, paid-in capital, and retained earnings).

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Types of SALT

Excise tax—Levied on the quantity of an item or sales price. Examples include tax on gasoline, cigarettes, and alcohol. Can be charged to manufacturer or consumer.

Unemployment tax—Levied on taxable wages with a per employee limit (usually $7,000). Rate varies based on experience of employer.

Incorporation fees are charged for incorporating in a state or registering to do business in a state.

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Jurisdiction to Tax

Domestic corporations are entities incorporated under the laws of a particular state.

A foreign corporation is a corporation incorporated in another state.

It is difficult to determine the degree of power to tax foreign corporations.

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Jurisdiction to Tax

Supreme Court developed four tests to determine jurisdiction to tax *(Complete Auto Transit v. Brady):*

1. Activity must have substantial nexus with state
2. Fairly apportioned
3. Not discriminate against interstate commerce
4. Fairly related to services that the state provides

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Nexus

Nexus for taxing a corporation's income does not exist if activity in the state is limited to:

- Advertising;
- Determining reorder needs of customers; or
- Furnishing autos to sales staff.

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Public Law 86-272

Prohibits a state from imposing a tax on the net income

- Of an out-of-state business
- If the business' activity within the state is limited to the solicitation of orders
- For the sale of tangible personal property
- If the orders are sent out of the state for approval
- If the delivery originates from an out-of-state location

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Ancillary Activities

Activities ancillary to solicitation do not create nexus with the state:

- In-state home office for the employee
- Provision of company car
- Inspection of inventory
- Setting up promotional items at retail locations
- Attending trade shows for 14 days or fewer

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Owning or Leasing Property in State Creates Nexus

- Any office other than in-home office
- Real property or fixtures for real property of any kind
- Meeting place for directors, officers, or employees
- Repair shop
- Parts department
- Warehouse
- Storing inventory (other than samples)
- Mobile stores

South Dakota v. Wayfair, Inc., June 21, 2018

Supreme Court held that states can assert nexus for sales and use tax purposes without requiring a seller's physical presence in the state. This overturns the Supreme Court's decision in *Quill Corp. v. North Dakota* from 1992.

The Supreme Court found that the ruling in *Quill* banning sales tax collection when businesses lack "physical presence" in a state was incorrect.

The Court reasoned that *Quill* was "a judicially created tax shelter for businesses that decide to limit their physical presence and still sell goods and services" to a state's residents.

State Taxable Income

The starting point for computing state income taxes is federal taxable income, increased by adjustments such as (specific rules depend on state):

- Dividends-received deduction
- Expenses related to interest earned on U.S. bonds
- State income taxes
- Depreciation in excess of that allowed for state
- Municipal interest taxed for state purposes

State Taxable Income

Decreased by:

- Federal income taxes paid
- Expenses related to municipal interest income
- Interest on U.S. bonds
- Depreciation in addition to that allowed for federal purposes

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Business and Nonbusiness Income

Business income is apportioned among all the states in which the corporation does business.

Nonbusiness income is apportioned only to the corporation's home state (determined in various ways) or the state in which the income is earned.

Designating income as business or nonbusiness is very important.

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Business and Nonbusiness Income

Business income is generally:

- Generated from business's regular operations (transactional test), or
- From the sale of property that is an integral part of the business (functional test).

Nonbusiness income generally includes investment income and income from transactions not part of regular operations.

If investment income is generated by regular business operations, it is business income.

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Apportionment

Business income is apportioned among the states in which it is earned based on apportionment factors such as sales, property, and payroll.

Some states use only one apportionment factor; others vary in how they weight the factors.

Different types of factors are used for financial institutions and service businesses.

Apportionment Factors

Sales factor is computed as:

$$\frac{\text{Total sales in state}}{\text{Total sales}}$$

Property factor is computed as:

$$\frac{\text{Average value of property in state}}{\text{All property}}$$

Apportionment Factors

Payroll factor is computed as:

$$\frac{\text{Compensation paid or accrued in state}}{\text{Total compensation paid or accrued}}$$

Review Question

BIG Corporation has business operations in five states (A, B, C, D, E). Taxable income is $110,000 of which $10,000 is from income from specific transactions in A. Sales, property, and payroll are apportioned as 10%, 30%, 20%, 15%, and 25%, respectively.

How is the taxable income apportioned among the states?

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Review Question—Solution

	A	B	C	D	E
Allocated	10,000				
Apportioned	10,000	30,000	20,000	15,000	25,000
Total Income	20,000	30,000	20,000	15,000	25,000

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Pass-Thru Entities

Note that some states do not recognize the federal S corporation election.

Some states also tax partnerships at the entity level.

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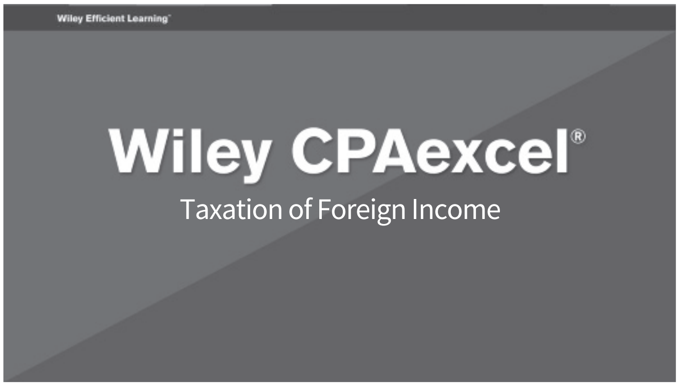
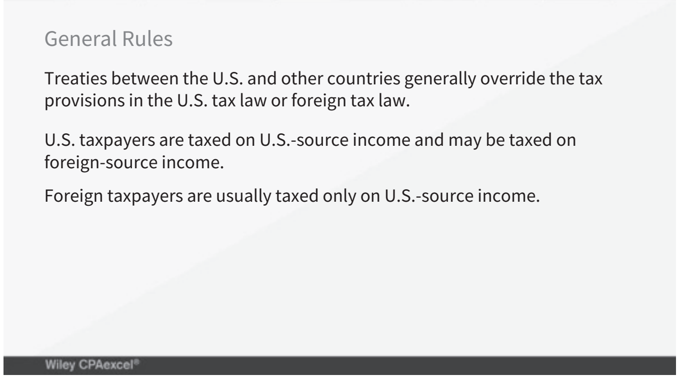
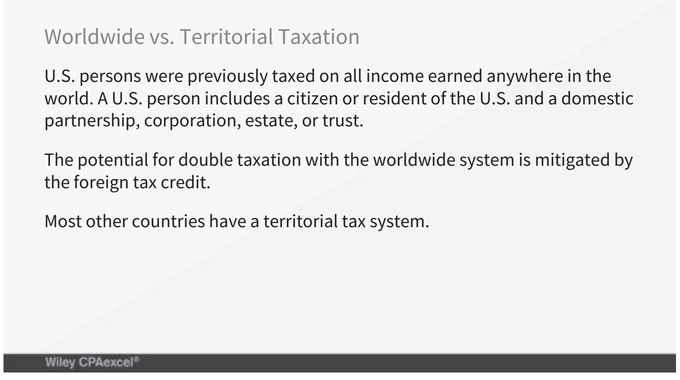
Taxation of Foreign Income







Worldwide/Territorial Taxation

Beginning in 2018 the taxation of foreign-source income to U.S. persons begins to transition towards a territorial tax system. The new rules overlay the historical worldwide taxation structure.

U.S. businesses that sells good and services abroad must continue to report that income immediately in the U.S.

Profits and losses from branch operations in foreign jurisdictions are also reported immediately.

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Outbound and Inbound Transactions

Outbound transactions refer to the taxation of foreign-source income by U.S. taxpayers.

Inbound transactions refer to the taxation of U.S.-source-income by non-U.S. taxpayers.

