CPA REVIEW TEXTBOOK

REG

Regulation

SECTIONS 4000–4500

2021 (EFFECTIVE JANUARY 1)

Surgent CPA Review:
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This book is written to provide accurate and authoritative information concerning the covered topics. It is not meant to take the place of professional advice. **The content of this book has been updated to reflect relevant legislative and governing body modifications as of January 2021.**

Printed in the United States of America.

Acknowledgments

Surgent CPA Review was developed by a team of professionals who are experts in the fields of accounting, business law, and computer science, and are also experienced teachers in CPA Review programs and continuing professional education courses.

Surgent CPA Review expresses its sincere appreciation to the many individual candidates, as well as accounting instructors, who took time to write to us about previous editions. The improvements in this edition are attributable to all of these individuals. Of course, any deficiencies are the responsibilities of the editors and authors. We very much appreciate and solicit your comments and suggestions about this year's edition.

The editors and authors are also indebted to the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the Governmental Accounting Standards Board for permission to quote from their pronouncements. In addition, the AICPA granted us permission to use material from previous Uniform CPA Examination Questions and Answers. AICPA codification numbers are used throughout the Auditing portion of the Review to indicate the source of materials.

We recognize the work and dedication of our team of software designers and developers. Their vision has made this the best product possible. They contributed countless hours to deliver this package and are each fully dedicated to helping you pass the exam. Our thanks go out to the many individuals who have made contributions to both the software and textbook portions of the CPA Review. We extend our gratitude to our team of software testers who ensure that you receive only the highest quality product. Finally, we express appreciation to the editorial teams who have devoted their time to review this product. They have provided invaluable aid in the writing and production of the Surgent CPA Review.

Good luck on the exam!

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Section 4000
Overview of the Regulation Examination

4010 The CPA Examination

4010.01 The Exam

The Uniform CPA Examination (the Exam) provides reasonable assurance to state boards of accountancy that individuals who pass the Exam possess the minimum level of technical knowledge and skills necessary for initial licensure. Ongoing changes in the business world, along with advancements in technology, have impacted the accounting profession and affected the required knowledge, skills, and professional responsibilities of newly licensed Certified Public Accountants (CPAs).

To remain relevant to the real-world demands of the profession, the AICPA has determined that newly licensed CPAs must not only demonstrate sufficient content knowledge, but also possess:

a. higher-order cognitive skills, including critical thinking, problem solving, and analytical ability, as well as professional skepticism,

b. a thorough understanding of professional and ethical responsibilities,

c. a strong understanding of the business environment and processes, and

d. effective communication skills.

4010.02 AICPA Skill Framework

The AICPA has adopted a skill framework based on the modified Bloom's Taxonomy of Educational Objectives. Bloom's Taxonomy classifies a continuum of skills that students can be expected to learn and demonstrate. The taxonomy is widely used in educational and licensure testing to define the level of skills to be assessed and to guide the development of test questions.

In applying this framework, approximately 600 representative tasks that a newly licensed CPA may be expected to complete were identified. Based on the nature of a task, one of four skill levels is assigned to each of the tasks, as follows:

Skill Levels	
Evaluation	The examination or assessment of problems, and use of judgment to draw conclusions.
Analysis	The examination and study of the interrelationships of separate areas in order to identify causes and find evidence to support inferences.
Application	The use or demonstration of knowledge, concepts, or techniques.
Remembering and Understanding	The perception and comprehension of the significance of an area utilizing knowledge gained.

4010.03 Exam Focus

The percentage for each skill level for each exam section is shown in the table below:

Section	Remembering and Understanding	Application	Analysis	Evaluation
AUD	**30%-40%**	**30%-40%**	**15%-25%**	**5%-15%**
BEC	**15%-25%**	**50%-60%***	**20%-30%**	**-**
FAR	**10%-20%**	**50%-60%**	**25%-35%**	**-**
REG	**25%-35%**	**35%-45%**	**25%-35%**	**-**

** Includes written communications*

4010.04 Content Integration

As discussed previously, each of the Exam sections is designed to test higher-order skills by incorporating the applicable content knowledge and skills that are required in the context of the work of a newly licensed CPA. Tasks that involve application, analysis, and/or evaluation skills may include some content from other Exam sections, which would occur naturally in the task from a contextual perspective. These tasks will always be based upon the primary content knowledge of a particular Exam section, but could draw upon a candidate's basic knowledge of general accounting, auditing, tax, and business concepts. For example, in the AUD section of the Exam, a TBS designed to evaluate inventory observation audit procedures might include some inventory valuation/obsolescence or sales cutoff considerations, even though these concepts would be evaluated more extensively in FAR.

4010.05 Blueprint

The Blueprint is organized by content AREA, content GROUP, and content TOPIC. Each topic includes one or more representative TASKS. The purpose of the Blueprint is to:

a. document the minimum level of knowledge and skills necessary for initial licensure.

b. assist candidates in preparing for the Exam by outlining the knowledge and skills that may be tested.

c. apprise educators of the knowledge and skills candidates need to function as newly licensed CPAs.

d. guide the development of Exam questions.

The tasks in the Blueprint are representative; they are not intended to be viewed as an all-inclusive list of tasks that may be tested. It is important to note that the number of tasks associated with a particular content group or topic is not indicative of the extent such content group, topic, or related skill level will be assessed on the Exam.

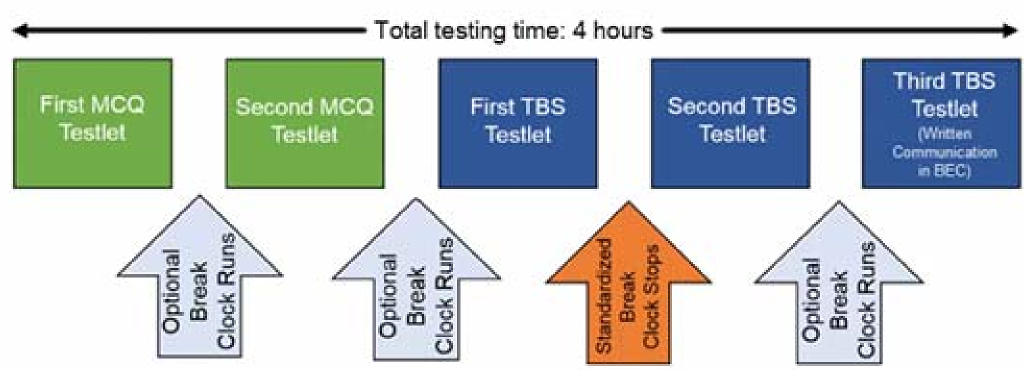
4010.06 Exam Testing Time

Total Exam time is 16 hours—four sections of 4 hours each. Candidates must complete the information on the welcome screen within 5 minutes and must accept the policy statement and confidentiality policy screens within 5 minutes. If these screens are not completed within this time frame, the exam will shut down and will not be restarted.

Each of the four exam sections consists of a series of five testlets. Each testlet contains either (but not both) multiple-choice questions (MCQs) or task-based simulations (TBSs); for BEC, the last testlet contains three written communication (WC) tasks. There is at least one research question (research-oriented TBS) in the AUD, FAR, and REG sections.

A 15-minute standardized break is given after the first TBS testlet, at approximately the two-hour point. The Exam clock pauses for this break only; you can choose to decline the standardized break and continue testing, but the break will not be offered again. If you choose to take the standardized break, you must leave the testing room, adhering to all security protocols, and you will be readmitted to the testing room once cleared by Prometric personnel. If you have not returned and started the fourth TBS testlet prior to the expiration of 15 minutes, the Exam clock will restart. You will be asked to re-enter your launch code to restart the exam.

Candidates may choose to take an optional break between any two testlets, but it will count against total testing time as the Exam clock continues to run.



Source: AICPA

4010.07 Testlet Organization

Section	Question Type	Weighting	Testlet
AUD	72 MCQs 8 TBSs	50% 50%	#1 36 MCQs #2 36 MCQs #3 2 TBSs #4 3 TBSs #5 3 TBSs
BEC	62 MCQs 4 TBSs 3 Written Communications	50% 35% 15%	#1 31 MCQs #2 31 MCQs #3 2 TBSs #4 2 TBSs #5 3 WCs
FAR	66 MCQs 8 TBSs	50% 50%	#1 33 MCQs #2 33 MCQs #3 2 TBSs #4 3 TBSs #5 3 TBSs
REG	76 MCQs 8 TBSs	50% 50%	#1 38 MCQs #2 38 MCQs #3 2 TBSs #4 3 TBSs #5 3 TBSs

4020 The Regulation Section of the CPA Examination

4020.01 The Regulation (REG) section tests a candidate's knowledge and skills required of newly licensed CPAs with respect to federal taxation, ethics and professional responsibilities related to tax practice, and business law. The tasks listed in the Blueprint are representative only; they are not intended to be an all-inclusive listing.

4020.02 Section Content

REG content areas and allocation of content to be tested are presented in the following table:

I. Ethics, Professional Responsibilities, and Federal Tax Procedures	10%–20%
II. Business Law	10%–20%
III. Federal Taxation of Property Transactions	12%–22%
IV. Federal Taxation of Individuals	15%–25%
V. Federal Taxation of Entities	28%–38%

4020.03 REG Skill Allocation

Each representative task in the REG section blueprint is assigned a skill level. The REG section does not test any content at the Evaluation skill level as newly licensed CPAs are not expected to demonstrate that level of skill in regards to REG content. REG section considerations related to the skill levels are as follows:

1. **Remembering and Understanding** is primarily tested in Areas I and II. The content is these two areas is tested at the lower end of the skill-level continuum.
2. **Application** and **Analysis** skills are concentrated in Areas III, IV, and V. These areas contain more of the day-to-day tasks that newly licensed CPAs are expected to perform, and are therefore tested at the higher end of the skill-level continuum.

4020.04 References for the Regulation section include the following:

1. Revised Model Business Corporation Act
2. Revised Uniform Limited Partnership Act
3. Revised Uniform Partnership Act
4. Securities Act of 1933
5. Securities Exchange Act of 1934
6. Uniform Accountancy Act
7. Uniform Commercial Code
8. Internal Revenue Code of 1986, as amended
9. Treasury Department Circular 230
10. Treasury Regulations
11. Other administrative pronouncements regarding federal taxation
12. Case law on federal taxation
13. Public Law 86-272
14. Uniform Division of Income for Tax Purposes Act (UDITPA)
15. Current textbooks covering business law, federal taxation, auditing, accounting, and ethics

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Section 4100
Ethics, Professional Responsibilities, and Federal Tax Procedures
(10% - 20%)

4110 Ethics and Responsibilities in Tax Practice

4111 Regulations Governing Practice Before the Internal Revenue Service

4111.01 The Secretary of the Treasury has the power to prescribe rules and regulations regarding the conduct of tax practitioners who represent taxpayers before the IRS. These rules are in Title 31 of the Code of Federal Regulations and are commonly referred to as "Circular 230."

4111.02 The Secretary of the Treasury also has the power to appoint a director of practice under Circular 230. The director's duties include:

a. acting upon applications for enrollment to practice before the IRS,

b. instituting and conducting disciplinary hearings,

c. making inquiries as to matters under his or her jurisdiction, and

d. other duties that are necessary to carry out his or her functions.

Practice Before the IRS

4111.03 Practice before the IRS is defined in Circular 230 as involving all matters connected with a presentation to the IRS, or any of its officers or employees, relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. This includes:

- **a.** preparing and filing documents,
- **b.** corresponding and communicating with the IRS,
- **c.** rendering written advice with respect to any entity, transaction, plan, or arrangement, and
- **d.** representing a client at conferences, hearings, and meetings.

4111.04 Certified public accountants (CPAs) and attorneys may practice before the IRS provided they are not under suspension or disbarment from practice before the IRS. A CPA is any person duly qualified to practice as a CPA in any state, possession, territory, commonwealth, or the District of Columbia. An attorney is a person who is a member in good standing of the bar of the highest court of any state, possession, territory, commonwealth, or the District of Columbia. CPAs and attorneys must file a written declaration that they are currently qualified as a CPA or attorney and that they are authorized to represent the taxpayer in question.

4111.05 Individuals may also practice before the IRS if they qualify as an enrolled agent. An application for enrollment must be filed with the Director of Practice. The applicant must then demonstrate competence in tax matters by passing a written examination.

4111.06 An individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries may also practice before the IRS. Practice by an enrolled actuary is limited by Circular 230 to issues concerning pension and employee benefit plans.

4111.07 An individual may also practice before the IRS as an enrolled retirement plan agent (practice is limited to certain issues and programs involving retirement plans). Enrollment as a retirement plan agent is granted after the individual passes a written examination that demonstrates special competence in qualified retirement plan matters.

4111.08 Former IRS employees may be granted enrollment as an enrolled agent or enrolled retirement plan agent by virtue of their past service and technical experience gained as an IRS employee.

4111.09 Circular 230 allows individuals who are not CPAs, attorneys, or enrolled agents to engage in limited practice before the IRS. As a result, an individual can represent themselves before the IRS provided they present satisfactory identification.

Limited Practice Before the Internal Revenue Service

4111.10 An individual may also engage in limited practice before the IRS even if the taxpayer is not present, in the following situations:

- **a.** An individual may represent a member of their immediate family.
- **b.** A regular, full-time employee of an individual employer may represent the employer.
- **c.** A general partner or a regular full-time employee of a partnership may represent the partnership.

d. A bona fide officer or regular full-time employee of a corporation (including a parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group.

e. A regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust.

f. An officer or a regular employee of a government unit, agency, or authority may represent the governmental unit, agency, or authority in the course of his or her official duties.

g. An individual may represent any individual or entity who is outside the United States, when the representation takes place outside the United States.

h. An individual who signs the taxpayer's return as the preparer (or who prepares a return but is not required to sign the tax return) may represent the taxpayer before IRS employees of the examination division regarding the tax liability of the taxpayer for the period covered by the return.

Practitioner Duties and Restrictions

4111.11 A practitioner has a duty to promptly submit records or information to the IRS upon proper request. Also, there is a duty not to interfere with any lawful effort of the IRS to obtain such records or information. These duties exist unless the practitioner in good faith and on reasonable grounds believes the record or information is privileged.

4111.12 A practitioner has a duty to provide the director of practice with any requested information regarding violations of any regulations dealing with practice before the IRS.

4111.13 A practitioner who knows that a client has not complied with the revenue laws of the United States, or has made an error in or omission from any return, document, affidavit, or other paper, has a duty to advise the client promptly of such noncompliance, error, or omission.

4111.14 A practitioner must exercise due diligence in the following situations:

a. In preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to IRS matters

b. In determining the correctness of oral or written representation made by the practitioner to the Department of the Treasury

c. In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS

A practitioner will be presumed to have exercised due diligence if the practitioner relies on the work product of another person.

4111.15 A practitioner may not unreasonably delay prompt disposition of any matter before the IRS.

4111.16 A practitioner may not knowingly and directly or indirectly accept assistance from or assist any person who is under disbarment or suspension from practice before the IRS. The practitioner must also not accept assistance from any former government employee disqualified from practice under any rule or U.S. law.

4111.17 A practitioner may not act as a notary public with respect to any matter administered by the IRS for which the practitioner is employed as counsel, attorney, or agent, or in which the practitioner may in any way be interested.

4111.18 A practitioner may not charge an unconscionable fee in connection with any matter before the IRS.

4111.19 A practitioner generally may not charge a contingent fee for services rendered in connection with any matter before the IRS. However, a practitioner may charge a contingent fee for services rendered in connection with the IRS's examination of or challenge to:

a. an original return or

b. an amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of or a written challenge to the original return.

A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS. A practitioner can charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

4111.20 In general, a practitioner must, at the request of the client, promptly return any and all records of the client that are necessary for the client to comply with his or her federal tax obligations. The practitioner may retain copies of the records returned to a client (Circular 230, Section 10.28).

4111.21 Generally, a practitioner is not allowed to represent conflicting interests in his or her practice before the IRS. However, the practitioner may represent conflicting interests provided the representation is not prohibited by law, and each affected client waives the conflict of interest by informed, written consent.

a. The AICPA *Code of Professional Conduct* and Treasury Circular 230 both address conflicts of interest, but also have key differences.

	AICPA *Code of Professional Conduct*	**Treasury Circular 230**
Client Relationships	Addresses conflicts arising from client relationships with other members of the same firm	No reference to client relationships with other members of the same firm
Waiver of Conflicts	Does not need to be in writing	Must be in writing
Perception of Others	Perception of others about independence matters	No reference to perception of others

b. Practitioners providing tax services must consider both the AICPA *Code of Professional Conduct* and Treasury Circular 230 when determining whether a conflict of interest exists.

c. Member firms must have a procedure in place to determine whether a conflict of interest exists. Such procedure must be appropriate for the size of the firm and type of practice. Per Circular 230 guidelines, the firm's tax leaders are responsible to ensure all firm members comply with such procedures.

4111.22 Practitioners are subject to various duties and restrictions regarding advertising and solicitation. For example, a practitioner may not use any form of public communication that contains any statement or claim that is false, fraudulent, unduly influencing, coercive, unfair, misleading, or deceptive. Also, a practitioner may not make any uninvited written or oral solicitation of employment in matters before the IRS if the solicitation violates federal or state law or other applicable rule.

4111.23 A practitioner who prepares tax returns may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a federal tax liability.

4111.24 A practitioner may not advise a client to take a position on a document, affidavit, or other paper submitted to the IRS unless the position is not frivolous.

4111.25 A practitioner may not advise a client to submit a document, affidavit, or other paper to the IRS:

a. the purpose of which is to delay or impede the administration of the federal tax law,

b. that is frivolous, or

c. that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation, unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

4111.26 A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to a position taken on a tax return if the practitioner advised the client with respect to the position or the practitioner prepared or signed the return. Also, a practitioner must inform the client of any penalties reasonably likely to apply regarding any document, affidavit, or other paper submitted to the IRS. A practitioner must inform the client of the opportunity to avoid any penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

4111.27 A practitioner can generally rely on information furnished by a client without verification. However, a practitioner cannot ignore information which is actually known and must make reasonable inquiries if the information furnished by the client appears incorrect, inconsistent, or incomplete.

4111.28 A practitioner may give written advice (including electronic communication) concerning federal tax issues only if the practitioner:

a. bases the written advice on reasonable factual or legal assumptions (including assumptions as to future events),

b. reasonably considers all relevant facts and circumstances that the practitioner knows or has reason to know,

c. uses reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter,

d. does *not* rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable,

e. relates applicable law and authorities to facts, or

f. does *not,* in evaluating federal tax matters, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

Email communication with clients on simple matters will not be held to the rigorous standards set out above.

Example: J, a practitioner, fails to note that there is a split among the circuit courts on the subject matter of his legal advice. This is a violation of *e.* above.

Sanctions for Violation of the Regulations

4111.29 The Secretary of the Treasury, after notice and an opportunity for a proceeding, may censure (a public reprimand), suspend, or disbar any practitioner from practice before the IRS if the practitioner:

a. is shown to be incompetent, or disreputable,

b. refuses to comply with any rules in Circular 230, or

c. with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client.

4111.30 Incompetence and disreputable conduct for which a practitioner may be sanctioned includes, but is not limited to, the following:

a. Conviction of any criminal offense under the federal tax laws

b. Conviction of any criminal offense involving dishonesty or breach of trust

c. Conviction of any felony under federal or state law for which the conduct involved renders the practitioner unfit to practice before the IRS

d. Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading. Facts or other matters contained in testimony, federal tax returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."

e. Solicitation of employment as prohibited under Circular 230, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the IRS or any officer or employee thereof

f. Willfully failing to make a federal tax return in violation of the federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any federal tax

g. Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade federal taxes or payment thereof

h. Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States

i. Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the IRS by the use of threats, false accusations, duress, or coercion; by the offer of any special inducement or promise of an advantage; or by the bestowing of any gift, favor, or thing of value

j. Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any state, territory, or possession of the United States, including a commonwealth, or the District of Columbia, any federal court of record or any federal agency, body, or board

k. Knowingly aiding and abetting another person to practice before the IRS during a period of suspension, disbarment, or ineligibility of such other person

l. Contemptuous conduct in connection with practice before the IRS, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter

m. Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the federal tax laws

n. Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by federal tax laws unless the failure is due to reasonable cause and not due to willful neglect

o. Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a disciplinary proceeding

4111.31 A practitioner may also be disbarred or suspended from practice for:

a. willfully violating the regulations in Circular 230 or

b. through recklessness or gross incompetence, violating the standards in Circular 230 with respect to tax returns, documents, affidavits, and other written advice.

4111.32 **Rules applicable to disciplinary proceedings**

a. Circular 230 contains detailed rules regarding the process to be followed in disciplinary hearings regarding a practitioner's violation of any of the rules.

b. Proceedings are held before an administrative law judge following procedures specified in Circular 230. The judge files his or her decision with the Director of Practice.

c. An appeal of the decision of the administrative law judge can be made to the Secretary of the Treasury within 30 days of the decision.

d. If a practitioner is suspended as a result of the proceedings, they are prohibited from practicing before the IRS during the period of the suspension.

e. If a practitioner is disbarred, the practitioner is not allowed to practice before the IRS until authorized to do so by the Director of Practice. A practitioner who is disbarred may petition for reinstatement after five years from the date of disbarment. Reinstatement is only granted if the Director of Practice believes that the petitioner is not likely to conduct themselves in violation of the rules and that granting reinstatement is not contrary to public policy.

4112 Internal Revenue Code and Regulations Related to Tax Return Preparers

4112.01 A compensated tax return preparer can be liable for civil and criminal penalties for negligently or intentionally understating a taxpayer's liability.

4112.02 A compensated preparer can be liable for the greater of $1,000 or a 50% penalty of income derived (first-tier penalty) for each tax return or claim for refund that understates the taxpayer's liability due to unreasonable positions. There is a second-tier penalty of $5,000 or 75% penalty of income derived if the preparer willfully or recklessly understated the liability. This penalty applies if the preparer did the following:

- **a.** Understated tax liability by taking a position that does not have a realistic possibility of being sustained
- **b.** Knew or should have known of this position
- **c.** Did not disclose the position in the return or an attachment to the return

4112.03 The following are some of the compensated tax return preparer's requirements under the Internal Revenue Code; under Title 26, failure to comply can result in a penalty of $50 for each failure, with a maximum penalty imposed on any tax return preparer not to exceed $26,500 (for calendar year 2020) in a return period:

- **a.** Sign the return, and give the address and IRS identification number of self or employer.
- **b.** Furnish the taxpayer a copy of the prepared return no later than the time the original return is presented for signing.

  Example: J, a return preparer, fails to send copies to all clients. J will be penalized $50 for each client, up to $26,500 total for a calendar year.
- **c.** Maintain a file of returns and log of all returns prepared for three years following the close of the return period. The penalty assessed for failure to comply with the requirements of sections *a.–b.* is $50 per occurrence. The penalty will not apply if the failure is due to reasonable cause and not to willful neglect.
- **d.** Do not cash another person's tax refund check. A penalty of $530 is assessable against a preparer who violates this provision.

4112.04 Criminal penalties can be imposed for the following:

- **a.** Tax evasion
- **b.** Perjury on a tax return
- **c.** Bribery of an IRS employee

4120 Licensing and Disciplinary Systems

4121 Role of State Boards of Accountancy

4121.01 The professional ethics division of the AICPA interprets the *Code of Professional Conduct,* investigates potential disciplinary matters involving members, and presents cases before the AICPA joint trial board (this board judges disciplinary charges against state CPA society and AICPA members).

4121.02 The AICPA professional ethics division's activities are performed within the joint ethics enforcement program (JEEP), in which 48 state CPA societies participate. Generally, the codes of conduct of these societies conform to the AICPA Code.

4121.03 The AICPA and state societies act as agents of each other in ethics investigations. They present cases before the joint trial board according to the bylaws of each organization. For example, if the AICPA conducts an ethics investigation of a member, it does so on its own behalf and also on behalf of the state society of which the individual is a member. The same idea applies in reverse if a state society is conducting the investigation.

4121.04 Bylaws provide for the jurisdiction of the joint trial board over the membership of both the AICPA and the state societies.

4121.05 The AICPA professional ethics division is authorized to start an investigation based on information from various sources. This information of a potential disciplinary matter can come from such sources as written complaints, reports in the media, or referrals from government agencies.

4121.06 The AICPA professional ethics division works through several committees:

a. The professional ethics executive committee

b. The technical standards subcommittee (an investigative body)

c. The government technical standards subcommittee (which investigates engagements in which the clients are state or local government entities or receive federal financial assistance)

d. The independence-behavioral standards subcommittee (which investigates and interprets the Code's rules on independence, confidentiality of client information, and other behavioral concerns)

4121.07 The AICPA professional ethics division has the authority to settle cases brought before it. This enables the division to conclude investigations without the delay or expense of formal hearings.

4121.08 **CPE requirements:** State boards of accountancy are generally in charge of maintaining records of continuing education of all CPAs licensed in that state. The CPA must attest to the state board that the continuing education requirements have been completed. Most jurisdictions run random audits of the CPA records to determine if the reporting of continuing education was both accurate and timely.

4121.09 **Requirements for a CPA license:** Most states have specific requirements for the college credit hours that must be completed in auditing and accounting courses by a candidate for a CPA license. Candidates with deficiencies must complete college credit courses to fulfill the requirements for a CPA license.

4121.10 Reciprocity is a recognition of licenses between states. Therefore, before a certified public accountant moves to another state, he/she must look into the reciprocity rules in the new state. The ability to transfer licensing credentials from one state to another is controlled by state boards and reciprocity is not guaranteed.

4121.11 The NASBA (National Association of State Boards of Accountancy) is the regulating department for the state boards. The NASBA Tools for Accounting Compliance give the candidate much information to inform him/her of the requirements for multiple jurisdictions.

4121.12 In the United States, licensing of certified public accountants is the responsibility of state boards of accountancy. There are 54 jurisdictions that license CPAs, including the 50 states, the District of Columbia (Washington, D.C.), Puerto Rico, Guam, and the U.S. Virgin Islands. Each board of accountancy operates under the AICPA and National Association of State Boards of Accountancy (NASBA) Uniform Accountancy Act (UAA), which establishes the board and sets the requirements for licensing for certified public accountants. The state laws are generally modeled on the UAA.

4121.13 To qualify for a CPA license in any of the 54 jurisdictions, a candidate must successfully complete the Uniform CPA Examination. Every state uses the examination prepared by the AICPA. The scores are sent to the state where the candidate has registered, but the scores can then be transferred from the test state to any other state.

4121.14 State boards of accountancy all use scores from the Uniform CPA Examination to qualify candidates for certification and licenses to practice. Each state board establishes its own rules on residency, citizenship, education, and experience, and some require the completion of an ethics examination to qualify for a CPA license. After licensing, state boards have established requirements for continuing professional education (CPE). State boards establish the rules to qualify for a license and also the rules for revoking a license.

4130 Federal Tax Procedures

4131 Audits, Appeals, and Judicial Process

4131.01 **Preliminary review**

a. The IRS Service Center where the return is filed conducts a routine review of the return for obvious errors such as:

(1) a failure to sign the return,

(2) a failure to report an item from an information return on the tax return, or

(3) a mathematical error or clerical error, such as the use of an incorrect table.

b. The taxpayer is then mailed a corrected tax calculation and, if there is a deficiency, a request to pay the additional amount.

c. If the taxpayer fails to respond, the IRS generally conducts either a correspondence or an office audit.

d. This review process is not considered a formal examination of the return. Therefore, the taxpayer is not entitled to the administrative remedies available for formal examinations.

4131.02 Selection of returns for audit

a. The IRS uses a method called the Discriminant Function System (DIF), which uses mathematical formulas in order to select returns that are most likely to contain errors and to generate the most additional revenue on audit. The formulas used are developed from information gained in regular audits and audits of randomly selected returns. The randomly selected returns are chosen under the National Research Program (NRP).

b. Specific factors used by the IRS in determining which returns are selected for audit are not disclosed by the IRS.

c. In addition to the computerized selection process, returns can be selected for audit under a number of other methods. For example, returns can be selected for audit:

(1) due to information obtained as a result of information exchange programs with state or foreign agencies,

(2) due to information obtained from an informant,

(3) because the return is linked in some way to another return already being audited, or

(4) because the taxpayer’s taxable income, total assets, gross receipts, or deductions exceed certain thresholds established by the IRS.

4131.03 Types of examinations: Correspondence examinations

a. If only a few items are in question on the taxpayer’s return, an examination may be conducted through correspondence with the taxpayer.

b. The examiner will contact the taxpayer by letter and ask that the questionable items on the return be verified by appropriate documentation.

c. A taxpayer involved in a correspondence examination has the same appeal rights as a taxpayer involved in an office or field examination.

d. If the issues cannot be resolved, the case will be referred for handling as either an office or field examination

4131.04 Types of examinations: Office examinations

a. For more complex issues, the examination will be conducted as an office examination at the appropriate IRS District Office by a tax auditor.

b. The taxpayer will be asked to bring particular records to support items claimed on the return.

c. Generally, the scope of the office examination is limited to the issues stated in the notification letter sent to the taxpayer

4131.05 Types of examinations: Field examinations

a. If the tax issues are more complex, the IRS generally conducts a field examination.

b. In this situation, the IRS examiner, a revenue agent, goes to the taxpayer's place of residence or business to examine the taxpayer's records. The revenue agent is also authorized to take related testimony and to administer oaths.

c. A field examination is open-ended. The revenue agent may investigate any questionable items on the taxpayer's return (not only those previously identified) or any questionable items in the taxpayer's records.

4131.06 Audit process

a. Before the start of an examination, the IRS is required to provide the taxpayer with an explanation of the audit process and the rights available to the taxpayer. The taxpayer must also be informed that the taxpayer can suspend the interview at any time to consult with a representative.

b. A taxpayer may represent themselves or they may be represented by a CPA, an attorney, an enrolled agent, or the preparer of the return who signed the return as the preparer.

c. The taxpayer must give a representative written authority to represent them. This is generally done by use of IRS Form 2848 (*Power of Attorney and Declaration of Representative*).

d. At the conclusion of the exam, the tax auditor or revenue agent provides the taxpayer with any proposed adjustments of tax liability and any tax balance due.

e. If the taxpayer agrees with the adjustments, the taxpayer will sign an IRS Form 870 (*Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment*). By signing this form, the taxpayer waives the right to receive a statutory notice of deficiency (90-day letter) needed to petition the Tax Court and also gives up the right to go to the IRS Appeals Division.

f. If the taxpayer does not agree with the adjustments, the taxpayer will receive a 30-day letter notifying them of the right to appeal the proposed adjustment to the IRS Appeals Office within a 30-day period. If an appeal is not requested, the taxpayer is issued a Notice of Deficiency (90-day letter), which gives them 90 days in which to file a Tax Court petition.

4131.07 Appeals process

a. An oral request for an Appeals conference can be made in the case of an office examination or a correspondence examination.

b. In the case of a field examination, a written request is necessary in order to have the case sent to the IRS Appeals Office.

c. If the proposed adjustment in tax for a particular period is $25,000 or less, the taxpayer only has to file a small case request indicating the adjustments they disagree with and stating the reasons for disagreement.

d. If the total amount of proposed adjustment in tax for a particular period is over $25,000, a formal written protest is required.

e. The written protest must include:

(1) a list of the proposed changes that the taxpayer does not agree with and the reason for disagreement,

(2) the tax periods involved,

(3) a statement of facts supporting the taxpayer's position, and

(4) a statement of the law or other authorities that the taxpayer relies upon.

f. The Appeals Division will settle disputes based on the hazards of litigating the issues in court.

Example: The taxpayer will have to weigh the cost of appealing against the amount of the tax owed. Furthermore, the Appeals Division can raise additional issues.

g. If a taxpayer agrees to settle the case with the Appeals Division, they will sign an IRS Form 870-AD (*Offer of Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment*). Acceptance of this form means that the case will not be reopened unless there has been fraud, misrepresentation of a material fact, a significant error in a mathematical calculation, or other administrative wrongdoing.

h. If a settlement is not reached with the Appeals Division, a statutory notice of deficiency (90-day letter) is sent to the taxpayer. This gives the taxpayer the opportunity to file a petition, within 90 days, with the Tax Court. The 90-day period is statutory. *No* extension of the time can be granted by the Tax Court. A case in the Tax Court is heard without payment of the tax. If the taxpayer loses, the taxpayer pays the tax with interest. If the 90-day *statutory* period is missed, the taxpayer *must* pay the tax and sue for a refund in the U.S. District Court or the U.S. Court of Federal Claims. To assure receipt by the Tax Court, the petition should be sent by registered mail; this is not required, but it is prudent.

Example: If the alleged tax owed is high, a taxpayer's better option is to file in the Tax Court and defer paying the tax until after the judgment of the Tax Court, rather than to liquidate assets to pay the tax and file for a refund.

4131.08 Judicial process

a. After a taxpayer has exhausted their administrative remedies with the IRS, the taxpayer may generally litigate the case in court.

b. All cases must start at the trial court level. For a federal tax dispute, there are three trial courts in which the case may be heard:

(1) Tax Court

(2) U.S. District Court

(3) U.S. Court of Federal Claims

c. If either the government or the taxpayer does not agree with the trial court's decision, the case may be appealed to either the appropriate U.S. Court of Appeals or the U.S. Court of Appeals for the Federal Circuit.

4131.09 Trial court: U.S. Tax Court

a. The U.S. Tax Court hears only federal tax disputes. The Tax Court is officially located in Washington, D.C., but judges travel to various cities across the United States to hear cases.

b. Generally, the case is heard by one judge. There are no juries in the Tax Court.

c. The Tax Court is a "deficiency court" in that the taxpayer can have the Tax Court hear their tax dispute without first paying the tax deficiency.

d. Appeals from the Tax Court go to the U.S. Court of Federal Appeals that covers the geographic area in which the taxpayer resides.

e. The Tax Court also has a simplified small tax case procedure that is more informal and where cases are heard by magistrates. To have a case heard in a small tax case procedure, the amount of tax in dispute cannot exceed $50,000. The taxpayer can elect this option in lieu of the U.S. Tax Court; however, there is *no* appeal from a small tax case procedure decision.

4131.10 Trial court: U.S. District Court

a. A taxpayer can also have their tax dispute heard by the U.S. District Court for the federal district in which they reside. The United States is divided into 11 regional Court of Appeal circuits. Each Circuit is then subdivided into Districts.

b. To have the case heard by the U.S. District Court, the taxpayer must first pay the tax and then sue the government in the District Court for a refund.

c. In District Court, one judge hears the case, and the taxpayer may also request a jury trial.

d. The District Court hears both tax and nontax cases.

e. Appeals from the U.S. District Court go to the U.S. Court of Federal Appeals for the geographic area in which the taxpayer resides.

4131.11 Trial court: U.S. Court of Federal Claims

a. The U.S. Court of Federal Claims generally hears cases in Washington, D.C. There is one judge and no jury.

b. This trial court hears cases involving claims (tax and nontax) against the federal government. Therefore, the taxpayer must first pay the tax and sue for a refund in this court.

c. Appeals from the U.S. Court of Federal Claims are heard by the U.S. Court of Appeals for the Federal Circuit, which sits in Washington, D.C.

4131.12 Trial court: U.S. Federal Court of Appeals

a. An appeal can be filed with the appropriate U.S. Federal Court of Appeals as a matter of right by either the taxpayer or the government if they disagree with the trial court decision. This means the appeals court must hear the appeal as long as proper procedures are followed in filing the appeal.

b. Normally the appeal is heard by a three-judge panel. In certain cases, all of the judges of the Circuit may hear the case and take part in the decision.

c. The trial courts whose decisions are appealable to a particular Court of Appeals are bound to follow the prior decision of the appellate court on the same issue.

d. One Court of Appeals, though, is not bound to follow a decision of another Court of Appeals on the same issue.

e. The Court of Appeals hears appeals of both tax and nontax cases from the trial courts.

f. Decisions of the U.S. Federal Courts of Appeals are appealable to the U.S. Supreme Court.

4131.13 U.S. Supreme Court

a. Either the taxpayer or the government can request that the U.S. Supreme Court review a decision in a tax case which has been rendered by a U.S. Court of Appeals. There is no appeal as a matter of right to the U.S. Supreme Court in a federal tax case.

b. To file an appeal, the taxpayer or the government must file a writ of certiorari requesting that the Supreme Court hear the case.

c. The Supreme Court generally does not hear appeals of tax cases. The situations in which the Court grants the writ of certiorari and hears the appeal in a tax case will usually involve either a situation in which the Courts of Appeals have issued opinions that are in conflict, the tax issue in the case impacts a large number of taxpayers, or the tax issue involves a large amount of tax revenue.

d. If the Supreme Court grants the appeal and renders a decision in the case, this is generally the final word on the issue (unless Congress acts legislatively). All of the lower courts, trial and appellate, must follow the Supreme Court decision in future cases.

4132 Substantiation and Disclosure of Tax Positions

Substantiation

4132.01 Substantiation requirements (in general)

a. A taxpayer must generally be able to substantiate any item on their tax return if an issue is raised regarding the item by the IRS.

b. In addition to the general requirement that all items must be able to be substantiated, the Internal Revenue Code, regulations, and other tax pronouncements contain numerous rules regarding the specific substantiation requirements for certain types of deductions or credits taken on a taxpayer's return.

c. While including all of the situations where specific substantiation requirements are laid out in the tax rules is beyond the scope of this outline, two examples follow in sections **4132.02** and **4132.03.**

4132.02 Substantiation of medical expenses

a. Beginning January 1, 2019, all taxpayers may deduct only the amount of the total unreimbursed allowable medical care expenses for the year that exceeds 10% of their adjusted gross income.

b. To substantiate these medical expenses, a statement or itemized invoice should be retained that shows:

(1) the name and address of each person or entity paid,

(2) the amount and date of each payment, and

(3) what medical care was received and who received it.

4132.03 Substantiation of charitable contributions

a. For cash contributions, a deduction is only allowed if the taxpayer has written receipts such as a canceled check or a written statement from the charity that show:

(1) the name of the charity and

(2) the date and amount of the contribution.

b. A written statement must provide an estimate of the value of any goods or services received by the donor if:

(1) a payment is made to the charity for more than $75 and

(2) the payment is partly a charitable contribution and partly a payment for goods and services.

c. For gifts of property other than money, the taxpayer must have a receipt from the charity. If the property is clothing or other household items, the property must in "good used condition or better."

d. To deduct a single cash or noncash property contribution of $250 or more, the taxpayer must receive a written acknowledgment from the charity. The acknowledgment must include:

(1) the amount of cash received or a description of the noncash property contributed,

(2) whether or not the charity provided the donor any goods or services for the contribution, and

(3) a description and estimate of the value of any goods or services that were provided.

e. If the taxpayer donates noncash gifts valued at more than $500, additional substantiation must be provided with the taxpayer's return. This includes:

(1) how the property was acquired and

(2) the taxpayer's basis in the property.

f. If a taxpayer makes a noncash contribution that exceeds $5,000 in value, a qualified appraisal regarding the value of the property may also be required.

g. If a taxpayer donates a used car to a charity, the taxpayer must obtain a statement from the charity stating the sales price of the car in cases where the car is sold by the charity. The amount that the charity receives from selling the car generally is the amount that the taxpayer can deduct for contributing the car to the charity.

Required Disclosure of Tax Return Positions

4132.04 Required disclosure of tax return positions (in general)

a. In IRS Schedule UTP, certain companies are required to disclose specific information regarding uncertain tax positions taken on their tax return.

b. Schedule UTP requires the reporting of each U.S. federal income tax position taken by an applicable corporation on its U.S. federal income tax return if the following two conditions are met:

(1) The corporation has taken a tax position on its federal income tax return for the current tax year or a prior tax year.

(2) Either the corporation or a related party has recorded a reserve with respect to that tax position for U.S. federal income tax in audited financial statements, or the corporation or related party did not record a reserve for that tax position because the corporation expects to litigate the position.

c. A tax position meeting one of the two above criteria must be reported regardless of whether the audited financial statements are prepared based on U.S. generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS), or other country-specific accounting standards, including a modified version of any of the above.

d. A tax position taken on a tax return is a tax position that would result in an adjustment to a line item on that return if the position is not sustained. If multiple tax positions affect a single line item, each tax position must be reported separately on the Schedule UTP.

e. Analysis of whether a reserve has been recorded for the purpose of completing Schedule UTP is determined by reference to the reserve decisions made by the corporation or related party for audited financial statement purposes.

f. A corporation is not required to report on Schedule UTP, a tax position taken in a tax year beginning before January 1, 2010, even if a reserve is recorded with respect to that tax position in audited financial statements issued in 2010 or later.

4132.05 Who must file

a. A corporation must file Schedule UTP with its income tax return if:

(1) the corporation files IRS Forms 1120, 1120-L, or 1120-PC,

(2) the corporation has assets that equal or exceed $10 million,

(3) the corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year, and

(4) the corporation has one or more tax positions that must be reported on Schedule UTP.

b. The Schedule UTP should not be filed separately but should be attached to the corporation's income tax return.

4132.06 Policy of restraint

a. The IRS has announced that it will use a policy of restraint and forgo seeking certain documents that relate to uncertain tax positions and the workpapers that document the completion of IRS Schedule UTP.

b. If a document is otherwise privileged under the attorney-client privilege, the tax advice privilege in IRC Section 7525, or the work product doctrine and the document was provided to an independent auditor as part of an audit of the taxpayer's financial statements, the IRS will not assert during an examination that privilege has been waived by such disclosure.

c. The above will not apply if:

(1) the taxpayer has engaged in any activity or taken any action, other than those described in that paragraph, that would waive the attorney-client privilege, the tax advice privilege in IRC Section 7525, or the work product doctrine; or

(2) a request for tax accrual workpapers is made because unusual circumstances exist, or the taxpayer has claimed the benefits of one or more listed transactions.

d. Under current procedures, examiners request tax reconciliation workpapers as a matter of course. The taxpayer may redact the following information from any copies of tax reconciliation workpapers relating to the preparation of Schedule UTP it is asked to produce during an examination:

(1) Working drafts, revisions, or comments concerning the concise description of tax positions reported on Schedule UTP

(2) The amount of any reserve related to a tax position reported on Schedule UTP

(3) Computations determining the ranking of tax positions to be reported on Schedule UTP or the designation of a tax position as a Major Tax Position

e. Other than requiring the disclosure of the information on the schedule, the requirement to file Schedule UTP does not affect the policy of restraint.

4133 Taxpayer Penalties

4133.01 Failure to file and failure to pay

a. If a taxpayer fails to file a tax return by the due date, including any extension, a penalty of 5% per month (up to a maximum of 25%) is imposed on the amount of tax shown as being due on the return.

b. If the failure to file is due to fraud, the penalty is 15% per month (up to a maximum of 75%).

c. If a taxpayer fails to pay the tax shown as due on the return, a penalty of 0.5% per month (up to a maximum of 25%) is imposed on the tax due. The penalty amount is doubled if the taxpayer fails to pay the tax once a deficiency assessment has been made.

d. During any month in which both the failure to file and failure to pay penalties are applicable, the failure to file penalty is reduced by the amount of the failure to pay penalty.

e. These penalties do not apply if the taxpayer can show that either the failure to file or failure to pay was due to reasonable cause, not willful neglect.

f. In *Haynes and Haynes v. United States,* the Western District Court of Texas held that previously decided late-filing penalty cases are not limited to only paper returns. The Court ruled that electronically filed tax returns are subject to the same set of standards as paper returns, and reasonable cause exceptions to the late-filing penalty are the same for both paper and electronically filed returns.

4133.02 Failure to pay estimated tax

a. A penalty can be imposed on a taxpayer who fails to pay a sufficient amount of estimated income taxes. The amount of the penalty is based on the interest rate in effect at the time for deficiency assessments.

b. The penalty is not applied if the tax due for the year after withholding and credits is less than $500 for corporations or $1,000 for all other taxpayers.

c. For an individual, the underpayment of estimated tax is the difference between the estimated tax paid and the lowest of:

(1) 90% of the current year's tax,

(2) 100% of the prior year's tax, or

(3) 90% of the tax that would be due on an annualized income computation for the period that runs through the end of the quarter.

If the prior-year AGI of the taxpayer exceeds $150,000 ($75,000 if married filing separate), the 100% above becomes 110%.

d. A corporation's underpayment of estimated tax is generally the difference between the estimated taxes paid and the lowest of:

(1) the current-year tax,

(2) the prior-year tax, or

(3) the tax on an annualized income computation using of one of three computation methods allowed by the Internal Revenue Code.

e. Any fines and/or penalties paid are not allowed as deductions on the tax return.

4133.03 Accuracy-related penalties

a. The accuracy-related penalty combines several related penalties so that multiple penalties will not apply to a single understatement of tax.

b. Each of the accuracy-related penalties is 20% of the portion of the tax underpayment attributable to:

(1) negligence or disregard of rules and regulations,

(2) substantial understatement of tax liability,

(3) substantial valuation overstatement, or

(4) substantial valuation understatement.

c. The penalty will not apply if the taxpayer can show a reasonable basis for the position that was taken on the return.

d. Interest on the accuracy-related penalty runs from the due date of the return, including extensions, until the penalty is paid.

e. The negligence penalty will apply to an underpayment that is attributable to a failure to make a reasonable attempt to comply with the tax law. A taxpayer is automatically considered negligent if they fail to report income that is covered by an information return (IRS Form 1099) filed by the payor with the IRS.

f. A substantial understatement of tax liability occurs if the understatement exceeds the larger of 10% of the tax due or $5,000:

(1) For a C corporation, a substantial understatement is the lesser of 10% of the tax due (at least $10,000) or $10 million.

(2) In all cases, the understatement to which the penalty applies is the difference between the amount of tax shown on the return and the amount of tax that should have been shown.

(3) The penalty can be avoided if:

(a) the taxpayer has substantial authority for the position taken or

(b) there is adequate disclosure of the position taken on the IRS Form 8275 attached to the return.

g. Substantial valuation overstatement:

(1) The penalty is 20% of the additional tax that should have been paid if the correct value of the property had been used.

(2) The penalty applies only if the valuation used is 150% or more of the correct valuation. The penalty is doubled if the taxpayer makes a gross overvaluation (200% or more).

(3) The penalty only applies when the income tax underpayment that results from the overvaluation exceeds $5,000 ($10,000 for a C corporation).

h. Substantial valuation understatement:

(1) An accuracy penalty can be imposed for an estate or gift tax valuation understatement.

(2) The penalty is 20% of the additional estate or gift tax that would be due if the correct valuation had been used.

(3) The penalty is imposed only if the value of the property claimed on the return is 65% or less than the correct valuation.

(4) The penalty is doubled if the taxpayer makes a gross undervaluation (the reported value is 40% or less than the correct value).

(5) The penalty only applies if the additional estate or gift tax liability exceeds $5,000.

4133.04 Civil fraud penalty

a. A 75% civil penalty is applied to any underpayment of tax resulting from fraud by the taxpayer.

b. If the fraud penalty is applicable, then the accuracy-related penalty is not applied to the same portion of the underpayment of tax.

4133.05 Penalty on erroneous refund claims

a. If a taxpayer files a claim for refund that is greater than the amount actually allowable, a penalty equal to 20% of the improperly claimed amount applies.

b. The penalty does not apply if the taxpayer can show that they had a reasonable basis for the excessive refund claim.

4133.06 False information: Withholding

a. A civil penalty of $500 applies if a taxpayer claims withholding allowances that are based on false information.

b. A criminal penalty can also apply to a willful failure to supply information or for willfully supplying false or fraudulent information regarding withholding. The penalty is an additional fine of up to $1,000 and/or up to one year in prison.

4133.07 Failure to deposit taxes

a. A penalty can be applied if there is a failure by the taxpayer to deposit amounts withheld from employee wages for FICA and income tax.

b. A penalty of up to 15% of any under-deposited amount can be imposed unless the employer can show that the failure was due to reasonable cause and not due to willful neglect.

c. If the action of the employer is willful, a 100% penalty can be imposed on any "responsible person" of the business. While there may be several persons who meet the definition of a "responsible person," the IRS may not collect more than the total amount due.

4133.08 **Criminal penalties:** The criminal tax penalties in the Internal Revenue Code include the following:

a. Willful attempt to evade or defeat tax: The maximum penalty is a $100,000 fine and/or five years in prison. For a corporation, there is no imprisonment, but the maximum fine is $500,000.

b. Willful failure to collect or account for and pay over tax: The maximum penalty is $10,000 fine and/or five years in prison.

c. Willful failure to pay a tax or an estimated tax, to file a required return, to keep required records, or to provide required information: The maximum penalty is a $26,000 fine and/or one year in prison. For a corporation, there is no imprisonment, but the maximum fine is $100,000.

d. Willfully furnishing an employee with a false statement regarding tax withholding on wages: The maximum penalty is a $1,000 fine and/or one year in prison.

e. Making a knowingly false declaration under penalty of perjury, preparing or assisting in preparation of a fraudulent return or other documents, or concealing goods or property in respect of any tax: The maximum penalty is a fine of $100,000 and/or three years in prison.

4134 Authoritative Hierarchy

4134.01 **Assessing tax sources**

a. When conducting tax research, the first step is locating sources of tax authority that have a bearing on the tax issue being researched.

b. Once the sources are located, it is important to assess the sources and determine the authoritative hierarchy of the sources that have been found.

4134.02 **Legislative sources**

a. The Internal Revenue Code (IRC) is the ultimate authoritative source since it is the tax law enacted by Congress. All other tax sources are simply interpreting what Congress intended by the language that was used in the statute.

b. If the Code provides the answer to the researcher's question, no other tax sources are necessary. However, in most cases, the researcher must consult other tax sources in order to determine the scope of the applicable Code section.

c. The legislative history behind the Code section is also a valuable source because it often answers questions regarding the intent of Congress in enacting the Code section and the scope of the Code section itself.

d. The legislative history is found in the:

(1) House Ways and Means Committee Report,

(2) Senate Finance Committee Report, and

(3) Joint Conference Committee Report (if one exists).

4134.03 Administrative sources

a. The Treasury Regulations are the official interpretation of the Internal Revenue Code by the Department of the Treasury. The regulations are the administrative source of tax authority that carry the most weight.

b. Regulations are given great deference by the courts if the taxpayer ends up litigating their tax dispute with the government. This is because the regulations are the interpretation of the Code by the government department responsible for administering the tax law.

c. A court will generally only invalidate a regulation if the taxpayer can convince the court that the regulation does not clearly reflect the intent of Congress in enacting the Code section.

d. The second most important source of administrative tax authority is revenue rulings.

e. Revenue rulings carry far less weight than regulations. This is because a Revenue Ruling is issued by the Internal Revenue Service and is therefore viewed as the position of the IRS on a particular tax issue.

f. Revenue rulings are therefore easier to challenge in court. As a result, finding a revenue ruling that conflicts with the position of the taxpayer may not be fatal. It does, however, show the IRS position on the issue.

g. Other administrative tax sources generally carry less weight than regulations and revenue rulings. However, in a given situation, one of these other sources may be very valuable to the taxpayer position in question. These other administrative sources include the following:

(1) Revenue Procedures

(2) Letter Rulings (These technically cannot be cited as authority by any taxpayer other than the taxpayer requesting the ruling; note, however, that letter rulings have been cited by courts, including Courts of Appeals.)

(3) Treasury Decisions

(4) Determination Letters

(5) Technical Advice Memoranda

4134.04 Judicial sources

a. Generally, the higher the level of the court that rendered a decision, the greater the weight the decision should be given.

b. A decision rendered by the U.S. Supreme Court is the definitive answer on a tax issue. The only way that the rule laid down by a Supreme Court decision can be impacted is if Congress disagrees with the Supreme Court’s interpretation and changes the tax law by amending the Internal Revenue Code.

c. A decision rendered by a court of appeals (e.g., the Sixth Circuit Court of Appeals) should generally be given more weight than a decision rendered by a trial court (e.g., a U.S. Federal District Court).

d. Regarding the Tax Court, a reviewed decision of the Tax Court (in which all the Tax Court judges participate) should generally carry greater weight than a normal Tax Court decision (decided by a single Tax Court judge).

e. The geographic location of the court rendering the decision should also be factored into the weight given to the case. More weight should be given to an opinion from a court in which the taxpayer could possibly have his case heard. For example, a taxpayer located in Florida should put more weight on an opinion from the Eleventh Circuit Court of Appeals than one from the Sixth Circuit Court of Appeals because Florida is located in the Eleventh Circuit.

f. Finally, if a court opinion is consistent with decisions rendered by other courts, that opinion should be given more weight than an opinion not supported by other decisions.

4140 Legal Duties and Responsibilities

4141 Common Law Duties and Liability to Clients and Third Parties

Liability to Clients Under Common Law

4141.01 The CPA may be held liable to clients in an audit, taxation, or consulting services engagement for the following:

a. Fraud

b. Gross negligence or constructive fraud

c. Negligence (ordinary or simple)

d. Breach of contract

4141.02 **Fraud** is an *intentional* misrepresentation of a material fact with resultant harm to another party, intending to result in financial or personal gain.

4141.03 **Gross negligence** (constructive fraud) is *extreme, flagrant, or reckless departure* from the standards of due care and competence in performing or reporting upon professional engagements.

a. There need not be actual intent to deceive (scienter).

b. Fraud may be inferred from sloppy performance (e.g., CPA omits a vital procedure such as a bank reconciliation in order to save time).

4141.04 **Negligence** (ordinary or simple) is the failure to do what an ordinary, reasonable, prudent CPA would do in similar circumstances.

a. To establish negligence, the plaintiff (client) must establish the following:

(1) The defendant (CPA) owed a legal duty.

(2) The CPA breached that duty.

(3) The CPA's action was the proximate cause of the resulting injury to the client.

(4) The CPA's actions caused damage (loss).

b. CPAs are not liable for an honest error in judgment as long as they act with reasonable care.

4141.05 The CPA's responsibility to the client is determined by the applicable State Board of Accountancy. Such authorities increasingly rely on the profession's standards, as defined by:

- **a.** generally accepted auditing standards (GAAS) and/or specific terms of the contract for attest services,
- **b.** AICPA Statements on Standards for Tax Services and Treasury Circular 230 for tax compliance services, and
- **c.** AICPA Statements on Standards for Consulting Services for management advisory services.

4141.06 Greater responsibility may be assumed by an express contract that goes beyond the professional standard.

4141.07 The agreement between the CPA and the client should be expressed in writing in an engagement letter. The engagement letter, written to the client on the CPA's letterhead, should provide a place for the client to indicate agreement with the terms of the undertaking via the client's signature. An important case on this point is *1136 Tenants' Corporation*. Because the CPA firm did not have an engagement letter, it was found liable for $237,000 (relative to a $600 annual fee) of damages for failure to discover defalcations. The CPA firm contended that the engagement called for preparation of unaudited financial statements, not an audit. The plaintiff was successful in establishing that an audit was agreed upon.

4141.08 Many legal actions by clients involve claims based upon failure to discover a theft or, more commonly today, bad tax advice or failure to identify a tax compliance issue.

Defenses

4141.09 Defenses available to the CPA include the following:

- **a.** The CPA was not negligent or fraudulent.
- **b.** Contributory negligence of the client caused the loss.
- **c.** The CPA adhered to professional standards.
- **d.** The error was immaterial.
- **e.** The proximate cause of loss was not the CPA's error.

4141.10 **Tax return preparer liability.** A client may be able to sue the CPA who prepared a tax return that caused the client to incur penalties or other sanctions due to the CPA's wrongful action. Basis of liability could be breach of contract or the tort of negligence.

4141.11 For taxation engagements, while many claims arise from the CPA's failure to meet a filing date for a tax return, some of the largest claims allege failure to properly apply the law to a transaction.

- **a.** The CPA may be liable for interest on late payment *plus* penalty.
- **b.** The CPA may be liable for interest, penalty, *and* tax if the client can prove erroneous tax advice rendered by the CPA.

Liability to Third Parties Under Common Law: Ultramares Rule

4141.12 The CPA may be held liable to third parties for any of the following:

- **a.** Fraud
- **b.** Gross negligence

4141.13 Under common law, CPAs have not (until recently) been found liable to those not in privity on the theory of ordinary negligence.

- **a.** Third parties include investors and creditors.
- **b.** The term "privity" refers to a contractual or near contractual relationship.

4141.14 In 1931, the common-law Ultramares rule was promulgated. The court in *Ultramares* stated that where a CPA recklessly certifies to the truth of financial statements without taking the proper procedures to determine whether or not the financial statements are in fact true, a jury might find the CPA guilty of fraud.

- **a.** *Ultramares* developed a concept of gross negligence or constructive fraud.
- **b.** According to *Ultramares*, the third party that proves gross negligence will be successful in reaching the CPA without regard to privity.
- **c.** Gross negligence is a deceit that involves a misrepresentation of a material fact, with lack of reasonable ground for belief, relied upon by another, which causes damage to that party.
- **d.** *Ultramares* refused to hold a CPA liable to third parties for simple negligence.

4141.15 *Ultramares* is still a good precedent in some jurisdictions; however, in many states substantial inroads have been made on *Ultramares* through creation of the following rules.

Liability to Third Parties Under Common Law: Third-Party Beneficiary Rule

4141.16 The CPA may be held liable for ordinary negligence by third parties when the CPA knows that the services for a client are *primarily* for the benefit of a third party.

4141.17 When the services are primarily for the benefit of a third party, the third party is, in effect, a party to the contract.

4141.18 In order for plaintiff to be a third-party beneficiary, the *aim* and *end* of the transactions must be to benefit the third party.

