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2020 SuperfastCPA Review Notes

Table of Contents

Area I: Ethics, Professional Responsibilities & Federal Tax Procedures	1
Ethics & Responsibilities in Tax Practice	2
Regulations governing practice before the IRS	2
Internal Revenue Code and Regulations related to tax return preparers	4
Licensing and disciplinary systems	7
State Boards of Accountancy	7
Federal Tax Procedures	9
Audits, appeals, and judicial process	9
Substantiation and disclosure of tax positions	11
Taxpayer penalties	13
Authoritative hierarchy	15
Legal Duties and Responsibilities	17
Common law duties and liabilities to clients and third parties	17
Privileged communications, confidentiality, and privacy acts	19
Area II: Business Law	22
Agency	23
Authority of agents and principals	23
Duties and liabilities of agents and principals	
Duties and liabilities of agents and principals	25
Contracts	29
Formation	29
Performance	37
Discharge, breach, and remedies	38
Debtor-Creditor Relationships	42
Rights, duties, and liabilities of debtors, creditors, and guarantors	42
Bankruptcy and insolvency	44

Secured transactions	50
Government Regulation of Business	54
Federal securities regulation	54
Other federal laws and regulations	60
Business Structure	68
Selection and formation of business entity and related operation and termination	68
Area III: Federal Taxation of Property Transactions	79
Acquisition and Disposition of Assets	80
Basis and holding period of assets	80
Taxable and nontaxable dispositions	83
Amount and character of gains and losses, and netting process (including installment sales)	86
Related party transactions (including imputed interest)	89
Cost recovery (depreciation, depletion, and amortization)	93
Estate and Gift Taxation	101
Transfers subject to gift tax	101
Gift tax annual exclusion and gift tax deductions	102
Determination of taxable estate	103
Area IV: Federal Taxation of Individuals	106
Gross Income	106
Reporting of Items from Pass-Through Entities	112
Adjustments and Deductions to Arrive at Adjusted Gross Income and Taxable Income	114
Passive Activity Losses	124
Loss Limitations	126
Filing Status	128
Computation of Tax and Credits	132
Alternative Minimum Tax	136
Area V: Federal Taxation of Entities	138

Tax Treatment of Formations and Liquidations of Business Entities	138
Differences Between Book and Tax Income	142
C Corporations	144
Computations of taxable income, tax liability and allowable credits	144
Net operating losses and capital loss limitations	147
Entity/owner transactions, including contributions, loans, and distributions	148
Consolidated tax returns	153
Multi-jurisdictional tax issues	154
S Corporations	157
Eligibility and election	157
Determination of ordinary business income(loss) and separately stated items	159
Basis of shareholder's interest	161
Entity/owner transactions	162
Built-in gains tax	163
Partnerships	164
Determination of ordinary business income(loss) and separately stated items	164
Basis of partner's interest and basis of assets contributed to the partnership	166
Partnership and partner elections	169
Transactions between a partner and the partnership	170
Impact of partnership liabilities on a partner's interest in a partnership	171
Distribution of partnership assets	172
Ownership changes	174
Limited Liability Companies (LLCs)	176

Trusts and Estates	178
Types of trusts	178
Income and deductions	179
Determination of beneficiary's share of taxable income	180
Tax Exempt Organizations	181
Types of organizations	181
Obtaining and maintaining tax exempt status	181
Unrelated business income	182

Area I: Ethics, Professional Responsibilities & Federal Tax Procedures

Ethics & Responsibilities in Tax Practice

Regulations Governing Practice Before the IRS

The regulations governing an accountant practicing before the IRS (representing a client before the IRS) are from the Treasury Department's Circular 230.

Defining "Practice before the IRS":

Circular 230 defines this as:

- All matters connected with presenting to or corresponding with the IRS relating to a taxpayer's rights, privileges, or liabilities under the laws or regulations administered by the IRS.
- This includes (but is not limited to):
 - Preparing & filing documents with the IRS
 - Communicating with the IRS
 - Representing a client at IRS hearings or meetings
 - Rendering written advice with potential for tax avoidance or tax evasion

Who can "practice before the IRS":

In general, it can only be:

- Attorneys
- CPAs
- Enrolled agents

Some key points from Circular 230:

If a client requests their records be returned to them, the CPA must comply, even if the client still owes the CPA money for their services.

A CPA should not represent a client if it would create a conflict of interest, specifically to another client.

If the CPA finds an error made in a previous year, the CPA must advise the client of the error. However, what to do about it is up to the client. The CPA is NOT required to notify the IRS of the error, and they are not required to file an amended return (the client may choose to do this, but the key is that the only rule in this situation is that the CPA must notify the client of the error).

A CPA is not required to verify information provided by a client. The CPA is allowed to rely on good faith regarding the information provided by the client.

When an authorized officer or employee of the IRS makes a lawful request for records or information, the CPA is required to submit the records requested unless the CPA believes in good faith and on reasonable grounds that the records or information are privileged.

All paid tax return preparers must register with the IRS. Preparers will not represent a taxpayer before the IRS, this is limited to attorneys, CPAs, or an enrolled agent.

No practitioner may charge “unconscionable” fees for representing a client before the IRS.

A CPA can charge a contingent fee under three circumstances:

- 1) For services rendered dealing with an IRS examination or challenge to an original return or amended return or claim of refund.
- 2) When claiming a refund solely for statutory interest or penalties previously assessed by the IRS.
- 3) If the CPA is representing the client in judicial proceedings dealing with the IRS.

Even though some CPAs become very familiar with tax law, there is nothing in the regulations that authorizes a CPA to practice law in any form.

Internal Revenue Code and Regulations Related to Tax Return Preparers

Tax return preparers are required to obtain a preparer tax identification number (PTIN). Signers and non-signer preparers are subject to this requirement.

The definition of a tax return preparer (TRP) is:

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

This includes anyone who prepares any federal income tax returns, and estate and gift tax returns, and is paid to do so. Being compensated is key. One layperson helping their mom do her taxes in TurboTax is not considered a preparer.

Keep in mind it includes anyone who prepares a “substantial portion” of the return as well, not just the signing TRP.

Tax return preparer penalties

If a TRP aids or abets federal tax evasion, then the TRP can be prohibited from working as a preparer, AND face federal criminal prosecution.

If a TRP endorses or otherwise negotiates a refund check issued to a

taxpayer, this is not allowed and the TRP will pay a fine of \$510. So, a TRP cannot endorse and cash a client's refund check, even if for some reason the client asked them to.

Understating a taxpayer's tax liability: If the preparer takes unreasonable positions which understate a taxpayer's tax liability, the penalty is the greater of \$1,000 or 50% of the income derived by the TRP with respect to the return or claim for refund. Also, if there is understatement due to willful or reckless conduct, the penalty is the greater of \$5,000 or 75% of the income derived by the TRP with respect to the return or claim for refund.

Failure to furnish a copy to the taxpayer: If the TRP fails to provide the client with a copy of the return, there is a \$50 penalty for each instance.

Failure to sign a return: A penalty of \$50 for each instance of not properly signing a return.

Failure to provide PTIN: A penalty of \$50 for each failure to provide the TRP's identification number on a return.

Failure to retain a copy: A penalty of \$50 for each instance of not retaining a copy of the return.

Failure to file correct information return: Any person that employs other TRPs needs to file an information return that lists the names and social security numbers of such employees. Failure to file this information results in a penalty of \$50.

Failure to be diligent in determining eligibility for earned income credit: This results in a penalty of \$510 for each failure.

Promoting abusive tax shelters: Penalty is \$1,000 for each case in which such a shelter was planned or arranged.

Aiding and abetting understatement of tax liability: This results in a \$1,000 fine.

Unauthorized disclosure of information by a TRP: If a TRP discloses or uses information from preparing a return for any other purpose than preparing and filing the return, there is a \$250 fine for each use of such information. This can also be a misdemeanor and a fine of up to \$1,000 and possibly imprisonment of up to a year.

Fraud and false statements: This is guilty of a felony, and upon conviction a fine of not more than \$100,000 and possibly imprisonment for not more than 3 years.

Fraudulent returns or statements: This is guilty of a misdemeanor, and upon conviction a fine of not more than \$10,000 and possibly imprisonment of not more than a year.

Licensing and disciplinary systems

State Boards of Accountancy

These are the boards of each state that govern the practice of CPAs within their jurisdiction. These are bodies that issue licenses to practice in their jurisdictions, so it is also up to the state board to revoke a CPA's license to practice. The AICPA nor the PCAOB can directly revoke a CPA's license to practice, this must be done by the CPA's state board.

Each state board has the same general requirements to become a licensed CPA:

- 1) 150 hours of college education. Most states now require a master's degree
- 2) State-specific ethics course
- 3) Ongoing CPE
- 4) Passing the CPA exams
- 5) 2,000 hours of professional experience

There are a number of reasons a state board will revoke a CPA's license and possibly impose fines:

- Fraud in obtaining a certificate
- Failing to properly renew the CPA license
- If the CPA's right to practice is revoked before a federal or state agency, such as the PCAOB
- Violation of professional standards
- Conviction of a felony or any crime involving dishonesty
- Dishonesty, fraud, or gross negligence while performing services for clients

- Failing to file the CPA's own tax returns

AICPA

The AICPA works closely with state boards of accountancy, but implementing and enforcing regulations is up to the individual state boards

The AICPA can't directly revoke a CPA's right to practice, but most state boards have rules that mirror the rules of the AICPA. This is why it's important for CPAs to adhere to the rules of the AICPA. There is also the Joint Ethics Enforcement Program that involves joint enforcement of the AICPA's and the state board's ethics rules.

The AICPA will suspend or expel members without hearing for:

- Filing a fraudulent tax return
- If a state board revokes that CPA's license to practice
- If the CPA is convicted of a crime punishable by imprisonment for 5 years (convicted of a felony)
- Failing to file their own tax return

Federal Tax Procedures

Audits, Appeals, and Judicial Process

Audit process

The first part of the audit process is matching up returns with W-2s and 1099s. Then returns are assigned a score, and from there the scores are used to decide which returns will be audited.

The IRS has 3 years from the later of 1) the date the return was filed or 2) the date the return was due to impose additional tax. However, if the gross income omitted was more than 25% of the gross income claimed on the return, then the statute of limitations is 6 years. If there was fraud involved in the return, then there is no time limitation on the IRS assessing additional taxes and penalties.

Audits can be handled through written correspondence, in the field, or in an IRS office.

The taxpayer can hire an enrolled agent, a CPA, or an attorney to represent him/her in the audit.

After the audit is complete, the IRS agent reports their audit findings in an Income Tax Examination Changes report.

Then there's a negotiation period about whether the taxpayer agrees with the findings in the Income Tax Examination Changes report.

If an agreement is reached:

When an agreement is reached, then the agent will issue a "Revenue

Agent's Report", which the taxpayer will sign. If the taxpayer agrees to the findings and signs this report, then the taxpayer cannot pursue relief through the appeals process, AND the IRS can't come back later with additional judgements regarding the items listed in the report. But this only applies to the specific items outlined in the agreement.

If an agreement is not reached (the appeals process):

If the taxpayer and the agent can't come to an agreement during the negotiation process, then the taxpayer will receive a copy of the agent's report and a 30-day letter. The 30-day letter is a notice that the taxpayer has 30 days to appeal the decision, and it includes instructions on how to appeal. The taxpayer is NOT required to respond to this letter, and if they don't, they will then receive a 90-day letter. The IRS wants the taxpayer to agree to the "Revenue Agent's Report", but again, the taxpayer is not required to respond to this 30-day letter.

If the taxpayer wants to appeal, they will file a petition to request an appellate conference. This petition needs to outline the taxpayer's position for each item and include support for taking each position. The IRS doesn't have to grant an appeal, but they usually will. This process takes place between the taxpayer and the IRS appeals office, as opposed to the formal judicial process. If an agreement is reached during the appeals process, then the audit process is over.

IF the taxpayer:

- 1) Does not reach an agreement during the appeals process, OR
 - 2) Doesn't respond to the 30-day letter, THEN
- The taxpayer will receive the 90-day letter.

After the 90-day letter is received, the taxpayer now has 90 days to file a Tax Court petition with the U.S. Tax Court. Once a petition has been filed with the Tax Court, the IRS can't enforce its assessment until after the Court's decision is finalized.

If the taxpayer doesn't file a tax court petition, after 90 days the findings of the audit are binding, and the IRS will move to collect the amounts owed. After the 90 days, the taxpayer's only recourse is through U.S. District Court or the U.S. Claims Court, but the deficiency will have to be paid before the court process can begin.

Substantiation and Disclosure of Tax Positions

According to Statements on Standards for Tax Services (SSTSs) #1, the CPA needs to comply with standards from taxing authorities if possible, on taking a specific tax position. A CPA/TRP that takes an "unreasonable position" can be punished.

There are different levels of what a "reasonable position" means according to SSTS #1:

A "reasonable basis" would be if the CPA did their research and concluded there is a 20-33% chance the IRS would support the position. At this level, there needs to be a disclosure of the position so that the IRS can review it.

A "realistic possibility" of a position being upheld would be 33% or more.

However, Congress is the overriding authority and there is a provision that says it needs to be "substantial authority" to take a given tax position. In this case, "substantial" means at least a 40% chance that the IRS would accept the position. You don't need to know how to judge the percentage, or how a "40% chance" would be calculated, but

the standard is a 40% chance that the IRS would agree with the position.

So, the main thing to remember is that in general, there needs to be a 40% or more chance that the IRS would support a position in order to take any given federal tax position. If it's not a federal tax issue, then the AICPA SSTS rule of greater than 33% would apply.

For a "tax shelter", it is automatically unreasonable unless there is a "more likely than not" (more than 50%) chance that the IRS would accept the position.

The CPA needs to inform the client of potential penalties if the position is rejected, and if applicable, how penalties can be avoided through proper disclosure of the position.

What is "appropriate disclosure" for a tax position?

The information regarding the position needs to be "appropriately disclosed", and this disclosure should include a description of the position being taken, the amount of tax involved, and the basis for the position. If the taxing authority has a specific form for such a position, then that form needs to be used. Or, if there are specific administrative guidance for a certain position, that needs to be followed as well.

Remember, a CPA doesn't have to verify every number the client provides, but the CPA should make a "reasonable inquiry" if something doesn't add up, or even just to clarify something with the client. If the client wants to pursue a tax position that the CPA doesn't believe would be upheld, the CPA should decline to prepare or sign the return. If the client tells the CPA that documentation for a position exists, then the CPA can take the client at their word and does not need to take further action.

If it turns out that the client just lied to their CPA about a deduction, and is later figured out by the IRS, the CPA is not subject to any penalties.

Going along with this, the declaration that the CPA signs on a client's return is warranting that the information provided by the client was relied upon in preparing the return unless it appeared incorrect or incomplete. This does not mean that every figure provided by the client was fully audited and substantiated by the CPA.

A few random facts related to this that could be seen on questions:

If legislation causes a change to previous advice given to a client, the CPA is actually NOT required to notify the client of the changes, unless the exact issue was specifically the reason for the engagement.

If a question on a federal return has not been answered, there needs to be "reasonable grounds" for not answering the question.

If errors are discovered on a previous return, the CPA's duty is to inform the client of the errors and suggest an amended return, but the decision is up to the client.

If, for example, a CPA does a client's return, and then the client alters figures before sending in the return, and then the CPA finds out later, the CPA is NOT obligated take any action such as contacting the IRS, but the CPA should obviously evaluate their relationship with the client in respect to any further engagements.

Taxpayer Penalties

There are 4 types of taxpayer penalties imposed by the IRS:

1) Non-filing penalties

- 2) Non-payment or late payment penalties
- 3) Underpayment penalties
- 4) Accuracy penalties

Non-filing penalties

The penalty for filing late is 5% a month of the tax due, up to 25% of the tax due. If the return is filed more than 60 days late, then the penalty is the lesser of \$205 or 100% of the unpaid tax. If the taxpayer doesn't owe any taxes or is due a refund, no penalties will apply.

Non-payment or late-payment penalties

Taxes are due by the filing date. If they are not paid by the filing date, interest on late payments starts to accrue immediately.

The late payment penalty is 0.5% (1/2 a percent) per month, up to a max of 25% of the taxes owed. However, if the non-filing penalty is also applicable, then that 5% per month accrues and the 0.5% penalty is not applicable.

Underpayment penalties

For individuals:

Taxes are paid through withholding, or through estimated tax payments.

If the amount of tax owed total will be more than \$1,000, then the taxpayer must make estimated tax payments on the 15th of April, June, September, and January. (Again, this is if taxes aren't being paid through withholding)

No penalty will be imposed if the tax payments during the year were at least 90% of the current year's taxes or 100% of last year's taxes. If the taxpayer's AGI exceeds \$150,000, then the tax payments during the year must be 110% of last year's taxes.

Accuracy penalties

A 20% of the tax due penalty for an inaccurate tax position due to negligence. This is waived if there is a reasonable basis for the position

A 20% of the tax due penalty for substantially understating the tax due. This is waived if there is substantial authority for taking the position, OR if the position was appropriately disclosed on the return.

A 20% of the tax due penalty if there is a substantial overstatement or 40% for a gross overstatement of the value or basis of any property. Substantial is 150% or more of the actual value, gross is 400% or more of the actual value.

If fraud is involved in the underpayment, then there is a 75% of the tax due penalty.

Random facts you could see a question on:

If a taxpayer wants to make a claim for a refund on paying too much tax in a previous year, the form they would use is the 1040X, the “Amended US Individual Income Tax Return”

To file an amended return, the taxpayer has 3 years after the filing date of the original return, or 2 years after the payment of tax related to the return, whichever is later.

Authoritative Hierarchy

For federal tax purposes, here’s the hierarchy of authority for determining tax positions or tax planning:

At the very top, you have the US Constitution, or in other words, Congress.

Then you have the IRS's Internal Revenue Code (IRC) Statutes.

Then you have the US Treasury Regulations.

Then you have Judicial Authority in the following order:

- US Supreme Court
- US Circuit Court of Appeals
- US District Court
- US Tax Court
- US Court of Federal Claims

Then you have IRS Positions such as:

- Revenue Rulings
- Revenue Procedures
- Private Letter Rulings or Determination Letters
- IRS forms, publications, or FAQs

In general, the main source will be the IRS Internal Revenue Code. A CPA would then try to find support from some source below that if nothing explicit was found in the IRC.

Legal Duties and Responsibilities

Common Law Duties and Liabilities to Clients and Third Parties

Common Law Liability to Clients

CPAs have an obligation to their clients to exercise due professional care. With an engagement letter, it provides the client and other third parties with rights of recovery. Therefore, if the CPAs are not performing within the agreement set forth in the contract this will be considered a breach of contract. The clients may also claim negligence against the CPAs if the work was performed but contained errors or was not done professionally. This is considered a tort action.

In order to recover from an CPA under common law, the client must prove:

- Duty of care
- Breach of Duty
- Losses
- Causation

CPAs may defend against a breach of contract if they can prove that the client's loss occurred because of factors other than negligence by the auditors. If the CPA proves the loss resulted from causes other than the CPA's negligence, a client may be accused of contributory negligence. If a state follows the doctrine of contributory negligence, the CPA may eliminate their liability to the client based on contributory negligence by the client. Many states do not follow this doctrine. Most states permit a jury to assess the fault and apply the correct percentage of fault to the parties involved. This is called comparative negligence.

Common Law Liability to Third Parties

If a third party brings a suit against a CPA there are several things the

third party must prove:

- 1) They must prove that the CPA had a duty to exercise due care
- 2) They must prove that the CPA knowingly breached that duty
- 3) They must prove that the CPA's breach was the direct cause of the loss
- 4) They must prove that they suffered an actual loss

A few examples:

If a CPA recklessly departs from the standards of due care when performing an audit, the CPA can be held liable to third parties who relied on the audited financial statements based on gross negligence. A breach of contract would only be applicable to direct clients of the CPA. Also, it is a 'reckless departure' that results in gross negligence. If it was failure to comply with some standards of due care, then it would be negligence, not gross negligence.

A failure to complete an audit on time would result in a breach of contract (breaching the terms set in the engagement letter), and the client could sue the CPA firm for breach of contract under common law.

If an audit is performed according to Generally Accepted Auditing Standards (GAAS), even if a material misstatement is not detected which later causes injury to users of the statements, the auditor will have a good defense against being sued.

Understand "privity of contract" or lack of privity: This means that in a lot of cases a defense for the CPA would be lack of privity of contract, meaning that a third party can't sue the CPA if the audit was not for their express purpose. On the other hand, when a client has a contract with a CPA, there is privity of contract, and if the CPA fails to fulfill the requirements of the contract, that is breach of contract. The client can

sue for damages resulting from the breach of contract.

Going along with “privity”, there was the Ultramares case that specified in cases of negligence, the CPA will be held liable to the client and also any third parties that were intended beneficiaries of the contract. But this doesn’t include all third parties, just intended beneficiaries of the contract. This would mean users of the financial reports, such as a bank using the statements to decide whether or not to give the audited company a loan.

The best description of the relationship between a corporation and the CPA firm it hires to do its audit is an employer (the corp) and an independent contractor (the CPA firm).

Knowingly issuing an unqualified opinion when there is a material misstatement is fraud, not negligence or breach of contract.

“Constructive fraud” occurs when the following elements are present: 1) a false misrepresentation of a material fact 2) reckless disregard for the truth, 3) reasonable reliance by the injured party, 4) injury, 5) a fiduciary relationship between the parties. With constructive fraud, intent(scienter) doesn’t need to be proven as with actual fraud

The term “strict liability” will never be used to determine the liability of a CPA. This is term specifically for some product liability cases.

Privileged Communications, Confidentiality, and Privacy Acts

There are just a few situations where a CPA can legally disclose confidential information:

- 1) If GAAP requires disclosure
- 2) A valid subpoena or summons has been issued. The CPA is not

required to inform the client that the information has been subpoenaed.

- 3) During a peer review of the CPA's firm
- 4) Disclosure to another firm member if pertinent to the engagement
- 5) An ethics review

When it comes to outsourcing work, which may involve confidential client information, the CPA firm is responsible for maintaining the confidentiality of clients' information, but the CPA is NOT required by law to notify the client when confidential information is shared with an outsourcing partner.

If the IRS requests confidential client information, the CPA is not obligated to comply, unless as noted above it involves a valid subpoena.

When it comes to workpapers involved in an audit, the workpapers are not subject to the same privileged communication rules as the client's own source documents and information. The workpapers remain the property of the CPA firm after the audit, and the workpapers can be obtained by third parties if they appear to be relevant to issues in litigation.

If a partner dies, his clients' workpapers can be assigned to a surviving partner.

Random facts that could be questions:

Under federal law, there is no "accountant-client" privilege with regard to confidentiality. However, several states do have an accountant-client privilege.

Read this one carefully: If a CPA firm is selling their practice, it IS permitted to let prospective buyers of the practice view confidential

client information. BUT, if the purchase goes through, before any confidential records are actually turned over to the buyer of the firm, they would need the client's permission.

Area II: Business Law

Agency

Authority of Agents and Principals

An agency agreement is when one party designates another to act on his or her behalf

There are two parties in an agency relationship:

Principal: the party who hires the agent

Agent: the party who acts on behalf of the principal

Types of Agency Relationships

General agent: This type of agent has broad authority to carry out transactions on behalf of the principal, but usually related to specific business transactions.