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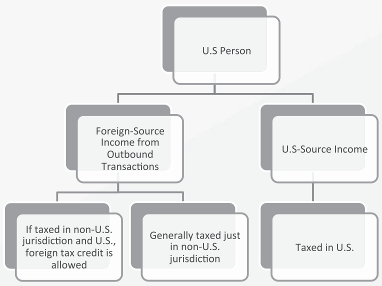
Taxation of Cross-Border Transactions to U.S. Persons



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Controlled Foreign Corporations (CFC)

A CFC is a foreign corporation for which more than 50% of the voting power or value of stock is owned by U.S. shareholders (limited to those who own, direct and indirect, 10% or more of the foreign corporation) on any day of the tax year of the foreign corporation.

U.S. shareholders may be taxed on CFC income (Subpart F income) as a constructive dividend.

Only certain income from a CFC is taxed to the U.S. shareholder as a constructive dividend.

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Controlled Foreign Corporations (CFC)

The main type of income that is taxed is that which is:

- Not connected economically to the country in which it is organized
- From insuring the risk of loss from outside the county in which it is organized

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CFC—Problem

Bottom, Inc. is a CFC for the entire tax year.

Top, Inc., a U.S.-based corporation, owns 75% of Bottom for the entire year. Both are calendar year-corporations. Subpart F income is $50,000, and no distributions have been made.

What is Top's constructive dividend for the tax year?

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Territorial System

In prior years, if foreign-source income was not Subpart F income or not taxed immediately under another provision, it was not taxed until the U.S. business repatriated the profits back to the U.S.

The new system provides a 100 percent deduction by U.S. corporations for foreign-source portion of dividends received from the earnings and profits of 10 percent owned foreign affiliate. This deduction completely offsets the income from the foreign subsidiary.

The U.S. business must have owned stock in the foreign affiliate for at least one year.

No foreign tax credit or deduction will be allowed for any taxes paid or accrued with respect to a dividend that qualifies for the deduction.

Price Paid for Territorial System – Deemed Repatriation

U.S. shareholders owning at least 10% of a foreign subsidiary must include in income the shareholder's share of post-1986 Earnings & Profits if not previously taxed in U.S. This is included for the subsidiary's last tax year beginning before 2018.

The E&P is taxed at 8% except the portion due to cash is taxed at 15.5%.

The balance can be paid immediately, or over 8 years with most of it paid in the last three years.

Global Intangible Low-taxed Income

The Global Intangible Low-taxed Income (GILTI) applies broadly to certain income generated by a controlled foreign corporation (CFC). United States shareholders must include in income the aggregate amount of certain income generated by its CFC(s), even if not actually repatriated.

This provision taxes the U.S. shareholder on its allocable share of CFC earnings to the extent the earnings exceed a 10% return on the shareholder's allocable share of tangible assets held by CFCs. This tax applies to C corporations and flow-through taxpayers.

If the U.S. shareholder is a domestic C corporation, it is eligible for up to an 80 percent deemed paid foreign tax credit (FTC) and a 50 percent deduction of the current year inclusion. This reduced the effective tax rate on GTLII to 10.5%.

Foreign-Derived Intangible Income Deduction

The Foreign-Derived Intangible Income (FDII) deduction is a deduction for domestic C corporations that generate certain types of foreign income.

The deduction applies to U.S. taxpayers that generate income from export sales or services. The deduction is a percentage of eligible income and reduces a taxpayer's effective tax rate on this income to 13.125%.

Foreign-Derived Intangible Income Deduction

U.S. taxpayers that generate gross receipts from the following activities may qualify for the deduction:

- Sale, lease, license, exchange or other disposition of property by a taxpayer to a non-U.S. taxpayer for foreign use.
- Services provided by taxpayer to any person, or with respect to property, not located in the U.S.

The provision assumes a corporation earns a fixed rate of return on its tangible assets. Any remaining income is assumed generated by intangible assets, even if that is not actually the case. So, a corporation can receive an FDII deduction even if no intangible assets are owned.

Base Erosion and Anti-Abuse Tax (BEAT)

Tax applies to U.S. corporations that have average gross receipts for the previous three years of at least $500 million and that have a base erosion percentage of at least 3%.

BEAT does not apply to regulated investment companies, real estate investment trusts, or S corporations.

Base erosion payments are deductible amounts paid to a related party and include:

- Interest
- Royalties
- Purchase of depreciable/amortizable property

Base erosion payments do not include cost of goods sold.

Overview of Key Components to Tax Strategy

100% deduction for foreign-source dividends received by domestic corporations from 10%-owned foreign corporations. Foreign tax credit is not available for this income.

Foreign earnings in excess of a deemed return (10% of certain business assets) is taxed currently as another type of controlled foreign corporation (CFC) income (GILTI). 10.5% effective tax rate and 80% FTC is available.

An incentive is provided to produce intangible income in the U.S. with an effective tax rate of 13.125%. This incentive applies to inbound income also (FDII). 80% FTC is available.

A base erosion tax (BEAT) of 10% is imposed on deemed base erosion payments such as royalties and interest. Cost of good sold payments are not subject to BEAT.

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Transfer Pricing

U.S. corporations can sell goods to foreign subsidiaries at transfer prices that minimize the overall tax to the corporation.

The IRS can impose significant penalties on corporations whose transfer prices are unreasonable.

The corporation can agree to a safe harbor transfer price with the IRS through an Advance Pricing Agreement (APA).

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Foreign Tax Credit

The credit for foreign taxes paid is limited if the U.S. effective tax rate exceeds the foreign effective rate.

Limit =

$$\text{U.S. tax on worldwide income} \times \frac{\text{foreign-source taxable income}}{\text{worldwide taxable income}}$$

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Foreign Tax Credit

Excess foreign tax credits can be carried back one year and carried forward 10 years.

The foreign tax credit is computed separately for four separate types of income:

- Active business income
- Portfolio income
- Income from foreign branches
- Intangible income

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Foreign Income Exclusion

Qualifying individuals can exclude:

- Foreign-earned income from personal services
- Employer-provided foreign housing income

Exclusion is subject to a limit that is indexed for inflation.

Taxpayers must file an election to take the exclusion, which is binding for future years until revoked.

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Foreign Income Exclusion

Qualifying individuals must meet one of two tests to benefit from this exclusion:

- During a continuous period that includes an entire tax year, the individual is a bona fide resident of at least one foreign country, or
- The individual has a tax home in a foreign country and was present in one or more foreign countries for at least 330 days during any 12 consecutive months.

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Foreign Currency Gains and Losses

Foreign currency exchange gains and losses resulting from the normal course of business operations are ordinary.

Foreign currency exchange gains and losses resulting from investment or personal transactions are capital.

U.S. Taxation of Foreign Persons

Nonresident foreign persons generally are subject to U.S. tax on two categories of income:

1. Income that is effectively connected with a U.S. trade or business (ECI).
2. Certain passive types of U.S.-source income commonly (30% rate levied on interest, dividends, rents, royalties, etc.).

Source of Income

Earned income is foreign-source if earned in a foreign country and U.S.-source if earned domestically.

This also includes employee benefits.

Unearned income is foreign-source if received from a foreign resident or for property that is used in a foreign country.

Source of Gain from Sales

Income from the sale of personalty is determined based on the residence of the seller, except:

- Inventory is sourced based on the location of the production of the property.
- For depreciable property, recapture is sourced where depreciation was claimed; remaining gain is sourced where title transfers.

Income from the sale of intangibles is sourced where the amortization was claimed.

Income from the sale or exchange of real property is sourced based on the location of the property.

Source of Interest Income

Interest income is U.S.-source if received from:

- U.S. government.
- Noncorporate U.S. residents, and
- Domestic corporations.

If a U.S. corporation receives 80% or more of its active business income from foreign-sources over the previous three years, then interest received is foreign-source.

Source of Dividends

Dividends from U.S. corporations are U.S.-source and from foreign corporations are foreign-source.