Liability to Third Parties Under Common Law: Foreseeability Rules

4141.19 A CPA who is negligent in issuing the report can be liable to third parties who can be foreseen as being injured.

4141.20 According to the foreseen user rule applied by some courts, if a CPA is retained by a client to perform an audit examination for purposes of obtaining a bank loan from Fourth National Bank, the bank may successfully recoup loan losses by proving that the CPA was negligent (if the bank, in fact, relied upon the audited financial statements).

4141.21 Under the foreseen class of users rule applied by some courts, *any* bank creditor in reliance upon the negligently audited financial statements proving negligence will be successful.

4141.22 On the other hand, a trade creditor or an investor is not foreseen; therefore, such third-party users in the bank loan situation would have to prove fraud or constructive fraud in order to reach the CPA. They could not recover based on simple negligence.

4141.23 According to *Restatement of Torts,* the plaintiff (third party) does not have to be identified by a specific person to the accountant but only has to be identified by class (e.g., bank credit). This follows the foreseen class of users rule. The *Restatement of Torts* is an attempt by the American Law Institute "...to present an orderly statement of the general common law of the United States, including in that term not only the law developed solely by judicial decision, but also the law [that] has grown from the application by the courts of statutes…." (*Restatement, Torts* viii, ix (1st ed.))

4141.24 In recent years, a few courts have applied a foreseeable users test. For CPAs to be liable, it is only necessary that they generally could expect or foresee the use of their work product by the third party in question.

4141.25 The following matrix summarizes what the plaintiff (third party) must prove to successfully reach the defendant (CPA) for fraud, gross negligence, and simple negligence.

	Fraud	**Gross Negligence**	**Simple Negligence**
False representation	*	*	*
Awareness	Knowledge	Reckless disregard	Failure to exercise care
Intention to induce reliance	*	X	X
Justifiable reliance	*	*	*
Resultant damage	*	*	*

* = Plaintiff must prove
X = Not essential

4141.26 Common law varies from state to state; thus, some jurisdictions are *Ultramares* states while others apply the foreseeability doctrine. Both alternatives should be presented in responding to a CPA Examination question. An *Ultramares* state, of course, ignores the foreseeability rule and requires the third-party plaintiff to establish fraud or gross negligence.

Liability to Third Parties Under Common Law: Unaudited Financial Statement Liability

4141.27 A third party in a common-law suit involving unaudited financial statements must prove that the CPA was either fraudulent or grossly negligent in order to successfully reach the CPA.

4141.28 The concept of foreseeability has yet to be applied to unaudited financial statements.

4142 Privileged Communications, Confidentiality, and Privacy Acts

Communications With or on Behalf of Clients

4142.01 How much detail should be included in communication with or on behalf of clients, and how technical the communication should be, will be determined by the audience. Communication addressed to a taxpayer with little tax knowledge should obviously be much less detailed and technical than a communication directed toward an IRS agent or a superior within the researcher's accounting firm.

4142.02 Generally, a communication should include the following elements:

- **a.** A brief statement of the essential facts necessary to answer the tax question(s)
- **b.** The identification of the tax issue(s). If there are multiple tax issues to be researched, each issue should be separately laid out for clarity.
- **c.** A clear identification of the conclusion(s) reached by the researcher. A separate conclusion should be stated for each tax issue. Also, if more than one conclusion may exist due to a conflict in the tax authorities, this should be clearly communicated.
- **d.** A clear statement of the tax sources on which the conclusion was based and the reasoning that supports the conclusion

Privileged Communications

4142.03 In common law, there is *not* a privilege that an accountant or client may invoke to prevent disclosures.

4142.04 About 17 states have adopted statutes creating an accountant-client privilege. The statutes vary as follows:

- **a.** Some apply only to CPAs, while others extend to all public accountants.
- **b.** Some provide that the privilege is not applicable to criminal or bankruptcy actions.
- **c.** Some exclude certain services such as auditing.
- **d.** Some statutes do not state clearly whether the client or the CPA has the benefit of the privilege. Usually, the privilege belongs to the client and the client is in control of whether or not the information is disclosed by the CPA.

4142.05 There is no general *federal* accountant-client privilege.

- **a.** Generally, any state-created accountant-client privilege is *not* recognized for federal law purposes.
- **b.** Under Internal Revenue Code (IRC) Section 7525, however, a privilege is available for communication between a federally authorized tax practitioner (e.g., a CPA, attorney, enrolled agent, or enrolled actuary) and a client or potential client.
    - (1) This privilege can only be asserted in either of the following:
        - (a) Noncriminal tax matters before the Internal Revenue Service
        - (b) Noncriminal tax proceedings in federal court brought by or against the United States

(2) Tax advice is advice given with respect to a matter that is within the scope of the tax practitioner's authority to practice before the IRS.

(3) The privilege exists only to the extent the communication would be privileged under the attorney-client privilege if the communication had been made between a client and an attorney.

(4) The privilege does not apply to any written communication between a tax practitioner and a corporate representative (including a director, shareholder, officer, employee, or agent) concerning the corporation's participation in any tax shelter (as defined in IRC Section 6662(d)(c)(iii)).

4142.06 The AICPA *Code of Professional Conduct* mandates a *confidential relationship* but not *privileged communication.*

CPA's Workpapers

4142.07 The CPA must generally keep the information in the workpapers confidential. CPAs are independent contractors, not employees; thus, they have legal title to their workpapers. The workpapers do not belong to the client; however, the CPA's ownership of the workpapers is custodial. This means the accountant cannot generally transfer them to a third party without the client's permission. Exceptions include subpoena by a federal court or agency or inspection by an AICPA or state society quality review team.

4142.08 A seller of an accounting practice has a duty to obtain permission of the client before making workpapers available to a purchaser of the practice. CPAs do not have a common-law lien on client workpapers coming into their possession.

4142.09 A deceased partner can convey workpapers to copartners.

Section 4200
Business Law
(10% - 20%)

4210 Agency

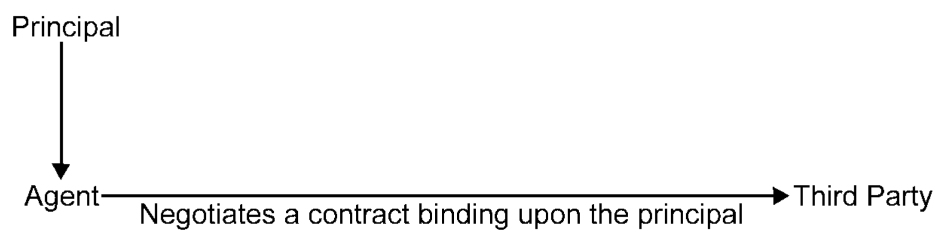
4211 Overview

4211.01 An *agency* is a fiduciary relationship between two persons when one person (the agent) acts for the benefit and under the control of the other person (the principal) and has the power to affect the legal relationships of the principal.

4211.02 The word *person* is used in the legal sense. A corporation, a partnership, or an individual can be a person and can therefore act in the capacity of either a principal or an agent.

4211.03 The relationship is consensual. Both persons must consent to enter into an agency relationship. Consent can be expressed or implied from the conduct of the parties.

4211.04 The agency relationship can be shown as follows:



4211.05 Agency law involves the following relationships:

a. Principal and agent

b. Employer (master) and employee (servant)

c. Principal and independent contractor

4211.06 If a principal/agent relationship exists, the agent will also be viewed as either an employee or an independent contractor.

4211.07 The word *agent* is often used interchangeably with the word *employee (servant).* However, not every employee is an agent; only an employee who is also an agent can make contracts with third parties for the principal (the employer).

4211.08 Agency is used by the principal to expand activities. A corporation, being an artificial entity created by government authorization, can act only through agents. In partnerships, each partner can act as an agent for the partnership entity. A sole proprietor hires agents so that the sole proprietor can transact more business.

4211.09 The agency relationship can be used in either business or personal situations.

4211.10 **Formalities.** No particular formalities are required to form the agency relationship. The formation can be oral, written, or the agency can be created by some conduct of the principal that may be interpreted by a third party as an intention to appoint an agent. If formed by contract, it must satisfy the requirements of a contract. The statute of frauds requires an agency contract to be in writing to be enforceable if the contract cannot be performed within one year from the time of making the contract.

Power of attorney. A power of attorney is a formal instrument, usually acknowledged by a notary public, to confer authority on an agent. The agent is referred to as an attorney-in-fact, to distinguish them from a lawyer who is an attorney-at-law.

Agency Relationships

4211.11 **Principal and agent.** The agent works for the benefit and under the control of the principal and has the right to represent the principal and make contracts with third parties on behalf of the principal.

- **a.** The agent must be either an employee or an independent contractor (but not all employees or independent contractors are agents).
- **b.** The principal is liable on contracts made by an agent if the agent has authority to act on behalf of the principal.
- **c.** The principal is not liable on contracts made by an employee or independent contractor unless that person is also an agent.
- **d.** The principal may be held liable for torts against third parties committed by agents who are employees of the principal, but not for torts committed by independent contractors.
- **e.** **Example:** SAS Corporation hires Gerry to sell its products as an outside salesman. Gerry calls on customers and makes sales contracts with them. SAS Corporation would be the principal, Gerry would be an agent, and the customers would be third parties. Contracts entered between Gerry and the customers would generally be binding on SAS Corporation.

4211.12 **Employer and employee.** The employee works for the benefit and under the control of the employer but does not have the right to represent the principal or make contracts with third parties. Several factors are considered in determining if an individual is an employee. The most important of these is the right of the employer to control the physical details of the employee's work. An employee can be an agent if the employee is also given the authority to enter contracts with third parties that are binding on the principal.

Example: SAS Corporation hires Lila to be a production line worker. Lila would be an employee and SAS Corporation would be the employer. Lila is not an agent because she does not have the authority to represent her principal in dealing with third parties.

4211.13 **Principal and independent contractor.** The independent contractor acts for the benefit of the principal but not under the principal's control. The principal who deals with an independent contractor is sometimes called a proprietor. The principal contracts for the end result, but the principal has no right of direction or control while the activity is being performed. The principal is not usually liable for the torts of an independent contractor even though the independent contractor is acting for the principal at the time the tort occurred.

- **a.** **Example:** In conducting an audit for a client, the CPA acts as an independent contractor. The client seeks an opinion, but the CPA determines what is audited and how it is audited. If the client controlled the audit, the CPA would not have professional independence.
- **b.** **Example:** SAS Corporation hires Williams to repave its parking lot. Williams completes the work over the weekend with no involvement by SAS Corporation. Williams would be an independent contractor as to SAS Corporation because the principal exercised no control over the physical details of the work.

c. **Example:** Williams (in the prior example) hires individuals to work for him in his repaving business. Williams tells them what to do in repaving the SAS Corporation parking lot. These individuals would be employees of Williams since he has control over the physical details of the work they perform.

It is a question of fact as to what type of relationship exists between two persons. The question arises when there is a tort while the other person is acting for the benefit of the principal. Liability of the principal is determined by the control factor.

4211.14 **Franchiser and franchisee.** This relationship is normally that of principal and independent contractor. However, the relationship could be found to be that of employer and employee if the franchiser exercises significant control over the franchisee in running the franchise. The franchiser is not liable for the torts of the franchisee if the franchisee acts as an independent contractor.

Example: Fast-food restaurants are often franchise operations. Well-known examples are Wendy's, McDonald's, and Burger King. In most chains there are stores owned by the chain (employer-employee) and franchised stores (principal-independent contractor).

Creation of an Agency

An agency can be created by the following means:

4211.15 **Contract.** Both the principal and the agent contractually agree to the relationship. This is the usual way of creating the agency relationship.

Example: Harry agrees that he will sell the products of the Doyle Corporation for a 10% commission on the sale price.

4211.16 **Agreement but not a contract.** Both the principal and the agent agree to the relationship, but the agreement is not a contract because it lacks some of the required elements. The agreement can be shown by the principal's and agent's conduct.

Because it is not necessary that the agreement be a contract, consideration is not a requirement for creation of an agency.

4211.17 **Ratification.** Ratification occurs when the principal gives approval of an act previously done by the purported agent for the principal without authority. When the act happens, it must have been done for the purported principal, not for the purported agent. The ratification must also occur within a reasonable time.

- **a.** The principal can expressly ratify the unauthorized act by indicating the intent to be bound. Oral or written statements to either the third party or the agent can result in an express ratification.
- **b.** An implied ratification can result if the principal retains the benefits and advantages of the contract with the third party.
- **c.** Ratification retroactively acts as an acceptance by the principal of the unauthorized contract from the date the contract was made.
- **d.** Ratification cannot generally be retracted once done.
- **e.** The third party can withdraw from the contract before ratification by the principal, but not after.
- **f.** The entire contract must be ratified by the principal. Partial ratification of the favorable parts and rejection of the unfavorable parts of the contract are not permitted.

g. Ratification is possible only when the principal knows all the important terms of the contract.

4211.18 **Estoppel.** This is called creation of agency by *apparent* authority. This occurs when the principal leads a third party to reasonably believe that a person acts as the principal's agent. The principal is prohibited from denying the existence of an agency relationship if the third party deals with the person as the principal's agent. Technically, no agency relationship is created by estoppel, but the principal is legally liable as if there were an agency relationship. It must be the principal, not the agent, that leads the third party to believe that an agency relationship exists.

4211.19 **By operation of law.** An agency relationship can be imposed by operation of law in some unusual circumstances. These are examples:

a. **Necessity.** This happens by operation of law when an emergency situation develops and the agent is given power to act beyond normal authority. Usually these conditions exist when the following are true:

(1) The agent cannot contact the principal for instructions.

(2) Failure to act will cause substantial loss to the principal.

b. A spouse or child who purchases necessities for the family is the agent of the other spouse.

4211.20 Marriage itself does not create an agency relationship. One of the spouses can act as an agent for the other spouse, but it is not because of the marriage that the agency exists.

Example: A wife tells her husband to buy some goods from a particular store and charge the purchase price to her charge account. The husband is acting as an agent for the wife. Marriage is not the basis of the agency, rather the consent of the principal (wife) to have the husband (agent) act for her.

Classification of Agents

4211.21 **General agent.** An agent who is authorized to do a series of transactions for the principal for a continuing period of time. A general agent has much *implied authority*.

a. **Example:** Mildred hires Tom to operate her ice cream store. Tom is a general agent having implied authority to do many types of activities relating to the store.

b. **Example:** A business manager of a retail store, as a general agent, has implied authority to engage in such normal activities as the following:

(1) Buying and selling inventory

(2) Purchasing supplies and equipment

(3) Hiring and firing employees

However, that manager would lack implied authority to do such things as the following:

(1) Mortgaging the property

(2) Borrowing money from the bank

(3) Selling the business

The manager would not have implied authority to do these activities because they are *outside* the scope of the authority that a manager of a retail store would normally have.

4211.22 **Special agent.** An agent who conducts some specific transaction for the principal over a limited period of time. A special agent has less implied authority than a general agent. Examples of special agents include the following:

a. **Broker.** Brings the seller and buyer together. The broker is a special agent of one of the two parties and has very limited implied authority.

b. **Factor.** A factor receives possession of some other person's property to sell for a commission. The factor is a special agent, having only that implied authority that relates to the sale of the property. The factor is sometimes called a *commission merchant.* The factor receives a commission from the sale and sells in his/her own name.

c. **Lawyer.** A lawyer handles a particular case for the client. The lawyer is a special agent of the client and has only implied authority as it relates to the particular case.

d. **Auctioneer.** Person who auctions the seller's property. Once the property has been sold, the auctioneer acts as an agent for both the seller and the buyer to transfer legal title.

4211.23 **Gratuitous agent.** Person who agrees to act as an agent without expectation of compensation. The relationship is generally the same as in the case of a compensated agent, except that a gratuitous agent has no obligation to act for the principal unless the gratuitous agent has caused the principal to reasonably rely on the agent to perform the act.

Example: Dave wants to place a bid on property being sold at auction but is unsure that he will be able to be there in time. A friend, Bill, offers to go and place the bid on Dave's behalf. If Bill fails to go and make the bid, he may be liable to Dave because Dave reasonably relied on Bill placing the bid at the auction.

4211.24 **Compensated agent.** Person who agrees to act as an agent with expectation of compensation. This would be the assumed situation between unrelated persons.

4211.25 **Subagent.** Person appointed by an authorized agent to act for the agent. If the agent is authorized to appoint a subagent, the acts of the subagent are binding on the principal. If the agent lacks authority to appoint a subagent, the subagent's acts are not binding on the principal.

Classification of Principals

4211.26 **Disclosed principal.** A disclosed principal is a person whose existence and identity are known to the third party at the time of making the contract with the agent.

4211.27 **Partially disclosed principal.** A partially disclosed principal is a principal whose *existence* is known to the third party at the time of contracting with the agent. The specific identity of the principal, though, is unknown to the third party.

4211.28 **Undisclosed principal.** An undisclosed principal is a principal whose existence and identity are not known to the third party at the time of contracting. From the third party's point of view, the agent appears to be acting on their own behalf.

Legal Capacity of the Parties

4211.29 **Of the principal.** If the principal does not have legal capacity to enter a contract, the principal does not have the capacity to appoint an agent. In other words, if a principal cannot legally enter a contract directly, they cannot do so indirectly through an agent.

4211.30 **Of the agent.** To make a contract for the principal, an agent does not need contractual capacity; only the principal needs capacity to enter a contract. A minor can act as an agent for an adult, and contracts made by a minor agent are legally binding on the adult principal. These contracts with third parties would not be voidable by the adult principal even though the agent was a minor. The minor agent, however, could disaffirm the agency contract because this is a voidable contract to the minor agent. This would not, however, impact any contracts entered for the principal with third parties prior to the disaffirmance.

Example: Harris, a minor acting as an agent for Lynn, makes a contract with James. The contract is valid so long as both Lynn and James have legal capacity. It makes no difference that the agent was a minor with only limited capacity to contract for himself.

4211.31 Anyone who can act for him/herself can act through an agent.

4211.32 The purpose of the agency must be legal. Any agreements lacking a legal purpose will be found to be an illegal bargain for which the courts will not adjust equities between the parties to the agreement.

Agency Coupled with an Interest

4211.33 An agency coupled with an interest is an agency relationship where the agent has an interest in the subject matter of the agency. The subject matter is a property interest or a security interest. The principal acting alone cannot terminate the agency. Death, insanity, or bankruptcy of the principal does not terminate the agency. This relationship is sometimes called an "agency power coupled with an interest" or an "agency coupled with security."

Example: Kevin loaned $5,000 to Brian, and the debt has not yet been repaid. Brian appoints Kevin as an agent to negotiate the sale of Brian's property, with Kevin receiving a part of the sale proceeds to repay the loan. This is an agency coupled with an interest.

4212 Authority of Agents and Principals

Authority of the Agent to Act for the Principal

4212.01 The **authority**, or power, of an agent is the capacity to change the legal status of the principal by dealing with third parties.

4212.02 The authority of the agent is determined by the principal and can come only from the principal. Authority comes from the consent of the principal.

- **a.** The burden of proving the agent's authority rests with the third party who deals with the agent. If authority cannot be proved, the purported principal is not liable on the contract.
- **b.** The agent cannot create their own authority.
- **c.** A third party who deals with an agent, knowing the agent exceeds their authority, does so at their own peril and will not generally be able to hold the principal liable for the agent's unauthorized act.

4212.03 **Express authority.** Authority that is stated in spoken or written words by the principal.

Example: David owns a fruit and vegetable market. He tells Jennifer to enter a contract with Acme Produce Wholesalers to purchase 10 cases of apples. Jennifer, as agent, has express authority to make this purchase.

4212.04 **Implied authority.** The authority that is commonly and customarily needed to conduct the purpose of the agency. Implied authority is needed to fill in the gaps to carry out the agent's express authority. It cannot come from words or conduct of the agent. It can vary from one location to another. It can vary among different types of businesses.

Example: Brian owns a clothing store. He hires Erin and gives her the authority to manage the store. Erin enters a contract with ABC Clothing Corporation in order to obtain clothing to sell in the store. Even though Erin did not have express authority to enter the contract with ABC, she would have implied authority to enter this contract since it is necessary to fulfill the purpose of the agency.

4212.05 **Incidental authority.** Same as implied authority.

4212.06 **Actual authority.** The combination of express and implied authority.

4212.07 **Customary authority.** The authority that comes from the customs of that type of business.

4212.08 **Apparent authority.** Apparent authority, or appearance of authority, comes from the words or actions of the principal that lead a third party to reasonably believe and act upon the belief that actual authority exists in the purported agent. Belief and reliance are shown when the third party makes a contract with the purported agent. Apparent authority is determined from the view of the third party dealing with the purported agent. The words or actions must come from the principal, not the purported agent, in order to create apparent authority.

a. **Example:** Andrea, an outside salesperson for Mamou Corporation, called on customers, sold merchandise, delivered merchandise, and collected receivables. After being fired, Andrea collected some of the receivables from existing customers and disappeared. The existing customers will not have to pay Mamou again. The principal, Mamou, created the situation by allowing Andrea to collect the receivables previously. From the customers' point of view, Andrea had apparent authority to collect the balances due. The firing terminated actual authority, but the principal, Mamou, had led the customers to believe and act upon the belief that Andrea had actual authority. These existing customers should be informed of the firing in order to terminate the apparent authority.

b. The following factors are sometimes considered in determining whether apparent authority exists:

(1) The third party's knowledge of the agent's actual authority and limitations

(2) The customs in that type of business

(3) The principal's prior approval of similar activities by the agent

4212.09 **Ostensible authority.** Another term for apparent authority.

4212.10 **Power to appoint subagents.** As a general rule, an agent *cannot* appoint subagents in order to delegate the agent's duties and obligations. This is because the principal selects the agent based on personal qualifications. If the duties of the agent are purely ministerial, mechanical, or routine, an exception is allowed and the agent may appoint a subagent. If the duties require skill, discretion, or judgment, no subagent may be appointed unless the principal gives permission.

4212.11 **Financial powers.** An agent who sells goods for cash, and has possession of the goods, has the authority to collect the cash. The agent has no implied authority to accept credit in place of cash. Payment to an agent lacking authority to accept the payment does not discharge the debt. The third party would still be required to make payment to the principal.

4212.12 **Termination.** The agent's actual authority ceases when the agency is terminated; however, the agent still has apparent authority from the viewpoint of third parties with whom the agent has dealt. These third parties must be given actual notice of the termination to end the apparent authority. For those third parties who have not dealt with the agent, constructive notice is adequate to end the apparent authority. Publishing the termination in a newspaper having general circulation is adequate constructive notification as to those third parties.

Termination of the Agency

4212.13 **Revocation by the principal.** The principal acting alone can revoke the authority of the agent. This is because an agency is a consensual relationship requiring the consent of both parties.

- **a.** If the relationship is an agency coupled with an interest, the principal cannot revoke the agency.
- **b.** The principal can still be liable on the agency relationship because the agent may still have apparent authority from the view of third parties with whom the agent has previously dealt. These third parties should be given actual notice of the dismissal of the agent. This notice would eliminate the lingering apparent authority. The notice can be given in person, by letter, or by phone.
- **c.** If the revocation is contrary to the agency contract, the principal could be liable for breach of contract if the breach is not justified. This is true because, while principals have the power to terminate the agency, they may not have the legal right to do so.

4212.14 **Renunciation by the agent.** Renunciation takes place when the agent acting alone withdraws from the agency relationship.

- **a.** If the renunciation is contrary to the agency contract, the agent could be liable for the breach of contract if the breach is not justified. Like the principal, the agent also has the power to terminate the agency but may not have the legal right to do so.
- **b.** **Example:** Dave employs Jennifer as his agent under a three-year agency agreement. After six months, Jennifer withdraws as Dave's agent. Jennifer has the power to terminate the agency in this way but will be liable to Dave for breach of contract.

4212.15 **Mutual agreement of both principal and agent.** If the principal and the agent mutually agree to end the agency relationship, it ends.

4212.16 **Accomplishment of the purpose of the agency.** When the purpose of the agency is done, the agency relationship terminates.

Example: The legal case given to the lawyer is settled and paid. The lawyer, a special agent, has accomplished the purpose of the agency, and the agency relationship is terminated.

4212.17 **Time period ends.** If the principal and agent have agreed that the agency relationship will end after an express period of time, the lapse of that time will terminate the agency relationship.

4212.18 Operation of law. Operation of law means automatically without any action needed by the parties. All authority of the agent is terminated, even apparent authority, when the termination is by operation of law. An agency relationship is terminated by operation of law without notice being required in the following circumstances:

a. **Death of the principal or agent.** It is not necessary that the other party have knowledge of the death.

b. **Insanity of the principal or agent.** It is not necessary that the other party have knowledge of the insanity.

c. **Bankruptcy of the principal.** It is not necessary that the other party have knowledge of the bankruptcy. The agency relationship is not terminated if the agent becomes bankrupt.

d. **Impossibility of performance.** If the purpose of the agency becomes objectively impossible to perform, the agency terminates by operation of law.

   Example: Caitlin is acting as agent to sell Erin's office building. If the building is destroyed by fire, the purpose of the agency becomes objectively impossible to perform. The agency therefore terminates by operation of law.

e. **The performance of the agency becomes illegal.**

   Example: Brian employs Kevin as his agent to sell fireworks to third parties. If the state subsequently passes a statute making the sale of fireworks illegal, the agency would terminate by operation of law.

4212.19 Notice to third parties

a. Generally, the principal should give personal notice of termination of the agency to any third party who has dealt with the agent. This would eliminate any problems with the principal being bound to contracts entered by the former agent under the doctrine of apparent authority.

b. Published notice of termination of the agency is generally sufficient notice to any third parties who have not dealt with the agent previously.

c. Acts of the agent after a termination by operation of law cannot bind the principal or the principal's estate based on a theory of apparent authority.

4213 Duties and Liabilities of Agents and Principals

Agent's Duties and Obligations

4213.01 Agent's duties and obligations to the principal. This is a fiduciary relationship, one of trust and confidence. Some of the attributes of this fiduciary relationship are the following:

a. **Loyalty.** Undivided loyalty to the principal with no conflict with the agent's personal interests. The agent should not disclose confidential information to anyone except the principal. The agent should not act for two principals (dual agency) unless both principals know and agree. The agent may not make a secret profit on the subject matter of the agency. The agent cannot engage in self-dealing.

   (1) An agent who breaches the fiduciary duty of loyalty loses any compensation, fee, or commission that would have been due to the agent.

   (2) If the principal finds the agent has been self-dealing, the transaction is voidable at the principal's option.

Example: The principal employs an agent to purchase a specified piece of land. If the agent instead purchases the land for herself, this is a breach of the duty of loyalty to the principal.

b. **Obedience.** The agent should follow instructions unless they are criminal or illegal. If the agent fails to follow instructions, the agent is personally liable for any loss incurred by the disobedience. If there are no instructions, the agent is not disobedient if the agent uses judgment in discretionary or emergency situations.

   Example: The principal tells the agent not to give goods to Kevin until Kevin pays. Kevin promises the agent that he will pay in three days if the agent gives him the goods now. If the agent hands over the goods and Kevin does not pay, the agent is liable to the principal for the contract price.

c. **Accounting.** The agent must keep records for examination by the principal. The agent must not commingle the principal's property with his own. The agent is legally liable if commingling causes a loss.

   If the agent uses the principal's funds for their own purpose, the principal can sue the agent for the return of the funds. If the agent has purchased property with the funds, the principal can generally elect to take the property even if it is of greater value.

   Example: An agent uses the principal's funds ($500) to purchase a painting. The principal can recover either the $500 or the painting, even if the painting has appreciated in value.

d. **Due care.** The agent must use reasonable care and not be negligent in carrying out the agency. Reasonable care is that care a reasonably prudent person would use in like or similar circumstances. The agent may be liable to the principal if the agent is negligent in carrying out the agency.

e. **Give notice of information.** The agent must transmit important information to the principal. Failure to do this could be costly to the principal because notice to the agent is legally equivalent to notice to the principal. The agent can be held liable for any damages that result from the failure to give notice.

f. **Indemnification.** The agent must indemnify the principal if the principal pays damages in a legal action for the wrongful acts of the agent.

g. **Competition.** The agent must not compete with the business activity of the principal.

h. **Termination.** After the agency relationship is terminated, the former agent cannot continue to act as the principal's agent. The duty not to disclose confidential information regarding the agency continues, however, even after the agency is terminated.

4213.02 **Agent's duties and obligations to employees.** Unless they are also agents, employees do not act in a fiduciary relationship to their employer.

Principal's Duties and Obligations

4213.03 The principal's duties and obligations to the agent are not fiduciary. The agent owes a fiduciary duty to the principal, but the principal does not owe a fiduciary duty to the agent.

4213.04 These are the duties and obligations that the principal owes to the agent:

a. **Compensation.** The principal generally owes to the agent the duty of compensation. If the amount is expressly mentioned in the contract, that will be the amount. If no amount is expressly mentioned, it will be the reasonable amount as determined by the court. The compensation may be on a contingent fee basis. A person may act as a gratuitous agent, but the normal assumption is that a person expects to be compensated for activities done for the benefit of some other person.

b. **Reimbursement.** The principal must reimburse the agent if the agent spends their own funds to carry out the agency.

Example: Erin, acting as agent for Jennifer, delivers goods to a customer of Jennifer. The customer refuses to accept the goods and Erin incurs costs to store the goods. Erin is entitled to reimbursement from Jennifer for the storage costs.

c. **Indemnity.** The principal must indemnify the agent if the agent suffers expenses from a legal action resulting from carrying out the agency.

Example: Erin, acting as agent for Jennifer, her undisclosed principal, enters into a contract with Emily. The contract is breached and Emily sues Erin, collecting a judgment of $5,000. Jennifer must indemnify Erin for the $5,000 loss.

d. **Contractual.** The principal must perform all the terms of the agency contract or be legally liable for breach of contract.

e. **Warnings.** The principal must warn the agent of any dangers and unreasonable risks involved in the employment.

Third Party's Duties and Obligations

4213.05 The third party is liable for all the duties and obligations that arise from the contract.

Agent's Rights

4213.06 **Agent's rights against the principal.** The principal's duties and obligations are the rights of the agent. The agent has the following rights:

a. **Have the principal perform the agency contract.** If the principal breaches this contract, the agent can sue the principal.

b. **Compensation.** Unless it is agreed otherwise, it is assumed that the principal should compensate the agent for the work. The amount will be the contract amount. If no amount is given in the contract, it will be the reasonable value of the services.

c. **Reimbursement.** If the agent expends their own funds in carrying out the agency, the principal must repay the agent.

d. **Indemnity.** If the agent pays damages from a legal action based on carrying out the agency, the principal must indemnify the agent.

4213.07 **Agent's rights against the third party.** For the usual situation involving a disclosed principal and a contract, the agent has no rights against the third party because the agent is not a party to the contract. If the agent is liable on the contract due to the fact the principal is undisclosed or partially disclosed, the agent has whatever rights come from the contract. The presence or absence of the agency relationship does not affect the rights of the agent on the contract.

Principal's Rights

4213.08 **Principal's rights against the agent.** The principal has the following rights:

a. Performance of the agency contract by the agent.

b. Indemnification from the agent/employee if obligated to pay damages for the torts of the agent/employee in a suit by a third party based upon the doctrine of *respondeat superior.*

Example: Agent/employee negligently operates the employer's delivery truck while working and injures a pedestrian. Under the doctrine of *respondeat superior,* the injured pedestrian sues the employer and collects $25,000. The employee must indemnify the employer for the amount of $25,000.

c. In addition to the rights that the principal has by virtue of the agency relationship, the principal also has the right to expect the agent to act as a fiduciary. This fiduciary relationship requires the agent to place the interests of the principal above their own interests. The principal has the right to sue the agent for breach of this fiduciary duty.

4213.09 The principal has the right to expect performance of contracts made with third parties regardless of whether the contract was made personally or by an agent. If the third party has committed a tort against the principal, the principal has a right to sue for damages.

4213.10 The principal can enforce their rights in the following ways:

a. By suing for the legal remedy of damages

b. By seeking an equitable remedy, such as an injunction, specific performance, rescission of the contract, or an accounting

c. By revoking the agency. This would involve discharging the agent.

Third Party's Rights

4213.11 Third party's rights against the principal

a. **For contracts.** The third party has the rights that arise from the contract. If the principal breaches the contract, the third party can sue the principal for breach of contract.

b. **For torts of the agent/employee.** The third party can sue the principal for torts of the agent if the agent/employee was acting in the scope and course of the agency when the tort happened. This is called the doctrine of *respondeat superior*.

4213.12 Third party's rights against the agent

a. **For contracts.** If the principal was undisclosed or partially disclosed, the agent can be sued on the contract. If the principal was disclosed at the time of making the contract, the agent cannot be sued on the contract.

b. **For torts of the agent.** The agent, like everyone else, is responsible for his/her own torts. The third party can sue the agent for the agent's torts against the third party.

Agent's Liability

4213.13 Agent's liability on contracts

a. As a general rule, the agent is *not* personally liable on contracts the agent makes for the principal.

b. **With a disclosed principal.** When the third party knows that the agent is acting as an agent and also knows the identity of the principal, the agent is not liable on the contract. This is the usual and most common situation.

c. **With a partially disclosed principal.** A partially disclosed principal exists when the third party knows the agent is acting for a principal, but the third party does not know the principal's identity. The agent is liable on the contract. Once the identity of the principal is discovered, the third party could also sue the principal but cannot recover from both.

d. **With an undisclosed principal.** An undisclosed principal exists when the third party, at the time of contracting, does not know the person is acting as an agent. The agent is liable on the contract. Once discovered, the third party can also sue the principal but cannot recover from both.

e. **With a nonexistent principal.** The agent is personally liable on the contract if the agent contracts with a third person by representing that the agent acts for a fictitious or nonexistent principal. The agent would be breaching the implied warranty of authority that is made to the third party.

f. The agent is personally liable to the third party on a contract in the following instances:

(1) The agent makes the contract in her own name. The principal would be either undisclosed or partially disclosed.

(2) The agent guarantees the performance of the principal, and the principal fails to perform.

(3) The agent contracts for a nonexistent principal and makes no guarantees.

(4) The agent acts without authorization from the principal in making the contract.

g. The agent is *not* liable on a contract in the following instances:

(1) The agent contracts for a disclosed principal.

(2) The principal ratifies an unauthorized contract made by the agent for the principal. In this case, the action of the agent is treated as if it were authorized from the beginning.

(3) The third party elects to hold the newly discovered principal liable on a contract made by the agent for an undisclosed or partially disclosed principal.

4213.14 **Agent's liability for torts.** An agent/employee, like any individual, is liable for his/her own torts. This liability exists even though the agent/employee is working for the principal when the tort occurs. If the injured third party sues the principal under the doctrine of *respondeat superior* and collects, the agent/employee has the legal duty to indemnify the principal since this is a breach of the duty to carry out the agency using due care.

4213.15 **Agent's liability for crimes.** The agent/employee, like any individual, is liable for his/her crimes. The fact that the agent/employee is working for a principal when the crime is committed is no defense for committing the crime.

4213.16 **Agent's liability on negotiable instruments.** An agent will be liable on a negotiable instrument if the agent signs his/her own name without indicating the existence and the identity of the principal.

a. If the act is authorized, the agent can expect reimbursement from the principal for the amount paid on the negotiable instrument.

b. To avoid liability on the instrument, the agent must indicate that the signing is in a representative capacity (as an agent for another party).

Example: The agent is not liable on the instrument if agent Ann Addley signs for SAS Corporation like this:

SAS Corporation
by Ann Addley, Agent

c. The agent will also be liable on a negotiable instrument if the agent signs the principal's name without authority. This is forgery.

Principal's Liability

4213.17 Principal's liability for contracts

a. When the agent had actual (express or implied) authority, the principal is liable on the contract.

b. When the agent did not have authority but the act was later ratified by the principal, the principal is liable on the contract.

c. When the purported agent had apparent authority to make the contract, the principal is liable on the contract.

d. The principal is not liable even if the purported agent represents that she acts for the principal if the act is unauthorized.

e. **Settlement before discovery.** If an undisclosed principal settles with the agent after the contract is made, after the goods are delivered, and before discovery by the third party, the principal is not liable on the contract. The agent would be liable.

f. **Settlement after discovery.** If an undisclosed principal settles with the agent after the contract is made, after the goods are delivered, and after discovery by the third party, the principal is liable on the contract.

g. **Notice to agent.** Notice to the agent or knowledge obtained by the agent within the scope of the agency binds the principal. The principal need not have actual knowledge to be held liable.

h. The principal is directly liable on all contracts he makes with other persons.

i. The principal is vicariously liable on contracts made by authorized acts of agents.

j. The principal can use the usual defenses to deny liability on a contract. The principal cannot use the defenses that are personal to the agent.

4213.18 Principal's liability for torts of the agent/employee. The principal is liable for torts of the agent if the agent was acting in the scope of and in the course of the agency when the tort happened. This vicarious liability is called the doctrine of *respondeat superior*. The term "vicarious" means a substitute. The principal is liable as a substitute for the agent. The principal is liable whether the tort was authorized or unauthorized. The principal is liable whether the tort was defined as intentional, negligence, or liability without fault.

a. The trend is to expand the doctrine of *respondeat superior* to make the principal legally liable in more circumstances.

b. If the agent/employee is not acting for the principal, the agent is on a detour or on a "frolic of their own" and is the only person liable for the tort.

4213.19 **Principal's liability for torts of an independent contractor.** As a general rule, the principal is not legally liable for the torts of an independent contractor. Only the independent contractor is liable for the torts. The exceptions to this rule are as follows:

a. **Work that is inherently dangerous.** It would be contrary to public policy to allow a person to avoid liability by hiring an independent contractor to do inherently dangerous work.

b. **Work that is illegal.** A principal cannot avoid liability by hiring an independent contractor to perform illegal work that will benefit the principal.

c. **Work that is inseparable from the principal's operation.** If the work is so integrated into the business operation that it cannot be delegated, the principal is liable.

Example: A hotel could not hire an independent contractor to operate the elevator system because operation of the elevator is essential to a multistory hotel's operation. If the independent contractor committed a tort while operating the elevator, the hotel, in addition to the independent contractor, would be liable.

d. **Work that cannot be delegated.** Some duties imposed by law are nondelegable.

4213.20 **Principal's liability for crimes of the agent.** The principal is not liable for the crimes of the agent unless the principal actually participated in the crime.

Example: Jim, acting as an agent, was making a delivery for his principal, Susan. While driving the truck he was given a ticket for speeding and reckless driving. Speeding and reckless driving are crimes. Susan, the principal, is not liable for the crimes of speeding and reckless driving.

4213.21 **Principal's liability on negotiable instruments.** A principal will be liable on a negotiable instrument if either of the following is true:

a. An agent with authority signs the principal's name.

b. The principal signs his own name.

Third Party's Liability

4213.22 The third party is liable on contracts that they make. The agency relationship on the other end of the contract does not affect the liability of the third party. The third party is liable even if the principal is undisclosed or partially disclosed.

4220 Contracts

4221 Formation

4221.01 A *contract* is a legally enforceable agreement.

Classifications of Contracts

4221.02 **Express contract:** The parties manifest their agreement by spoken or written words.

4221.03 **Implied contract:** Implied in fact. The agreement is manifest, not by direct words, but from the conduct of the parties.

4221.04 **Quasi contract:** Implied in law. One party is unjustly enriched at the expense of the other party such that the court will impose an obligation on the enriched party to pay the other party. No quasi contract will be imposed if there is an express or implied contract existing between the parties. The court implies a contractual obligation without regard to the agreement of the parties in order to prevent the unjust enrichment from occurring.

4221.05 **Formal contract:** Under seal. Consideration is conclusively presumed. A notary public's imprint on a document is not a seal.

4221.06 **Informal contract:** Without a seal. Most contracts are informal and do not require a seal to be legally enforceable.

4221.07 **Divisible contract:** Promises that are not dependent on each other. Partial performance of the contract is allowed.

4221.08 **Indivisible contract:** Interdependent promises that cannot be separated.

4221.09 **Unilateral contract:** A promise in exchange for an act.

4221.10 **Bilateral contract:** Promise in exchange for a promise.

4221.11 **Executory contract:** Something remains to be completed on the contract.

4221.12 **Executed contract:** All parties to the contract have done all that they are obligated to do.

4221.13 **Unenforceable contract:** A contract that will not be enforced by the court. Valid when made but made unenforceable by some later event, such as the running of the statute of limitations or discharge of the contract in bankruptcy.

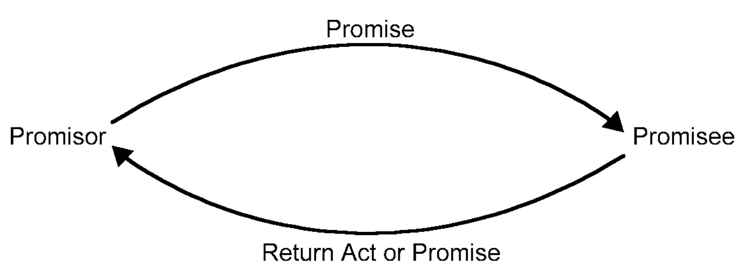
4221.14 **Valid contract:** Binding and enforceable.

4221.15 **Void contract:** Never had legal effect because of the lack of an essential element.

4221.16 **Voidable contract:** Valid until one party exercises a right to avoid the contract.

Parties to a Contract

4221.17 Parties to a contract may be diagrammed as follows:



Laws Governing Contracts

4221.18 **Laws governing contracts for sale of goods** (personal property): Uniform Commercial Code (UCC). If no specific UCC rule applies, common law applies.

4221.19 **Laws governing contracts for sale of real property:** Common law rules apply.

4221.20 **Laws governing contracts for services** (employment): Common law rules apply.

Elements of a Contract

4221.21 There are four **elements** necessary to have a valid contract:

1. Agreement: Manifestation of mutual assent
2. Consideration
3. Legal purpose
4. Competent parties

4221.22 An *agreement* is a mutual understanding between two or more persons.

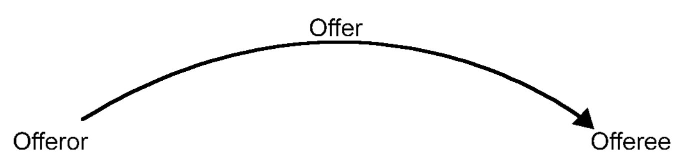
4221.23 There must be a manifestation of mutual assent for the parties to be legally obligated on the contract.

4221.24 Objective standard is used to determine agreement. This means what persons show by their conduct, not necessarily what is thought.

4221.25 Normally, an agreement is reached by an offer and an acceptance of that offer.

4221.26 An *offer* is a promise to do or refrain from doing something in the future provided the other party complies with the stated conditions.

4221.27 Parties to an offer may be diagrammed as follows:



4221.28 The offer is always a promise.

4221.29 To have a valid offer, the following must be true:

a. **There must be contractual intent.** Use the reasonable person objective standard. Ask, "Would a reasonable person based on the circumstances believe that an offer had been made?" An offer is not any of the following:

   (1) A social invitation. "If you promise to come over to my house tonight, I promise to cook you a steak dinner." This creates a social, not a legal, obligation.

   (2) A statement made in obvious jest. "I will give a million dollars to anyone who will tell me the name of that song."

   (3) A statement made in anger, rage, or excitement. "I will give a million dollars to anyone who tells me the name of the person who stole that bike from me."

   (4) An invitation to negotiate further

b. **The offer must be definite and have a certainty of terms.** Courts cannot enforce what cannot be determined. It need not be with absolute certainty but must be capable of determination with reasonable certainty.

(1) Usually need time of performance, price, what is to be done, and subject matter of the contract identified.

(2) Output contracts are OK. An *output contract* promises to sell all of a person's production over a set period of time.

(3) Requirements contracts are OK. A *requirements contract* promises to buy all of a person's requirements for the product over a set period of time.

(4) Failure to state a specific dollar price is OK, if the price can be objectively determined.

Example: I promise to sell you 1,000 bushels of corn at the market price next Thursday.

c. **The offer must be communicated to the offeree.** It may be to an individual or to a group.

4221.30 **Advertisements:** Attempts to solicit an offer from the reader. Advertisements are not definite enough to be an offer, even if it contains a stated price.

4221.31 **Quote:** Invitation to make an offer—not an offer.

4221.32 **Bid:** An offer.

4221.33 **Preliminary negotiations:** Dickering before a final contract—not an offer.

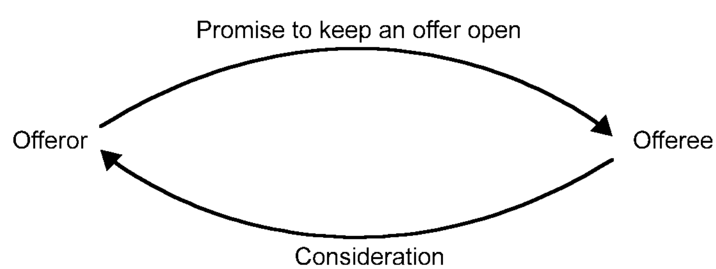
4221.34 An offer may be withdrawn (revoked) by notifying the offeree any time before acceptance.

4221.35 Revocation of an offer by the offeror is effective when received by the offeree.

4221.36 Rejection of an offer by the offeree is effective when received by the offeror.

4221.37 An offer may not be assigned to anyone else.

4221.38 **Option contract:** A contract entered to keep an offer open; the offer cannot be withdrawn without breach of contract during the agreed-upon time period.



4221.39 An offer may be terminated by the following:

a. Expiration of the time specified in the offer or a reasonable time if no time is mentioned

b. Revocation received by the offeree before acceptance

- **c.** Rejection by the offeree (a counteroffer is a rejection combined with a new offer to the original offeror)
- **d.** Death of the offeror or offeree
- **e.** Insanity of the offeror or offeree
- **f.** Destruction of the subject matter relating to the offer without the fault of either party
- **g.** Intervening illegality—subsequent legislation making the offer or the resulting contract illegal (e.g., an offer to sell bourbon just before prohibition became effective)

4221.40 **Irrevocable offers** are exceptions to the general rule that offers are revocable. These are some examples of irrevocable offers:

- **a.** Option contract—made irrevocable by a contract between the parties in which the offeror agrees to keep the offer open in return for some consideration from the offeree.
- **b.** Unilateral contract when the offeree has begun substantially to perform the contract. Revocation would be unfair to the party who has begun performance.
- **c.** Stated time of a written offer signed by a merchant even though there is no return consideration received in exchange for the promise. (UCC 2-205)

4221.41 Acceptance is assent of the offeree to the terms of the offer.

4221.42 Offer + Acceptance = Mutual assent

4221.43 The acceptance must conform to the terms of the offer. An acceptance that adds terms to the original offer is a counteroffer. See UCC 2-207 for an exception for nonmaterial terms for contracts between merchants.

4221.44 The acceptance must be communicated to the offeror. Acceptance is effective when dispatched if an authorized method is used even if it is not received by the offeror.

- **a.** Dispatch means to send.
- **b.** If the method of acceptance is specified, that is the only authorized method.
- **c.** If the method of acceptance is not specified, the following would be authorized methods:
  - (1) Same as the offeror used to convey the offer
  - (2) Customary method used in this type of transaction
  - (3) Prior method used between the parties in question

4221.45 The offeree must have knowledge of the offer for there to be an acceptance. You cannot accept what you do not know about. (This comes up in reward cases.)

4221.46 Silence does not constitute acceptance unless justified by prior dealings, or the parties agree that silence will operate as an acceptance.

4221.47 Acceptance may be by making a return promise (bilateral contract) or completion of an act (unilateral contract).

4221.48 To create a contract, mutual assent (agreement) must be given. Real assent is lacking if a party is induced to contract by mistake, fraud, duress, or undue influence, in which case the wronged party can avoid the contract. A contract obtained by mistake, fraud, duress, or undue influence is voidable.

Fraud in the Inducement

4221.49 **Fraud in the inducement** is a false representation of a material fact intentionally made, justifiably relied upon, and resulting in injury.

4221.50 **Definitions**

- **a.** **Fact:** It is not an opinion or a prediction of what will happen in the future. An opinion by an expert may be considered a fact. A fact is something that can reasonably be subject to exact knowledge.
- **b.** **Material:** It must be related to something of substance and must be important.
- **c.** **Intentionally:** Known by the speaker to be false.
- **d.** **Justifiably:** No better information available. If the party knows the statement is false, or could easily and should reasonably have checked the statement, the reliance is not justifiable.
- **e.** **Injury:** Some damages result from the wrong.

4221.51 Fraud may be an act, an omission, a concealment, or a nondisclosure.

4221.52 Silence alone is not fraud unless there is a duty to speak based on the relationship between the parties.

4221.53 If the misrepresentation is innocent and not made with the intent to deceive, the injured party may rescind the contract, but cannot obtain damages for the tort of deceit. Deceit is the tort equivalent to *fraud in the inducement* for contracts.

Fraud in the Execution

4221.54 **Fraud in the execution** results from the substitution of one document for another. The contract so executed is void because there is no consent to contract. The person signing either does not intend the signature to show agreement to a contract or is misled, through no negligence of their own, as to the contents of the writing.

Duress

4221.55 **Duress** is a wrongful act that compels contractual agreement through fear. Duress is subjective (what a person thinks), not objective (what a person shows). Age, sex, experience, intelligence, and relation of the parties must be considered.

4221.56 The acts leading to duress need not be illegal, although they often are. The threats can be against the individual, someone closely related to the individual, or their property.

- **a.** Threat of a civil suit is not duress. A person has the right to file a civil suit.
- **b.** Threat of criminal suit may be duress.
- **c.** Mere argument, advice, persuasion, or annoyance is not duress.
- **d.** Duress makes the contract voidable.

Undue Influence

4221.57 **Undue influence** is unlawful control exercised by the dominant party, which is a substitute for the free will of the dependent party.

4221.58 Undue influence is similar to duress but is generally applied to persons in a close confidential relationship, such as the following:

- **a.** Husband and wife
- **b.** Parent and child
- **c.** Guardian and ward
- **d.** Trustee and beneficiary

4221.59 Courts are not strict in determining what is a confidential relationship.

4221.60 If there is a transaction where the dominant party has gained at the expense of the dependent party, the undue influence is presumed, and the burden of proof is upon the dominant party to prove otherwise.

Mistakes

4221.61 **Mutual mistake.** If both parties are mistaken as to a material fact (neither at fault or both at fault equally), the contract is voidable.

Example: The parties enter a contract for the sale of a horse, both believing the horse is alive at the time. If the horse in fact has died before the agreement is entered, the contract is voidable by either party based on mutual mistake.

4221.62 **Unilateral mistake.** One party is mistaken. There is a good contract so long as the other party is not aware of the mistake and has not entered the contract to take advantage of the mistaken party.

4221.63 A mistake as to value is an ordinary risk in the normal business transaction. A contract cannot generally be avoided for a mistake in value.

4221.64 A mistake of law as to the parties' legal rights under the contract is not grounds for rescission.

4221.65 If a person knowingly and voluntarily signs a document, the person is conclusively presumed to know its contents and assent to them. The person cannot avoid the contract for a mistake.

Unconscionable Contract

4221.66 If the court finds as a matter of law that a contract is unconscionable, it may reform the contract to serve justice (see UCC 2-302).

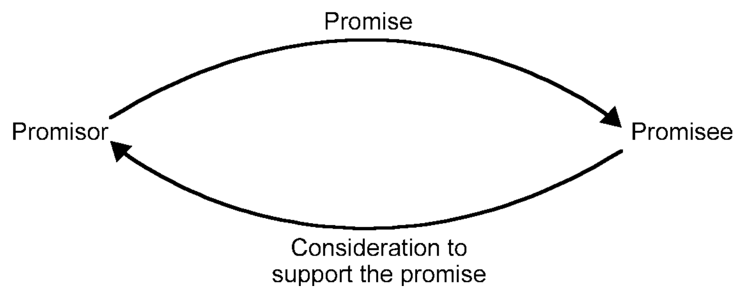
4221.67 If the parties are in unequal bargaining positions, the courts are more likely to find an unconscionable contract and will allow the party in the inferior position to avoid the obligation.

4221.68 An unconscionable contract is a contract that no rational person would enter into and no ethical person would want to impose on another person.

4222 Performance

Consideration

4222.01 **Consideration:** A bargained-for exchange in which there is legal detriment to the promisee or legal benefit to the promisor.



4222.02 Consideration is the inducement to enter the contract. Most people would not enter into a contract unless they received something in return.

4222.03 Consideration must be bargained for. It cannot have already happened. Past consideration is not valid consideration.

4222.04 A contract must be supported by consideration to be valid and enforceable. It is one of the four elements of a contract.

4222.05 Relative value differs from legally sufficient consideration. The two considerations need not be of approximately the same value. Generally, courts do not look at the adequacy of the consideration.

4222.06 Consideration applies only to executory contracts, not executed contracts. If the contract is already completed, there is no longer a question of the contract being enforceable.

4222.07 The following are not good considerations:

a. **Illusory promise:** A promise in form but not in substance.

(1) A promise to buy whatever gasoline I want for the next year. This is a promise in form but really obligates me to do nothing. I could buy nothing or I could buy 500 gallons of gasoline and still not break my promise.

(2) Output and requirement contracts are not illusory.

b. **Doing what one is already legally bound to do by previous contract or statutory duty**—for instance, paying a police officer to catch criminals. This is a preexisting duty.

c. **Past consideration**—cannot be consideration for a new contract.

d. **Moral consideration**—a person may feel morally obligated, but this does not mean legally obligated.

4222.08 Consideration may be any of the following:

- **a.** A return promise to do something the promisee is not legally obligated to do
- **b.** An act other than a return promise that the promisee is not legally obligated to do
- **c.** A forbearance—promising not to do something that the promisee has a legal right to do

4222.09 **Liquidated debt:** Debt for a sum that both parties agree as to amount. Payment of a lesser sum will not discharge the balance since the debtor has a preexisting duty to pay the agreed amount. Some additional consideration is needed to support a promise to forget about collecting the remaining amount. Paying before the due date would be such additional consideration if both parties agree. This is true, since prior to this agreement the party is not legally obligated to pay early.

4222.10 **Unliquidated debt:** Amount is disputed in good faith by the parties. Payment of a sum less than the amount suggested by one of the parties discharges the obligation if the other party accepts the lesser amount as full payment.

4222.11 **Promissory estoppel**

- **a.** A substitute for consideration
- **b.** Three elements must exist for promissory estoppel to apply:
  - (1) A promise by the promisor that is reasonably expected to be relied upon by the promisee
  - (2) The promisee does in fact detrimentally rely on the promise.
  - (3) Injustice can be avoided only by enforcing the promise.
- **c.** A promise that induces action is binding without return consideration if justice is served.
- **d.** **Example:** A promise of a donation to a charity when the charity makes expenditures in anticipation of the donation but does not give return consideration to support the promise to donate. Promissory estoppel could be used to enforce the promise to donate to the charity even though the promise is not supported by consideration.

4222.12 **Seals.** If a document has a seal, consideration is conclusively presumed. The Uniform Commercial Code (UCC) negates the effect of seals for sale of goods contracts. A seal can be the word *seal* on the contract.

4222.13 Promises that do not require consideration under the Uniform Commercial Code (UCC):

- **a.** A claim for breach of contract for sale of goods can be discharged without consideration if a written waiver is signed and delivered.
- **b.** A written offer (promise) by a merchant to buy or sell goods cannot be withdrawn for the time stated, even though the offeree has not given return consideration to be binding.

4222.14 A promise that does not require consideration under the common law:

A renewed promise to pay a debt that cannot be enforced, because of the statute of limitations, needs no new consideration.

Illegal Bargains

4222.15 An agreement whose formation or performance is a tort, a crime, or is opposed to public policy constitutes an illegal bargain.

4222.16 The court will not enforce an illegal bargain, generally leaving the parties where the court finds them. This means the court will not adjust the equities between the parties. The courts will sometimes grant relief to the following persons even though they are involved in an illegal bargain:

- **a.** A party that the violated law intended to protect. States have laws that require all physicians to be licensed by the state. An unlicensed physician who contracts with a patient has violated the licensing statute making the agreement an illegal bargain. The courts will help the patient, but not the physician. The licensing statute was enacted to protect patients from unlicensed physicians.
- **b.** A party that is not in a good bargaining position when making the agreement. This party is said to be not equally at fault (not *in pari delecto*). Courts will sometimes grant relief to this type of party.
- **c.** A party who seeks to back out of an illegal bargain before execution
- **d.** A party to an agreement when part is legal and part is illegal. Sometimes the courts will grant relief if the obligations are severable. This means the courts will separate the agreement to make an enforceable portion and an unenforceable illegal bargain.

4222.17 **Violation of statutes**

- **a.** **Criminal statutes:** The bargain is always illegal and unenforceable. The following are examples:
  - (1) Bribing a government employee to get a contract
  - (2) An agreement to commit any statutory crime, such as hiring a hit man to kill someone
- **b.** **Licensing statutes:** Illegal and unenforceable only if licensing is for regulatory purposes.
  - (1) **Regulatory:** The purpose is to protect the public against unqualified persons, for instance, a lawyer, physician, CPA, or real estate broker. The professional could not recover on the agreement if they were not properly licensed.
  - (2) **Revenue-producing:** The purpose is to raise money, for instance, a salesperson's license or driver's license. Failure to have a license required by a revenue-producing statute does not make the contract illegal. Either party could recover on the contract.
- **c.** **Wagering or gambling agreements:** The agreement is not enforceable. A gambling agreement results when the parties bet on the outcome of an uncertain event in which the parties have no interest other than the bet.
- **d.** **Usury:** Charging an interest rate in excess of the maximum allowed by statute for the loan of money.
  - (1) Remedy for violation:
    - (a) Lender collects principal but not interest in the majority of states.
    - (b) Lender collects principal and interest up to the lawful rate.
    - (c) Lender loses both principal and interest.