Universal agent: An agent with authority to handle all affairs - business & personal - of the principal. If a couple were going abroad for 3 years, they could designate an adult child of theirs to be their universal agent while they're gone. A person can have only one universal agent. Then they might have multiple general agents that each handle certain parts of their business. A universal agent will usually have general power of attorney regarding the principal.

Power of attorney: This is a type of general agency where the agent is given authority to act on behalf of the principal in specific matters, or even to be able to do or sign anything on behalf of the principal as if the principal were there in person. The principal needs to sign the power of

attorney, but the agent does not need to sign it to be valid.

Special agent: When the agent has authority only in specific or designated instances. Example would be hiring a CPA to represent you before the IRS when they find out about your tax shelter.

Independent contractor: Someone you've given authority to act on your behalf in a limited and specific capacity, and you don't control their day-to-day activities. An example would be hiring an attorney to draft your will. There are specific liabilities regarding independent contractors that distinguish them from special agents, see the next section.

Creation of Agency Relationships

To create an express agency relationship:

You can think of "express" as "explicit" or "direct" authority. This is where a principal specifically gives an agent authority. If any duties are incidental to the express authority granted, then the agent also has implied authority for those incidental duties/tasks.

A written agreement is not required, unless the contract being entered into falls under the Statute of Frauds OR, if the agency relationship will last more than a year.

Capacity: to form an agency relationship, only the principal needs to be competent. Note that agency does terminate if either the principal or agent become incapacitated, but you could see a question on the distinction to form an agency relationship.

The agency relationship does not require consideration.

Apparent agency:

An agency relationship may be implied from the facts or circumstances surrounding a person's actions on behalf of another. If the principal acts in a way that makes a third party assume the agent has authority to act on behalf of the principal, then there could be apparent authority, and the principal could have contracts entered into by the agent enforced against them.

Ratification

If an agent acts on behalf of a principal without express or apparent authority, the principal is required to ratify the contract before it is binding.

To summarize: Express authority is explicitly given by the principal. Apparent authority is when the actions of the principal cause a third party to believe the agent has authority on behalf of the principal.

Duties and Liabilities of Agents and Principals

Duties of Principals and Agents

The main duties of the principal to the agent are to comply with the terms of the agency contract, and to reimburse reasonable expenses in carrying out the agency agreement.

The duty of the agent to the principal is a fiduciary duty. A fiduciary duty is the highest standard of care, and the agent is required to make known any material facts to the principal in fulfilling the agency agreement. This extends to the other logical duties such as obedience,

reasonable care, providing an accounting of all the principal's funds involved in fulfilling the agency agreement, disclosure, and a duty of loyalty.

Termination of Agency

There is termination of agency based on acts by the parties, and then termination based on operation of law.

Termination based on acts of the parties:

These are things like one of the parties ending the agreement, the fulfillment of the agreement, if the specified time frame passes, or if the agent and principal mutually end the agency.

When there is termination by acts of the parties, the principal has a duty to notify third parties of the termination. It is still possible for the agent to act with apparent authority after the termination if a third party is unaware of the termination. When the termination of agency is due to an operation of law, this doesn't apply.

Termination based on operation of law:

The death of either the principal or agent terminates the agency.

The insanity of the principal terminates the agency.

Termination due to the bankruptcy of the principal, or the bankruptcy of the agent if the bankruptcy compromises the agent's ability to fulfill the agency agreement.

Termination due the change of a law. If a law changes and makes the subject matter of the agreement illegal, then the agency is terminated.

Contract Liability of Principals/Agents

When the agent has actual authority (express or implied) , and there is a disclosed principal - meaning the third party knows who the principal is and the agent has made it clear they are working on behalf of said principal - the contract is between the principal and the third party, even if the agent has done all the negotiating and working with the third party. The liability for the contract is between the principal and the third party.

In the same scenario, except the agent is acting with apparent authority, then the principal is only liable to the third party, but the agent is also liable to the principal for acting with apparent authority.

If there is a disclosed principal, but the agent is acting without any authority from the principal, then the agent is liable to the third party for any contractual obligations.

If there is an undisclosed or partially disclosed principal, and the agent is acting with actual authority, then the agent and the principal can be held liable to the third party. However, because the agent was acting with actual authority, the principal would be liable to the agent if the third party sued the agent.

If there is an undisclosed or partially disclosed principal and the agent is acting without actual authority (if the principal is undisclosed then there can't possibly be apparent authority), then the agent is directly liable to the third party.

Tort Liability

Agents are individuals, and individuals are always liable for their own

torts. It's possible that the principal can be liable for the agent's tort, but the agent will also be liable.

In an employer/employee relationship (master/servant), the principal will always be liable for the torts of their agents, if the tort happened within the scope of employment, or in performing within the scope of the agreement. If it's an independent contractor, then it's less likely the principal would be held liable for their torts.

If an agent commits a tort acting outside of the agreement, the principal generally would not be liable, EXCEPT IF:

- 1) the principal was negligent in hiring that agent (didn't screen properly)
- 2) the principal was negligent in supervising the agent
- 3) if there was a pattern of the behavior and it wasn't corrected previously (implicit approval)

When an extra hazardous activity is involved, the principal has strict liability in regard to the agent's actions.

Other key facts or definitions

Agency coupled with an interest: This is an agency agreement in writing that also gives the agent an interest in the subject matter of the agreement. This agreement can't be terminated by the principal, whereas a normal agency relationship can be terminated at any time by the principal.

Contracts

Formation

To have proper formation of a contract, there needs to be:

- Offer
- Acceptance
- Consideration
- (Lack of) Defenses to formation (legally valid reasons the contract could be voided)

Offers:

To have a valid contract, the first step is to have an offer, and then have acceptance of that offer. There is “making an offer”, but there is also “making an invitation to make an offer”, which is not actually making an offer.

A commercial on TV for a sale at a car dealership is an invitation to make an offer... NOT an offer itself.

A valid offer will meet several criteria, such as:

- Genuine intent
- Offer is properly communicated
- Must contain definite terms and conditions

In general, an offer can only be accepted by the party to whom the offer is made. The offer can't be assigned to another party unless the offeror consents to the assignment.

Acceptance:

Acceptance binds the contract. If the offeror wants to “take back” (revocation) their offer, they must do so before their offer is accepted. Once the offer is accepted, there is an enforceable contract.

For unilateral offers, acceptance takes place upon completion (performance) of the act required by the offer.

Common law contracts use a “mirror image rule” for the language used. Anything besides agreement to the exact terms made in the offer become a counteroffer and rejection of the original offer.

For example, in a real estate contract, if everything was agreed on and then the buyer wanted the seller to throw in the leather recliners in the movie room, that one request is a rejection of the current offer and constitutes a new offer.

If acceptance is sent by an authorized medium (such as the mail), as soon as the acceptance is sent, a contract is formed.

If the offer doesn't specify a required response medium (such as overnight mail), then any medium that is the same or faster method of communication will constitute acceptance. Pay attention to the question because if an offer does specify a medium for the acceptance, then the acceptance needs to be sent by that medium to be valid.

So, if acceptance document is dropped off in the mail before the deadline, then the offer has been accepted. This is the “mailbox rule”. The mailbox rule is only for acceptance, it doesn't apply for offers, counteroffers, or rejection- those have to be received to be effective. However, an offer can explicitly stipulate that acceptance is not effective until the acceptance is received, and if this is the case then the

mailbox rule doesn't apply.

Consideration:

Consideration is the benefit promised by the offeror and the legal detriment promised or performed by the offeree. You are offering \$20 (benefit) if I mow your lawn (my time and effort is my detriment)

Consideration has to be of legal value, but the values do not have to be equal. You could have a contract to trade a Honda Accord for a Lexus- the court doesn't try to make contracts "fair". The key phrase is "legally sufficient".

Bargained-for-exchange: This concept means that the contract induces legal detriment on both sides (both sides are giving something up).

Past actions cannot count as consideration for current promises. If I say, "I should give you \$20 for mowing my lawn last week", I can't be held to that promise because there is no consideration.

Also, consideration cannot be something you were already obligated to do. A fireman can't promise to put out a fire for you for \$1,000 fee.

Defenses to formation:

Certain circumstances can void a contract later on if they were present when the contract was formed. Some examples of 'defenses to formation' are:

- Mistakes
- Fraud
- Misrepresentation

- Undue influence (duress)
- Illegal acts/subject matter

Note: In the “steps” to have a valid contract at the top of this section, the 4th item is “lack of defenses to formation”. So, a valid contract needs to have two parties that won’t have a valid reason down the line to void the contract. Defenses to formation aren’t key to a contract... it’s the lack of defenses to formation that is necessary for a valid contract.

Capacity

Each party to a contract must be of legal age. Any minor entering a contract has the right to disaffirm (void) the contract up until they become of legal age.

If the item is “of necessity” (food, shelter, or clothing), and the item is in value with what the minor is accustomed to, the seller can recover a “reasonable value” from the minor.

The minor must return any consideration gained in order to disaffirm the contract.

If the minor ratifies the contract after they become an adult, they are fully liable to the terms of the contract.

The minor (now an adult) can either explicitly ratify the contract, OR, if they keep performing on the contract for a reasonable time after becoming an adult, they are implying ratification, and the contract is binding.

Mental capacity is required to make or enter into a binding contract. This includes mentally incompetent persons.

It also includes intoxicated persons meaning that someone can void a contract that they entered into while intoxicated to the extent that they didn't understand what they were agreeing to.

Mistakes

A unilateral mistake is a mistake by one party to the contract. The mistake will be binding unless:

the other party knows the mistake or should know the mistake.

OR, the mistake is material and obvious, such as writing \$500 instead of \$5,000 on the contract.

OR, the error was due to a mathematical calculation.

A bilateral mistake is when both parties are mistaken as to the subject matter. If I thought I had a genuine Picasso painting and you agreed to buy it, then we found out it was a fake, there is no contract.

Innocent Misrepresentation

Know the difference between "statements of fact" and "sales puffing".

A statement of fact would be "You will lose 20lbs on this diet". An

example of sales puffing would be "this diet will help you feel better"

For a valid defense to formation, there needs to be a "statement of fact" that turned out to be false, and it needs to be "material", meaning it was enough to influence the buyer's decision.

Fraud or "fraud in the inducement"

The thing that separates fraud and misrepresentation is intentional deception. If I unknowingly leave out a key fact, that is

misrepresentation. If I leave out the key fact on purpose, that is fraud.

Undue Influence

This is when someone in a position of trust or authority over someone

else uses that trust or authority to get a party to enter a contract with them. Such contracts are voidable.

Duress

Duress is when someone is coerced into a contract by physical force or threats of physical force, threats to disclose private information, or economic pressure. Such contracts are voidable.

Illegality

Contracts in violation of laws or statutes are voidable.

Rejection

Any time the offeree rejects an offer in any way, the offer is terminated.

Counteroffer

If, the offeree says something like, “I won’t pay \$100, but I’d pay \$80”, this is a counteroffer, NOT acceptance of the original offer

Termination: Offers can be terminated through lapse of time, or by an operation of the law.

Death or insanity of the offeror or offeree terminates an offer.

Destruction of the subject matter terminates an offer. If you’re selling your car and it blows up before the deal is done, there is no more contract.

If the subject matter of the contract is illegal, there is no valid offer and a court would terminate the contract.

Types of contracts:

Express contract: This is a contract made orally and/or written. If I offer to sell you a laptop for \$1,000 and you say that yes, you want it.

Implied contract (implied-in-fact): This is when a contract is formed by intent and conduct of the parties. When you go take your car to the mechanic, it's not clear exactly what the costs will be, but it is implied that you will pay for the repairs, whatever they may be.

Quasi contract or implied-in-law: When a court imposes a contract because there was performance by a party. If you ordered catering, the caterers showed up, you and your guests ate the food, and then you tried telling the caterers you weren't going to pay because the chicken was overcooked... that would be "unjust enrichment" on your part (free food) and a court would most likely order you to pay the caterer.

Bilateral contract: Both sides make a promise. The bank gives you \$100,000 to buy a home and you promise to pay it back over 30 years.

Unilateral contract: A contract where one party makes a promise in exchange for some type of performance. I'll pay you \$20 to wash my car.

Executed contract: A contract that has been fulfilled by both parties.

Executory contract: A contract that has NOT YET been fulfilled by both parties.

Partially executed contract: Only one side of the contract has been

fully performed.

Valid contract: A contract that has been legally formed and meets the necessary requirements for formation.

Void contract: A contract that lacks a legal purpose or involves an illegal act.

Voidable contract: An otherwise valid contract that can be voided due to one party having legal protection for various reasons. This would be if I got you to agree to buy a Rolex for regular price even though it's a fake.

Unenforceable contract: A contract that the courts would not enforce due to some legal reason, but the parties can still execute if they both choose to.

Statute of Frauds

This law requires that certain types of contracts be in writing. Any contract involving the sale of real property must be in writing to be enforceable. Also, if the contract will take more than a year to fulfill, then the contract must be in writing to be enforceable.

In general, contracts for items (goods, NOT services) less than \$500 can be made orally and are still enforceable. Anything worth \$500 or more should be in writing to be enforceable.

Don't get tripped up by questions similar to this involving services. There can be oral contracts worth more than \$500 involving services.

Also, there is an exception to the “in writing” rule if the buyer and seller cannot be returned to the “status quo” because of partial performance. An example is if I was selling my house and I took a down payment and let the buyer move in before the sale was finalized, and then I tried to refuse to sell the house.

Parol Evidence Rule

This rule applies to complete written contracts, and it means that any evidence besides what is written in the contract is not admissible. Once the contract is written and accepted, one party can't claim that other things were agreed to orally; the contract is strictly what is written in the contract. An exception to the parol evidence rule is fraudulent statements. If fraud occurred, it will be admitted as evidence in court.

Performance

Once a valid contract is formed, the next thing to happen is the performance of that contract. There are some specific conditions that can affect the performance of a contract:

Precedent conditions: This is something that must happen before a party has a duty to perform. This could be qualifying for a loan before purchasing a house, or if you were hired to clean the carpets in a house, the furniture would have to be moved before you could be expected to perform your part of the contract.

Subsequent: This is something that must happen after a duty to perform has arisen. This could be having to return a TV within 30 days in order to receive a full refund.

Concurrent: This is each party's duty to perform under a contract simultaneously. An example is shopping at the store; you're there choosing the food to buy, you take it to the register, the cashier is there who takes your payment, then the goods are yours. Performance is happening concurrently.

If the conditions to perform are not present, then the duty to perform is absent. There is also an implied agreement in every contract that the parties won't hinder performance of the other party.

Statute of limitations regarding contracts: generally 10 years for written contracts, and 5 years for oral contracts. If the statute of limitations has run out and one party hasn't performed but the other party also hasn't sued for nonperformance, the duty to perform is discharged.

Discharge, Breach, and Remedies

Discharge of duty: There are several ways in which the duty to perform can be discharged:

- By failure of conditions. If a condition precedent or subsequent doesn't occur, there is no duty to perform.
- The parties can agree to release one another, or to mutually discharge a contract.
- "Novation" is a new party replacing one party in the contract and assuming their liability in the contract. All parties need to agree, and a new contract is formed.
- Discharge by accord & satisfaction: When performance is completed on the original contract, or one party agrees that the contract can be satisfied by completion of a different

performance.

Discharge by operation of law

- Statute of limitations: The time limits vary from state to state
- Bankruptcy
- Discharge by impossibility
- Death or insanity
- Destruction of subject matter: The car you're trying to sell is wrecked
- Illegality

Discharge by performance

If both parties have performed under the terms of the contract, then the contract has been completed.

Substantial performance: When performance of contract is hard to judge or has a broad spectrum of what could be considered performance, then substantial performance which was performed in good faith will be valid performance.

Discharge by material breach: If one side of a contract materially breaches the contract, the other party is not required to perform.

Personal satisfaction: If the contract stipulates performance to the personal satisfaction of one party, then that is the requirement for performance to be completed.

Remedies for Breach

Damages: This is when monetary damages are awarded.

Punitive damages are when money is awarded to punish a wrongdoer.

Compensatory damages are awarded to compensate for costs or loss actually suffered.

Mitigation of damages: When a breach happens, the law usually requires the non-breaching party to take some action to mitigate the breach, such as finding a new renter if their old renter just took off with 8 months left on their lease.

Specific performance: This is requiring the other party to perform the contract. This happens when money damages won't sufficiently compensate the injured party. An example would be a contract involving the sale of a rare baseball card. Money damages aren't the same as getting the rare card, so the court would likely award specific performance and enforce the sale of the card.

Rescission: This is when the parties go back and are restored to their positions before the contract as much as possible.

Reformation: A contract is rewritten to address or solve an issue between the parties.

Other Contract Matters

An incidental beneficiary cannot sue to enforce contracts. This would be if I contracted with you to build my new office building, and in the contract, I specify that I want you to use ABC plumbing. If you use XYZ

plumbing instead, ABC cannot sue you or me because ABC was an incidental beneficiary of the contract.

Unless a contract's terms expressly prohibit a party from assigning their rights to another party, one party's rights are generally assignable in contracts.

If a sales contract is being assigned to a third party, the assignment cannot materially increase the other party's risk or duty in doing so or the assignment is invalid.

Debtor-Creditor Relationships

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

Suretyship

A surety or “guarantor” is someone who agrees to be liable for someone else’s debt. It’s like ‘co-signing’, and gives creditors another form of backup for the debt

The creditor loans money to the debtor, and the surety backs up the debtor.

- The creditor
- The debtor
- The surety or guarantor

The surety is liable only after the original debtor has defaulted, and there can be more than one surety, or co-sureties.

When two people act as a co-surety, neither can be held liable for an entire debt. Once the debtor defaults, if one co-surety pays more than their share of the debt, they can recover the amount paid in excess of their share from the other co-surety. This is called “contribution”, and this doesn’t apply to a single surety since they are the last in line for the obligation.

In general, where there are co-sureties, the amount each one is liable for will be pro-rata. For example, if ABC is loaning Tom \$300,000, and he has 3 co-sureties: Bill, Cal, and Dave. Bill is responsible for \$150,000,

Cal for \$75,000, and Dave for \$75,000. So, their pro rata amounts are:

$$Bill = \frac{150,000}{300,000} = 50\% \quad Cal = \frac{75,000}{300,000} = 25\% \quad Dave = \frac{75,000}{300,000} = 25\%$$

If Tom defaults after paying off \$200,000, then there is \$100,000 left that Bill, Cal, and Dave are responsible for. It's simply each surety's pro-rata amount, so Bill would pay \$50,000, and Cal and Dave would each pay \$25,000.

But what if Cal went bankrupt before Tom defaulted on the debt? In this case, Cal is not liable as a surety, and to determine Bill and Dave's obligation, you remove Cal's portion from the denominator to determine their portions:

$$Bill = \frac{150,000}{300,000 - 75,000} = \frac{150,000}{225,000} = 67\%$$

$$Dave = \frac{75,000}{300,000 - 75,000} = \frac{75,000}{225,000} = 33\%$$

Remember to think of it in common sense terms: If one surety has gone bankrupt, then each of the two remaining sureties will each owe a larger portion than when there were three sureties.

On the opposite side of this, if the creditor releases one co-surety from their liability, then the remaining co-surety's obligation will be reduced by the pro-rata portion of the surety that was released.

If the creditor releases one co-surety without the consent of the debtor

or the other co-surety, then the remaining co-surety is only liable for half of the debt.

On a “guaranty of collection”, the surety is only liable if collection against the primary debtor fails first.

A creditor is required to disclose any known material facts to a surety before the surety signs the loan agreement. For example, if the creditor knows that the debtor’s financial information is leaving out material facts, but doesn’t disclose this to the surety, the surety can use this later as a defense to repayment.

A surety CANNOT compel the creditor to either:

- collect from the principal debtor
 - OR, proceed against the principal debtor’s collateral
 - A surety is primarily liable for the debt upon the debtor’s default.
- The creditor can proceed to collect from the surety

If a surety loses capacity, then they won’t be liable for the debt any longer.

Suretyship contracts must be in writing according to the Statute of Frauds, or else they are not enforceable.

The death of the principal debtor does NOT release the surety’s obligation.

Bankruptcy and Insolvency

The actual laws on bankruptcy are complicated, and it would be counter-productive to try and learn all of it for the REG exam. So, here’s

just a list of the facts you're most likely to see on the exam:

Chapter 7 bankruptcy: this is a liquidation bankruptcy – everything is sold (liquidated) to try and pay a few things back. It allows voluntary or involuntary petitions (meaning either you can initiate bankruptcy, or a creditor can try to take you through bankruptcy because you haven't been making your payments). There is a "means" test for determining whether the debtor can pay back their debts. The means test uses specific monthly expenses compared to wages to determine "disposable income". The more disposable income, the less likely the petitioner will be able to file Chapter 7. This test is also used to determine "bankruptcy abuse" (trying to just get out of paying off debts through declaring bankruptcy). If there is bankruptcy abuse, the consumer and the consumer's lawyer can be held liable for costs. A trustee is appointed in a chapter 7 bankruptcy.

A debtor does NOT need to be insolvent or have a certain number of creditors to file chapter 7. Almost anyone can file a petition for chapter 7 relief, BUT, there will be the test for "bankruptcy abuse".

If a business is being petitioned into bankruptcy by a creditor, and the business challenges the petition, the challenge will fail if the business has not been paying their bills as they become due.

There is a creditor's meeting where the party declaring bankruptcy can be examined under oath by the creditors. If the debtor fails to attend (unless excused) the creditor's meeting, it's considered a failure to cooperate and grounds for denial of the debtor's discharge.

Also, if a debtor fails to reasonably explain a loss of assets, the

discharge will be denied.

Corporations and partnerships can go through Chapter 7, but they don't qualify for a general discharge of debts like a regular person does.

The following are not eligible for chapter 7 bankruptcy:

- Credit unions
- Banks
- Insurance companies
- Railroad companies
- Small business investment companies

Chapter 11 bankruptcy: The purpose of a chapter 11 is to “re-organize”, and for the firm to stay in business (although an individual can file chapter 11). This allows for a reorganization of a debtor to pay their debts. This results in a court-supervised reorganization plan that will pay some or all of the business's debts or an extended period of time. Chapter 11 also allows voluntary and involuntary petitions. There is generally no trustee. Chapter 11 is the most complex and costly form of bankruptcy.

The reorganization plan must be approved by half of the creditors that make up at least 2/3 of the total claims, and the court must approve this plan.

The following are not eligible for chapter 11 bankruptcy:

- Banks
- Insurance companies

Chapter 13: Also called a “wage-earner's plan,” this type allows for the

adjustment of debts of an individual with regular income (chapter 13 is only for individuals). Chapter 13 allows only voluntary petitions. There is always a trustee with Chapter 13. A 3-5-year plan is made as a result of the bankruptcy. Corporations and partnerships can't file for chapter 13.

Chapter 13 has debt limits for the filer – if the filer's debt exceeds these limits then they must file for Chapter 11.

Chapter 13 debt limits (for 2019-2022):

- \$419,275 of unsecured debt
- \$1,257,850 of secured debt

Bankruptcy Summary

	Chapter 7	Chapter 13
Type of Bankruptcy	Liquidation	Reorganization
Who can file	Individuals & businesses	Individuals only (including sole proprietors)
Eligibility restrictions	Subject to the “means test”	Less than: \$419,275 unsecured or \$1,257,850 of secured debt
How long to receive discharge	3-5 months	Upon completion of plan payments – usually 3-5 years
Benefits	Ability to discharge most debts and provides “fresh start”	Ability to keep property and catch up on missed payments

When a debtor declares bankruptcy, the debtor cannot prefer one creditor over another.