If a foreign corporation receives 25% or more of gross income from income connected with a U.S. business for the three previous tax years, then dividend is U.S.-source.

Source of Income-Producing Property

Source of income from the use of tangible property is determined by the country in which the property is located.

Source of income from the use of intangible property is determined by the country in which the property is used.

Deductions

Deductions must be allocated or apportioned as U.S.-source or foreign-source.

The IRS has the authority to change allocation of income and deductions if it determines that the taxpayer's methods do not clearly reflect income.

Tax-Exempt Entities

Tax-Exempt Organizations

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Tax-Exempt Organizations

Tax-Exempt Organizations

Tax-exempt organizations include charities, labor organizations, social clubs, pension and profit-sharing trusts, political organizations, and private foundations.

An exempt organization (EO) may be in the form of a corporation or trust, and it must apply for and receive an exemption from taxation (Form 1023 or Form 1024).

A private foundation is a tax-exempt organization which receives less than one-third of its annual support from the general public, governmental units, churches, charitable organizations, etc.

Annual Filing Requirement

EO must file an information return (Form 990) if gross receipts exceed $50,000.

This form reports income, expenses, and substantial contributors.

Churches do not file Form 990.

Private foundations file Form 990-PF.

Acceptable Activities

To qualify as an EO, the organization must operate exclusively for a tax-exempt purpose.

Influencing legislation or political parties is not an acceptable purpose.

Section 501(c)(3) organizations can participate in lobbying efforts if an election is made and lobbying expenditures do not exceed certain ceilings.

Review Question

Maple Avenue Assembly, a tax-exempt religious organization, operates an outreach program for the poor in its community. A candidate for the local city council has endorsed Maple's anti-poverty program. Which of the following activities is (are) consistent with Maple's tax-exempt status?

I. Endorsing the candidate to members

II. Collecting contributions from members for the candidate

A. I only
B. II only
C. Both I and II
D. Neither I nor II

Unrelated Business Income

An exempt organization is taxed on its unrelated business income (UBI).

To be UBI, income must:

- Be from a business regularly carried on.
- Not be substantially related to the EO exempt purposes.

Unrelated Business Income

Related income includes:

- An activity where substantially all work is performed for no compensation.
- A business carried on for the convenience of students or members of a. charitable, religious, or scientific organization.
- Sale of merchandise received as contributions.
- In general, investment income.
- Rents from real property.

Unrelated Business Income

Income from advertising in journals of the EO is UBI.

Qualified corporate sponsorship income is not UBI.

UBI is taxed (only if it exceeds $1,000) at regular corporate rates if the organization is a corporation; at trust rates if it is a trust.

Review Question

Which of the following activities conducted by a tax-exempt organization will result in unrelated business income?

I. Selling articles made by handicapped persons as part of their rehabilitation, when the organization is involved exclusively in their rehabilitation

II. Operating a grocery store almost fully staffed by emotionally handicapped persons as part of a therapeutic program

A. I only
B. II only
C. Both I and II
D. Neither I nor II

Tax Cuts and Jobs Act of 2017

Unrelated Business Taxable Income must be computed separately for each trade or business activity.

An excise tax equal to 1.4% of net investment income is imposed on private colleges and universities:

- That have at least 500 students,
- Where more than 50% of students are located in the United States, and
- That have assets equal to at least $500,000 per student (not including assets used in meeting exempt purpose).

Must pay corporate tax on excess executive compensation.

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Partnership Taxation

Formation and Basis

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Formation and Basis

Partnerships—Introduction

General partners can participate in management and have joint and several liability for the partnership's debts. All partnerships must have at least one general partner.

Limited partners are only liable up to their investment, but they cannot participate in management without losing their limited liability status.

LLC members have limited liability.

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Entities Taxed as Partnerships

General partnerships—All GPs

Limited partnerships—At least one GP and at least one LP

Limited liability companies—All members have limited liability

Limited liability partnerships—Liability protection may be more limited than for LLC members

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Check-the-Box Regulations

Nonincorporated entities (i.e., partnerships, limited liability companies) are taxed as follows:

- If only one business owner, the default classification is that the entity is disregarded for tax purposes.

Nonincorporated entities (i.e., partnerships, limited liability companies) are taxed as follows:

- If more than one owner, the default classification is partnership.
- However, the owners can elect to be taxed as a corporation if they wish.

Advantages of Partnerships

Partnerships provide business owners substantial flexibility.

Limited liability companies are popular because all members have limited liability.

Partners can usually get into and out of a partnership without recognizing a gain.

Single taxation.

Formation of a Partnership

A partner and a partnership will not recognize gain or loss from the contribution of property in exchange for a partnership interest.

Almost all tax elections are made by the partnership as opposed to by the partners.

Partnership Interest Received for Services

This provision does not apply to partnership capital interests received for services, for which wage income is recognized equal to the fair market value of the partnership interest.

Partnership interests that are profits interests received in return for services that hold investments or real estate have special rules.

The profits allocated to the profits-interest partners must be from assets held for more than three years to produce long-term capital gain. Additionally, the partnership interest itself must be held for more than three years when it is sold for any resulting gain to be long-term.

Profits Interest Example

An investment fund manager holds a profits interest in a partnership that was received in connection with the performance of services. For the current year, the manager's separately stated net long-term capital gain in connection with that interest is $20 million. However, only $12 million of that amount is attributable to underlying investments that have been held for more than three years. Thus, she will be treated as having received $12 million of long-term capital gain which will be taxed at capital gains rates, and $8 million of short-term capital gain which will be taxed at ordinary income tax rates.

Basis

The partner takes a substituted basis in the partnership interest (i.e., basis partner had in property transferred), and the partnership takes a carryover basis in assets it receives.

Once the partnership begins operations, a partner's adjusted basis for his or her partnership interest must be adjusted to reflect the results of operations.

Holding Period

Partner's holding period in partnership interest:

- Holding period tacks for contributions of capital assets and Section 1231 assets.
- For other assets, the holding period starts when the contribution is received by the partnership.

Partnership's holding period in property received always includes the holding period the partner had in property.

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Basis Adjustments

The initial basis is increased by:

- The partner's share of taxable and nontaxable income
- Increases in the partner's share of partnership debt
- Additional contributions the partner makes to the partnership

The basis is reduced by:

- Share of the deductions, losses, nondeductible and noncapitalizable expenditures of the partnership
- Decreases in the partner's share of partnership debt
- Any distributions from the partnership to the partner

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Basis Problem

Gray is a 50% partner in Fabco Partnership. Gray's tax basis in Fabco on January 1 was $5,000. Fabco made no distributions to the partners during this year, and recorded the following:

Ordinary income	$ 20,000
Tax-exempt income	8,000
Portfolio income	4,000

What is Gray's tax basis in Fabco on December 31 of the current year?

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Basis Problem—Solution

Initial basis	5,000
Ordinary income	10,000
Tax-exempt interest	4,000
Portfolio income	2,000
Basis, December 31	21,000

Ordering Rules

A partner's basis for the partnership is adjusted in the following order:

- Increased for all income items (including tax-exempt income)
- Decreased for distributions
- Decreased by deductions and losses (including nondeductible items not charged to capital)

Problem

A partner with a basis of $50 for his partnership interest at the beginning of the partnership year receives a $30 cash distribution during the year and is allocated a $60 distributive share of partnership ordinary loss and an $8 distributive share of capital gain. What is his ending basis?

Changes in Liabilities

An increase in the partnership's liabilities increases each partner's basis in the partnership by each partner's share of the increase.

Any increase in a partner's individual liability by reason of the assumption by the partner of partnership liabilities increases a partner's basis.

Any decrease in the partnership's liabilities reduces each partner's basis in the partnership by each partner's share of the decrease.

Any decrease in a partner's individual liability by reason of the assumption by the partnership of such individual liabilities is reduces the partner's basis.

Liabilities—Recourse Debt

Partners increase/decrease basis as their share of partnership debt changes.