(2) The following are permissible and are not usury violations:

(a) Collecting a legal maximum interest in advance

(b) Adding a reasonable service fee to cover incidental cost of inspection, service, and recording

(c) Having a credit price and a cash price for the sale of goods

(3) Statutory exceptions allowing higher interest rates exist for the following:

(a) Pawnshops

(b) Small loan companies

(c) Credit unions

(4) Usury does not apply to time payment differential on the sale of goods, only to lending money.

(5) Many states have enacted consumer credit laws to make consumer credit sales, revolving charge accounts, and interest on credit card sales subject to maximum percentages of interest. In effect, the loan of money and these consumer transactions are both subject to a maximum interest rate.

4222.18 Bargains contrary to public policy are also illegal and unenforceable.

a. Restraint of trade

(1) Society looks with disfavor on any agreement that unnecessarily restrains a person from exercising their trade, business, or profession.

(2) Contracts in total restraint of trade are always illegal. A contract in total restraint of trade has as its prime purpose the establishment of a monopoly through price fixing, division of sales territories, and limitations on production.

(3) A contract in partial restraint of trade, if the restraint is secondary to the main purpose of the contract (ancillary in nature).

(a) It is enforceable if the following are true:

i. The restraint is necessary to protect the purchaser, the remaining members of the business, or the employer.

ii. The restraint is reasonable as to time and geographic area.

iii. The restraint does not place an undue burden on the promisor.

iv. It occurs in the sale of a business or profession, the sale of property, or the termination of employment.

(b) This type of agreement is referred to as a covenant not to compete.

(4) Courts will enforce the remainder of the contract without the restraint of trade clause.

b. Obstructing the administration of justice, such as bribing a judge or juror

c. Corrupting public officials

d. **Exculpatory clause:** Provision of a contract which relieves a person of liability for his own negligence. Attempts to do this are sometimes seen on signs in parking lots, such as “Not responsible for damage done to your car.” Courts do not enforce exculpatory clauses that are determined to be contrary to public policy.

e. Unduly influencing legislative or executive action

Contractual Capacity

4222.19 Every party to a contract is presumed to have contractual capacity until shown otherwise.

4222.20 **Minors**

a. A minor's contract is voidable at their option, but the other party to the contract may not avoid the contract.

b. Generally, the age of majority, when the individual is no longer a minor, is the age of 18.

c. Contracts by a minor for necessities:

(1) A minor will still have to pay the reasonable value of necessities. This may or may not be the same as the contract price. This is a quasi-contractual obligation imposed by the courts to prevent unjust enrichment.

(2) What is a necessity is a question of fact. Necessities have always been considered food, clothing, lodging, and medical services not supplied by a parent. Items for health, education, and transportation may be necessities in some cases.

(3) In order to recover, the burden of proof as to what is a necessity rests with the adult seller.

d. **Disaffirmance**—getting out of the contract

(1) A minor may disaffirm contracts while still a minor and for a reasonable time after reaching majority.

(2) It may be an express or an implied disaffirmance.

(3) If a minor has the goods, the minor must return them to the seller to disaffirm a contract for the sale of the goods. The goods can be in any condition. The right to disaffirm is not conditioned on being able to return the goods.

(4) A disaffirmance of a conveyance of land can only be done after the minor reaches majority; however, the minor who sold land and disaffirmed the contract can retake the land before reaching the age of majority.

(5) A minor who has sold goods may not be able to regain the goods even if they disaffirm. The Uniform Commercial Code (UCC) allows a person with a voidable title to transfer good title to a good-faith purchaser for value. If the adult has sold the goods to someone else in good faith and for value, the minor cannot get them back. The minor can get the money equivalent to the value of the goods.

(6) A minor is liable for torts if the torts are independent of the contract. Misrepresentation of age is a good example of a tort that precedes, and is independent of, the contract of sale.

(7) Contracts a minor may not be able to disaffirm include the following (it varies by state):

(a) Educational loans

(b) Court-approved contract (court has already checked to see that the contract is fair)

(c) Enlistment contract

(d) Insurance contract

(e) Medical care

(f) Bank account

(g) Stock transfer

(h) Business contract

(i) Marriage contract

e. **Ratification**

(1) A person is liable on a contract made during their minority if they ratify the contract. A minor can ratify a contract only after reaching the age of majority.

(2) Ratification may be expressed in words or implied by actions.

(3) Retention of goods for an unreasonable time after reaching majority age can amount to ratification of the contract.

f. A parent is not liable for the minor's contracts unless the minor is acting as the parent's agent.

g. A minor's contracts are voidable, not void.

4222.21 **Insane persons**

a. A mentally incompetent person may avoid liability on contracts. Test: "Is the person unable to understand the effect and nature of the act?"

b. It is not necessary to be adjudicated insane to be mentally incompetent.

c. If a person is adjudicated insane, his agreements are void. If a person can show that he is mentally incompetent without prior adjudication of insanity, his contracts are voidable.

4222.22 **Intoxicated persons**

a. A contract made by a person so intoxicated so as not to be able to comprehend the nature and effect of the transaction may be voidable. This is allowed very rarely since courts may view the intoxicated person as being at least partly responsible for their condition.

b. Being drunk is not a good excuse to disaffirm a contract.

4222.23 **Private corporations**

a. A private corporation exceeding its scope of power is held liable on its contracts.

b. *Ultra vires*: Beyond the corporation power.

4222.24 **Public corporations**

a. A city or a town is an example of a public corporation.

b. There is generally no recovery against a public corporation that exceeds its legal limits in making a contract.

Statute of Frauds

4222.25 Certain contracts must be in writing and signed by the party to be charged or the contract is unenforceable if the statute of frauds is raised as a defense.

4222.26 The party to be charged is the party that is being sued to be held liable on the contract.

4222.27 The writing may be a note, a memorandum, an informal notification, or more than one writing. The writing must meet the test of reasonable certainty and should contain the name of the parties, subject matter, and material terms and conditions.

4222.28 **Sale of goods**

- **a.** A contract for the sale of goods for a price of $500 or more must be in writing to be enforceable.
- **b.** **Exceptions** (see UCC 2-201):
  - (1) Between merchants, an oral contract is enforceable if one of the merchants sends a written confirmation to the other and receives no objection within 10 days after sending it. Both merchants are bound on the oral contract.
  - (2) If the goods are specially manufactured (for a unique purpose and cannot be resold as shelf items), the oral contract is enforceable if the manufacturer has made a substantial start on their manufacture before the other party tries to withdraw from the contract.
  - (3) If the goods have been paid for and accepted or received and accepted, the oral contract is enforceable. If there has been only a partial acceptance of the goods or a partial payment, the contract is enforceable only to that extent.
  - (4) If the person admits in court to have contracted with the plaintiff, the contract is enforceable to the quantity admitted.

4222.29 **Securities.** Any contract for the sale of securities must be in writing to be enforceable.

4222.30 Sale of intangible personal property (e.g., a patent, copyright, or royalty right) for more than $5,000 must be in writing.

4222.31 **Transfer of an interest in land**

- **a.** Transfer of any interest in real property must generally be in writing.
- **b.** This provision would include sale of real estate, giving a lien (mortgage) on the real estate, certain leases of real estate, and granting an easement.
- **c.** Agreements to build on real estate, do other work such as landscaping, or to lend money to buy real estate do not generally have to be in writing to be enforceable.
- **d.** **Exception:** An oral contract for the sale of real property is enforceable if the buyer takes possession and/or makes valuable improvements on the land. This is called the doctrine of part performance. A valuable improvement might be building a house on the land.

4222.32 **Contracts that cannot be performed within one year**

- **a.** An executory, bilateral contract that cannot be performed within one year of making the contract is not enforceable unless it is in writing.
- **b.** Time starts from the time of making the contract, not from the time of expected performance.
- **c.** If it is possible to perform the contract within one year, no matter how improbable, an oral contract is enforceable.

4222.33 **A promise to pay the debt of another must be in writing to be enforceable.**

- **a.** This is called *suretyship*.
- **b.** The person making the promise to pay the debt of another is called a surety or a guarantor.
- **c.** The promise must be to the creditor. This is referred to as a collateral promise rather than an original promise.
- **d.** An oral promise to the debtor to pay the debtor's debt is enforceable even if oral. It was not made to the creditor and is considered an original promise.
- **e.** **Exception:** An oral promise made to the creditor to pay the debt of the debtor made solely to benefit the person making the promise. It is called the main purpose doctrine or the leading objective rule.

4222.34 **Promise when one and only one of the promises is a promise to marry**

- **a.** Must be in writing to be enforceable
- **b.** Mutual promises to marry may be oral and still be enforceable.
- **c.** **Example:** Father promises boy $10,000 if he promises to marry daughter. Boy will not get the $10,000 if father does not want to pay if it was an oral promise.

Parol Evidence Rule

4222.35 **Parol-extrinsic:** Evidence about the agreement that is not in the written agreement. It is outside the agreement and usually oral.

4222.36 **Parol evidence rule.** Extrinsic (oral or written) evidence is not admissible to add to, alter, or vary the terms of a written contract. The reason is that all preliminary negotiations are merged into the writing.

4222.37 It is acceptable to make an oral contract and a written contract at the same time if the subjects of the contracts are different.

4222.38 It is not a violation of the parol evidence rule to admit oral testimony to prove or explain the following:

- **a.** The contract was obtained by fraud, misrepresentation, duress, or undue influence.
- **b.** The contract was illegal.
- **c.** An oral condition precedent to the contract. Until the condition precedent happens, the contract does not come into existence.
- **d.** A subsequent modification has been made to the contract. This could be oral or written.
- **e.** Ambiguous terms in the written contract. Oral testimony would clear it up.
- **f.** The contract is voidable due to a party being a minor or being insane.
- **g.** Fill in blank spaces regarding nonmaterial terms if the written contract is incomplete. These terms cannot vary, alter, or contradict the written contract.

Interpretation of Contracts

4222.39 If the terms of a contract are unclear or conflict, the court will apply principles of construction and interpretation.

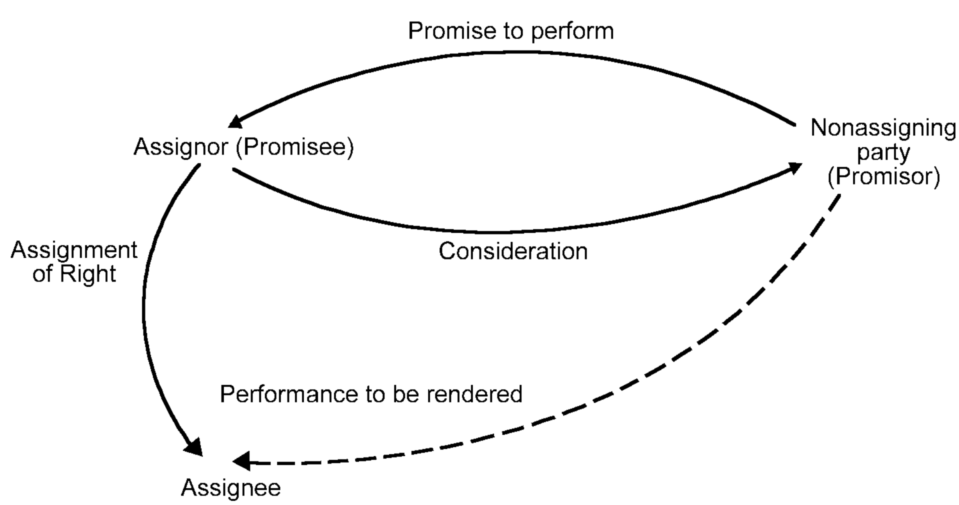
4222.40 Under rules of interpretation and construction for contracts:

- **a.** > means "control" for purposes of this list.
- **b.** The contract is construed as a whole, not in parts. The whole contract is read with all words and sentences taken in context.
- **c.** Written > typed > printed. Written provisions of a contract are more likely to be current than printed words on a preprinted contract.
- **d.** Specific > general. If there is an inconsistency, the specific provisions control and qualify the meaning of the general provisions.
- **e.** Lawful > unlawful. If a provision can be interpreted in both a lawful and unlawful manner, it is assumed that the parties intended a lawful purpose.
- **f.** Words > figures to determine amount or quantity.

  Example: A check says "$467.88" and "Four hundred seventy-six dollars and eighty-eight cents." The amount the bank will pay is $476.88 (words) instead of $467.88 (figures). Figures are easier to transpose than are quantities written in words.
- **g.** Public > private. Where the public interest is affected, an interpretation is preferred that favors the public interest over any private interests of the parties.
- **h.** Nondrafter > drafter. Since the drafter wrote the contract, he/she has already had the opportunity to clear up any ambiguity. Therefore, any ambiguity will be resolved in favor of the nondrafter by construing the contract language most strongly against the drafter.

Assignments of Contracts

4222.41 **Assignment of contracts**



- **a.** An assignment involves a transfer by one party to a contract of some or all of the rights to another person who is not a party to the original contract.

b. Agreement or consent of the nonassigning party is not needed unless the contract requires consent. In mega-leases, there is often a consent clause.

c. **Assignor:** Transferor. The party that transfers the rights.

d. **Assignee:** Transferee. The party that gets the rights from the transfer.

e. No special language is necessary to make an assignment.

f. May be a total transfer or partial transfer of the contract by the assignor.

g. No consideration is necessary. The assignment may be part of another contract or it may be gratuitous.

h. When a right is assigned, the assignor normally no longer has any interest in the right.

4222.42 Contracts ordinarily are assignable.

a. An offer to enter into a contract is not assignable.

b. Rights (legal ability to get something from the other party) are almost always assignable.

4222.43 Contracts not assignable

a. Contracts involving personal services, such as an employment contract.

Example: Your employer could not assign your employment contract to the local garbage department to work on the garbage truck.

b. Contracts that involve the personal satisfaction of one of the parties.

Example: An artist tells you that you need not pay the $100 fee for painting your portrait unless you are personally satisfied. You could not assign the contract to someone else who might be more critical of any painting.

c. Contract that states the contract is not assignable can generally not be assigned.

(1) A person may assign the right to sue the other party for damages even though the contract prohibits assignment.

(2) A creditor may assign the contract of an account debtor even though the contract prohibits assignment.

d. Contracts where the assignment would treat the nonassigning party unfairly by doing the following:

(1) Materially changing the duties under the contract

(2) Materially increasing the burden or risk under the contract

(3) Materially impairing the chance of obtaining return performance

4222.44 Effect of assignment

a. **Liability of assignor:** Still liable to the nonassigning party on the contract for the promised consideration.

b. **Liability of assignee:** Not liable just because of receiving the assignment. The nonassigning party may be able to sue the assignee if the nonassigning party is a creditor beneficiary of the contract between the assignor and assignee.

c. **Rights of assignee:** Assignee gets all the rights of the assignor. Any defenses the nonassigning party has against the assignor can be asserted against the assignee (up to the amount of the assignment).

d. To protect the right to receive performance, the assignee should notify the nonassigning party of the assignment. If there is no notice and the nonassigning party performs for the assignor, their duty under the contract is discharged.

e. If no notice is given and the nonassigning party performs for the assignor, the assignee can sue the assignor for damages.

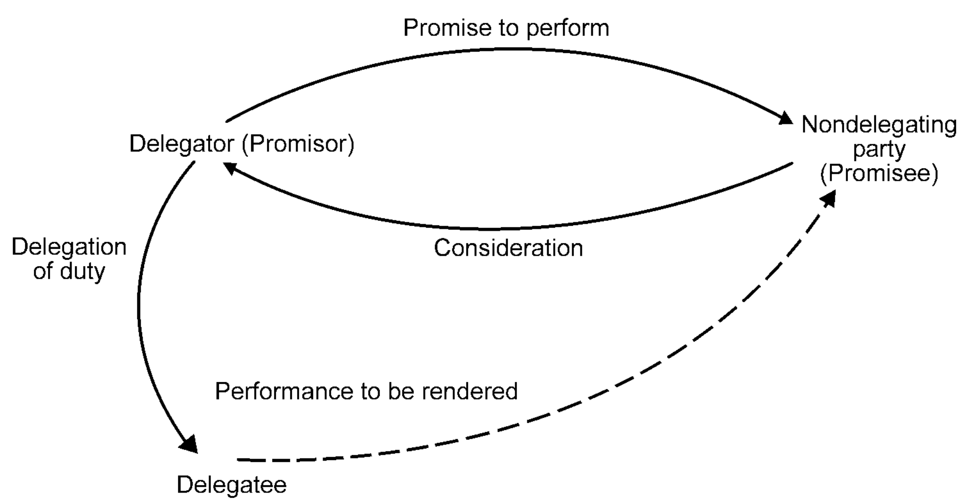
4222.45 Priorities among successive assignees when the assignor assigns the same rights to more than one assignee

a. **American rule:** First assignee in point of time prevails. Once the assignment is made, the assignor has nothing left to assign.

b. **English rule:** First assignee to give notice to the nonassigning party prevails.

Delegation of Duties

4222.46 Delegation of duties (legal obligations to do something for another party)



4222.47 Delegation involves the appointment by the delegator of the delegatee to render performance on the delegator's behalf.

4222.48 Though the terms are often used interchangeably, assignment and delegation are the flip sides of the coin. Rights are assigned. Duties are delegated.

4222.49 When a duty is delegated, the delegator is still liable to the nondelegating party for any defective performance by the delegatee. The delegator is relieved from liability only if the nondelegating party agrees to release by way of a novation (see section **4223.13**).

4222.50 Nondelegable duties

a. A duty is nondelegable when performance by the delegate would vary materially from performance by the delegator.

b. If the contract is based on the artistic skill or unique ability of the delegator, the duty to perform is nondelegable.

c. If the duties under the contract simply call for mechanical skills, which can be tested by objective standards, the duty to perform is delegable.

d. Examples:

(1) A contract duty to paint a portrait would generally be nondelegable, because it involves unique abilities and artistic skill.

(2) A contract duty to install a concrete driveway would generally be delegable, because this usually would involve only mechanical skills that can be tested by objective standards.

4223 Discharge, Breach, and Remedies

Remedies for Breach of Contract

4223.01 Contract remedies are intended to put the injured party in the same position as if the contract had been performed insofar as possible. If the legal remedy of damages is not adequate, the equitable remedies of specific performance, rescission, or injunction may be used.

4223.02 Compensatory damages

a. For sale of goods contracts

(1) If buyer has the goods and title has transferred to buyer— the contract price.

(2) If seller has the goods and no title has transferred—the difference between the contract price and the fair market value. If not a stock item, the seller will have to sell the goods in a good faith transaction (not to a related party) to determine the fair market value.

(3) Seller will not deliver the goods—the difference between the contract price and the fair market value. Buyer will have to buy an identical item from another seller (called covering) to establish the fair market value. If the buyer is able to get the goods from another seller at a price that is lower than the contract price, the buyer need not refund the savings. There would be no compensatory damages.

b. For sale of services

(1) Seller will not perform—difference between fair market value of getting the services done and the contract price.

(2) Buyer refuses to accept the services—profit that would have been made by the seller.

c. Damages include any expense that is reasonably foreseeable with whatever knowledge the breaching party has.

4223.03 Nominal damages

a. A small sum, like $1, would be awarded for breach of contract either:

(1) with no compensatory damages or

(2) when unable to prove damages with reasonable certainty.

b. No logical person would sue if they expected to collect only nominal damages. They would still have to pay attorney fees and would actually lose money by bringing the suit.

In awarding nominal damages, the court merely pats the winner on the back, says they were in the right, and awards them a small amount.

4223.04 Special damages

- **a.** These are damages that would not be foreseen unless a person has some special information about the circumstances.
- **b.** The wronged party can recover these special damages only if the breaching party has this special information. With this specific information the damages would be foreseeable.

4223.05 Liquidated damages

- **a.** Amount of damages is agreed upon in advance and included in the contract. This provision is found in sophisticated contracts. Often the easy part of a lawsuit is establishing a breach. The second issue is establishing the damages. The liquidated damages provision is often included to avoid this second issue.
- **b.** Used where the actual compensatory damages would be difficult to determine (e.g., breach of construction contracts)
- **c.** The court will enforce liquidated damage provisions in a contract if they were a reasonable estimate of the probable loss when made and are not a penalty used to prevent a breach. Because both contracting parties negotiated the amount of liquidated damages, the defaulting party will have a heavy burden in arguing that the amount was not reasonable. Most contracts include a sentence that the liquidated damages are not to be construed as a penalty.
- **d.** If the courts find the liquidated damage provision to be a penalty, they will disregard the provision and make the party try to prove compensatory damages.

4223.06 Mitigation of damages. After a breach, the injured party must take steps to minimize further loss. The injured party failing to take this action will not be able to collect the additional portion of the damages that could have been prevented.

4223.07 Restitution

- **a.** An equitable remedy available only if damages would be inadequate to make the nonbreaching party whole.
- **b.** Also called *rescission.*
- **c.** Restitution involves return to the injured party of the consideration given or its value.

4223.08 Specific performance

- **a.** An equitable remedy available only if damages would be an inadequate remedy for breach of the agreement.
- **b.** Two common examples of specific performance:
  - (1) **Contract to buy (not sell) land.** Each piece of land is unique unto itself. The buyer could not go into the marketplace and buy an exact equivalent.
  - (2) **Purchases of unique personal property.** These are one-of-a-kind items. They would also include items like the controlling interest stock of a corporation. The buyer could not go into the marketplace and buy the same item.
- **c.** The promise must be clear and relate to a specific identifiable item.

d. No specific performance for the following:

(1) **Building contract.** Too difficult for the court to supervise.

(2) **Personal services.** This would be involuntary servitude prohibited by the Thirteenth Amendment of the U.S. Constitution. Courts will enforce a negative injunction to prohibit the individual from doing that type of work during the period of the contract. This has happened when a professional basketball player jumped to a new league but still had a contract with the old team.

Discharge of a Contract

4223.09 Discharge: End of a contractual obligation.

4223.10 Discharge related to conditions

a. Condition precedent not happening

(1) A condition precedent must occur before a contractual obligation comes into existence.

(2) **Example:** Buyer agrees to purchase a house on condition that he can obtain a $90,000 loan at 7.75% or lower within the next 30 days. Being able to get the loan is a condition precedent to being obligated to purchase the house.

b. Condition subsequent happening

(1) A condition subsequent ends an existing contractual obligation.

(2) **Example:** Returning the goods in 10 days and getting a full refund if you are not satisfied. This is a condition subsequent that terminates the promise to pay a refund for the goods after 10 days have passed.

4223.11 Performance of the contract

a. Complete performance

(1) Discharges the contract

(2) Must be exactly as agreed

b. Substantial performance

(1) Slightly less than complete performance where there is technically a breach, but it is not material

(2) Allows the person to recover the contract price less the amount needed to complete the contract

(3) Usually applies to construction contracts where it is an oversight rather than intentional

c. Partial performance

(1) Less than substantial performance

(2) Allows the person to recover only by a quasi-contract (contract implied in law) for the value of the services rendered. A quasi-contract is imposed only when unjust enrichment would result.

4223.12 Payment

- **a.** Full payment discharges the obligation.
- **b.** Payment by check is conditional upon the check being paid by the bank.
- **c.** Partial payment:
  - (1) Must be applied as directed by the debtor
  - (2) If the debtor does not specify, the creditor may apply it in any way.
  - (3) It may even be applied to a debt which would be unenforceable because the statute of limitations has run out.
- **d.** Consumer credit statutes may give the priorities of application to the creditor for some types of transactions.

4223.13 **Novation:** A three-party agreement where the creditor agrees to release the debtor and take some third party as a substitute. The novation discharges the contractual obligation of the original debtor. Novations are rare because the original debtor is discharged.

4223.14 Accord and satisfaction

- **a.** **Accord:** Agreement between the two contracting parties where some different performance will replace the original performance. An accord by itself does not discharge the contractual obligation.
- **b.** **Satisfaction:** Carrying out the accord
- **c.** An accord and satisfaction discharges the contractual obligation.

4223.15 Impossibility of performance

- **a.** **Subjective impossibility**—it is inconvenient or too expensive to carry out the contract—does not discharge the contract.
- **b.** **Objective impossibility**—discharges the contractual obligation
  - (1) Nobody could carry out the contract. This is real impossibility.
  - (2) Either of the following would be objective impossibility:
    - (a) The subject matter of the contract is destroyed after making the contract but before performance is due.
    - (b) The person who is to perform a personal services contract dies after making the contract but before the performance is due.
- **c.** **Doctrine of commercial frustration**—excuses contractual performance if both parties contemplated the happening of some event that does not occur

  Example: Coronation case in England. People rented apartments to see the parade, but the king got sick and the parade was canceled.

4223.16 Release

- **a.** Give up the legal right to sue the other party on a contract.
- **b.** It discharges the other party.
- **c.** A release of one joint obligor releases all other joint obligors.

4223.17 Covenant not to sue

a. Promise not to sue a person, discharges that person.

b. Promise not to sue does not affect other joint obligors.

4223.18 Operation of law

a. The statute of limitations runs out so that a lawsuit can no longer be filed to enforce the contract.

b. The person is discharged of the debt through bankruptcy proceedings.

4223.19 Breach

a. Failure to perform without a valid reason

b. Breach by one party discharges the duty of performance by the other party.

4223.20 Anticipatory breach

a. Repudiation of the contract by informing the other party that the contract will be breached when performance is due

b. Other party may do either of the following:

(1) Wait and do nothing until the time for performance passes.

(2) Sue immediately for the breach even though the time for performance has not yet arrived; however, damages may be difficult to establish. (See liquidated damages as discussed in section **4223.05**.)

Joint and Several Contracts

4223.21 Joint contracts

a. Two or more persons jointly promise to perform an obligation.

b. Suit must be brought against all joint promisors.

c. Judgment may be levied against one of the joint promisors.

d. A release of one joint obligor releases all of them.

e. If one joint promisor dies, the remaining promisors remain obligated to perform.

f. A promise by two or more persons is presumed to be joint.

g. "We jointly promise" is a joint contract.

4223.22 Several contracts

a. Severally = individually

b. Two or more persons who separately agree to perform the same obligation may be sued individually.

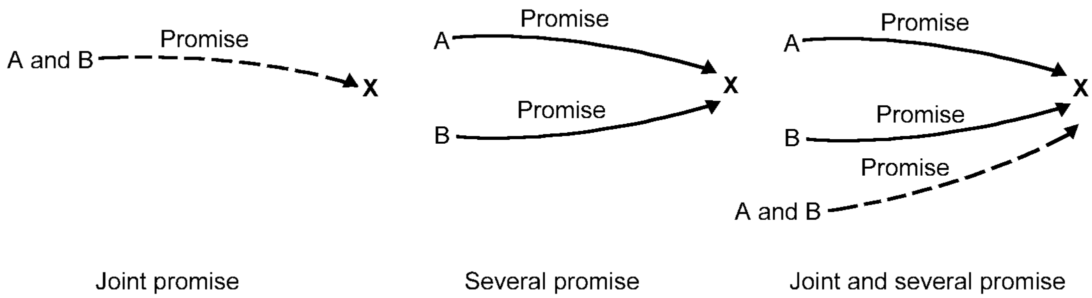
c. If one of several obligors dies, his estate is liable on the obligation.

d. A release of one obligor has no effect on the other.

e. "Each of us promises" or "We severally promise" is a several contract.

4223.23 Joint and several contracts

- **a.** Two or more persons are bound both jointly and severally.
- **b.** "We, and each of us, promise" are joint and several contracts.



4230 Debtor-Creditor Relationships

4231 Rights, Duties, and Liabilities of Debtors, Creditors, and Guarantors

4231.01 The rights and duties of debtors and creditors outside of bankruptcy are governed primarily by state law.

4231.02 Once a debt is past due, a creditor may file a legal action against the debtor in order to obtain a judgment and satisfy the claim out of the debtor's property.

4231.03 State law also provides a number of nonbankruptcy compromises that may be used to provide relief for a debtor.

Attachment

4231.04 Attachment is the prejudgment, court-ordered seizure of property of the debtor.

4231.05 The creditor can make use of an attachment to ensure that assets of the debtor are available to satisfy a judgment obtained by the creditor.

4231.06 The creditor's attachment rights are created by state statute.

4231.07 To make use of the remedy of attachment, the creditor generally must do the following:

- **a.** File an affidavit with the court showing the debtor to be in default and the statutory grounds for the attachment.
- **b.** Post a bond with the court to compensate the debtor for any loss suffered if the creditor fails to win the suit.

4231.08 If all of the requirements are met, the court will issue a writ of attachment ordering a court officer (sheriff) to seize property of the debtor.

4231.09 If the creditor wins the suit, the attached property can be sold to satisfy the judgment.

Writ of Execution

4231.10 If a court judgment is obtained against the debtor, the creditor may have to resort to post-judgment remedies to collect.

4231.11 If the debtor does not voluntarily pay the judgment, the creditor will have the clerk of courts issue a writ of execution.

4231.12 The writ of execution is a court order directing an officer of the court (sheriff) to levy against (seize) specific property of the debtor.

4231.13 The debtor's property is then sold at a judicial sale and the proceeds are used to pay the judgment and the costs of the sale. Any excess is returned to the debtor.

4231.14 The debtor generally has the right to redeem the seized property before the sale takes place by paying the amount of the judgment.

Exempt Property

4231.15 Most states provide for the exemption of certain property of the debtor from attachment or execution. The exact property that is exempt varies greatly from state to state.

4231.16 All states provide a homestead exemption under which either the entire family home or a specific dollar value of the home is exempt from attachment or execution by creditors. This exemption generally would not apply to a valid home mortgage lien.

4231.17 Most states also provide exemptions for certain personal property of the debtor. The most common items include the following:

- **a.** Household furnishings up to a specific dollar amount
- **b.** A motor vehicle (for a specific dollar amount)
- **c.** Clothing and certain personal possessions (e.g., family photos) of the debtor
- **d.** Equipment and tools used in the debtor's trade or business up to a specific dollar amount

4231.18 Exempt property would generally not be exempt from an IRS tax lien resulting from a failure to pay tax.

Garnishment

4231.19 Garnishment is a statutory remedy of the creditor that is directed at a third party, rather than the debtor.

4231.20 The third party (garnishee) must either owe a debt to the debtor or be holding property that belongs to the debtor.

4231.21 As a result of the garnishment, the third party is ordered to turn over the payment of the debt or the property of the debtor to satisfy the creditor's judgment.

4231.22 The most common garnishments are served on the debtor's employer to garnish the debtor's wages or upon a bank to garnish the funds in the debtor's accounts.

4231.23 Both federal and state laws limit the amount that can be garnished from the debtor's weekly wages. Similar to the property exemptions described in section **4231.17,** the limitation allows the garnishee sufficient funds to continue to work.

Composition Agreement

4231.24 A composition agreement is an agreement between the debtor and the creditors whereby the creditors receive a pro rata portion of the debt owed them in exchange for a promise to forgive the rest of the debt.

4231.25 The agreement must meet all of the requirements of a contract.

4231.26 The consideration for the promise of each creditor to forgive the balance of the debt owed to them is the promises of the other creditors to forgive the balance of their claims against the debtor.

4231.27 The debtor is released only from the claims of the creditors who agree to the composition. Other creditors may still pursue judicial remedies such as attachment of the debtor's property.

Assignment for the Benefit of Creditors

4231.28 In an assignment for the benefit of creditors, the debtor voluntarily transfers property to a trustee. The trustee uses the property to pay the debtor's creditors on a pro rata basis.

4231.29 An assignment does not require the consent of the creditors. Each creditor may also choose to accept or reject the partial payment.

4231.30 Acceptance of partial payment from the trustee does not legally discharge the debtor from the balance of the debt. The creditors can still attempt to collect the full amount of their claims unless they agree to forgive the balance by way of a composition agreement.

Equity Receivership

4231.31 In an equity receivership, the court appoints a receiver to collect the assets and income of the debtor.

4231.32 The receiver is appointed to handle the debtor's affairs upon petition of a creditor.

4231.33 The court then orders the receiver to take such action as the following:

- **a.** Liquidating the debtor's assets by way of public or private sale in order to pay creditors
- **b.** Operating the debtor's business for a period of time in order to continue a stream of income that can be used to pay creditors' claims

Fair Debt Collection Practices Act

4231.34 The Fair Debt Collection Practices Act (FDCPA) is a federal statute that was passed to control abuses in the debt collection process.

4231.35 The FDCPA regulates the collection of consumer debt. Consumer debt is defined as debt that arises for personal, family, or household purposes.

4231.36 Commercial debt, such as debt arising from the purchase of inventory, is not covered by the FDCPA.

4231.37 The FDCPA applies to debt collectors. Debt collectors are defined as third-party collectors, such as collection agencies.

4231.38 The FDCPA rules do not apply to original creditors collecting their own debts.

4231.39 Debt collectors must provide written verification of the debt if the debtor asks. Collectors must automatically provide written verification within five days of contacting the debtor. This writing must include the following:

a. The amount of the debt

b. The name of the creditor

c. The debtor's right to dispute the debt in writing within 30 days

4231.40 If the debtor disputes the debt, the debt collector must cease all further collection efforts until it supplies the debtor with a written verification of the debt. Verification can be satisfied by either of the following:

a. A judgment evidencing the debt

b. A statement itemizing the debt owed by the consumer and the consideration the debtor received

4231.41 The FDCPA provides restrictions on the debt collector's contact with the debtor. Among these are the following:

a. Debtors cannot be contacted at inconvenient times, generally before 8:00 in the morning or after 9:00 at night. Debtors who work at night cannot be disturbed during their daytime sleeping hours.

b. Debtors cannot be contacted at their place of employment if the employer objects or has a policy prohibiting such contact.

c. If the debtor notifies the collector in writing that the debtor wants no more contact, the collector must stop contacting the debtor and take other steps to collect the debt.

d. If the debtor has an attorney and notifies the collector of this fact, the collector can generally contact only the attorney from that point on.

4231.42 Debt collectors are generally prohibited from communicating with third parties about the debt.

a. Third parties may be contacted only to obtain information to locate the debtor such as address, phone number, or place of employment.

b. When contacting third parties, debt collectors are prohibited from doing the following:

(1) Disclosing that the debtor owes a debt

(2) Communicating with the third party (or debtor) by postcard

(3) Disclosing in correspondence that the sender is in the debt collection business

(4) Identifying the debt collector's employer unless expressly requested

4231.43 Other conduct is also restricted under the FDCPA. For example:

- **a.** Collectors may not harass, oppress, or abuse the debtor.
- **b.** Debt collectors may not falsely misrepresent that they:
  - (1) are affiliated with the government,
  - (2) are attorneys,
  - (3) have sold the debtor's account to another, or
  - (4) will take actions that they cannot lawfully take.

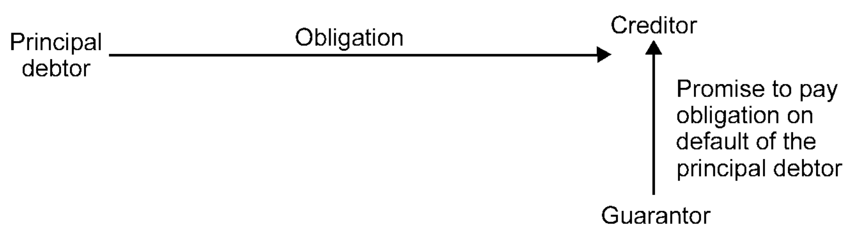
4231.44 Remedies available under the FDCPA include the following:

- **a.** The Federal Trade Commission is responsible for enforcement of the act.
- **b.** Under the FDCPA, debtors can bring civil actions against collectors who violate the act. Debtors can recover damages for actual injuries suffered.
- **c.** Debtors can collect up to $1,000 in addition to actual damages based upon the nature of the collector's conduct.
- **d.** Attorneys' fees and court costs may also be recovered by debtors under the act.

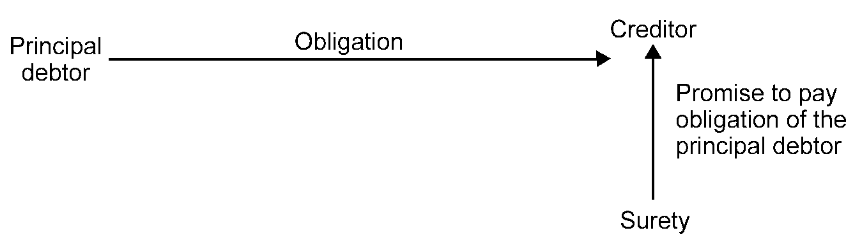
Rights, Duties, and Liabilities—Guarantors

4231.45 Parties that promise a creditor that they will be liable for the principal debtor's performance are either guarantors or sureties.

4231.46 **Guaranty:** Relationship among three parties in which the guarantor promises to pay the obligation of the principal debtor that is owed to the creditor if the principal debtor defaults on the obligation.



4231.47 **Suretyship:** Relationship among three parties in which the surety promises to pay the obligation of the principal debtor that is owed to the creditor.



4231.48 Difference between guarantor and surety

a. Guarantor:

(1) Liability created in some other instrument from that of the principal debtor—often at a different time.

(2) Promise to perform if the debtor cannot perform. The guarantor is *secondarily* liable.

(3) "I will pay if the debtor cannot pay."

(4) The creditor needs to demand payment from the debtor and give notice of default to the guarantor to collect from the guarantor.

(5) The promise of the guarantor is said to be collateral to that of the principal debtor.

b. Surety:

(1) Liability is created concurrently with that of the debtor.

(2) Promise to do the same thing the debtor promises. The surety is *primarily* liable.

(3) "I will pay if the debtor does not."

(4) The creditor does not need to demand payment from the debtor to collect from the surety.

(5) Liability is established in the same instrument as the principal debtor.

The legal rights and duties of guarantors and sureties are similar but note the technical but important difference in *a.(4*) and *b.(4)* above.

4231.49 Consideration: Legally sufficient consideration is required to make a suretyship or guaranty contract enforceable.

4231.50 Statute of frauds

a. Any promise to pay the debt of another person is unenforceable unless there is a writing signed by the party to be charged.

b. The statute of frauds applies only to guaranty contracts because they involve secondary promises. Surety contracts, which involve primary promises to pay, do not fall under the statute of frauds.

c. Promise must be made to the creditor to fall within the statute of frauds. If the promise is made to the principal debtor, the promise is valid and enforceable even if oral.

4231.51 Main purpose doctrine: This is an exception to the statute of frauds when the promise is made for the primary benefit of the promisor. This means that an oral promise to pay the debt of another is enforceable if the oral promise was made primarily to benefit the promisor.

4231.52 Classification of guarantors and sureties:

a. Unconditional or absolute

(1) Binds the guarantor unconditionally to perform the obligation.

(2) Absolute guarantor becomes liable when debtor defaults. Nothing else is needed.

(3) Suretyship contracts are unconditional unless a condition is present.

b. Conditional

(1) Binds the guarantor only after the performance of some act by the creditor.

(2) Typical acts that make liability conditional include the following:

(a) Unsuccessful attempt to collect from the debtor

(b) Unpaid judgment

(c) Showing it would be futile to proceed to a judgment against the debtor

c. General

(1) Addressed "To whom it may concern"

(2) Any creditor who has knowledge of the guaranty and extends credit may enforce the guaranty.

d. Special: Addressed to a particular person.

e. Temporary (or limited or single): Limited to a single transaction, a specified period of time, or a specified maximum amount.

f. Continuing

(1) Contemplates a transaction of indefinite time

(2) May be a series of credits or a credit line

g. Compensated: Person who agrees to serve as a surety and receives compensation (usually money) for undertaking the risk. An example would be a bonding company.

h. Noncompensated (also called accommodation): Person who agrees to serve as a surety without compensation. Courts tend to discharge the noncompensated surety from an obligation for any change the creditor makes in the contract with the principal debtor.

4231.53 **Rights of creditor:** A creditor may proceed against the principal debtor alone, the surety alone, the surety and the principal debtor, or foreclose on any security interest furnished by the principal debtor, or against the guarantor after default by the principal debtor.

4231.54 **Defenses available to the principal debtor:**

a. Discharge in bankruptcy. This is a personal defense available only to the principal debtor. This defense may not be used by the guarantor or surety to avoid paying the creditor.

b. Minority of the principal debtor. This is a personal defense available only to the principal debtor. (Minority generally refers to being under the age of 18.) This defense may not be used by the guarantor or surety to avoid paying the creditor.

c. Performance of the obligation. If the principal debtor has done what was promised, the creditor or the surety cannot insist that the debtor do it again.

d. Breach of contract by the creditor. Like any other contract, the wrongdoer cannot insist on performance if the wrongdoer has not done what they promised to do.

4231.55 **Defenses available to the guarantor or surety to avoid liability to the creditor:**

a. All nonpersonal defenses of the principal debtor are available. Remember that bankruptcy and minority of the debtor are personal defenses not available to the guarantor or surety.

b. **Minority or bankruptcy of the guarantor or surety is a defense.** Minors can avoid liability on all contracts, even guarantor or suretyship contracts.

c. **Creditor's fraud or nondisclosure of something important.** For example, the creditor does not tell the surety that one of the principal debtor's employees was embezzling money.

d. **Creditor modifying principal debtor's contract.** For example, the creditor extends the time for the principal debtor to repay.

e. Creditor's release of security or co-guarantors or co-sureties

f. Creditor's release of the principal debtor

g. Anything the creditor does that will hurt the guarantor's or surety's chance of coming out whole will discharge the surety from the obligation to the creditor.

   (1) Courts tend to release the noncompensated guarantor or surety for any change in the contract.

   (2) For a compensated guarantor or surety, only the amount lost due to the change will be excused.

4231.56 Remedies of the guarantor or surety:

a. **Defense:** Use a defense to avoid payment to the creditor.

b. **Reimbursement or indemnity:** Get the principal debtor to pay the guarantor or surety for the amount the guarantor or surety had to pay the creditor.

c. **Subrogation:** When the guarantor or surety discharges the principal debtor's obligation to the creditor, the guarantor or surety gets all the creditor's rights regarding the obligation.

d. **Contribution:** From co-guarantor or co-sureties for paying more than legally obligated.

4231.57 **Surety bonds:** These bonds are an acknowledgment of an obligation to make good the performance by another of some act or duty.

a. **Common-law bonds:** No law requiring them

b. **Statutory bonds:** Required by statute

c. **Construction bonds** (performance bonds):

   (1) Cover the performance of a contract

   (2) Often used in construction contracts and supply contracts

   (3) May cover laborers and materialmen as third-party intended beneficiaries to the contract between the creditor and the surety. Remember that third-party intended beneficiaries can sue to enforce the contract.

   (4) Subclassifications

      (a) Performance bonds—for performance of work

      (b) Payment bond—for payment of laborers and materialmen

   (5) Miller Act

      (a) Federal act that requires a performance and payment bond on all construction contracts for the federal government for more than $2,000

(b) Not required for construction that is only financed by the federal government (e.g., Federal Housing Administration)

d. **Fidelity bonds**

(1) These bonds indemnify the employer against loss from dishonesty of an employee.

(2) Surety gets right of subrogation against a wrongdoing employee.

e. **Official bond:** Required on some public officials that have custody of public funds

f. **Judicial bonds**

(1) Required in connection with judicial proceedings to indemnify the other party against damages resulting from the proceedings

(2) Examples:

(a) Bail bond

(b) Appeal bond

(c) Injunction bond

(d) Attachment bond

4232 Bankruptcy and Insolvency

4232.01 Bankruptcy results when the intended performance of the debtor becomes impossible due to excessive debt. The solution is to take the debtor's property and distribute it to the unpaid creditors through a uniform process.

4232.02 The U.S. Constitution contains an express provision allowing Congress to enact uniform bankruptcy laws. Major bankruptcy laws were enacted in 1898, 1938, 1978, and 2005. The most recent major revision is the Bankruptcy Prevention and Consumer Protection Act of 2005.

4232.03 **Reasons for a bankruptcy law**

a. Fair distribution of the debtor's property so that there is equal treatment of unsecured creditors

b. To give honest but overextended debtors a fresh start through discharge of debts or postponement of the time for payment

4232.04 The chapters on topics of the Bankruptcy Law are as follows:

Chapter	Topic
1	General Provisions
3	Case Administration
5	Creditors, the Debtor, and the Estate
7	Liquidation
9	Adjustment of Debts of a Municipality
11	Reorganization
12	Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income
13	Adjustment of Debts of an Individual with Regular Income
15	Ancillary and Other Cross-Border Cases

Written Notice to Consumer Debtor

4232.05 Before a bankruptcy case is commenced by an individual whose debts are primarily consumer debts, the bankruptcy clerk must give the individual written notice containing the following:

a. A brief description of:

(1) Chapters 7, 11, 12, and 13 and the general purpose, benefits, and costs of proceeding under each of those chapters and

(2) the types of services available from credit counseling agencies

b. Statements specifying that:

(1) a person who knowingly and fraudulently conceals assets or makes a false oath or statement under penalty of perjury in connection with a bankruptcy case will be subject to fine, imprisonment, or both, and

(2) all information supplied by a debtor in connection with a bankruptcy case is subject to examination by the attorney general

Who May Be a Debtor Under Chapter 7

4232.06 A debtor under Chapter 7 must reside in the United States and have a domicile, a place of business, or property in the United States.

4232.07 The debtor in a proceeding under Chapter 7 cannot be any of the following:

a. A railroad

b. An insurance company

c. A domestic bank

d. Any other lending institution (like a credit union or a savings and loan association)

e. A governmental unit

4232.08 Debtors under Chapter 7 are not eligible for bankruptcy relief. These organizations are covered by special statutes, and their liquidations are supervised by certain regulatory agencies.

Voluntary Petition

4232.09 A voluntary petition is filed by the debtor.

4232.10 A voluntary petition may be filed jointly by husband and wife if both consent.

4232.11 Filing a voluntary petition automatically subjects debtors and their property to jurisdiction of the bankruptcy court.

4232.12 In a voluntary petition, the debtors need not be insolvent. They only need to show that they have debts.

4232.13 An individual must receive credit counseling from an approved nonprofit budget and credit counseling agency within 180 days before filing a voluntary bankruptcy petition.

a. The debtor must participate in either individual or group sessions that outline opportunities for available credit counseling and assist the individual in related budget analysis.

b. A certificate of compliance from the nonprofit budget and credit counseling agency must be filed with the petition.

c. Exception may be made to the budget and credit counseling requirement:

(1) in districts where the bankruptcy trustee (or bankruptcy administrator, if any) determines that adequate budget and credit counseling services are not available.

(2) for debtors who are unable to complete the requirement due to incapacity (impairment by reason of mental illness or mental deficiency), disability (physical impairment), or active military duty in a military combat zone.

4232.14 The bankruptcy court may dismiss a voluntary bankruptcy petition for several reasons. These include:

a. unreasonable delay by the debtor that is prejudicial to creditors,

b. nonpayment of any fees or charges,

c. failure of the debtor to file required documents and information within required time periods,

d. the debtor has income above the average median family income for the state where the bankruptcy petition is filed,

e. the debtor fails to pay post-petition alimony or child support,

f. the debtor was convicted of a drug trafficking crime and the victim files a motion to dismiss the petition, or

g. the debtor was convicted of a violent crime and the victim files a motion to dismiss the petition.

Involuntary Petition

4232.15 An involuntary petition is filed by the debtor’s creditors.

a. If there are 12 or more creditors, 3 or more must file against a debtor if their total unsecured claims are at least $16,750. (Insiders or employees are not creditors.)

b. If there are fewer than 12 creditors, 1 or more creditors must file if their total unsecured claims are at least $16,750.

4232.16 Involuntary petitions are allowed only for Chapter 7 (Liquidation) and Chapter 11 (Reorganization). There is no involuntary petition for Chapter 9 (Adjustment of Debt for a City) or Chapter 13 (Adjustment of Debt for an Individual with Regular Income). These last two types of bankruptcy proceedings are initiated only by a voluntary petition filed by the debtor.

4232.17 Involuntary petitions cannot be filed against any of the following:

a. Farmer

b. Wage earner

c. Railroad, insurance, or banking corporation

d. Building and loan association

e. Nonprofit corporation

4232.18 When the involuntary petition is filed, the debtor and their property automatically come under the jurisdiction of the bankruptcy court if no challenge is made by the debtor.

4232.19 If the debtor contests the involuntary petition, the creditors must prove either of the following:

a. The debtor has not been paying debts as they come due.

b. The debtor's property has been placed in a receivership or an assignment for the benefit of creditors within 120 days before the involuntary petition was filed.

4232.20 A debtor involuntarily petitioned into bankruptcy under Chapter 7 of the Federal Bankruptcy Code who succeeds in having the petition dismissed could recover:

a. court costs and attorney's fees,

b. compensatory damages, and

c. punitive damages.

4232.21 The filing of the petition stays all pending actions by creditors against the debtor.

Estate

4232.22 The debtor's estate consists of all tangible and intangible property of the debtor, unless specifically exempted.

4232.23 The estate has the same interest as did the debtor in the property.

4232.24 The debtor's estate includes certain after-acquired property. Specifically, the estate includes any type of property that the debtor acquires, or becomes entitled to acquire, within 180 days after the petition filing date:

a. by inheritance,

b. as a beneficiary of a life insurance policy, or

c. as the result of a divorce decree or a property settlement agreement with the debtor's spouse.

4232.25 Earnings from services performed by the individual debtor after the filing of the petition are not included in the estate.

Exempt Property

4232.26 A debtor who is an individual (*not* a partnership or corporation) can claim certain exemptions. This exempt property is not included in the debtor's estate and is therefore not liquidated to pay the debts.

4232.27 Exemptions are established by either state or federal law.

4232.28 The debtor may choose to keep certain property either exempted by state law, or exempt under federal law, unless state law specifically disallows use of the federal exemptions.

4232.29 Federal exemptions from the bankruptcy law, if allowed by state law, include the following:

a. Up to $25,150 of the debtor's interest in a homestead (this may be either a house or trailer of the debtor used as a residence) or in a burial plot for the debtor or a dependent of the debtor

b. Up to $4,000 of the debtor's interest in one motor vehicle—the equity in the motor vehicle is based on the motor vehicle's market value.

c. Up to $625 for each item of furniture, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments held for personal, family, or household use of debtor or dependent of debtor—this exemption applies up to a maximum total of $13,400.

d. Up to $1,700 in jewelry for personal use

e. Up to $1,325 plus up to $12,575 of any unused homestead exemption in any other property that the debtor chooses

f. Up to $2,525 in implements, professional books, or tools of the trade

g. Any unmatured life insurance owned by the debtor other than a credit life insurance contract

h. Up to $13,400 in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract owned by the debtor under which the insured is the debtor or an individual of whom the debtor is a dependent

i. Right to receive Social Security, veterans', unemployment, or disability benefits, reasonable alimony, support, or separate maintenance payments

j. Professionally prescribed health aids for the debtor or dependent of the debtor

k. The debtor's right to receive, or property that is traceable to:

(1) an award under a crime victim's reparation law;

(2) a payment on account of the wrongful death of an individual of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(3) a payment under a life insurance contract that insured the life of an individual of whom the debtor was a dependent on the date of such individual's death, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor;

(4) a payment, not to exceed $25,150, on account of personal bodily injury, not including pain and suffering or compensation for actual pecuniary loss, of the debtor or an individual of whom the debtor is a dependent; or

(5) a payment in compensation of loss of future earnings of the debtor or an individual of whom the debtor is or was a dependent, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor

l. Retirement accounts which are tax exempt under the Internal Revenue Code. However, there is a cap on the exemption amount for IRAs of $1,362,800. This limit may be increased if "the interests of justice so require."

m. Certain contributions to qualified education savings accounts. To be excludible, the designated beneficiary must be a child, stepchild, grandchild, or stepgrandchild of the debtor for the tax year in which the funds were placed into the account. (Adopted and foster children also qualify.)

n. Contributions to qualified state tuition programs. These are excluded from the bankruptcy estate under the same monetary limits stated previously for contributions to qualified education savings accounts.

4232.30 State law often gives debtors exemptions for assets that differ from those allowed under the Federal Bankruptcy Code. In some states, a debtor can choose federal or state exemptions. In other states, debtors are required to use state exemptions.

Current bankruptcy law prevents a debtor from moving to a more generous exemption state shortly before filing in order to protect a greater amount of their assets. A debtor must have resided in the state for two years (730 days) in order to use that state's exemption law. If this time requirement is not met, the exemption rules of the debtor's prior state of residency apply.

Also, state homestead exemptions can vary from the federal amount, with some states allowing a homestead exemption of an unlimited dollar amount.

Right to Setoff

4232.31 **Setoff:** Subtracting receivables from payables to see how much is owed; subtracting payables from receivables to see how much is due.

4232.32 Setoff is always an advantage to creditors, since without setoff they would have to pay the full amount on payables but would get only a percentage of the receivables in the bankruptcy proceeding.

4232.33 A person who is both a debtor and a creditor of the debtor has the right to setoff.

Administration

4232.34 The debtor must file a list of creditors, schedule of assets and liabilities, statement of financial affairs, and list of property claimed as exempt.

4232.35 The debtor must cooperate with the trustee. If not, the court may not discharge the debtor.

4232.36 The debtor must appear at a meeting of creditors and answer questions.

4232.37 The trustee may operate the debtor's business.

4232.38 The trustee may void preferential or fraudulent transfers made by the debtor within 90 days of filing.

Possible Defenses to Challenge a Particular Transfer

4232.39 There are five general *requirements,* all of which must be present for the trustee to void a potential transfer:

1. Transfer goes to a creditor.
2. It must be in payment for a previous debt owed by the debtor.
3. It must have been made while the debtor was insolvent.

4. It must have been made within 90 days of filing the petition (one year if the creditor was an insider or had reason to think the debtor was insolvent). An insider is someone with a special relation to the debtor—for example, a relative or a partner.

5. The creditor got more than they would have received had the transfer not been made (usually considered to be the creditor's share of a Chapter 7 liquidation).

4232.40 The trustee cannot void the transfer under the following circumstances:

- **a.** If credit transactions are exchanges of equal value done at the same time (this is because the transfer does not reduce the value of the debtor's estate)
- **b.** If the creditor is acting in the ordinary course of business or in accordance with ordinary business terms
- **c.** If security interest is given in goods the debtor buys from the seller (called purchase money security interest)
- **d.** If the creditor gives new value to the debtor to offset the prior transfer by the debtor
- **e.** If creditors are holding a security interest in inventory or receivables
- **f.** For statutory liens that cannot be voided
- **g.** To the extent the transfer was a bona fide payment of a debt for a domestic support obligation
- **h.** In a case filed by an individual debtor, whose debts are primarily consumer debts, when the aggregate value of all property that constitutes or is affected by the transfer is less than $650
- **i.** In a case filed by a debtor whose debts are not primarily consumer debts, when the aggregate value of all property that constitutes or is affected by such transfers is less than $6,825

Transfers by a Debtor

4232.41 Transfers by a debtor that defraud creditors are always voidable.

4232.42 Transfers by the debtor can be voided by the trustee if made as follows:

- **a.** Within two years of filing with actual intent of defrauding creditors or
- **b.** Within two years of filing, and the debtor received much less than an equal exchange, and:
  - (1) was insolvent at the time of the transfer, or became insolvent because of the transfer,
  - (2) was left with an unreasonably small amount of capital, or
  - (3) intended or believed the debts would be beyond their ability to repay

4232.43 **Preferential transfers:** One creditor preferred over other creditors

4232.44 **Fraudulent transfers:** Defrauds all creditors

4232.45 **Transfer voids made before the filing of the bankruptcy petition:** The trustee can void fraudulent transfers made within two years prior to filing of the petition.

4232.46 **Transfer voids made after the filing:** (Remember, the debtor can continue to run the business even after filing unless the court orders the debtor not to.) The trustee must exercise this power within two years after the transfer is made or before the bankruptcy case is closed—whichever comes first.

4232.47 The trustee can cancel any contracts of the debtor based on any defenses that are available to the debtor (e.g., duress, undue influence, fraud, failure of consideration).

Claims

4232.48 Creditors present their claims to the court by filing a proof of claim against the debtor.

4232.49 A debtor or trustee may file a proof of claim for the creditor if the creditor does not file.

4232.50 Only allowed claims share in the distribution of the debtor's assets.

4232.51 Only unsecured creditors must file a proof of claim to recover.

4232.52 Secured creditors are not required to file a proof of claim. However, to the extent the claim exceeds the value of the collateral securing the claim, the creditor is treated as an unsecured creditor. A proof of claim must be filed in order to recover any of this amount.

4232.53 Any interested party can object to a filed claim. If an objection is made, a court hearing is held to decide the amount or the validity of the claim.

4232.54 The following are disallowed claims that are not paid through the bankruptcy proceeding:

- **a.** Unmatured interest
- **b.** Claims already offset by a receivable by the creditor (this prevents double payment)
- **c.** Tax due on property where the tax exceeds the value of the property (in this case, the property is forfeited)
- **d.** Excess charges for services by an insider or attorney of the debtor
- **e.** Alimony and child support not yet due—the debtor still owes these even after the discharge in bankruptcy
- **f.** Claims by a lessor for a broken lease that exceeds the larger of either of the following:
  - (1) One year's rent
  - (2) 15% of total lease payments, but not more than three years' rent
- **g.** Claims by employees for a broken employment contract that exceeded one year after filing

Priority in Distribution to Secured and Unsecured Creditors

4232.55 The claim of a secured creditor to the debtor's property has priority to the claims of all unsecured creditors.

4232.56 The secured creditor has three choices to satisfy the debt that is owed:

1. Accept the collateral as full payment of the debt.

2. Foreclose on the collateral and apply the proceeds from sale of the property to offset the debt.
3. Allow the trustee to dispose of the collateral and remit the proceeds from the sale of the property to the secured creditor.