The debtor's estate in bankruptcy is considered to be all tangible and intangible property the debtor held at the beginning of the bankruptcy proceedings. It also includes any income generated from such property after the beginning of the bankruptcy proceedings.

Not only income from the property, but any appreciation in value of the property as well.

Also, any gifts received or property via inheritance received within 180 days of the filing of the bankruptcy petition are considered part of the estate.

"Payments", such as alimony or social security payments received after the filing are NOT considered part of the estate.

Distribution of debtor's estate:

Below is the order in which a debtor's estate is divided up after a bankruptcy. This is a topic frequently tested, and you should know the order of this list. This list is in order of priority:

- Perfected secured parties
- Claims for domestic support: this includes child support AND alimony
- Administration costs: includes costs and expenses related to the bankruptcy proceedings. Includes attorney fees, accounting fees, appraisals, and trustee fees
- Employee wages: employee wages are limited to those earned in

within 180 days of the filing up to a maximum of \$13,650.

Anything above the \$13,650 is put in the same category as “general creditors”

- Contributions to employee benefit plans: any claims for contributions to an employee benefit plan from services performed within 180 days before the filing up to \$13,650 per employee
- Claims of farm producers and fisherman: up to \$6,725 per creditor
- Consumer creditors: up to \$3,025 per creditor. Any amount above that is treated as a general creditor claim
- Claims of governmental units for taxes
- Claims for death or personal injury
- All general unsecured creditors
- If anything is left, this goes back to the debtor

Items NOT discharged in bankruptcy:

- Claims arising from alimony or child support
- Student loans
- Federal tax liens (unpaid taxes)
- Debt acquired through false representations (lying about income or some other fraud in order to get a loan)

Other bankruptcy facts:

- If a debtor is being represented by an attorney, the creditor needs to communicate with the attorney, not the debtor.
- An involuntary petition, if not contested by the debtor, will result in an order for relief. If the petition is contested, then the creditor needs to prove the debtor hasn't been making payments to get the order for relief.

- A writ of garnishment is an order that allows a creditor to take a portion of a debtor's wages as a means of repayment.
- **Artisan's lien/Mechanic's lien:** Work done to improve or repair property gives the artisan a security interest in the property. It is a possessory lien, meaning that the creditor can take possession of the property and sell it to satisfy the debt. Any amount from the sale above what was owed is returned to the owner of the property. A possessory lien has priority over other perfected secured liens in most states. Auto mechanics are an example of who could place an artisan lien.

Secured Transactions

A security interest gives a creditor specific collateral the borrower owns that the creditor will get if the borrower doesn't pay back their debt. To create a security interest, the creditor must give value, the debtor must have rights in the collateral (you can't offer your friend's car as collateral), and the creditor must take possession of the collateral or obtain an agreement with the debtor. These 3 things CREATE a security interest, and to PERFECT a security interest, a financing statement must be filed. Note: The debtor must agree to the creation of the security interest.

If a security interest does not attach, it is not effective against the debtor or third parties.

To summarize, a security interest attaches when the following occurs:

- The secured creditor gives value (provides the loan)
- The debtor has rights in the collateral (can't offer his friend's car as collateral)

- A security agreement exists

And for the interest to be PERFECTED, a financing statement must be filed. A financing statement lasts for 5 years but can be re-filed indefinitely every five years.

A security interest can be 'perfected' without having to file a financing statement if the sale is made to a consumer. Example is buying a TV on credit from a store with credit extended from the store itself. The term you'll probably see on a question is "purchase money security interest in consumer goods."

When inventory is the collateral, a financing statement must be filed to perfect the security interest.

A filing statement is valid if it contains the names of the debtor, the names of the secured party, and a description of the collateral. Leaving one of these out invalidates the filing.

The point of perfecting a security interest is to take priority over other creditors in the same collateral. When two creditors both have perfected interests in the same collateral, the priority goes to the creditor whose interest was perfected first.

Priority of secured transactions

If a creditor has a perfected security interest in some collateral, then they will have priority over:

- A creditor with a security interest that is unperfected
- Unsecured creditors
- Lien creditors where the interest was perfected before the lien

attached

- Judgement liens where the interest was perfected before the judgement lien attached

Another important fact is that even if a creditor has a perfected interest in some collateral of the debtor, if a buyer purchases the collateral in the ordinary course of business, the buyer will be unaffected by the security interest in the collateral. If a creditor has a security interest in the inventory of a TV store, and you come in a purchase a TV, the creditor can't come after you for anything - you own the TV free and clear.

Debtor moves to new jurisdiction:

If a debtor moves to another jurisdiction, someone with a security interest against them has 4 months to file a financing agreement in the new jurisdiction. Until the 4 months passes, the oldest security interest has superiority, even against another security interest in the new jurisdiction. After 4 months, if the oldest security interest has not filed in the new jurisdiction, then the oldest properly filed security interest becomes the most superior security interest.

Example

If Abby has a security interest against me and I move to a new jurisdiction, and immediately purchase some equipment from Barry and he gets a security interest against me, if I default on both debts only after 1 month of being in the new jurisdiction, Abby's interest is superior to Barry's even if Abby hasn't properly filed her interest against me in this new jurisdiction.

When a debtor defaults, the secured creditor may repossess the

collateral on its own as long as the repossession is performed without disturbing the peace. The secured party can then sell the goods and apply the proceeds towards the debt. Or, the secured party can try to recover through the judicial process.

Government Regulation of Business

Federal Securities Regulation

Definition of a security:

- A “security” as defined by the 1933 Act is an investment that:
- Is an investment of money
- In a common enterprise
- With the expectation of profit
- To be earned primarily by the action of others

These are things like stocks, bonds, notes, and limited partnership interests. Doesn't include a general partnership interest, since this involves participating in the day to day operations of the partnership.

Registration

Any initial offering of securities must be registered with the SEC unless it meets one of the exemptions, which are covered below

The primary purpose of registration is to adequately and accurately disclose financial and other information that investors can use to make investment decisions.

After a prospectus and registration statement have been filed with the SEC, there is a 20-day waiting period before the stocks can be issued. During these 20 days, a preliminary or “red herring” prospectus can be issued to investors.

Also during the 20 days, a “tombstone ad” may be placed which is a restricted ad that let's investors know a prospectus on the stock is

available.

Under the Act of 1933, a non-WKSI securities-registration statement must disclose (WKSI means Well-Known Seasoned Issuers and they have less rules to follow):

- a description of the security
- how the corporation will use the proceeds from the sale
- a description of the registrant's business and management
- and a financial statement

It also must contain a prospectus

Exempt Securities

There are 3 major types of transactions that are exempt from registering with the SEC:

Small offering exemption. These types of offerings are so small that they pose a small threat to the public.

Private placement exemption. These transactions only involve accredited investors, and therefore do not need the protection of the 1933's Act disclosure rules.

Intrastate offering exemptions. These are transactions that are contained within one state and therefore are subject only to that specific state's regulations.

Specific Exemption Rules (for all below, one general rule is that the SEC must be notified within 15 days of the first sale of securities)

Rule 504 of Regulation D

- This rule is mostly for small companies

- Can only be used to raise \$5 million in any 12-month period without registration
- Securities can be sold to anyone

Rule 506 of Regulation D

- No limit on the amount
- Securities can be sold to an unlimited number of accredited investors but no more than 35 unaccredited investors

Regulation A

- Can raise \$20 million per 12 months if sold to anyone, or \$50 million per 12 months if restricted to accredited investors and unaccredited investors can only invest up to 10% of their annual income or net worth.
- It's pursuant to the JOB Act of 2012

Rule 147 Intrastate offering

Issuer must be organized and doing business in the same state which the offering will be. There's an 80% test that means 80% of the assets should be in state, 80% of revenue should be in state, and 80% of the proceeds of the offering should be in state.

Other rules

The resale of limited partnership interests will generally be limited. Governmental securities such as municipal bonds are exempt from registration under the 1933 Act.

Securities issued by a charitable organization are exempt from registration.

JOBS Act

This is not really a “jobs” act, it is a securities law. The idea is that it would make it easier for small companies to raise capital, and therefore create jobs.

The act did 5 main things:

- Created a new category of businesses called “emerging growth companies (EGCs)” which can have an IPO to raise capital but can also avoid most burdens of being a public company for 5 years
- Encouraged crowdfunding (foreign firms CANNOT use the crowdfunding exemption)
- Increased the Regulation A amount that can be raised from \$5 to \$50 million
- Allows firms doing private placements to use general solicitation and advertising which wasn’t previously allowed
- Changed the definition of a public company so that firms could grow larger before becoming “public” and thus avoid all the regulations and red tape involved with being a public company

Other JOBS act elements

A firm can use general solicitation in an offering as long as they take “reasonable steps” to ensure that they only sell to accredited investors under Regulation D.

\$100,000 is the most an individual can invest in crowdfunded ventures in one year. If someone invested 100k in company A’s venture, he cannot invest in any other crowdfunded ventures that year.

Requirements to be an EGC

- Have less than \$1 billion in annual gross revenue during most recent fiscal year
- Have been publicly traded for less than 5 years
- Have a public float of less than \$700 million (shares in the hands of public investors as opposed to company officers)
- Have not issued \$1 billion in non-convertible debt in the prior 3-year period

Benefits of being an EGC (the following apply to the firm for up to 5 years after its IPO):

- The registration statement is confidentially reviewed by the SEC
- There is reduced requirements regarding audited financial statements: they only need 2 years of audited financials instead of 3 years
- Don't need to comply with SOX 404(b) requirements for audit of internal controls
- Don't need to comply with new PCAOB rules
- There's reduced disclosure requirements regarding executive compensation

Violations of Securities Laws

Liability Provisions of 1933 Act

This mainly deals with Section 11, which remedies misleading statements and omissions contained in the registration statement.

Elements involved in a Section 11 claim:

A CPA who certifies financial statements included in a registration

statement will generally not be liable to a purchaser of the security if the CPA can prove due diligence. This includes if mistakes were made. As long as the CPA/auditor acted carefully in performing the audit, the CPA will have a due diligence defense.

The main things that a plaintiff (the party suing) must show to win a Section 11 claim are:

- That there was a material misstatement in the registration statement on the effective date
- That they can trace their shares to that registration statement
- And that they suffered damages

These make it fairly easy for a plaintiff to win, because they don't need to prove reliance, or that there was fraud.

Basically, as long as it is discovered the registration statement contained a material misstatement for whatever reason, and that they plaintiff suffered a loss, the plaintiff will win.

Victims of fraudulent misstatements are entitled to rescind the transaction OR recover their losses caused by their reliance on the false statements.

“Scienter” is a “guilty mind”. The key idea is that there was the intention to do something wrong. If the word “negligence” is used, then it was a mistake that was unintentional.

If a CPA acts willfully to certify materially misstated financial statements, they can be punished criminally under the “criminal provisions” of the 1933 and 1934 acts.

In insider-trading cases it is common for the SEC to bring civil charges and then the Department of Justice to bring criminal charges.

Other Federal Laws and Regulations

Anti-Discrimination

The main act was “Title VII” of the 1964 Civil Rights Act.

There can be no discrimination in employment based on:

- Race
- Color
- Religion
- Religion limitation: A Lutheran church is allowed to not hire a Catholic priest, but an HR firm cannot discriminate against any candidates no matter their religion
- Sex
- National origin: this includes discrimination because of accents

These rules apply to:

- Employers having 15 or more employees
- AND whose business affects interstate commerce
- Federal, State, and local government employees

These rules are enforced by the Equal Employment Opportunity Commission (EEOC).

Age Discrimination in Employment Act (ADEA)

This was meant to supplement Title VII which didn’t address age discrimination.

The act protects individuals 40 years and older. The main effect was to

prohibit mandatory retirement.

Americans with Disabilities Act (ADA)

Applies to employers with 15 or more employees, all state and local governments, and most private businesses that provide accommodations, goods, or services to the public.

Employee Welfare

Social Security benefits are meant to partially replace income when a worker retires.

To be “fully insured”, one must accrue a minimum of 10 years of contributions.

A “fully insured” worker is entitled to the following benefits:

- Survivor benefits for widow or widower and dependents
- Disability benefits for worker and family
- Old age retirement benefits to worker and dependents

A “currently insured” worker is eligible for:

- Limited survivor benefits
- Benefits for disabled workers and dependents
- Lump-sum death benefits

Investment income and pension income are expected during retirement, so these will not reduce Social Security benefits. But, earning salaries, fees, or wages by working in some form can result in Social Security benefits being reduced.

Medicare cover portions of costs and hospitalization of insured workers and spouses 65 and older.

Disability benefits cover workers who suffer a severe physical or mental

impairment that prevents that person from working for a year or more or is expected to result in the victim's death.

Employment Taxes

Federal Insurance Contributions Act (FICA)

Imposes social security tax on employers, employees, and the self-employed.

Under FICA, contingent fees, bonuses, and commissions are all considered wages. Reimbursed travel expenses are NOT considered wages for FICA.

If an employer pays both the employer and employee portions of FICA, but fails to collect the employee portion from the employee, the employer has the right to be reimbursed by the employees for the employees' share.

Federal Unemployment Tax Act (FUTA)

These are taxes paid by employers which go into federal and state pools to compensate workers who have lost their jobs and can't find new employment.

Unemployment benefits are given to people who lose their jobs and are not fired for a reason. When a business "downsizes", the laid off workers will receive unemployment benefits.

An employer can take credits against Federal unemployment taxes if they have paid into a state unemployment fund first.

Taxes paid to the Federal Unemployment Tax are deductible by the employer as a business expense for federal income taxes.

Fair Labor Standards

Non-exempt workers must be paid overtime for all hours over 40 in any given week. If an employee had weekly hours of 38, 42, 36, and 44, the employee must be paid overtime for 6 hours (2 hours from 42 and 4 from 44). Employers are not allowed to average weekly hours. This act regulates minimum wage, overtime, and the number of hours in the working week.

Affordable Care Act

Some of the biggest impacts of the ACA are:

- People with pre-existing conditions can't be refused coverage.
- Coverage can't be canceled for illnesses, only for failing to pay premiums or fraud.
- Eliminated pricing discrimination based on gender or other factors.
- Eliminated lifetime limits - insurance companies can't cap what they'll spend on a patient.
- "Applicable large employers" (ALEs) are required to provide "minimum value" coverage to at least 95% of their full-time employees. An ALE is a company that employs at least 50 full-time employees.
- If a required employer does not offer coverage, then the fine would be \$2,570 per uncovered employee (excludes the first 30 employees).
- The TCJA repealed the individual mandate, meaning there's now no penalty for not having health insurance.

Employee Benefits

Employee Retirement Income Security Act (ERISA)

The act protects employees' rights in existing pension plans.

It preempts state regulation and replaces it with comprehensive federal regulation.

It also offers tax incentives to employers for setting up employee benefit plans that meet certain IRS requirements.

ERISA does not apply to government pension plans.

If an employer offers a pension plan, ERISA mandates that the plan be offered to new employees without undue delay.

Federal Consolidated Budget Reconciliation Act (COBRA)

This mainly provides health insurance in some circumstances after a worker loses their job.

Usually covers the employee for 18 months after losing their job.

The coverage period is 29 months if the insured was disabled at the time of the qualifying event.

This includes the employee's spouse. If an employee is laid off, their coverage will last 18 months. If the employee's spouse was disabled at the time the employee lost their job, then the spouse's coverage will last 29 months.

The Family and Medical Leave Act (FMLA)

This was set up to balance an employee's workplace demands with the needs of a family.

This provides an employee with up to 12 weeks of unpaid leave without losing his/her job for:

- Birth of a child

- Adoption
- A personal serious health condition
- The care of a child, spouse, or parent with a serious health condition
- Impending order of active duty of an employee's spouse, child, or parent

To be eligible, the employee must have worked for the employer for at least 12 months, AND at least 1,250 hours during the previous 12 months.

Employers

- FMLA applies to employers with over 50 employees within a 75-mile radius
- State and local government agencies
- It is not the burden of employers to offer FMLA, employees must request FMLA leave to be entitled to it

Employee Health and Safety

Workers' Compensation Act

This provides compensation for employees who have work-related injuries. The employer has strict liability, the employee doesn't have to prove employer negligence or fault by the employer.

If a worker is killed in an accident on the job, then workers comp will make monthly payments to dependent children.

Workers comp would also pay burial expenses when a worker dies in a work-related accident.

Workers comp will pay for prosthetic devices if the worker loses a limb

while working.

The worker will NOT receive workers comp benefits if:

- The injury was self-inflicted
- If the worker was intoxicated while at work and the injury happened

OSHA

Requires that the employer provides a workplace free from recognized hazards.

OSHA is authorized to establish standards that protect employees from exposure to substances that may be harmful to their health.

Under OSHA, a worker can refuse to work if there is a present safety violation that threatens physical harm or danger. Also, an employer can fire an employee for failing to comply with OSHA rules

OSHA does not apply to the federal government, state governments, or industries that are subject to other safety regulations such as mining.

Unions

If an employee wants to bring a union to his workplace, he will need to get 30% of eligible employees to sign authorization cards to require the employer to hold elections as to whether a union will be implemented.

During upcoming collective bargaining, a company cannot lock out unionized employees in order to:

- destroy the union
- punish the workers for organizing
- avoid good faith bargaining responsibilities

Management must rehire striking workers after an “unfair labor

practice” strike. If the strike was over wages, the company does not have to rehire the workers.

Copyright Laws

A copyright lasts for the life of the author, plus 70 years.

A work for hire (if you write a book for me but I have the rights to the book) is protected for the shorter of:

95 years from the date of publication or 120 years from the date of creation.

Patent Laws

A patent expires 20 years from the date of filing, NOT the date that the patent is granted.

Abstract ideas are not patentable.

An invention is patentable if it:

- Is a tangible application of a new idea
- It is useful
- It is novel
- It is non-obvious. This means that you can't just patent a slightly different version of a device that has already been patented - the original device gave you the idea.

Business Structure

Selection and Formation of Business Entity and Related Operation and Termination

Businesses can be structured in several different ways in order to gain certain benefits.

Types of Business Entities

Sole proprietor

A single owner business where the assets and liabilities belong solely to the owner.

Formation

No formal requirements or filings to be a sole proprietor. Very simple to setup, there's no specific forms to file to create the entity. There might be required business licenses but nothing specific to form a sole proprietorship. Disadvantage is the individual has unlimited personal liability.

Since there is nothing formal to file to "setup" a sole proprietorship, there is also no formal process for termination - the individual would simply stop performing the business activities.

General partnership

Two or more persons working as co-owners to earn a profit. The

partners are personally liable for business debts, and any profits will “flow through” to the individual partners for tax purposes. There is nothing formal required to setup a general partnership. There is pass through taxation, and there is unlimited personal general liability for the partners.

Note: There is a governing set of provisions for partnerships called the Uniform Partnership Act (UPA), which was revised in 1994 and is mostly referred to as the Revised Uniform Partnership Act (RUPA). RUPA outlines procedures or rules for the formation, operations, and termination of partnerships. If a partnership agreement doesn't include specifics on certain matters, then the partnership would be subject to the RUPA rules.

Operational features

Unless there is a written partnership agreement that details otherwise, all partners have equal say in the day to day operations of the business. A unanimous vote is required for major decisions such as admitting a new partner, assigning partnership property, or any decision that would impair the operation of the partnership.

Partnerships operate using capital accounts for each partner that account for money or property contributed, share of net profits, share of liabilities, etc. Again, unless specified in the partnership agreement, all partners share in profits and losses equally. This includes if one partner has contributed more or works more, if a specific allocation is NOT outlined in a partnership agreement or profit-sharing agreement, then the partners share the profits equally.

If a partner retires, they are liable to creditors for existing debts of the

partnership. They are not liable for partnership liabilities incurred after their retirement. If a new partner is going to replace the retiring partner, the existing debts can be transferred to the new partner if agreed to by the creditors through a novation. This differs from the partner's right to their share of the profits, which is freely assignable to a new partner without the consent of the other partners, unless this is expressly prohibited in the partnership agreement.

If a partnership has no time duration specified, then it is a "partnership at will".

A tort committed by one partner while performing partnership business can result in all partners of the partnership being held liable.

Termination

If not specified in a partnership agreement, the rules for termination will follow RUPA. Several things can cause the dissolution of a partnership according to RUPA such as the death of a partner, one partner wanting to end the partnership, the bankruptcy of a partner, a violation of the partnership agreement by one of the partners, or an event happening that was in the partnership agreement that would dissolve the partnership.

If a general partnership is dissolved, the liabilities of the partnership still exist, and the owners or former partners are still liable.

You might see questions regarding one partner "going into competition" with the partnership. This would be any situation where a partner performs some act that hurts the partnership. There is a fiduciary duty of each partner to not "enter competition" with the

partnership.

If a partner acts with “apparent authority” and enters a contract on behalf of the partnership, the partnership will be held to the contract.

Limited partnership

Involves at least one general partner and one limited partner but there can be multiple of each. A general partner is a full partner which includes working on the day to day operations of the business, as well as being fully liable for the business debts. A limited partner contributes capital but doesn’t actively manage the business and has limited liability for business debts.

Formation

Formation of a limited partnership differs from a general partnership in that formal documents must be filed with the state. A limited partnership is designated by a “LP” or “Ltd” at the end of the business name.

Operational features

A limited partnership has pass through taxation. Liability is limited for limited partners, but to maintain their “limited” status they can’t be involved in the management or day to day operations of the business. There will be one or more general partners that are “running” the business day to day and making management decisions, and then one or more limited partners that are essentially investors.

The operations of a limited partnership are the same as a general partnership, such as each partner having a capital account

Termination

This is substantially the same as with a general partnership. One difference is that a limited partner leaving the partnership doesn't dissolve the partnership.

Limited liability partnership (LLP)

This form provides more protection from liability specifically for professionals such as doctors, accountants, and attorneys. The main idea is to protect partners from the malpractice of other partners. If partner A is found guilty of malpractice, partner A is personally liable and not partners B, C, and D. Limited partners do lose their limited liability status if they start participating in management activities.

Formation

Like a limited partnership, there are formal documents that need to be filed to form an LLP. The certificate of limited partnership filed with the state needs to contain the names of any general partners, but it is not required to contain the names of the limited partners.

Termination

Same as other partnerships.

Corporation

Provides limited liability for the owners - you can buy a share of stock in Apple, and your liability is limited to the amount you invested. The corporation is a legal being separate from its owners. A downside of corporations is the "double taxation": the corporation is taxed on its profits, but the shareholders are taxed again on dividend income.

A corporation is “domestic” in the state in which it is formed and is “foreign” in other states.

Formation

To form a corporation, “articles of incorporation” are submitted which must include:

- the name of the corporation
- the number of shares it is authorized to issue, and classes of stock to be issued
- the street address of its registered office and the name of its agent at that address
- the name and address of each incorporator

After the articles are filed, there will be the first board of directors’ meeting, and at that meeting the officers will be elected. The corporation’s bylaws are also drafted and adopted.