For recourse debt, each partner's share of debt is measured by his/her economic risk of loss assuming a "constructive liquidation scenario" occurred.

Limited partners are not allocated any share of recourse debt.

Liabilities—Nonrecourse Debt

Nonrecourse debt is debt for which the lender's only recourse, in the event of default, is to take back the property.

Nonrecourse debt is often allocated based on the partners' profit- sharing ratios.

In contrast with recourse debt, both general and limited partners are allocated nonrecourse debt.

Liabilities and Basis Problem

Bailey contributed land with a fair market value of $75,000 and an adjusted basis of $25,000 to the ABC Partnership in exchange for a 30% interest.

The partnership assumed Bailey's $10,000 recourse mortgage on the land.

What is Bailey's basis for his partnership interest?

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Liabilities and Basis Problem—Solution

Beginning basis	25,000
Partner's debt assumed	(10,000)
Partners' share of partnership debt	+ 3,000
Basis in partnership interest	18,000

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Year-ends

Partnerships use the same year-end as their majority interest partner(s) (more than 50% capital interest and profits interest).

If the partnership has no single year for the majority test, then the partnership uses same year-end as all of its principal partners (5% or more profits interest).

Least aggregate deferral method

Section 444 election allows a year-end different from required year-end but deferral cannot exceed three months.

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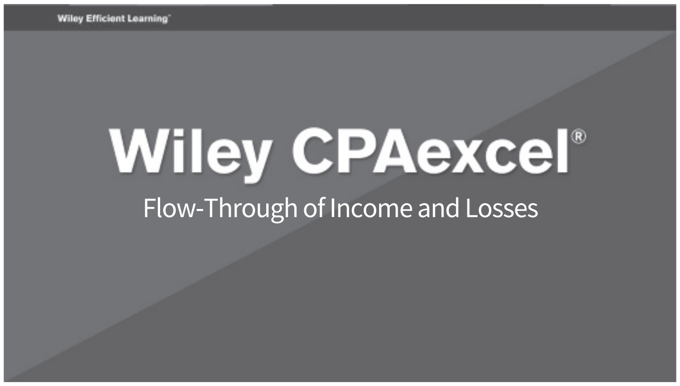
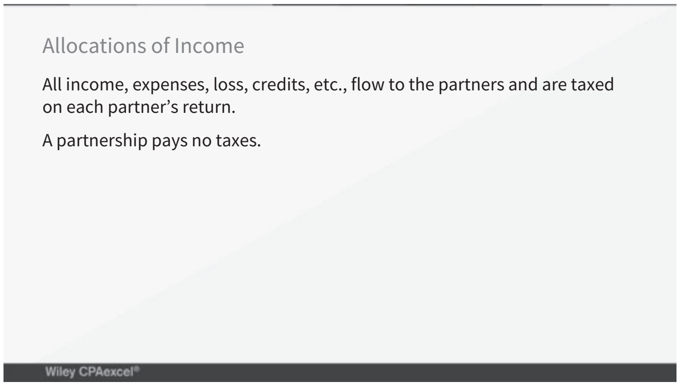
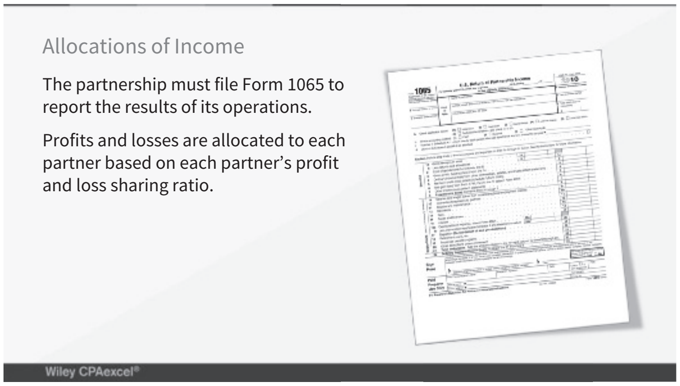
Flow-Through of Income and Losses







Allocations of Income

All items of income, gain, deduction, loss, or credit which are required to be separately stated, or which are specially allocated, are removed from the partnership's ordinary income or loss determination.

Each partner's proportionate share of these items is reported on Schedule K-1.

The remaining items are lumped together to produce the ordinary business income or loss, which is also proportionately reported to each partner.

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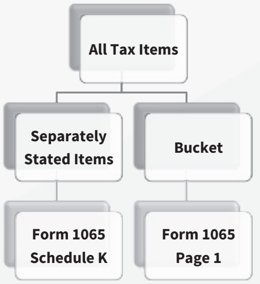
Income Flow-Through



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Separately Stated Items

Capital gains and losses
Sec. 1231 gains and losses
Charitable contributions
Foreign income taxes
Sec. 179 expense deduction
Interest, dividend, and royalty income
Interest expense on investment indebtedness
Net income (loss) from rental real estate activity
Tax-exempt income

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Non-Separately Stated Items

Sales less cost of goods sold

Business expenses, such as wages, rents, bad debts, and repairs

Deduction for guaranteed payments to partners

Depreciation

Amortization (over 180 months) of partnership organization and start-up expenditures

Sec. 1245 and 1250 recapture

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Income—Problem

Partnership M, a law partnership, had the following items this year:

		Bucket	SS
Income from clients	$200,000		
Repairs	1,000		
Depreciation	2,000		
Dividends on capital stock	500		
Other operating expenses	125,000		
Charitable contribution	1,500		
Sec. 1231 gain on sale of office furniture	1,200		
Sec. 1245 gain on sale of office furniture	1,000		

What is Partnership M's ordinary income?

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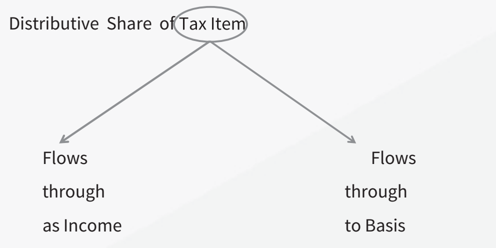
Flow-Through Effects



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Partnership Losses

A partner can deduct partnership losses on her tax return only to the extent of her basis in her partnership interest.

A partnership loss will be a passive loss to a limited partner.

A partnership loss may be a passive loss to a general partner depending upon whether the partner meets the material participation test.

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Loss Limitations Problem

Linda and Mark each have a 50% interest in the LM Partnership. The partnership and the individuals file on a calendar-year basis. For its Year 4 tax year, LM Partnership had a $30,000 loss. Linda's adjusted basis in her partnership on January 1, Year 4, was $8,000. In Year 5, LM Partnership had a profit of $28,000.

Assuming there were no other adjustments to Linda's basis in the partnership in Years 4 and 5, what amount of partnership income (loss) would Linda show on her Years 4 and 5 individual income tax return?

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Loss Limitations Problem—Solution

Year 4 Distributive loss	
Loss allowed (equal to basis)	
Carryforward loss	
Ending basis is	
Year 5 Beginning basis	
Year 5 Income	
Loss carryforward from Year 4	
Year 5 Ending basis	

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Loss Limitations

Three hurdles must be cleared for a loss to be deducted:

Basis in partnership interest

At-risk amount (generally basis less share of nonrecourse debt)

- Passive income (if the loss is passive)

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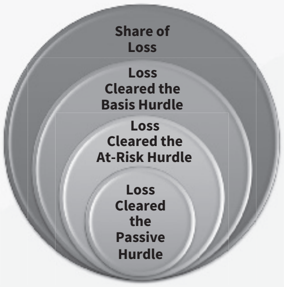
Loss Limitations



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Loss Limitation Problem

Jose's share of Partnership JAK's loss is $50,000.

Other relevant tax information is as follows:

Basis in partnership interest	$40,000
At-Risk amount	35,000
Passive income	20,000

How much loss from the partnership can Jose deduct on this year's tax return?