4232.57 The secured creditor generally may also recover any reasonable fees and costs that result from the debtor's default on the secured debt.

4232.58 Any part of the value of the collateral that exceeds the secured interest is available to satisfy claims of unsecured creditors.

4232.59 If the value of the collateral is less than the amount of the secured debt, the secured creditor can file a proof of claim for this deficiency. The secured creditor is considered an unsecured creditor as to this amount.

4232.60 The priority in distribution to unsecured creditors is as follows:

- **a.** Administrative expenses, court costs, and fees
- **b.** Debts owed for domestic support obligations (alimony, maintenance, child support)
- **c.** Unsecured debts incurred during the involuntary gap (between filing of involuntary suit and order for relief and trustee appointment) arising in the ordinary course of the debtor's business
- **d.** Wages, salaries, or commissions earned within 180 days of filing, up to $13,650 for each individual
- **e.** Contributions to employee benefit plans for services within 180 days of filing. Cannot exceed $13,650 times the number of employees. This amount is reduced by the aggregate amount paid to employees for wages, salaries, or commissions (see item *d.* above) and by the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan.
- **f.** Certain unsecured claims of persons engaged in the production of grain or engaged as U.S. fishermen to the extent of $6,725 for each individual
- **g.** Deposits of money by individuals with the debtor for purchase or rental of property or personal services for personal or household use up to $3,025 each (like a layaway plan or security deposit)
- **h.** Federal, state, or local taxes (like income taxes, property taxes, or withholding taxes)
- **i.** Allowed unsecured claims based upon any commitments by the debtor to a federal depository institution's regulatory agency
- **j.** Claims for death or personal injury resulting from operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance

Bankruptcy Plan

4232.61 A plan is required in bankruptcy Chapters 9, 11, and 13.

4232.62 The plan can specify the following:

- **a.** How much creditors will be paid (may be partial or full)

b. In what form creditors will be paid

c. Other necessary details

4232.63 During the repayment period, the debtor is protected from creditor pressure.

4232.64 The plan often classifies claims and interest into classes.

4232.65 The plan must consider all classes and treat all members of a class equally.

4232.66 The plan must be confirmed by the court. The debtor, trustee, creditors, SEC (Securities and Exchange Commission), and others may raise objections.

Debts Not Discharged by Bankruptcy

4232.67 The following are among the debts not discharged by bankruptcy:

a. Taxes

b. A debt obtained by false representation

c. Debts not listed on the schedule of debts submitted by the debtor

d. Obligations resulting from breach of fiduciary duty

e. Judgments for embezzlement or larceny

f. Debts owed for alimony or child support

g. Judgments for intentional injury by the debtor to a person or property of another (called intentional torts)

h. Amounts for fines and penalties due to a governmental unit

i. Amounts owed on educational loans unless this would impose an undue hardship on the debtor and the debtor's dependents

j. Debts that survived a previous bankruptcy

k. Consumer debt owed to a single creditor of more than $725 for "luxury goods or services" incurred by an individual debtor on or within 90 days before the filing of the bankruptcy petition (luxury goods or services do not include goods or services reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor)

l. Cash advances of more than $1,000 that are extensions of consumer credit under an open-end credit plan (as defined in the Consumer Credit Protection Act) that are obtained on or within 70 days before the filing of the bankruptcy petition

m. Amounts owed for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance

n. Fines or penalties imposed under federal election law

Discharge of Debtor

4232.68 A discharge can be given to individuals only.

4232.69 Discharge will generally be given unless the individual debtor did any of the following within one year prior to filing or during the bankruptcy proceedings:

a. Destroyed or concealed property in order to defraud creditors

b. Destroyed, falsified, or concealed records

c. Failed to cooperate (lied, withheld information, made false claim)

d. Refused to obey lawful order of court

e. Refused to testify in answering questions approved by the court

Trustee

4232.70 Once the debtor becomes subject to bankruptcy proceedings, the court appoints an interim trustee to take over the debtor's property or business.

4232.71 Shortly, a permanent trustee takes over. Usually, the permanent trustee is elected by the creditors at a creditor's meeting.

4232.72 The trustee is an individual or a corporation who, under court supervision, represents the debtor's estate.

4232.73 The basic duties of the trustee are the following:

a. Investigate the financial affairs of the debtor.

b. Collect the debtor's assets and any claims owed to the debtor.

c. Temporarily operate the debtor's business if necessary.

d. Reduce the debtor's assets to cash.

e. Receive and examine claims of creditors. The trustee will challenge in bankruptcy court any claims that are questionable.

f. Oppose the discharge of the debtor if the trustee feels there are legal reasons why the debtor should not be discharged.

g. Render a detailed accounting to the bankruptcy court of all assets disposed of and received.

h. Make a final report to the bankruptcy court when administration of the debtor's estate is completed.

4232.74 The trustee is paid from the estate.

4232.75 Compensation cannot exceed the following amounts of the debtor's estate under the Bankruptcy Reform Act of 1994.

Amount			Percentage
$ 0	to	$ 5,000	25
$ 5,001	to	$ 50,000	10
$50,001	to	$1,000,000	5
	Over	$1,000,000	3
			(or reasonable compensation if less)

4232.76 The trustee can employ attorneys, accountants, appraisers, and other individuals with prior court approval.

4232.77 The trustee can also sue and be sued as trustee.

Chapter 7 Bankruptcy

4232.78 A Chapter 7 bankruptcy can be voluntary or involuntary.

4232.79 A Chapter 7 bankruptcy has special provisions for stockholders and commodities brokers.

4232.80 A Chapter 7 bankruptcy can apply to a business debtor or a nonbusiness debtor (like an individual).

4232.81 The attorney for the debtor in a Chapter 7 bankruptcy has certain specified obligations, including:

- **a.** filing an affidavit with the bankruptcy court stating that they have informed the debtor of the various forms of bankruptcy and their details and
- **b.** reasonably verifying the information contained in the bankruptcy petition and the supporting schedules.

4232.82 Individual debtors with income below the median for their state of residency can generally receive the protection of a Chapter 7 proceeding. In contrast, an individual debtor with income above the state median income must submit to a means test that measures the extent to which the debtor can repay general unsecured claims.

4232.83 A Chapter 7 case will be dismissed or, with the debtor's consent, converted to a Chapter 13 case if it is found that there is abuse by an individual debtor with primarily consumer debt. Abuse can be found in the following two ways:

1. Abuse can be found due to bad faith or fraud on the part of the debtor.
2. Abuse is presumed if a debtor has sufficient income to pay back a portion of their debts as determined under the means test.

4232.84 Under the Chapter 7 means test, abuse is presumed to exist if net monthly income (current monthly income less the deduction listed below) multiplied by 60 is not less than the lesser of:

- **a.** 25% of the debtor's nonpriority unsecured claims in the case, or $8,175, whichever is greater; or
- **b.** $13,650.

4232.85 In a Chapter 7 bankruptcy, the presumption of abuse can only be rebutted if the debtor presents detailed documentation of "special circumstances." Special circumstances include a debtor having a serious medical condition or being on active duty in the military. These special circumstances must justify adjustments to income or expenses.

4232.86 The debtor's net monthly income is determined by deducting two major categories of expenses:

1. Reasonable living and other expenses allowed in the Internal Revenue Service Financial Analysis Handbook as "necessary expenses" and

2. The following expenses authorized under the Federal Bankruptcy Code:
    a. Expenses to maintain the safety of the debtor and the debtor's family from domestic violence
    b. Payments to secured creditors that will become due in the five years after filing, divided by 60 (past due payments may be included only if the collateral is necessary for the support of the debtor and the debtor's dependents)
    c. Alimony, child support, and other priority claims such as unpaid taxes divided by 60
    d. Expenses that are reasonable and necessary for the care and support of an elderly, disabled, or chronically ill family member
    e. Actual expenses for grade and high school up to $2,050 per child annually, if the expenses are not covered by applicable IRS standards and the debtor documents that they are reasonable and necessary
    f. Actual expenses for household utility services, if the expenses are not covered by the IRS Local Standards and the debtor documents that they are reasonable and necessary

4232.87 In Chapter 7, an interim trustee can be appointed after the case is filed. He or she serves until the regular trustee is elected or designated and is appointed from a panel of private trustees.

4232.88 A Chapter 7 proceeding may be converted (one change only) to Chapter 11 or Chapter 13.

4232.89 The court can order a Chapter 7 bankruptcy case to Chapter 11 (but not Chapter 13).

4232.90 Under current law, a debtor who obtains relief under Chapter 7 must wait eight years before filing under Chapter 7 again.

Chapter 9 Bankruptcy

4232.91 Chapter 9 bankruptcy is available only to municipalities.

4232.92 A Chapter 9 bankruptcy applies only to a municipality that:

- **a.** is insolvent or not able to meet debts as it matures,
- **b.** wants a plan to adjust debts, and
- **c.** has obtained creditor agreement, has negotiated in good faith with creditors but has not reached agreement, or is unable to negotiate with creditors because it is impractical.

4232.93 A Chapter 9 bankruptcy must be voluntary, not involuntary.

4232.94 There is no trustee under a Chapter 9 bankruptcy.

4232.95 For a Chapter 9 bankruptcy, a proof of claim need not be filed by creditors because a list of creditors is required to be filed by the debtor.

4232.96 A municipality cannot liquidate. Chapter 9 bankruptcy allows the city to operate while it adjusts or refinances its creditor claims.

4232.97 A Chapter 9 bankruptcy must end up with an approved plan.

Chapter 11 Bankruptcy

4232.98 A Chapter 11 bankruptcy is used if it is felt continuing the business is preferred to a liquidation.

4232.99 A Chapter 11 bankruptcy applies only to those who could be a debtor under Chapter 7 and railroads.

4232.100 A Chapter 11 bankruptcy can be voluntary or involuntary. The same requirements apply for filing an involuntary petition as in a Chapter 7 proceeding.

4232.101 Chapter 11 contains special provisions for reorganization of railroads.

4232.102 Chapter 11 is primarily for businesses. Individuals can use this Chapter, but it would probably be too burdensome and expensive.

4232.103 In a Chapter 11 bankruptcy, a trustee may or may not be appointed. The debtor may remain in possession of property at the court's discretion. If a trustee is appointed, they take over the business and have the same basic powers as in a liquidation proceeding.

4232.104 Railroads can only be in Chapter 11 reorganization.

4232.105 In a Chapter 11 bankruptcy, a proof of claim need not be filed by creditors because a list of creditors is required to be filed by the debtor.

4232.106 A Chapter 11 bankruptcy may be converted (one conversion only) to Chapter 7.

4232.107 The purpose of a Chapter 11 bankruptcy is to restructure finances so the debtor can continue to operate. It binds nonconsenting creditors, while a common-law composition does not. It would hurt employees and the economy if some large corporations went out of business. Chapter 11 often restructures the debt of a large corporation. Creditors will take less but better that than a large corporation liquidating.

4232.108 A Chapter 11 bankruptcy must end up with an approved plan.

4232.109 When the debtor is an individual, unless the bankruptcy court orders otherwise for cause, confirmation of a Chapter 11 plan does not discharge any debts provided for in the plan until the court grants a discharge on completion of all payments under the plan.

4232.110 If the debtor is an individual, earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor can be used to pay creditors for execution of a Chapter 11 plan.

4232.111 A Chapter 11 bankruptcy plan can divide creditors into classes (for example, claims of employees and bondholders) but all creditors in each class must be treated equally.

4232.112 The court will approve a Chapter 11 reorganization plan if one of the following is true:

- **a.** each class has approved the plan or
- **b.** the court rules that the plan is "fair and equitable" to all classes (even if creditors object to the plan).

4232.113 In a Chapter 11 bankruptcy, if the parties involved cannot produce an acceptable plan or if the plan does not work, the court can dismiss the case or convert it into a liquidation proceeding (Chapter 7).

4232.114 After a Chapter 11 bankruptcy plan is confirmed, the debtor is discharged from those claims not provided for in the plan. Nondischargeable debts are the same in Chapter 11 as in Chapter 7.

Chapter 13 Bankruptcy

4232.115 A Chapter 13 bankruptcy applies only to an individual (or individual and spouse) with regular income who owes unsecured debts of less than $419,275 and secured debts of less than $1,257,850.

4232.116 A Chapter 13 proceeding must be voluntary. The creditors cannot institute an involuntary Chapter 13 bankruptcy.

4232.117 A Chapter 13 bankruptcy can only be used by individuals (not partnerships or corporations). A small sole proprietorship can qualify as an individual if the other requirements are met.

4232.118 A Chapter 13 bankruptcy requires a trustee whose main function is to receive and distribute the debtor's income on a periodic basis.

4232.119 A Chapter 13 bankruptcy may be converted (one conversion only) to Chapter 7.

4232.120 A Chapter 13 bankruptcy must end up with an approved plan.

4232.121 A Chapter 13 bankruptcy plan must do the following:

- **a.** State the portion of the debtor's future income that will be turned over to the trustee for distribution to creditors. In determining the disposable income of the debtor, exclusions are made for numerous items, including up to 15% of the debtor's gross income for charitable contributions and the reasonable cost of health insurance for the debtor and their family.
- **b.** Describe how creditors will be paid.
- **c.** Generally, the plan may not provide for payments over a period that is longer than three years. However, the bankruptcy court for good cause (based on a specified computation of family income) may approve a period that is not longer than five years.

4232.122 A Chapter 13 bankruptcy plan can separate creditors into classes, but creditors in a class must be treated equally.

4232.123 A Chapter 13 bankruptcy plan can provide for partial payment of debts, but must provide for full payment of any claims that are given priority in a Chapter 7 proceeding.

4232.124 A Chapter 13 bankruptcy protects the debtor's credit standing better than Chapter 7 liquidation.

4232.125 The court will confirm a Chapter 13 bankruptcy plan if the following are true:

- **a.** The debtor proposes it in good faith.
- **b.** All secured creditors accept the plan.

4232.126 A hearing on confirmation of a Chapter 13 bankruptcy plan may be held not earlier than 20 days and not later than 45 days after the required creditors meeting. The hearing may be held earlier only if the bankruptcy court determines that it is in the best interests of the creditors and the estate and there is no objection to the earlier date.

4232.127 Unsecured creditors are bound by a Chapter 13 bankruptcy plan if it is confirmed by the court, even if the plan modifies their claims.

4232.128 Any time before or after confirmation of a Chapter 13 plan, the debtor can convert the proceedings to a liquidation case.

4232.129 The court can convert the proceedings of a Chapter 13 bankruptcy to a liquidation case or dismiss the case if the debtor fails to perform according to the plan.

4232.130 In a Chapter 13 bankruptcy, before a debtor can receive a discharge, they must complete a financial management course.

4232.131 A debtor who fully performs a Chapter 13 bankruptcy plan will generally be granted a discharge upon completion. In certain cases, debtors can be discharged even if they do not complete the plan, provided the failure is due to circumstances beyond their control.

4232.132 In a Chapter 13 bankruptcy, discharge can be revoked within one year if it is discovered that the discharge was obtained by fraud.

Insolvency

4232.133 Insolvency is the inability of an individual or company to meet its financial obligations as the debts become due. In other words, the individual's or company's debt exceeds the assets owned. Insolvency proceedings may be started in order to liquidate assets to pay off the outstanding debt.

4232.134 Assets would include, but not be limited to, assets considered collateral, interest in pension plans, and retirement accounts. Liabilities include, but are not limited to, recourse debt and nonrecourse debt that is not in excess of the fair market value of the property that is security for the debt.

4232.135 The taxpayer's insolvency is measured by how much the liabilities exceed the fair market value of the assets right before the discharge.

4233 Secured Transactions

4233.01 A *secured transaction* is a transaction in which the debtor gives to the creditor an interest in specific personal property to secure the payment of the debt. If the debt is not paid, the creditor can sell the personal property and apply the proceeds to the unpaid debt. This is faster and cheaper than suing the debtor, getting a judgment, locating property owned by the debtor, seizing the property, and having it sold at public auction to satisfy the debt. The real property equivalent of a secured transaction is a mortgage (called a "deed of trust" in some states). The secured transaction also gives the creditor a priority over other creditors of the debtor in the personal property used to secure the debt.

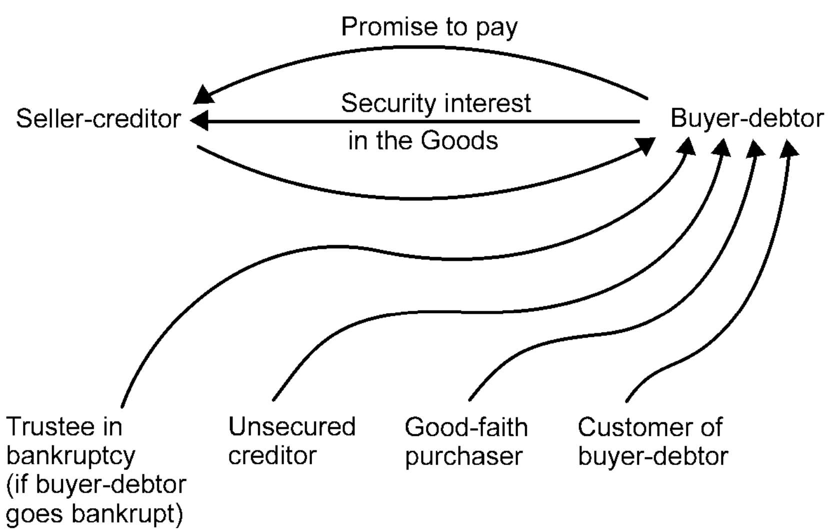
4233.02 The *secured party* is the lender, seller, or other party in whose favor the security interest arises (i.e., the creditor).

4233.03 The *debtor* is the party that owes payment or other performance of the obligation that is secured.

4233.04 The law of secured transactions comes from Article 9 of the Uniform Commercial Code (UCC). A revised Article 9 has been adopted by all of the states and is the basis for the following discussion. Revised Article 9 applies to transactions that create a security interest in tangible or intangible personal property or fixtures. A fixture is personal property that is attached to real property. A central air conditioning unit that is installed in a house would be an example of a fixture.

4233.05 A *security interest* is an interest in personal property or fixtures that secures payment or performance of an obligation.

4233.06 *A security agreement* is an agreement between the debtor and secured party that the secured party shall have an interest in the debtor's property to secure payments or performance of an obligation. It creates the security interest. It may be oral or written (but beware of oral agreements because there is the question of proof).



Other persons who might have rights in or compete for goods

4233.07 **Requirements of a written security agreement are as follows:**

- **a.** It must be "authenticated" by the debtor. This can include traditional signatures as well as "signatures" that are not handwritten on paper. This facilitates the use of electronic security agreements.
- **b.** It must reasonably identify the collateral. Generally, Article 9 types of property (i.e., "inventory," "accounts") can be used to identify the collateral.

4233.08 The agreement must be in writing to be enforced against the debtor and certain third parties unless the secured party has taken possession of the collateral pursuant to an agreement. (See section **4233.06** regarding oral security agreements.) The agreement must be made so that the person will have possession for purposes of security.

Attachment of a Security Interest

4233.09 **Attachment:** Creation; coming into existence of a security interest. In order for a security interest to be legally enforceable, it must attach to particular collateral.

4233.10 Before a security interest attaches, the following must occur:

a. There must be a security agreement (oral or written) between the debtor and the secured party.

b. The secured party must give value.

c. The debtor must have rights in the collateral.

4233.11 The security interest cannot attach until the secured party gives value. Value is generally any consideration that would support a contract. Value also includes any security for preexisting obligations or any binding commitment to extend credit in the future (future advances).

4233.12 The debtor has no rights in an account until the account comes into existence, a contract until the contract is made, timber until the trees are cut, minerals until extracted from the ground, crops until the crops are planted, and fish until the fish are caught.

4233.13 Attachment establishes the creditor as having superior rights against the debtor, but attachment alone does not establish superior rights against a trustee in bankruptcy, unsecured creditors, other secured creditors, and good-faith purchasers from the buyer.

Classifications of Collateral

4233.14 **Collateral:** Property that is subject to a security interest.

4233.15 Revised UCC Article 9 covers security interests that are created in personal property. Personal property includes that which is both tangible and intangible.

4233.16 **Tangible property:** Goods; these are classified by use. The rules applied may vary based on the category involved.

a. **Consumer goods:** For personal use and consumption, like buying a refrigerator for your home.

b. **Equipment:** For business (profit or nonprofit) use. This is also the default classification if you cannot classify it anywhere else. An example would be a doctor buying a refrigerator to use in his office to store medicine.

c. **Farm products:** Used by a debtor engaged in farming as an occupation. An example would be a farmer buying a refrigerator to keep eggs cold before he sells them to a supermarket.

d. **Inventory:** Goods held for sale or lease. This includes raw materials, work-in-progress, finished goods inventory, and supplies. An example would be refrigerators held by an appliance dealer for sale to consumers.

Note that a refrigerator could be any one of the four classifications, depending on its use.

4233.17 Software "embedded" in goods so that it becomes "part of the goods" is treated as goods. If software is not "embedded" in a good it is considered a general intangible.

4233.18 **Intangible personal property:** No physical existence; a right to receive property. Classifications are as follows:

- **a.** **Instruments:** Negotiable instruments or investment securities. Examples would be checks, drafts, promissory notes, certificates of deposit, bonds, and shares of stock.
- **b.** **Document of title:** A document of title issued by or addressed to a bailee or covering goods in the bailee's possession. Examples are a bill of lading and a warehouse receipt.
- **c.** **Chattel paper:** Writing that evidences both a monetary obligation and a security in or lease of specific goods. An example would be a security agreement. A security agreement held by a creditor could be used to secure a debt owed to another creditor.
- **d.** **Accounts:** Right to receive payment for goods sold or leased not evidenced by an instrument or chattel paper. The account does not need to be due and payable. Accounts also include payment obligations arising out of the sale, lease, or license of all kinds of tangible and intangible personal property (i.e., license fees payable for use of software). Also included are credit card receivables.
- **e.** **Contract right:** Right to payment under a contract not yet earned by performance nor evidenced by an instrument or chattel paper. These are potential accounts.
- **f.** **General intangibles:** Whatever is not otherwise classified. Examples are goodwill, literary rights, right to performance from someone else, copyrights, trademarks, and patents.

Financing Statement

4233.19 A financing statement is filed to give public notice of the security interest. It provides constructive notice of the security interest. Third parties are deemed to know it exists even if they do not have actual knowledge.

4233.20 A financing statement must contain the following:

- **a.** Names and addresses of both the secured party and the debtor. If an incorrect name of the debtor is used, the financing statement is ineffective, if a "standard" search would not find it.
- **b.** Description of the collateral (If the collateral is a fixture, it must also include a description of the real estate to which the fixture is attached.)
- **c.** Under Revised UCC Article 9, signature of the debtor is not required if the secured party is authorized by the debtor to make the filing without the debtor's signature. This facilitates electronic filing of financing statements.

4233.21 Location of filing of a financing statement:

- **a.** Statewide only (generally the Secretary of State's office)
- **b.** The filing must be in the place of the debtor's "location" except for fixed time filings and filings to perfect a security interest in as-extracted collateral and timber to be cut. Location is defined as follows:
  - (1) For "registered organizations" created by filing with a state, the state of filing
  - (2) For an entity not created by a filing, the entity's location is its chief executive offices.
  - (3) For an individual, the place of their principal residence

c. Perfection of an agricultural lien on farm products occurs by filing centrally in the jurisdiction where the farm products are located. A fixture filing is made locally where the real estate is located.

4233.22 A filed financing statement is effective for five years.

a. After five years, the security interest becomes unperfected. Creditor clients should be reminded of the five-year period as necessary.

b. It can be continued if a continuation statement is filed. It would be good for five more years. This can be done indefinitely.

4233.23 A financing statement generally need not be filed for property subject to a state certificate of title laws. In these cases, the security interest must be noted on the title for the secured party to be protected. This rule would apply, for example, to cars, boats, and mobile homes.

Perfection of a Security Interest

4233.24 The security agreement *binds* the debtor and the secured party from the moment it is made. Generally, however, it does not *protect* the secured party against the rights of third parties until it is perfected.

4233.25 Perfection of a security interest can occur in various ways, but *both* attachment and perfection of the security interest must occur before the interest is good against other creditors.

4233.26 Perfection of a security interest can occur by taking the collateral into possession, public filing of a financing statement, or by attachment alone to make the security interest effective against third parties.

4233.27 **Perfection of a security interest for accounts, contract rights, and general intangibles:** Perfection by filing only

4233.28 **Perfection of a security interest for goods:** Perfection by taking possession or filing a financial statement. No filing is needed if the secured party has possession of the collateral goods.

4233.29 **Perfection of a security interest for consumer goods:** The security interest is automatically perfected upon attachment if the purchaser buys on credit or the secured party lends to the debtor the funds that are used to make the purchase. The security interest is called a purchase money security interest (PMSI); however, this perfection by attachment is not good against a buyer of consumer goods who does any of the following:

a. Purchases without knowledge of the security interest

b. Gives value for the goods

c. Purchases for their own personal family or household use

d. Purchases before a financing statement is filed

Note: This buyer is an individual who bought the consumer goods from the original purchaser.

4233.30 **Perfection of a security interest for instruments, documents and chattel paper:** Perfection by possession or filing

4233.31 **Perfection of a security interest for fixtures:** Perfection only by filing a financing statement with the office where mortgages on real estate are recorded

4233.32 A security interest in instruments and negotiable documents is perfected by attachment alone for 21 days without filing or possession.

Rights and Duties of the Parties

4233.33 A secured party with possession of the collateral must exercise reasonable care in preserving the collateral. Legally, the secured party is a bailee in a mutual benefit bailment.

4233.34 Expenses incurred in the custody, preservation, and operating of the collateral are paid by the debtor.

4233.35 Risk of loss is with the debtor.

Priorities Among Conflicting Security Interests

4233.36 The issue of priority is important when several creditors claim interests in the same collateral.

4233.37 Where multiple security interests exist in the same collateral, the security interests rank in priority according to the time of filing of financing statements or perfection, whichever is earlier.

4233.38 If no security interests have been perfected, the interests have priority based upon the order in which they attached to the collateral.

4233.39 The holder of a purchase money security interest (PMSI) in inventory of the debtor has priority over another secured party who has a prior security agreement with the debtor that contains an "after acquired property clause" covering the debtor's inventory if either of the following is true:

- **a.** The PMSI is perfected by filing at the time the debtor receives the inventory.
- **b.** The PMSI secured party gives written notice to the prior secured party before the debtor gets possession of the inventory.

4233.40 The holder of a PMSI in collateral other than inventory has priority over conflicting security interests in the same collateral if the PMSI is perfected either:

- **a.** at the time the debtor receives the collateral or
- **b.** within 20 days.

4233.41 A buyer in the ordinary course of business from a merchant seller takes free of any security interest in the property purchased even if it is perfected and the buyer is aware of it. The purpose of this rule is to allow a consumer to buy a merchant's inventory without fear that it could be repossessed by the secured party.

4233.42 Artisans' liens have priority over any perfected security interests in the collateral.

Default

4233.43 Default is not defined in the Uniform Commercial Code (UCC). The debtor and secured party are therefore able, by agreement, to define what constitutes a default in their particular case.

4233.44 The secured party may take possession of the collateral either by judicial process or without judicial process if it can be done without a breach of the peace.

4233.45 Generally, the secured party can retain the collateral in satisfaction of the debtor's obligation. Written notice of the intention to keep the collateral must be sent to the debtor and also (except for consumer goods) to any other secured party from whom written notice of a claim in the collateral is received.

4233.46 If no objection to the secured party keeping the collateral is received within 21 days, the collateral may be retained. If objection is made, the secured party must sell the collateral.

4233.47 The secured party must dispose of the collateral if the collateral is classified as consumer goods and the debtor has paid 60% or more of the purchase price. The secured party must sell the consumer goods within 90 days or be liable to the debtor.

4233.48 If the collateral is sold, the proceeds of the sale go to pay the expenses of the sale, then to satisfy the unpaid debt, then to any other debts owed by the debtor to the creditor. Any amount remaining is returned to the debtor. If there is a deficiency, the debtor can be held liable for this amount.

Types of Liens

4233.49 **Floating lien.** This type of security interest is valid. This is often referred to as an "after acquired property clause."

4233.50 An example of a floating lien would be a security interest in the inventory of a new car dealer. The dealer sells cars daily and gets new shipments from the factory weekly. The security interest would float from the cars sold to the new cars coming into the dealer's inventory.

4233.51 A *common law lien* is given to artisans, innkeepers, and common carriers to secure payment for services rendered.

4233.52 Contractors who provide labor or materials that improve real property can establish a mechanic's lien on the improved property for the unpaid balance.

4233.53 Possessory: The lienholder has the right to keep the property until the debt is paid.

4233.54 The lien is lost if possession of the property is surrendered.

4233.55 If the lien is lost, the lienholder cannot retake possession, but he/she can sue the debtor for the value of the service.

4233.56 A *statutory lien* is a lien on personal property created by a statute enacted by the legislature.

4233.57 If the lien was not recognized at common law, the courts construe the language of the statute strictly.

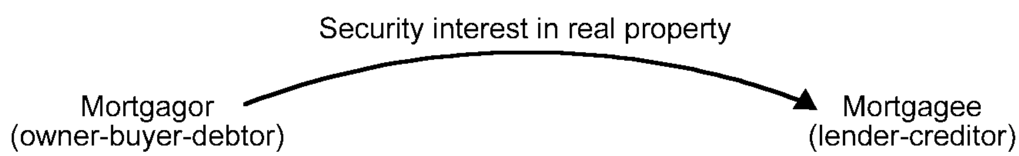
4233.58 **Simplifies the foreclosure.** The creditor holds the property for the statutory period, notifies the person, and then sells the property for whatever they can get. There is no need to get judgment, levy on the property, and have the property sold at public auction by the sheriff. This is expensive and not worth the effort for many low-cost items.

Mortgages

4233.59 A mortgage is a nonpossessory lien on real property to secure payment of a debt.

4233.60 A mortgage is security for a debt. The debt is usually for the unpaid purchase price on the real property, but the mortgage can be used as security for any debt or obligation.

4233.61 Diagram of a mortgage:



4233.62 A mortgage is executed with the same formality as a deed. Because it is an interest in real property, the statute of frauds requires that mortgages must be in writing. Oral mortgages are not enforceable.

4233.63 A person cannot issue a mortgage unless the person owns the property. A mortgage can be issued to cover property acquired in the future.

4233.64 The first recorded mortgage has priority over later recorded mortgages. Tax liens and mechanic's liens on property have priority over mortgages.

4233.65 Mortgages should be recorded to give other parties notice. An unrecorded mortgage has no effect on a subsequent third-party purchaser. An unrecorded mortgage is only effective as between the mortgagor and the mortgagee.

4233.66 The mortgage is recorded in the county where the real property is located.

4240 Government Regulation of Business

4241 Federal Securities Regulation

State Regulation of Securities

4241.01 Securities transactions can be subject to state law as well as federal law.

4241.02 Compliance with both sets of laws governing the securities transaction is necessary.

4241.03 The state regulatory laws, like the federal laws, are designed to protect the investing public from the fraudulent schemes of unscrupulous promoters.

4241.04 There are three types of state laws that regulate securities:

1. Antifraud laws impose sanctions if fraud has been used in the sale of securities. These include civil and criminal penalties as well as the issuance of injunctions to prevent continuation of the fraudulent acts.
2. Registration of dealers and brokers makes it unlawful for dealers and brokers to engage in securities transactions unless they register with the state.
3. Disclosure of information by registration of securities using one of these three methods:
   (1) **Notification:** Quick method for companies with a proven record of earnings
   (2) **Qualification:** Detailed and time-consuming registration process where state officials judge the merits of the securities
   (3) **Coordination:** Accept a copy of the documents filed with the Securities and Exchange Commission (SEC) to meet federal requirements under the Securities Act of 1933.

4241.05 State regulation was not effective for various reasons, including the following:

a. Differences among the states regarding their securities laws. Some had no legislation and some had inadequate laws. The laws could often be avoided by operating across state lines.

b. States failed to provide proper enforcement of the laws.

c. Unjustified exemptions in the state laws

4241.06 State laws are called *blue-sky* laws. While the origin of "blue sky" is not known, it may be based on the belief that some promoters in the past would attempt to "sell the blue sky" to unwary investors.

4241.07 In 1911, Kansas was the first state to enact a law to regulate the sale of securities. By 1913, a total of 22 other states had enacted such laws. Today, all states have such laws.

4241.08 State laws often parallel the federal laws by allowing the same classes of securities to be exempt from registration. Some state laws exempt securities that are listed on a national stock exchange.

4241.09 State laws are not uniform. The 1956 effort of the National Conference of Commissioners on Uniform State Laws to get their Uniform Securities Act adopted in all states has not been successful. About two-thirds of the states have adopted the act, but many have made significant changes to it.

4241.10 Typical abuses during the 1920s that led to the enactment of the federal securities laws included the following:

a. **Price manipulation.** Brokers and dealers used wash sales or matched orders to create a false impression of activity to force prices up.

b. **Deceit.** False and misleading statements were used to induce persons to invest in questionable schemes.

c. **Excessive use of credit.** There was no limit to the amount of credit a broker could extend to a customer.

d. **Misuse of corporate information.** Insiders took advantage of fluctuations in stock prices to make a personal profit.

4241.11 The objective of securities regulation is to protect innocent persons from investing their funds in speculative investments over which they have little control.

4241.12 The Securities Act of 1933 and Securities Exchange Act of 1934 were enacted in response to the great stock market crash of 1929.

Definitions

4241.13 **Accredited investor:** Accredited investors are certain banks; insurance companies; certain trusts and IRC 501(c)(3) organizations with total assets in excess of $5 million; any director, executive officer, or general partner of the issuer; and persons with a net worth of over $1 million or persons with an annual income of over $200,000 for the last two years. Accredited investors would not be wiped out by an unsuccessful investment. (SEC Rule 501)

4241.14 **Broker:** A person who serves as the agent of the investor (principal) in buying or selling the securities of the investor. The broker acts as an agent and owes a fiduciary duty to the investor.

4241.15 **Buying stock on margin:** Using credit to buy and hold stock. The percentage of credit allowed is controlled by the Federal Reserve Board and enforced by the SEC.

4241.16 **Controlling person:** A person who controls or is controlled by the issuer. The person could be a major stockholder, a director, or an officer. An offer to sell securities to the public made by a controlling person is subject to the registration requirements of the Securities Act of 1933.

4241.17 **Dealer:** A person who acts for him/herself and buys securities from or sells securities to the investor. The dealer does not act as an agent in the transaction.

4241.18 **Disclosure:** Providing all material facts. Full disclosure is required in many aspects of the Securities Act of 1933 and Securities Exchange Act of 1934.

4241.19 **Due diligence:** The reasonable professional standard of care that would relieve a person of liability under the Securities Act of 1933 on a registration statement that contained untrue statements of a material fact or omissions of a material fact.

4241.20 **Exemption:** Release from the legal obligation. Certain types of securities and certain types of securities transactions are exempt from the registration requirements of new securities.

4241.21 **Expert:** A person whose professional statement or report is used in a registration statement. Accountants, engineers, and appraisers are examples of experts acting in their professional capacity. Such experts are liable if a registration statement contains untrue statements of a material fact or omissions of a material fact unless the expert acted with “due diligence.”

4241.22 **Insider:** A director, an officer, or a person who owns more than 10% of the class of securities registered under Section 12 of the Securities Exchange Act of 1934. Insiders must register with the SEC their initial ownership of securities of the company and subsequent changes in their ownership. The stock ownership of 10% includes direct and indirect ownership. Insiders are covered in the 1934 act.

4241.23 **Issuer:** The person who issues securities. The person can be a corporation, partnership, or other organization.

Example: The SAS Corporation decides to sell two million new shares of its common stock. SAS would be an issuer.

4241.24 **Matched orders:** A sale of securities by one party and a purchase by another party to manipulate price and give the appearance of active trading. A matched order is a violation of the antitrust provisions of the Securities Exchange Act of 1934.

4241.25 **Offering circular:** A legal offering document describing and offering a security for sale. Compared to a prospectus, the offering circular is less detailed and unaudited. An offering circular is filed with the SEC before issuance of the securities and is used with low-dollar Regulation A issues. The offering circular must be given to all offerees of the security. Because the offering circular is less detailed, it costs less and allows smaller transactions to go forward without incurring prohibitive costs.

4241.26 **Primary offering:** New securities initially offered by the issuer to the underwriters, then to the general public. Offerings are either primary or secondary.

4241.27 **Prospectus:** A legal offering document describing and offering a security for sale. The prospectus must be given to all persons who are offered the opportunity to buy securities. The prospectus is a summary of the registration statement. The prospectus can be a notice, circular, advertisement, TV or radio production, or a letter.

4241.28 **Proxy:** A shareholder's written assignment of the right to vote the shares owned by the shareholder

4241.29 **Proxy statement:** A document that contains detailed information and must be included in a proxy solicitation. Before being sent to shareholders, the proxy statement must be submitted to the SEC, which reviews it to ensure that full disclosure is made.

4241.30 **Registration statement:** The formal document that must be filed with the SEC before a company can undertake a primary offering of securities. Registration statements are public information.

4241.31 **Restricted security:** A security purchased from the issuer in a nonpublic offering that is subject to restrictions on resale. A restricted security must be registered before resale unless SEC Rule 144 exempts it.

4241.32 **Scienter:** Intentional misconduct; intent to deceive, manipulate, or defraud. Scienter is required for an SEC Rule 10b-5 violation.

4241.33 **Secondary offering:** Securities that are purchased and sold through a stock exchange or over-the-counter sales. Securities issued in a secondary offering were previously issued by the corporation and held by an investor.

4241.34 **Securities exchange:** Same as stock exchange. An organized secondary market where investors can buy and sell securities. The best-known example is the New York Stock Exchange.

4241.35 **Security:** A stock, bond, investment contract, or plans to make profits by the efforts of other persons. For the federal securities law, a security is more than just stock of a corporation. A security includes both equity and debt interests. A security is an investment of money in a common enterprise with an expectation of profits from the efforts of others. Under this broad definition, courts have found securities to include the following:

- **a.** Sale of a limited partnership interest
- **b.** Sale of live cattle with contracts to care for them
- **c.** Sale of a citrus grove with a management contract
- **d.** Sale of condominiums
- **e.** Sale of fractional undivided interest in gas, oil, or mineral rights
- **f.** Sale of a franchise

4241.36 **Short-swing profit:** A profit made by the purchase and sale of a security within a six-month period of time. Insiders cannot keep short-swing profits.

4241.37 **Stock exchange:** Same as securities exchange. An organized secondary market where investors can buy and sell securities. The best-known example is the New York Stock Exchange.

4241.38 **Tender offer:** An offer to buy shares of a company. Usually, the tender offer is part of an effort to gain control of a company and is made to existing shareholders. The tender offer may contain conditions regarding the offer. A typical condition is that at least 50% of the shareholders must accept the offer before the shares will be purchased.

4241.39 **Tippee:** Person to whom material nonpublic information, called a tip, is transmitted. If the tippee uses the information to buy or sell securities, the tippee is liable under SEC Rule 10b-5.

4241.40 **Underwriter:** A person or organization, usually an investment banker, who buys securities from the issuer for resale to the general public. For large offerings of stock, the underwriters often form a syndicate. The underwriters buy all the securities offered and own what they cannot resell to the public. A dealer who sells securities for an underwriter for a commission is not considered an underwriter.

4241.41 **Wash sale:** A sale and a purchase of a security by the same person. The wash sale manipulates price and gives the appearance of active trading. A wash sale violates the antifraud provisions of the Securities Exchange Act of 1934.

Securities Act of 1933

4241.42 The purpose of the Securities Act of 1933 is to protect the unsophisticated investing public. The protection is accomplished by enforcing antifraud provisions and requiring that new issues of securities be registered with the Securities and Exchange Commission (SEC) prior to issuance. Registration requires full disclosure of all important information. The act applies to situations in which the securities are sold to the general public by the issuer, an underwriter, or a controlling person. There are some exempt securities and exempt transactions that do not require the registration of the securities. Each investor or potential investor must be given a prospectus. The prospectus discloses important information summarized from the registration statement that allows the investor to make informed investment decisions.

4241.43 **Registration.** Any security that is not exempt must be registered with the SEC before it can be sold to the general public in interstate commerce by the issuer, by an underwriter(s), or by a controlling person. The company that issues the securities must file a registration statement with the SEC and give potential investors a prospectus.

4241.44 The registration statement contains the following:

- **a.** Information about the planned offering and distribution of the securities
- **b.** Names of officers of the company and their salaries
- **c.** Names of persons who control the company
- **d.** Information about the securities to be offered
- **e.** Information about the issuing company, including audited financial statements
- **f.** How the company will use the proceeds of the sale
- **g.** A description of pending or threatened lawsuits
- **h.** The prospectus that will be given to investors
- **i.** Risks involved with the securities

4241.45 **SEC examination:** The SEC has 20 days to examine the registration statement. In actual practice, the time can be much longer since the SEC can require an amendment that will require a new 20-day waiting period. The SEC cannot rule on the merits of the issue, but it can compel complete disclosure of information.

4241.46 **Restrictions:** During the 20-day period that the SEC has to examine the registration statement:

- **a.** securities cannot be sold.
- **b.** the seller of the securities (issuer, underwriter, or controlling person) can distribute a "red herring" prospectus. This preliminary prospectus contains a statement in red ink that a registration statement has been filed but is not yet effective.
- **c.** the seller of the securities can publish tombstone advertisements that announce the participating underwriters and the number of securities and their price. A tombstone ad must state that the ad is not an offer to sell, nor a solicitation of a buy offer, because any offer must be made by means of a prospectus.
- **d.** oral, but not written, offers to buy can be received.

4241.47 **Changes:** After the 20-day period that the SEC has to examine the registration statement:

- **a.** the registration statement is effective.
- **b.** the securities can be sold. Investors must be given the prospectus before purchase of the securities.

4241.48 **Simplified registration**

- **a.** **SEC Regulation A+:** Regulation A+ is the name given to the SEC rules that amended and expanded a rarely used offering exemption named Regulation A. Regulation A+ provides two tiers: Tier 1 for offerings of up to $20 million and Tier 2 for offerings up to $50 million. Key provisions of the SEC's A+ rule include the following:

(1) **Proceeds:** For Tier 1 offerings, the annual limit is $20 million, with not more than $6 million from selling security holders. For Tier 2 offerings, there is an annual offering limit of up to $50 million in securities, including no more than $15 million from selling security holders.

(2) **Testing the waters:** Issuers may solicit interest in a potential offering with the general public, either before or after the filing of the offering statement, so long as any solicitation materials are preceded or accompanied by a preliminary offering circular.

(3) **Blue sky:** Offerings made under Tier 2 are generally exempt from state securities law registration and qualification requirements. Tier 1 offerings are subject to state blue-sky regulations, but a new review process has dramatically reduced the burdens.

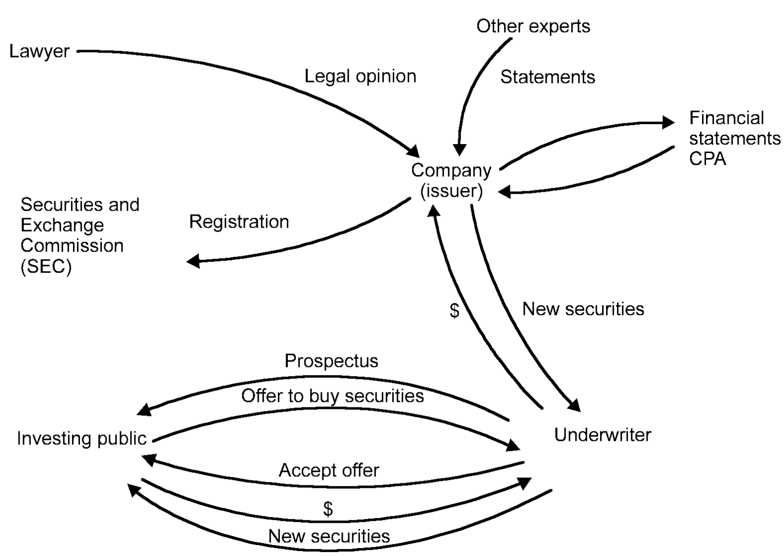
(4) **Offering circular:** Issuers can confidentially file statements for SEC qualification. The offering circular must include audited financial statements and balance sheets for the two most recently completed fiscal-year ends.

(5) **Ongoing reporting:** Issuers that conduct a Tier 2 offering must electronically file annual and semiannual reports with the SEC, but those who conduct Tier 1 offerings generally have no ongoing reporting obligations.

(6) **Transferability for investors:** Securities sold in these offerings are not "restricted securities" under the Securities Act, and are therefore freely tradable in the secondary market.

b. **SEC Rule 240** exempts securities issues of up to $100,000 within a 12-month period from registration but not from antifraud provisions. Sales to full-time employees are excluded from the $100,000, but there cannot be more than 100 holders of the securities and no solicitation of the general public. The issuer must file a short form with the SEC. This is not a total exemption but is an exemption from the filing of the more costly and time-consuming registration statement.

4241.49 **Security offerings:** The following diagram shows how the registration statement is integrated into the process of issuing securities.



4241.50 SEC Rule 415—Shelf Registration

a. This rule provides for shelf registration. This involves registration of securities that are registered for an offering to be made on a continuous (i.e., an employee stock benefit plan) or a delayed basis in the future (i.e., market conditions become more favorable to issuance of the securities).

b. Rule 415 provides that shelf registration applies only to certain types of offerings, including the following:

(1) Securities offered pursuant to a dividend or interest reinvestment plan or an employee benefit plan

(2) Securities issued upon the exercise of outstanding options, warrants, or rights

(3) Securities that are to be issued upon conversion of other outstanding securities

(4) Securities that are pledged as collateral

(5) Mortgage-related securities

(6) Securities that are to be issued in connection with business combination transactions

(7) Securities of certain large, publicly traded companies eligible to use short-form registration procedures

c. A post-effective amendment to the registration statement must be made to reflect in the prospectus any facts or events arising after the effective date of the registration statement that, individually or in the aggregate, represent a fundamental change in the information set forth.

d. Amendments must also be made to the registration statement to include any material information regarding the plan of distribution not previously disclosed in the registration statement or any material change to such information.

e. Also, a post-effective amendment must be made to remove from registration any of the securities being registered that remain unsold at the termination of the offering.

4241.51 **Exempt securities.** These securities are exempt from registration (but not from the antifraud provisions):

a. **Commercial paper.** Commercial paper that matures within nine months of issue that is used for current business operations is exempt from registration. Any commercial paper used for capital projects is not exempt.

b. **Securities of the government.** Securities issued by or guaranteed by the government are exempt from registration. An example would be the bonds of a local government to expand an airport.

c. **Securities of banks.** Because banks are already regulated by the Federal Reserve Board, their securities are exempt from registration.

d. **Securities of nonprofit organizations.** Securities issued by religious, educational, or charitable nonprofit organizations are exempt from registration.

e. **Securities of savings and loan associations.** Because these associations are already regulated by other state and local administrative agencies, their securities are exempt from registration.

f. **Securities of common carriers or contract carriers.** Carriers include railroads and truckers. They are already regulated by the Interstate Commerce Commission, so their securities are exempt from registration.

g. **Insurance, annuity, and endowment policies.** Insurance, annuity, and endowment policies issued by an insurance company are not considered securities within the meaning of the Securities Act of 1933. Insurance policies are not subject to the registration process. Stock and other securities issued by insurance companies are subject to registration.

h. **Exchange securities issued in bankruptcy reorganizations.** These would be from Chapter 11 of the bankruptcy law and issued by a trustee in bankruptcy.

i. **Securities exchanged with existing security holders.** Securities that are exchanged with current holders by the issuer are exempt from registration if no commissions are given. An example would be when a corporation gives a stock dividend, has a stock split, or exchanges one class of stock for another class.

4241.52 **Exempt transactions.** The following transactions are exempt from registration (but not from the antifraud provisions).

4241.53 **Private placement:** A transaction by an issuer not involving any public offering. The following factors are important in determining if there has been a nonpublic offering:

a. The number of offerees—the smaller the number, the more likely the offering is private.

b. The relationship of the offerees to each other

c. The relationship of the offerees to the issuer

d. The number of shares offered—the lower the number, the more likely the offering is private.

e. The total dollar size of the offering

f. The manner of offering

   (1) Direct offers to the buyers are more likely to be considered as private offerings.

   (2) Use of the channels of public distribution to attract offerees is less likely to be considered a private offering.

   (3) A public advertisement cannot be considered a private offering.

g. **SEC Rule 146** establishes these factors to qualify as a private offering:

   (1) Around 35 persons

   (2) No general advertisements

   (3) The offerees are sophisticated investors.

   (4) The offerees have access to or disclosure of company information. This could be by employment or bargaining power.

   (5) Purchase of the stock is made for investment and not for resale.

Resale of securities purchased in a private placement is severely restricted. Initial purchasers must hold the securities for a minimum time period (typically two years) and thereafter sell only small amounts (such as no more than 1% in any quarter). Quick resale by the investor would make the investor liable as an underwriter selling securities without registration. See SEC Rules 144 and 237.

4241.54 **Intrastate offerings. SEC Rule 147** allows corporations to sell their securities within the state without registration if all of the following criteria are met:

- **a.** The corporation is incorporated and doing business in that state.
- **b.** The corporation derives at least 80% of its gross revenues from within the registration state and has at least 80% of its assets located in the state.
- **c.** Eighty percent (80%) or more of the proceeds from the offering will be used in the state.
- **d.** All of the corporation's officers are residents of the state.
- **e.** The stock contains a provision that it cannot be resold to nonresidents for nine months. Resale of the stock to residents of the state is not restricted.

These restrictions make exemption based on intrastate offerings extremely difficult.

4241.55 **Small issues of securities**

- **a.** **SEC Rule 242** exempts securities issues of up to $2 million within any six-month period if sold to accredited persons. Accredited persons are institutional investors, buyers of $100,000 or more in securities, and the issuer's officers and directors. The issuer can sell to up to 35 nonaccredited investors but must furnish a simplified prospectus to all purchasers, even if they are accredited persons.
- **b.** Simplified registration for small issues under Regulation A and SEC Rule 240 is discussed in section **4241.48**.

4241.56 **Casual sales.** Sales by investors of securities they own are an exempt transaction. The investor cannot also be an issuer, underwriter, dealer, or controlling person. The sale is typically done by a broker on the investor's order.

4241.57 **Regulation D.** This regulation is a combination of the private placement and small issue exemptions. Issuers must file Form D, which lists minimal information, with the SEC. Regulation D has three separate thresholds with differing requirements:

- **a.** **SEC Rule 504.** This rule can only be used by companies not reporting to the SEC, usually closely held companies. No registration is required if no more than $5 million of securities are sold within a 12-month period with the following:
  - (1) No limit on the number of investors
  - (2) No general public offering or advertising
  - (3) No restrictions on resale by the investor
  - (4) If the securities are registered exclusively under a state blue-sky law that allows it, general solicitation and general advertising may be permitted. However, sales are allowed only to "accredited investors."
- **b.** **SEC Rule 506.** No registration of securities is required for a private placement of an unlimited amount of securities as follows:
  - (1) To any number of accredited investors
  - (2) To up to 35 unaccredited but sophisticated investors experienced in financial matters and able to evaluate risks involved in the investment
  - (3) With no general public offering or advertising
  - (4) Restricted resale by the investor

(5) Distribution of audited financial statements to nonaccredited investors

(6) Under Rule 506(c), a company may advertise the offering if:

(a) the investors are all accredited and

(b) the company has taken reasonable steps to verify its investors are accredited investors.

Exemptions Under Regulation D	**Rule 504**	**Rule 506**
Restrictions on Resale	None	Yes. Must hold for 2 years or more and not for resale
Number of Investors	Any number	Unlimited Accredited Investors
Type of Investors	Any type	35 or less Unaccredited Investors (but they must be **sophisticated**)
Maximum Dollar Limitation	$5 million (within 12 mos.)	Unlimited
General Advertising Allowed	No*	No**
Disclosure Required	No disclosure required	Disclosure with audited financial statements required for Unaccredited Investors
Companies Eligible	Unregistered companies only	Registered companies (SEC Reporting)

*General solicitation and general advertising is permitted if registered exclusively under a state law that allows it. However, sales are allowed only to "accredited investors" as defined in Rule 501(a). See Rule 504(b).

** The company may advertise the offering if the investors are all accredited and the company has taken measures to verify the investors are accredited as defined in Rule 506(c).

(7) Sales by dealers of securities that have been registered and issued:

(a) 90 days after offering to the public if the securities are the initial offering by the issuer or

(b) 40 days after offering to the public.

4241.58 **Sale of unregistered securities.** If nonexempt securities are being offered and sold in interstate commerce without first being registered, the SEC can issue a stop order to prohibit further sales and the buyer can sue for any damages suffered.

a. The sale of new unregistered securities is covered in Section 5 of the Securities Act of 1933. It is unlawful for any person to do either of the following:

(1) Offer to sell a security unless a registration statement has been filed with the SEC.

(2) Sell a security unless the registration statement is effective.

b. When a preliminary prospectus has been filed with the SEC, securities can be offered to the public, but sales cannot occur until the prospectus is effective.

4241.59 **False registration statements.** If securities are offered and sold, and their registration statement, including the prospectus, contains material misstatements and/or material omissions, the following are true about the purchaser:

- **a.** Can sue if money was lost and the material misstatements and/or omissions are proved
- **b.** Is not required to show reliance on the misstatements or omissions
- **c.** Can sue the issuer. The issuer is absolutely liable for all misstatements. There is no defense that the issuer can use to avoid liability.
- **d.** Can sue experts (CPAs, attorneys, engineers, appraisers), underwriters, officers, and directors who contribute to and sign the registration statement. These persons can avoid liability if they can show that they acted with the standard of care of an expert exercising due diligence. This is called the due diligence defense.
- **e.** Can recover damages

Also, the SEC can issue a stop order to prohibit further transactions.

4241.60 **Antifraud provisions.** Fraudulent securities transactions are prohibited whether the securities are registered or are exempt from registration; there are no exemptions from the antifraud provisions.

- **a.** **Section 12.** Oral or written misstatements of material facts or omissions of material facts are prohibited where necessary to keep the statements from being misleading in the circumstances where they were made.
- **b.** **Section 17.** It is illegal to use any type of fraud, any untrue statement of a material fact, or omission of a material fact involving the sale of securities in interstate commerce or through the mail.

4241.61 **Sanctions.** Both the SEC and private parties can seek sanctions.

- **a.** **SEC actions.** The SEC can issue a stop order to prevent the illegal distribution of securities that do not have a registration statement or appear misleading. Section 24 provides for criminal liability for any person who willfully violates the Securities Act of 1933. Violators are subject to a $10,000 fine and up to five years' imprisonment.
- **b.** **Section 12(1) and 12(2).** Purchasers of unregistered securities can sue the sellers (brokers, not the issuer) for rescission or damages. Privity of contract is required.
- **c.** **Section 11.** Purchasers of securities can sue if the registration statement contains material misstatements or omissions.
  - (1) The purchaser of securities need not have relied on, or even have seen, the registration statement.
  - (2) The purchaser is not required to prove that the defendant either negligently or intentionally misstated or omitted a material fact.
  - (3) The purchaser must not know of the misstatement or omission. Actual knowledge by the purchaser is a defense that can be used by the defendant.
  - (4) Persons liable on registration statements that contain material misstatements or omissions who qualify as experts can avoid liability if they can show "due diligence." The auditors can use this "due diligence" defense, which involves proving that they were not negligent.
- **d.** Reliance on an expert is a defense, except for the issuer. This reliance must include a reasonable investigation before reliance.

e. The following persons can be liable in a civil suit by the purchaser under Section 11:

(1) Every person who signed the registration statement

(2) Every corporate director or corporate officer or partner of a partnership that issues the securities

(3) Every person who is about to become a director or partner of the issuer who consents to and is named in the registration statement

(4) Every expert who assists in the preparation or certification of the registration statement (experts include the auditor, accountant, appraiser, and engineer)

(5) Every underwriter who participates in the offering

Disclaimers of liability and other types of warnings by these persons contained in the registration statement are not effective.

f. Damages are the difference between the purchase price paid by the plaintiff and the value of the security at the time of filing the suit or at the time the plaintiff sold the security, whichever is first.

g. The statute of limitations is one year for civil and criminal liability. The statute of limitations starts to run when the untrue statement or omission is discovered or when it should have been discovered, but it cannot be more than three years from issue.

h. When securities are issued with material misstatements or material omissions, the purchaser could recover for common law fraud in the inducement. The fraud action requires proof of material misstatement or omission, scienter, reliance, intent, privity, proximate cause, and damages. To recover under the Securities Act of 1933, only proof of material misstatement or omission and damages is needed.

Securities Exchange Act of 1934

4241.62 The purpose of the Securities Exchange Act of 1934 is to protect the unsophisticated investing public. This protection is accomplished by requiring companies that have their securities traded in secondary markets to register and report periodically; by requiring stock exchanges, security associations, brokers, and dealers to register; by supervising market activities, such as proxy solicitations, tender offers, insider trading, and short-swing profits; and by enforcing antifraud provisions.