There is a “promoter” (can be more than one) that solicits people to invest money into a corporation, and “sets up” the corporation such as finding and leasing office space. The promoter has a fiduciary duty to the shareholders of the corporation. This can be a shareholder in the corporation.

For example, if you are the one starting the business, and you go out and find investor money and lease office space, you are the promoter. You are liable for the debts or contracts entered into until the corporation is formed and the corporation assumes the debts/contracts through a novation.

So remember that the promoter is personally liable for contracts entered into or debts accumulated until the corporation adopts them through a novation.

Operational features

The basic operational structure of a corporation is that there are shareholders who elect directors (board of directors), and then the board selects officers who will run the day to day operations of the corporation.

“Piercing the corporate veil” means that a corporation’s shareholders become personally liable. One of the biggest things that can cause this is the corporation being “thinly capitalized” which endangers the legitimate interests of creditors and tort creditors. Another thing that can cause the corporate veil to be pierced is when the owners commingle their funds with the funds of the corporations or using corporate assets for owner’s personal uses.

Shareholder rights:

- Shareholders of a public corporation have the right to a reasonable inspection of corporate records
- Shareholders have “preemptive rights” when it comes to purchasing newly issued shares. This is so that the original owners of a corporation can maintain control
- The board of directors of a corporation is best described as a “fiduciary duty”, which is the duty of highest loyalty

Corporate securities

Corporations can issue stock, which can be common stock or preferred stock. Preferred stock is cumulative and will accrue if they aren’t paid in

a given year. Preferred stock also holds dividend priority over common stock shareholders. A corporation can also issue debt securities such as notes or bonds. The debt securities of a corporation are not equity securities (involve an ownership interest).

Stock of a corporation can be “purchased” through services performed, services promised to be performed, or a promissory note to pay cash. These are obviously in addition to just purchasing stock, but you could see this in a question.

Termination

Corporations can be dissolved by the vote of the directors and shareholders, or they can be dissolved by judicial action or by the state they are incorporated in. This would be for things like failing to pay taxes or file annual reports, or by breaking laws or regulations. A shareholder can bring judicial action that could lead to the dissolution of the corp, for example if the board of directors were abusing or wasting corporate assets.

When a corporation is terminated, the directors are responsible to take the corporation’s resources and pay claims/creditors, and the distribute the rest to shareholders.

If two corporations are going to merge, the board of directors of both corporations have to approve the merger. Also, the remaining corporation will be liable for the debts of the acquired corporation.

Other corporation facts

If a corporate officer acts in good faith but makes a mistake that results in losses or damages to the corporation, then they won’t be liable to

the corporation. This is the “business judgment rule”. Remember however that individuals are always liable for their own torts, regardless of what other circumstances apply. Going along with this, the doctrine of “respondeat superior” is when a corporation is liable for the torts of its employees committed within the scope of their employment.

Remember that agency rules apply to directors of corporations. A director may have express authority to enter certain contracts on behalf of the corporation, or even apparent authority.

A corporate promoter can’t profit from the activities of being a promoter, this is part of being a fiduciary to the shareholders.

A director of a corporation can sell property to the corporation if the transaction is fair, reasonable, and at fair market value.

A stockholder has the right to inspect the books and records with 5 days’ notice. This request will be denied if the purpose can be shown to be for an unwarranted purpose not related to the shareholder’s corporate interest.

There is entity called a “professional corporation” that provides limited liability for professionals such as doctors, lawyers, and accountants. The limited liability is mostly for corporate debts, as each professional is still liable for their professional acts such as negligence when performing in a professional capacity.

Subchapter S: An “S-corp”

This entity type limits the effects of double taxation since it's a flow through entity. To elect S-corp status, the entity must meet certain requirements such as having less than 100 shareholders, and all shareholders must be individuals (some exceptions for estates and trusts), and no nonresident aliens can be shareholders (must be U.S. Citizen or resident). S-corps must stay below 100 or fewer shareholders to retain the S-corp status. S-corps also only have one class of stock.

Professional corporation (PC)

A special type of corporation aimed at professionals like attorneys and accountants that provides the limited liability and other benefits of the corporate form. These operate like a corporation.

Limited liability company (LLC)

This form provides limited liability, but the tax benefits of a flow through entity. The owners are known as “members” in an LLC. As part of the formation process for an LLC, there should be an “operating agreement” document. This should be in writing, and it maps out how things will work and how disputes will be resolved among the members of the LLC

Formation

LLCs must file registration documents with the state where formed. The documents include the articles of organization, and an operating agreement that outlines operations, members' profits allocations, etc.

If not specified in the operating agreement, profits are shared according to capital accounts.

Termination

LLC laws can vary widely state to state, much more than corporation laws or partnership laws. There can be terminating or dissolving events specified in the operating agreement that could cause an LLC to dissolve. Also, the consent of all members will dissolve an LLC, as can a court order for various reasons.

Area III: Federal Taxation of Property Transactions

Acquisition and Disposition of Assets

Basis and Holding Period of Assets

Assets for tax purposes, can be divided into 3 categories:

- Ordinary assets: Includes inventory, accounts receivable, and notes receivable
- Section 1231 assets: This includes depreciable property used in a trade or business that have been owned for more than a year
- Capital assets: Assets other than what is listed as ordinary assets or 1231 assets, and include property held for investment use or personal use. The keyword for capital assets is “investment”

The info in this segment is primarily for capital assets. Business assets (ordinary assets and 1231 assets) will be discussed in following segments.

The tax basis in an asset at its most simple is what you paid for it. Then, when it appreciates in value and you sell it, you’d have a gain, because you made a profit over what you’ve invested in that property.

To calculate the adjusted tax basis in a piece of property, the formula is:

Original cost of property (includes delivery costs, installation costs, etc)
+ Capital improvements (does not include repairs)
- Depreciation or amortization
= Adjusted basis

Example:

ABC corporation purchases a building for \$100,000. At the time of purchase they also make capital improvements of \$100,000. The basis in the building is now \$200,000. As they depreciate it over 20 years, the adjusted basis goes down by \$10,000 each year. So at the end of year 3, the adjusted basis is now \$170,000. If they sold it for \$200,000 at that point, ABC would have a gain of \$30,000.

Holding period

Holding period of an asset begins at acquisition and determines if a gain or loss is short-term or long-term. If the asset is held for a year or less and then sold, the gain or loss is short-term. If the asset is held for longer than a year and then sold, it's a long-term gain or loss. There are situations where the holding period of an asset will transfer to the new owner, and those will be covered in other sections. But in a standard transaction where an asset is acquired, the holding period will begin on the date of acquisition.

Holding period comes into play for gifted assets or assets received via inheritance.

Gifts

When property is received as a gift, there is a gain basis, and a loss basis. It's important to note that in general, property received as a gift or inheritance will be a capital asset, which is why the holding period matters... to determine if the gain or loss would be a short or long-term capital gain or loss.

Gain basis = the adjusted basis the donor had in the property.

This is also the depreciable basis.

The holding period includes the donor's holding period if the gain basis will be used to compute a gain. If the loss basis is used to compute a loss, then the holding period begins at the date the gift was received.

Loss basis = the lower of the FMV at the date of gift, or the adjusted basis of the donor.

A gain is only recognized if the property is later sold for more than the gain basis.

A loss is only recognized if the property is later sold for less than the loss basis.

If the property is sold for an amount between the gain and loss basis, there is no gain or loss recognized.

Example:

Ron bought an antique 10 years ago for \$10,000. Now the piece is worth \$20,000, and he gifts it to his son Ben. Ben's gain and loss basis in this case is \$10,000. However, if the piece was worth \$5,000 when Ron gifted it to Ben, then Ben's gain basis would be \$10,000 and his loss basis would be \$5,000 (the lower of FMV or the adjusted basis). If Ben sold the piece for \$12,000, he has a gain of \$2,000 which is a long-term capital gain because he takes over Ron's holding period. If he sells it for \$4,000 3 months after Ron gave it to him, he has a \$1,000 loss which is a short-term capital loss because the holding period began when Ben received the gift. And, if he sold the item for \$7,000, there would be no gain or loss because it's in between the gain and loss basis.

Inheritances

The basis in property received from an inheritance is the FMV at the date of death.

OR, if the “alternate valuation date” is used, then it is the FMV at 6 months after the date of death. These are the only two options for the FMV of inherited property.

As far as the holding period, it is always considered long-term for inherited property.

Taxable and Nontaxable Dispositions

Realized and Recognized Gains and Losses

Realized gains

When property is sold or disposed of, you compute the realized gain or loss.

Realized gain formula:

Amount realized - adjusted basis = realized gain or loss

“Amount realized” includes any cash received, plus the fair value of any property or services received, plus any liabilities assumed by the buyer, less selling expenses.

“Adjusted basis” is the cost of the property, including other factors such as improvements or depreciation (see previous section).

A recognized gain or loss is the amount of a realized gain or loss that is included in the taxable income of the taxpayer. So, a realized gain or

loss won't always be recognized - the gain, or part of the gain (or loss), could be deferred or excluded from taxable income for various reasons.

Example:

If ABC corporation has a piece of property with a basis of \$50,000 and they have a mortgage on it of \$30,000, and they sell it for \$60,000 cash and the buyer assumes the mortgage, the amount realized is \$90,000 (60,000 in cash and 30,000 of debt they got out of). The gain is \$40,000 (90,000 - their basis of \$50,000).

Remember that the recognized gain or loss will never exceed the realized gain or loss, but the realized gain or loss can be larger than the recognized gain or loss.

Like Kind Exchanges

The general rule is that when "like kind" property is exchanged, no gain is recognized unless boot is received. There are never losses with a like-kind exchange.

(Again, "recognized" means it is included in taxable income, it can be a realized gain but deferred and isn't included in taxable income until the property is sold.)

The only types of property that qualify for like-kind exchanges are business property and investment property. All realty or real property (real estate) is considered "like kind" for the purposes of like kind exchange rules. So if a building is exchanged for bare land, that is still a like kind exchange.

Inventory, stocks or bonds, CDs, and partnership interests do not qualify for like-kind exchanges.

“Boot” is cash or other non-qualifying property. If you exchange a piece of land for a smaller piece of land, some cash, and a vehicle, the cash and vehicle are boot. Debt relief is also boot, such as still owing \$2,000 on a vehicle- if the vehicle is exchanged and the other party assumes the \$2,000 of debt, that is a \$2,000 gain to you.

In a transaction involving boot, the recognized gain will be the lesser of the realized gain or the boot received.

Example:

ABC exchanges a building with a FMV of \$100,000 (basis of \$50,000) for a building worth \$75,000 and \$25,000 of cash. The realized gain is \$50,000 (ABC is coming out with \$50,000 more in equity than before), but the boot is the cash of \$25,000. So the recognized gain is the lesser of the realized gain and the boot received, so \$25,000. There would be a deferred gain of \$25,000.

Alternatively, let's say that ABC received a building worth \$25,000 and \$75,000 in cash. The realized gain is still \$50,000, but the boot is the cash of \$75,000. So in this case, the recognized gain is limited to the realized gain of \$50,000. And in this case, there is no deferred gain.

Remember there are no losses with like-kind exchanges. If you exchange a building worth 200k for a building worth 150k and that's the entire transaction, there would be no gain or loss even though the property values are different.

The holding period of like-kind property received takes the holding period of the property exchanged.

Amount and Character of Gains and Losses, and Netting Process (including installment sales)

Capital Gains and Losses

Remember that capital assets are assets that are not business assets or 1231 assets (depreciable assets or land used in a business). So this basically boils down to assets held as investments and personal assets. These are things like stocks, bonds, and real estate. Also, the goodwill of a corporation is a capital asset.

When a capital asset is sold, it will trigger either a capital gain or a capital loss.

A long-term capital gain or loss is for assets held for more than one year.

All long-term capital gains and losses are netted together.

A short-term capital gain or loss is for assets held for one year or less.

All short-term gains and losses are netted together.

The netting process:

You first net short-term gains and losses together, and long-term gains or losses together. Then you net the short-term gain or loss against the long-term gain or loss. The sum takes the character of whatever was larger.

Example:

ABC corporation has ordinary income of \$50,000. They had short-term capital gains of \$5,000 and short-term capital losses of \$2,000. They had long-term capital gains of \$2,000 and long-term capital losses of \$3,000.

So first we net short-term and long-term and we end up with: \$3,000 of short-term gain, and long-term loss of \$1,000. We then net these together and we have: \$2,000 of short-term capital gains, since the short-term was larger. Regardless of whether it's a corporation or an individual, short-term capital gains or losses would be added to ordinary income. So ABC corporation ends up with ordinary income of \$52,000.

However, if it was a long-term capital gain, it would still become part of ordinary income for a corporation, but an individual has a different(lower) tax rate on long-term capital gains.

If the net-short term and net long-term gains and losses are negative, then an individual can deduct this net capital loss from ordinary income up to \$3,000.

Net short-term capital gains are taxed as ordinary income for individuals and corporations.

Net long-term capital gains are taxed as ordinary income to corporations, but individuals have a separate tax rate for long-term capital gains.

A corporation's net capital losses are carried back 3 years and forward 5 years and can only be used to offset capital gains, but it cannot create a net operating loss, nor can capital losses reduce taxable income to the corporation. A corporation's unused net capital loss that is carried back or forwards is always treated as a short-term capital loss, whether or

not is was short-term when it was incurred.

So in a year where a corporation has a net capital loss, it cannot offset any ordinary income. It can only be carried back 3 years and forward 5 to offset capital gains.

Installment Sales

An installment sale is when you sell a capital asset to a buyer, and you receive at least one payment after the year in which the sale took place. All that is happening is the income from the sale is being spread out over two or more years instead of all at once.

If the asset sold was held for more than a year before the sale, then each payment results in long-term capital gains. But, if the asset was held for less than a year, then each payment is a short-term capital gain (ordinary income), even if the payments are spread across multiple years.

Also, each payment after the initial payment will have some amount of interest. And of course, it's not just the amount of each payment... the adjusted basis in the asset figures into what amount is actually a gain on each payment.

The formula is:

$$\text{Annual gain} = \frac{\text{Total Gain}}{\text{Contract Price}} \times \text{Annual Payment}$$

So in other words, each payment is just multiplied by the gain percentage of the total sales amount.

Example:

Ryan sells Ben his personal car that Ryan owned for 5 years previously. Ben pays Ryan \$1,000 upfront, and then payments of \$1,000 for 4 years afterwards, for 5 payments in total. Ryan had an adjusted basis of \$3,000 in the car. So Ryan's total gain is \$2,000, and $\$2,000 / \$5,000 = 40\%$. So on each subsequent payment, Ryan will have a long-term capital gain of \$400 (40% of each \$1,000 payment). This is example doesn't include the interest amounts. Any interest received with each payment is ordinary income to Ryan.

Note: The total gain is the selling price less any selling expenses, and less the adjusted basis in the asset.

So if Ryan had \$1,000 of selling expenses as part of this transaction, then the total gain would be just \$1,000, which would lower the yearly gain to 20%.

Depreciation: The problem might mention depreciation of the asset before it was sold, so remember that depreciation decreases basis. If the problem said that Ryan purchased the car for \$3,000 and had depreciated \$500, then his basis in the car is \$2,500, and that would change the solution.

Related Party Transactions (including imputed interest)

For the items listed below, a related party would be any of the following:

- Anyone within the direct family line of the taxpayer from grandparents down to children. Cousins, uncles, aunts, in-laws are not considered related.

- A corporation or partnership where more than 50% of the stock or capital interests is owned by the taxpayer.

There are several factors that come into play if an asset is sold to a related party:

Loss of capital gains treatment:

Whether or not you've held an asset for a year or more, when it's sold to a related party any gain is ordinary income.

Loss of installment sale status:

If the asset was sold to a related party, the installment method can't be used. The buyer can make yearly payments, but the taxpayer would need to report all the payments as a lump sum in the year of the sale and any applicable gain would be ordinary income and fully taxable.

No losses allowed:

No losses, short-term or long-term, are allowed to be recognized when an asset is sold to a related party. The buyer's basis will be the amount they paid for the asset, regardless of the seller's basis.

Like-kind exchange treatment:

If a like-kind exchange takes place with a related party, if the related party disposes of the asset within two years of the exchange, any gain from the original transaction is now taxable to the taxpayer.

Disposition of an asset to an unrelated third party that was purchased from a related party:

Let's say Bob sells stock he purchased for \$5,000 to his son Lance for \$4,000, the FMV. Bob can't recognize a loss. Then Lance goes and sells

it to an unrelated third party for \$4,500. Lance has a realized gain of \$500, but he doesn't have to recognize a gain on the sale to the extent of Bob's loss (\$1,000). This pattern is specific to related parties where the related buyer goes and sells the asset to an unrelated third party. If Lance sold the asset for less than \$4,000 - his basis - he could recognize the loss. Also, there is no tack-on of the holding period: If Lance sold the stock to the unrelated third party within a year of purchasing it from his father, then it would be a short-term capital loss for Lance.

Corporate Stock Ownership Percentages

There are rules for corporate stock ownership to determine if the parties are related for federal tax purposes. Two corporations would be related if the same person directly or indirectly owns more than 50% of the outstanding stock of both corporations. This can also be a partnership and a corporation, or an S-corp and a partnership... greater than 50% ownership in both entities would be considered related parties.

Computing direct ownership in a corporation:

Of shares owned / # of outstanding shares. If there are 100 outstanding shares and you own 10 of them, you own 10% of the corporation.

Computing indirect ownership in a corporation:

If a person (or entity) owns a certain percentage of stock in corporation A, and corporation A owns corporation B, then you multiply the percentage they own in A by the percentage A owns in B.

Example:

Ross owns 40% of ABC corp, and ABC corporation owns 50% of DEF corp. So, multiply Ross's 40% by ABC's 50%, which gives you 20%. So Ross indirectly owns 20% of DEF via his ownership of ABC stock.

Indirect ownership via relation

A person has constructive ownership of a corporation if certain family members own shares in a corporation. Family members means direct family: parents, siblings, half-siblings, spouse, children or grandchildren. Note that this does not include grandparents. If you are the grandparent and your grandchild owns the stock, it counts, but not the other way around.

In this case you add up any percentages different family members own.

Example:

If Jim's father owns 10% of ABC corp, and his wife owns 20% of ABC corp, then Jim is considered to own 30% of ABC corporation when determining related parties.

Imputed interest on loans to related parties

When one party makes a loan to a related party, there needs to be a minimum amount of interest charged. This is usually based on the applicable federal rate (AFR). If the interest charged in a related party loan is less than the AFR (or no interest at all), then the IRS treats the loan as if it had been made at the AFR, and then classifies this amount to as ordinary income to the lender.

Example:

Katy loans her son Drake \$50,000, interest-free. If the AFR is 2%, then Katy should be charging Drake at least 2% interest, or \$1,000 each year. The IRS would collect this amount from Katy as ordinary income.

Exception:

Loans less than \$10,000 between individuals isn't subject to these imputed interest rules.

Cost Recovery (depreciation, depletion, and amortization)

Depreciation

Depreciation acts as cost recovery, so there are rules as to what can be depreciated and how. Any discussion of depreciation is referring to assets used for business - personal use property is never depreciated. Any property placed in service after 1987(basically anything at this point) will be under the Modified Accelerated Cost Recovery System (MACRS).

Under the umbrella of depreciation, there are currently 3 "types" of depreciation:

- MACRS
- Section 179
- "Bonus" depreciation

Each of these is discussed in this section.

Also, it will help to understand a few definitions as they relate to rules regarding depreciation:

Personal Property

Also called “personalty”, this term can be confusing because it sounds like it’s referring to the property of an individual. Personal property means any property that is moveable, so any property besides real property or realty. This includes both tangible and intangible personal property. Also, whenever you’re talking about depreciation, it is for business use. So don’t get confused by the term “personal” if a depreciation problem refers to personal property. To be “business use”, the property must be used for business more than 50% of the time.

Under MACRS, the 200% declining balance is used for personalty (see useful lives section below).

The 200% declining balance depreciation is calculated as double the straight-line method each year, based on the book value of the asset (each year the book balance is reduced by the depreciation amount).

Mid-Year Convention

In general, when personal property is placed into service, the asset is treated as being placed into service at the mid-year point, regardless of when it is purchased. So when calculating depreciation on a problem, you’d be calculating 6 months of depreciation for the year the asset is put into service.

Note:

There is an exception to this when more than 40% of the assets placed into service that year were put into service in the last quarter of the year. When this happens, there is a mid-quarter convention that applies that treats the assets as placed into service at the midpoint of the

quarter in which the asset is put into service, regardless of which quarter. To say it another way, in a given year, if more than 40% of the assets that are put into service during the year happened in the 4th quarter, then the mid-quarter convention is used for all assets placed into service that year.

Real Property

Also called “realty”, this includes land, and anything affixed to land such as buildings, machinery, or crops.

Under MACRS, realty is depreciated using the straight-line method. Residential realty (houses, apartments) is depreciated over a 27.5-year period. Nonresidential realty (office building) is depreciated over a 39-year period.

Mid-Month Convention:

When real property is placed into service, the asset is treated as being placed into service at the midpoint of the month its placed into service.

Example:

If an office building that cost \$46,800 is placed into service on Aug 23, the depreciation for that first year is $\$46,800 / 39 = \$1,200$ per year, or \$100 per month, then you’d multiply it by 4.5 months (Sep, Oct, Nov, Dec, and half of Aug), which is \$450. The fact pattern is: nonresidential real property = 39-year straight line depreciation, using a mid-month convention.

MACRS Useful lives (recovery period) for common asset types:

3 years: Special tools for specific manufacturing applications

5 years: Computers, copy machines, cars & trucks

7 years: Office furniture & equipment, machinery

10 years: Water vessels

(The main ones you'll see questions on are 5- and 7-year assets. Just remember that electronics and vehicles are 5 year, and furniture and equipment are 7 year)

The 200% declining balance method is used for assets with MACRS recovery periods of 3,5,7, and 10 years. The 150% method is used for 15- and 20-year property.

Section 179

A section 179 election allows a taxpayer to expense a certain amount of business property instead of depreciating it. The amount allowed under 179 for 2020 is \$1,040,000. An important rule to remember is that the amount expensed cannot exceed business income. If the income rule limits a 179 expense, that amount can be carried forward.

Also, there is a dollar-for-dollar reduction on the total asset value put into service above \$2,590,000 in 2020.

Example:

If a business purchases a new software system for \$500,000, the entire amount could be expensed under section 179 UNLESS the company's income was less than \$500,000. Then the company could only expense the software up to the amount of taxable business income.

If the asset's price was \$3,090,000, then the amount expensed under 179 would be \$540,000 ($3,090,000 - 2,590,000 = 500,000$, then the full

\$1,040,000 deduction minus the \$500,000 = \$540,000)

Bonus Depreciation

Bonus depreciation is usually taken in addition to the section 179 deduction. It is for qualifying business equipment - equipment with a recovery period of 20 years or less and it does not apply to buildings, but it can be used for improvements to the interior of nonresidential property after the property has been placed into service. Bonus depreciation is 100% for 2020. This applies to new AND used qualifying property.

Example:

ABC purchases new equipment for \$4,040,000. ABC can expense the first \$1,040,000 via section 179 and use the 100% bonus depreciation for the remaining \$3,000,000.

1231 Assets and 1231, 1245, and 1250 Recapture

There are complicated rules about depreciation recapture when a business asset is sold or involuntarily disposed of. The basic idea is that the business has been taking depreciation on the asset, which lowers the basis in the asset. Then, when the asset is sold, the depreciation is “recaptured” by classifying all or part of the gain on the sale as income to the business.