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Loss Limitations Problem—Solution

50,000

	Cleared hurdle	Carry-forward
Basis		
At-risk amount		
Passive income		

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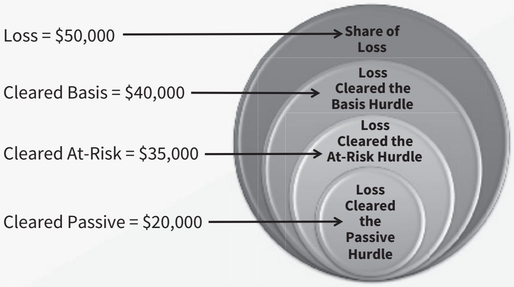
Loss Limitations



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Excess Business Losses

- After 2017, no deduction is allowed for:
  - a noncorporate taxpayer's,
  - excess business loss,
  - that exceeds $500,000/$250,000 (married filing joint/other).
- The disallowed amount is added to the taxpayer's NOL carryforward.
- This limitation applies after application of the passive loss rules.
- The limit applies to the aggregate net loss from all of the taxpayer's trade and businesses.
- For flow-through entities, the limitation applies at the owner level.

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Organization and Start-Up Costs

Organization costs: $5,000 of these expenses may be deducted, but the $5,000 is reduced by the amount of expenditures incurred that exceed $50,000.

Expenses not deducted must be capitalized and amortized over 180 months, beginning with the month that the corporation begins its business operations (unless an election is made to not do so).

Same rules apply for start-up costs.

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Dispositions of Property

The character of any gain or loss recognized on the disposition of property may be based on the nature of the property to the contributing partner before the contribution.

Unrealized receivables

Inventory

Capital loss property

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Transactions with Partners

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Transactions with Partners

Guaranteed Payments

Guaranteed payments are determined without regard to partnership income and are paid to the partner in his or her role as a partner (i.e., salaries).

Guaranteed payments are taxable as ordinary income to the partner and are deductible by the partnership.

They are taxed as if they were paid on the last day of the partnership's taxable year.

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Review Question

Evan, a 25% partner in Vista partnership, received a $20,000 guaranteed payment in Year 3 for services rendered to the partnership. Guaranteed payments were not made to any other partner. Vista's Year 3 partnership income consisted of:

Net business income before guaranteed payments	$ 80,000
Net long-term capital gains	10,000

What amount of income should Evan report from Vista Partnership on his Year 3 tax return?

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Review Question—Solution

Net income before guar. payment
Guaranteed payment
Ordinary business income
Income reported on tax return:
  Ordinary income 60,000 × 25%
  Capital gains 10,000 × 25%
  Guaranteed payment

Built-in Gains/Losses

If a partnership disposes of an asset that was contributed by a partner and at the time of contribution the asset had a built-in gain or built-in loss, the recognized gain/loss is allocated back to the contributing partner to the extent of the built-in gain/loss.

If asset contributed has:

FMV = $10,000

Adjusted basis = $7,000

BIG = $3,000

Built-in Gains/Losses

Section 704(c) prevents taxpayers from using partnerships to transfer appreciation to other partners.

Section 704(c) applies to both gains and losses.

There is no time limit on the application of this provision.

Review Question

Art, Bart, and Dart decide to form the equal ABD partnership at the beginning of Year One. Art contributed depreciable assets that he has owned for two years that have a basis of $15,000 and a value of $20,000. Bart contributed $20,000 cash. Dart contributed $12,000 in cash and land with a basis of $5,000 and a value of $8,000.

What are the tax consequences if the partnership sells the land contributed by Dart for $11,000?

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Review Question—Solution

Land

FMV

Adjusted basis

Built-in gain

Land Sale:

Amount realized – Adjusted basis = Recognized gain

Built-in gain → Dart

Remaining gain → Dart, Art, Bart

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Related-Party Losses

Losses disallowed between a partnership and person owning more than 50% of capital or profits interest

Losses disallowed between two partnerships if same person owns more than 50% of capital or profits interest

Note application of constructive ownership rules

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Review Question

The FAD partnership is an equal partnership.

F and D are father and daughter and F sells a business asset, with an adjusted basis of $12,000, to the FAD partnership for $8,000.

What are the tax consequences of this transaction?

What if FAD later sells the asset to an unrelated third party for $10,000?

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Review Question—Solution

Father's ownership interest:

Amount realized

Adjusted basis

Realized loss

Recognized loss

Right of offset

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Review Question—Solution

FAD Sale

Amount realized

Adjusted basis

Realized gain

Right of offset

Recognized gain

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Fringe Benefits

Partners are generally not considered to be employees for purposes of employee fringe benefits.

The value of a partner's fringe benefits are deductible by the partnership as guaranteed payments and must be included in a partner's gross income.

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Partnership Distributions

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Partnership Distributions

Nonliquidating Distributions

In general, no gain or loss is recognized by the partnership or the partner for a proportionate nonliquidating distribution.

Assets are assumed to be distributed in the following order:

- Cash
- Unrealized receivables and inventory (all assets except for cash, capital assets, and Section 1231 assets)
- Capital assets and Section 1231 assets

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Nonliquidating Distributions

The distributee partner recognizes gain if the cash distributed exceeds the partner's outside basis in the partnership immediately before the distribution.

Gain recognized by the partner is usually capital gain.

In general, distributed property takes a carryover basis to the distributee partner.

The partner reduces his basis in his partnership interest by the basis of the property distributed.

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Review Question

The adjusted basis of Jody's partnership interest was $50,000 immediately before Jody received a current distribution of $20,000 cash and property with an adjusted basis to the partnership of $40,000 and a fair market value of $35,000.

What amount of taxable gain must Jody report as a result of this distribution?

What is Jody's basis in the distributed property?

Review Question—Solution

	Basis in partnership
Interest	
Cash	
Land: Lower of AB or Remaining basis in interest	
Ending Basis	
Basis in land to Jody	

Liquidating Distributions

Rules are the same as for nonliquidating distributions, with the following exceptions:

- Loss is recognized if:
  - The partner receives only cash, unrealized receivables, and inventory from the partnership
  - The inside basis of these assets is less than the partner's outside basis in the partnership immediately before the distribution
- The partner's basis must be reduced to zero.

Review Question

The adjusted basis of Vance's partnership interest in Lex Associates was $180,000 immediately before receiving the following distribution in complete liquidation of Lex:

	Basis to Lex	Fair Market Value
Cash	$100,000	$100,000
Real estate	70,000	96,000

What is Vance's basis in the real estate?

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Review Question—Solution

	Basis in partnership
Interest	
Cash	
Land	
Basis in land to Vance	

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Partner Retirements

If a partner retires from the partnership, in general payments received are treated the same as for liquidating distributions.

If the partner is a general partner in a service-oriented partnership, then:

- Payments for unrealized receivables and unstated goodwill are taxed as ordinary income.
- Remaining payments are treated as being in exchange for partnership property.

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Sales and Terminations

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Sales and Terminations

Sales of Partnership Interests

A partnership interest is a capital asset. Thus, gain/loss from the sale of a partnership interest is, in general, capital in nature.

However, to the extent the partnership has hot assets, gain will be recharacterized as ordinary income.

The look-through rules may also affect the tax rates applied to a portion of the gain.

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Sales of Partnership Interests

Hot assets are:

- Unrealized receivables (receivables of a cash basis taxpayer; includes depreciation recapture)
- Inventory

If the partnership has hot assets at the time a partnership interest is sold, the selling partner must allocate a portion of the sale proceeds to these assets and recognize ordinary income.

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Review Question

The personal service partnership of Allen, Baker & Carr had the following cash basis balance sheet at December 31, Year 4:

Assets	Adjusted basis per books	Market value
Cash	$102,000	$102,000
Unrealized accounts receivable	-	$420,000
Totals	$102,000	$522,000

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Review Question

Carr, an equal partner, sold his partnership interest to Dole, an outsider, for $154,000 cash on January 1, Year 5. In addition, Dole assumed Carr's share of the partnership's liability.