4241.63 Who must register and report periodically (Securities Exchange Act of 1934):

a. Companies whose securities are listed on the national and regional securities exchanges

(1) Even if the securities were not registered under the Securities Act of 1933

(2) From Section 12(b)

b. Companies whose securities are traded over-the-counter if their total assets exceed $10 million, they have 500 or more shareholders, and if the securities are traded in interstate commerce

(1) Even if the securities were not registered under the 1933 act

(2) Companies that do not meet the asset and shareholder tests may decide to register and report voluntarily.

(3) From Section 12(g)

c. National and regional stock exchanges

- **d.** Brokers and dealers who conduct securities business in interstate commerce
- **e.** Transfer agents
- **f.** Clearing agencies
- **g.** Brokers and dealers who sell municipal securities
- **h.** Securities information processors
- **i.** Companies whose securities are registered under the 1933 act
- **j.** Associations of stock dealers—NASD, for example

Over 10,000 companies are now registered with the SEC, and most of them have securities traded over-the-counter (OTC).

4241.64 **Exempt securities.** The following securities need not be registered by the organization:

- **a.** Securities issued or guaranteed by the U.S. government
- **b.** Securities issued or guaranteed by a state government or political subdivisions
- **c.** Industrial development bonds

4241.65 **Reports** to file with the SEC:

- **a.** **8-K.** Current report for material events must be filed within 15 days of the material event. In the case of either the resignation of a director or the change of an auditor, notification must be made to the SEC within 5 days.
- **b.** **10-Q.** Quarterly report to the SEC must be filed for the first three fiscal quarters of the year.
- **c.** **10-K.** Annual report to the SEC must be filed at the end of the fiscal year. The annual report must have financial statements audited by a CPA.

4241.66 Companies having securities subject to the disclosure requirements of the Securities Exchange Act of 1934 are subject to the other regulations under the 1934 act. These other regulations include proxy solicitation, tender offers, and short-swing profits.

4241.67 **Antifraud provisions.** When selling or buying securities, it is illegal to use any manipulative or deceptive device or contrivance to violate SEC rules.

- **a.** Use of the mails or interstate commerce must be involved.
- **b.** From Section 10(b) of the Securities Exchange Act of 1934. This section has been augmented by SEC Rule 10b-5.

4241.68 **SEC Rule 10b-5.** Liability is imposed on any person who commits fraud (an intentional misrepresentation or omission of a material fact) in connection with the purchase or sale of any security.

- **a.** Scienter is required for liability. Negligence is not enough.
- **b.** Only actual purchasers or sellers of the security can recover. Those who failed to purchase cannot recover lost profits.
- **c.** To recover, the purchaser or seller must have relied upon the false statement and must not have known that the statement was false.

d. Rule 10b-5 applies to officers, directors, majority shareholders, tippees, or anyone else who receives important nonpublic information that affects securities trading.

e. Examples of material facts could include the following:

(1) Change in dividends

(2) New product

(3) New process

(4) Change in company's financial condition

(5) Discovery of mineral or petroleum reserves

f. The rule applies to any trading of securities:

(1) through a stock exchange,

(2) over-the-counter, or

(3) by private sale between the buyer and seller.

g. The rule applies to all types of securities and could include the following:

(1) Stocks

(2) Bonds

(3) Participation in a profit-sharing agreement

h. The securities can be registered under either the Securities Act of 1933 or Securities Exchange Act of 1934, or unregistered.

i. The sale of the securities must involve interstate commerce. (Use of mail or national exchanges is considered interstate commerce even if the state line is not crossed.)

j. There are no securities and no transactions exempt from SEC Rule 10b-5.

k. It is not necessary that the buyer and seller of the securities deal directly with each other. There will be liability even if trading is done through the computerized system of a stock exchange.

l. The person who buys or sells securities in a transaction with the wrongdoer can recover damages. To recover damages, four factors must exist:

(1) Existence of a material omission or misrepresentation made in connection with the sale of securities

(2) Intent by the defendant, not mere negligence

(3) Reliance and due diligence by the plaintiff

(4) Damages

m. SEC Rule 10b-5 can apply to misstatements, mismanagement, and insider trading.

n. The rule imposes liability for misstatements. These misstatements could be from any company document, press release, report, or public statement by a company representative. Misstatements could include the following:

(1) Misinformation about future prospects of the company

(2) Overly optimistic statements by company representatives

(3) Releasing unfounded pessimistic information

o. The rule imposes liability for mismanagement that reduces the value of securities held by investors. Mismanagement could include the following:

(1) Unjustified merger

(2) Transaction by a company in its own securities

(3) Abusing minority shareholder rights

(4) Any corporate management action that would reduce the value of securities of the corporation

4241.69 **Short-swing profits.** Inside information cannot be used to make short-term profits in the stock market.

a. Insiders are directors, officers, and large shareholders.

b. Directors, officers, and beneficial owners of 10% or more of the stock are required to file reports with the SEC disclosing stock ownership and changes in ownership.

c. A beneficial owner of stock includes stock owned in the person's own name or in the name of a spouse, minor children, and relatives who live in the owner's home.

d. Profits from the sale and purchase of stock within a period of less than six months by an insider can be recovered by the company. If the company does not act within 60 days of notification, the owner of any stock of the company can sue for the company.

e. The statute of limitations is two years from the date of the sale.

f. Intent need not be proven.

g. Insiders cannot engage a short sale (sale of securities they do not own) or make a sale against the box (own the securities but not deliver them).

h. Purchase and sale of securities for a loss in less than six months is permitted.

i. From Section 16

4241.70 **Tender offers.** Any person seeking to acquire over 5% of a company's stock by purchase or tender offer and persons soliciting shareholders to accept or reject a tender offer must disclose important information to the SEC and shareholders.

a. The requirement was established by the 1968 Williams Act, passed by Congress to regulate tender offers so shareholders may make an informed decision whether to tender their shares for purchase.

b. If a person acquires 5% of a class of securities, they must report to the following:

(1) Issuer

(2) Stock exchange where the securities are traded

(3) SEC

c. The report must include the following:

(1) The number of shares already owned

(2) The purpose of acquiring control of 5% or more of stock

(3) The changes planned in operation or structure of corporation

(4) The identity of persons who are buying the stock

(5) Tender offers planned for additional shares

4241.71 **Proxy solicitation.** Before solicitation of proxies, the persons seeking the proxies must disclose all material facts in a filing with the SEC. The SEC must approve the proxy statement by seeing that important information is disclosed. Full disclosure is required for any proxy contest between present management and dissident shareholders.

4241.72 **Margin trading.** The Board of Governors of the Federal Reserve System can set limitations on the amount of credit that can be extended for the purchase or carrying of securities. The SEC investigates and enforces the restriction.

- **a.** Applies to persons getting credit from brokers, dealers, and banks.
  - (1) Does not apply to exempt securities.
  - (2) Range of allowed credit is 50% to 100% of the sale price of the securities.
  - (3) Margin means amount of credit.

4241.73 **Credit rules**

- **a.** Brokers, dealers, and exchange members can borrow money only from a bank that is a member of the Federal Reserve System or a bank that agrees to follow the rules of the Federal Reserve System.
- **b.** Brokers and dealers that have possession of the investor's securities cannot lend them unless they have written permission.
- **c.** Brokers and dealers cannot pledge (hypothecate) securities owned by a customer that are in the possession of the broker or dealer for the loans of the broker or dealer.
- **d.** An exchange member cannot trade in their own account, except for odd-lot dealers.

4241.74 **Sanctions.** The SEC can use these sanctions:

- **a.** **Injunction.** Used to stop violations of the act or the SEC rules
- **b.** **Criminal prosecution.** The SEC can refer facts to the U.S. Department of Justice if fraud or willful violations are detected.
- **c.** **Administrative relief.** The SEC can suspend, expel, or revoke brokers and dealers, or prohibit individuals from employment with a registered firm.

Foreign Corrupt Practices Act of 1977

4241.75 The Foreign Corrupt Practices Act of 1977 is an amendment to the Securities Exchange Act of 1934.

4241.76 The Foreign Corrupt Practices Act of 1977 requires issuers of registered securities and issuers who are required to file reports with the SEC to keep records and have a system of internal controls. These requirements apply not only to foreign business transactions but also to domestic activities.

4241.77 Under the Foreign Corrupt Practices Act of 1977, it is unlawful for issuers or domestic businesses or their officers, directors, employees, agents, or shareholders to use interstate or foreign commerce (mail, phones, etc.) to offer or give anything of value (money) to a foreign official, foreign political party, or foreign political candidate for the purpose of influencing action or inducing those persons to use their influence in their official capacity to obtain or retain business for the organization.

4241.78 Under the Foreign Corrupt Practices Act of 1977, it is unlawful to transfer anything of value to an intermediary knowing that the end purpose is to use influence for business.

4241.79 The penalties for violation of the Foreign Corrupt Practices Act of 1977 are as follows:

a. Up to $2 million for the company

b. Up to $100,000 and/or up to five years' imprisonment for officers, directors, stockholders, employees, or agents (The organization may not pay the fine of an individual.)

4241.80 It is not a violation of the Foreign Corrupt Practices Act of 1977 to use facilitating or grease payments to low-level ministerial or clerical government officials. Examples are payments to do either of the following:

a. Expedite a shipment of goods through customs.

b. Get a permit or license.

Securities and Exchange Commission (SEC)

4241.81 The Securities and Exchange Commission (SEC) was created by the Securities Exchange Act of 1934.

4241.82 The SEC has five commissioners appointed for a term of five years by the president with the advice and consent of the Senate. Not more than three of the commissioners can be from a particular political party. The appointments are staggered so that one appointment expires on June 5 of each year. The chairman is designated by the president.

4241.83 The SEC is an independent, bipartisan administrative agency created to administer laws that protect investors and the general public in securities transactions.

4241.84 Some of the federal laws administered by the SEC include the following:

a. Securities Act of 1933

b. Securities Exchange Act of 1934

c. Public Utility Holding Company Act of 1935

d. Trust Indenture Act of 1939

e. Investment Company Act of 1940 (An investment company is an organization that invests and trades in securities. Open-ended investment companies are better known as mutual funds. Mutual funds must register with and are regulated by the SEC. Excluded from coverage are banks, insurance companies, savings and loan associations, finance companies, oil and gas drilling firms, charitable foundations, tax-exempt pension funds, and closely held companies.)

f. Investment Advisers Act of 1940

g. Securities Investor Protection Act of 1970

h. Foreign Corrupt Practices Act of 1977

4241.85 The following are some of the activities of the SEC:

a. **Registration of securities.** Before securities can be offered to the public, the issuer must file a registration statement with the SEC. The SEC examines the registration statement for content and allows correcting amendments. After a lapse of 20 days, the securities may be sold, but each investor must file a registration application with the SEC. After initial registration, the companies must file annual, quarterly, and other reports with the SEC.

b. **Corporate reporting.** All companies that have their securities listed on a securities exchange must file a registration application with the SEC. Larger companies that have their securities traded over-the-counter must also file a registration application with the SEC. After initial registration, the companies must file annual, quarterly, and other reports with the SEC.

c. **Proxy solicitation.** Before making a proxy solicitation for registered securities, persons must file with the SEC documents that are reviewed for content.

d. **Tender offer solicitation.** Any person who makes a tender offer for more than 5% of a registered security must file with the SEC documents that show disclosure of important information.

e. **Margin trading.** After establishment by the Board of Governors of the Federal Reserve System, the SEC investigates and enforces margin trading regulations for the purchase and carrying of securities.

f. **Market surveillance.** The SEC monitors securities exchanges and over-the-counter trading of securities. They look for undesirable market practices, such as the following:

   (1) Fraud

   (2) Market manipulation

   (3) Misrepresentation

   (4) Stabilization—underwriters bid for securities to stabilize their price during issue.

g. **Registration** of national and regional stock exchanges, brokers and dealers who sell securities in interstate commerce, transfer agents, clearing agencies, municipal brokers and dealers, and securities information processors. All of these persons and organizations must file registration applications with the SEC. (There are about 13 national and regional stock exchanges.)

h. **Investigation.** The SEC investigates possible violation of the securities laws.

i. **Enforcement.** The SEC enforces the securities laws by the following:

   (1) **Civil injunction.** By going to the U.S. District Court, the SEC can get an injunction to stop activities that violate the securities laws.

   (2) **Criminal prosecution.** The SEC can refer cases of fraud or willful violations to the U.S. Justice Department.

   (3) **Administrative remedies.** The SEC can issue orders to suspend or expel members from an exchange or dealer association; denying, suspending, or revoking registration of brokers and dealers; censuring individuals for misconduct; and temporarily or permanently banning individuals from employment with a registered firm.

j. **Dealer or broker revocations.** The SEC can revoke the license to operate as a dealer or broker in securities transactions.

k. **Registration and supervision** of the activities of the mutual funds

l. **Making of rules.** The SEC makes rules to implement the acts it administers. The best known rule is Rule 10b-5.

4241.86 In early 2003, the SEC adopted rules which strengthen the auditor independence requirements consistent with the provisions of the Sarbanes-Oxley Act. The SEC rules reiterate many of the provisions found in the Sarbanes-Oxley Act regarding nonaudit services.

4241.87 The SEC rules provide that an accounting firm can provide tax services to an audit client without impairing independence.

- **a.** The audit committee however, must pre-approve these services.
- **b.** Companies must also disclose the amount paid for tax services in this situation.
- **c.** The rules state that certain tax services could in certain circumstances impair independence. The rules state that audit committees should carefully review use of their audit firm for a transaction recommended by the accountant which may have tax avoidance as its sole purpose and whose tax treatment may not be supported by the Internal Revenue Code.

4241.88 The SEC rules also require the lead audit partner and audit review partner to rotate off the audit every five years. The rules also state that there is a five-year “time-out” period for these partners before they can return to that audit client. Also, audit partners with significant involvement on the audit must rotate off after seven years and are subject to a two-year “time-out” period before they can return.

4241.89 **SEC Rule 144.** This rule allows the purchaser of restricted securities to resell those securities without registration if the following are true:

- **a.** The seller has held them for two years.
- **b.** The seller sells through a broker.
- **c.** The total sales of the security for the prior three months are 1% or less of the average weekly sales during the prior four weeks.

4241.90 **SEC Rule 145.** The issue of securities from a corporate reorganization, like a merger or consolidation, is subject to registration unless the securities qualify for an exemption under the Securities Act of 1933.

4241.91 **SEC Rule 242** exempts security issues of less than $2 million within any six-month period if sold to accredited persons. Accredited persons are institutional investors, buyers of $100,000 or more in securities, and the issuer’s officers and directors. The issuer can sell to up to 35 nonaccredited investors but must furnish a simplified prospectus to all purchasers, even if they are accredited persons.

SEC Forms

4241.92 Many forms are utilized by the SEC in regulating and administering the securities laws.

4241.93 For the Securities Act of 1933, these are some of the more important forms:

- **a.** **Form S-1.** To register a security for issue in the primary market
- **b.** **Form S-18.** To register a security issue of under $5 million, of which $1.5 million can be sold to persons other than the issuer

4241.94 For the Securities Exchange Act of 1934, there are at least 21 forms. These are some of the more important forms, listed in approximate order of importance:

a. **Form 10-K.** Annual report of a company. Must be filed within 90 days after the close of the fiscal year.

b. **Form 10-Q.** Quarterly report of a company

c. **Form 8-K.** Current report that must be filed within 15 days of a “material” event. The deadline is five days for reporting the resignation of a director or for a change in auditors.

d. **Form 10.** For registration of a class of securities to be listed on a national securities exchange or sold over-the-counter

e. **Form BD.** For registration of brokers and dealers

4242 Other Federal Laws and Regulations (Employment Tax, Qualified Health Plans, Worker Classification)

Social Security (FICA)

4242.01 Social Security is a federal law administered by the Social Security Administration under the Department of Health and Human Services (DHHS). It is also called FICA (Federal Insurance Contributions Act).

4242.02 **Historical development of Social Security (FICA)**

1935—Law passed. Covered only retired workers in industry and commerce.

1939—Paid survivors when worker died.

1950—Coverage extended to self-employed persons, state and local government employees, household and farm workers, members of the armed forces, and members of the clergy.

1954—Disability insurance added to cover a worker who was totally disabled.

1965—Medicare added. Hospital and medical insurance to persons aged 65 and older.

1972—Benefits go up automatically as cost of living goes up.

1973—Medicare coverage expanded to cover people under the age of 65 who are disabled for two years and people with permanent kidney failure who need dialysis or kidney transplants.

1983—Medicare coverage expanded to federal employees.

1984—Employers paid more than employees for one year only. Coverage extended to all newly hired federal employees plus all current and future members of Congress, the president and vice president, all sitting federal judges, magistrates, bankruptcy judges and referees in bankruptcy, and all executive level and senior executive service political appointees. Other current federal employees at the time could elect coverage under Social Security.

1990—Self-employed persons paid the same combined amount as an employee and employer.

1991—Social Security (OASDI—Old Age, Survivors, and Disability Insurance) and Medicare (HI—Hospital Insurance) separated and became subject to different maximums.

1994—Maximum income limit removed from the Medicare portion of the payment.

2000—Retirement age for those born after 1937 is gradually extended, eventually to the age of 67.

4242.03 Major programs of Social Security (FICA) (under which payments are received)

a. Retirement

(1) At age 62 with reduced payments

(2) At age 66 with regular payments

b. Disability before age 65

(1) The individual must have a physical or mental condition that keeps the person from working, which is expected to last 12 months or result in death.

(2) Payments start for sixth full month of the disability.

c. Survivors of deceased worker

Those who may receive payments include the following:

(1) Unmarried child under the age of 18

(2) Unmarried child under the age of 19 if a full-time student in primary or high school, but *not* college

(3) Surviving spouse aged 60 or older

(4) Surviving spouse or divorced parent who takes care of the deceased's children under 16 years of age

(5) Dependent parents aged 62 or older

(6) Divorced spouse if marriage lasted 10 years

d. Retired or disabled workers

Those who may receive payments include the following:

(1) Unmarried child under the age of 18

(2) Unmarried child under the age of 22 if a full-time student

(3) Surviving spouse aged 62 or older

(4) Wife under the age of 62 if taking care of child(ren) under the age of 18

e. Medicare

(1) Hospital insurance and medical insurance for the following:

(a) Individuals aged 65 and older

(b) Disabled individuals under the age of 65 who are entitled to Social Security disability benefits

(c) Workers and dependents who need dialysis treatment or a kidney transplant because of permanent kidney failure

(2) Hospital insurance covers cost of inpatient hospital care.

(a) No cost to the individual

(b) Covered automatically

(3) Medical insurance covers cost of physicians, outpatient hospital care, and other medical expenses.

(a) Medical insurance requires a monthly premium.

(b) The premium covers about 30% of the actual cost. The remainder comes from general revenues of the federal government.

f. Supplemental Security Income (SSI)

(1) Additional income to help the aged, blind, and disabled person

(2) Financed from general revenues (not a special trust fund)

(3) Monthly payments are received by the eligible individuals.

(4) The individual must have little or no regular cash income and no substantial assets that can be sold for cash (excludes house and household goods).

(5) An individual can get both Social Security and SSI if eligible for both.

4242.04 Contribution rates and amounts

a. Starting in 1991, the Old Age, Survivors, and Disability Insurance (OASDI) (Social Security) and Medicare Hospital Insurance (HI) (Medicare) components were separated and different maximum wage bases were applied.

b. If an individual works for two employers, each is required to withhold up to the maximum. If the employee's combined income exceeds the maximum income amount, the FICA tax withheld will exceed the maximum employee tax for the year. If this occurs, the excess FICA tax paid is claimed as a credit on the individual's income tax return.

c. The maximum amount of salary and wages that is taxable automatically increases based on a formula that uses national average wage index ratios.

d. The employer portion of the FICA tax is deductible as an ordinary and necessary business expense by the employer.

e. The following table shows the OASDI and SSI (Supplemental Security Income) program rates and limits for 2019:

Old Age, Survivors, and Disability Insurance (OASDI)	
Tax rates	
Social Security (Old-Age, Survivors, and Disability Insurance)	
Employers and employees, each[a]	6.20%
Medicare (hospital insurance)	
Employers and employees, each[a, b]	1.45%
Maximum taxable earnings	
Social Security	$132,900
Medicare (hospital insurance)	No limit
Earnings required for work credits	
One work credit (one quarter of coverage)	$1,360
Maximum of four credits a year	$5,440
Earnings test annual exempt amount	
Under full retirement age for entire year	$17,640
For months before reaching full retirement age in given year	$46,920
Beginning with month reaching full retirement age	No limit
Maximum monthly Social Security benefit for workers retiring at full retirement age	$2,861
Full retirement age	66
Cost-of-living adjustment	2.8%
[a] *Self-employed persons pay a total of 15.3%: 12.4% for OASDI and 2.9% for Medicare.*	
[b] *This rate does not reflect the additional 0.9% in Medicare taxes certain high-income taxpayers are required to pay. See IRS information on this topic.*	
Supplemental Security Income (SSI)	
Monthly federal payment standards	
Individual	$771
Couple	$1,157
Cost-of-living adjustment	2.8%
Resource limits	
Individual	$2,000
Couple	$3,000
Monthly income exclusions	
Earned income[a]	$65
Unearned income	$20
Substantial gainful activity (SGA) level for the nonblind disabled	$1,220
[a] *The earned income exclusion consists of the first $65 of monthly earnings, plus one-half of remaining earnings.*	
—Office of Retirement and Disability Policy, U.S. Social Security Administration	

4242.05 Social Security (FICA) compensation:

a. Includes earnings from wages and salary

b. Includes vacation pay and dismissal pay

c. Includes bonuses, commissions, and prizes

- **d.** Does not include expenses reimbursed
- **e.** Does not include fringe benefits paid by employer (like hospitalization, group life insurance, and pension payments)
- **f.** If an employer pays the employee's share of FICA, the employer must include the amount of taxes that they pay in the employee's gross wages for income tax purposes (gross wages) but does not count them as Medicare or Social Security wages.

4242.06 **Employees subject to the withholding:**

- **a.** Includes corporate officers
- **b.** Includes domestic workers (maids and babysitters) making at least $50 per quarter
- **c.** Need not include spouse and minor children of the employer
- **d.** Does not include independent contractors (they pay as self-employed persons)

4242.07 Federal employees hired after 1983 are covered by Social Security.

4242.08 **State employees**

- **a.** State employees as a group can elect to be covered by Social Security.
- **b.** Some states have recently decided to get out of Social Security.

4242.09 Social Security benefits have been taxable in certain cases since 1984 based on the amount of the individual's modified adjusted gross income.

4242.10 **Social Security Trust Fund:**

- **a.** The Social Security Trust Fund is the accumulation of receipts less benefits.
- **b.** The fund currently has a surplus that will continue to grow, then gradually decrease as post-World War II baby boom persons reach retirement age and start receiving their Social Security benefits.
- **c.** The fund can be used to pay other government bills but will likely be dedicated only to Social Security benefits.

4242.11 **Retirement age for full benefits:** For people born in 1943 through 1954, the full retirement age is 66. The full retirement age increases gradually each year until it reaches age 67 for people born in 1960 or later. Earned income includes:

- **a.** wages, salaries, tips, and other taxable employee pay,
- **b.** union strike benefits,
- **c.** long-term disability benefits received prior to minimum retirement age, and
- **d.** net earnings from self-employment if:
  - (1) you own or operate a business or a farm,
  - (2) you are a minister or member of a religious order, or
  - (3) you are a statutory employee and have income.

Legal Liability for Payroll and Social Security Taxes

4242.12 Along with the Social Security tax, an employer is generally required to withhold income tax on each payment of wages made to an employee.

4242.13 An employer who is subject to either Social Security taxes or income tax withholding, or both, is required to file a quarterly return on IRS Form 941. This quarterly form combines the reporting of FICA and income taxes withheld from employees' wages.

4242.14 Generally, an employer is required to deposit the FICA taxes and income taxes withheld at an authorized commercial bank depository.

4242.15 Generally, an employer is classified as either a monthly or semiweekly depositor. The status for a particular calendar year is decided annually, based on the employment tax reporting history for a 12-month lookback period ending on June 30 of the prior year. The IRS notifies employers by November of each year as to their classification for the next calendar year. The classification is based on the aggregate amount of employment taxes reported during the lookback period.

4242.16 In spite of the above rule, an employer with $100,000 or more of accumulated liability during a monthly or semi-weekly period is required to deposit the taxes by the first banking day after the $100,000 amount is reached.

4242.17 Employers that have less than $2,500 of liability during the quarter are not required to deposit the taxes. Instead, they send the full payment for the quarter with their quarterly IRS Form 941.

4242.18 Employers that fail to deposit the full amount of taxes due are not subject to penalty if the shortfall does not exceed the greater of $100 or 2% of the amount of employment taxes due. This is true provided the shortfall is deposited on or before a prescribed makeup date.

4242.19 An employer also will not be subject to a penalty if they can show that the failure to deposit was due to reasonable cause (IRC Section 6656).

4242.20 A multi-tier penalty structure generally applies to situations where the employer fails to make timely deposits of employment taxes. The penalty is as follows:

- **a.** 2% of the amount of the underpayment if the failure is for no more than 5 days
- **b.** 5% of the amount of the underpayment if the failure is for more than 5 days but for no more than 15 days
- **c.** 10% of the amount of the underpayment if the failure is for more than 15 days
- **d.** 15% of the amount of the underpayment if a required tax deposit is not made on or before the day that is 10 days after the date of the first delinquency notice to the employer

4242.21 Under IRC Section 6672, any responsible person (usually a corporate officer or employee) who willfully fails to withhold, account for, or pay over withholding tax is liable for a penalty equal to 100% of such tax. Generally, the IRS only assesses this penalty in situations where the employment taxes cannot be collected from the employer. In addition, every taxpayer must be identified by a taxpayer identifying number (Social Security numbers (SSNs) or employer identification numbers (EINs)). This identifying number must be included on every required tax paper filed: every tax return, declaration of estimated tax, information return, and other necessary information. It must also be furnished on request to every employer and everyone else who pays to the taxpayer income required to be reported on an information return.

Federal Unemployment Tax Act (FUTA)

4242.22 The Federal Unemployment Tax Act (FUTA) is also known as unemployment compensation tax.

4242.23 FUTA's purpose is to provide economic security for temporarily unemployed workers. Only employers pay FUTA, and it is deductible as an ordinary and necessary business expense of the employer.

4242.24 An employer is obligated to pay FUTA taxes if the employer:

- **a.** paid wages of $1,500 or more in any calendar quarter or
- **b.** had one or more employees for any 20 calendar weeks during the year.

4242.25 An employer is obligated to pay FUTA taxes if the employer paid total cash wages of $1,000 or more to any household employee in any calendar quarter. A household employee is an individual who performs household work in a private home, local college club, or local fraternity or sorority chapter.

4242.26 FUTA must be paid if farmworkers received cash wages of $20,000 or more during any calendar quarter or employed 10 or more farmworkers during at least some part of a day (whether or not at the same time) during any 20 or more different weeks.

4242.27 For 2019, the FUTA tax rate is 6.0%. The tax applies to the first $7,000 paid to each employee as wages during the year.

4242.28 Employers can take a credit against their FUTA tax for amounts paid into state unemployment funds. Employers may take the maximum credit if they paid their state unemployment taxes in full, on time, and on all the same wages as are subject to FUTA tax, and as long as the state is not determined to be a credit reduction state.

4242.29 Administration and enforcement of FUTA are under the jurisdiction of the Social Security Administration.

4242.30 The federal taxes are paid to the United States Treasury.

4242.31 Willful failure to pay, file returns, or keep records is a misdemeanor and subject to a fine of up to $10,000, or imprisonment of not more than one year, or both. There are civil penalties of an additional tax for late filing and liability for double the tax amount.

Affordable Care Act

4242.32 **Individual mandate:** Under the Patient Protection and Affordable Care Act (ACA), U.S. citizens and legal residents who do not qualify for an exemption are required to purchase a minimum of health care coverage through health care exchanges. For those who cannot afford health insurance at any price, the federal government has established financial assistance programs to assist in offsetting the cost of the mandated insurance.

4242.33 **Employer requirements:** Under certain conditions, employers with 50 or more full-time employees that do not offer coverage are assessed a fee of $2,500 per full-time employee for 2019, excluding the first 30 employees from the assessment. Employers with 50 or more full-time employees that offer coverage but have at least one full-time employee receiving a premium tax credit pay the lesser of $3,750 for each employee receiving a premium credit or $2,500 for each full-time employee, excluding the first 30 employees from the assessment. Employers with more than 200 employees must automatically enroll employees into health insurance plans offered by the employer (employees may opt out of coverage).

4242.34 Under the ACA, employer-sponsored health care coverage must conform to certain standards:

- **a.** Free preventive care (for example, routine physicals)
- **b.** Caps on co-payments
- **c.** Insurers cannot increase premiums for those more likely to use medical services; for example, due to age, gender, or preexisting conditions.

4242.35 There are 10 essential benefits under the ACA:

1. Prescription medication
2. Emergency services
3. Hospitalization and surgery
4. Laboratory services
5. Mental health services
6. Outpatient care
7. Pediatric care
8. Pre- and postnatal care
9. Preventive care (for example, checkups)
10. Rehabilitative care

4242.36 Premium subsidies are available to exchange enrollees if their income is between 100% and 400% of the federal poverty level. Medicaid is available to enrollees with incomes up to 138% of the poverty level in those states that have expanded Medicaid under the ACA.

4242.37 Medicaid is expanded to all non-Medicare eligible individuals under age 65 (children, pregnant women, parents, and adults without dependent children) with incomes up to 138% FPL (federal poverty level) based on modified adjusted gross income. All newly eligible adults are guaranteed a benchmark benefit package that meets the essential health benefits available through the health care exchanges. The Supreme Court has ruled that states can opt out of Medicaid expansion.

4242.38 Businesses with fewer than 50 full-time employees do not have to insure the employees. Small employers with no more than 25 employees and average annual wages of less than $50,000 that purchase health insurance for employees are provided a tax credit.

4242.39 The ACA includes a number of changes related to health insurance. These changes:

- **a.** exclude the costs for over-the-counter drugs not prescribed by a doctor from being reimbursed through a health reimbursement arrangement (HRA) or health flexible spending account (FSA) and from being reimbursed on a tax-free basis through a health savings account (HSA) or Archer medical savings account (MSA).
- **b.** increase the tax on distributions from a health savings account or an Archer MSA that is not used for qualified medical expenses to 20% (from 10% for HSAs and from 15% for Archer MSAs) of the disbursed amount.
- **c.** limit the amount of contributions to a flexible spending account for medical expenses to $2,500 per year increased annually by the cost-of-living adjustment.
- **d.** limit the threshold for the itemized deduction for unreimbursed medical expenses to 10% of AGI for regular tax purposes.
- **e.** limit the Medicare Part A (hospital insurance) tax rate on wages to 2.35% on earnings over $200,000 for individual taxpayers and $250,000 for married couples filing jointly and impose a 3.8% tax on unearned income for higher-income taxpayers (thresholds are not indexed).
- **f.** provide dependent coverage for children up to age 26 for all individual and group policies.

Workers' Compensation

4242.40 Workers' compensation used to be called workmen's compensation. Coverage under these statutes varies from state to state.

4242.41 **Problems with the common law tort liability system before workers' compensation**

- **a.** Time. Possibly years in the court system before the injured worker could collect.
- **b.** Attorney's contingent fees (often 20%–50%) reduced the dollar amount the injured worker actually received.
- **c.** Defenses available to the defendant employer include the following:
  - (1) Employee plaintiff assumed a known risk in accepting the job.
  - (2) Employee plaintiff was contributorily negligent. In some states, a plaintiff cannot collect unless totally fault free. Other states with a comparative negligence allow a percentage recovery based on the comparative fault of the two parties.
  - (3) Fellow servant rule. If the injury was caused by a fellow employee, the employer is not liable. The negligence of the employee is not imputed to the employer as is the usual case with the doctrine of *respondeat superior.* The injured employee can only sue the fellow employee for the negligence.

4242.42 **Purpose of workers' compensation law enacted by the states:**

- **a.** To protect employees and their families from the risks of financial loss as a result of accidental injury, death, disease, or disability resulting from employment
- **b.** To correct the problems of the common law tort liability system

c. To provide an employee's exclusive remedy against the employer for covered injuries

4242.43 Employers are strictly liable without fault for injury, death, disability, or disease resulting from employment.

4242.44 **Typical statutory exclusions from workers' compensation coverage:**

a. Domestic employees (e.g., maids)

b. Agricultural employees

c. Employers having less than some minimum number of employees

4242.45 **Two types of workers' compensation statutes:**

1. **Compulsory law**

(a) The employer has no choice—must be covered by workers' compensation law.

(b) Majority of states have a compulsory law.

2. **Noncompulsory law**

(a) The employer is liable for injury or death resulting from and proximately caused by the employer's negligence if the employer does not elect coverage.

(b) There is no statutory limit on the amount of damages that can be recovered.

(c) The employer may elect to be covered by the workers' compensation law that provides statutory limits.

(d) If the employer does not elect the workers' compensation coverage, the employer loses the usual common law defenses.

4242.46 **Ways of providing coverage:**

a. **Self-insurance**

(1) The employer pays all claims directly.

(2) The employer must demonstrate capability to pay claims. Usually only large corporations can do this.

b. **Insurance with a private company**

(1) Some insurance companies specialize in this type of insurance.

(2) Rate is determined by claim experience and number of employees.

c. **Insurance with the state fund**

(1) Usually the most expensive way

(2) Rate is based on claim experience and number of employees.

4242.47 **Workers' compensation**

a. The employer must pay the entire cost. It cannot be deducted from the employee's wages.

b. This was the first form of social insurance in the United States.

c. This was the first "liability without fault" system in the United States.

d. Today all 50 states have workers' compensation systems.

4242.48 New trends

a. Covers diseases as well as injuries as long as they are work related

b. Covers psychological injuries as well as physical injuries

Example: High-pressure job causing an air traffic controller to have a mental breakdown

c. Established by the 1972 report by the 15 members of the presidentially appointed commission on state workmen's compensation laws. Their recommendations were as follows:

(1) Require all states to conform to specific standards as to coverage and benefits.

(2) Cover all employees.

(3) No time or money limits on type, extent, or expense of medical care

(4) Weekly death or total benefits of at least two-thirds of the average weekly wage

(5) Offer rehabilitation services to reduce disability and restore physical, psychological, social, and vocational functioning of injured employees.

(6) Spouse gets death benefits for life or until remarriage.

(7) Children get death benefits until the age of 18, or 25 if a full-time student.

(8) Adjust compensation benefits to reflect increases in wage levels.

4242.49 Employers' reaction to the workers' compensation law has been to reduce the frequency and severity of job-related disabilities to minimize the premium and other expenses.

a. Inspect physical facilities for the following:

(1) Gas

(2) Vapor

(3) Fumes

(4) Dust

(5) Heat

(6) Noise

(7) Lighting

(8) Radiation

(9) Ventilation

(10) Any other dangerous conditions

b. Education programs for loss control include the following:

(1) Accident investigation

(2) Safety rules (e.g., wearing hard hats when there is overhead danger)

(3) Feedback information

4242.50 **Admiralty law.** Under the Jones Act of 1920, injured seamen are entitled to a trial by jury with no limit on awards for occupational injuries. Injured seamen may elect to be covered by the liberal federal law and avoid the state workers' compensation laws. Commercial fishing is also subject to U.S. admiralty law and the Jones Act.

4242.51 Various federal statutes cover other employees, such as railroad workers, longshoremen, and harbor workers, for job-related injuries.

Worker Classification

4242.52 The Fair Labor Standards Act (FLSA) requires that most employees be paid at least the federal minimum wage for all hours worked and time and one-half the regular rate of pay for all hours worked over 40 hours in one workweek. However, the FLSA exempts certain employees from both the minimum wage and overtime pay requirements if they are classified as exempt employees (e.g., executives, administrative positions, professionals, outside sales employees, and certain computer employees). As such, it is imperative that business owners correctly determine whether the individuals providing services are employees or independent contractors.

4242.53 Employee classification under the FLSA refers to the exempt or non-exempt status of employees. An exempt classification generally means the employer is not obligated to pay overtime when the employee works more than 40 hours in a workweek. Conversely, a non-exempt classification means the employee is not exempt from overtime and must be paid overtime when hours worked exceeds 40 in a workweek. While some states differ in overtime laws and regulations, federal regulations use a 40-hour workweek as the measurement.

- **a.** To qualify for an exemption under the FLSA, employees generally must meet certain tests regarding their job duties and be paid on a salary basis at not less than $455 per week. Job titles alone do not determine exempt status. If a business classifies an employee as an independent contractor and with no reasonable basis for doing so, the employer may be held liable for employment taxes for that worker (the relief provisions, discussed below, will not apply).
- **b.** For workers classified as employees, employers generally withhold income taxes, Social Security, and Medicare taxes, and pay unemployment tax on wages paid to an employee. For independent contractors, these amounts are not withheld; the contractor is responsible for remitting any taxes directly to the state or federal government.
- **c.** The risk in misclassifying employees does not lie in classifying employees as non-exempt; rather, it rests with classifying as exempt. Because an exempt classification generally removes the employee's right to receive overtime pay for hours worked over 40 in a workweek, employers must take care to ensure proper classification. If misclassification is discovered by the employee or a regulatory agency, the employer may be responsible for paying the employee back wages plus any applicable penalties and fees. If an employer is faced with a wage and hour claim for overtime owed, it also could result in a full-scale audit encompassing all employees, both active and inactive, over a period of up to three years (or more depending on state law).

4242.54 Businesses should consider the following factors when determining whether a worker is an employee or independent contractor. As no one factor is more important than the other, the key is to look at the entire relationship, consider the degree or extent of the right to direct and control, and finally, to document each of the factors used in coming up with the determination. Facts that provide evidence of the degree of control and independence fall into three categories:

1. **Behavioral:** Who controls what the worker does and how the worker does his or her job?

2. **Financial:** Who compensates the worker (i.e., how is the worker paid, are expenses reimbursed, who provides tools/supplies, etc.)?
3. **Type of relationship:** Are there written contracts or employee type benefits (i.e., pension plan, insurance, vacation pay, etc.)?

4250 Business Structure

4251 Selection, Formation, Operation, and Termination of a Business Entity

Partnerships

4251.01 Creation of a partnership

a. No formalities are required; it is a voluntary contractual relationship. A partnership can be created by express agreement or through an implied agreement. A partnership can also generally be created either orally or in writing.

b. Intent governs. It can be by express words (oral or written) or implied by the actions of the parties.

c. **Tests of existence:**

(1) The sharing of net profits and losses creates a rebuttable presumption that a partnership exists. This presumption can be overcome by showing that profits are being shared for another reason. The following are examples:

(a) Repayment of a debt owed to the other party by way of the transfer of a portion of the profits

(b) Wages or rent owed to another party being paid as a portion of the profits

(c) Annuity to a deceased partner's spouse (Thus the spouse is *not* a partner simply because the spouse is receiving an annuity payment based on profits.)

(d) Interest on a loan owed to another party being paid as a portion of the profits

(e) Consideration for the sale of goods being paid from the profits

(2) Co-ownership of property—this does not of itself establish that a partnership exists but is a factor courts look at in determining if the relationship between the parties is a partnership.

(3) Joint control and management is another factor considered. Courts often view delegating management responsibilities or giving up control as an exercise of joint control.

4251.02 Partnership by estoppel. This doctrine is used to hold a person liable as a partner to a third party when they either hold themselves out as a partner or consent to the holding out of themselves as a partner. Partnership by estoppel does not actually make a person a partner, but it creates the same legal effect of being a partner. A partnership can only be created by the voluntary agreement between the persons. Therefore a partner by estoppel receives no rights of a true partner (i.e., right to manage, right to profits).

4251.03 Types of partners

a. **General.** Has a right to manage the partnership business. Has unlimited personal liability to the creditors of the partnership for partnership debts.

b. **Limited.** Merely an investor in a partnership whose liability is limited to the possible loss of their capital contribution. This limited liability rests upon the fact that the partner does not participate in management of the partnership.

c. **Nominal (ostensible)/partner by estoppel:** A person who is not in fact a partner but holds himself out as a partner or allows others to hold him out as a partner. In some instances, he may be liable as a partner to third persons who rely on this holding out.

Example: Brian tells Erin that Kevin is his partner during contract negotiations. Kevin is present at the time and does nothing to indicate that this is untrue. Kevin also tells Erin, "We will be sure to do a first-rate job if you enter this contract." If Erin enters the agreement with Brian, Kevin is liable on the agreement as a partner by estoppel.

4251.04 Partnership agreement

a. A partnership agreement is also sometimes referred to as *articles of partnership* and *articles of co-partnerships.*

b. A formal written agreement creating the partnership relationship is not required, but it is a good idea to prevent disputes between or among the partners.

c. Generally, a partnership agreement can be oral. If any part of the partnership agreement falls under the statute of frauds, however, a writing is needed as a practical matter to make the agreement enforceable.

Example: Caitlin and Jennifer enter a partnership agreement and specify that the duration of the partnership will last for a period of more than one year (i.e., for two years). For the agreement to be enforceable, a writing is required under the statute of frauds.

d. The Uniform Partnership Act (UPA) fills in the rules regarding the relationship between or among the partners unless the agreement specifies a different rule. Thus, the UPA operates as a gap filler.

4251.05 Ordinary business matters

a. In deciding ordinary business matters, a majority vote of the partners prevails as long as it does not violate any special provisions in the partnership agreement.

b. A tie vote leaves the matter as it was, since this is viewed as a deadlock.

4251.06 Extraordinary matters

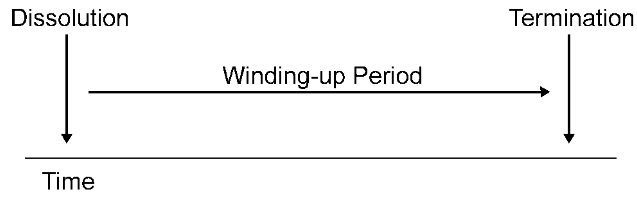
Unanimous agreement of all partners is necessary to make a change involving an extraordinary matter. A majority vote is not sufficient. The decision to go out of business or to change the nature of the partnership business would be examples of extraordinary matters requiring unanimous agreement of all the partners.

4251.07 Ending a partnership

a. **Dissolution.** This is the point in time when the object of all or any of the partners changes from continuing the organization in its current form to discontinuing it.

b. **Winding up.** Settling partnership affairs after dissolution. No new business can be carried on during the winding-up period. This is the span of time between dissolution and termination.

c. **Termination.** End of the winding-up period



4251.08 Causes of dissolution

a. Without violation of the partnership agreement

(1) The agreed time limit of the partnership ends.

(2) The agreed partnership purpose has been completed.

(3) A partner quits a partnership that has no stated duration. This type of partnership is called a partnership at will. The withdrawing partner has no liability to the other partners since they may withdraw at any time.

(4) A mutual agreement of all partners may terminate the partnership.

b. In violation of agreement. Any partner may dissolve a partnership at any time, but that partner may be liable for damages. The partner has the power, but may not have the right, to dissolve the partnership.

Example: Caitlin and Erin form a partnership and agree that the partnership will have a duration of five years. After one year a dispute arises and Caitlin withdraws, causing a dissolution of the partnership. Caitlin had the power to dissolve the partnership, but not the legal right; therefore, she could be held liable for damages by Erin.

c. By operation of law (done without agreement of the partners)

(1) The business becomes illegal. This automatically terminates the partnership.

(2) Bankruptcy of the partnership or an individual partner. This must be by adjudication and not merely insolvency.

(3) Death of one or more of the partners (This provision can be overridden by agreement of the partners.)

(4) Court decree. A court decree can be obtained based on the following:

(a) If just and equitable to terminate the partnership

(b) Serious misconduct of a partner—such as habitual drunkenness

(c) Incapacity of a partner; cannot perform duties—such as insanity

(d) Business is impractical

(e) Other partner habitually or purposely commits breach of the partnership contract

4251.09 Priority of payments on dissolution

a. Creditors of the partnership are paid first.

b. Loans made to partnership by partners are next repaid to the extent capital remains.

c. Return of capital contributions made by the partners is next in line of priority.

d. Profits or losses are then divided among the partners as follows:

(1) As agreed upon in the partnership agreement

(2) Equally if there is no partnership agreement to the contrary

(3) Losses are divided the same as profits if there is no partnership agreement to the contrary.

4251.10 Marshaling of assets

a. Partnership creditors get first rights on the partnership assets, and individual creditors get first rights on individual partners' assets.

b. Partnership creditors must be completely paid before creditors of individual partners have any rights in partnership assets.

c. Creditors of individual partners must be completely paid before partnership creditors have any rights in the personal assets of the individual partner.

Corporations

4251.11 Entity

a. A corporation is an organization formed under state law or federal law that is legally separate and distinct from those persons who own the corporation. This means the shareholders are not liable for corporate obligations except to the extent of their investment in the corporation.

b. Due to its separate legal existence, the corporation is also generally not liable for the personal obligations of its shareholders, directors, officers, or employees.

c. The corporate entity is recognized as being separate except when it is used to defeat public convenience, perpetrate fraud, evade the law, or commit a crime.

d. Ignoring the corporate entity is referred to as "piercing the corporate veil." When this is done, the shareholders can be held liable by the creditors of the corporation for corporate obligations.

e. For courts to ignore the corporate entity and *"pierce the corporate veil,"* two elements must generally be present:

(1) **Domination by a shareholder or group of shareholders.** The idea here is that the shareholder or shareholders control the corporation for their own benefit in an attempt to insulate themselves from liability for wrongdoing.

(2) **Improper use of the corporation.** Various types of improper use by the dominating shareholder can cause the corporation to be disregarded as a separate entity. For example:

(a) Using the corporation to perpetrate a fraud

(b) Thin capitalization of the corporation; here the corporation is formed as a "dummy" entity with insufficient capital to meet reasonably expected business obligations.

(c) Shareholders looting the corporation to the detriment of the corporation's creditors, such as having the corporation sell assets to a shareholder for a price far below fair market value

f. The corporation can hold property in the corporation's name.

g. The corporation can sue and be sued in the corporation's name.

h. Contracts can be entered in the corporation's name with the corporation as a party to the contract.

4251.12 State incorporation laws

a. When states first allowed corporations to be formed, it was necessary for the incorporators to appear before the state legislature to ask it to be allowed to form the corporation.

b. If the legislature decided to allow the formation of the corporation, it granted a corporate charter. Legally, this was permission to operate as a corporation in the state.

c. The individual appearances of the incorporators before the legislature became very time-consuming, so the legislatures drafted a general incorporation law and delegated the administrative responsibility to a state official. Most states designate the secretary of state.

d. **Model Business Corporation Act (MBCA)**

(1) The act is the model that most states use as the basis for their incorporation laws.

(2) The MBCA was first drafted in 1946 and has been amended many times. It was completely revised in 1984 and has been amended since then.

(3) The majority of states have adopted the revised MBCA, in whole or in part.

(4) The revised MBCA is used on the CPA Examination to cover the topic of corporation law.

(5) Individual state corporation law may differ somewhat from the revised MBCA. Questions on the CPA Examination, however, should be answered using the rules of the revised MBCA.

e. **Foreign corporations**

(1) All of the states allow foreign corporations to do business in the state.

(2) Foreign corporations doing business in intrastate commerce must qualify to do business in the state and obtain a certificate of authority from the state. Failure to obtain a certificate results in the denial of access to the courts by the corporation as a plaintiff, a statutory penalty, and personal liability of the officers and directors.

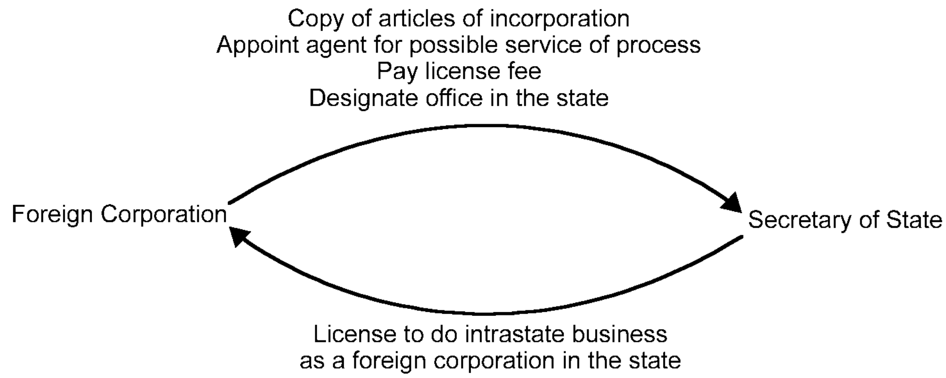
(3) A foreign corporation engaged wholly in interstate commerce need not qualify or obtain a certificate of authority.

(4) Only the state of incorporation can regulate the internal affairs of a corporation.

(5) Foreign corporations are treated the same as domestic corporations for regulation purposes. If a state treated foreign and domestic corporations differently, it would be a burden on interstate commerce and, therefore, a violation of the Commerce Clause (unconstitutional).

(6) A foreign corporation, registered or unregistered, can always defend itself as a defendant. A state cannot take away this right, because it would be a denial of due process.

(7) The following is a diagram of a foreign corporation applying to do business in the state:



4251.13 Formation of a corporation

a. A corporation is formed by applying to the state.

b. **Start of corporate existence.** Issuance of a certificate of incorporation by the secretary of state is considered the start of corporate existence. Such certificate puts third parties on notice that a corporation exists with limitations on liability for the shareholders.

c. **Domicile.** A corporation may have only one domicile—its state of incorporation. However, it can qualify to do business in any other state.

(See section **4511** for additional information on corporation formation.)

4251.14 Incorporators

a. Incorporators are the individuals who apply to the state for incorporation.

b. Incorporators need not have any interest in the corporation. Sometimes the secretaries in the lawyer's office are made the incorporators.

c. Incorporators owe a fiduciary duty to the corporation being formed.

4251.15 Promoters

a. Promoters are the motivating force in creating the corporation. They do such things as employing services of attorneys and accountants, borrowing funds, and purchasing property for use by the nascent (to be formed) corporation.

b. Promoters owe a fiduciary duty to the corporation being formed.

c. Promoters are liable on preincorporation contracts to third parties unless the following are true:

(1) The corporation adopts the contract.

(2) The contract expressly says the promoter is not liable on the contract.

(3) The contract indicates that neither party is obligated unless the corporation is formed.

d. Promoters are liable on preincorporation contracts if they contract in their own name or in the name of the not-yet-formed corporation, and the corporation is not formed or does not adopt the contract.

e. Promoters cannot make secret profits in forming the corporation.

4251.16 Corporation citizenship

- **a.** Citizenship must be determined to see if a federal court has jurisdiction of a case involving the corporation based on diversity of citizenship.
- **b.** The federal courts have jurisdiction only if the parties (plaintiff and defendant) are citizens of different states and the amount in controversy exceeds $75,000.
- **c.** For this purpose, a corporation is a citizen of both the state of incorporation and the state where its principal place of business is located.

4251.17 Articles of incorporation

- **a.** The articles of incorporation are like a constitution—they outline the organization of the corporation.
- **b.** Corporate existence starts when the articles of incorporation are filed or when the certificate of incorporation is issued. There is a split of authority. It depends on which view the state selects.
- **c.** The articles are prepared by the promoters or incorporators.
- **d.** The articles of incorporation include the following:
  - (1) Name of the corporation
  - (2) Period of time for the corporation's existence—usually is perpetual
  - (3) Purpose—usually stated as any legal purpose
  - (4) Share structure, including the number of authorized shares and whether or not there is a preemptive right
  - (5) Address of registered office
  - (6) Structure of the board of directors and names and addresses of persons serving as directors until the first annual meeting
  - (7) Name and address of each incorporator
- **e.** Amending the articles of incorporation:
  - (1) All corporations allow for changing, deleting, or adding to their articles of incorporation.
  - (2) To amend the articles of incorporation, the following must be done:
    - (a) The board of directors adopts a resolution and submits it to the vote of the shareholders.
    - (b) Shareholders must be given written notice.
    - (c) A majority of shares entitled to vote is generally necessary for approval.
    - (d) The amendments must be filed with the secretary of state.

4251.18 Bylaws

- **a.** **Bylaws:** Rules adopted by the corporation's board of directors for regulation and management of the affairs of the corporation
  - (1) Bylaws are subordinate to the articles of incorporation and the state of incorporation's corporation laws.

(2) Bylaws may not conflict with the articles of incorporation or with the state's corporation laws.

b. Initial bylaws are adopted by the board of directors.

c. Bylaws can be changed by the board of directors unless reserved to the shareholders in the articles of incorporation.

4251.19 Suing a corporation

a. Due process requires that anyone being sued, even a corporation, must be given notice.

b. When a corporation incorporates (for a domestic corporation) or applies to do business in another state (for a foreign corporation), it must designate a registered agent to receive service of process if the corporation is sued.

c. The secretary of state maintains a listing of the registered agents for all corporations in the state.

4251.20 Permitted actions of a corporation

a. **Owning own shares.** A corporation may buy and sell its own shares if cash and retained earnings permit. If insolvent or if the purchase would cause insolvency, the corporation cannot acquire the shares. Shares repurchased by the corporation are called treasury shares.

b. **Indemnification of officers, directors, employees, and agents**

(1) A corporation may indemnify an officer, director, employee, or agent of the corporation for any legal action (civil or criminal) done in good faith for the corporation. Generally, indemnification cannot be made if there was negligence or misconduct on the part of the officer, director, employee, or agent.

(2) Indemnification is often done through insurance.

c. **Loans to officers and directors**

(1) A corporation may make loans to officers and directors. Generally, either the shareholders must approve the loan, or the directors must approve it after finding that approval of the loan will benefit the corporation.

(2) For *corporate* law purposes, the loans can even be without interest.

d. **Employment incentives.** A corporation may offer incentives to officers and key employees. These incentives may include the following:

(1) Stock purchase option

(2) Bonus

(3) Liberal expense account

(4) Country club membership

4251.21 Prohibited actions of a corporation

The state incorporation law and the corporation's articles of incorporation and bylaws often contain items that cannot be done. These items may include the following:

a. Paying a dividend that would impair stated capital

b. Taking advantage of a minority shareholder

4251.22 Major changes in corporate structure

a. Some major changes in a corporation are permitted only if approved by a majority vote of the shareholders. These changes include the following:

(1) **Merger.** One or more corporations are acquired by another existing corporation, thereby losing their separate corporate existence.

(2) **Consolidation.** Two or more corporations join together as a new corporation, thereby losing their separate corporate existence.

(3) **Sale** of substantially all the assets of a corporation not in the ordinary course of business.

b. Merger or consolidation

(1) Two or more corporations can merge or consolidate. To do so, the following must occur:

(a) The board of directors approves a plan and submits it for shareholder approval.

(b) Written notice of an annual or special meeting must be given to shareholders at least 20 days prior to the meeting.

(c) A majority of shares entitled to vote is necessary for approval.

(d) Articles of merger must be filed with the secretary of state. If the state of incorporation of the surviving corporation and the state of the merged corporation are different states, the articles of merger must be filed in both states.

(2) Creditors of the existing corporation are still creditors of the new or surviving corporation.

c. Merger of subsidiary corporation. If a corporation owns at least 90% of a subsidiary corporation, it may merge without vote of the shareholders of either corporation.

d. Sale of substantially all the assets of a corporation

(1) A sale of assets in the usual course of business can be done by the board of directors alone, without shareholder approval.

(2) A sale of assets not in the usual course of business must be done by resolution of the board of directors, notice to shareholders, and approval by a majority of shareholders.

4251.23 Termination of the corporation

a. Articles of dissolution are filed with the secretary of state after a corporation has been dissolved.

b. Dissolution of a corporation requires the corporation to wind up its business affairs and liquidate its assets.

c. If the corporation has not yet done business or issued shares, it can be dissolved by majority vote of the incorporators or initial directors.

d. A corporation that is doing business can be dissolved by a resolution of the directors approved by shareholder vote.

e. The secretary of state has the power to force a corporation to dissolve involuntarily through administrative or judicial proceedings for such conduct as the following:

(1) Failing to file annual reports

(2) Failing to pay taxes

(3) Failing to appoint a registered agent in the state

(4) Obtaining the articles of incorporation by fraud

f. A shareholder may obtain judicial dissolution of a corporation if any of the following occur:

(1) The directors are deadlocked, and irreparable injury to the corporation is threatened.

(2) The directors or those in control of the corporation are acting in a manner which is illegal, oppressive, or fraudulent.

(3) Shareholders are deadlocked and cannot elect directors for two years.

(4) Corporate assets are being misapplied or wasted.

g. Creditors may obtain a judicial dissolution if the corporation is insolvent.

h. Termination of the corporation occurs when the assets are liquidated and the proceeds distributed to creditors and shareholders.

4252 Rights, Duties, Legal Obligations, and Authority of Owners and Management

Partnerships

4252.01 Who can and cannot be a partner

a. **Minor.** May become a partner but can disaffirm the partnership contract. Partnership creditors have a preference on partnership assets before a minor gets his/her capital contribution returned. Partnership creditors may not get personal assets of a minor partner if the minor partner disaffirms.

b. **Insane person.** A judicially declared insane person cannot make a contract—any effort is void. If a person becomes insane after making a contract, the other partner may get dissolution due to the insanity by way of a court order.

c. **Corporation.** The Uniform Partnership Act (UPA) allows a corporation to become a partner, but the general corporation laws of some of the states do not allow a corporation to become a partner.