1231 assets are assets used in a business that are also held longer than one year. They include realty and depreciable property, but it does NOT include capital assets, inventory, or accounts receivable.

When 1231 assets are sold, the gains and losses are netted together, if there's a net gain it's taxed as a long-term capital gain. If the gains and

losses net to an overall loss, then it's an ordinary loss.

But, within the 1231 assets there are rules for 1245 assets and 1250 assets. 1245 assets are depreciable personalty. 1250 assets are realty.

Under the umbrella of 1231, there are 2 types of recapture:

Section 1245: this takes gains on personalty (personal property) as ordinary income up to the amount of accumulated depreciation.

If you sell a piece of equipment for 200k that you purchased for 150k, and it has 50k of accumulated depreciation (so your basis is 100k), that 50k of accumulated depreciation would become ordinary income based on the 1245 rule. The remaining 50k gain would be a 1231 gain.

Section 1250: this is a recapture of accumulated accelerated depreciation on buildings in excess of straight-line depreciation as ordinary income.

Netting 1231 Gains & Losses

To the extent that 1231 gains exceed 1231 losses, the net gain is treated as a long-term capital gain.

If 1231 losses exceed 1231 gains, the loss is deductible as an ordinary loss.

1231 Lookback provision

There is a 1231 provision that says 1231 gains must be offset by net 1231 losses going back 5 years that have not previously been recaptured. Any gains that can be "absorbed" by previous 1231 losses are treated as ordinary income.

Example:

If you have a 50k 1231 gain in the current year, but in the last 5 years you have 20k of unabsorbed 1231 losses, that 20k is absorbed by the 50k gain this year, and the 20k is ordinary income. The remaining 30k is a 1231 gain.

Amortization

Intangible assets are amortized instead of depreciated - though the concept is the same: expensing the cost over a period of time.

Start-up costs

\$5,000 of startup costs or organizational expenses can be expensed immediately, and the remaining amount is amortized over 15 years. There is a cap of \$50,000, and any startup costs above \$50,000 reduces the allowed \$5,000 dollar for dollar. So, if a company has \$55,000 in startup costs, they need to amortize the entire amount and can't immediately expense any.

Qualified intangibles

Qualified intangibles are the common types of intangible assets, and they are amortized over a 15-year period. It's important to note that these are intangibles that are acquired. These include acquired goodwill (created goodwill is a capital asset), patents, copyrights, customer lists, trademarks, and licenses or permits.

When a patent is created, then it is amortized over its useful life, which is usually 17 years. It can be deducted early in the year it becomes obsolete.

Depletion

This is the same idea as depreciation or amortization but applied to a natural resource property.

The formula for calculating yearly depletion is:

$$\frac{\text{Adjusted basis in property}}{\text{Estimated units of mineral}} \times \text{Mineral units sold}$$

The total deductions allowed are limited to the unrecovered capital investment in the property.

Estate and Gift Taxation

Transfers Subject to Gift Tax

When you give away property while you're alive, that transfer is subject to the gift tax. The gift tax is placed on the giver of the gift.

When property is transferred as a result of your death, that transfer is subject to the estate tax (covered in next section).

When a gift is made, the value of the gift is the FMV of the property. Gift tax is reported using Form 709.

Type of gifts that are subject to the gift tax:

- Cash
- Property
- Debt that is forgiven to a family member or friend

The gift has to be accessible and usable to the recipient. If you put money in a bank account for your grandson, it's not a gift until the grandson takes money out to use for his benefit.

There is a \$15,000 exclusion per recipient, so you can give away 10 gifts of \$15,000, or 100 gifts of \$15,000 tax free as long as each gift is to different recipients. Couples can elect gift-splitting, which means a couple can give gifts of double the annual exclusion, and each gift is treated as being half from the husband, half from the wife. Electing gift-splitting requires Form 709 to be filed.

Example:

Ron and Mary gift property worth \$40,000 to their son Jon. They elect gift-splitting and file Form 709. For tax purposes, the gift is first divided

in half, so treated as a gift of \$20,000 each, and they each get to apply the \$15,000 exclusion. This results in a taxable gift of \$5,000 each (20,000 - 15,000 exclusion). Note that if they had not elected gift-splitting and it was just Ron gifting the property, then Ron would be paying taxes on \$25,000 (40,000 - 15,000).

When is Form 709 required?

Whenever there is a taxable gift made that doesn't fall within one of the exclusions, Form 709 needs to be filed:

- Anytime a gift is made that is larger than the annual \$15,000 exclusion
- When a couple elects gift-splitting

If no gift is larger than the annual exclusion, or the only gift made was excluded due to it being a gift for tuition or medical payments, then filing Form 709 is not required.

The gift tax return is due April 15th following the year in which the gift was made.

Gift Tax Annual Exclusion and Gift Tax Deductions

Gift Tax Exclusions & Deductions

Annual Exclusion:

The annual gift exclusion is \$15,000 for 2020. Remember that a married couple can elect gift splitting which combines the exclusion to \$30,000. Gifts of less than \$15,000 cannot offset gifts of more than \$15,000 to other recipients.

Education Exclusion:

There is an unlimited exclusion for education gifts if the gift is for

tuition and is paid directly to the school. The educational institution generally needs to be in the United States. The exclusion does NOT apply to room and board.

Medical Exclusion:

There is an unlimited exclusion for medical gifts if the gift is paid directly to the medical provider.

Deductions:

Note that “deduction” means deduction from the amount of gift tax owed. It is not a deduction from taxable income if you give a gift to your spouse or a charitable organization.

Marital Deduction:

There is an unlimited exclusion for gifts to spouses, as long as the couple is married at the time of the gift.

Charitable Contribution Deduction:

There is an unlimited exclusion when property is gifted to a charitable organization.

Determination of Taxable Estate

Estate Tax

In general, a person won't pay estate taxes unless their estate is worth more than \$11,580,000 in 2020. The estate tax return doesn't need to be filed unless the gross estate value is larger than this amount.

The value of property received from an estate will be one of two things: 1) the FMV of the property at the date of death. Or 2) the executor of an estate can choose the “alternate valuation date”, then the assets in a decedent's estate will be valued 6 months from the date of death, on

the date of disposition. This is instead of being valued at the date of death. This election is only allowed if it causes the value of the gross estate and tax payable to decline.

One exception to the FMV rule.

If property is gifted by A to B, and then the property transfers back to A due to the death of the B, A takes the basis of the property in the hands of B (which will be the A's original basis in the property).

Example:

Jon gifts stock to Mary when the FMV of the stock is \$10,000. Jon's basis in the stock is \$7,000. A year later the stock's value has gone up to \$15,000 and Mary dies and leaves the stock to Jon. Jon's basis in the stock isn't the FMV, it is his original basis of \$7,000.

Marital Deduction

If the decedent is married, their estate can pass tax-free to the surviving spouse. When that spouse dies the estate would become subject to the estate tax. The surviving spouse must be a US citizen for this to apply.

Property Jointly Owned at Death

For a married couple that jointly owns their property, when one spouse dies half of the value of all assets is included in the estate of the first spouse to die.

If property was held by tenancy in common, then the FMV of the decedent's share is included.

If joint tenancy in property was acquired through a gift or inheritance,

then the decedent's share is included.

If a decedent had joint ownership in property through a purchase in a non-spouse relationship, you would take the percentage of the cost furnished by the decedent to determine what portion of the property's value to include in the decedent's estate.

Example:

Jon and Joyce (friends) own land together in joint tenancy. They originally bought the land for \$20,000, of which Jon paid \$15,000 and Joyce paid \$5,000. When Joyce died, the property was worth \$100,000. Since Joyce paid 25% of the cost of the property, \$25,000 would be the amount included in her estate.

Admin expenses and selling expenses can be deducted from a decedent's gross estate.

Charitable contributions and funeral expenses are also deductible from the gross estate.

Medical expenses paid within one year of death can either be deducted on the estate tax return or the final tax return of the decedent.

An estate tax return is due 9 months after the date of death, but only if the decedent's gross estate was valued at more than cutoff amount. The estate tax return is Form 706.

Area IV: Federal Taxation of Individuals

Gross Income

Gross income

Gross income is an individual's total personal income, before taxes and deductions. The general rule is that any increase to an individual will be included in taxable income, unless there is a specific exclusion in the tax law. For example, if a person is unemployed and receives unemployment compensation from the state, it might seem like that wouldn't be taxable income, but it is an increase to the individual and replaces wages they would earn if working, so it is taxable income.

Income doesn't just mean receiving cash... again, any increase to a taxpayer results in income, which - unless there's a specific rule that excludes it - will be taxable income.

Example:

Bill is a dentist and Ted is an artist. Bill and Ted agree to trade services: Bill cleans Ted's teeth and Ted paints a mural in Bill's living room. Bill's services are valued at \$100, and Ted's services are valued at \$200. Bill would include \$200 in his taxable income, even though they "traded" services - Bill recognizes the fair market value of Ted's services as income. Ted would include \$100 in his taxable income.

Questions Tip

With questions on what should be included in taxable income - and these can be asked in a lot of ways, the value to be included will almost always be equal to the fair market value of whatever has been received.

Constructive receipt: This means a taxpayer is required to include in

gross income the value of property in the period which they gained the right to the property, or when the recipient of the income has “control” over it. So, any income that is actually received or “constructively received” in a given year should be included in gross income. If an exact amount of accrued income can’t be determined, then the income should be included in taxable income in the year in which the exact amount can be established.

A cash basis tax payer should report income in the year in which income is actually OR constructively received.

Example:

Tom is attorney and is owed \$10,000 by a client. Tom accepts a piece of art worth \$9,000 in full satisfaction of the obligation. Tom would include \$9,000 in his taxable income.

An accrual basis taxpayer includes income when they have the right to receive the income, or, once it has been earned. If the amount of an income item is based on an estimate, and the actual amount is more than was reported for the estimate, the difference would be reported in the year when the exact amount was determined.

Example:

In 20X8 Ted reported \$10,000 of income based on a reasonable estimate. The actual amount received from the same transaction actually ended up being \$15,000 in 20X9, so Ted included an additional \$5,000 of income on his 20X9 return.

Tax-benefit rule: If a taxpayer deducted an item, such as a casualty loss in a prior period, and then ends up receiving the money in a later year, the reimbursement needs to be included in income because the original expense provided a tax benefit.

Example:

Brad had part of his home destroyed by a fire. The amount of damage was \$50,000. The insurance company disputed the cause of the fire and it wasn't until two years later that Brad received the \$50,000 reimbursement. In the year of the fire Brad deducted the \$50,000 as a casualty loss, but two years later when he received the \$50,000, he would need to include the \$50,000 in his gross income.

Interest Income

In general, any interest income will be included in taxable income unless it is specifically excluded (see excluded items below).

Interest received on US Treasury certificates is NOT exempt from federal income taxes. Also, interest received on a tax refund is taxable income. The refund itself is not taxable, but any interest received on the refund is taxable.

Interest income on state obligations or most municipal bonds is tax exempt, such as state or county bonds.

Interest on redeeming EE savings bonds can be excluded from income if the bonds were issued after the taxpayer's 24th birthday, the taxpayer is the sole owner of the bonds, and the taxpayer incurred higher education expenses for themselves, a spouse, or a dependent in the year of redemption.

Interest income on personal injury awards is taxable interest income.

Income from Rental Property

Income from rental property is included in gross income. Note that even rent received in advance is included in the year received.

A deposit is not included until the landlord is entitled to the funds, such

as when the tenant moves out and the landlord finds damage that will use up the deposit. If a renter barter services in exchange for free rent, the amount of rent would still be included as income to the landlord.

Note: if a personal dwelling is rented out for less than 15 days per year, then the rental income does not have to be included in gross income. This also goes the other way: no deductions for rental use are allowed on a property rented out less than 15 days a year.

If a taxpayer receives a gift/donation of property and then gifts the same property to a charitable organization, the taxpayer will add the fair market value of the property received to their gross income AND deduct the same amount as a charitable contribution.

Unemployment compensation is included in taxable income.

If a taxpayer accepts services instead of a cash payment, the amount included in gross income would be the FMV of the services.

If an income item is accrued as an estimate, and then a larger amount is actually received in a following year, the difference is taxable in the year received.

Debt that is forgiven is considered income to the taxpayer, unless the debt was forgiven as a gift, then it's not taxable.

Taxation of Employee Benefits

The value of an employee discount can be excluded from income if:

- The value is up to 20% of services
- OR, no more than the average gross profit percentage for goods

Certain insurance premiums that are paid by the employer for the employee can be excluded from the employee's income such as:

- Group term life insurance up to \$50,000 of coverage (remember that amounts above 50k of coverage will be taxable)
- Health insurance premiums
- Disability insurance premiums

The following types of fringe benefits can be excluded from an employee's income:

- Meals and lodging for the convenience of the employer
- Working condition expenses: These are benefits provided by the employer that would be deductible if the employee had paid the expense. Also, if the cost is reimbursed by the employer it is also excluded from income
- De minimus fringes
- Employee discounts
- Employee gifts under \$25
- Safety or achievement awards

Exclusions from Gross Income

Gifts received are excluded from income. However, "gifts" from employer to employee constitute compensation and are included in gross income.

Scholarships are not taxable up to the amount of tuition and expenses. Scholarship money used on room and board is taxable income. The student cannot be required to work as part of the scholarship, if they are then the money is taxable.

After 2018, child support and alimony is NOT taxable to the recipient, and there is NO deduction for the payer. Also, property settlements as part of a divorce (getting the house) is not taxable.

Money received as compensation for physical injuries or sickness (worker's comp) are excluded from income.

Stock and Dividend Splits

These are not a taxable event because no new property is received. But, the taxpayer must adjust their basis in each share. IF there is even an option to receive cash, such as "you can choose \$100 or 10 more shares", then the event triggers income to all recipients, regardless of whether recipients choose cash or more shares.

However, regular dividends received are gross income. Also, if a person has access to a company stock purchase plan that lets them purchase stock at a discount, the difference between the FMV of shares purchased and the discounted amount is included in gross income.

Example:

Tom can purchase discounted shares of stock from the company he works for. When the market share price of the stock is \$100 per share, Tom buys 10 shares at his discounted price of \$90 per share. Tom would recognize \$100 of gross income on this transaction.

If a person receives an award for achievement without any action on their part, it can be excluded from gross income only if they assign it to charity. Otherwise, the reward is taxable.

Life Insurance Proceeds

Proceeds from life insurance due to the death of the insured are excluded from income. Also, dividends received from a life insurance policy are not taxable up to the amount of premiums paid. You might see questions that ask about the taxable amount if the policy is sold to another individual other than the original beneficiary. In this case, the policy is an investment to the new buyer of the policy and the regular basis and gains would apply. The proceeds are only non-taxable to the

original and intended beneficiary.

Example: Tom purchased a \$100,000 life insurance policy on one of his parents, and then sold the policy to Dave for \$10,000. And then Dave ends up paying premiums of \$15,000 until the parent dies. Dave would have a cost basis in the policy of \$25,000, so he would include \$75,000 from the proceeds in his gross income.

Jury Duty

If an employee is required to give the employer any funds paid to them for jury duty in exchange for regular payment from the employer, the jury duty funds given to the employer would be deducted from gross income to arrive at adjusted gross income.

Reporting of Items from Pass-Through Entities

Dividend's received by a taxpayer who is a shareholder in the business will be dividend income as long as the business has earnings & profits. If there is no E&P for the year, then dividends are considered a return of capital. After an owner has received all their capital back, then any dividends received are classified as a capital gain.

Stock dividends on common stock are not taxable, but stock dividends as part of preferred stock are taxable.

Remember that in a stock dividend, if there is the option to receive cash instead of shares, that will be a taxable dividend.

Flow Through from Partnerships / S-corps / LLCs

Remember that a partnership/S-corp doesn't pay any taxes - the transactions flow through to each partner's (or shareholder's) individual taxes. Each partner receives their distributive share of partnership income based on the partnership agreement.

Within a partnership or S-corp, there are transactions that occur in the ordinary course of business, and these results in ordinary income or losses. Then, there are “separately stated” transactions such as charitable contributions, a section 179 write-off, gains and losses on sale of equipment, rental activities, or tax credits. Then each partner’s share of the ordinary income is passed through to the individual, but then also each partner’s share of the separately stated items will pass through.

A partner’s share of the ordinary income from a partnership is reported on Form K-1 and is included in his/her gross income. Then, capital gains/losses or deductions retain their character when they flow through to the partner (from the separately stated items). A partner can only deduct partnership losses up to the extent of their basis in the partnership.

Income example:

ABC partnership has two partners, Mark and Marvin. ABC generated net income of \$100,000. \$50,000 is reported on Mark’s K-1, and the same on Marvin’s K-1. Then, Mark and Marvin each report \$50,000 as gross income on their respective 1040s.

Loss example:

Fred is a 100% shareholder in an S-corp, and he has basis in the S-corp of \$10,000. By December the business has net income of \$20,000, but Fred takes a salary of \$60,000 for the year, which results in the business having a loss of \$40,000. On his 1040, Fred reports income of \$60,000, but can only deduct a loss of \$10,000, which is his basis in the S-corp.

Adjustments and Deductions to Arrive at Adjusted Gross Income and Taxable Income

Deductions can either be deductions FOR AGI or deductions FROM AGI. Deductions for AGI are items that lower your gross income to arrive at AGI, and once you know what your AGI is, then there might be some deductions from AGI that apply. Deductions from AGI are also known as itemized deductions.

Deductions for AGI

These are the “for AGI” deductions, which are subtracted from gross income (all income) to arrive at adjusted gross income (AGI). These are also called “above the line” items:

- Trade or business expenses
- Rent or royalty expenses
- 50% of self-employment tax
- 100% of medical insurance premiums if self-employed
- Contributions to retirement plans
- Contributions to health savings accounts (HSAs)
- Student loan interest: this is limited to \$2,500 of interest on student loans in one year. Deduction phases out for married taxpayers with AGI over \$140,000 if married filing jointly, \$70,000 if filing single
- Moving expenses are no longer deductible. TCJA suspended any deductions for moving expenses, except for members of the Armed Forces

Question Tip

Remember the difference between being a “for AGI” deduction vs a “from AGI” deduction. You might see a question that lists several deduction items that asks which ones are deductible if the taxpayer is itemizing, and it will frequently include a portion of the self-employment tax. This would not be included in itemizing deductions, since the

deduction for half of the self-employment tax is an above-the-line deduction to arrive at AGI.

Retirement Plans

Contributions to retirement plans are usually pre-tax, or above the line deductions, so they reduce income to arrive at AGI. (Unless they are the ROTH version)

The maximum contribution that can be made to a 401(k) plan to reduce taxable salary is \$19,500 in 2020, plus another \$6,500 for ages 50 and older.

The maximum contribution that can be made to a Traditional or Roth IRA in 2020 is \$6,000. It's \$7,000 for those 50 and older. Note these amounts are combined - you can contribute \$6,000 total among traditional or Roth IRA accounts.

Traditional IRAs

Contributions to a Traditional IRA are deductible, as long as the taxpayer has AGI below certain levels.

If a taxpayer withdraws funds from a traditional IRA early and no exceptions apply, then there is a 10% penalty tax on the amount withdrawn.

Roth IRAs

Contributions to a Roth IRA are not deductible. Contributions are made with "after tax" dollars.

"Late" IRA contributions can be made up until the due date of that year's tax return (April 15). This means you're allowed to contribute towards your \$6,000 for 2020 up until April 15th of 2021. Even if an extension is filed, the original due date of the return is the last day to

make a late contribution.

HSA Contributions

If a taxpayer has HSA-qualified health insurance, they can contribute pre-tax dollars to a Health Savings Account and deduct the contributions to arrive at AGI. Money taken out must be used on qualified medical expenses, or it's subject to a 20% penalty.

The contribution limits for 2020 are \$7,100 for families, and \$3,550 for single taxpayers.

Pensions

Payments on annuities and pensions are excludable from taxable income to the extent they are a return of capital.

Whatever the employee contributed will be considered to be recovered pro rata over the life of the payouts.

Example

Wesley paid in \$24,000 to his pension over his time as an employee. After he retired, his life expectancy was 20 years. As he receives the payments, he would be able to exclude \$100 of each monthly payment over the 20 years, since his \$24,000 divided over 240 months = \$100 per month.

Itemized Deductions, or Deductions “From” AGI

There are several types of personal expenses that qualify as itemized deductions:

Medical expenses: Only medical expenses in excess of 10% of AGI are

allowable as a deduction. These are medical costs that were not reimbursed or covered by insurance. Costs for doctors, eyeglasses, dentists, health insurance, prescribed drugs, medical transportation and travel up to \$50 per night per person (\$100 per night if it's a parent traveling with a sick child), and the costs of altering the home for handicapped persons are deductible.

This includes any of the costs that are paid with borrowed funds, such as on a credit card in December and paying the card off in January of the next year- the deduction is still claimed in the year the cost was incurred.

Deductible medical expenses include medical expenses paid for the taxpayers, and expenses paid for dependents, and for individuals qualifying as a dependent, even though a dependency exemption can't be claimed based on their income.

Example

Rick and Jan had medical expenses of \$7,000 during 20X8. They also paid \$2,000 of medical expenses for Rick's mother, who lives full-time with Rick and Jan. Rick's mother has income of \$5,000 for 20X8. In this situation, Rick's mother is a qualifying dependent even though they can't claim a dependency exemption because she has gross income above the limit for a dependent \$4,300 in 2020.

Cosmetic surgeries are not deductible unless the surgery is medically necessary, such as facial reconstruction resulting from an accident.

Deductible qualified residence interest: For home mortgage interest, interest paid on debt relating to the principal residence and a second home is deductible. The deduction is limited to interest on a total indebtedness of up to \$750,000 to purchase, construct, or substantially improve a residence. Interest on home equity loans is not deductible,

unless it is to substantially improve the home, and fits within the \$750,000 of allowable indebtedness.

If a taxpayer pays a penalty for early repayment of mortgage, the penalty is also deductible when computing itemized deductions.

Note: The \$1 million mortgage will still be deductible if incurred before Dec 15, 2017.

State Income Tax and Property Taxes

Personal income taxes imposed by state, local, or foreign governments are deductible, including property taxes for real property. Tax penalties such as interest on a tax deficiency, or a late filing penalty are not deductible.

Only \$10,000 of state income taxes and/or property taxes are deductible for 2020.

For state taxes paid during the year, the deduction is equal to what was actually paid in the calendar year the return is for.

Example:

In 20X8 Karen made estimated state income tax payments of \$300 on the 15th of April, June, September, and then another \$300 on January 15th of 20X9. Her deduction for state income taxes on her 20X8 return would be the \$900 actually paid. The January payment would be deductible on her 20X9 return.

Question Tip

If you see a question where property is being sold and one party pays all of the property taxes for the year as part of the sale, the taxpayer in

question can only deduct the portion of the property taxes allocated to how much of the year they owned the property.

Charitable contributions: Contributions must be made to a qualifying organization (randomly giving money to a 'needy family' doesn't count).

Contributions can be cash or property but not services. Written records of contributions are required. The deduction for contribution of property is limited to 50% of AGI. Beginning in 2018, cash contributions of up to 60% of AGI can be deducted.