Liability and Capital Note payable	$ 60,000	$ 60,000
Capital accounts:		
Allen	14,000	154,000
Baker	14,000	154,000
Carr	14,000	154,000
Totals	$ 102,000	$522,000

What was the total amount and character of the gain recognized by Carr?

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Review Question—Solution

Total sale amount realized	Total Sale
Cash	154,000
Debt Relief	+ 20,000
	174,000
Adjusted basis 14,000 + 20,000	(34,000)
Recognized gain	140,000

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Review Question—Solution

	If Hot Asset Sold
Amount realized	420,000
Adjusted basis	-0-
Ordinary income	420,000
Allocated to Carr	× 1/3
	140,000
Total gain	140,000
Ordinary income	(140,000)
Capital gain	0

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Character of Gain on Sale

In addition to hot assets, if the partnership owns collectibles or has Section 1250 assets, these items may also impact the gain from the sale of a partnership asset.

The selling partner's gain will be taxed at 28% to the extent it is due to collectibles, and an unrecaptured Section 1250 gain will be taxed at 25%.

Collectibles include coins, stamps, antiques, artwork, etc.

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Character of Gain on Sale

The look-through rules now also impact the character of gain for the sale of a partnership interest by a foreign person if the partnership is engaged in a U.S. trade or business.

Gain from the sale is "effectively connected" with a U.S. trade or business to the extent the foreign partner would have had effectively connected gain or loss had the partnership sold all of its assets at FMV on the dates of the sale.

Such gain or loss is allocated to partners in the same manner as non-separately stated income and loss.

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Partnership Terminations

No part of the business continues to be carried on by any partner in the partnership form.

Termination requires a closing of the partnership tax year.

Partnership Terminations

When the partnership's business and financial operations are continued by other members, there is:

- A deemed distribution of assets to the remaining partners and the purchaser
- A hypothetical recontribution of assets to a new partnership

Partnership Divisions

When a partnership divides into two or more partnerships, the original partnership is continued in each of the new partnerships which contain partners that controlled 50% or more of the partnership interest in the original partnership.

S Corporation Taxation

Eligibility, Elections, Terminations

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Eligibility, Elections, Terminations

S Corporations—Introduction

The S election can only be made by a corporation, and the corporation retains its legal corporate status after the election.

S corporations retain corporate status and their corporate characteristics:

- Shares can be freely transferred.
- Shareholders are not liable for corporate debt.
- Shareholders can be employees (separation of ownership and management).

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S Corporations

Most rules are similar to corporate rules, except for flow-through rules, year-end rules, and basis rules.

Default rules for S corporations are the regular corporation rules, not the partnership rules.

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S Corporations—Eligibility

No more than 100 shareholders.

Husbands and wives are treated as one shareholder (as are individuals and their estates).

A family may elect that all family members be treated as one shareholder.

Shareholders can only be individuals, estates, and certain trusts.

Nonresident aliens are not eligible to be shareholders.

Can only have one class of stock (voting and nonvoting stock is acceptable).

Banks and insurance companies are not eligible.

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Election Requirements

To be effective for the current year, the S corporation election must be filed on or before the 15th day of the third month of the taxable year.

All individuals owning stock any time during the taxable year must consent to the election.

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Review Question

On February 10, Year 5, Ace Corp., a calendar-year corporation, elected S corporation status and all shareholders consented to the election. There was no change in shareholders in Year 5. Ace met all eligibility requirements for S status during the pre-election portion of the year.

What is the earliest date on which Ace can be recognized as an S corporation?

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Termination of S Status

Once the election is terminated, must wait five years before reelecting S status.

Occurs if shareholders owning more than 50% of voting and nonvoting stock elect to revoke election.

If any eligibility requirements are violated.

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Terminations Problem

An S corporation has 30,000 shares of voting common stock and 20,000 shares of nonvoting common stock issued and outstanding. The S election can be revoked voluntarily with the consent of the shareholders holding, on the day of the revocation.

Shares of voting stock	Shares of nonvoting stock
0	20,000
7,500	5,000
10,000	16,000
20,000	0

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Termination of S Status

If passive investment income earned by the corporation…

- Exceeds 25% of gross receipts for 3 consecutive taxable years,
- The S corporation had accumulated earnings and profits.
- Then the S election is terminated as of the beginning of the fourth year.

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Income and Basis

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Income and Basis

Income Flow-Through

Any income, losses, deductions, and credits which can affect shareholders differently are separately stated, and each shareholder reports a pro rata portion of each item.

The nonseparately computed items are combined together, and each shareholder reports a pro rata portion of this amount.

Items are prorated as follows:

Allocation =
Item × Ownership %
× Portion of Year Owned

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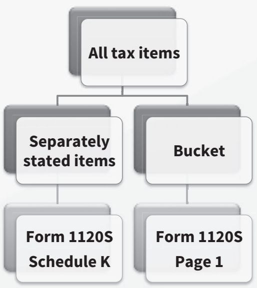
Income Flow-Through



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Special Rules

All items retain their character as they pass through to each shareholder. For example, tax-exempt income at the corporate level will be tax-exempt income at the shareholder level.

S corporations are not allowed a dividends-received deduction.

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Review Question

As of January 1, Year 2, Kane owned all the 100 issued shares of Manning Corp., a calendar-year S corporation. On the 40th day of Year 2, Kane sold 25 of the Manning shares to Rogers. For the year ended December 31, Year 2 (a 365-day calendar year), Manning had $73,000 in nonseparately stated income and made no distributions to its shareholders.

What amount of nonseparately stated income from Manning should be reported on Kane's Year 2 tax return?

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Review Question

Item × Ownership % × Time

40 days

325 days

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Loss Limitations

Losses may flow through to the shareholder, but only to the extent of the shareholder's stock and loan basis.

Loan basis is created when the shareholder loans funds directly to the S corporation.

Disallowed losses are carried forward until there is basis to deduct them.

Loss Limitation—Example

Distributive share of losses—sch. K-1
Stock basis
Loan basis
Allowed loss on Form 1040
Carryforward loss

Basis in Stock

The shareholder's basis in the S corporation is determined as follows:

Initial basis
+ Stock purchases
+ Taxable and tax-exempt income
− Deductible and nondeductible expenses
− AAA distributions

AAA = (accumulated adjustments account)

Basis in Stock Problem

Beck Corp. has been a calendar-year S corporation since its inception on January 2, Year 1. On January 1, Year 5, Lazur and Lyle each owned 50% of the Beck stock, in which their respective tax bases were $12,000 and $9,000. For the year ended December 31, Year 5, Beck had $81,000 in ordinary business income and $10,000 in tax-exempt income. Beck made a $51,000 cash distribution to each shareholder on December 31, Year 5.

What was Lazur's tax basis in Beck after the distribution?

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Basis in Stock Problem—Solution

Beginning basis, 1/1/05
Ordinary income
Tax-exempt income ____________

Distribution ____________
Ending basis, 12/31/05 ____________

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Flow-Through Effects

Distributive Share of Tax Item

Flows through as Income

Flows through to Basis

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Basis Ordering Rules

Increased for all income items

Decreased for distributions that are excluded from gross income

Decreased for nondeductible, noncapital items

Decreased for deductible expenses and losses

Fringe Benefits—Shareholders

S corporation shareholders who own more than 2% of the stock are treated as partners for fringe benefit purposes, meaning that the following are included in income:

- Employer-paid premiums to health and accident plans
- Benefits paid under employer-sponsored accident and health plans
- Cost of up to $50,000 of employer-paid group term life insurance
- Meals and lodging provided by employer

Fringe Benefits

Health and accident insurance premiums and other fringe benefits paid by an S corporation on behalf of a more than 2% shareholder-employee are:

- Deductible by the S corporation as compensation.
- Includible in the shareholder-employee's gross income on Form W-2.