4252.02 Authority of a partner

a. Authority of a partner is merely an extension of agency law.

b. Agency law applies to partnerships in the following manner:

(1) Each partner is an agent for the partnership. The partnership is the principal.

(2) A partnership is liable for the actions of a partner if the partner either:

(a) has actual authority or

(b) is acting within the apparent scope of the partnership activity and the third party does not know the actual authority of the party.

(3) If the partnership is not liable on a contract, then the individual partner making the contract is liable.

(4) A partner is personally liable for the torts the partner commits.

(5) A partnership is liable for the torts of a partner if the partner was acting within the scope of the partnership business when the tort occurred.

(6) A partner is personally responsible for his/her crimes.

(7) A partnership is not liable for a partner's crimes unless the other partners actually participated in the crimes.

(8) If a partner enters a contract without authority, the partnership may recover damages from the wrongdoing partner if the partnership is held liable to a third party.

4252.03 Types of authority

a. Actual

(1) Also called *real authority*

(2) May be expressed or implied authority

b. Apparent

(1) Sometimes called *ostensible* or *customary authority*

(2) When a partnership restricts a partner's actual authority, the partner may still have apparent authority to act. This occurs because a third party can reasonably believe that the partner, who is an agent for the partnership, can perform acts necessary to carry out the partnership business.

Example: Erin, Brian, Kevin, and Caitlin are partners and agree that only Kevin can enter contracts to purchase inventory for the partnership. If third parties are not notified of this restriction, Erin, Brian, and Caitlin will have apparent authority to purchase inventory.

(3) Different types of firms have different authority.

(a) **Trading partnership:** Much customary authority

(b) **Nontrading partnership:** Little customary authority (A nontrading partnership does not normally engage in activities such as borrowing money. There is, therefore, no apparent or customary authority to borrow money. A trading partnership would regularly do this, for example, to finance inventory.)

(4) Typical customary or apparent authority examples include the following:

(a) Entering into usual contracts for that type of business

(b) Sales in the ordinary course of business

(c) Purchasing goods in the scope of business

(d) Loans for a trading partnership

(e) Insuring property of the partnership

(f) Employing persons for the partnership

c. Certain actions are completely unauthorized, and no partner can bind the partnership by these acts. They require the unanimous consent of all partners. Examples include the following:

(1) A decision to go out of business

(2) Suretyship (guaranty)—cannot promise to pay somebody else's debts or obligations

(3) A decision to arbitrate a dispute between the partnership and a third party

(4) Confess judgment—this is equivalent to pleading guilty in advance

(5) Assignment for the benefit of creditors

(6) Make a personal obligation for the partnership to pay

4252.04 Partner's individual liability

a. Every partner is the agent of the partnership for the purpose of its business. The partnership is bound by all transactions negotiated by a partner if such transactions are within the usual course of partnership business.

b. **Tort.** If the wrongful act is committed within the scope of and in the course of partnership business, the partners and the partnership will be jointly and severally liable. *Jointly and severally liable* is used in civil cases where two or more people are liable for damages (such as a partnership). The winning plaintiff can collect the entire judgment from any one of the parties, or all the parties, in various amounts, until the judgment has been paid in full. If any one of the defendants does not have sufficient money or assets to pay their portion, the other defendants must make up the difference.

c. **Crimes.** Only the partner who commits a crime is liable unless the other partners participate.

d. **Contracts.** Partners are jointly (all together at the same time) liable for contracts made by a partner within the scope of the real or apparent authority of a partnership. If the contract is made in the partner's personal name, the other partners are liable as undisclosed principals.

4252.05 Withdrawal of a partner

a. Existing creditors are entitled to actual notice of a partner withdrawing. If there is no notice, the withdrawing partner could still be liable to a creditor of the partnership for partnership debts that happened after the withdrawal.

b. Creditors who have not dealt with the partnership previously are entitled only to constructive notice (i.e., in a newspaper).

4252.06 Admission of a new partner

a. New partners are liable for all partnership obligations that arise after they are admitted.

b. New partners are liable for all partnership obligations that arose before admission, but only to the extent of their share of the partnerships' assets. The new partner's individual assets are not available to satisfy these claims.

4252.07 Rights of partners

a. **Right to share in profits.** Partners share equally in profit regardless of the amount of capital contributions or the amount of time spent in the partnership business. The partnership agreement may specify that profits are shared differently. (This is why a written agreement is important.)

b. **Right to return of capital.** When a partnership is being dissolved, each partner has the right to obtain the return of his/her capital contribution before the partnership profit or loss is calculated. This occurs after partnership creditors are paid.

c. **Right to participate in management.** There is equal right to participation in management among partners unless they agree otherwise. This is true regardless of the amount of capital contributed or the amount of services rendered to the partnership.

d. **Right to information and inspection of the books.** Any partner has the right to demand to see the books and accounts of record at any point in time.

e. **Right to an accounting.** This is the right of a partner to come into court to force other partners to give an accounting of the partnership activities.

f. **Rights in specific partnership property.** Individual partners do not own any part of any specific partnership property. Unless agreed otherwise, the Uniform Partnership Act (UPA) states that each partner has an equal right to possess partnership property for partnership purposes. The right to possess and control partnership property cannot be transferred to a third party.

g. **Right to compensation.** Unless agreed otherwise, a partner is not entitled to any salary for services provided to the partnership. After a partnership is dissolved, however, a partner who is in charge of winding up the affairs of the partnership is entitled to reasonable compensation for those services.

h. **Right to reimbursement.** A partner that incurs reasonable expenses in carrying out partnership business has a right to reimbursement from the partnership.

Example: Dave, a partner, attempts to deliver goods to Brian on behalf of the partnership. Brian breaches the contract by refusing to accept the goods. Dave pays storage expenses for the goods and incurs costs to ship them to another buyer. If Dave pays these expenses, he can generally get reimbursed by the partnership.

4252.08 Duties of partners

a. **Fiduciary.** This means trust and confidence, loyalty and good faith to the firm, obedience to the partnership agreement, exercise of reasonable care in doing partnership business, providing needed information to the partnership, and providing an accounting of partnership matters.

b. **Duty to share in losses.** Division of losses is in the same percentage as sharing of the profits unless agreed otherwise in the partnership agreement.

4252.09 Assignment or transfer of partnership interest

a. A partner may assign or transfer all or part of his/her interest in the partnership to someone else.

(1) This does not dissolve the partnership. The assignor is still a partner.

(2) Consent of the other partners is not required for a valid assignment or transfer.

(3) The assignee does not automatically become a partner nor does the assignee have any of the rights of a partner. If the other partners agree, the assignee could become a partner.

(4) The assignee obtains only the right to the assignor's share of partnership profits and what the assignor would receive if the partnership is dissolved.

b. As long as the assigning partner performs their required duties, the other partners are not adversely affected by the assignment.

Corporations

4252.10 Board of directors

a. The board of directors exercises corporate powers and manages the business. They are in a fiduciary relationship with the corporation.

b. Directors need not be residents of the state of incorporation.

c. Directors need not be shareholders.

d. They have authority to fix their own compensation unless the articles of incorporation or bylaws say they are prohibited from doing so.

e. The board can be one or more persons as fixed by the articles of incorporation or bylaws. Traditionally, state statutes required at least three directors. Today most statutes permit fewer than three directors for corporations that have fewer than three shareholders.

f. The board holds office until the next annual meeting or until replaced.

g. The board can be divided into classes, with staggered election dates, if there are nine or more directors.

h. The board can fill vacancies for the unexpired time by a majority vote of the remaining directors.

i. Directors can be removed by the shareholders' vote with or without cause. Directors serve at the pleasure of the shareholders.

j. The board has a quorum when a majority of the number of directors is present.

k. The board can make an act effective if it is passed by the majority of the directors present at a meeting when a quorum exists.

l. The board of directors can divide itself into committees and delegate power to them. Examples are the executive committee and the audit committee.

m. The board can meet anywhere. It need not be in the state of incorporation.

4252.11 Notification to directors of regular or special meetings of the board of directors is specified by the bylaws.

4252.12 Meetings of the board of directors can be conducted via a conference call. They merely have to be able to hear each other at the same time.

4252.13 The board of directors may act without a meeting if all directors consent in writing.

4252.14 **Loans to directors.** Loans to directors are allowed only if authorized by the shareholders.

4252.15 **Liability of directors.** A director is individually liable if the director engages in illegal conduct or conduct that is a breach of fiduciary duty to the corporation. For example, if the director votes:

a. for an illegal dividend, such as a dividend that would make the corporation insolvent,

b. to illegally buy shares of the corporation, or

c. to pay off shareholders before creditors,

…then the director would be individually liable.

4252.16 **Business judgment rule.** This rule protects the directors from shareholder lawsuits alleging a lack of due care on the part of the directors in carrying out the corporation's business. This rule will apply as follows:

a. When the board makes an informed decision

b. When there is no conflict of interest

c. When there is a rational basis for the board's decision

4252.17 **Dividends**

a. Dividends are declared by the board of directors.

b. They may be paid in cash, property, or shares of the corporation.

c. They cannot be declared if the dividend would make the corporation insolvent.

d. Cash and property dividends are paid out of unreserved and unrestricted earned surplus (retained earnings). Some states allow payment out of net earnings of the current year and the previous year taken together, even if there is a negative earned surplus.

4252.18 **Officers of the corporation**

a. The *officers* are appointed by the board of directors.

b. They are the president, vice president(s), secretary, and treasurer.

c. One person can hold multiple offices, but the president and secretary generally cannot be the same person. Exceptions to this rule exist in some states where "one person corporations" are allowed.

d. The officers can be removed by the board of directors for any reason, but firing an officer may be a breach of an employment contract for which the corporation may be liable.

e. Officers of a corporation owe a fiduciary duty to the corporation.

4252.19 **Managers of the corporation**

a. The *managers* are hired by the officers.

b. The managers serve at the pleasure of the *officers,* unless they have negotiated an employment contract.

c. The managers owe a fiduciary duty to the corporation.

4252.20 **Shareholders**

a. Shareholders are the owners of the corporation.

b. Shareholders do not generally owe fiduciary duties to the corporation. Controlling shareholders may be deemed to owe fiduciary duties that prevent them from exercising control to further their own interests to the detriment of the corporation and minority shareholders.

c. Shareholders elect the board of directors.

4252.21 Shareholder voting

a. A *quorum* for a meeting is a majority of shares outstanding, unless the articles of incorporation specify otherwise.

b. A majority of the quorum prevails on votes, unless articles of incorporation specify otherwise.

c. Treasury shares get no votes. Treasury shares are those owned by the corporation.

d. A vote can be in person or by proxy. A proxy is a signed document authorizing another person to vote the shareholders' shares of stock. Proxy must be written and is valid for a maximum of 11 months.

e. **Cumulative voting**

(1) Cumulative voting applies only for electing the board of directors.

(2) The number of votes a shareholder gets is determined as follows: Number of shares owned × Number of directors being elected.

(3) A shareholder can distribute votes in any way desired. All the votes can be put on one nominee.

(4) Cumulative voting increases the chance of minority representation on the board of directors.

(5) Most states permit cumulative voting if the articles provide for it.

f. **Straight voting:** One vote for each share for each directorship to be filled

4252.22 Voting by proxy

a. A shareholder may vote by proxy.

b. A director is not permitted to vote by proxy.

4252.23 Shareholder meetings

a. Annual meeting details are fixed by the bylaws.

b. Shareholders are entitled to notice of place, day, and hour of meetings 10 to 50 days before the meeting.

c. The purpose must also be given for holding special (not annual) shareholder meetings. The meeting is then limited to these stated purposes.

d. **Notice:** Mailing details by U.S. mail to shareholders of record

4252.24 Preemptive right

a. Preemptive right is the right of a shareholder to buy a pro rata share of newly issued stock.

b. The purpose is to allow the current shareholders to maintain their proportionate interest in the corporation.

c. In most states, a shareholder has no preemptive right unless the right is given in the articles of incorporation.

d. In some states, a shareholder has a preemptive right unless it is denied in the articles of incorporation.

4252.25 Dissenting shareholders

a. Dissenter's rights exist for shareholders who disagree with certain corporate actions. Shareholders can dissent from the following actions:

(1) Merger

(2) Consolidation

(3) Sale of substantially all the assets of the corporation, not in the usual course of business

b. To dissent, the shareholder must file a written objection with the corporation, vote against the proposal, and make written demand for payment of the fair value of the shareholders' stock within 10 days of the vote.

c. Fair value is the stock value on the day before the proposal was voted on by the shareholders.

4252.26 Shareholders' lawsuits

a. If a group of shareholders has been injured, a shareholder may be able to file a *class action suit* on behalf of the class.

b. Most of these suits arise from violations of federal securities laws and have the following requirements:

(1) The number in the class is so large it is impractical for all to sue.

(2) The shareholder suing has substantially the same interest as others in the class.

(3) The shareholder can fairly and adequately protect and present the interests of the class.

c. A shareholder may also be able to file a *derivative suit* on behalf of the corporation when the corporation has been injured.

d. Most of these suits are brought against directors, officers, or someone closely related to them. These suits require that the shareholder is either of the following:

(1) Currently a shareholder at the time the derivative suit is filed

(2) Was a shareholder when the wrongful act was committed against the corporation

e. Generally, a derivative suit can be brought only after the shareholder demands that the board of directors file suit. This demand requirement is excused if it would be futile (e.g., all of the directors have committed fraud against the corporation).

4252.27 Inspection of records

a. At common law, shareholders have certain rights to inspect the books and records of the corporation. Generally, the shareholder right to inspect is found in state corporation statutes.

b. The Model Business Corporation Act (MBCA) requires that a shareholder must have a proper purpose for an inspection. Also, the right of inspection may be limited to shareholders who own at least 5% of the corporation's stock *or* have owned their stock for at least six months.

c. The Revised Model Business Corporation Act (RMBCA) gives all shareholders an absolute right to inspect the following:

(1) Shareholder lists

(2) Articles of incorporation

(3) Bylaws

(4) Minutes of shareholder meetings held during the past three years

d. The RMBCA requires that the shareholder have a proper purpose for inspection of other records such as accounting and tax records, minutes of board of directors' meetings, and minutes of shareholder meetings held more than three years in the past.

e. Officers or agents of the corporation who improperly deny a shareholder's inspection request can be held liable for damages. Under the RMBCA, the shareholder can recover an amount that equals up to 10% of the value of the shares owned in the corporation.

f. The shareholder can appoint an agent, such as an attorney or accountant, to inspect the books and records of the corporation on their behalf.

Section 4300
Federal Taxation of Property Transactions
(12% - 22%)

4310 Acquisition and Dispositions of Assets

Overview

4310.01 **Two major types of property:** All property falls into one of two categories: real property or personal property.

- **a.** **Real property (realty):** Land and anything permanently attached to the land or very closely and exclusively associated with the use of the land; immovables

  Examples: Land, buildings, and growing trees

- **b.** **Personal property (personalty):** Property that is not real; movables

  Examples: Car, table, or book

4310.02 **Conversion from real to personal property:** Conversion from real to personal property is called *severance.*

Examples of severance:

- **a.** A growing tree is cut into firewood. While growing in the ground, the tree is real property. When cut into firewood, it becomes personal property.
- **b.** Sand is dug from the ground and put on a truck. While in the ground, the sand is real property. When dug from the ground and put on the truck, it is personal property.

4310.03 **Conversion from personal to real property:** Conversion from personal to real property is called *attachment.*

Examples of attachment:

- **a.** A brick is mortared into the wall of a building. While loose, the brick is personal property; when mortared into the wall, it becomes a part of the real property.
- **b.** A central air conditioning unit is installed in a house during construction. The unit is personal property until it is installed, then it becomes real property.

4310.04 For federal tax purposes, all property is either classified as ordinary income property or as a capital asset.

Tax Treatment of Gains and Losses

4310.05 When a taxpayer has determined that the taxpayer has a gain or a loss to be recognized, the next step is to establish whether it is to be treated as a capital gain or loss or as an ordinary income or loss item.

4310.06 A capital gain or loss is that gain or loss arising from the sale or exchange of a capital asset.

4310.07 **Capital assets** are defined as all property, *except* for the following:

- **a.** Property held for resale (inventory)
- **b.** Depreciable property or real property used in a trade or business
- **c.** Accounts or notes receivable acquired in normal business operations
- **d.** A copyright or a literary, artistic, or musical composition in the hands of the creator or anyone who assumes the creator's basis (property received through gift)

e. U.S. government publications received from the government other than by purchase at the price that it is offered for sale to the public

f. Certain commodities derivative instruments held by a commodities derivatives dealer

g. Any hedging transaction that is clearly identified as such before the close of the day on which it is acquired, originated, or entered into

h. Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer

4310.08 **Real property subdivided for sale:**

a. Individuals and S corporations subdividing real estate for sale may qualify for capital gain treatment if the following conditions apply:

(1) Subdivider must *not* be a real estate dealer.

(2) No substantial improvements may be made to the lots sold.

(3) Lots sold must be held at least five years (unless inherited).

b. All gain is capital gain until the year the sixth lot is sold. Contiguous lots sold to one buyer are treated as one lot.

(1) When the sixth lot is sold, 5% of the revenue from all lots sold that year is ordinary income.

(2) This ordinary income is offset by any selling expenses to determine the net amount taxed as ordinary income. Any gain not taxed as ordinary income is capital gain.

Section 1231 Assets

4310.09 Section 1231 of the Internal Revenue Code provides long-term capital gain treatment for certain transactions involving noncapital assets (generally land, buildings, and equipment used in business). If there is a loss, the loss is treated as an ordinary versus a capital loss.

4310.10 Section 1231 transactions include the following:

a. Sale or exchange of real or depreciable business property

b. Involuntary conversion of:

(1) real or depreciable business property

(2) any capital asset that is held for more than one year and is held in connection with a trade or business or a transaction entered into for profit

c. Certain farming transactions involving crops and livestock

d. Certain transactions involving timber, iron ore, and coal

4310.11 To qualify as Section 1231 property, the property items listed must be held long enough to meet the long-term capital gain and loss holding period requirement, greater than one year.

4310.12 **Section 1231 benefits:**

a. Gains and losses from Section 1231 transactions must be grouped and compared.

(1) If Section 1231 gains exceed Section 1231 losses, the net gain will be treated as ordinary income to the extent of net Section 1231 losses claimed by the taxpayer in

the previous five years. Any remaining gain will receive long-term capital gain treatment.

(2) If Section 1231 losses exceed Section 1231 gains, the net loss will receive *ordinary loss* treatment.

Example: The taxpayer has a net Section 1231 gain of $21,000 for the current year. This is the taxpayer's first net Section 1231 gain in over six years. Looking back, the taxpayer was able to deduct $9,000 of net Section 1231 losses during the last five years. The gain is taxed as follows—$9,000 is taxed as ordinary income and the remaining gain of $12,000 is taxed as long-term capital gain.

b. A special rule applies to casualty and theft losses on property used in the business and capital assets in the business held longer than one year.

(1) Gains and losses from these involuntary conversions must be separately grouped and compared.

(2) If casualty gains exceed casualty losses, these gains and losses are then grouped with Section 1231 items to compute the net Section 1231 gain or loss.

(3) If casualty losses exceed casualty gains, the resulting net loss is treated as an ordinary loss. In this situation, these casualty gains and losses are not grouped with the Section 1231 items.

4311 Basis and Holding Periods of Assets

4311.01 In determining the taxpayer's investment (adjusted basis) in an asset, several cost factors must be considered.

	Original basis
+	Capital additions
–	Capital recoveries
=	Adjusted basis

a. The basis of property *must be adjusted* by the cost of any improvements made since its acquisition. Real property taxes and mortgage interest on unimproved and unproductive real property may be capitalized at the election of the taxpayer.

b. The basis of property *must be reduced* for depreciation and depletion along with other recoveries such as casualty losses.

4311.02 Establishing the basis of property acquisitions depends primarily on the method by which the property was acquired.

a. **Standard purchase**—Basis is cost.

b. **Group purchase**—The cost is allocated to the individual assets in proportion to their fair market values.

c. **Bargain purchase**—Basis is the cost plus the bargain (fair market value at the date of the bargain purchase).

d. **Inherited property**—Basis is usually the fair market value at date of death.

(1) Fair market value (FMV) six months after death, of all property included in the estate, is an alternative for an estate tax return if this produces a lower value for the gross estate and a lower estate tax liability. The FMV at six months after death can only be used for basis if an estate tax return is filed using that FMV.

(2) If the alternative value is chosen and property is disposed of before the six-month period has expired, that property shall be valued at the fair market value at the date of disposition, the sale price.

e. Gift property acquired since January 1, 1921:

(1) **Basis to compute gain**—donor's basis

(a) On gifts made before 1977, any gift taxes paid by the donor could be added to the donor's basis as long as the addition of the taxes did not cause the basis of the property in the donee's hands to exceed the fair market value of the property at the date of the gift.

(b) On gifts made after 1976, the basis of the property is increased by the gift tax attributable to the net appreciation in the value of the gift property, but the donee's basis cannot be increased beyond the fair market value of the property at the date of the gift.

(2) **Basis to compute loss**—lower of:

(a) donor's basis plus the gift tax adjustment or

(b) fair market value at date of gift

In certain situations, neither a gain nor a loss can be computed on the sale of property received by gift. In such a situation, the selling price is less than the basis for gain and more than the basis for loss.

(3) **Basis for calculating depreciation**—Use the gain basis.

(4) **Basis of gifts made prior to 1921**—fair market value at date of gift

f. Personal property converted to income production:

(1) **Basis for gain**—adjusted basis of the asset at conversion minus allowable depreciation after conversion

(2) **Basis for loss**—lower of:

(a) the adjusted basis of the asset at conversion minus allowable depreciation or

(b) fair market value at conversion minus allowable depreciation thereafter

(3) **Basis for calculating depreciation**—lower of:

(a) the adjusted basis of the asset at conversion or

(b) fair market value at conversion

g. Property received as compensation for services: Basis is the fair market value of the property when received.

h. Property transferred to a controlled corporation in exchange for its stock:

(1) The basis of stock received for property transferred to a controlled corporation is equal to the basis of the property exchanged plus any recognized gain on the exchange minus any cash and/or other property received.

(2) The basis of property acquired by the corporation is the same as it was in the possession of the transferor plus any gain recognized by the transferor on the exchange.

(3) To qualify as a controlled corporation, persons transferring property to a corporation for its stock or securities must own 80% of the voting stock plus 80% of all other stock of the corporation immediately after the exchange.

i. **Taxable exchange**—Basis is the fair market value of the property received.

j. The calculation of basis for the following property acquisitions is covered in section **4312**.

(1) Tax-free exchange

(2) Involuntary conversion

(3) Sale of personal residence

(4) Wash sale

4311.03 Capital gains and losses, once determined, must be classified as either short term or long term depending on the holding period of the asset given up.

a. Holding period requirements:

(1) One year or less—short term

(2) More than 12 months—long term

b. The holding period for long-term capital gains and losses is measured as follows:

(1) As a minimum, property must be held to that day of the 12th month following the month of acquisition that is numerically *one day* later than the date acquired.

(2) If property is purchased on the last day of the month, it must be held to at least the first day of the 13th month.

c. The holding period normally begins on the day that the basis originated.

d. In transactions in which some portion of the basis of an asset carries forward, the holding period begins at the time the carryover basis originated.

Example: If the donor's basis is used to establish the basis of gift property, the holding period for the donee begins at the time the donor's basis originated.

If the fair market value is used as the basis of gift property (a loss situation), the holding period begins at the date of the gift.

e. The Internal Revenue Code provides that inherited property disposed of within one year shall be considered to have been held for more than one year.

f. If any security, which is a capital asset, becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a sale or exchange of a capital asset on the last day of the taxable year.

4312 Taxable and Nontaxable Dispositions

4312.01 Once the amount of gain or loss has been calculated, the amount of the gain or loss to be recognized for tax purposes must be computed.

a. Generally, gains on property transactions are recognized, but the recognized gain never exceeds the realized gain.

b. Losses on the sale, exchange, or condemnation of *personal use* assets are *not* recognized.

c. Losses on the sale of income-producing property to certain related parties are *not* recognized. However, the disallowed loss may be used by the related purchasing party to offset any gain on a later disposition of this property.

d. Gains are generally recognized in the year of the sale.

(1) Taxpayers using the installment method of reporting sales recognize and report capital gain as payments are received.

(2) The gain reported each year is determined by multiplying the gross profit percentage on the sale by the payments received that year.

(3) The installment method cannot be used to report losses or ordinary income.

e. In certain transactions, some or all of the gain or loss may be postponed.

(1) Postponement is possible in these transactions *only if replacement property is acquired.*

(2) Postponement is accomplished by modifying the basis of the new property according to the following guidelines:

(a) Postponed gains: *Decrease* the basis (fair market value (FMV)) of the new asset by the amount of the unrecognized gain.

(b) Postponed losses: *Increase* the basis (FMV) of the new asset by the amount of the unrecognized loss.

4312.02 Property transactions in which recognition of the gain or loss may be postponed, or deferred, by adjusting the basis of replacement property include the following:

a. Tax-free exchange

b. Involuntary conversions (condemnation, casualty, theft)

c. Wash sale

4312.03 **Tax-free exchange (IRC Section 1031):**

a. To defer recognition of a gain or loss, property held for productive use in a trade or business, or for investment, must be exchanged for property of like kind to be held for business or investment purposes. Under the Tax Cuts and Jobs Act of 2017, the tax-free exchange provision applies only to real property and no longer applies to personal property.

b. Treatment of gains and losses:

(1) If a gain is realized on the exchange of properties, the gain is recognized to the extent of the lesser of the gain realized or the fair market value (FMV) of the boot (cash or other assets) received. Any unrecognized gain is postponed (deferred).

(2) A loss incurred in a tax-free exchange is generally not recognized. The unrecognized loss is postponed (deferred).

(3) If boot is given in the exchange, gain or loss on the boot is recognized to the extent that the boot has appreciated or depreciated in value.

c. The following property items are not tax-free exchange items:

(1) Property held primarily for sale

(2) Securities

d. The following exchanges do *not* qualify as "like-kind":

(1) Real property for personal property

(2) Livestock of different sexes

(3) Interests in a partnership

(4) After December 31, 2017, any property other than real property

e. Tax-free exchanges *do* include the following special items:

(1) Exchanges of the same type of stock in the same corporation

(2) Transfer of property to a controlled corporation (80% owned)

(a) No gain or loss is recognized if property is exchanged solely for stock or securities.

(b) If cash or other property is received in addition to the securities, gain is recognized to the extent of the lesser of the gain realized or the cash or FMV of the other property received.

(3) Certain types of corporate reorganizations, including the following:

(a) A statutory merger or consolidation (Type A)

(b) An exchange of stock for voting stock (Type B)

(c) An exchange of assets for voting stock (Type C)

(d) A divisive reorganization—spin-offs, split-offs, split-ups (Type D)

f. The basis of property acquired in a tax-free exchange is equal to the adjusted basis of the property surrendered, *or*:

(1) the amount derived when the unrecognized gain is subtracted from the FMV of the new asset or

(2) the amount derived when the unrecognized loss is added to the FMV of the new asset.

4312.04 **Involuntary conversions** (condemnation, casualty, theft):

a. Gains:

(1) Taxpayer may elect to recognize the gain.

(2) Taxpayer may elect deferral. (IRC Section 1033)

(3) Taxpayer must recognize gains to the extent that there are proceeds left over after replacement of the asset.

b. Losses:

(1) If income-producing property, the loss is recognized.

(2) If non-income-producing property, the loss is recognized only to the extent that the casualty or theft (but not a condemnation) exceeds $100 for each event.

(a) The deduction for casualty and theft losses on nonbusiness property is further limited to the excess of the loss over 10% of the taxpayer's adjusted gross income (AGI) for the year.

(b) For tax years beginning after December 31, 2017, and before January 1, 2026, the personal casualty and theft loss deduction is limited to a loss incurred in a disaster declared by the president under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

(c) However, when a taxpayer has personal casualty gains, losses may be offset against the gains.

(d) Taxpayers experiencing several allowable losses during the year may deduct the amount by which the combined losses (reduced by $100 per event) exceed 10% of AGI.

(3) In calculating the loss:

(a) The loss is limited to the difference in the fair market value immediately before and immediately after the event *or* the adjusted basis of the property, whichever is smaller.

(b) If business or income-producing property is completely destroyed, the adjusted basis may be deducted if it is greater than the fair market value immediately preceding the casualty.

(c) Insurance and/or other compensation received acts to reduce the loss.

c. Taxpayers must also net gains and losses when there are both recognized gains and recognized losses from the involuntary conversion of trade or business property held for more than one year.

(1) If the gains exceed the losses, *all* casualty and theft gains and losses are combined with the other Section 1231 transactions.

(2) If the losses exceed the gains, the net loss is deductible as an ordinary loss.

d. The basis of any replacement property is equal to the cost of the property reduced by any unrecognized gain.

e. Replacement must take place within a period that begins on the date of destruction or condemnation, or the date when the property was first threatened with condemnation, whichever is earlier.

(1) The period ends two years after the close of the tax year in which some part of the gain is realized.

(2) On the condemnation (as opposed to casualty and theft) of business and investment real property, the replacement period ends three years after the close of the tax year in which some part of the gain is realized.

(3) The replacement period for the involuntary conversion of a personal residence in a declared federal disaster area is extended to four years beyond the year of gain.

4312.05 Sale or exchange of a principal residence:

a. Individuals may exclude $250,000 ($500,000 on a joint return) of gain on the sale or exchange of a principal residence. Gains in excess of the excludible amount will be taxed. These excess gains may not be postponed by adjusting the basis of a replacement residence.

(1) The residence must have been owned and occupied by the taxpayer for an aggregate of at least two of the five years before the sale or exchange.

(2) The exclusion may be used only once every two years.

(3) The $500,000 exclusion is available to married taxpayers filing jointly if (a) *either* spouse satisfies the ownership test, (b) *both* spouses meet the occupancy test, and (c) neither spouse has used the exclusion within the last two years.

(a) When the spouse has used the exclusion within the past two years, an eligible taxpayer may still exclude $250,000 on either a joint return or a separate return.

(b) When a husband and wife each sell a principal residence, they are each eligible to exclude $250,000 on the sale of their residences. They may claim their exclusions on either a joint return or separate returns.

(c) A surviving spouse can exclude up to $500,000 from the sale of a principal residence if the sale is within two years of the date of death and the other requirements were met on the date of death.

(4) If the ownership and occupancy tests are not met, a prorated exclusion is available if the sale or exchange is the result of (a) change of place of employment, (b) health, or (c) unforeseen circumstances.

(5) An individual is treated as using property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce decree or separation instrument.

b. Losses are not recognized; neither are they deferred.

c. The basis of any new residence is its cost. There is no basis adjustment for unrecognized gains and losses.

4312.06 Wash sale:

a. A wash sale takes place when securities are sold at a loss and replaced with substantially identical securities within 30 days *before* or *after* the sale.

b. Such losses are not recognized—they are deferred. The deferred loss increases the basis of the stock or securities acquired.

c. This law does not apply to dealers.

4312.07 Section 1202: Depending on the acquisition date of qualified small business stock (QSBS), IRC Section 1202 permits noncorporate investors to exclude a percentage of gain they realize on the disposition of QSBS issued after August 10, 1993, under certain conditions.

4312.08 Qualified small business stock (QSBS):

For a small business stock to qualify under IRC Section 1202:

a. The business must be a United States C corporation with $50 million or less in capital. Exceeding the $50 million limit does not disqualify otherwise qualifying stock, but the corporation can never again issue qualified stock.

b. The stock must have been directly acquired as an original issuance from the C corporation (or via gift or inheritance from the original acquirer).

c. The stock must be held for more than five years from the date of acquisition.

d. Eighty percent (80%) of the value of the corporate assets must be used in the active conduct of business.

e. The company must provide services in an eligible sector—those in personal services, law, banking, finance, leasing, hospitality, health, farming, or mining are not eligible for this exclusion.

4312.09 QSBS capital gain exclusions:

Acquisition Date	Capital Gain Exclusion Percentage
Before 2/18/2009	50%
2/18/2009–9/27/2010	75%
After 9/27/2010 (see PATH Act)	100%

4312.10 The PATH Act:

In December 2015, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) was signed into law.

a. The PATH Act made the small business stock gains exclusion permanent; 100% of the gain on the sale or exchange of QSBS (qualified small business stock) acquired after September 27, 2010, and held for more than five years is excluded from taxable income, with certain limitations.

b. The PATH Act also permanently extended the rule that eliminates the 100% excluded QSBS gain as a preference item for alternative minimum tax (AMT) purposes.

c. In addition, QSBS gain excluded from income is not subject to the 3.8% "Obamacare" tax on "net investment income" from capital gains (and other investment income) on high-income taxpayers.

4312.11 Per-issuer limitation on gain exclusion:

a. Eligible gain from any one corporate issuer in any given tax year cannot exceed the greater of:

(1) $10 million reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior years from the same issuer or

(2) 10 times the adjusted basis of all qualified stock of the issuer that the taxpayer disposed of during the tax year.

c. The $10-million limitation is applied on a shareholder-by-shareholder basis and any property contributed to the issuing corporation is its fair market value as of the contribution date.

d. Married taxpayers filing separately have $5 million of eligible gain for each spouse.

4312.12 Section 1244 stock:

IRC Section 1244 allows losses from the sale of shares of small, domestic corporations to be deducted as ordinary losses instead of as capital losses up to an annual maximum of $50,000 for individual tax returns or $100,000 for joint returns.

a. The corporation's aggregate capital must not have exceeded $1 million when the stock was issued.

b. The corporation must not derive more than 50% of its income from passive investments.

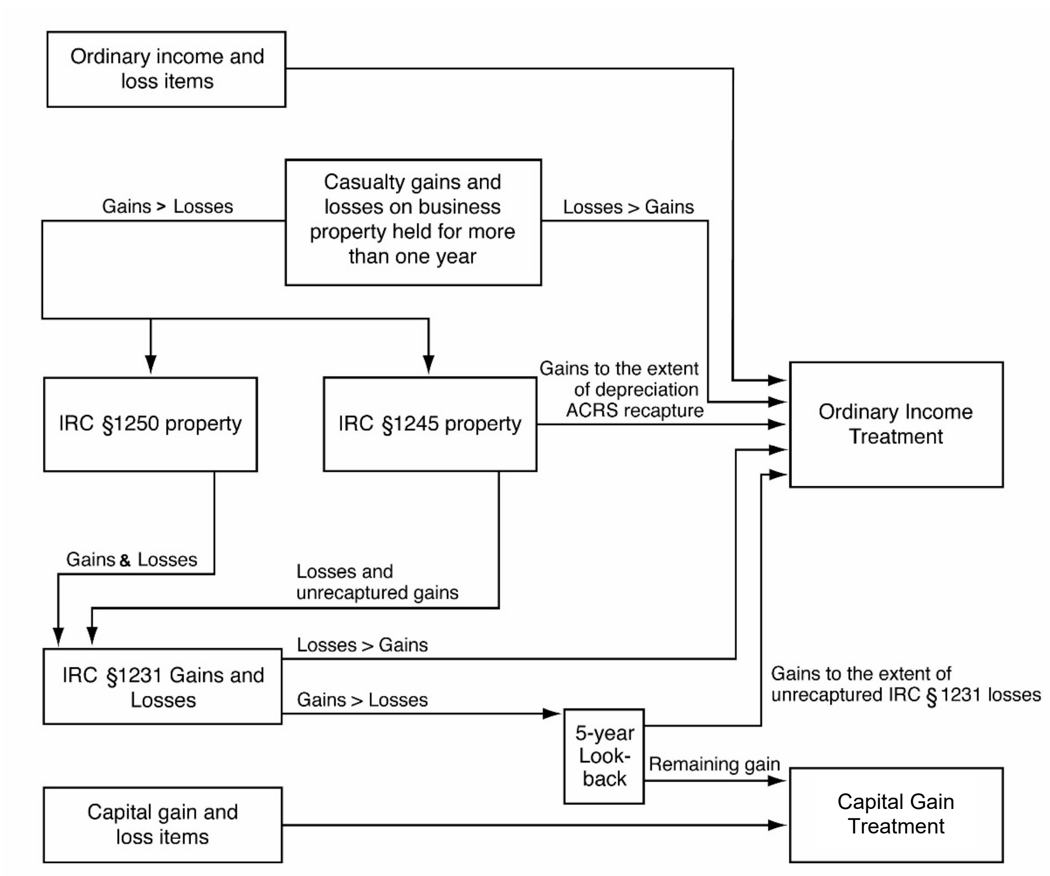
c. The shareholder must have paid for the stock and not received it as compensation.

d. Only individual shareholders who purchase the stock directly from the company qualify for the special tax treatment.

e. Losses in excess of the maximum can then be deducted as a capital loss on Schedule D (IRS Form 1040).

4313 Amount and Character of Gains and Losses, and Netting Process

4313.01 The following summarizes the tax treatment of gains and losses.



4313.02 Gain or loss on the disposal of property is computed by comparing the value of the assets received with the investment (basis) in the property given up.

	Amount realized
–	Adjusted basis
=	Gain or loss

4313.03 The amount realized on the disposition of property is equal to the net proceeds received for that property.

	Gross selling price
–	Selling expenses
=	Amount realized

a. The gross selling price includes everything received for the property given up, including the following:

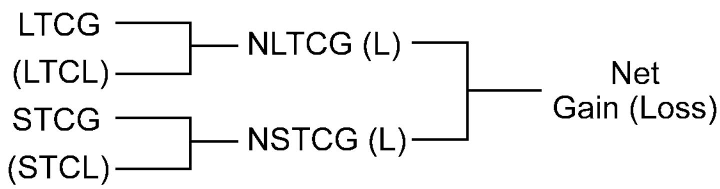
(1) Cash

(2) Fair market value of property and services received

(3) Amount of mortgage, assumed by buyer, on property given up

b. Selling expenses include advertising, legal fees, commissions, and any other costs required to effect the transfer of property.

4313.04 All items receiving capital gain or loss treatment should be classified as short term or long term and summarized as follows:



The result is either a net gain or a net loss.

4313.05 **Net gains for individuals, estates, and trusts:**

a. Any of the net gain arising from short-term sales and exchanges receives ordinary income treatment.

b. Capital gain is subject to one of three rates depending on the nature of the asset responsible for the gain. Maximum rates are 25% on recaptured depreciation on real property, 28% on gains from the sale of collectibles and IRC Section 1202 stock, and—finally—20% on all other "regular" gains.

c. Regular capital gain tax rates for tax year 2020 are 0% for individuals earning up to \$40,000, 15% for individuals earning up to \$441,450, and 20% for individuals earning over \$441,450. For married filing jointly, the rates and breakpoints are 0% up to \$80,000, 15% up to \$496,000, and 20% above \$496,000. Rates and breakpoints are also different for taxpayers filing as head of household: 0% up to \$53,600, 15% up to \$469,050, and 20% over \$469,050. Married filing separate rates and breakpoints are exactly one-half of married filing joint.

These same breakpoints apply to qualified dividends. Breakpoints will change with inflation. Do not forget the following exceptions:

(1) Unrecaptured IRC Section 1250 gain (gain up to the original cost of real property; usually a recapture of depreciation to the extent of tax benefit) will be taxed at a maximum rate of 25%. Any excess of sales price over original cost of real property used in a trade or business is regular gain taxed at 0%, 15%, or 20%.

(2) Taxable gains arising from the sale of collectibles (e.g., art, coins, and antiques) and Section 1202 stock will be taxed at a maximum rate of 28%.

4313.06 **Net capital losses for individuals, estates, and trusts:**

a. If the taxpayer has a net capital loss, up to \$3,000 may be deducted in the current year as a deduction to arrive at adjusted gross income (reported on Schedule D of IRS Form 1040).

b. Short-term losses are used before long-term losses.

c. Both short-term (STCL) and long-term (LTCL) losses are deductible dollar-for-dollar.

d. Any remaining capital loss will be carried forward indefinitely.

e. The carryover will be treated as STCL or LTCL depending on its origin.

4313.07 Special netting procedures:

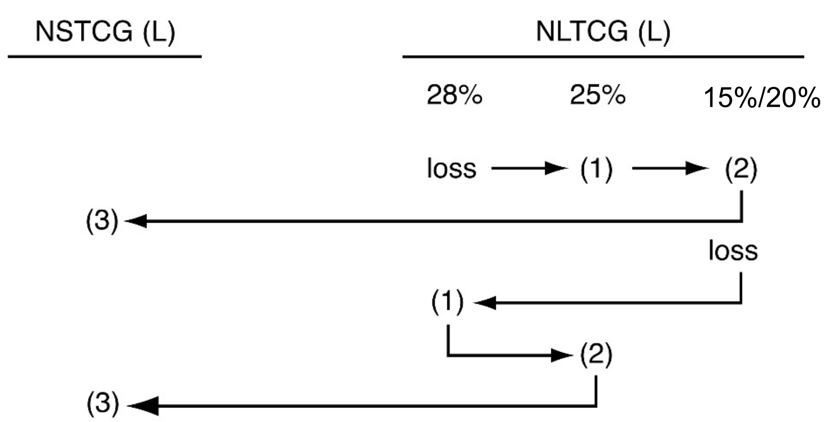
a. Long-term capital gain and loss items are netted in the following manner. Separately list 28% gains (losses), 25% gains, 15%/20% gains (losses), then:

(1) offset any 28% losses against 25% gains, then against 15%/20% gains. If a loss still exists, offset it against any available net short-term gain. Any remaining loss is eligible for the $3,000 deduction. A loss in excess of $3,000 carries forward indefinitely.

(2) offset any 15%/20% losses against 28% gains, then 25% gains. Offset any remaining loss against available net short-term gain. If a loss remains, it is eligible for the $3,000 deduction. A loss in excess of $3,000 carries forward indefinitely.

While losses can result from the sale of 28% and 15%/20% items, the 25% situation involves only gains (by definition).

Summary of the netting process for long-term capital gains and losses:



When the netting process produces a net long-term capital gain, the gain is used to absorb any net short-term capital loss. Any remaining 28%, 25%, or 15%/20% gains will be taxed at those rates (see short-term netting process in part *b.,* following).

Example: A single taxpayer with $250,000 of taxable income (35% tax bracket in 2020) has no short-term gains and losses, but does have the following long-term capital gains and losses:

(a) 28% gain from the sale of stamp collection: $4,000

(b) 25% gain from unrecaptured depreciation on sale of a commercial building: $105,000

(c) 15%/20% loss from sale of stock held as investment: $65,000

In this situation, the taxpayer first offsets the $65,000 loss against the $4,000 gain. The remaining loss of $61,000 then offsets the 25% gain of $105,000. The remaining NLTCG (net long-term capital gains) of $44,000 is taxed at 25%.

b. Short-term capital gains and losses are netted to produce a net short-term gain or loss.

(1) If the result is a gain, the gain is used to absorb any net long-term capital loss. Any remaining short-term capital gain is taxed as ordinary income.

(2) If the netting process results in a net short-term capital loss, the loss will offset available net long-term capital gain in the following order: 28% gains, 25% gains, and 15%/20% gains. If a loss remains, up to $3,000 may be deducted as a deduction for adjusted gross income (AGI). Any additional loss is carried forward indefinitely.

Example: If the taxpayer in the preceding example also had a net short-term capital loss of $15,000, the loss would offset the NLTCG of $44,000. The remaining $29,000 gain would be taxed at 25%.

(3) Capital losses of individuals carry forward as either long term or short term depending on their origin. However, short-term losses are used first in calculating the $3,000 deduction.

4313.08 Net capital gains for corporations:

a. Corporate capital gains are taxed at the same tax rate as ordinary income.

b. Before 1987, corporate capital gains received favorable tax treatment through an alternative tax.

4313.09 Net capital losses for corporations:

a. Corporations are not allowed to deduct capital losses in excess of capital gains from ordinary income.

b. Capital losses of a corporation can only be used to offset capital gains, but they can be carried back and/or forward.

c. Net capital losses carry back three years and forward five years as capital losses.

d. Ordering of losses:

(1) If carrying losses from more than one year, use the earlier losses first.

(2) Loss carryback/carryforward rules operate as follows:

(a) First, carry back to the third prior year.

(b) Next, carry back what is left to the second prior year.

(c) Next, carry back to the year immediately preceding the loss.

(d) Then, whatever loss remains is carried forward for the five years following the year of loss.

(e) Finally, any loss remaining after five years is lost.

Installment Sales

4313.10 Installment sales (in general)

a. Generally, a taxpayer is required to recognize the gain or loss from a sale or exchange of property at the time of the sale or exchange.

b. Under the installment sales method, a taxpayer elects to report capital gain from an installment sale over the period during which payments are received. The installment sale rule does not apply to the reporting of losses or ordinary income.

c. The installment method generally applies to sales in which the taxpayer has a capital gain if at least one payment will be received after the tax year in which the sale occurs.

d. The installment sale reporting method may not be used:

(1) to report gains on property held for sale in the ordinary course of business (inventory),

(2) for gain that must be recaptured as ordinary income under IRC Section 1245 or 1250, or

(3) for any gain on stocks or securities that are traded on an established securities market.

e. However, the installment method can be used to report gain on the sale of:

(1) time-share units,

(2) residential real estate lots if the seller has made no improvements to the lots, and

(3) property used or produced in farming.

f. If the installment method applies to a sale, the taxpayer generally must use that method unless they elect out. Electing out is done by simply reporting the entire gain from a transaction in the year of origin.

4313.11 Computation of gain

a. The gain recognized under the installment method is computed using the following formula:

$$\frac{\text{Total gain}}{\text{Contract price}} \times \text{Payments received during the tax year} = \text{Gain recognized}$$

b. **Total gain** is the selling price of the property reduced by the adjusted basis of the property and any selling expenses.

c. The **contract price** is the selling price of the property reduced by any of the seller's liabilities that are assumed by the buyer as part of the sale.

4313.12 Installment sales: Other issues

a. Generally, if a taxpayer disposes of the installment obligation, the remainder of any gain from the installment sale is accelerated and must be recognized in the year of the disposition of the obligation.

b. A taxpayer can make an election not to use the installment reporting method. This election is made by reporting all of the recognized gain from the installment sale in the tax year of the sale.

c. A taxpayer must receive IRS permission to revoke an election not to use the installment sales reporting method.

4314 Related Party Transactions

4314.01 IRC Section 267 places certain restrictions on related party transactions. One of these restrictions is that recognition of any losses from the sale or exchange of property, directly or indirectly, between related parties is disallowed for income tax purposes. If the property, on which loss is disallowed in a related party transaction, is later sold to an unrelated party, any gain on that sale is reduced by the previously disallowed loss.

Example: Father sells property to Son (a related party) at a loss of $10,000, which is not recognized due to the related party rules. If Son later sells the property to an unrelated party at a gain of $14,000, Son only recognizes a $4,000 gain (realized gain of $14,000 - $10,000 related party disallowed loss).

4314.02 The PATH (Protecting America from Tax Hikes) Act of 2015 modifies the related party loss rules for sales and exchanges of property acquired after December 31, 2015. The modification prevents losses from being shifted from a tax-indifferent party (e.g., a foreign person not subject to U.S. tax) to another party in whose hands any gain or loss with respect to the property would be subject to U.S. taxation.

- **a.** The Act provides that the general rule of IRC Section 267 does not apply to the extent gain or loss (with respect to property that has been sold or exchanged) is not subject to Federal income tax in the hands of the transferor immediately before the transfer, but any gain or loss with respect to the property is subject to Federal income tax in the hands of the transferee immediately after the transfer.
- **b.** The basis of the property in the hands of the transferee will be its cost for purposes of determining gain or loss, thereby precluding a loss importation result.

4314.03 IRC Section 267 also contains a special rule dealing with expenses that are unpaid to a related party at the end of the tax year.

- **a.** This rule only applies in a transaction between related parties where the related party that will have the deduction is on the accrual basis and the related party that will receive the income is on the cash basis.
- **b.** This rule states that the accrual-basis related party can only deduct the expense to the cash-basis related party, when the cash-basis related party includes the payment in income (generally when it is actually received).
- **c.** This effectively means that the related accrual basis payor is on the cash basis as to deduction of this payment.

4314.04 For purposes of IRC Section 267, related parties are:

- **a.** brothers and sisters, spouses, ancestors, and lineal descendants,
- **b.** a corporation and a shareholder, if the shareholder owns (directly or indirectly) more than 50% by value of the outstanding stock of the corporation,
- **c.** two corporations that are members of a controlled group, and
- **d.** a series of other relationships between trusts, corporations, and individuals.

4314.05 Constructive ownership rules apply in determining if two taxpayers are related. Under these rules, a taxpayer is considered to own stock owned by:

- **a.** a family member (brother or sister, spouse, ancestor, or lineal descendant),
- **b.** a proportionate share of any stock owned by an entity (partnership, corporation, estate, or trust) of which the taxpayer is a member, and
- **c.** partners of the taxpayer (if the taxpayer is a partner in a partnership).

4320 Cost Recovery (Depreciation, Depletion, and Amortization)

Depreciation

4320.01 A deduction is allowed for wear, tear, exhaustion, and normal obsolescence of property held for the production of income or for property used in a trade or business.

a. This cost recovery process can take the form of depreciation, cost recovery, amortization, or depletion.

b. While depletion relates to natural resources, no depreciation, cost recovery, or amortization is available for the following:

(1) Personal property not used in a trade or business

(2) Inventory

(3) Land

4320.02 For assets acquired after 1986, depreciation is computed using the modified accelerated cost recovery system (MACRS). Under this system, the full cost of the property (including salvage value) is written off over a prescribed recovery period:

a. Revenue Procedure 87-56 sets out a class life, general depreciation system life, and alternative depreciation system life for classes of tangible property used in a trade or business or held for the production of income.

(1) MACRS uses the recovery period.

(2) Class life and alternative depreciation system lives have special purposes not generally affecting calculation of regular taxable income.

b. MACRS depreciation cannot be used for intangible property and property not depreciated in terms of years (units-of-production method).

c. Revenue Procedure 87-57 describes the applicable depreciation methods, applicable recovery periods, and applicable conventions that must be used in computing depreciation allowances under IRC Section 168.

d. **Real estate:**

(1) Under MACRS, real estate acquired after 1986 is depreciated using the straight-line method over the following periods:

Residential real estate	27.5 years
Nonresidential real estate placed in service before May 13, 1993	31.5 years
Nonresidential real estate placed in service after May 12, 1993	39.0 years

(2) Real property acquisitions are subject to the *mid-month convention.* One-half month's cost recovery is allowed in both the month of acquisition and the month of disposition.

(3) The Tax Cuts and Jobs Act of 2017 (TCJA) provides that a real property trade or business electing out of the limitation on the deduction for business interest is required to use ADS (alternative depreciation system) to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property.

e. Personal property:

(1) There are six recovery periods for personal property—3, 5, 7, 10, 15, and 20 years.

(a) Under MACRS, the 200% declining-balance method is used for the 3-, 5-, 7-, and 10-year properties. The 150% declining-balance method applies to the 15- and 20-year properties. Both methods switch to straight-line depreciation when that method produces a larger deduction.

(b) The 5- and 7-year properties are most common.

i. The 5-year class includes automobiles, general-purpose light trucks, computers, and office machinery (typewriters, calculators, copiers, etc.).

ii. The 7-year class includes heavy, special-purpose trucks and office furniture and fixtures (desks, filing cabinets, etc.).

(2) Generally, a half-year's recovery deduction is taken in the first year of use regardless of the month the property was placed in service (half-year convention).

(3) Basically, the recovery deduction is determined by applying a prescribed statutory percentage to the unadjusted basis of the property. The government provides tables listing the applicable percentages.

(4) A mid-quarter convention will apply to property acquired after 1986 if more than 40% of the value of all property acquired during a tax year is placed in service during the last quarter of the year.

(a) If the mid-quarter convention applies, property acquisitions must be grouped by the quarter in which they were acquired.

(b) A cost recovery deduction for each of these groups is computed as follows:

Acquisitions	**Depreciation Allowable**
1st quarter	10.5 months
2nd quarter	7.5 months
3rd quarter	4.5 months
4th quarter	1.5 months

These adjustments are built into the MACRS tax tables for the mid-quarter convention.

(5) Disposal of personal property generally results in a cost recovery deduction in the year of disposal.

(a) In most cases, a half-year of cost recovery is allowed in the year of disposition or retirement.

(b) If the mid-quarter convention applies, the cost recovery will range from 1.5 months to 10.5 months of depreciation depending on in which quarter the disposal of the property takes place.

(6) The taxpayer may elect to use the straight-line method of depreciation for personal property. This election is available on a class-by-class basis for each tax year.

(7) Under Section 179 of the Internal Revenue Code, the taxpayer, other than an estate, a trust, or certain noncorporate lessors, may elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property or certain real property placed in service during the tax year in the taxpayer's trade or business.

(a) The basis of the asset(s) must be reduced by the amount expensed. The amount "expensed" cannot exceed the taxpayer's aggregate taxable income from trade or business activities. Amounts in excess of trade or business income that would otherwise be deductible are carried forward indefinitely.

(b) Under the Tax Cuts and Jobs Act of 2017 (TCJA), in 2020 a taxpayer may expense $1,040,000. The phaseout threshold is now $2,590,000. These amounts are indexed for inflation.

(c) The TCJA further clarifies that the cost of roofing; heating, ventilation, and air conditioning property; fire protection and alarm systems; and security systems can be deducted under IRC Section 179 as "qualified real property."

(8) "Bonus depreciation" refers to a special depreciation allowance for the first year that certain classes of property are placed in service.

(9) Under the Tax Cuts and Jobs Act of 2017, bonus depreciation increases from 50% to 100% for property acquired and placed in service (both new and used, so long as the use is new to the taxpayer) after September 27, 2018, and before 2023. After 2023, there is a gradual decrease in the percentage: 80% for 2023, 60% for 2024, 40% for 2025, and 20% for 2026.

f. Alternative depreciation system:

(1) After 1986, an alternative depreciation system (ADS) must be used in certain computations.

(a) To compute that portion of depreciation treated as a tax preference item for purposes of the alternative minimum tax for property purchased before 1999

(b) To calculate depreciation for property:

i. Used predominantly outside the United States

ii. Leased or used by a tax-exempt entity

iii. Financed with the proceeds from tax-exempt bonds

iv. Imported from countries engaged in discriminatory practices

v. Listed property used 50% or less in a qualified business use

vi. Certain farming equipment

(c) To compute depreciation for earnings and profits purposes

(2) Generally, depreciation under this method is calculated using the straight-line method without regard to salvage value.

(3) Depreciation of personal property for the alternative minimum tax is calculated by using 150% declining-balance depreciation, switching to the straight-line method when appropriate to maximize deductions.

(4) Depreciation of real estate for the alternative minimum tax uses the mid-month convention.

(5) The recovery period for the ADS, while generally the ADR midpoint life of an asset, is provided for every asset's class in Revenue Procedure 87-56..

(6) Taxpayers may elect to use ADS in lieu of MACRS.

g. The government publishes tables that automatically provide for each of the special conventions that a taxpayer may use in the year of acquisition for both real estate and personal property.

h. Listed property:

(1) Special rules apply to property suitable for both business and personal use (only automobiles after the Tax Cuts and Jobs Act of 2017 (TCJA)).

(a) If business usage of such property is not more than 50%, the property does not qualify for regular (accelerated) MACRS, bonus, or the Section 179 first-year expense. It must be depreciated under ADS using the straight-line method.

(b) If business usage exceeds 50%, the property is available for regular MACRS and Section 179 depreciation. If future business usage drops below 50%, a permanent switch to the straight-line method is required. In addition, previous cost recoveries in excess of straight-line depreciation must be recaptured as additional income.

(2) An additional limitation is placed on so-called "luxury automobiles." A dollar limit for depreciation is mandated for each year the car is in use. For tax years beginning after 2017, these limits will be adjusted for inflation using the automobile component of the consumer price index (CPI).

(a) The Tax Cuts and Jobs Act of 2017 (TCJA) increased allowable depreciation for a passenger automobile in lieu of bonus depreciation or a Section 179 amount as follows:

Year 1	$10,000
Year 2	16,000
Year 3	9,600
Year 4 and after	5,760

(b) These limits must be reduced proportionately if business usage is less than 100%.

(c) Trucks, SUVs, and vans weighing over 6,000 pounds are not subject to the luxury automobile limits. Likewise, ambulances, hearses, taxis, and limousines are not subject to these limits.

Recovering the Cost of Leasehold Improvements and Intangible Assets

4320.03 Improvements made by the lessee that are made in lieu of rent are deductible as rent by the lessee and included as income by the lessor.

4320.04 Improvements made by the lessee that are *not* made in lieu of rent must be capitalized by the lessee and written off using the modified accelerated cost recovery system (MACRS).

4320.05 Taxpayers generally amortize the cost of intangibles acquired after August 10, 1993, over a 15-year period on a straight-line basis, beginning with the month acquired.

a. Section 197 intangibles are a qualifying asset acquired and held in connection with the conduct of a trade or business. This includes goodwill, going-concern value, trademarks, and franchises.

b. Copyrights, patents, and covenants not to compete are included when acquired with the purchase of a business.

c. Intangibles not required to be written off over 15 years are amortized over their useful lives. Such assets include copyrights and patents acquired separately, not acquired with the purchase of a business.

d. Interests in land, financial interests, computer software, mortgage servicing, and leases of tangible personal property are excluded from the definition of Section 197 intangibles.

e. A loss cannot be recognized on the disposition of Section 197 intangibles if the taxpayer retains other Section 197 intangibles acquired in the same transaction.

f. Research and experimental expenditures may be (1) expensed in the year paid or incurred, (2) capitalized and amortized over a period of time not less than 60 months, or (3) capitalized and amortized ratably over 10 years and thereby avoiding alternative minimum tax considerations.