IF the contribution is something containing a long-term gain such as stock that has appreciated in value, then the deduction is limited to 30% of AGI. If your AGI is 100k, and you donate stock that you bought for 20k but is now worth 40k, you can only deduct 30k.

Casualty Losses

Casualty losses are for unreimbursed losses from a federally declared disaster.

The deduction is equal to:

The lower of the decline in FMV or the adjusted basis in the property

Less: Insurance reimbursement

Less: \$100 floor per casualty

Less: 10% of AGI

= The casualty loss deduction

Employee Business Travel Expenses

- Business travel expenses that are deductible are limited to trips that the primary purpose is business
- The amount and purpose must be substantiated
- Meals and lodging "away from home overnight" are deductible
- Only 50% of the meal costs are deductible

Entertainment Deductions

- Starting in 2018, entertainment business expenses are no longer deductible.

Business Gifts

A business gift of \$25 per customer is deductible. If multiple gifts of varying values are given, gifts less than \$25 per customer are counted at their value, and any gifts above \$25 are calculated at just \$25 each. So if you gave 5 gifts worth \$5 each and 5 gifts worth \$50 each, you can only deduct \$25 total for the \$5 gifts, and \$125 for the \$50 gifts. You don't get to "move" the excess value in gifts to the cheaper gifts to make a larger deduction.

Qualified Business Income Deduction

The TCJA added a new deduction for qualified business income (QBI). The deduction is generally 20% of a taxpayer's QBI from a partnership, S-corp, or sole proprietorship.

QBI is defined as the net amount of income, gain, deduction, or loss relating to any qualified business or trade of the taxpayer.

Employee compensation and guaranteed payments to a partner are excluded.

The QBI deduction is taken AFTER determining AGI but BEFORE any itemized deductions. So it's not a deduction FOR AGI, and it's not an itemized deduction.

Important:

For these QBI deduction questions, types of businesses the "business income" comes from is basically divided into two types:

- Qualified business: Any business that is not a “specified service trades or business”
- Specified service trade or business (SSTB)

Specified Service Trade or Business (SSTB)

Taxpayers in certain service-related businesses are eligible for the deduction, but only up to certain income levels. These service-related businesses include healthcare professionals, attorneys, accountants, performing artists, consultants, financial service professionals, or any business where the principal asset is the reputation or skill of one or more of its employees.

If the business is a SSTB, the deduction is only allowed if taxable income is less than \$426,600 filing joint, or \$213,300 filing single. See the “phase-in” below.

Taxpayers with income less than \$326,600 joint or \$163,300 single:

Whether the taxpayer has QBI from a SSTB or not, if their taxable income is below these levels, then the QBI calculation is the lesser of:

- The combined QBI of the taxpayer, or
- 20% of their taxable income, less net capital gains

Example

Kelly has sole proprietorship selling golf balls. She has one employee who is paid \$50,000 during 20X7. The income from the business is \$200,000, and on her joint return, Kelly has taxable income of \$300,000. Since Kelly’s income is below the \$326,600 cutoff, her QBI deduction is the lesser of:

- *20% of \$200,000 = \$40,000*
- *20% of \$300,000 = \$60,000*

So Kelly’s deduction is \$40,000.

The \$100,000 Limitation Phase-In:

For taxpayers with income above the \$326,600 joint & \$163,300 single levels, there is a limitation phase-in over the next \$100,000 of taxable income for married filing jointly, and the next \$50,000 for filing single. So this means between \$326,600 to \$426,600 for married filing jointly, and between \$163,300 to \$213,300 filing single. This again is whether or not the income is from a qualified business or a SSTB.

The calculation (which is determining a percentage) is:

$$20\% - \left[\left(\frac{\text{Income over \$326,600 limit}}{\$100,000} \right) \times 20\% \right]$$

(above uses joint return limits for the example)

Example

Take the example above but say Kelly's income is \$376,600.

The calculation would be:

$$20\% - \left[\left(\frac{\$376,600 - \$326,600}{\$100,000} \right) \times 20\% \right]$$

Which is:

$$20\% - \left[\left(\frac{\$50,000}{\$100,000} \right) \times 20\% \right] = 20\% - (0.5 \times 0.2) = 20\% - 10\% = 10\%$$

You then take this 10% and multiply it by her QBI of \$200,000 which makes her deduction = \$20,000.

QBI Wage Limitation

Once the taxpayer's taxable income gets above \$426,600 filing jointly or \$213,300 filing single, if the business is a SSTB, there is no QBI deduction whatsoever.

If the income is from a qualified business, then the deduction is based on the following wages limitation:

The deduction for each business will be the lesser of:

- 1) 20% of the QBI with respect to the trade or business
- 2) The greater of:
 - A) 50% of the W2 wages paid by the business
 - B) 25% of the W2 wages paid by the business + 2.5% of the unadjusted basis of qualified property immediately after acquisition (meaning prior to depreciation)

Example

Let's use Kelly's example, but say her taxable income is \$450,000, and the business has \$100,000 unadjusted basis in qualified property. Remember the business paid \$50,000 in wages to an employee.

Her QBI deduction would be the greater of:

- *50% of the wages paid, or \$25,000, or*
- *25% of the wages paid (\$12,500) + 2.5% of unadjusted basis in \$100,000 of qualified property (\$2,500) = \$15,000*

So Kelly's QBI deduction is \$20,000, because the 20% of business income is less than \$25,000 of wages paid. Also, notice in the 3 examples how Kelly's QBI deduction gets smaller as her taxable income increases... which is the whole point.

Passive Activity Losses

Passive activity losses

A passive activity is rental real estate or a business in which the taxpayer doesn't materially participate. The test for "materially participating" is putting in over 500 hours in the year, or at least 100 hours but is more time than anyone else in the business.

However, don't get a "passive activity" confused with "portfolio income". You'll often see questions where it lists several sources of income and/or losses, and you need to know the difference. Portfolio income is investment income or interest income from stocks, capital gains, etc. Passive activities are business ventures where the taxpayer doesn't materially participate, such as rental real estate or being a limited partner in a partnership.

Passive activity limitations apply to individuals, estates, trusts, closely held C corps, and personal service corporations.

In general, passive activity losses will be limited to the income generated from the activity.

However, passive losses from one activity can offset income from a different passive activity. Remember that "portfolio income" doesn't offset passive losses. For example, partner's share of interest income doesn't offset their share of a passive loss amount.

If a taxpayer has excess passive activity losses in one year, they can be carried forward and used in future years when there is passive activity income, or until the property is disposed of in a taxable transaction.

For passive activity losses, they are only deductible up to the amount of income from passive activities.

Example:

Amy is a limited partner in a partnership and her interest in the partnership results in a \$5,000 loss for the year. This loss is not deductible to Amy since there is no income attributable to the passive activity.

However, suspended losses and current-year losses are fully deductible in the year in which the taxpayer fully disposes of all interest in the passive activity.

Example:

If Amy disposes of her partnership interest in the same year as the \$5,000 loss, then the loss would be fully deductible. If she had a loss carryover of \$10,000 in the partnership, then she would be able to deduct \$15,000 from other sources of income for the year.

Rental real estate losses: If a taxpayer has passive losses from rental real estate, then the deductible amount is limited to \$25k of losses in one year (the person must own at least 10% of the rental activity and actively participate).

IF the taxpayer's AGI is above 100k, then the 25k is reduced by 50% of the taxpayer's AGI above 100k. That means that at \$150,000 of gross income, there would be no deduction.

Exception for Real Estate Professionals

The passive activity limitations don't apply to a rental real estate activity IF:

1) More than half of the individual's personal services during the year were performed in real property trades or businesses in which the individual materially participates, and 2) the individual spends more than 750 hours performing real property trades or in businesses in

which the individual materially participates.

Loss Limitations

Casualty & Theft Losses

Casualty and theft losses are disallowed by TCJA unless they are attributable to federally declared disaster areas.

Losses and Bad Debt

To deduct non-business bad debt:

- It must be an actual loan
- It is deductible as a short-term capital loss in the year it is determined to be completely worthless
- Partial worthlessness is NOT deductible

To deduct business bad debts:

- Only the direct write off method is allowed
- It is deducted to the extent the loan is partially worthless

Deducting worthless assets:

- The asset must be totally useless
- It is treated as sold for no consideration on the last day of the taxable year
- Worthless securities receive capital loss treatment for individuals, but they are an ordinary loss if incurred by a corporation when investing in 80% or more in another corporation (an affiliated corporation)

Capital Losses

If a taxpayer has net capital losses in a year, up to \$3,000 of capital losses can be deducted against ordinary income, and the rest is carried forward indefinitely.

Net Operating Losses

NOLs have no carryback period, and can now be carried forward indefinitely. When the NOL is applied, it can only be applied in a given year up to 80% of income, and the rest is carried forward. Note that NOLs are only associated with conducting a trade or business, so the amounts are separate from nonbusiness(personal) income and deduction items.

Example:

Art had business losses of \$100,000 in 20X6. In 20X7, Art had taxable income of \$100,000. Art can apply the NOL, but only in the amount of 80% of his current year income. So he'll have a deduction of \$80,000, and will have a NOL carryforward of \$20,000 remaining.

Excess Business Losses

Losses for a non-corporate taxpayer that exceed \$500,000 married filing jointly (\$250,000 single) are disallowed in the year they occur, and they are added to the taxpayer's NOL carryforward.

At-Risk Loss Limitations

This is a rule that limits losses to the amount that is "at risk" in an activity. If you have a passive investment of \$20,000 and it loses \$5,000 per year, you can only claim that loss for 4 years ($4 \times \$5,000 = \$20,000$), when the loss equals your "at risk" amount.

The general rule is that a taxpayer is considered "at risk" for the amount of cash they've contributed to an activity, the adjusted basis of property they've contributed, or any debt they are personally liable for they've taken on as part of the activity. Debt secured by property used in the activity usually isn't considered when calculating the "at risk" amount. Although debt secured by property NOT used in the activity is considered "at risk", for example, taking out a loan secured by your

home to start a business - that amount would be “at risk”.

Example:

Max starts a painting business, and contributes \$5,000 of cash, \$10,000 of equipment he has a basis in of \$5,000, and he takes out a personal loan for \$10,000, and then takes out another loan of \$10,000 secured by equipment he uses in the business.

Under these circumstances, Max’s “at risk” amount includes the \$5,000 of cash, his \$5,000 of basis in the equipment contributed, and the \$10,000 personal loan, for a total of \$20,000. Max is not considered “at risk” for the loan secured by the equipment. Note if the \$10,000 loan would have been secured by Max’s home, then it would be included in the “at risk” amount.

Gambling Losses

Gambling losses can only be deducted up to the amount of gambling winnings. If you lost \$5,000 during the year gambling, and won \$2,000, you are only allowed to deduct \$2,000 of losses. Under TCJA, expenses related to gambling - such as traveling to and from a casino - can also be included in your “losses”, but only up to the amount of winnings. With the previous example, if you spent \$100 getting to and from the casino, you could deduct \$2,100 from your \$5,000 of winnings.

Filing Status

Personal Exemptions

Personal exemptions were disallowed by TCJA. However, you still need to know how to identify dependents because other things apply based on dependents, such as the head of household filing status (see below) and tax credits (see Computation of Tax Credits section).

Going along with this, the standard deductions were increased. See below.

Types of Filing Status

Married filing jointly: Married status is determined on the last day of the year, or the last day the taxpayer is alive. Note that a husband and wife can still file jointly even if they have different accounting methods. A couple can be living separately but still file jointly if they agree. If, on the last day of the year, they are divorced or legally separated, then they would each file as single, unless head of household applies.

Married filing separate: There are rules that prevent taxpayers from benefitting by filing separately, such as that neither spouse filing separately can claim the earned income credit, an education credit, or the child credit and/or the credit for other dependents.

Surviving spouse: A surviving spouse can use the joint rates for two years after the spouse passed away. The surviving spouse must provide more than 50% of the costs of maintaining the household for a dependent child, stepchild, or adopted child. In the year of the death of the spouse, the surviving taxpayer will file “married filing jointly”, and then the next two years will be filed as “surviving spouse”, which again allows them to use the same standard deduction as “married filing jointly”.

Abandoned Spouse: A married taxpayer can file as if they aren’t married if their spouse hasn’t lived in the house for at least 6 months out of the tax year. They can file as head of household if they provide more than 50% of the cost of maintaining a home for themselves and a dependent child.

Head of household: The taxpayer alone must provide more than 50% of

the cost of maintaining the household for one or more dependents.

Single: If unmarried and does not qualify for head of household or surviving spouse.

Definition of a Dependent

A dependent can be either:

- A qualifying child
- Or a qualifying relative

For both types, they must:

- Be a U.S. Citizen, a U.S. National, a U.S. Resident, or a resident of Canada or Mexico
- Only be claimed as a dependent by one taxpayer (or married couple filing jointly)
- Not be filing jointly with another taxpayer

Qualifying child:

- Relationship test: must be a natural, step, adopted or foster child. Can also be a sibling or stepsibling, or the offspring of any of these
- Residence test: the child must have the same residence as the taxpayer for more than one half of the taxable year
- When parents are divorced, the parent with custody (or having the child more than half the year) gets to claim the exemption. The custodial parent can waive the exemption and let the other parent claim the exemption
- Age test: dependent must be under age 19 at end of tax year, or under 24 if a full-time student for at least 5 months of the tax year. No age limitation if the dependent is permanently and totally disabled

- Not self-supporting: the dependent must not have provided more than 50% of his or her own support during the tax year

Qualifying relative:

If the taxpayer provides more than 50% of the support for a qualifying relative, the taxpayer can claim the relative as a dependent. If no one person provides more than 50% of the support for a qualifying relative, then any individual who provides more than 10% of the support can claim them as a dependent if the other support-providers consent to that person claiming them as a dependent. The dependent must have gross income of less than \$4,300 in 2020, or they can't be claimed as a dependent.

What constitutes "support": Food, clothing, lodging, medical costs, and recreational costs. Life insurance premiums, funeral expenses, and income taxes paid from the dependent's own income are not considered support.

- A qualifying relative is very broad and includes anyone living in the taxpayer's house for the full tax year.
- There is no age test for a qualifying relative.
- Gross income test: the dependent's gross income must be less than the exemption amount for the year, which is \$4,300 in 2020.

Filing Status and the Standard Deduction

Instead of itemizing deductions, a taxpayer can claim the "standard deduction", which is a set amount that for many taxpayers is a larger deduction than their itemized deductions added up.

The standard deduction amounts for 2019-2020 are:

Filing Status	2019	2020
Single	\$12,200	\$12,400
Married Filing Jointly	\$24,400	\$24,800
Married Filing Sep.	\$12,200	\$12,400
Head of Household	\$18,350	\$18,650

If the taxpayer is either blind or over age 65, then there is an additional standard deduction of \$1,650 for unmarried persons and \$1,300 for married persons.

Examples:

If Paul and Mary are legally separated and live in and maintain separate homes, for the entire year of 20X9, their only option to file is as single taxpayers. However, if they had a dependent child and the child lived with Mary through the year, then she could file as head of household, while Paul would still file as single.

If Frank's wife died in 20X6, Frank would still file 'married filing jointly' in 20X6. In 20X7, as long as Frank was still unmarried and paid over 50% of the cost of maintaining a home for himself and one dependent child, Frank would file as a surviving spouse, and could do so again in 20X8. In 20X9 if the circumstances were still the same, then Frank would file as head of household. Note that if there was no dependent child, then Frank would file as single for every year except the year that his wife died, when he could still file as married filing jointly.

Computation of Tax and Credits**Estimated Tax Payments**

Whether an individual is an employee or self-employed, taxes are supposed to be paid during the year on income received. For

employees that have taxes withheld, this is something they never have to think about. Everyone else is expected to make estimated tax payments quarterly. This applies to anyone who expects to owe at least \$1,000 in federal taxes for the year.

The payment dates are:

- April 15th for January to March
- June 15th for April to May
- September 15th for June to August
- January 15th of following year for September to December

Tax Credits

Child credit

This gives a \$2,000 credit for each qualifying child under the age of 17(see the qualifying child definition in the Filing Status section). This is for dependent children, stepchildren, or grandchildren. There is no credit for married taxpayers with AGI above \$400,000, or \$200,000 for all other taxpayers.

The max refundable amount per credit is \$1,400.

Family Tax Credit

This is a \$500 nonrefundable credit for certain dependents who don't qualify for a full child tax credit (if they are over the age limit, a disabled child of any age, or certain non-child dependents).

This could be anyone who is a qualifying relative, children between 17-19, or under 24 if they are a full-time student for at least 5 months of the year.

American Opportunity Credit

\$2,500 per year for each eligible student.

It is for 100% of the first \$2,000 and 25% of the next \$2,000 of qualified education expenses, which totals the maximum of \$2,500.

The student must be enrolled in at least a half-time basis to claim the credit. This credit is only for the first 4 years of postsecondary education. This credit is only applicable if the individual is NOT claiming the lifetime learning credit for that same tax year.

Lifetime Learning credit

Up to a maximum of \$2,000 per taxpayer per year for qualified education expenses at an eligible institution for one or more students. It is calculated as 20% of education expenses up to a max of \$10,000 of expenses. The eligible student(s) must be the taxpayer, a spouse, or a dependent listed on the taxpayer's return. As the name implies, it can be claimed for an unlimited number of years.

Dependent care credit

Provides a nonrefundable tax credit for portion of expenses for caregiving while the taxpayer is working.

The person receiving the care, which must be a child under 13 or a disabled adult, must live with the taxpayer for more than half the year.

The care can be given in the home, but it can't be from a dependent relative or child. The care can be given by a relative as long as the relative isn't a dependent of the taxpayer. The taxpayer must be employed and make at least as much as the expenses. The costs of transporting the person or child to the place of care is NOT included in this credit.

The credit is calculated as up to 35% of \$3,000 in qualifying expenses for one child or dependent, or up to 35% of \$6,000 for two or more

children or dependents. The credit percentage is reduced by 1% for every \$2,000 increment of AGI above \$15,000 and bottoms out at 20% if AGI is above \$43,000.

Example:

Tara has AGI of \$14,000 and incurred childcare expenses of \$6,000 for her two children during the year. Since her AGI is below the \$15,000 threshold, she can claim a credit for the full 35% of the childcare expenses. $\$6,000 \times 35\% =$ a credit of \$2,100.

If Tara's AGI was \$45,000, the credit percentage would go down to 20% of the childcare expenses, for a credit of \$1,200.

Adoption credit

Credit is allowed for adoption expenses up to \$14,300 if the taxpayer's income is less than \$214,520 in 2020. This credit is nonrefundable. The credit applies in the year that the adoption becomes final and can include adoption expenses from previous years related to the same adoption.

Earned Income credit

This is a way of reducing the tax burden of low-income taxpayers. The % of the credit increases based on the number of qualifying children the taxpayer has.

The credit is based on earned income from wages, salaries, tips, or self-employment income.

A married taxpayer must file as 'married filing jointly' to receive the credit. 'Married filing separately' are not eligible for the EIC. This credit can result in a refund even if the taxpayer has no tax liability. If there is no qualifying child, then the filer must be between the ages of 25 and 64 and can't be claimed as a dependent by another taxpayer.

Alternative Minimum Tax

This is a tough topic to master. The most important things to know with AMT are the AMT adjustments and AMT preferences. With AMT you take your taxable income, and then you add or subtract “adjustments”, then you add in any “preferences” (these will always be an increase), and that puts you at AMT income. Then you subtract the applicable exemption, apply the applicable rate, subtract any tax credits, and subtract regular taxable income to see if there’s a difference. If there’s an amount left, then that is the AMT tax you would pay.

AMT is the excess of the tentative AMT tax over the regular tax which is meant to prevent taxpayers with a lot of income from paying a smaller percentage of tax than other taxpayers. If the tentative AMT tax comes to \$1,000 and your regular tax was \$800, the AMT tax you would pay is the \$200 difference. It’s not a full \$1,000 on top of your regular taxes.

AMT adjustments: these are adjustments that either increase or decrease taxable income in computing AMT income

- No standard deduction allowed, it is added back if used
- If itemizing, no deduction for state income tax or property taxes, they must be added back to regular taxable income
- If itemizing, home mortgage interest is deductible if used to acquire or improve the home
- If itemizing, medical expenses in excess of 10% of AGI is deductible

AMT preferences: these always increase AMT income

- Depletion over adjusted basis for certain minerals, the difference is added back
- Interest on “private activity” bonds

- Qualifying small business stock (QSBS)

The AMT exemption for married filing jointly is \$113,400 for 2020.
The AMT exemption for single filers is \$72,900 in 2020.

If a taxpayer has to pay AMT in a given year – let's say the \$200 from the example – that \$200 becomes an AMT credit that can be carried forward indefinitely and offset timing differences in a future year against regular taxes (when no AMT is due).

Area V: Federal Taxation of Entities

Tax Treatment of Formations and Liquidations of Business Entities

When forming a corporation, a person or persons transfer property (or cash) to the corporation in exchange for the stock of the corporation. To have control of the corporation, these persons need to own at least 80% of the corporation after formation. “Control” is defined as owning at least 80% of the voting and nonvoting stock. The 80% doesn’t have to be one person. It can be two or more individuals as long as together they own 80% or more of the corporation immediately after formation. You can see this asked in a number of different ways, so remember that “control” involving the formation of a corporation is owning 80% of the stock.

In general, transferring property to a corporation is a tax-free exchange when the exchange is solely for stock in the corporation, and the transferor is in control directly after the exchange.

“Boot” is anything received other than stock for contributing property to the corporation. Such as contributing \$100k worth of inventory to the corporation and receiving \$80k worth of stock and \$20k of cash- the \$20k is boot and triggers a gain of \$20k.

If boot is received, the gain recognized by the shareholder will be the lower of the:

- realized gain OR
- the fair market value of the boot received

Basis in contributed property and stock received

The corporation’s basis in the property contributed is the basis that the transferor had, plus any gain recognized by the transferor. Note that

this is only when the corporation is being formed.

Example:

Mike Honcho is the sole shareholder of ABC corp, and at formation of ABC he transfers property worth \$500,000 into the corp. Mike had basis in the property of \$200,000. A year later, Ricky Bobby transfers property worth \$300,000 to ABC for 10% ownership. Ricky Bobby had basis in the property of \$100,000. In these two transactions, ABC takes Mike's basis of \$200,000 in Mike's transferred property, but it takes basis of \$300,000 (FMV) in Ricky Bobby's property. This is because Ricky Bobby's transaction isn't subject to the 351 exchange rules regarding the formation of a corporation. So Ricky Bobby would have a gain of \$200,000, because he's receiving stock worth \$300,000, and ABC has \$300,000 of basis in the property.

The shareholder's basis in the stock he or she receives is the basis of the transferred property, plus any gain recognized, less any boot received and less any liabilities assumed by the corp.

Liquidating Distributions

Liquidating distribution from a corporation:

A liquidating distribution is full payment in exchange for a shareholder's stock. The shareholder will recognize a gain equal to the difference between the FMV of cash and/or property received, and the shareholder's basis in the stock.

Example:

ABC corporation liquidated and gave each shareholder \$1,000 cash and property with a basis of \$5,000 and FMV of 8,000. Each shareholder had basis of \$4,000 in the ABC stock. In this transaction each shareholder

recognizes a gain of \$5,000: \$1,000 cash + property with FMV of \$8,000 makes \$9,000 the amount realized by each shareholder. Then, each shareholder has a basis in the stock of \$4,000, which makes the gain on the liquidation \$5,000 to each shareholder.