Distributions and Special Taxes

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Distributions and Special Taxes

Passive Investment Income Tax

If the S Corp's passive investment income exceeds 25% of gross receipts and the S Corp. has C corporation AE&P, a tax is imposed at the highest corporate rate.

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Built-in Gains Tax

A C corporation that makes an S election and has unrealized built-in gains in its assets as of the election day must pay a built-in gains tax on this appreciation if it is recognized within the next 5 years.

Gain is taxed at the highest corporate tax rate.

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Built-in Gains Tax Problem

Prail Corporation is a C corporation that on February 1, Year 2, elected to be taxed as a calendar-year S corporation. On June 15, Year 2, Prail sold land with a basis of $100,000 for $200,000 cash. The fair market value of the land on February 1, Year 2, was $150,000. Prail had no other income or loss for the year and no carryovers from prior years.

What is Prail's tax?

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Built-In Gains Tax Problem—Solution

Built-in Gain at Date of Election:

FMV
Adjusted basis

June 15 sale:

Amount realized

Adjusted basis

Recognized gain

Built-in gains tax to corporation:

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Distributions with E&P

If the corporation has earnings and profits, distributions are taxed in the following order:

- Tax-free to the extent of AAA (accumulated adjustments account)
- Ordinary dividend to the extent of accumulated E&P
- Tax-free to the extent of basis in stock
- Excess is treated as capital gain

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Distributions if No E&P

If the corporation does not have earnings and profits, distributions are taxed in the following order:

- Tax-free to the extent of basis in stock
- Excess is treated as capital gain

Accumulated Adjustments Account

AAA reflects the cumulative income and losses for all of the S corporation years that have not been distributed.

Similar in concept to earnings & profits for C corporations.

Only tax-exempt income and the nondeductible expenses related to tax-exempt income are excluded in computing the amount in the AAA.

Distributions Problem

JAS Corporation was formed in Year 1. It properly elected S corporation status on January 1, Year 4, when it had earnings and profits of $20,000. In Year 4, JAS earned $20,000 and made a cash distribution in December Year 4 of $50,000. JAS was founded by its sole shareholder, J.A. Stephens. His basis in JAS stock on January 1, Year 4, was $8,000.

How much capital gain will Stephens recognize from the distribution?

Distributions Problem—Solution

Distribution amount	
AAA (not taxable)	
Earnings and profits	
(dividend income)	
Basis in stock	
Long-term capital gain	

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Distribution Problem

An S corporation distributes property to a shareholder with a fair market value of $50,000 and adjusted basis of $20,000. Assume that the S corporation has no earnings & profits and the shareholder's basis in her stock is $35,000.

How much gain does the S corporation recognize?

How much gain does the shareholder recognize?

What is the shareholder's basis in the property?

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Distribution Problem

An S corporation distributes property to a shareholder with a fair market value of $50,000 and adjusted basis of $20,000. Assume that the S corporation has no earnings & profits and the shareholder's basis in her stock is $35,000.

How much gain does the S corporation recognize?

How much gain does the shareholder recognize?

What is the shareholder's basis in the property?

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Fiduciary Taxation

Income Taxation of Fiduciaries

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Income Taxation of Fiduciaries

Filing Requirements

Trusts and estates report their income on Form 1041.

Estates may adopt a calendar or any fiscal taxable year.

Trusts must use a calendar year.

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Income Concepts

Income is taxed only once to either the fiduciary or the beneficiary.

A distribution deduction for fiduciary prevents double tax.

Income taxed to beneficiaries retains its character (a conduit approach).

The deductions and credits allowed (or disallowed) are similar to those allowed for an individual taxpayer, with some exceptions.

The estate's administration costs and losses during the administration of the estate may be deducted by the estate. If administration expenses are deducted on the fiduciary return, they cannot also be deducted on the estate tax return (i.e., no double deduction is allowed).

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Income Computation

State inheritance or estate taxes are not deductible for estates or for individual taxpayers on their respective income tax returns.

State and local taxes that are deductible for estates and individual taxpayers include income taxes, personal ad valorem property taxes, and real property taxes.

Extraordinary items are allocated to principal; that is, payments that are made irregularly, such as proceeds from a fire.

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Income Computation

Charitable contributions can be deducted in full regardless of the level of AGI.

Contributions to foreign charities are deductible.

A deduction is allowed for the amount of fiduciary accounting income distributed to the beneficiaries.

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Exemptions

Fiduciaries get a personal exemption depending on the type of fiduciary:

- $600 for estates
- $300 for simple trusts and for complex trusts that distribute all of their income currently
- $100 for all other complex trusts

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Income in Respect of a Decedent

Gross income includes income in respect of a decedent (IRD).

IRD is income that was earned by the decedent but not constructively received before death.

IRD is included in the gross estate for estate tax purposes and is included in taxable income for the estate also.

Distributable Net Income

The estate/trust must pay tax on any income not distributed to the beneficiaries. Income that is distributed to beneficiaries is not taxed to the estate/trust.

Key concept is distributable net income (DNI).

DNI is the maximum amount that the entity can use as a distribution deduction for the year and on which the beneficiaries can be taxed.

The beneficiaries may be taxed on less than DNI since DNI includes tax-exempt interest.

DNI Computation

Taxable Income

+ Net tax-exempt income

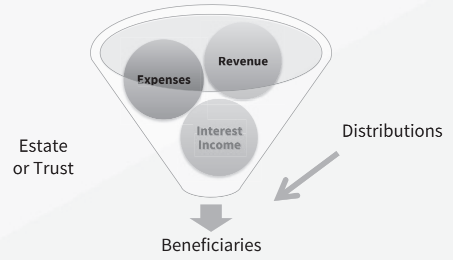
+ Personal exemption

+ Net capital loss

– Net capital gains allocable to corpus

Distributable net income

Distributable Net Income



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Review Question

Raff died in Year 4 leaving her entire estate to her only child. Raff's will gave full discretion to the estate's executor with regard to distributions of income. For Year 5, the estate's distributable net income was $15,000, of which $9,000 was paid to the beneficiary. None of the income was tax exempt.

MAX = DVI = 15,000

What amount can be claimed on the estate's Year 5 fiduciary income tax return for the distributions deduction? $9,000

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Review Question

The charitable contribution deduction on an estate's fiduciary income tax return is allowable

A. If the decedent died intestate.

B. To the extent of the same adjusted gross income limitation as that on an individual income tax return.

C. Only if the decedent's will specifically provides for the contribution.

D. If the beneficiaries elect to do so.

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Tax Credits

Business Tax Credits

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Business Tax Credits

Foreign Tax Credit

The credit is limited to the lower of the foreign tax paid or the proportion of U.S. tax allocable to foreign source income, which is equal to:

$$\text{U.S. tax} \times \frac{\text{Foreign taxable income}}{\text{Worldwide taxable income}}$$

Excess foreign tax credits carry back 1 year and forward 10 years.

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Review Question

The following information pertains to Wald Corp.'s operations:

Worldwide taxable income	$ 300,000
U.S. source taxable income	180,000
U.S. income tax before foreign tax credit	96,000
Foreign source taxable income	120,000
Foreign income taxes paid on foreign source taxable income	39,000

What amount of foreign tax credit may Wald claim?

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Review Question—Solution

Lower of:

Foreign tax paid ($39,000), or

$$\text{U.S. tax} \times \frac{\text{Foreign taxable income}}{\text{Worldwide taxable income}}$$

$$\$96{,}000 \times \frac{120{,}000}{300{,}000} = \$38{,}400$$

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General Business Credit

The general business credit consists of a combination of credits designed to subsidize certain activities. While each credit is calculated independently, the combination of credits is subject to an overall limit.

The general business credit is limited to the taxpayer's *net income tax* reduced by 25% of *net regular tax liability* that exceeds $25,000.