Depletion

4320.06 **Depletion** is the process whereby owners of an economic interest in natural resources may recover the cost of their investment (e.g., oil, timber, gas, minerals).

4320.07 Two methods are available for computing depletion. Annually, the taxpayer must choose the method that gives the *greatest* depletion deduction for that year.

a. Cost depletion method:

(1) Divide the estimated number of units in a resource deposit into the cost or other adjusted basis of the property to obtain the cost depletion per unit.

(2) Multiply this quotient by the number of extracted units that were sold for that year to obtain the cost depletion deduction.

(3) Cost depletion is no longer applicable when the adjusted basis of the resource is reduced to $0.

b. Percentage depletion method:

(1) Percentage depletion is the *lesser* of the following two figures:

(a) A flat percentage of gross receipts from the property; the percentage is specified in the Internal Revenue Code and varies according to the type of resource or

(b) 50% of taxable income from the property before taking a depletion deduction.

(2) Percentage depletion is not restricted to the cost basis of the resource. Consequently, taxpayers can recover through depletion deductions far more than they have invested in the resource. The excess taken becomes a tax preference for alternative minimum tax.

(3) Some of the more common percentage depletion rates are:

(a) 15% for copper, gold, silver, iron, and oil and gas;

(b) 10% for coal and lignite; and

(c) 5% for gravel, peat, sand, and pumice.

c. The cost basis of the resource must be reduced each year by the amount claimed as depletion, whether determined by the cost or the percentage method. The basis cannot be reduced below $0, however.

4320.08 Timber is not eligible for percentage depletion; the cost method must be used.

4320.09 Percentage depletion is generally not available for oil and gas wells. Exceptions include certain domestic gas wells and small independent producers and royalty owners. A special section in the Internal Revenue Code, Section 613A, deals with oil and gas while all other depletion is covered in IRC Section 613.

Depreciation and Recovery Allowance Recapture

4320.10 Whereas IRC Section 1231 provides long-term capital gain treatment for certain noncapital assets, IRC Sections 1245 and 1250 deny this special treatment where the gain represents a recovery of some or all of the depreciation allowances previously deducted. IRC Sections 1245 and 1250 take precedence over IRC Section 1231.

4320.11 Section 1245 recapture:

- **a.** IRC Section 1245 requires that any gain on IRC Section 1245 property will be treated as ordinary income to the extent of *all* depreciation taken.
- **b.** Any gain on IRC Section 1245 property which is not recaptured as ordinary income becomes IRC Section 1231 gain.
- **c.** IRC Section 1245 property refers primarily to equipment used in a trade or business. It also includes most buildings acquired during the ACRS (accelerated cost recovery system) recovery period (1981–1986).
- **d.** Depreciation recapture rules do not apply when property is disposed of by gift or by transfer at death.
- **e.** Gift property retains its ordinary income potential in the hands of the donee.
- **f.** The charitable contribution deduction for Section 1245 property must be reduced by the amount that would have been recognized as ordinary income if the item had been sold at its fair market value.
- **g.** In tax-free exchanges and involuntary conversions of Section 1245 property, depreciation recapture is considered only to the extent that a gain is recognized on the exchange or conversion.
- **h.** Any depreciation recapture resulting from an installment sale is to be recognized in the year of sale even if no proceeds are received.

4320.12 Section 1250 property rules:

- **a.** IRC Section 1250 applies to real property—buildings and their structural components.
- **b.** IRC Section 1250 requires that excess depreciation (actual depreciation in excess of straight-line depreciation) be recaptured as ordinary income. However, this provision no longer applies since straight-line depreciation has been required on buildings acquired after 1986. Thus, there is no excess depreciation, and all of the depreciation is "unrecaptured."
- **c.** The unrecaptured gain on the sale of a building becomes IRC Section 1231 gain. If Section 1231 gains exceed Section 1231 losses for the current and past five years, the remaining gain receives long-term capital gain treatment. However, unrecaptured Section 1250 gain may be taxed at a special rate of 25%.
    - (1) Unrecaptured Section 1250 gain is equal to the lesser of the gain or the total depreciation taken on the property.

(2) Any gain not treated as unrecaptured Section 1250 gain (excess of sales price over cost before depreciation) is taxed at the long-term capital gain rate applicable to the transaction based on the taxpayer's tax bracket.

Example: A commercial building acquired at a cost of $2,028,000 was sold in 2020 for $3 million after deducting straight-line depreciation of $650,000 over the years. Assuming that no other Section 1231 events affect this transaction, the taxation of the $1,622,000 gain is as follows.

Because straight-line depreciation was used, no depreciation is recaptured as ordinary income. Consequently, there is unrecaptured Section 1250 gain of $650,000. This portion of the gain is taxed at 25%. The remaining gain of $972,000 is taxed at 20%, assuming the taxpayer is an individual with taxable income in excess of $434,550.

Amount realized		$3,000,000
Less: Adjusted basis		
Cost	$2,028,000	
Less: Straight-line depreciation	(650,000)	(1,378,000)
Realized gain		$1,622,000
Recognized gain:		
As ordinary income		$ 0
As unrecaptured Section 1250 gain taxed at 25% rate		650,000
As Section 1231 long-term capital gain taxed at 20% rate		972,000
Total recognized gain		$1,622,000

d. Additional rule for C corporations (IRC Section 291):

(1) A C corporation's ordinary income from the sale of IRC Section 1250 real property will be increased by 20% of the lesser of (1) depreciation taken or (2) the recognized gain.

Example: Over the years, $30,000 of straight-line depreciation was taken on a building costing $100,000. If this property is sold for $110,000, a gain of $40,000 results ($110,000 – ($100,000 – $30,000)). The corporation must recognize $6,000 ($30,000 × 20%) of this gain as ordinary income under IRC Section 291.

Amount realized		$110,000
Less: Adjusted basis		
Cost	$100,000	
Less: Straight-line depreciation	(30,000)	(70,000)
Realized gain		$ 40,000
Recognized gain:		
As ordinary income, Section 291:		
Lesser of: $30,000 × 0.20 = $6,000		
or $40,000 × 0.20 = $8,000		$ 6,000
As Section 1231 long-term capital gain		34,000
Total recognized gain		$ 40,000

(2) This provision does not affect Subchapter S corporations.

4330 Estate and Gift Taxation

4331 Transfers Subject to the Gift Tax

4331.01 The gift tax is levied against the donor on the fair market value of all taxable gifts made in each calendar year. The gift tax is an excise tax levied on the transfer of property where less than adequate and full consideration was received.

4331.02 A gift tax return is required by each donor who makes gifts of a present interest in property, when the total value of such gifts to any one donee exceeds $15,000 during 2020. That annual limit is periodically adjusted for inflation.

- **a.** Any gift of a future interest in property must be reported on a gift tax return.
- **b.** A present interest is the unrestricted right to deal with the property as the donee's own.
- **c.** The gift tax return (IRS Form 709) is filed on a calendar-year basis, and the due date for filing the return and paying the tax is April 15.
- **d.** Gifts in excess of $15,000 to a qualified charity do not require a gift tax return if the donor's entire interest in the property was transferred.
- **e.** There is an exception to the **present interest** rule. A transfer for the benefit of a person who has **not** attained age 21 is considered a gift of a present interest if **all** of the following conditions are satisfied:
  - (1) **Both** the **property** and its **income** may be spent by or for the benefit of the minor before she or he reaches 21 years old.
  - (2) Any portion of the property or its income not expended for the minor before reaching 21 years of age must go to the minor at 21 years of age.
  - (3) If the minor dies before reaching 21 years of age, the property and its income must be payable to the minor's estate or as the minor directs (under a "general power of appointment").

4331.03 The gift tax formula for 2020 is as follows:

	Gross gifts for the current period
–	Deductions
=	Taxable gifts for the current period
+	Taxable gifts from prior periods
=	Total taxable gifts by the donor
×	Unified tax rate
=	Gift tax on total gifts
–	Gift tax computed on prior gifts using the unified tax rate
=	Tentative tax on current gifts
–	Applicable credit
=	Tax due on gifts of the current period

4331.04 A lifetime exemption of $11,580,000 is available for gifts in excess of the annual exclusion in 2020.

4331.05 If, upon the creation of a trust, a transferor retains the right to revoke the trust, then a gift has not occurred.

4332 Annual Exclusion and Gift Tax Deductions

4332.01 Gross gifts:

a. Gross gifts include only the fair market value of gifts made to a donee in excess of $15,000 during the year due to the annual exclusion.

b. Exclusions:

(1) Although the first $15,000 of gifts made to each donee in each calendar year is excluded in determining the amount of gross gifts for the year, gifts of future interest are not covered by the $15,000 exclusion and must be included in gross gifts in their entirety.

(2) The following payments are not subject to the federal gift tax:

(a) Tuition payments made to an educational organization on another's behalf

(b) Medical care payments for the health care of another person; payments must be made directly to the care provider

(c) Transfers to political organizations

4332.02 Gift splitting:

a. Gift splitting may be used by married taxpayers to reduce the amount of property subject to the gift tax. This technique reduces the total amount of gift taxes payable.

b. The donor's spouse may elect to treat the donor's gift as though the gift was made one-half by each.

c. Each spouse will then apply the $15,000 annual exclusion to the gifts made to each donee, enabling a total of $30,000 to be excluded from gift tax.

d. Each spouse will also apply the gift tax applicable credit, or that portion of it that still remains available, against the gift tax liability.

e. Since each taxpayer must compute the gift tax individually (a joint return for gift taxes is not permissible), the half of the gift reported by each spouse will be taxed in a lower tax bracket than would be the case if the entire gift were credited to one spouse.

4332.03 Deductions from gross gifts:

a. Charitable deduction: An unlimited deduction is available for charitable contributions where the value of such contributions has been included in gross gifts.

b. Marital deduction: An unlimited deduction is available for all property given to a spouse. No deduction is allowed, however, where the interest given to the spouse is terminable.

4333 Determination of Taxable Estate

4333.01 The estate tax is imposed on the estate of the decedent rather than on the beneficiaries. Consequently, the executor of the decedent's estate is generally responsible for the payment of the tax.

4333.02 Generally, an IRS Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* must be filed and the tax paid within nine months after the death of the decedent, if a tax return is required. With the passage of the Tax Relief Act of 2010, the federal estate tax was reinstated with a higher exemption ($11,580,000 in 2020). Under the Tax Cuts and Jobs Act of 2017, the top rate is 40%. It is possible to secure an extension for filing the return, but all tax due must be paid within nine months of death.

For a discussion of the executor's responsibility for filing a return to assure preservation of an election ("portability") to preserve any unused exemption of the first spouse to die, see section **4333.18.**

4333.03 The estate tax formula is as follows:

	Gross estate
–	Deductions:
	Funeral expenses
	Administration expenses
	Debts of the decedent
	Casualty losses
	Charitable bequests (unlimited)
	Marital deduction (unlimited)
=	Taxable estate
+	Post-1976 taxable gifts
=	Total post-1976 transfers
×	Unified tax rate
=	Unified tax on total post-1976 transfers
–	Unified tax previously paid on post-1976 gifts
=	Tentative estate tax
–	Applicable credit
–	Other credits
=	Estate tax

4333.04 **Gross estate:**

a. The gross estate includes all property, regardless of location, in which the decedent had an interest at the time of death. The taxable estate of nonresident aliens is limited to property situated within the United States.

b. The value of property included in the decedent's gross estate is generally the fair market value of such property at the date of the decedent's death.

(1) The executor of the estate may elect an alternate valuation date that is six months after the date of the decedent's death if this election reduces both the gross estate and the federal estate tax liability.

(2) If the alternate valuation date is elected and the property is distributed during this six-month period, the property is valued at its fair market value at the date of distribution.

c. Examples of properties included in the gross estate:

(1) Joint ownerships:

(a) Husbands/wives: A spouse's estate should include the following:

i. One-half of community property

ii. One-half of property held by spouses in joint tenancy or tenancy by the entirety

(b) Tenants in common: Include only the decedent's share of property.

(c) Joint tenants (other than spouses): Include only that portion of the property that reflects the decedent's contribution to the total cost of the property.

(2) Lifetime transfers of property by the decedent where certain privileges were retained:

(a) Transfers with a retained life estate

(b) Transfers with the power to alter, amend, revoke, or terminate the transfer

(3) Properties in which the decedent possessed a general power of appointment—special powers of appointment are not included.

(4) Life insurance proceeds payable to the estate and proceeds from policies in which the decedent possessed any of the incidents of ownership: power to change beneficiaries, revoke an assignment, cancel the policy, or pledge the policy for a loan

(5) Income earned by the decedent at the time of death

(6) Gift taxes paid on gifts made within three years of death

4333.05 Deductions from the gross estate:

a. The following items may be deducted from the gross estate:

(1) Funeral expenses

(2) Expenses incurred in the administration of the decedent's estate

(3) Debts of the decedent

(4) Casualty and theft losses occurring during the period of administration

(5) Charitable bequests (These *must* have been specified by the decedent.)

(6) The value of all property left outright to the surviving spouse (marital deduction) but not property with a terminable interest

(7) State death taxes

b. The resulting taxable estate is then subject to taxation under the unified gift and estate tax rate schedule.

4333.06 Estate tax structure:

a. The taxable estate must be combined with taxable gifts made after 1976 to determine total life and death transfers made after 1976.

b. The unified transfer tax is computed on the total of these transfers.

c. This unified transfer tax is then reduced by any taxes previously paid on post-1976 gifts.

d. The applicable tax credit is used to offset the remaining tax.

e. Other tax credits may also be available.

4333.07 Estate tax credits:

a. **Applicable credit:** Each estate is allowed an applicable unified tax credit of $4,577,800 against the estate tax liability for 2020. This represents an exemption of $11.58 million of property from estate taxes in 2020.

b. **Tax on prior transfers:** When property included in the decedent's estate was taxed in the estate of a person who died within 10 years of the death of the decedent, all or part of the estate tax paid by the prior estate will be allowed as a credit against the decedent's estate tax liability.

c. **Foreign death taxes:** A limited credit is available to U.S. citizens and residents for death taxes paid to foreign countries.

d. **Gift taxes:** A limited credit is allowed for gift taxes that have been paid on any property that is included in the donor-decedent's gross estate.

4333.08 Generation-skipping transfer tax:

a. Taxpayers frequently create life interests in assets for members of one generation, with remainder interests reserved for members of subsequent generations.

(1) When the first-generation heir dies, none of the property is included in that person's estate. The estate tax on one generation of beneficiaries is avoided.

(2) Consequently, the law imposes an additional generation-skipping transfer tax (GSTT) when one generation is bypassed in favor of the later generation.

b. The GSTT can apply to transfers by gift or by death.

(1) The GSTT does not use the graduated rate structure for gift and estate taxes. Instead, generation-skipping transfers are taxed at a flat rate of 40%.

(2) Each grantor is entitled to a $11,580,000 lifetime exclusion, adjusted annually for inflation, that can be allocated to whichever generation-skipping transfers the grantor chooses. Gift splitting applies. Thus, a married couple in 2020 has a $23,160,000 exemption to work with.

4333.09 Basis consistency rule:

On July 31, 2015, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act) was signed into law. The Act was primarily designed as a temporary extension of the Highway Trust Fund. However, in the fine print of the Act, several tax law changes to help generate revenue to fund federal infrastructure projects until a long-term bill is passed were included. One of those changes addresses the basis of property acquired by reason of death.

a. The basis of property received by reason of death under IRC Section 1014 (i.e., by inheritance) must equal the value of that property for estate tax purposes—fair market value at death or six months after death (alternative date).

b. The basis consistency rule only applies to a property whose inclusion in the decedent's estate increased the liability for the tax imposed by Chapter 11 of U.S. Code Title 26 (*Estate Tax*) (reduced by credits allowable against such tax) on the estate.

c. For purposes of IRC Section 1014, the basis of property has been determined for purposes of the estate tax imposed by Chapter 11 if:

(1) the value of such property is shown on a return required under IRC Section 6018 and that value is not contested by IRS before the expiration of the time for assessing a tax under the estate tax rules;

(2) in a case not described in (1), above, the value is specified by the IRS and that value is not timely contested by the executor of the estate; or

(3) the value is determined by a court or pursuant to a settlement agreement with the IRS.

d. A special rule applies when the estate includes appreciated property that the decedent acquired by gift within one year of death, and after the decedent's death, the property passes back to the donor (or the donor's spouse). In this situation, the property's basis to the donor will be its adjusted basis in the hands of the decedent immediately before death.

4333.10 **Executor's responsibilities:** Executors of an estate have many responsibilities, encompassing, at a minimum, the following, after filing IRS Form 56, *Notice Concerning Fiduciary Relationship*:

(a) Execute the decedent's final wishes.

(b) Offer the will for probate.

(c) Distribute property to beneficiaries.

(d) Pay taxes and debts of the estate.

(e) Prepare a final accounting of the estate.

(f) Prepare and file an income tax return (IRS Form 1041) if the estate has taxable income during administration.

(g) Prepare and file an estate tax return (IRS Form 706).

Marital Deduction

4333.11 In computing the gift tax, an unlimited marital deduction is available for gifts made to the donor's spouse. Therefore, a donor can generally transfer an unlimited amount of gifts to a spouse free of the gift tax.

4333.12 For the gift tax marital deduction to apply, the spouse must be a U.S. citizen at the time of the gift.

4333.13 A gift tax marital deduction does not apply to a transfer of a terminable interest in property. A terminable interest is one that will terminate on a lapse of time or on the occurrence, or failure to occur of a contingency.

4333.14 An unlimited marital deduction is also allowed against the estate tax. For this deduction to apply:

a. the decedent must be married and survived by their spouse,

b. the spouse must be a U.S. citizen,

c. the property must be included in the decedent's gross estate and pass to the surviving spouse, and

d. the spouse's interest in the property must not be a terminable interest.

Unified Credit

4333.15 The unified credit is a credit that allows donors and decedents to transfer a limited amount of property without being subject to the gift or estate tax. To calculate the unified credit, first start with the gift/estate lifetime *exclusion* amount, which is $11.58 million for 2020 (the annual exclusion is $15,000).

4333.16 Once the lifetime exclusion amount is determined, the amount of the unified credit for estates can be determined by running it through the estate tax brackets. For 2020, the unified credit is $4,577,800. In other words, this credit offsets the tax due on the first $11,580,000 transferred by gift or through the estate; anything additional above that is taxed at 40%.

4333.17 For 2020, the exclusion amount for the gift tax is $11,580,000 and the basic exclusion amount for the estate tax is also $11,580,000. This is the maximum amount subject to either/or gift and estate taxes and represents the amount of property that a taxpayer may transfer free of either gift or estate tax. Gift tax paid on taxable gifts given during the taxpayer's lifetime reduces the applicable credit against the estate tax.

Portability

4333.18 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 contains a provision that will allow the unused portion of a decedent's exclusion (taxable estate protected by the unified credit) to be used upon the subsequent death of the surviving spouse.

- **a.** An election is required to take advantage of that provision, called a "portability election."
- **b.** The election is made with a timely filed IRS Form 706 (*United States Estate (and Generation-Skipping Transfer) Tax Return).*
- **c.** The American Taxpayer Relief Act of 2012 extended the portability election indefinitely. The amount of taxable estate protected by the exclusion is $11.58 million in 2020.
- **d.** The executor or personal representative must assure the filing of IRS Form 706 (*United States Estate (and Generation-Skipping Transfer) Tax Return*) for the decedent's estate in order to assure that portability will be available, even if filing that form is not otherwise required by taxability of the estate.

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Section 4400
Federal Taxation of Individuals
(15% - 25%)

4405 Tax Planning

Alternative Treatments

4405.01 When engaging in tax planning, the tax practitioner researches the tax consequences of various potential courses of action.

4405.02 In certain situations, conflicting sources of tax authority may be found. If this is the case, there should be a thorough analysis of the alternative tax treatments that could result.

4405.03 Alternative tax outcomes should be communicated to the taxpayer so that they can make a fully informed decision as to the course of action they wish to take.

4405.04 The AICPA Statements on Standards for Tax Services (SSTS) and Treasury Circular 230 provide guidance on the CPA's ethical responsibilities with regard to both the advice that might be given to a taxpayer and the manner in which any advice should be communicated.

Projections of Tax Consequences

4405.05 Part of the tax planning process is developing alternative courses of action for the taxpayer. As potential courses of action are developed, the tax planner also develops projections of the tax consequences that will result from each option. As a result, the taxpayer can make an informed decision as to the option that will provide them with the optimal after-tax result.

Impact of Proposed Tax Audit Adjustments

4405.06 It is important to factor the impact of proposed tax audit adjustments into the tax planning process. If a taxpayer follows a particular course of action, is audited, and audit adjustments result, this will generally result in additional costs to the taxpayer. Not only will the taxpayer be liable for the back taxes due, but they also will be liable for interest on the tax deficiency. Additionally, the taxpayer may be liable for penalties.

4405.07 A major part of tax planning is to be sure that any course of action taken by the taxpayer can be justified if the taxpayer is audited and adjustments are proposed. Planning for any potential IRS challenges to the position taken by the taxpayer will minimize the impact of any potential tax audit adjustments.

Impact of Estimated Tax Payment Rules on Planning

4405.08 Part of the tax planning process is determining the tax liability that will result for the taxpayer from various courses of action. This is especially important for the particular course of action that is actually chosen by the taxpayer.

4405.09 By properly projecting the tax liability that will be due, the appropriate estimated tax payments that will be due throughout the tax year can be calculated. This will allow the taxpayer to plan ahead to be sure that the resources are available to make the required estimated tax payments. This in turn will allow the taxpayer to avoid the imposition of any penalties that could result from the failure to pay the correct amount of estimated tax as the payments come due throughout the year.

Role of Taxes in Decision Making

4405.10 In the decision-making process, the role of taxes should play a significant part. Whether the decision is being made in a personal or business context, one of the goals of tax planning should be to minimize the taxpayer's tax liability as much as possible. However, the ultimate goal should be to optimize the taxpayer's after-tax result. This may not in all cases result in the lowest tax liability for the taxpayer.

4405.11 In making decisions, taxes should be a factor, but not the only factor. In certain cases, nontax considerations may be as important, or more important, than the tax considerations. Therefore, in decision making, all factors, tax and nontax, should be considered. Generally, no decision should be made based on the tax considerations alone if the personal or business considerations involved would point to not making the same decision.

4405.12 Joint vs. separate returns

a. At the time of filing their tax return(s), a husband and wife can elect to file as married filling joint or married filing separate.

b. A husband and wife may elect to file a joint return even though one spouse has no income, deductions, or credits.

c. If a husband and wife elect the married filing separate status, both the husband and wife must itemize their deductions or both must take the standard deduction. In other words, one spouse cannot itemize deductions while the other spouse takes the standard deduction.

4405.13 Accounting period

Every taxpayer must figure taxable income for an annual accounting period called a tax year. A tax year is an annual accounting period for keeping records and reporting income and expenses.

a. The calendar year is the most common tax year and consists of 12 consecutive months beginning on January 1 and ending on December 31. Generally, anyone can adopt the calendar year. However, a calendar year must be adopted if no books or records are maintained or the individual has no annual accounting period.

b. A fiscal year is 12 consecutive months ending on the last day of any month except December 31.

c. A 52/53-week tax year is a fiscal year that varies from 52 to 53 weeks but may not end on the last day of a month; it must always end on the same day of the week. That is, the 52/53-week tax year must always end on:

(1) whatever date this same day of the week last occurs in a calendar month or

(2) whatever date this same day of the week falls that is nearest to the last day of the calendar month.

d. A tax year is adopted by filing the first income tax return using that tax year. A tax year *cannot* be adopted by:

(1) filing an application for an extension of time to file an income tax return,

(2) filing an application for an employer identification number (IRS Form SS-4), or

(3) paying estimated taxes.

4405.14 Accounting method

Each taxpayer must use a consistent accounting method, which is a set of rules for determining when to report income and expenses. The most commonly used accounting methods are the cash method and the accrual method.

a. Under the cash method, income is generally reported in the tax year it is received and expenses are deducted in the tax year in which they are paid.

b. Under the accrual method, income is generally reported in the tax year it is earned regardless of when payment is received. Expenses are deducted in the tax year incurred regardless of when payment is made.

4405.15 Change in filing status

If an individual files the first tax return using the calendar tax year and later begins business as a sole proprietor, becomes a partner in a partnership, or becomes a shareholder in an S corporation, they must continue to use the calendar year unless they obtain approval from the IRS to change it, or are otherwise allowed to change it without IRS approval.

4410 Gross Income

4411 Inclusions and Exclusions

4411.01 **Gross income** is all income from whatever source, except for those items that are specifically excluded by the Internal Revenue Code.

a. Gains are included in gross income in the year in which the gain is realized as determined by the taxpayer's accounting method (cash or accrual basis).

(1) Cash-basis taxpayers report income when they actually or constructively receive cash or property.

(2) Taxpayers using the accrual method of accounting report income in the year when the right to the income becomes fixed and the amount can be determined with reasonable accuracy.

(a) If reported income is properly accrued on the basis of a reasonable estimate and, in a subsequent year, the exact amount is higher than estimated, the difference is reported as income in the year that such a determination is made.

(b) An amended return is not required.

b. Income received in advance is generally taxed in the year in which it is received, even though the accrual basis is used.

c. Mere appreciation in the value of property is **not** considered income. The property must be converted into cash or other property before a gain is realized.

4411.02 In computing gross income, the taxpayer faces two problems:

1. Recognizing potential income items

2. Identifying those income items specifically excluded by law

4411.03 Health insurance costs:

a. Self-employed taxpayers may deduct 100% of the medical insurance premiums paid for themselves and their families. Included are premiums for certain long-term care insurance contracts. This deduction cannot exceed the net earnings from the business. IRC Section 213(d)(10)(A) provides for limitations on the amount of eligible long-term care insurance premium deduction allowed per person based on age at the end of the year.

b. No deduction is available to those self-employed taxpayers who are eligible to participate in an employer's subsidized health insurance program. The employer may be the employer of the taxpayer or the spouse.

c. The remainder of the medical insurance premiums is available as an itemized medical expense deduction, subject to a special limitation.

d. Taxpayers who are not otherwise covered by health insurance may choose to establish a health savings account (HSA). Contributions to such accounts are fully deductible if the account meets a number of requirements and limitations. HSA accounts can operate in concert with high-deductible health plans, and allowable limits and contributions change annually.

e. For 2020, HSA contribution limits are $3,550 for an individual and $7,100 for a family. If you are 55 or older, you can contribute an extra $1,000 per year.

f. The term "high-deductible health plan" means, for self-only coverage, a health plan that has an annual deductible that is not less than $1,400 ($2,800 for a family) and under which the annual out-of-pocket expenses required to be paid for covered benefits do not exceed $6,900 ($13,800 for a family).

4411.04 Military combat pay:

a. U.S. Armed Forces members, including enlisted persons or warrant officers, may exclude military pay received for military services for the entire month of any month while serving in a combat zone. Commissioned officers are capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received.

b. Military pay received by enlisted personnel who are hospitalized as a result of injuries sustained while serving in a combat zone is excluded from gross income for the period of hospitalization.

c. Reenlistment bonuses received are excluded from gross income if the member reenlists early while in a combat zone even if the bonus is not received until several months later while stationed outside the combat zone.

d. Deadlines, including filing and paying income tax due, are automatically extended for service persons in a combat zone.

4411.05 Retirement plan benefits:

Roth IRAs

a. Distributions from a qualified Roth IRA will be tax-free and penalty-free if the distributions are made:

(1) five years or more after the first contribution was made, and

(2) on or after the date the taxpayer attains age 59-1/2, or

(3) to a beneficiary as a result of the taxpayer's death, or

(4) on account of the taxpayer's disability, or

(5) for first-time homebuyer expenses ($10,000 limit), or

(6) for a qualified birth or adoption ($5,000 limit per individual or $10,000 limit for married couples filing a joint return), or

(7) for coronavirus-related distributions made after January 1, 2020 ($100,000 limit). A coronavirus-related distribution must meet one of the following criteria:

(a) Made to an individual who is diagnosed with COVID-19

(b) Made to an individual whose spouse or dependent is diagnosed with COVID-19

(c) Made to an individual who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19, or other factors as determined by the Treasury Secretary

b. When distributions do not meet the criteria, amounts received in excess of contributions will be included in gross income and taxed. A 10% early withdrawal penalty will also apply to the taxable amount. Note that contributions are returned before any earnings are distributed with a Roth IRA.

c. Setting up a Roth IRA:

(1) For 2020, taxpayers who qualify may make nondeductible contributions of up to $6,000 each year to a Roth IRA. A qualifying taxpayer over age 50 may add $1,000 to that amount for a total contribution of $7,000. That $1,000 is referred to as a "catch-up amount."

(2) There is no age limit on contributions to a Roth IRA.

(3) Distributions before death are not required.

(4) Contribution limits (covered by a retirement plan at work):

(a) The 2020 contribution limit of $6,000 ($7,000) is phased out proportionately between the following AGI levels:

i. Singles and head of households: $124,000–$139,000

ii. Joint filers: $196,000–$206,000

iii. For 2020, for a married individual filing a separate return, the phaseout is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

(b) For 2020, the limit for total contributions to Roth IRAs and traditional IRAs combined is $6,000 ($7,000) (before phaseouts), not counting rollover contributions.

d. Rollover contributions:

(1) Funds in one Roth IRA can be rolled over tax-free to another Roth IRA.

(2) Funds in a traditional IRA can be rolled over penalty tax-free to a Roth IRA, but income tax must be paid on the distribution from the traditional IRA. However, the rollover is tax-free only if the taxpayer is not married filing a separate return.

(3) Before the Tax Cuts and Jobs Act of 2017 (TCJA), it was possible to recharacterize a contribution to a traditional IRA to a Roth IRA (and the reverse) by trustee-to-

trustee transfer. Under the TCJA, the tax-free conversion from a traditional IRA to a Roth IRA is repealed.

Retirement plans

e. Self-employed persons may deduct up to $57,000 in 2020 for contributions to a qualified retirement plan (Keogh plan). Simplified employee pension (SEP) IRAs have similar limits and have replaced the Keogh plan among all but high-income professionals who established Keogh plans over a decade ago.

(1) For 2020, the deduction cannot exceed 25% of earned income.

(2) Earned income is income after the retirement contribution has been deducted.

(3) Additional earnings may be transferred to a Keogh plan (but not to a SEP IRA) with no resulting tax deduction (after tax).

f. For 2020, taxpayers may contribute (and deduct) up to $6,000 ($7,000 if over age 50) to a traditional individual retirement account (IRA), and this may equal up to 100% of their earned income. Included as acceptable investments are coins and bullion of gold, silver, and platinum, but not collectibles (e.g., stamps and antiques).

(1) For plans established to include a nonworking spouse, the deduction ceiling of $6,000 ($7,000 if over age 50) applies to each spouse, permitting a total of $12,000 to be deducted from their joint taxable income ($14,000 if both are age 50 or over). However, the contribution cannot exceed the sum of their earned incomes.

(2) Alimony, if included in income, is treated as compensation for purposes of calculating allowable contributions to an IRA.

(3) Taxpayers who are active participants in an employer-sponsored retirement plan or Keogh plan face an IRA deduction phaseout.

(a) For 2020, the phaseout takes place when AGI falls within these ranges:

		2020 MAGI
i.	Single taxpayers and Heads of household	$65,000–$ 75,000
ii.	Married filing jointly	$104,000–$124,000
iii.	Married filing separately	$ 0–$ 10,000

(b) One spouse's active participation in an employer-sponsored plan will not disqualify the other spouse from making deductible IRA contributions.

(c) The maximum $6,000/$12,000 IRA deduction is phased out proportionately for each dollar of AGI that falls within the phaseout range.

(d) Taxpayers with AGI above the phaseout range may still contribute up to $6,000/$12,000 to an IRA.

i. These contributions will be *nondeductible.*

ii. The earnings on such contributions will be tax-free until withdrawals are made from the IRA.

iii. This program continues as an option to the Roth IRA.

(e) The limit for total contributions to all retirement IRAs combined is $6,000, before phaseouts, for each individual. This amount increases by $1,000 if "catch-up" contributions are involved.

(4) There is no maximum age for traditional IRA contributions in tax years after 2019.

(5) **Qualified charitable distributions (QCD)**: Taxpayers who are over age 70-1/2 are permitted to make a "qualified charitable distribution" of up to $100,000 *directly* from an IRA to a charity.

(a) The contribution to the charity is not claimed as a tax deduction; the age for QCDs remains 70-1/2 (even as the required minimum distribution age rises to 72).

(b) The QCD counts toward the taxpayer's required minimum distribution (RMD) obligations.

(c) QCDs are deemed to be first in the order of distributions, from any untaxed gain in the IRA, so that the QCD does not reduce the taxpayer's basis. This allows future distributions to the taxpayer to be tax-free to the extent there is basis in the IRA.

(d) Beginning in 2020, QCDs are reduced by the aggregate deductible IRA contributions made by an individual age 70-1/2 and older in an effort to curb potential abuse.

(e) The PATH Act of 2015 made the QCD rules permanent, at their existing levels and thresholds (still capped at $100,000 per taxpayer, and the taxpayer must still be over age 70-1/2 at the time of the distribution).

(6) Taxation of distributions:

(a) Distributions from a traditional IRA are generally taxable. However, taxpayers making nondeductible contributions to their accounts may withdraw these contributions tax-free using the rules for annuity proceeds.

(b) Taxpayers receiving distributions before age 59-1/2 are subject to an additional 10% penalty on the taxable portion of the distribution. This penalty will not apply when the distribution is as follows:

i. Due to a death or disability

ii. Used to pay deductible medical expenses

iii. Used by an unemployed person to buy health insurance

iv. Used to pay qualified higher education expenses

v. Used to pay expenses of a qualified first-time homebuyer

a. There is a $10,000 lifetime limit.

b. A first-time homebuyer is one who has not owned a principal residence in the past two years.

vi. Used to pay for a qualified birth or adoption: There is a $5,000 limit per individual or $10,000 limit for married couples filing a joint return.

vii. Used for coronavirus-related distributions made after January 1, 2020 ($100,000 limit). A coronavirus-related distribution must meet one of the following criteria:

a. Made to an individual who is diagnosed with COVID-19

b. Made to an individual whose spouse or dependent is diagnosed with COVID-19

c. Made to an individual who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19, or other factors as determined by the Treasury Secretary

(c) Taxpayers must start withdrawing IRA funds no later than April 1 of the year after turning age 72. Required minimum distributions (RMD) must be taken annually. However, if the taxpayer turned 70-1/2 in 2019, the taxpayer will need to follow the old laws that require earlier RMDs. If there are no distributions, or if the distributions do not equal or exceed the minimum required distribution amount, the taxpayer incurs a 50% excise tax on the amount not distributed as required.

(d) Congress recognized the impact of COVID-19 on the economy. As a result, the CARES (Coronavirus Aid, Relief, and Economic Security) Act, signed into law on March 27, 2020, temporarily waived the RMD rules. Individuals were not required to take any RMDs in calendar year 2020.

g. SIMPLE retirement plan for small businesses:

(1) **The Savings Incentive Match Plan for Employees (SIMPLE)** simplifies complexities of retirement plans.

(a) The amount an employee contributes from his or her salary to a SIMPLE IRA cannot exceed 13,500 in 2020. See *(c)* below regarding an additional $3,000 contribution permitted for employees age 50 or over.

(b) If an employee participates in any other employer plan during the year and has elective salary reductions under those plans, the total amount of the salary reduction contributions that an employee can make to all the plans he or she participates in is limited to $19,500 in 2020.

(c) If permitted by the SIMPLE IRA plan, participants who are age 50 or over at the end of the calendar year can also make catch-up contributions. The catch-up contribution limit for SIMPLE IRA plans is $3,000 in 2020.

(2) SIMPLE plans can be adopted by employers having 100 or fewer employees.

(a) The employee must not be part of another employer-sponsored retirement plan.

(b) All contributions are fully vested immediately.

(c) Employee contributions are deductible for AGI, and taxation on accumulations is deferred until distributed.

(3) **Caution:** Distributions before age 59-1/2 are subject to an additional tax of 10% (25% if taken during the two-year period beginning on the date the individual first participated in any SIMPLE IRA plan of the employer). Exceptions include distributions for the following:

(a) Death

(b) Disability

(c) Deductible medical expenses

(d) Health insurance of an unemployed individual

(e) Qualified higher education expenses:

i. includes tuition, fees, books, supplies, equipment, and room and board for postsecondary education (includes graduate-level courses),

ii. applies to taxpayer, spouse, children, and grandchildren, and

iii. expenses are reduced by scholarships and similar excludible funding.

(f) First-time homebuyer expenses ($10,000 limit)

(g) Qualified birth or adoption ($5,000 limit per individual or $10,000 limit for married couples filing a joint return)

(h) For coronavirus-related distributions made after January 1, 2020, and before December 31, 2020 ($100,000 limit). A coronavirus-related distribution must meet one of the following criteria:

i. Made to an individual who is diagnosed with COVID-19

ii. Made to an individual whose spouse or dependent is diagnosed with COVID-19

iii. Made to an individual who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19, or other factors as determined by the Treasury Secretary

4412 Characterization of Income

4412.01 A complete list of potential income items and exclusions is impossible. Many items can only be identified as includible or excludible after the facts of the individual case have been examined. This portion of the tax review lists selected items that are frequently encountered.

4412.02 Alimony and separate maintenance payments:

Note: The Tax Cuts and Jobs Act of 2017 (TCJA) changes the treatment of alimony and separate maintenance payments negotiated **after** December 31, 2018. (See *(f)* below.)

a. Excluding the portion that is designated for child support, "qualified payments" are included in the gross income of the recipient and deductible from gross income by the payor if the payments are made after:

(1) decree of divorce or separate maintenance,

(2) written separation agreement, or

(3) decree for support (this applies to periods pending finality of divorce or legal separation).

b. "Qualified payments" (pursuant to a divorce decree or separate maintenance agreement in force before December 31, 2018) are required to meet the following guidelines:

(1) Payments must be in cash.

(2) Payments must terminate at the death of the recipient.

(3) Payments cannot be made to a payee who lives in the same household as the payor.

(4) Payments cannot be specified as something other than alimony.

c. Special rules apply if alimony payments in the second or third year decrease by more than $15,000 from the payments made in the previous year.

(1) If the change in payments exceeds statutory limits, recapture of excessive alimony payments will result.

(2) All of the recapture will take place in the third year.

(a) The payor must include the excess amounts in gross income.

(b) The payee is allowed to deduct the excess payments from gross income to arrive at adjusted gross income.

d. Any amount that can be identified as *child support* cannot be treated as alimony.

(1) Child support payments are neither deductible by the payor nor income to the recipient.

(2) If both child support and alimony are provided for in the agreement, any amounts paid are first considered to be child support until that obligation is met.

e. The transfer of property between divorcing spouses in exchange for release from marital obligations is nontaxable. The basis of the transferred property to the transferee will be the same as it was to the transferor.

f. Noncash property settlements, payments used to keep up the payer's property, or use of the payer's property are **not** considered alimony.

g. For any divorce or separation agreement executed after December 31, 2018 (*not* 2017), or executed before that date but modified after it (if the modification expressly provides that the new amendment applies), alimony and separate maintenance payments are not deductible by the payor spouse nor includible in income of the payee spouse.

4412.03 Annuity proceeds:

a. The taxpayer may exclude from income the portion of any annuity proceeds that represents the recovery of the taxpayer's previously taxed investment. Excess proceeds are included in gross income.

b. To determine the portion of annuity proceeds that is excluded from gross income, an exclusion ratio is applied against the amount received:

$$\frac{\text{Taxpayer's investment in contract}}{\text{Total expected return on contract}} \times \text{Amount received}$$

(1) Life expectancy tables (annuity tables) are used to compute the expected return on the contract.

(2) The exclusion ratio, once computed, does not change. It is used each year until the taxpayer's total investment in the annuity is recovered. Additional receipts are fully taxed.

c. For qualified retirement plan annuities, a different procedure applies:

$$\frac{\text{Taxpayer's investment in contract}}{\text{Number of anticipated monthly payments}} = \text{Amount excluded}$$

(1) The number of anticipated monthly payments is determined from the following table:

Age of Annuitant on Annuity Starting Date	Number of Anticipated Monthly Payments
55 and under	360
56-60	310
61-65	260
66-70	210
71 and over	160

(2) The number of payments requires adjustment when the annuity payments are not made on a monthly basis. For example, if the number of payments is fixed, the number of payments becomes the denominator.

d. In *b.* and *c.* above, the "taxpayer's investment" includes only nondeductible (fully taxed) amounts invested.

e. If the annuitant dies before the total investment is recovered, the remaining investment is deductible as an itemized deduction on the decedent's final return.

4412.04 Bargain purchase:

a. Property purchased at a cost less than market value by an employee or shareholder is a bargain purchase.

b. The difference between fair market value and purchase price may be income to the purchaser at the time of purchase. Any amount included in the taxpayer's income will increase basis in the acquired property.

c. Generally, property purchased by an employee under an employee discount policy does not constitute a bargain purchase. However, certain employee discounts may create income under the bargain purchase provisions.

(1) If the discount is for merchandise, the excludible amount cannot exceed the selling price of the item to the public multiplied by the employer's gross profit percentage.

(2) If the discount is for services, the discount exclusion is limited to 20% of the price at which it is offered to the public.

4412.05 Bequests:

a. The value of property received by bequest, devise, or inheritance is excluded from gross income.

b. Income produced by such property is taxable.

4412.06 Canceled debt:

a. Generally, a canceled debt is income to the debtor when the cancellation is not intended to be a gift.

b. The presence or absence of consideration is a vital factor in determining whether or not a gift was intended.

c. When a seller cancels a buyer's purchase indebtedness, the buyer can generally avoid income recognition by electing to reduce the basis of the property by the amount of the debt discharged.

d. Discharge of indebtedness due to debtor insolvency or federal bankruptcy law is generally not included in gross income but is used instead to reduce the basis of assets or other items carrying favorable tax attributes, such as loss or credit carryovers.

e. For purposes of determining income from forgiveness of indebtedness (canceled debt), debtor insolvency is measured at the time of an "identifiable event." Identifiable events are reported to the debtor in the Form 1099-C, *Cancellation of Debt,* that reports the debt forgiveness amount.

f. A shareholder's cancellation of a corporation's indebtedness is treated as a contribution of capital.

g. Some *states* make loans to students under an agreement that the loan will be canceled if the student works in a certain profession, in a location within the state after graduation.

(1) The canceled debt is excluded from gross income.

(2) This exclusion also applies to loans from tax-exempt charitable organizations. However, the debt cancellation cannot relate to services performed for the lender organization.

(3) The Tax Cuts and Jobs Act of 2017 (TCJA) excludes any income resulting from the discharge of student debt due to death or disability for discharges of student loans after 2017 and before 2026.

4412.07 Child support:

a. Amounts received as child support are not included in income of the recipient.

b. Child support cannot be deducted by the payor but may be used to measure support for a possible dependency exemption under pre-1985 agreements.

4412.08 Childcare facilities:

a. The value of child and dependent care services provided by the employer are excludible up to $5,000 per year ($2,500 for married persons filing separately).

b. The exclusion cannot exceed the taxpayer's earned income or, if married, the earned income of the spouse with the lesser amount of earned income.

4412.09 Damages collected:

a. Compensatory damages received under a suit for physical injury or sickness are excluded from income.

b. Punitive damages and damages for loss of profits are income.

4412.10 Dividends of cash or property:

a. Dividends are distributions of cash or property from corporations to their shareholders. Generally, dividends are taxable when received. However, some distributions may be tax free, depending on a calculation of earnings and profits (E&P) by the distributing corporation. Federal law requires a corporation to inform the shareholder as to taxable and nontaxable amounts.

b. For individuals in 2020 there is a 0% tax on dividends when taxable income is $40,000 or less, a 15% rate for individuals up to $441,550, and a rate of 20% for individuals above that amount. For joint filers, those amounts are $80,000 and $496,600; for heads of household, the amounts are $53,600 and $469,050.

c. For individuals there is an additional 3.8% Medicare contribution tax on the lesser of net investment income or the modified adjusted gross income (MAGI) for the year over a threshold amount. The threshold amount for 2020 is $250,000 for joint returns, $125,000 for married filing separate returns, and $200,000 for other filing status.

d. If the taxpayer has a choice of stock or cash:

(1) any cash received is income.

(2) any stock received is income to the extent of the fair market value of the stock on the date received.

(a) The basis of the new stock is also the fair market value of the stock.

(b) The holding period for the new stock begins on the date the dividend is received.

e. Stock dividends that do not result in a disproportionate distribution are not considered income. Likewise, stock splits do not produce income for the shareholders.

(1) The basis of original shares must be allocated between the new and the original shares.

(2) The holding period of the acquired stock is the same as that of the old stock.

f. Any distribution of stock or stock rights made to preferred shareholders is taxable as a dividend.

(1) The fair market value of the property received constitutes income and establishes the basis of that property.

(2) The holding period for this property begins at the date of receipt.

g. Property received as a dividend is income.

(1) The fair market value of the property on the date of distribution constitutes income.

(2) The basis of the property is also equal to the fair market value.

(3) The holding period of the property acquired begins on the date the property is received.

h. Amounts received in a partial or complete liquidation are treated as follows:

(1) A return of capital *until* the taxpayer's investment is recovered

(2) A capital gain on amounts received after the taxpayer's investment is recovered

4412.11 **Employee death benefit:** Employer payments to the employee's survivors will be taxed unless the payment qualifies as a gift.

4412.12 **Farming income:**

a. The cash-basis farmer includes in gross income all cash receipts and the value of all property received from the sale of livestock and produce raised or bought for resale. Income received from any other source that is related to the farming business is also included.

(1) Crop insurance proceeds may be included in the next year's income if the taxpayer can prove that the destroyed crop's income would have been included in next year's income.

(2) The Tax Cuts and Jobs Act of 2017 (TCJA) reduced the recovery period for any machinery or equipment used in a farming business (other than any grain bin,

cotton ginning asset, fence, or other land improvement) the original use of which begins with the taxpayer and is placed in service after December 31, 2017, from seven years to five years.

The TCJA also repealed the required use of the 150% declining-balance method for property used in a farming business except for any 15- or 20-year property used in the farming business to which the straight-line method does not apply, or to property for which the taxpayer elects the use of the 150% declining-balance method.

(3) Income from sale of a crop should be included in the year the crop is sold. The farmer may have pledged his crop to secure a Commodity Credit Corporation loan; the farmer may then report the crop sold for the loan proceeds in the year the cash is received rather than when the crop is sold to satisfy the loan.

b. Schedule F (IRS Form 1040, *Farm Income and Expenses*) is the schedule that all farmers must file to report their income from agricultural activities. Schedule SE is also needed for the computation of self-employment tax. Other schedules such as related taxable capital gain or loss may apply to farmers as well.

c. The accrual-basis farmer computes gross income from farming as follows:

	Ending inventory of produce and livestock raised or purchased for sale
+	All farming receipts for the year
–	Beginning inventory of the products and livestock held for resale
–	Cost of inventory items purchased during the year
=	Gross income from farming

d. Farming income is taxed the same as income from any other business.

4412.13 Gambling winnings and losses:

a. All gambling winnings are included in gross income.

b. Losses are deductible as an itemized deduction, but only to the extent of winnings. Under the Tax Cuts and Jobs Act of 2017 (TCJA), the law is clarified: for example, an individual's expenses traveling to and from a casino are only deductible to the extent of gambling winnings. That is, there is no separate deduction for expenses incurred in winning the gambling income.

4412.14 Gifts:

a. For 2020, the first $15,000 of gifts to any person is not included in the total amount of taxable gifts made during the year.

b. For 2020, the first $157,000 of gifts to a spouse who is not a U.S. citizen is not included in the total amount of taxable gifts made during the year.

c. For 2020, the "lifetime limit" on gifts not subject to the gift tax is $11.58 million.

d. Income generated by property received as a gift is taxable.

4412.15 Group-term life insurance:

a. When the employer pays the premiums on nondiscriminatory group-term life insurance for its employees, the cost of insurance coverage in excess of $50,000 is considered income to the employee.

b. *Any* amount paid by the employee for the group-term life insurance can be used to reduce this income.

c. A group-term life insurance plan is nondiscriminatory if it benefits 70% or more of all employees and at least 85% of all employees who are participants under the plan are not key employees.

4412.16 Employer contributions to a health savings account:

a. Within limits, employer contributions to an employee's health savings account (HSA) are excluded from the employee's income.

b. Both employer and employee contributions are combined to determine the maximum allowable contribution.

c. Contributions to an HSA are limited:

(1) For 2020, the maximum contribution amount is $3,550 for self-only coverage and $7,100 for family coverage, with an additional $1,000 allowed if age 55 or older.

(2) Employer contributions to an employee's HSA are excluded from income. However, both employer and employee contributions are combined to determine the maximum allowable contribution.

4412.17 Health care flexible spending accounts (FSAs):

a. A taxpayer's employer's plan can allow a $500 carryover balance to the following year for money not used for allowed purposes, or

b. Allow a grace period through March 15 of the following year.

c. For 2020, the dollar limit on amounts an employee may contribute through salary reduction contributions is $2,750 per year.

4412.18 Illness or injury benefits:

a. Benefits received for physical injury and sickness are excluded if received:

(1) under a workers' compensation act,

(2) as compensatory damages from a suit or settlement, or

(3) under self-purchased accident and health insurance.

b. Benefits received under an employer-financed accident and health plan may be exempt from taxation.

(1) Contributions by the employer to accident and health plans for personal injury or sickness are excludible.

(2) Payments received under the plan for medical care and permanent injury are excludible.

(3) Health and accident benefits other than those listed are income to the extent they are attributable to the employer's contribution.

c. A taxpayer who retired on disability must include in income any disability pension received under a plan that is paid for by their employer.

(1) Taxable disability payments are reported as wages until the minimum retirement age is reached. Minimum retirement age generally is the age at which the taxpayer can first receive a pension or annuity if not disabled.

(2) Beginning on the day after the minimum retirement age is reached, payments received are taxable as a pension or annuity.

The taxpayer may be entitled to a tax credit if permanently and totally disabled when they retired.

4412.19 Improvements made by lessee:

a. Generally, the value of improvements made by the lessee is not income to the lessor, and the basis of such improvements to the lessor is $0.

b. If the improvements are made in lieu of rent, improvements are income to the lessor.

(1) The income is recognized in the year improvements are completed.

(2) The market value of the improvements is the amount recognized as income.

(3) The landlord's basis in such improvements is the market value.

4412.20 Income from illegal acts:

a. Income from illegal activities is included in gross income.

b. Legitimate business expenses incurred to produce such income are deductible as a business expense.

c. In the case of illegal drug trafficking, only the cost of goods sold is deductible. No other expenses can be deducted.

4412.21 Interest:

a. Generally, all interest received (or accrued if using the accrual method) or available for withdrawal is taxable.

b. Interest on state and municipal obligations is excluded from gross income.

c. Interest on U.S. savings bonds may be reported in the year accrued or postponed until the year of surrender by a cash-basis taxpayer.

d. Amortization of premiums on taxable bonds is treated as an offset to interest income on bonds acquired after 1987.

e. Imputed interest:

(1) Certain lenders may be required to recognize imputed interest income on loans made below the market rate of interest. That interest rate is referred to as an applicable federal rate (AFR), published by the IRS monthly, and reflects the rate paid by the government on new borrowing. An AFR is stated for demand loans and loans of various terms and maturities.

(2) Imputed interest applies to the following types of below-market loans:

(a) Loans made out of love, affection, or generosity (gift loans)

(b) Loans to employees

(c) Loans to shareholders

(d) Tax avoidance loans

(3) Imputed interest will affect the lender and borrower in the following manner:

(a) The lender must recognize interest income, and the borrower will have interest expense.

(b) The amount of the imputed interest will be considered as a payment from the lender to the borrower. In most situations, this payment will be treated as a gift, as compensation, or as a dividend between the two parties.

(4) Exceptions:

(a) No interest is imputed on gift loans of $10,000 or less between individuals, unless the loan proceeds are used to purchase income-producing property. Employee and shareholder loans of $10,000 or less are also exempt unless tax avoidance is one of the principal purposes of the loan.

(b) Imputed interest cannot exceed the borrower's net investment income on loans of $100,000 or less between individuals.

(c) No interest will be imputed if the borrower's net investment income is $1,000 or less and the loan is not more than $100,000, unless one of the principal purposes of the loan is tax avoidance.

4412.22 Life insurance proceeds:

a. Life insurance proceeds paid by reason of death are not taxed as income (except for a policy received in a transfer for a valuable consideration).

(1) A lump-sum payment of the principal sum is fully excluded from gross income.

(2) The interest portion of any installment payments is taxable.

b. Dividends received on unmatured policies are not taxed unless the amount received exceeds the consideration (premiums) paid.

(1) Dividends received before maturity of the policy are considered as a return of premium.

(2) Dividends collected after maturity of the policy are fully taxable.

c. Qualified individuals may generally "cash out" their life insurance policies before death and receive tax-free treatment for the amount received.

(1) **Qualifications:** The insured person must be terminally or chronically ill.

(2) For chronically ill persons, the exclusion is limited to their unreimbursed long-term care costs paid by the amount received. Terminally ill taxpayers may use the proceeds for any purpose.

(3) Proceeds from the assignment or sale of a life insurance policy will qualify for tax-free recovery of the insured's basis in the policy. "Basis" for this purpose is total premiums paid minus the true cost of insurance.

4412.23 Meals and lodging:

a. If meals are served on the premises of the employer and are for the convenience of the employer, the value of such meals may not be income. The Tax Cuts and Jobs Act of 2017 (TCJA) imposed new rules on this particular fringe benefit and facts such as the availability of other options must be considered. There is no "one size fits all" approach for meals.

b. To exclude lodging from income, lodging on the premises must also be a condition of employment.

c. The rental value of housing provided for a minister is tax exempt as is a housing allowance used to pay for housing.

4412.24 Pensions:

a. Pensions paid to retirees are generally taxable.

b. Payments made under the Railroad Retirement Act or the Social Security Act are generally nontaxable.

(1) A portion of the taxpayer's Social Security and Railroad Retirement benefits may be included in gross income.

(2) Basically, the amount includible is the lesser of:

(a) one-half of the benefits received or

(b) one-half of the excess of:

i. AGI (with modifications) plus one-half of the benefits received *over*

ii. the base amount.

a. The base amount is $25,000 for singles, $32,000 for married persons filing jointly, and $0 for married persons filing separately.

b. For this calculation, adjusted gross income (AGI) must be modified to include excludible income earned outside of the United States and tax-exempt interest.

(3) Additionally, when the taxpayer's provisional income (modified AGI plus one-half of the benefits received) exceeds $25,000 but does not exceed $34,000 (singles) or exceeds $32,000 but does not exceed $44,000 (married persons filing jointly), the following rules apply:

If provisional income falls between the ranges above, the amount of the benefits subject to tax is the lesser of:

(a) 50% of the benefits received or

(b) modified AGI in excess of:

i. $25,000 if single.

ii. $32,000 if married, filing jointly.

(4) When the taxpayer's provisional income (modified AGI plus one-half of the benefits received) exceeds $34,000 (singles) or $44,000 (married persons filing jointly), the following rules apply:

(a) If provisional income exceeds $34,000 ($44,000 for married persons filing jointly), the amount of the benefits subject to tax is the lesser of:

i. 85% of the benefits received or

ii. the sum of:

a. 85% of the excess of provisional income over $34,000 ($44,000) plus

b. the lesser of:

1) the amount included under the basic rules listed previously or

2) $4,500 ($6,000 for married persons filing jointly).

(b) Married persons filing separately will include in income the lesser of:

i. 85% of the benefits received or

ii. 85% of the provisional income.

4412.25 Prizes and awards:

a. Prizes and awards are generally taxable.

b. Awards given in recognition of achievement in religious, charitable, scientific, educational, artistic, literary, or civic areas are generally taxable. These types of awards may be excluded from gross income if:

(1) the taxpayer is selected through no action on the taxpayer's part,

(2) the taxpayer need not perform any substantial future services for the award, and

(3) the award is transferred to a government unit or charitable organization before the taxpayer receives any benefit from it.

c. Awards given in recognition of safety achievement or length of service are not taxable if the award is tangible personal property valued at not more than $1,600 for all such awards received during the year ($400 for awards that are not qualified plan awards).

d. The Tax Cuts and Jobs Act of 2017 (TCJA) clarifies that the term "tangible personal property" does **not** include:

(1) cash, cash equivalents, gift cards, gift coupons, or gift certificates (other than those allowing the recipient to select an item of tangible personal property from a limited list preselected by the employer), *or*

(2) vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and similar items.

4412.26 Rents and royalties:

a. Royalties are included in gross income when received.

b. Rental income is any payment received for the use or occupation of property. A taxpayer must include in gross income all amounts that are received as rent.

(1) Rent is taxable when received if the taxpayer uses the cash basis; when accrued, if the taxpayer uses the accrual basis. Any amount received from a tenant to cancel a lease is treated as rent and included in income.

(2) If a tenant pays any of the taxpayer's expenses, the payments are rental income and included in income.