In a partial liquidation, then sale or exchange treatment applies, which is the same as the corporation selling property at FMV to a third party: The gain or loss would just be the difference between FMV and the corporation's basis in the property.

Liquidating distribution from a partnership:

A liquidating distribution occurs when a partner receives a distribution and it terminates the partner's interest in the partnership. It can also terminate an entire partnership.

In general, the liquidating distribution is treated as a return of capital to the partner, the property received takes the basis of the partner's basis in the partnership. The only time there's a gain on a liquidating distribution is if cash received is more than the partner's basis in the partnership. If a partner has basis in the partnership of \$20,000 and he receives \$25,000 cash in a liquidating distribution, he has a \$5,000 gain.

When cash and property is received, the partner's basis is reduced by the amount of cash, then by any receivables or inventory received, and then the remaining basis is assigned to the property received.

Example:

Ed received \$5,000 cash, inventory with FMV of \$3,000 and a basis of \$2,000, and a piece of land worth \$35,000 as a liquidating distribution in the partnership. The partnership had basis of \$15,000 in the land. Ed's basis in the partnership was \$25,000. So, Ed's basis in the land received would be the same as his \$25,000 basis in the partnership, but

you have to reduce that by the amount of cash received, which was \$5,000, AND by the \$2,000 partnership's basis in the inventory. So in the end, Ed has basis of \$18,000 in the land received as part of the liquidating distribution: $\$25,000 - \$5,000 - \$2,000 = \$18,000$. Also, Ed would have a \$2,000 basis in the inventory. When he sells the inventory, the gain or loss would be ordinary, and when he sells the land, the gain or loss would be a capital gain or loss.

A liquidating distribution from a partnership can trigger a loss if the distribution only consists of cash, inventory, or unrealized receivables, and if the property received is less than the partner's basis in the partnership.

Example:

Paul receives a liquidating distribution of \$15,000 in cash and inventory with basis and FMV of \$5,000. Paul's basis in the partnership was \$25,000. Paul would have a recognized loss of \$5,000 on this distribution: His \$25,000 is first reduced by \$15,000, and then by the \$5,000 of inventory leaving him with a loss of \$5,000.

Note that if in the example the inventory was replaced with a piece of land, then Paul would have no loss and would take basis in the land of \$10,000.

Cash vs. Accrual Basis

Most taxpayers and entities can use the cash basis method of accounting.

The following entities are required to use accrual accounting:

- Any regular C corporation with gross receipts over \$25 million. This is based on an average of the previous 3 years, and once that test is failed (an average above \$25 million), then the corporation

has to use the accrual method going forward

- Same rules as above for a partnership with C corporation partners

Differences Between Book and Tax Income

Corporations use an “schedule M-1” to reconcile book income to taxable income. Corporations with total assets of \$10 million or more are required to file a schedule M-3, which provides more detail than an M-1.

To reconcile book income to tax income, both temporary and permanent differences are considered.

Temporary differences are things like accelerated depreciation for tax and straight line for book, accrued liabilities, or estimates.

Permanent differences are things like tax exempt interest, penalties & fines, life insurance proceeds, and 50% of business meals/entertainment (valid expense for books, 50% allowed for tax deduction). These are all things that would be included in book income, but not for taxable income.

Any non-deductible expenses would be added to book income to arrive at taxable income, such as a long-term capital loss.

Any non-taxable income would be subtracted from book income to arrive at taxable income.

Example:

ABC corporation reports \$800,000 in taxable income on its federal return. Its book income was \$700,000. Here are the transactions that

create the difference done both ways:

Tax income reconciled to book income:

Taxable income = \$800,000

Less: provision for federal income tax (200,000) - this is an expense for book income

Less: Fines (50,000) - part of book income but not taxable income

Add: life insurance proceeds 100,000 - part of book income but tax exempt

Add: MACRS depreciation 100,000 - taken for tax income

Less: straight line depreciation (50,000) - subtract since included in book income

= Book income of \$700,000

Book income reconciled to tax income:

Book income = \$700,000

Add: provision for federal income tax 200,000 - an expense in getting to \$700,000

Add: fines = 50,000 - reduced book income but not tax income

Less: life insurance proceeds (100,000) - book income but tax exempt

Less: MACRS depreciation (100,000) - what you use for tax income

Add: straight line depreciation 50,000 - to remove, included in book income

= Taxable income of \$800,000

C Corporations

Computations of taxable income, tax liability and allowable credits

Corporate Income Tax Formula

A corporation's tax liability is calculated as:

Business Income

Less: Expenses

Equals: Gross Income

Less: Deductions

Equals: Taxable Income Before Special Deductions

Less: Special Deductions

Equals: Taxable Income

Then "Taxable Income" is multiplied by the tax rate, which is a flat 21% for corporations, which equals "Gross Tax".

From Gross Tax, any credits are subtracted, then any other taxes are added, which results in "Net Tax".

Tax-Related Items for Corporations

Charitable Contributions

The deduction for charitable contributions is limited to 10% of taxable income before the contribution.

Example:

ABC corporation has book income of \$50,000 that includes a charitable contribution of \$10,000. To get to taxable income for ABC, you would add back the contribution, so \$60,000, and take 10% of that, which is \$6,000, and subtract that from \$60,000, which gives ABC taxable

income of \$54,000.

Net Capital Losses

Capital losses can't offset income: Remember that capital losses cannot offset taxable income, they can only offset capital gains. A net capital loss can be carried back 3 years and forward 5 to offset capital gains.

Damages from Patent Infringement

Damages received from patent infringement are deductible, so they will be included in both book and taxable income.

Insurance Premiums on Key Executives

Premiums paid are not tax deductible, but if said person(s) dies the proceeds are not taxable. Premiums paid on a key executive are a valid expense for book income, but they would be added back to get to taxable income because they are not deductible. Also remember that if said key person dies, the proceeds from the policy are not taxable.

Organizational and Startup Costs

\$5,000 of organizational costs to form a corporation can be deducted from taxable income. But, the \$5k is reduced by the amount of expenses incurred above \$50k. So organizational costs of \$53k would only allow \$2k to be expensed. All remaining organizational costs must be capitalized and amortized over 180 months.

Stock issuance costs are "syndication costs", and they are not deductible.

Penalty Taxes

Accumulated Earnings Tax

This is a penalty tax when a corporation accumulates earnings and

profits for the purpose of avoiding income tax for its shareholders. The tax is 20% of the corporation's accumulated taxable income. Any dividends received deductions are added back to the income number for the purpose of evaluating "accumulated earnings".

Accumulated Earnings Credit

This is given to corporations when they are subject to the accumulated earnings tax.

The credit is the greater of the amount of current earnings and profit "reasonably needed" for the business, OR \$250k (\$150k for service businesses) less than the accumulated earnings and profits at the end of the preceding year

Personal Holding Company Tax

This tax penalizes a corporation that seems to hold a high level of stock investments since corporations receive the dividends received deduction.

If the IRS deems a corporation to be a personal holding company, then there is a 20% tax imposed

There are two tests to determine if a corporation is a PHC (the corporation has to "pass" both tests to be considered a PHC:

1) Income test: If passive income is 60% or more of adjusted ordinary gross income

2) Ownership test: If more than 50% of the corporation's stock is owned directly or indirectly by 5 or less people during the last half of the year. An example of indirect ownership would be something like one person owning 40% of the stock, and then another 20% through an estate with the same person being the estate's beneficiary.

Adjustments that either increase or decrease taxable income when

assessing a PHC penalty:

- Accrued income tax reduces taxable income
- Excess charitable contributions reduce taxable income
- After tax net capital gain reduces taxable income
- Adding back in any DRDs increases taxable income
- The carryover from NOLs increase taxable income

Also, pro-rata dividends reduce the taxable income of a PHC so that the penalty is lower. The PHC can also give a “deficiency dividend” which is a dividend paid within 90 days after a PHC penalty has been imposed, and this dividend will reduce taxable income.

Net operating losses and capital loss limitations

Net operating loss (NOL)

This is when a corporation has negative taxable income, it creates a net operating loss that can be carried forward indefinitely to offset future taxable income. A NOL can only be used to offset up to 80% of taxable income in a given year.

A charitable contribution can't add to a NOL. If a corporation had business income of \$100,000 and expenses of \$200,000 - which included a charitable contribution of \$10,000, then the corporation's NOL for the year is \$90,000. The charitable contribution has to be taken out when computing the NOL for the year.

Dividends Received Deduction

The “dividends received deduction” (DRD) is when a corporation (C-corps, S-corps do not get the DRD) owns stock in another company and that company pays dividends. The corporation gets to deduct a portion of the dividend income based on the percentage of stock it owns in the other company.

If the corporation owns less than 20%, the DRD is 50%.
If the corporation owns 20-79%, the DRD is 65%.
If the corporation owns 80% or more, the DRD is 100%.

Example:

ABC corporation has \$500,000 in revenue, receives \$100,000 in dividend income from a 40% owned corporation, and has operating expenses of \$200,000. The stock is 40% owned so it falls in the 65% DRD tier. So, ABC had \$500,000 of revenue, but only \$35,000 of the dividend income needs to be included for tax purposes ($\$100,000 - 65\% = \$35,000$), resulting in total income of \$535,000, less the \$200,000 of expenses, leaving \$335,000 of taxable income.

IF the corporation has taxable income of less than the dividend income, the DRD is limited to the taxable income amount. So if a corporation has taxable income before the DRD of \$50,000 and dividend income was \$100,000 with a 65% DRD, the DRD is only 65% of the \$50,000, NOT the \$100,000.

Entity/Owner Transactions, Including Contributions, Loans, and Distributions

Owner's Basis

Calculating a shareholder's basis in a corporation is based on the timing of transfers of property, distributions, and earnings & profit (E&P).

Let's start with formation. Again, when an owner transfers property to a corporation upon formation as part of a 351 exchange, the corporation takes the shareholder's basis in the property, and the shareholder receives stock and keeps the same basis in the stock received.

Example:

Arnold transfers property with a FMV of \$100,000 to a new corporation where Arnold is the sole shareholder. Arnold had basis in the property of \$80,000. Arnold's basis in the stock of the corporation remains \$80,000, and the corporation takes basis of \$80,000 in the property.

If an individual transfers property after formation of the corporation in exchange for ownership, then the corporation takes basis in the property equal to its FMV, regardless of the previous basis in the hands of the owner.

Example:

A year after Arnold's corporation was formed, Arnold's friend Pete transfers property worth \$200,000 for 10% ownership. Pete's basis in the property is \$100,000. The corporation would take basis of \$200,000 in the property, and Pete would have a gain of \$100,000 on the stock received and then have basis of \$200,000 in the stock.

If the corporation takes over a liability attached to transferred property, if the liability is greater than the transferor's basis, the difference triggers a gain to the transferor.

Also, remember the boot rules discussed in the "Tax Treatment of Formations" section. While transferring property in a 351 exchange, if the transferor receives boot in addition to stock, then the corporation takes basis equal to the transferor's basis in the property + the value of the boot received. The transferor will have a recognized gain that is the lesser of the boot received or the realized gain.

Distributions

When considering the tax effects of distributions, the "accumulated earnings and profits" is what matters. A distribution is a dividend as long as it is made from current or accumulated earnings & profit.

A distribution that is larger than a corporation's accumulated earnings is a return of capital (which lowers shareholder's basis) to the extent of the shareholder's basis in the stock and is not taxable.

Example:

ABC corporation had \$20,000 in accumulated E&P at the beginning of the year, and then \$10,000 of E&P in the current year. During the year, ABC corporation paid cash distributions of \$35,000 to shareholders. In this case, only \$30,000 of the distributions would be classified as dividends (\$30,000 in E&P), and the remaining \$5,000 would be considered a return of capital. If shareholders had basis of \$40,000 before this distribution, their basis would be lowered to \$35,000 because of the return of capital portion.

When a corporation distributes appreciated property to shareholders, the corporation recognizes a gain equal to the difference in basis and FMV. It's treated as if the property were sold to an unrelated party at FMV. If there's a liability attached to the property that exceeds FMV and that liability is assumed by the shareholder, then the gain to the corporation is equal to the liability less basis.

Example:

ABC corporation distributes property worth \$40,000 to a shareholder. ABC has basis in the property of \$30,000. ABC recognizes a gain of \$10,000 on this distribution.

Alternatively, let's say the property had a liability attached for \$50,000, which the shareholder assumes. In this case, the gain to ABC is \$20,000: \$50,000 liability less ABC's basis of \$30,000 = \$20,000 gain.

The shareholder's basis in property received via distribution will be the FMV of the property. If the shareholder assumes a liability in connection with a distributed property, if the liability is greater than the

FMV of the property, then the liability amount becomes the shareholder's basis in the property.

No losses on non-liquidating distributions to shareholders: If a corporation distributes property with FMV less than its basis to shareholders, no loss is recognized.

Constructive dividends: If a corporation sells property to a shareholder for less than FMV, the shareholder is considered to have received dividend income equal to the difference.

Example:

ABC corporation sells a piece of land with FMV of \$100,000 to a shareholder for \$75,000. The shareholder will report dividend income of \$25,000 on this transaction.

Liquidation

When a corporation is completely liquidated, property distributions are treated as a sale at FMV, which means the corporation will have a recognized gain equal to the difference of the FMV and the corporation's basis in the property (or a loss). The gain or loss will be a capital gain or loss. Again, if any liabilities are assumed by the recipient and the liability is greater than the FMV of the property, the corporation recognizes a gain equal to the difference of the liability amount and the corporation's basis in the property.

To the shareholder, when a redemption terminates their ownership, the redemption is a capital gain.

On a partial liquidation, the shareholder treats the redemption as a capital gain.

Expenses related to a liquidation are deductible by the liquidating

corporation. These include accounting and legal fees, filing fees, and other expenses related to the liquidation.

To Summarize...

When cash is distributed to shareholders, it is dividend income to the extent of accumulated + current E&P. Any amount above E&P is a return of capital (basis), and any amount above that is a capital gain.

In a complete liquidation of a corporation, both the corporation and the shareholder recognize a gain equal to the difference of basis and property distributed/received, just as if the property were sold at FMV.

Reorganizations

Corporate reorganizations are generally tax free to both the shareholders and the corporation

The 4 main types of corporate reorganizations:

- A: Most assets of target firm are exchanged for stock in the acquiring firm. This can be either an acquisition- where A acquired B and only A remains- or a consolidation where A & B combine and become C.
- B: Only stock for stock- the acquiring firm exchanges its stock for stock of the target and the acquiring firm must own 80% of the target stock after the acquisition. A acquires B, B remains in existence but is now 80% or more owned by A. B shareholders now own stock in A, the parent.
- C: Acquiring firm acquires 90% of net asset value of target's assets in exchange for voting stock. Target firm distributes stock to its shareholders. A acquires B, B dissolves, and B shareholders are now shareholders in A.
- D: Divisive- a spinoff or split off. One corporation divides by transferring assets to a sub in exchange for stock in the sub.

Consolidated tax returns

Affiliated Group and Consolidated Tax Returns

When one C corporation owns at least 80% of the voting power & value of another C corporation or multiple C corps, this is an “affiliated group”, and they can file one consolidated tax return. An S-corp is NOT allowed to be a member of an affiliated group.

When a parent and sub sell each other property, the seller will have a realized (not recognized) gain, and it will be recognized when the other party sells the property to an unrelated third party. The buyer in the original transaction will take basis equal to the purchase price, and if subsequently sells the property to an unrelated third party, will recognize a gain if sold for more than their basis.

Example:

ABC corporation is the parent of XYZ corp. XYZ sells ABC a piece of land for \$50,000. XYZ had basis of \$30,000 in the land, so XYZ has a realized gain of \$20,000. A year later, ABC sells the land to an unrelated third party for \$70,000. ABC then has a recognized gain of \$20,000, and at this time XYZ will also recognize the \$20,000 gain that was previously deferred. On the consolidated financials the end result is a gain of \$40,000: XYZ originally had basis of \$30,000 and the land ends up being sold to a third party for \$70,000.

One advantage of filing a consolidated return is that the net operating loss of one member can offset income of the other members. If the NOL absorbs all the income from the other members, it creates a consolidated NOL that can be carried forward indefinitely.

Dividends between affiliated members are eliminated in the consolidation process and are not reported in the consolidated tax return.

When one corporation has control of subsidiary corporations, there are 3 main advantages to filing a consolidated return:

- Inter-company dividends are excluded from taxable income
- Losses from one-member corporation offset gains of another member
- Inter-company profits are deferred until realized

Multi-Jurisdictional Tax Issues

“Domestic” corporations are corporations that are incorporated in their home state. A “foreign” corporation is a corporation that’s incorporated in another state. A Florida corporation is domestic in Florida, but foreign in Alabama.

State Taxes and Nexus

When property is purchased in one state but used in a different state, the state where the use takes place will probably impose a use tax.

Nexus is when a business has a relationship with another state to the point that the state has the right to impose taxes on the business. Nexus is referred to as “sufficient physical presence”. Nexus with other states can be created a number of ways, but most commonly would be having a temporary or permanent presence of your business people in a given state. Sales or service agents, or even consigned inventory in a warehouse can create nexus.

Apportionment

This is an attempt to allocate sales to the different states that a business operates in. Different states might use different apportionment factors, or just one factor.

Factors include:

Sales Factor

When a business has sales among multiple states that they also have nexus in, the sales factor for each state is determined on a percentage of sales basis. If you have sales of 10k in state A and sales of 90k in state B, your sales factor is 10% for state A and 90% for state B.

Formula is: Total sales in that state / Total sales

Property Factor

Average value of property in that state / Total value of all property

Foreign Income and Tax Considerations

Foreign branch vs foreign subsidiary

A U.S. Corporation that has branches in other countries owes federal tax on the income from a foreign branch, just as it would with its operations inside the U.S.

A foreign subsidiary on the other hand, the U.S. parent does not owe federal tax on the sub's earnings unless the sub sends money to the U.S. parent in the form of dividends.

Foreign Tax Credit for Corporations

A U.S. corporation that has paid foreign taxes can claim a credit on their federal taxes. The credit is the lesser of actual foreign taxes paid, or the foreign tax credit limit. This is a specific calculation, and the foreign tax credit cannot be more than this fraction multiplied by the U.S. tax liability. The fraction is: taxable income from sources outside the U.S. / Total taxable income from U.S. and foreign sources

Example:

ABC corporation had taxable income from the U.S. of \$100,000, and taxable income from foreign sources of \$50,000. ABC has already paid \$10,000 in foreign taxes. The foreign tax credit limit calculation would be: $\$50,000 / \$150,000$, or 33%. 33% of 100,000 is \$33,000, so the foreign tax credit for ABC would be the lesser of the foreign taxes paid and the foreign tax credit limit, which in this case is the \$10,000 of foreign taxes paid. \$10,000 would be ABC's foreign tax credit.

S-corporations

Eligibility And Election

Eligible shareholders for an S-corp:

- Individuals - must be U.S. citizen or U.S. resident
- Bankruptcy estates
- Single member LLC can elect to be taxed as an S-corp
- Testamentary trusts
- Revocable trusts as part of an estate

Ineligible shareholders:

- Nonresident aliens
- C corporations
- Partnerships
- Multiple member LLCs
- LLPs
- Foreign trusts

S-corp elements:

- No more than 100 shareholders (this is relaxed if some shareholders are family members)
- Can only have one class of stock, but it can be voting and nonvoting
- An S-corp's election as an S-corp can be revoked by a majority consensus of shareholders, including non-voting shareholders
- An S-corp election is only effective for the current tax year if the election is made by the 15th day of the third month of the tax year. If made after that date, the election is not effective until the beginning of the next tax year
- An S-corporation's tax year is usually the calendar year
- Shareholders are not liable for debt

- Shareholders can be employees
- Flow through taxation to shareholders
- S-corps can own stock in C corporations
- S-corps can be a partner in a partnership
- An S-corp can own 100% of the stock of an S-corp subsidiary
- A C corporation cannot own 100% of an S-corp

Process for making the S election:

The election to S-corp status must be unanimous by the shareholders. The election is made by filing Form 2553 with the IRS. If the election is made before the 15th day of the third month in the company's fiscal year, then it will be effective for that year. If the election is made after the 15th day of the third month, then the election will be effective at the beginning of the following year. Remember that this is for the fiscal year of the business.

Termination of S status:

S status can be terminated through a majority vote of the shareholders. If more than 50% of the owners change, then the new owners must agree to keep the S-corp status. Also, the S-corp status can be involuntarily terminated if passive income exceeds 25% of gross receipts for 3 years in a row.

If any of the eligibility rules are broken, then the IRS can terminate the S-corp status.

If an S-corp terminates, it must wait 5 years before it can re-elect to be an S-corp again.

Determination Of Ordinary Business Income(Loss) And Separately Stated Items

With S-corps, ordinary business income is separated from certain items referred to as “separately stated items”. Ordinary business income is generated through the primary activities of the business, and then separately stated items are things like:

- Charitable contributions
- Interest income
- Dividend income from investments
- Rental activities
- Section 179 deductions
- Capital gains and losses
- Tax credits
- Foreign taxes

These separately stated items are passed through to the S-corp owners ‘separately’ so that they retain their specific tax characteristics.

Example:

ABC, an S-corp, reported the following items during the year:

Revenue of \$100,000

Operating expenses of \$30,000

Long-term capital loss of \$10,000

Charitable contributions \$5,000

Business interest expense \$7,000

From these items, ABC would have ordinary income of \$63,000:

$\$100,000 - \$30,000 - \$7,000 = \$63,000$.

The capital loss would be separately stated and passed through, as would the charitable contributions. This allows for the shareholder to net other capital gains/losses, same thing with the charitable contributions.

Another example:

Bob is a 60% owner in ABC, an S-corp, and a 30% owner in XYZ, another S-corp. Both companies elected to take the maximum section 179 deduction during the year. The amount of each 179 deduction that flows through to Bob's personal return will be $(\$510,000 \times 60\%)$ \$306,000 from ABC, and $(\$510,000 \times 30\%)$ \$153,000 from XYZ, for a total of \$459,000. This would reduce Bob's basis by the respective amounts, but he could deduct the full \$459,000. If the two amounts added up to more than \$510,000, then Bob would carryover the remainder to a future year.

Accumulated Adjustments Account (AAA)

The AAA tracks previously taxed but undistributed earnings. When distributions are made from this account, they are tax free since the earnings have already been taxed. The AAA is adjusted just like shareholder's basis: income and separately stated income items increase it, except for tax exempt interest. It is decreased by negative separately stated items and any tax-free distributions. Also, the AAA can be negative, unlike shareholder's basis.

Note: An S-corp that has never been a C corporation will not use an AAA. Also, even if it was previously a C corporation, if there was not any E&P when converting to an S-corp, then the AAA isn't necessary either.

If an S-corp has an AAA, then distributions are first from AAA (which reduce basis), then from E&P which will be dividend income, then from stock basis which is a return of capital, and when basis is absorbed, any distributions are taxed as a capital gain.

Example:

ABC, a converted S-corp, has AAA of \$20,000 and E&P of \$10,000. If it

makes a distribution of \$50,000 to its sole shareholder who has basis of \$30,000 in ABC, here's how it breaks down: The first \$20,000 of the distribution is tax free from the AAA, and it reduces the shareholder's basis to \$10,000. The next \$10,000 of the distribution is dividend income from the E&P, the next \$10,000 is a tax-free return of capital, and the next \$10,000 of the distribution is considered a capital gain to the shareholder.