Net income tax is the sum of the regular tax liability and the AMT, reduced by certain nonrefundable tax credits (e.g., foreign tax credit). *Net regular tax liability* equals the *net income tax* less the AMT.

Unused credits are carried back one year and then forward 20 years.

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General Business Credit Example

Admiral Corporation's general business credit for the current year is $60,000. Admiral's net regular tax liability is $130,000. Admiral has no other tax credits. The general business credit allowed for the tax year is computed as follows.

Net regular tax liability	________
	________
Amount of general business credit allowed for tax year	========

Admiral has   of unused general business credits that may be carried back or forward.

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General Business Credit Example

Admiral Corporation's general business credit for the current year is $60,000. Admiral's net regular tax liability is $130,000. Admiral has no other tax credits. The general business credit allowed for the tax year is computed as follows.

Net regular tax liability	$ 130,000
	(25,000)
	$ 105,000
	x 25%
Amount of general business credit allowed for tax year	$ 26,250

Admiral has $34,750 ($60,000 - $26,250) of unused general business credits that may be carried back or forward.

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Research Credits

Incremental research expenditures are eligible for a 20% credit.

Research credit is not allowed for:

- Research after commercial production begins
- Market research, testing, routine data collection
- Research conducted outside the U.S.
- Research in the social sciences, arts, or humanities.

Taxpayers may elect to use an alternative simplified research credit. This is equal to 14% of the excess of qualified research expenses over 50% of the average research expenses for the last three years.

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Work Opportunity Tax Credit

The WOTC is calculated on the amount of wages paid per eligible employee during the first year of employment.

The credit is 40% of qualified wages, with a maximum credit of $2,400.

The credit is elective.

The credit is targeted at certain employee groups, such as veterans.

The WOTC reduces the deduction for wages.

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Small Business Health Care Tax Credit

This credit is 50% of nonelective health insurance premiums.

An eligible employer has:

- Less than 25 full-time equivalent employees whose average annual wages is less than a statutory amount.
- The employer pays at least 50% of premiums.
- Credit applies for any type of business, even a sole proprietorship.

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Employer-Paid Family and Medical Leave

Businesses can claim a general business tax credit equal to 12.5% of wages paid to qualifying employees while on family and medical leave.

The employee must receive at least 50% of the wages normally paid to an employee.

All qualifying employees must receive at least two weeks of annual paid family and medical leave.

The 12.5% is increased by .25 percentage points for each percentage point by which the wages paid exceed 50%.

Credit percentage can never exceed 25%.

Applies for tax years beginning in 2018 and 2019.

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Rehabilitation Credit

A 20% credit is allowed for qualifying expenditures made to rehabilitate a certified historic structure.

The credit is claimed ratably over five years beginning with the year the building is placed in service.

To qualify for credit, straight-line depreciation or ADS must be used for the building.

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Other Tax Issues

Tax Planning Strategies for Business Entities

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Tax Planning Strategies for Business Entities

Charitable Contributions

The corporation can elect to deduct accrued contributions if the contributions are actually paid in the first 3½ months following the year-end.

Increased deduction for inventory to use for ill, needy, or infants; lower of

AB of property + 50% × (FMV − AB)

or

2 × AB

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Non-Tax Considerations

Tax effects should never be the only factors considered for a decision.

Non-tax factors must be considered also.

It is possible that the alternative with the best tax result increases costs in other areas for the company.

Goal is to maximize after-tax income, not minimize taxes.

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Other Tax Strategies

Consider hiring children as employees as their wages will be taxed at a lower tax rate.

When forming a business entity, make sure that the rules are met to defer gains and losses.

For partnerships, increase basis in partnership interest with partnership debt so that additional losses can be used by partners on their tax returns.

For a regular corporation, use tax-free fringe benefits to maximize benefits to employees/owners and their family members.

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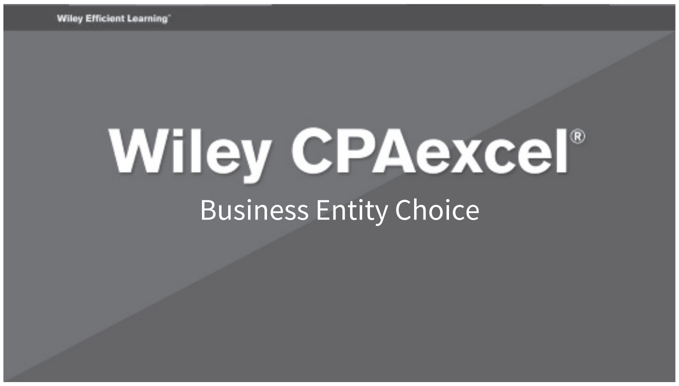
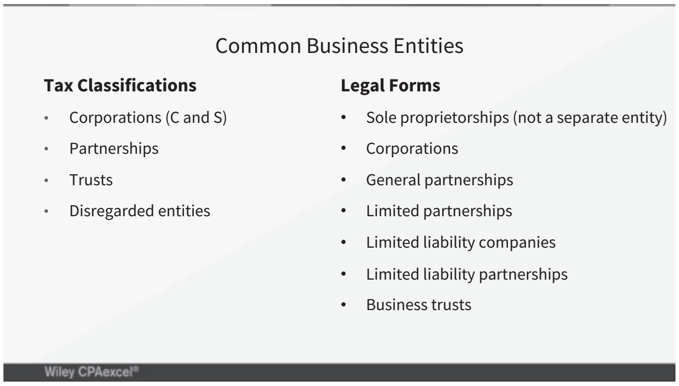
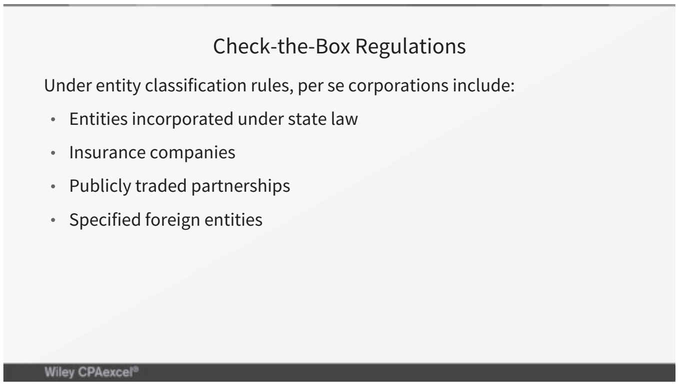
Business Entity Choice







Check-the-Box Regulations

Other entities (such as REITs, tax-exempt organizations, and entities with S corporation election) are classified as corporations.

Default classification for business entities:

- Corporation if on per se list
- Unincorporated business entities
  - Partnership if two or more owners
  - Disregarded entity if one owner

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Check-the-Box Regulations

Unincorporated business entities can elect to be taxed as an association/ corporation if they prefer.

An election under the check-the-box regulations is effective for the tax year if made within the first 75 days of the year.

An election can be changed after 5 years or with IRS permission.

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Comparison of Business Entities

Comparison of Business Entities

Issue	C Corporation	S Corporation	Partnership	Multi-member LLC	Sole Proprietorship
Limited liability	Yes	Yes	No—General; Yes—Limited	Yes	No
Double taxation	Yes	No	No	No	No
Retain income at lower tax cost	Depends on relative tax rates	No	No	No	N/A
Tax-deferred contributions	Possibly—subject to control test	Possibly—subject to control test	Yes	Yes	N/A
Double taxation on distributions	Yes	Possibly	No	No	No
Owner's basis for entity level debt	No	No	Yes	Yes	N/A

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Advantages of Partnerships (and LLCs)

Advantages

- Single taxation
- Flexibility
- Basis increase for debt
- Tax-free contributions/admissions and distributions/withdrawals (generally)

Disadvantages of Partnerships (and LLCs)

Disadvantages

- Unlimited liability for general partners
- Limited partners have limited management rights
- Distributive share for general partners is subject to self-employment tax