Basis of Shareholder's Interest

A shareholder's basis in S-corp stock is increased by all the flow through income (including tax exempt income) items and decreased by distributions and flow through deductions.

Example:

Bob is the sole shareholder in ABC, an S-corp. Bob's basis in ABC at the beginning of the year is \$50,000. At the end of year, ABC had ordinary income of \$30,000, tax exempt income of \$10,000, and capital gains of \$10,000. ABC made a \$40,000 distribution to Bob during the year. At the end of the year, Bob's basis is now \$60,000: His basis was increased by each of the income items and decreased by the distribution for ending basis of \$60,000.

Losses and Basis

A loss by the S-corp is deductible by the shareholders to the extent of their basis. If losses exceed basis, then the remaining loss can be carried forward indefinitely to another year when the shareholder has basis to use it.

Example:

Ron is the sole shareholder of ABC, an S-corp. Upon formation, Ron invests \$10,000 for the stock of ABC, and loans ABC \$20,000. During the

first year, ABC reports a loss of \$40,000. In the current year, Ron can claim a loss of \$30,000 on his personal return. His basis was the \$10,000 paid + the \$20,000 loan to ABC, so he only has basis of \$30,000 compared to the \$40,000 loss. The remaining \$10,000 can be carried forward to a year when Ron has basis again to use the loss.

Entity/Owner Transactions

Contributing Property to an S-corporation

Allocating Income to Shareholders

In an S-corp, all income is attributed to the shareholders, whether the income is distributed or not. The income increases the shareholder's basis, and when it's distributed it decreases the shareholder's basis.

Example:

Bob is the sole shareholder of ABC, an S-corp. ABC reports \$30,000 of ordinary income for the year and distributes \$15,000 to Bob. Bob will report income of \$30,000 on his personal tax return. Don't get confused with income and basis. Bob's basis is increased by the \$30,000 of income, but also decreased by the \$15,000 distribution. However, Bob still reports the full \$30,000 of income on his tax returns.

Distributions

As long as an S-corp doesn't have any earnings and profits (which will only happen if a C corporation had E&P and then converted to an S), any distribution a shareholder receives is a return of basis to the extent of the shareholder's basis, and anything above that is a capital gain. Note: if an S-corp does have E&P, then a distribution is first classified as dividend income to the extent of the E&P, just like a C corp.

Built-In Gains Tax

When a C corporation converts to an S-corp, appreciated property that the corporation owns is subject to the “built-in gains tax” if the property is sold within the recognition period, which is 21% of the built-in gain at the time of conversion to an S-corp. The recognition period is 5 years. At the same time, any built-in losses can offset built-in gains.

Note that a sole proprietor that converts to an S-corp is not subject to the built-in gains tax.

Example:

ABC corporation, originally a C corporation, converts to an S-corp. At conversion, ABC owns equipment with basis of \$50,000 and a FMV of \$90,000. A year after converting to an S-corp, ABC sells the equipment for \$100,000. To calculate the built-in gains tax on this transaction, it would be 21% of the built-in gain at conversion, which was \$40,000 ($90,000 - 50,000$). Notice that it is not calculated on the sale price, but rather the FMV at the date of conversion. So, the built-in gains tax would be $\$40,000 \times 21\%$, which = \$8,400.

Partnerships

Determination of Ordinary Business Income (Loss) and Separately Stated Items

Like S-corps, business income is separated from “separately stated items”. Again, this is so that the separately stated items can retain their tax character as they flow through to the partners’ individual tax returns.

The items that determine ordinary business income are what you’d expect: sales, COGS, expenses as part of operating the business, depreciation, and included in this for partnerships are guaranteed payments to partners.

Separately stated items are the same as for S-corps. They can include:

- Charitable contributions
- Interest income (including tax exempt interest income)
- Dividend income from investments
- Rental activities
- Section 179 deductions
- Capital gains and losses
- Tax credits
- Foreign taxes

Example:

ABC partnership reported the following:

- *Sales of \$100,000*
- *Interest income of \$5,000*
- *Charitable contributions of \$10,000*
- *Guaranteed payment to partners \$5,000*
- *COGS of \$40,000*

- *Depreciation of \$10,000*

Based on these items, ABC's non-separately stated ordinary income is \$45,000. (100,000 - 5,000 - 40,000 - 10,000). Remember that guaranteed payments to partners are included in determining ordinary income.

The separately stated items are the interest income and charitable contributions.

Partnership Basics

A general partner participates in day-to-day running of the business and has joint liability for the partnership's obligations. If there are two partners and the partnerships liabilities total \$100,000, each partner is on the line for \$50,000.

A limited partner has liability up the amount of his/her investment in the partnership and can't participate in management activities of the business, otherwise they become a general partner.

A partnership reports income on form 1065 and the share to each partner is reported on a schedule K-1.

The \$5k of organizational expenses rule applies the same way to partnerships. Anything above \$50k reduces the \$5k that can be expensed.

Basis of Partner's Interest and Basis of Assets Contributed to the Partnership

Partner's Basis in a Partnership

A partner's basis in the partnership is increased by:

- Contributions of property
- Proportionate share of income
- Proportionate share of increases in liabilities

There is no gain or loss on property contributed to the partnership. A partner's basis in the partnership immediately after formation is the substituted basis of the assets contributed, which means it has the same basis as it had in the hands of the individual, and the new partner's basis in the partnership is equal to the basis they had in the contributed property.

Example:

Bill and Ted form a partnership. Bill contributes \$50,000 in cash. Ted contributes property he has basis in of \$30,000, which has a FMV of \$40,000 and has a \$20,000 liability attached that the partnership assumes. Bill's initial basis in the partnership is \$50,000 + his share of the liability assumed. So, his basis is \$60,000.

If a partner contributes property with an attached liability, the liability reduces the partner's basis in the partnership by the proportionate amount of the liability. For example, if Max contributes a piece of land to ABC partnership for a 50% ownership interest, and Max has an adjusted basis of 10k in the land and the FMV of the land is 20k, but it has a \$5k mortgage that ABC will take over, then Max's basis in ABC

partnership is just \$7,500. (his 10k basis less $\frac{1}{2}$ of the 5k mortgage he is getting out of).

Continuing the previous example:

To calculate Ted's basis, his basis in the property he contributed was \$30,000, but he personally is getting out of the \$20,000 liability. However, the partnership is now liable, and he is a 50% partner, so his share of the liability is \$10,000. However you look at it, his basis is the basis he had in the property reduced by his net decrease in personal liability. So, it's the \$30,000 basis, and overall Ted is getting out of \$10,000 of the \$20,000 liability, which means Ted's basis in the partnership is \$20,000 ($30,000 - 10,000$). Also note that even though Bill and Ted are 50/50 partners, they have different basis in the partnership.

A partner's basis is decreased by:

- Distributions
- Proportionate share of expenses, losses, and decreases in liabilities

Example:

Ron is a 50% partner in ABC partners. At the beginning of the year, Ron has basis in ABC of \$10,000. During the year, ABC has ordinary income of \$20,000, interest income of \$5,000, made a distribution of \$5,000 to both partners, and took out a loan for \$20,000 but paid off \$10,000 of it by the end of the year.

To calculate Ron's basis at the end of the year, it would be increased by the 50% of the income and loan and decreased by the distribution and 50% of the loan payoff.

So, Ron's basis at the end of the year is: Beginning basis of \$10,000 + \$12,500 income + \$10,000 loan = \$32,500. Then the \$32,500 is decreased by the \$5,000 distribution, and his share of the loan payoff,

\$5,000. So, Ron's basis at the end of the year is \$22,500.

If a partner contributes services in return for a partnership interest, whatever the amount of the partnership interest is, that partner has to recognize that same amount in wage income. When this happens, the calculation for the amount of income to recognize is the FMV of the partnership interest the new partner is receiving for the services.

Example:

Peter gains a 10% interest in ABC partnership for services rendered. ABC's net assets have a FMV of \$50,000. This results in Peter reporting \$5,000 of ordinary income on his tax return.

Partnership's Basis in Contributed Property

A partnership takes the same basis the contributing partner had in the contributed property. If there's a liability attached that would put the partner's basis below zero - which can't happen - then the partner would recognize a gain to bring their basis back up to zero.

Example with no liability:

Steve contributes property with a FMV of \$50,000 to ABC partnership for a 50% interest in the partnership. Steve had basis of \$10,000 in the property. ABC takes Steve's basis in the property of \$10,000.

Example with liability:

Steve contributes property with a FMV of \$50,000 to ABC partnership for a 50% interest in the partnership. Steve had basis of \$10,000 in the property, and it had a liability attached of \$40,000 which the partnership assumes.

In this example we'll start with Steve: He contributes property he has basis in of \$10,000, so his basis in ABC starts at \$10,000. But, he's

getting out of \$40,000 of debt, which takes his basis to -\$30,000. But as a 50% partner, he's re-assuming half of the liability, so add back \$20,000 to his -\$30,000 and he's still at -\$10,000. You can't have negative basis, so Steve has to recognize a gain of \$10,000 to get his basis up to \$0. So, ABC takes basis in the property of Steve's original basis of \$10,000 + the \$10,000 gain recognized by Steve, for basis of \$20,000.

Partnership and Partner Elections

Accounting Period

A partnership is allowed to elect an annual accounting period. If this election is not made, then the partnership must adopt the accounting year of a partner that owns 50% or more of the partnership. This is to prevent the deferral of reporting income.

General Partnership Elections

Partners can elect a number of things such as accounting method, inventory method, depreciation method.

Foreign Tax Credit/Deduction

For foreign taxes paid, each partner can decide if they want to take their share as a deduction or a credit.

Electing Large Partnerships (ELP)

A large partnership that has more than 100 partners can make an ELP election which makes tax reporting more straightforward. The main effect is that the ELP can combine more items at the partnership level and pass through net amounts to partners.

The main items that can be combined with ordinary business income

for an ELP include deductions, passive activity income/losses, and charitable contributions.

Also, capital gains are netted at the partnership level instead of being separately reported.

Transactions Between a Partner and the Partnership

Guaranteed Payments

These are payments agreed to be made to a partner regardless of whether the partnership makes a profit in a given year. These are for non-partner services performed, or for contributing capital. The partner that receives the payment reports it as self-employed income, and the amount is deductible when calculating ordinary partnership income. A guaranteed payment does not reduce the basis of the partner it is paid to.

Example:

John is a 50% partner in ABC partnership. ABC has ordinary income of \$40,000 which includes a guaranteed payment to John of \$10,000. Based on these facts, John will report \$30,000 of gross income on his personal tax return. The guaranteed payment is figured into the partnership's ordinary income number, and so the \$10,000 guaranteed payment + John's share of ABC's income (\$20,000) = \$30,000 of income to John.

Built-in Gains on Contributed Property

When a partner contributes property to a partnership that has a built-in gain (partner's basis is less than FMV), if the partnership sells the property, the gain is allocated back to the contributing partner up to the FMV at the time of contribution. The remaining gain is distributed among the partners like any other income or gain.

Note: This rule has a 5-year limit, so if the partnership doesn't sell the property within 5 years of contribution, after that the entire gain is allocated to the partners according to the partnership's income allocations.

Example:

Bill is a 50% partner in ABC partnership. Bill contributed property with basis of \$30,000 and FMV of \$50,000. 2 years later, ABC sells the property for \$60,000. Bill's built-in gain at the time of contribution was \$20,000 ($50,000 - 30,000$). So, when ABC sells the property, that gain, which is now recognized, is allocated back to Bill. Since the property was sold for \$60,000, there's still \$10,000 of gain, and since Bill is a 50% partner, half of that (an additional \$5,000) would be allocated to Bill. This would be a capital gain to Bill.

Impact of Partnership Liabilities on a Partner's Interest in a Partnership

Partnership Liabilities

Liabilities in a partnership increase a partner's basis by their partner percentage. If a 50% partner's basis is \$10,000 and then the partnership takes out a loan for \$20,000, that partner's basis will increase by \$10,000.

When a partner contributes property to a partnership, if there was previously a liability attached to the property, then the contributing partner's basis is reduced by the net amount of the liability they are getting out of.

Example:

Pam contributes property with basis of \$20,000 and FMV of \$40,000 to ABC to become a 20% partner. The property has a \$10,000 liability that ABC will assume. To determine Pam's basis, start with her basis in the

property of \$20,000. Then, she is getting out of \$8,000 of the liability (partnership assumes all \$10,000 but she is now a 20% partner so she's liable for \$2,000 of the liability), so her \$20,000 basis is reduced by \$8,000. So, Pam's beginning basis in ABC is \$12,000.

At-Risk Amount

When a partnership has a business loss for the year, each partner can only deduct their share of the loss to the extent of their basis, or their at-risk amount if it is less. The at-risk amount is usually the partner's basis less their partner percentage of any non-recourse debt. This is because non-recourse debt by definition makes the partner not ultimately liable for the debt, so a partner's share of that debt is not "at risk".

Distribution of Partnership Assets

Liquidating distribution from a partnership:

A liquidating distribution occurs when a partner receives a distribution and it terminates the partner's interest in the partnership. It can also terminate an entire partnership.

In general, the liquidating distribution is treated as a return of capital to the partner, the property received takes the basis of the partner's basis in the partnership. The only time there's a gain on a liquidating distribution is if cash received is more than the partner's basis in the partnership. If a partner has basis in the partnership of \$20,000 and he receives \$25,000 cash in a liquidating distribution, he has a \$5,000 gain.

When cash and property is received, the partner's basis is reduced by the amount of cash, then by any receivables or inventory received, and then the remaining basis is assigned to the property received.

Example:

Ed received \$5,000 cash, inventory with FMV of \$3,000 and a basis of \$2,000, and a piece of land worth \$35,000 as a liquidating distribution in the partnership. The partnership had basis of \$15,000 in the land. Ed's basis in the partnership was \$25,000. So, Ed's basis in the land received would be the same as his \$25,000 basis in the partnership, but you have to reduce that by the amount of cash received, which was \$5,000, AND by the \$2,000 partnership's basis in the inventory. So in the end, Ed has basis of \$18,000 in the land received as part of the liquidating distribution: $\$25,000 - \$5,000 - \$2,000 = \$18,000$. Also, Ed would have a \$2,000 basis in the inventory. When he sells the inventory, the gain or loss would be ordinary, and when he sells the land, the gain or loss would be a capital gain or loss.

A liquidating distribution from a partnership can trigger a loss if the distribution only consists of cash, inventory, or unrealized receivables, and the property received is less than the partner's basis in the partnership.

Example:

Paul receives a liquidating distribution of \$15,000 in cash and inventory with basis and FMV of \$5,000. Paul's basis in the partnership was \$25,000. Paul would have a recognized loss of \$5,000 on this distribution: His \$25,000 is first reduced by \$15,000, and then by the \$5,000 of inventory leaving him with a loss of \$5,000.

Note that if in the example the inventory was replaced with a piece of land, then Paul would have no loss and would take basis in the land of \$10,000.

One key difference in liquidating distributions compared to non-liquidating, is that in a liquidating distribution the partner's basis must go to zero. That can mean recognizing a loss if the distribution only

consists of cash, inventory, or unrealized receivables, or it can mean taking an increased basis in distributed property to take the partner's basis to zero.

Example

Paul receives a liquidating distribution consisting of \$5,000 cash and land with basis to the partnership of \$20,000 and FMV of \$40,000.

Paul's basis in the partnership is \$30,000. The distribution would lower his basis first by the \$5,000 of cash, but taking the partnership's basis in the land of \$20,000 still leaves Paul with \$5,000 of basis. So, Paul would take basis in the land of \$25,000 to reduce his basis to zero.

Non-Liquidating Distributions (Current Distribution)

Distributions from a partnership are either a liquidating distribution or a current distribution. In a current distribution (any distribution that is not liquidating), the rules are generally the same as a liquidating distribution: basis is reduced first by cash received, and then by the partnership's basis in any distributed property.

Again, a partner's basis can't go below zero, so the basis taken in distributed property is limited to the partner's basis in the partnership.

A recognized gain will only happen if the partner receives more cash than the partner has basis in the partnership.

A recognized loss won't happen in a current distribution.

Ownership Changes

Termination of a Partnership

In the liquidation of a partnership, there is no gain or loss on property received unless a partner receives cash in excess of his/her adjusted

basis.

A partnership terminates when no part of the business operates or is carried out by any partner as the partnership.

Terminating a partnership requires closing the partnership tax year – meaning if the partnership operated on the regular calendar year and then it ceased operating as the partnership on August 3rd, the partnership's tax year would end for tax purposes as of August 3rd.

As of 2018, there are no more “technical termination” rules for partnerships.

Divisions of Partnerships

If a partnership divides into two or more different partnerships, the original partnership continues in whichever partnership has a partner that controlled 50% or more of the original partnership.

Selling a Partnership Interest

If a partner sells their interest in a partnership, it's like selling any other property: A gain or loss will be the difference between cash received and the partner's basis in the partnership. If the buyer assumes the partner's share of partnership liabilities, that adds to the gain for the partner.

Example:

Bob sells his interest in ABC partnership. Bob's basis in ABC was \$20,000, and he sells his interest for \$25,000. Also, the buyer will assume Bob's share of the partnership liabilities with his share being \$6,000. Based on these facts, Bob's gain will be \$11,000 (the \$25,000 + the \$6,000 of liabilities he's getting out of)

When a partner sells their interest in a partnership, their tax year as far as the partnership ends on the date of the sale. This is also the case if a partner dies.

When a partner sells their interest in a partnership, a partnership interest is a capital asset, so the gain or loss is a capital gain/loss. However, if the partnership has appreciated inventory or unrealized receivables (hot assets), then the partner's share of the hot assets will be ordinary income to the selling partner.

Example:

Tom sells his 20% interest in ABC partnership to Jerry for \$100,000. Tom's basis in the partnership is \$50,000. ABC partnership had receivables of \$100,000 and inventory of \$100,000. ABC has no basis in the receivables, and an adjusted basis of \$50,000 in the inventory.

Tom's gain on his sale of the partnership would be \$50,000 (\$100,000 - \$50,000). But, Tom has to recognize ordinary income on his portion of the receivables and inventory to the extent that his portion exceeds his basis in the receivables and inventory. So Tom's 20% of the receivables is \$20,000, and his 20% of the inventory is \$20,000, less his 20% basis in the inventory of \$10,000, so Tom will recognize \$30,000 of his \$50,000 gain as ordinary income. The remaining \$20,000 of the gain will be treated as capital gain.

Limited Liability Companies (LLCs)

LLCs can be classified in several different ways:

C corporation: LLCs can be treated as a C corporation for tax purposes if Form 8832 is filed.

S corporation: LLCs can be treated as an S-corp for tax purposes if Form

2553 is filed.

Partnership: LLCs with more than one member are very similar to partnerships for tax purposes if no election is made to be taxed as an S-corp or C corporation. The “partners” are referred to as “members” in an LLC, but each member receives a K-1 and then each member pays taxes individually.

Single-Member LLC or Disregarded Entity: An LLC with just one member that doesn’t elect S or C corporation treatment is a “disregarded entity” to the IRS. It’s just like being a sole proprietor.

Trusts and Estates

Types of Trusts

Trust Definitions

A trust is a legal entity setup by a grantor to transfer property/income to a beneficiary.

Living trust: Setup while you're alive and immediately becomes effective.

Testamentary trust: Doesn't become effective until you die.

Revocable trust: You retain ownership and control of the assets in the trust and can change terms, beneficiaries, and trustees.

Irrevocable trust: You give ownership and control to a trustee and you no longer are able to make changes.

Simple trust: This is a trust that is required to distribute all annual income to the beneficiaries, which cannot be charitable organizations. The income from the trust is taxable to the recipient, and the corpus (principal) must remain in the trust. Capital gains also stay within the trust and become part of the corpus.

Complex trust: A trust is considered complex if it does any one of the following: 1) Retains income in the trust, 2) distributes corpus, 3) distributions go to charitable organizations.

Income and Deductions

When calculating income for a trust, items are separated into income and corpus. Note that items in either group may be taxable or non-taxable. There might be tax-exempt interest that is part of income for the trust accounting, or a capital gain that is allocated to the corpus for trust accounting but is taxable.

The basic idea with income and deductions for a trust is you take the income the trust made during the year, subtract deductions, then the trust makes distributions of the distributable net income (DNI) to the beneficiaries - this lowers the taxable amount to the trust and the beneficiaries are taxed on their distributions - then the trust can take a personal exemption of \$300, and that gets you to the trust's taxable income. Then the applicable tax rate would apply, then subtract any credits and you're left with the trust's taxable income.

Here's a breakdown:

Gross income

Less: Interest, expenses, charitable contributions

Less: Distributions of DNI to beneficiaries

Less: Personal deduction (\$300 for trusts)

Equals: Taxable income

Taxable income x applicable tax rate

Equals: Gross tax

Less: any credits

Equals: trust tax payable

Other facts you might see as a question:

If the grantor retains control over the trust and can decide who the DNI

goes to, then the grantor will be taxed on the DNI, not the beneficiary.

Determination of Beneficiary's Share of Taxable Income

The beneficiary is taxed on their portion of distributable net income.

Example:

The ABC trust is setup to distribute \$50,000 each year to Peter, and \$150,000 each year to Paul. In 2018, the trust had \$140,000 of DNI, so Peter would report income of \$35,000, and Paul would report income of \$105,000. Each beneficiary receives their prorated portion of the DNI. Peter's is 25%, and Paul's is 75%.

Tax Exempt Organizations

Types of Organizations

Tax Exempt Entities

A tax-exempt organization can either be a corporation, a trust, or an association.

Tax exempt organizations include the following:

- Charitable organizations
- Religious organizations
- Social welfare organizations
- Labor organization
- Employee benefit associations or funds
- Veterans organizations
- Political organizations (but lobbying to influence legislation or political parties is not an exempt purpose)

An exempt entity must file an information return (Form 990) if gross receipts exceed \$50,000. Churches do NOT have to file a 990.

Obtaining and Maintaining Tax Exempt Status

501(c)(3) Organizations

To qualify as a tax-exempt organization, it must operate solely for a tax-exempt purpose. The organization has to apply for and receive exempt status.

The organization must be organized and operated exclusively for exempt purposes. No part of the organization's net earnings can benefit the private interests of any shareholder or individual.

To apply for exempt status, the organization must be a corporation, a trust, or an association. The application to become a 501(c)(3) organization is Form 1023.

If the organization's annual receipts are more than \$50,000, then it needs to file Form 990 each year which is an information return. If the organization's receipts are less than \$50,000, then it files 990-N which is an electronic form.

If the organization fails to file the required returns for 3 years in a row, it automatically loses its exempt status.

If the organization loses its exempt status, it has 15 months to re-apply and can have its exempt status retroactively reinstated to the date of revocation.

Unrelated Business Income

Unrelated Business Taxable Income (UBTI)

If an exempt organization has business income from activities unrelated to the exempt purpose, then it is taxed on that income. This income is only taxed if it is more than \$1,000, and it is taxed at normal corporate rates if the organization is setup as a corporation, and at trust rates if it's setup as a trust.

Business activities can avoid this treatment if it is substantially related to the exempt purpose of the organization.