(3) Prepaid rental income (i.e., advance rent) is recognized in the year received whether the taxpayer is on the accrual or cash basis.

c. Security deposits are not included in rental income if the amount is to be returned to the tenant at the end of the lease. If the taxpayer keeps part or all of the security deposit during any year because the tenant does not live up to the terms of the lease, the amount retained becomes income for that year.

d. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent, and as such, it is included as rental income in the year that it is received.

e. Rental of personal residence:

(1) When a personal residence is rented out for less than 15 days, no rental income is recognized and expenses are not required to be prorated between personal use and rental use.

(2) When a personal residence is rented out for more than 14 days, the rental income is recognized and the expenses must be allocated between personal use and rental use. A portion of mortgage interest and real estate taxes must be allocated to reduce the rental income. Taxpayers cannot deduct a loss from renting a personal residence.

4412.27 Recoveries (tax benefit rule):

a. If an income tax benefit was obtained by deducting an item on a previous tax return, any amount recovered must be included in current gross income.

b. If no tax benefit was received in prior years as a result of the item, no income is recognized on current recoveries.

4412.28 Scholarships and fellowships:

a. A degree candidate may exclude scholarships and fellowships to the extent the amount received is used for tuition, course fees, books, and supplies. Amounts used for room and board are taxable.

b. Amounts received are taxable if specific services, such as teaching, are required to receive the scholarship or fellowship.

c. Any amount paid to a nondegree candidate is taxable.

4412.29 Educational assistance:

a. Amounts paid by the employer for educational expenses (tuition, fees, books, and supplies) are excludible from gross income. The CARES (Coronavirus Aid, Relief, and Economic Security) Act expanded eligible educational expenses to include student loan repayments made after March 27, 2020, and before January 1, 2021. The annual exclusion is limited to $5,250.

b. The exclusion applies to both undergraduate- and graduate-level courses.

4412.30 Stock options:

a. An employee receiving a qualified incentive stock option will not recognize income when it is granted.

b. A sale of the stock will produce long-term capital gain if the sale occurs more than one year after exercise and two years after grant.

c. However, when computing the alternative minimum tax, the taxpayer generally must include the excess of the fair market value of the incentive stock options exercised during the year over the option price.

d. A nonqualified stock option plan requires employee recognition of the bargain element on the exercise date. The bargain element is the difference between the strike price and the fair market value on the exercise date.

4412.31 Stock rights:

a. Generally, the distribution of stock rights does not constitute income. Exceptions include the following:

(1) The option to receive cash or other property in lieu of money

(2) A distribution of stock rights made on preferred stock

b. Nontaxable stock rights:

(1) No income is recognized when rights are received.

(2) The basis of the rights received is generally $0.

(a) The taxpayer may elect to allocate a portion of the basis of the underlying stock to the rights according to the relative fair market values of each at the time of distribution.

(b) If the fair market value of the rights at the date of distribution is 15% or more of the fair market value of the stock on which they are issued, the basis of the stock *must* be allocated between the stock and the rights according to the relative fair market values of each.

(3) The holding period for stock acquired through the exercise of the rights begins at the date of exercise.

c. Taxable stock rights:

(1) Gross income is realized to the extent of the fair market value of the rights at the time of distribution.

(2) The basis of the rights received is equal to the fair market value of the rights.

(3) The holding period for stock acquired through exercise of the rights begins at the date of exercise.

d. The basis of the stock acquired through the exercise of the rights is equal to the subscription price plus the basis of the rights.

4412.32 Unemployment compensation:

a. All unemployment compensation benefits are includible in income.

b. Company-financed supplemental benefits are taxed.

c. Guaranteed annual wage payments are taxed.

d. The CARES (Coronavirus Aid, Relief, and Economic Security) Act created temporary Pandemic Unemployment Assistance through December 31, 2020, for workers affected by the COVID-19 pandemic who are ineligible for traditional unemployment benefits. Eligible workers include, but are not limited to, self-employed individuals, independent contractors, and workers with limited work history.

4412.33 Foreign income exclusion:

a. Certain taxpayers may elect to exclude foreign earned income of up to a maximum of $107,600 per year for 2020. The exclusion must be calculated on a daily (per diem) basis.

b. Taxpayers may also elect to exclude those housing costs incurred that exceed 16% of the foreign earned income exclusion amount. The amount of housing costs excluded is also subject to a maximum of 30% of the foreign earned income exclusion amount. The amount of housing costs excluded reduces the foreign earned income exclusion available. The foreign earned income and housing cost exclusions may be elected separately or together.

c. To qualify for these exclusions, the taxpayer must be a bona fide resident of a foreign country for an entire taxable year *or* must be physically present in a foreign country for 330 full days out of 12 consecutive months.

d. These two exclusions are subject to limitations and required calculations that can only be accomplished using IRS Form 2555 (*Foreign Earned Income*), which will be attached to the individual's IRS Form 1040.

4412.34 Income in respect of a decedent:

a. Only amounts properly includible as income at the time of death under the decedent's method of accounting are included as income on the decedent's final tax returns.

b. Income in respect of a decedent is income the decedent had a right to receive at the time of death that was not included on the final income tax return filed by the estate. The value of any amount of such income is included in the decedent's estate, and in the income tax return, of any person who receives it as a result of the decedent's death.

c. Without a taxable estate, over $11.58 million in value under current law (indexed for inflation), there can be no income in respect of a decedent.

4412.35 Educational savings bonds:

a. Interest on Series EE and Series I U.S. savings bonds may be excluded from gross income if the redemption proceeds are used for qualified higher education expenses.

b. Requirements include the following:

(1) The bonds must be issued after December 31, 1989.

(2) The bonds must be issued to a person at least 24 years old.

(3) A joint return is required, if married.

c. Qualified higher education expenses mean tuition and fees required to enroll the taxpayer, spouse, or dependent in an eligible educational institution. These expenses do not include room and board. Under the PATH Act of 2015, qualified expenses do include computer equipment and related expenses, such as internet access.

d. Qualified expenses must be reduced by scholarships and similar benefits not included in gross income.

e. When the redemption proceeds (including interest) exceed the education expenses, only a portion of the interest is excluded from income:

$$\frac{\text{Education expenses}}{\text{Redemption proceeds (including interest)}} \times \text{Interest} = \text{Interest exclusion}$$

4412.36 Adoption assistance programs:

a. Qualified adoption expenses paid or incurred by an employer for an employee's adoption of a child are excluded from the employee's income.

b. Payments must be pursuant to a written, nondiscriminatory adoption assistance program.

c. For tax year 2020, the amount that can be excluded is $14,300. The exclusion begins to phase out for MAGI in excess of $214,520 and is completely phased out with MAGI of $254,520 or more.

4412.37 Coverdell Education Savings Account:

a. Distributions from a Coverdell Education Savings Account are excluded from the income of the student (beneficiary of the account) if the funds are used to pay qualified education expenses.

(1) The student must be under age 30.

(2) Qualified expenses include the following postsecondary education expenses: tuition, fees, books, supplies, equipment, and room and board. For room and board to qualify, the student must attend school on at least a half-time basis in a program leading to a recognized education credential.

(3) Qualified expenses also include elementary and secondary school tuition and expenses. Tuition to both public and private schools qualifies.

(4) The Hope and Lifetime Learning tax credits may be claimed in the same year as a distribution from a Coverdell Education Savings Account as long as the proceeds from the distribution are not used for qualified expenditures toward these education credits.

b. When distributions exceed qualified educational expenses, some of the distributed earnings are taxed and some are excluded from income.

(1)

$$\frac{\text{Qualified educational expenses}}{\text{Total distributions}} \times \text{Earnings} \quad = \text{Excluded earnings}$$

(2) Earnings – Excluded earnings = Taxable earnings

(3) Distributions are treated as a pro rata distribution of contributions and earnings. Thus, if 25% of the account balance is earnings, 25% of the distribution is earnings.

c. Setting up a Coverdell Education Savings Account:

(1) Taxpayers may contribute up to $2,000 per child (beneficiary) per year to a Coverdell Education Savings Account. The amount is nondeductible.

(2) Contributions must be for a child of the taxpayer or any other child under the age of 18.

(3) Contribution limits:

(a) The annual $2,000 contribution limit is phased out proportionately between the following AGI levels in 2019 and 2020:

i. Singles: $95,000–$110,000

ii. Joint filers: $190,000–$220,000

iii. Corporations and other entities making contributions to Coverdell Education Savings Accounts are not subject to the phase-out rules.

(b) The maximum annual contribution to anyone's Coverdell account is $2,000.

(c) The deadline for making contributions is April 15 of the following year.

d. Unused balance:

(1) When the beneficiary reaches age 30, any unused amount in the savings account must be distributed to the beneficiary, unless the beneficiary has special needs.

(2) Any earnings included in the distribution will be added to the beneficiary's gross income and taxed.

(3) An additional 10% penalty tax on the earnings will also apply to the beneficiary.

(4) Unused amounts may be rolled over tax- and penalty-free into a Coverdell Education Savings Account of a child or a sibling or spouse of the beneficiary (if the person is under age 30).

4412.38 Parking and transportation provided by employer:

a. In 2020, up to $270 per month can be excluded for a "qualified parking fringe benefit": parking provided by the employer near the workplace.

(1) Employees can have a choice between cash and employer-provided parking.

(2) If cash is selected, it is included in gross income.

b. The qualified transportation fringe benefit allows an exclusion for combined commuter highway vehicle transportation and transit passes of $270 per month in 2020.

c. No deduction is allowed for any employer expense incurred for providing any transportation, or any payment or reimbursement for transportation fringe benefits, except as necessary to ensure the safety of the employee.

4412.39 Qualified state tuition programs:

a. Some states and private institutions make it possible for parents to prepay their children's college tuition and lock in current tuition rates.

b. If the child does not go to college, the payments, plus interest, are refunded to the parents. The interest is included in the parent's gross income.

c. When the accumulated funds are used to pay qualified higher education expenses, the entire distribution, including earnings, is tax-free.

d. Qualified higher education costs include tuition, fees, books, supplies, room and board, and equipment needed to complete course requirements.

4412.40 Section 1202 small business stock:

a. Noncorporate taxpayers may exclude 50% (100% on stock acquired after the enactment of the Creating Small Business Jobs Act of 2010) of the gain on the sale or exchange of qualified small business stock held for more than five years.

(1) Eligible gain cannot exceed the greater of $10 million or 10 times the taxpayer's basis in the stock ($5 million for married individuals filing separately).

(2) The stock must be C corporation stock acquired as original issue stock.

(3) Corporate assets cannot exceed $50 million at the date of issuance.

(4) At least 80% of the assets must be used in the active conduct of a trade or business.

(5) Service-based corporations do not qualify (e.g., law, insurance, engineering, architecture).

b. Any gain not excluded under this provision is capital gain taxed at the maximum rate of 20%.

4412.41 Section 1244 stock:

a. Generally, the disposition of stock produces capital gain or loss. However, a loss (from sale or worthlessness) on *qualified small business stock* (Section 1244 stock) may be treated as an ordinary loss—deductible for AGI.

(1) Ordinary loss treatment is limited to $50,000 ($100,000 on a joint return) each year.

(2) Any additional loss receives capital loss treatment.

b. Only individuals may receive this treatment and, in order to be *qualified small business stock:*

(1) the stock must have been acquired as original issue from a small domestic corporation.

(2) at the time the stock is issued, contributions of paid-in capital cannot exceed $1 million.

(3) the stock may be common or preferred stock.

c. If Section 1244 stock is sold at a gain, the gain is capital gain.

(1) Individuals may elect to roll over (postpone) the gain by reinvesting in other Section 1244 stock within 60 days after the sale. (IRC Section 1045)

(2) To qualify for the rollover treatment, the stock must have been held for over six months before it was sold.

(3) Gain is recognized to the extent the sale proceeds are not reinvested within 60 days.

4412.42 Employee contributions to retirement plans:

a. Employees who participate in their company's retirement plan may exclude (defer) from the current year's income amounts they contribute to the plan within the following guidelines.

(1) For 2020, participants in 401(k) plans, 403(b) annuities, and SEP programs may elect to contribute and defer taxes on a maximum of $19,500. Taxpayers age 50 and above may make an additional "catch-up" contribution of $6,500.

(2) Employees participating in a SIMPLE plan in 2020 may contribute and defer taxes on $13,500. Taxpayers age 50 and above may make an additional "catch-up" contribution of $3,000 for 2020.

b. Employee contributions and their subsequent earnings are taxed when withdrawn from the plan.

c. Qualified employer contributions to the program and related earnings are also taxed when withdrawn from the plan.

4412.43 Employee business expenses reimbursed by employer:

There are two types of employee business expense plans:

1. An accountable plan: The employer has a written policy establishing an "accountable plan" and the employee must provide substantiation for any expense to be reimbursed.

a. If the reimbursement equals the business expense, the employee excludes reimbursement from income.

b. If the reimbursement exceeds the expense, the excess is included in gross income.

2. A nonaccountable plan: The employee does not provide substantiation for the expenses to the employer. The employee includes reimbursements in income. The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated any deduction in an employee's Form 1040 for "unreimbursed business expenses."

4413 Accounting Periods and Methods

Note: The material in this section applies to individuals engaged in a trade or business as self-employed persons or conducting an activity for the production of income. The results of those undertakings are reported in the individual's annual federal income tax return along with other items of personal income.

4413.01 Accounting periods

a. Individuals subject to United States income tax law are generally not permitted to use a fiscal year (a 12-month period ending on the last day of a month other than December) for calculating and reporting their taxable income. Exceptions are possible, but rare. IRC Section 441 and Treasury Regulation 1.441-1(b) explain what would be required.

b. Taxpayers who established a fiscal year before becoming subject to U.S. tax law, and who keep adequate books and records, are generally permitted to use a fiscal tax year. If adequate books and records are not kept, the taxpayer generally must use a calendar tax year.

c. Certain taxpayers may elect to use a 52/53-week tax year.

(1) In this case, the tax accounting period includes either 52 or 53 weeks.

(2) Under this method, the taxpayer's tax year ends on the same day of the week (e.g., the last Sunday in December) each year.

d. A taxpayer makes the election to use a calendar, 52/53-week, or fiscal year at the time of filing their initial tax return.

e. For all subsequent tax years, the taxpayer is required to use the tax year initially selected unless he or she obtains IRS approval to change their tax year.

f. The request to change the taxpayer's tax year must be filed on IRS Form 1128 (*Application to Adopt, Change, or Retain a Tax Year*).

g. The IRS generally will not grant permission to change the taxpayer's accounting period unless there is a substantial nontax business reason for the change.

h. If the IRS allows the taxpayer to change their accounting period, the taxpayer must comply with all conditions set out by the IRS.

Accounting Methods

4413.02 Recognition of revenues and expenses

a. Internal Revenue Code (IRC) Section 446 states that taxpayers must compute their taxable income using the accounting method regularly used to keep their books and records.

b. If the method of accounting used by the taxpayer does not clearly reflect income, the Internal Revenue Service (IRS) can specify the accounting method that the taxpayer must use so that income is "clearly reflected."

c. Taxpayers may compute their taxable income under any of the following methods of accounting:

(1) The cash receipts and disbursements methods

(2) The accrual method

(3) Any other method permitted by the IRC (i.e., the installment method)

(4) Any combination of permissible methods

d. A taxpayer who is engaged in more than one trade or business can use a different method of accounting for each trade or business.

e. The accrual method must generally be used for sales and cost of goods sold if inventories are an income-producing factor in the taxpayer's business, and the taxpayer's average annual gross receipts equal or exceed $25 million.

f. Generally, a taxpayer must get IRS consent in order to change a method of accounting. To promote efficiency, the IRS issues Revenue Procedures explaining the automatic consent procedures for accounting method changes. Currently that guidance is contained in Revenue Procedure 2019-43, which incorporates changes required by the Tax Cuts and Jobs Act of 2017 (TCJA) in Revenue Procedure 2018-40.

4413.03 Cash method

a. Under the cash method, a taxpayer generally reports income when consideration is received. Consideration can be cash, a cash equivalent (a check), or property or services (e.g., fair market value of the property or services received in a barter transaction).

b. A taxpayer using the cash method is required to report income if it is constructively received. For constructive receipt to exist:

(1) the amount must be made available to the taxpayer and

(2) receipt of consideration by the taxpayer is not subject to any substantial limitations or restrictions.

c. The constructive receipt doctrine prevents cash-method taxpayers from avoiding income by refusing to accept payment hoping to defer recognition to a future tax year.

d. Cash-method taxpayers deduct expenses in the year paid.

e. However, if a cash-method taxpayer prepays expenses that cover a period substantially beyond the end of the tax year, such amounts must be capitalized and amortized over the period to which they relate.

f. Taxpayers, though, may deduct prepaid expenses in some circumstances if the period covered by the prepaid expenses expires before the end of the tax year following the year of payment, or:

(1) the item is recurring in nature and treated consistently,

(2) accrual results in better reflection of income,

(3) the "all-events test" is met, and

(4) "economic performance" occurs within a reasonable period, but no later than 8.5 months after the end of the tax year.

In any event, the deduction must not distort income. Clear reflection of income trumps any other provision.

g. The one-year rule does not apply to the deduction of prepaid interest. Prepaid interest expense can only be deducted over the period to which the interest relates.

4413.04 Accrual method

a. Under the accrual method, a taxpayer includes an item in income when:

(1) all events have occurred that create the taxpayer's right to receive the income (generally, the goods or services have been provided to the other party) and

(2) the amount of income to be received can be determined with reasonable certainty.

b. An accrual method taxpayer can generally deduct an expense only when:

(1) all events have occurred that establish the taxpayer's liability,

(2) the amount of the liability can be determined with reasonable accuracy, and

(3) the taxpayer has received economic performance from the other party.

c. Economic performance occurs when the services or receipt of property that give rise to the taxpayer's liability are actually received by the taxpayer.

d. An exception to the economic performance requirement allows deduction of recurring items before economic performance, provided:

(1) the item is recurring in nature and is treated consistently from year to year by the taxpayer,

(2) the item accrued is either not material or accruing before economic performance results in a better matching of income and expenses, and

(3) economic performance is received within a reasonable time that is no later than 8-1/2 months after the close of the tax year.

Under this exception to economic performance, all events must still have occurred to establish the taxpayer's liability and the amount of the liability must be known with reasonable certainty.

4413.05 Hybrid method

a. The taxpayer may use a hybrid method that combines more than one method, provided the use of the hybrid method clearly reflects income.

b. The most common example of a hybrid method is use of the accrual method for sales and cost of goods sold while using the cash method to report other income and expenses.

4413.06 Restriction on use of the cash method

a. For tax years beginning after December 31, 2018, taxpayers that have average annual gross receipts of $26 million or less during the preceding three years (up from $10 million under pre-TCJA (Tax Cuts and Jobs Act of 2017) law) are not required to account for inventories and related costs of goods sold; therefore, they are not required to use the accrual method of accounting. Such taxpayers will use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies or (2) conforms to the taxpayer's financial accounting treatment of inventories.

b. Prior to the TCJA, uniform capitalization (UNICAP) rules for the capitalization of certain costs applied to many taxpayers, with few exceptions. Under the TCJA, the exception is expanded to apply to taxpayers whose average annual gross receipts for the immediately preceding three years do not exceed $26 million (up from $10 million under pre-TCJA law). This increased threshold applies to both producers and resellers of real and personal property, rather than only resellers (as under pre-TCJA law).

c. Under the TCJA, in tax years beginning after December 31, 2017, corporations and partnerships that have a corporation as a partner satisfy the gross receipts test for the tax year if the taxpayer's average annual gross receipts are under $26 million for the three-tax-year period ending with the tax year that precedes the tax year for which the taxpayer is being tested. The $26 million limit is adjusted for inflation for tax years beginning after 2018.

d. Under the TCJA, a farming business owned by a C corporation (or a partnership with such a C corporation as a partner) is exempt from the rule requiring such corporations to use the accrual method if the corporation meets an inflation-adjusted $26 million gross receipts test for the tax year. This limit replaces both the non-inflation-adjusted $25 million limit for family corporations and the $1 million limit for nonfamily corporations in effect before the TCJA.

4420 Reporting of Items from Pass-Through Entities

4420.01 Certain domestic corporations may elect not to be taxed. Instead, the corporation makes an "S election" and income is passed through to the stockholders, who are taxed on their share of the corporation's earnings. Stockholders are taxed on their share of the earnings even though the earnings are not distributed. (For a detailed discussion of S corporation tax attributes, see section **4540.**)

4420.02 Shareholders must include on their personal tax returns their share of the S corporation's income or loss and special items from the corporate tax year that has ended with or within the shareholder's tax year. Thus, income is reported and recognized on a basis similar to, but not the same as, that of partnerships.

a. When ownership has changed during the year, each owner must recognize their share of income on a per-share per-day of ownership allocation.

b. Loss pass-throughs in excess of the taxpayer's basis in the corporation may be carried forward indefinitely and deducted when the taxpayer's basis is increased sufficiently, either by the corporation's income or a contribution of capital, to absorb the loss.

4420.03 Distributions of cash and property are basically given the same treatment. Shareholders must recognize, as a distribution, the amount of cash and the fair market value of any property distributed.

a. The taxability of a distribution is determined by its source.

b. Distributions from an S corporation come from the following sources in the order listed:

(1) Distributions are first considered to come from an "accumulated adjustments account" (AAA).

(a) The AAA represents income earned after 1982 adjusted by any additions and subtractions that shareholders were required to make to the basis of their stock for this period. However, no adjustment is made for the following:

i. Tax-exempt income

ii. Corporate expenses not deductible in computing taxable income and not chargeable to a capital account

(b) Distributions from the AAA are nontaxable.

(2) Distributions are then considered as dividends to the extent of any accumulated earnings and profits (E&P) from a time when the corporation's S election was not in effect.

(3) When E&P is exhausted, distributions are a return of capital to the extent of the shareholder's stock basis, and then capital gain.

c. If an S corporation distributes appreciated property to a shareholder, the transfer is treated as if the property had been sold to the shareholder at fair market value.

(1) A gain is recognized at the corporate level.

(2) The gain is subsequently reported to all shareholders, each of whom reports the percentage of the gain equal to her or his percentage ownership of the corporation's shares.

4420.04 Before 2018, partnerships were **not** taxable entities. They were reporting entities. Partnerships functioned as a conduit for income tax purposes and passed all items of income, deduction, gain, loss, and credits through to the partners.

a. Ordinary income and losses along with special gain and loss items flow through the partnership to the partners, who report these items on their tax returns. In addition to individuals, partners can be corporations, trusts, other partnerships, and estates.

b. The partnership must report each partner's distributive share of the ordinary gain or loss as well as any specially treated items that might affect a partner's taxable income as determined by other factors in that partner's individual return.

c. Self-employment taxes apply to all ordinary income, from the conduct of a trade or business, passing to general partners.

d. Beginning with tax year 2018, new rules for auditing partnerships and assessing tax deficiencies will apply. The new rules are commonly referred to as the "partnership audit regime" and they provide, among other items:

(1) a requirement that a partnership appoint a "partnership representative" who will act for the partnership in all matters involving the IRS.

(2) that a tax deficiency arising from an audit of a partnership is a liability of the partnership, not the partners.

(3) elections to deal with issues created by the new rules, such as assessing and collecting a partner's share of a tax deficiency.

(4) generally, partnerships can no longer file amended returns and instead must file administrative adjustment requests (AARs).

(5) a procedure for a small partnership to elect out and remain covered by the TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) rules.

4420.05 IRC Section 199A

a. The Tax Cuts and Jobs Act of 2017 (TCJA) repealed a section of the Internal Revenue Code, Section 199, that was intended to encourage domestic production by offering a deduction of up to nine percentage points in the tax rate paid by domestic producers. Any enterprise that manufactured, created, grew, or extracted to create value benefited from the domestic production activity deduction, or DPAD.

b. A tax incentive for production activities (activities that create wealth) is offered in new IRC Section 199A, and it is called the qualified business income amount, or QBIA. The

QBIA offers taxpayers other than corporations a deduction of 20% of qualified business income (QBI), subject to certain limitations.

c. Some commentators have called the new tax break for non-incorporated enterprises the “QBID” (qualified business income *deduction*) to emphasize that it is a deduction.

d. Qualified trades and businesses include all trades and businesses except the trade or business of performing services as an employee and "specified service" trades or businesses (e.g., services in law, consulting, accounting, or financial services, or where the business's principal asset is the reputation or skill of one or more owners or employees who are famous enough, for example, to draw a crowd to a public appearance).

e. The deduction is claimed on the individual IRS Form 1040 of a taxpayer with qualifying income from a sole proprietorship, partnership, S corporation, trust, or estate.

f. For tax year 2020, as long as the taxable income is below $163,300 in an individual return, or $326,600 in a joint return, and the qualified business income (QBI) is also below that threshold, the IRC Section 199A QBID will be 20% of the qualified business income.

g. When either taxable income or QBI exceeds those thresholds, one of four limitations in the new law will come into play to reduce or completely eliminate the QBID:

(1) Taxable income limitation: The QBID is limited to 20% of the lesser of taxable income or QBI.

(2) W-2 wage limitation: The QBID might be limited to 50% of W-2 wages.

(3) W-2 wage and qualified property limitation: The QBID might be limited to the sum of 25% of W-2 wages plus 2.5% of the original cost of all qualified property immediately after acquisition (before any cost recovery, bonus depreciation, or IRC Section 179 amount).

(4) Specified service trade or business limitation: If the trade or business producing the income is a personal service business, when QBI and taxable income exceed $213,300 in an individual return, and when they exceed $426,600 in a joint return, there can be no QBID. The three limitations above do not apply.

h. For tax year 2020, the W-2 wage limitation does not apply to taxpayers with taxable income of less than $163,300 for the year ($326,600 for married filing jointly) and is phased in for taxpayers with taxable income above those thresholds. Income from specified service businesses is not excluded from QBI for taxpayers with taxable income below those same threshold amounts.

i. Qualified business income (QBI) is the net amount of income, gain, deduction, and loss from the operation of a business, excluding investment income. Certain categories of income, including certain investment-related income, reasonable compensation paid to the taxpayer for services to the trade or business, and guaranteed payments are excluded from QBI.

j. The calculation, with phase-in, phase-out, and various limitations can get complicated. It is sufficient to know the tax law includes an incentive for individual taxpayers who own an interest in a business whose income is reported in their returns, in the form of a 20% deduction, leaving the individual to pay regular income tax on only the 80% remainder.

k. If the net amount of QBI is less than zero, such amount is treated as a loss from a qualified trade or business in the succeeding taxable year; in other words, the taxpayer’s net loss generated in year 1 is carried forward and reduces the subsequent year's IRC Section 199A deduction.

4430 Adjustments and Deductions to Arrive at Taxable Income

4430.01 In computing the tax of individuals, special attention must be given to three different income concepts: gross income, adjusted gross income, and taxable income.

4430.02 **Gross income** includes all income from whatever source derived minus certain exclusions that are specifically provided for by law.

a. It is the gross income figure that is used to determine whether or not a person must file a tax return.

b. Gross income is also one of the standards used to determine whether a person may be claimed as the dependent of another taxpayer.

4430.03 **Adjusted gross income** (AGI) is determined by subtracting certain expenses and other deductions allowed by the Internal Revenue Code from gross income.

a. Deductible from gross income are the following:

(1) Expenses of producing business income (Schedule C). This includes such items as advertising, insurance, rent on office space, supplies, fees paid to others, repairs to business property, taxes and licenses, professional education, travel for business, and 50% of business meals (no deduction for entertainment after 2017).

(2) The net capital loss deduction (Schedule D) (capital gains for the year plus $3,000)

(3) Expenses of producing rent and royalty income (Schedule E)

(4) Expenses of producing farm income (Schedule F)

(5) Educator's expenses (for 2020: K–12 teacher's supplies, $250)

(6) Certain expenses for reservists, performing artists, and fee-basis government officials

(7) Contributions to a Health Savings Account (Form 8889)

(8) 50% of self-employment tax (Schedule SE)

(9) Contributions to retirement plans, including IRAs, subject to limitations when the taxpayer is a participant in an employer's qualified retirement plan (Form 5498)

(10) 100% of self-employed health insurance premiums

(11) Penalty on early withdrawal of savings

(12) Qualified student loan interest up to $2,500, made permanent by the American Taxpayer Relief Act of 2012. For tax year 2020, the $2,500 maximum deduction begins to phase out for joint filers with modified adjusted gross income (MAGI) in excess of $140,000 and for single filers with gross income in excess of $70,000. It is completely phased out for MAGI of $170,000 for joint filers and $85,000 for single filers.

(13) Qualified higher education expenses include tuition, any fees that are required for enrollment, and course materials the student was required to buy from the school. Those expenses can be deducted if all three of these requirements are met: the taxpayer paid (not just billed) qualified education expenses; the expenses were

paid for an eligible student; and the eligible student is the taxpayer, their spouse, or their dependent. Taxpayers must have received a Form 1098-T from the college or other postsecondary institution.

(14) The CARES (Coronavirus Aid, Relief, and Economic Security) Act allows individuals to deduct up to $300 ($600 for married filing joint filers) of cash contributions made to qualified charitable organizations as an above-the-line deduction if the individual does not itemize deductions. This provision applies to tax years beginning after December 31, 2019.

b. AGI is used as a standard for limiting the amount recognized for such items as medical expenses, charitable contributions, and the dependent care credit.

4430.04 **Taxable income** is adjusted gross income minus the larger of itemized deductions or the standard deduction.

a. Itemized deductions include qualified personal expenditures incurred for such items as the following:

(1) Medical and dental care. The deduction for medical expenses is the amount of unreimbursed qualifying medical expenses paid during the year regardless of when the services were provided. Medical expenses are considered paid when the credit card charge is made regardless of when the credit card is paid. For calendar year 2020, medical and dental care expenses in excess of 7.5% of AGI are deductible.

(2) State and local taxes or state and local general sales tax deduction capped at $10,000 for tax years beginning after December 31, 2017

(3) Mortgage interest expense. The total amount of mortgage debt cannot exceed $750,000. Interest on any remaining debt from the previous $1 million amount is grandfathered in. Mortgage insurance premiums (e.g., private mortgage insurance, or PMI) are treated as qualified residence interest. In certain instances, home equity loan interest is also deductible (IR-2018-32).

(4) Enhanced mortgage reporting requirements for a lender will apply to returns required to be furnished after December 31, 2016. An interest recipient (lender) must file a separate information return for each qualified mortgage for which it receives $600 or more in interest for a calendar year. The return must include:

(a) the name, address, and taxpayer identification number of the individual from whom the interest was received,

(b) the amount of such interest (other than points) received for the calendar year, and

(c) the amount of points on the mortgage received during the calendar year and whether such points were paid directly by the borrower.

(5) Charitable contributions were limited by the Tax Cuts and Jobs Act of 2017 (TCJA) to 60% of the taxpayer's "contribution base." The taxpayer's contribution base is adjusted gross income (AGI) computed without regard to any net operating loss carryback to the tax year. Any excess contribution can be carried forward as a deductible charitable contribution over the next five years. For tax year 2020 only, the CARES (Coronavirus Aid, Relief, and Economic Security) Act waived the 60%-of-AGI limit for **cash** donations, and instead allowed for cash charitable contributions of up to 100% of AGI to qualified charitable organizations.

(6) Investment expenses, including investment interest

(7) Hobby losses (losses from an "activity not engaged in for profit," not a "trade or business" (IRC Section 183)):

(a) The Tax Cuts and Jobs Act of 2017 (TCJA) eliminates the itemized deduction for expenses not related to an activity conducted for profit, so-called "hobby losses." Some expenses, however, are deductible regardless of the activity in which they are incurred. These would include all expenses to which the taxpayer is normally entitled as an itemized deduction, such as interest, taxes, and casualty losses.

(b) An activity may be treated as a business if it meets the following profitability tests:

i. A profit is generated in any three out of five consecutive years.

ii. A profit is generated in any two out of seven consecutive years for breeding, training, showing, or racing horses.

(c) If facts and circumstances can prove an intent to make a profit, the activity may still be considered a business after failing test *(b)i.* However, the burden of proof is on the taxpayer.

(8) The Tax Cuts and Jobs Act of 2017 (TCJA) denies deductibility for dozens of other miscellaneous deductions that have been previously subject to the 2% floor. Some examples of expenses that are no longer deductible are:

(a) unreimbursed employee business expenses,

(b) union dues,

(c) fees for tax preparation, and

(d) dues to professional societies.

b. The standard deduction is an alternative to itemizing deductions. The standard deduction should be claimed when it exceeds total itemized deductions.

(1) The amount of the basic standard deduction for 2020 is projected to be as follows.

	2020
Unmarried	$12,400
Married, filing jointly	24,800
Qualifying widow(er) with dependent child	24,800
Head of household	18,650
Married, filing separately	12,400

(2) The basic standard deduction may be increased by an additional standard deduction for age 65 or over and/or blind. The additional standard deduction for people who have reached age 65 (or who are blind) is $1,300 for each married taxpayer or $1,650 for unmarried taxpayers.

(3) For tax year 2020, the standard deduction for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,100 or (2) the sum of $350 and the individual's earned income.

(4) The following taxpayers are not eligible to use the standard deduction, so they must itemize:

(a) A married taxpayer filing separately when the other spouse itemizes deductions

(b) A nonresident alien

(c) A taxpayer filing for a period of less than 12 months

c. **Exemptions.** Under the Tax Cuts and Jobs Act of 2017 (TCJA), the personal exemption has been repealed as a counterpoise to the increased standard deduction.

4430.05 **The tax table** is used by individuals to find their tax if taxable income is under a certain threshold (for example, $100,000). Taxable income is computed by figuring adjusted gross income (AGI) and subtracting deductions and credits. If taxable income is greater than the threshold, the tax rate schedules must be used to determine tax due.

4430.06 **Tax rate schedules** (IRS Publication 15-T) are available according to the filing status of the taxpayer.

a. There are seven brackets (10%, 12%, 22%, 24%, 32%, 35%, and 37%) applicable to each filing status. To compute the tax, the taxpayer must choose from one of the following schedules, which are ranked in the order of desirability. (The tax table is organized on a similar basis.)

(1) Married (couples) filing joint return and qualifying widow(er) with dependent child ("Married" is considered all couples who are legally married.)

(2) Unmarried head of household

(3) Single individual

(4) Married individual filing separate return

b. Separate rate schedules apply to estates, trusts, and C corporations.

c. Special rates also apply to long-term capital gains and dividends.

(1) The maximum rate is generally 20%.

(2) For tax year 2020, the capital gains tax rate is 0% for individuals with taxable income up to $40,000, 15% for taxable income up to $441,450, and 20% for taxable income over $441,450. For joint returns, the rates are 0% up to taxable income of $80,000, 15% up to $496,600, and 20% at $496,601 and above.

d. **Qualifying widow(er)s with dependent child** (surviving spouse) may use the joint return rate schedule for the two tax years following the year in which the death of the husband or wife occurred if the following conditions are met:

(1) The surviving spouse must be unmarried.

(2) The surviving spouse must maintain a home as the household of a dependent son or daughter for the entire year.

(3) The surviving spouse must have been entitled to file a joint return with the decedent in the deceased's final tax year.

e. **Head of household (HOH)** is available to a taxpayer who meets the following requirements:

(1) Unmarried individual, other than a nonresident alien or one who qualifies as a qualifying widow(er) with dependent child

(2) Maintains his or her home as the principal place of abode for one or more of the persons described as follows:

(a) A "qualifying child"

i. However, a "qualifying child" who is married must meet the dependency tests of a relative.

ii. Other children who do not meet the definition of a "qualifying child" (e.g., a child age 25) must also meet the dependency tests of a relative.

(b) A relative who qualifies as a dependent other than through a multiple support agreement

Exception: Dependent parents need not live with the taxpayer as long as the taxpayer maintains their household.

(3) The taxpayer's household must be a qualified person's abode for "more than half" of the taxable year. To qualify for head of household status, the taxpayer must pay more than half of the cost of keeping up a home for the year. This cost includes expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. It does not include the costs of clothing, education, medical treatment, vacations, life insurance, or transportation.

(4) The Tax Cuts and Jobs Act of 2017 (TCJA) added a new due diligence penalty for tax return preparers filing individual returns claiming head of household (HOH) status. Proposed regulations impose the same due diligence requirement that applies to the earned income credit. IRS Form 8867, *Paid Preparer's Due Diligence Checklist,* is used by the preparer to document attention to statutory requirements for HOH status.

f. A portion of the 2020 tax rate schedule for unmarried individuals follows**:**

If taxable income is between:	The tax due is:
0–$9,875	10% of taxable income
$9,876–$40,125	$987.50 + 12% of the amount over $9,875
$40,126–$85,525	$4,617.50 + 22% of the amount over $40,125
$85,526–$163,300	$14,605.50 + 24% of the amount over $85,525

4430.07 **Unearned income** of minor children (called the "kiddie tax") will simply be taxed in 2020 at the parents' marginal tax rate. That is a change returning to the rule in effect prior to the passage of the Tax Cuts and Jobs Act of 2017 (TCJA). In two successive tax acts, a new rule (explained below) was introduced by the TCJA and retroactively repealed by the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019.

This is a series of actions by the U.S. Congress illustrating how the tax law can change in ways that introduce extra complexity to preparation of individual income tax returns. To make it even more complex, in certain tax years parents may choose the rule that is most beneficial to them.

Caution: The TCJA rule described below was retroactively repealed by the SECURE Act but may be applied at the taxpayer's option for the 2018 or 2019 tax years instead of the SECURE Act rule. In other words, taxpayers may elect to apply either the TCJA rules or SECURE Act rules in tax years 2018 or 2019. From 2020 forward, the SECURE Act rules apply.

For 2018 and 2019, unearned income of minor children was taxed at the highest trust and estate tax rates. That provision applied if:

a. one of three age requirements is met:

(1) the child is under age 18 at year-end,

(2) the child is age 18 at year-end and did not have earned income that was more than half of the child's support, or

(3) the child is at least 19 years old and under age 24 at year-end, *and* a full-time student, *and* did not have earned income that was more than half of the child's support;

b. the child has at least one living parent;

c. the child has net unearned income of more than $2,200; and

d. the child does not file a joint return for the year.

4430.08 Charitable contributions:

a. Taxpayers may deduct charitable contributions of money or property made to qualified organizations if they itemize their deductions. Generally, the deduction is capped at 60% of adjusted gross income (AGI), but 20% and 30% limitations apply in some cases. The deduction for the fair market value of capital gain property is limited to 30% of AGI for the year.

The CARES (Coronavirus Aid, Relief, and Economic Security) Act waived the 60%-of-AGI limit for cash donations made in tax year 2020 only, and instead allowed for cash contributions of up to 100% of AGI to qualified charitable organizations.

b. Deductions may be made to, or for the use of, organizations that otherwise are qualified under Section 501(c)(3) of the Internal Revenue Code (IRC). These organizations include a community chest, corporation, trust, fund, or foundation organized and operated exclusively for charitable, religious, educational, scientific or literary purposes, or for the prevention of cruelty to animals or children.

c. Contributions must be paid in cash or other property before the close of the taxpayer's tax year to be deductible.

d. Donations other than cash to a qualified organization can generally be deducted at the fair market value of the property. If the property has appreciated in value, however, some adjustments may need to be made.

e. In general, contributions to charitable organizations may be deducted up to 60% of AGI. Contributions to certain private foundations, veterans' organizations, fraternal societies, and cemetery organizations are limited to 30% of AGI.

(1) The 60% limitation (100% for 2020 cash contributions only) applies to (1) all public charities, (2) all private operating foundations, (3) certain private foundations that distribute the contributions they receive to public charities and private operating foundations within 2-1/2 months following the year of receipt, and (4) certain private foundations the contributions to which are pooled in a common fund and the income and corpus of which are paid to public charities.

(2) The 30% limitation applies to private foundations, other than those previously mentioned that qualify for a 60% limitation (100% for 2020 cash contributions only), and to other organizations described in IRC Section 170(c) that do not qualify for the 60% limitation (100% for 2020 cash contributions only), such as domestic fraternal societies.

(3) A special limitation applies to certain gifts of long-term capital gain property.

(4) Deductions can be carried forward from any year in which the deduction limit is surpassed, up to a maximum of five years. Any contribution made in tax year 2020 in excess of the 100% AGI limitation may be carried forward up to five years, subject to the 60% AGI limitation in future years.

f. Taxpayers must retain proper documentation of their contributions.

(1) For cash donations, the IRS will only accept one of the following to substantiate a monetary gift: a canceled check, credit card statement, bank statement, or written acknowledgment from the charity.

(2) For donations in excess of $250, the taxpayer must retain a receipt from the charity that includes the following: the charity's name, the value of the gift, the date the donation was made, and a statement verifying that the taxpayer did not receive any goods or services in return for the gift.

(3) For donations of appreciated property there are, as values increase, requirements for disclosure and documentation that include proof of value, up to and including a qualified appraisal and the appraiser's sworn statement with the taxpayer's return.

g. An IRA owner who is at least age 72 in 2020 may make a qualified charitable distribution (QCD). This is a donation up to $100,000 to charitable organizations directly from their IRA, without that donation being counted as taxable income when it is withdrawn from the IRA. To qualify, contributions must come from a traditional IRA or Roth IRA, and they must be made directly to a qualified charitable organization. Additionally, the donor may not receive goods or services in exchange for the donation, and the donor must retain a receipt from each charity to which a donation is made.

Net Operating Losses (NOLs)

4430.09 Net operating losses (NOLs) may be carried forward indefinitely, but only to the extent of 80% of taxable income. Carrybacks are not permitted. (Tax Cuts and Jobs Act of 2017)

The CARES (Coronavirus Aid, Relief, and Economic Security) Act amended the TCJA and provides that NOLs arising in a tax year beginning after December 31, 2017, and before January 1, 2021, may be carried back to each of the five tax years preceding the tax year of such loss. It also temporarily suspends the taxable income limitation in the TCJA to allow an NOL to *fully offset* income. For taxable years beginning before 2021, taxpayers are eligible for an NOL deduction equal to 100% of taxable income. For taxable years beginning after 2021, the taxpayer will be eligible for a 100% deduction of NOLs arising in tax years prior to 2018 and will be eligible for a deduction limited to 80% of modified taxable income for NOLs arising in tax years after 2017.

NOL Generated in Tax Years	Eligible for Carryback	Eligible for Carryforward	Eligible to Offset % of Taxable Income
Beginning on or before 12/31/17	2 tax years	20 tax years	100% of taxable income
2018–2020	5 tax years	Indefinite	100% of taxable income prior to 2021 80% of taxable income after 2020
2021 and beyond	Generally no carryback	Indefinite	80% of taxable income

A taxpayer may elect to forgo the five-year carryback of NOLs arising in tax years beginning in 2018 and 2019. The election must be made by the due date (including extensions) for filing the taxpayer's return for the first tax year ending after March 27, 2020, the date the CARES Act was signed into law.

4430.10 Losses from the active conduct of a trade or business are limited to amounts invested by the taxpayer for which the taxpayer is "at risk." There may be other limitations, such as those described in section **4440,** but no loss is allowable unless the taxpayer invested assets or is unconditionally obligated to pay debts of the trade or business activity.

4430.11 If the taxpayer's taxable income is negative (a loss), no tax is due currently, and a net operating loss carryover may be available. To compute a net operating loss, remember the following:

- **a.** Capital losses are deductible only to the extent of capital gains.
- **b.** No net *operating loss* carryover deduction is allowed.
- **c.** Personal deductions can be used only to offset nonbusiness income.
- **d.** Salary is considered as business income.
- **e.** Contributions to a self-employment retirement plan are not allowed in calculating the loss.

4440 Passive Activity Losses

4440.01 **Losses and credits from passive activities:**

- **a.** Generally, losses from passive activities may only be used to offset income from passive activities.
  - (1) Passive losses cannot be used to offset the following:
    - (a) Active income: wages, salaries
    - (b) Portfolio income: dividends, interest, royalties, annuities
  - (2) Unused passive activity losses are "suspended" and carry forward to offset passive activity income in future years. In the year in which the taxpayer's entire interest in a passive activity is terminated, any remaining unused loss on that activity may be deducted in full.
  - (3) When passive losses are suspended, all related tax attributes retain their character and are suspended as well.
- **b.** Any tax credits related to passive activities can only be used to offset taxes attributable to passive income until no longer restricted when the activity to which the credit is related is disposed of in a fully taxable transaction.
  - (1) Excess credits carry forward to offset future taxes on passive income.
  - (2) Carryover credits on a terminated activity may be lost forever if they cannot be fully utilized in the year of disposition.
- **c.** Passive activities include the following:
  - (1) Trade or business in which the taxpayer does not materially participate
  - (2) Rental activities
  - (3) Any activity in which the taxpayer's liability is limited
- **d.** Rental real estate exceptions:
  - (1) Certain taxpayers may deduct real estate rental losses from active and portfolio income. This treatment applies to taxpayers who materially participate in a real

property trade or business. Both individuals and closely held C corporations may qualify.

(a) Individuals must meet *both* of the following tests:

i. More than 50% of their personal services must be rendered to a trade or business involving real estate.

ii. At least 750 hours must be spent in such services during the year.

A married couple meets these requirements only if one spouse separately satisfies both tests.

(b) A closely held C corporation meets the test if more than 50% of its gross receipts is from a real property trade or business.

(2) Other taxpayers who qualify as active participants in a rental real estate activity may also deduct a limited amount of losses from such activities against active and portfolio income.

(a) Generally, up to $25,000 of losses from such activities may be deducted against active income and portfolio income ($12,500 for married taxpayers filing separately).

(b) This $25,000 deduction limit is reduced by 50% of the taxpayer's AGI in excess of $100,000.

(c) To qualify for the $25,000 deduction, the taxpayer must:

i. actively participate in the rental activity (e.g., be involved in decision making) and

ii. own at least 10% of the activity.

e. Passive activity loss limitation rules apply to the following:

(1) Individuals

(2) Estates

(3) Trusts

(4) Any closely held C corporation

(5) Any personal service corporation

4440.02 **Nonpassive activities** include businesses in which the taxpayer materially participates. According to IRS Publication 925, an individual materially participates in a trade or business activity for a tax year if they satisfy any of the following seven tests:

1. The individual participated in the activity for more than 500 hours.

2. The participation was substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.

3. The individual participated in the activity for more than 100 hours during the tax year and participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year.

4. The activity is a significant participation activity and the individual participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which the individual participated for more than 100 hours during the year and in which the individual did not materially participate under any of the material participation tests, other than this test.

5. The individual materially participated in the activity (other than by meeting this test) for any 5 years (whether or not consecutive) of the 10 immediately preceding tax years.

6. The activity is a personal service activity in which the individual materially participated for any 3 preceding tax years (whether or not consecutive). An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.

7. Based on all the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year. The individual did not materially participate in the activity under this test if they participated in the activity for 100 hours or less during the year. The individual's participation in managing the activity does not count in determining whether they materially participated under this test if:

- **a.** any other person received compensation for managing the activity or
- **b.** any other person spent more hours during the tax year managing the activity than the individual did (regardless of whether the other person was compensated for the management services).

4450 Loss Limitations

Calculation of Gain or Loss

4450.01 The gain or loss on the disposal of property is computed by comparing the value of the assets received with the investment in the property given up.

	Amount realized
–	Adjusted basis
=	Realized gain or loss

4450.02 The amount realized on the disposition of property is equal to the net proceeds received for that property.

	Gross selling price
–	Selling expenses
=	Amount realized

a. The gross selling price includes everything received for the property given up, including the following:

(1) Cash

(2) Fair market value of property and services received

(3) Amount of mortgage on mortgaged property given up

b. Selling expenses include advertising, legal fees, commissions, and any other costs required to effect the transfer of property.

Tax Treatment of Gains and Losses

4450.03 When a taxpayer has determined that the taxpayer has a gain or a loss to be recognized (see sections **4312.01-.06**), the next step is to establish whether it is to be treated as a capital gain or loss or as an ordinary income or loss item (see sections **4310.07-.08** and **4311.03**).

4450.04 All items receiving capital gain or loss treatment should be classified as short term or long term (see section **4313.01-.09** for a further discussion on gains, losses, and netting process).

4450.05 **Loss limitation rules applicable to individuals (IRC Section 461(l)):** For taxable years beginning after December 31, 2017, and before January 1, 2026, the Tax Cuts and Jobs Act of 2017 (TCJA) provides that "excess business losses" of a taxpayer other than a corporation are not allowed for the taxable year. A taxpayer's excess business loss is the excess of:

- **a.** the taxpayer's aggregate deductions attributable to his trades or businesses for the year, over:
- **b.** the sum of:
  - (1) the taxpayer's aggregate gross income or gain for the year attributable to such trades or businesses, plus
  - (2) $250,000 for a single return (or $500,000 for a joint return)

Excess losses are carried forward as net operating losses (NOLs) and allowed in future years, subject to NOL limitations.

The CARES (Coronavirus Aid, Relief, and Economic Security) Act temporarily modified the loss limitation for noncorporate taxpayers set forth in the TCJA and allows them to deduct excess business losses arising in a tax year beginning after December 31, 2017, and before January 1, 2021. In other words, the CARES Act delayed the effective date of the TCJA excess business loss limitation until 2021.

4460 Filing Status

4460.01 There are five filing statuses that might apply to an individual, based on the individual's life circumstance: single, married filing jointly, married filing separately, head of household, and qualifying widow(er). The individual should choose the status, for which he or she qualifies, that results in the lowest tax.

4460.02 Single filing status is for individuals who are unmarried or legally separated on the last day of the year.

4460.03 Married filing jointly filing status is for individuals who are married at the end of the year and both spouses agree to file using the married filing jointly status. If both spouses receive income, they may want to figure the tax using the married filing separately status and married filing jointly status to get the lower combined tax available. If a spouse died during the year, a joint return may be filed. A husband and wife can file a joint return even if the spouses have different accounting methods. If either spouse was a nonresident alien, the couple may file a joint return only if both spouses make an election to file jointly.

4460.04 ***Obergefell v. Hodges*** is a 2015 landmark U.S. Supreme Court decision in which the Court held that the fundamental right to marry is guaranteed to same-sex couples by both the Due Process Clause and the Equal Protection Clause of the Fourteenth Amendment to the U.S.

Constitution. All states must now issue marriage licenses to same-sex couples and recognize same-sex marriages validly performed in other jurisdictions.

a. Prior to *Obergefell,* many states had issued guidance that required same-sex couples married in other states to file separate state income tax returns, even if their filing status was married filing jointly for federal income tax purposes.

b. Some states required that each individual who has income attributable to their state of residence, and who has filed a joint return with the IRS as a same-sex couple, must separately report adjusted gross income (AGI) for state income tax as a single filer. Each individual had to recalculate their federal AGI as if they had filed a single federal return, essentially requiring the preparation of "dummy" federal returns. As a result of the *Obergefell* decision, those in a same-sex marriage are considered married for state and federal return purposes, eliminating the need for the preparation of "dummy" returns.

c. Also, prior to *Obergefell,* same-sex couples with filing obligations in more than one state might have been required to file as married in one state and as unmarried in another state. *Obergefell* has now alleviated these types of state tax law complexities.

d. Until *Obergefell,* same-sex couples in many states did not benefit from the presumption of parentage for all children born within the marriage; often the non-birth parent had to undertake the expensive and difficult process of adoption. Additionally, since many states prohibit "second parent" adoptions, a parent in a same-sex relationship might not be recognized as a child's parent when the family relocated in another state. *Obergefell* resolves this problem; if states must recognize same-sex marriage, "on the same terms and conditions as opposite-sex couples," then states must recognize parents in such marriages as parents "on the same terms and conditions as opposite-sex couples."

4460.05 Married filing separately status is for individuals who want to be responsible for only their portion of income, or if it results in less tax than filing jointly.

4460.06 Head of household filing status is for individuals who meet the following requirements:

a. The individual is considered unmarried on the last day of the year.

b. The individual paid for more than half the expenses of keeping a home for the year, including rental value of the home, utilities, property taxes, food consumed in the home, homeowner's insurance, repairs, etc.

c. The individual had a "qualifying person" living with them for more than half the year. If the "qualifying person" is a dependent parent, he or she does not have to live with the individual.

4460.07 Qualifying widow(er) (surviving spouse) filing status allows an individual to retain the benefits of the married filing jointly status for two years after the year of the spouse's death. To qualify for the qualifying widow(er) filing status, all five of the following criteria must be met:

1. For the year in which the spouse died, the individual filed (or could have filed) a joint return.

2. The individual did not remarry (during the two years after the year of the spouse's death).

3. The individual has a child or stepchild (not a foster child) whom they are able to claim as a dependent.

4. The child lived with the individual in their home all year, except for temporary absences. There are exceptions for birth, death, or kidnapping.
5. The individual paid more than half the total cost of keeping up the home in which they and the child lived for the year. Costs include food expenses, rent, mortgage interest, home insurance, real estate taxes, utilities, repairs, maintenance, and other household expenses.

Personal Exemptions

4460.08 The Tax Cuts and Jobs Act of 2017 (TCJA) eliminated all personal exemptions.

4470 Computation of Tax and Credits

Tax Formula for Individuals

4470.01 The following tax formula is for individuals. Each step in the formula must be completed before the succeeding step is considered.

	Total income
–	Exclusions
=	Gross income
–	Deductions from gross income
=	Adjusted gross income
–	Larger of: Itemized deductions or standard deduction
=	Taxable income
×	Tax rate
=	Tax liability before additions and credits
+	Additions to tax
–	Tax credits
=	Final tax due (Refund)

4470.02 An expansion of the tax formula follows. It includes tax topics frequently encountered on the CPA Examination. This outline can be used as a quick review before the examination. However, keep in mind that the items in this expanded tax formula are “topics.” Many of them are subject to specific provisions in the law that provide for exclusion, limitation, or special treatment. These are explained in the material that follows.

Tax Formula – Individuals

Gross Income
(But Not Limited to)

- Alimony received (pre-2018 divorce decree)
- Annuities
- Dividends
  - Stock
  - Cash
  - Property
- Employee benefit programs
- Employer-paid adoption expenses
- Foreign earned income
- Gambling winnings
- Interest
- Gain on sale of residence
- Capital gains
- Rental income
- Unemployment benefits
- Social Security/railroad retirement
- Workers' compensation
- Prizes and awards
- Damages received for physical injury
- Recoveries
- Group-term life insurance
- Scholarships
- W-2 wages

– Deductions from Gross Income

- Alimony payments (pre-2018 divorce decree)
- Business expenses (Schedule C)
- Expenses of producing rent and royalty income (Schedule E)
- Capital loss deduction (Schedule D)
- Contributions to retirement plans (Self-employed SEP, SIMPLE, Keogh IRA, 401(k))
- Student loan interest
- Qualified higher education expenses
- Health Savings Account
- Up to $300 ($600 for married filing joint filers) of cash contributions to qualified charities (non-itemizers only)
- 50% of self-employment tax
- Self-employed health insurance premiums
- Interest forfeited to bank on premature withdrawals
- Certain expenses of Reservists, performing artists, and fee-basis government officials

= Adjusted Gross Income

Adjusted Gross Income

– Greater of:
Itemized Deductions
or
Standard Deductions

= Taxable Income

ITEMIZED DEDUCTIONS
Medical expenses
Taxes (state and local with limit of $10,000)
Interest expense
Contributions
Unrecovered investment in pension
Impairment-related work expenses of a handicapped person

STANDARD DEDUCTIONS
Additions to the standard deduction
- Age 65 married/single
- Blindness married/single

Tax Tables
Rate Schedules
= Tentative Tax

Married – joint return
- Qualifying widow(er) with dependent child

Head of household
Single
Married – separate return

+ Additions

Self-employment tax (Schedule SE)
Household employment taxes (Schedule H)
Alternative minimum tax

– Credits

= Income Tax

Foreign tax credit
Child/dependent care credit
Credit for elderly or disabled
American Opportunity Credit (formerly Hope credit)
Lifetime learning credit
Child tax credit
Credit for adoption expenses
General business credit:
- Business energy tax credit
- Credit for research and experimentation payments
- Investment credit
- Rehabilitation expenditures credit
- Low-income housing credit
- Disabled Access Credit
- Certain mortgage interest credit
- Credit for FICA tax on tips
- Work opportunity credit

Child tax credit and family credit
Credit for contributions to qualified retirement plans
Earned income credit

Tax Credits

4470.03 **Tax credits** reduce the tax liability on a *dollar-for-dollar basis*. While most tax credits are limited to the income tax liability, some credits are further restricted as to the amount of the tax liability that they can offset. The general business credit is an example of such a restricted credit.

a. General business credit

(1) Each of the business tax credits is computed separately and then combined to form a single "general business credit." A partial list of these credits follows.

(a) Investment credit

(b) Work opportunity credit

(c) Research activities credit

(d) Low-income housing credit

(e) Disabled access credit

(f) Employer-provided childcare credit

(2) The deduction for the general business credit is limited to the lower of:

(a) the excess of the taxpayer's regular tax liability over the tentative minimum tax for the year or

(b) $25,000 plus 75% of the tax liability in excess of $25,000.

(3) Any unused credit may be carried back 1 year and forward 20 years on a first-in, first-out basis.

b. Some tax credits are based on the qualifying dependent rules, including the child tax credit, dependent credit, and earned income tax credit. In addition, the rules help determine if the taxpayer can write off dependent daycare expenses, medical expenses, various itemized deductions, and most tax credits that involve children or family issues.

Qualified dependents are persons who qualify in one of the following three groups:

(1) **Qualifying relative:** A qualifying relative is anyone who meets the following five tests but does not meet the definition of a qualifying child (defined below).

(a) **Gross income test:** The dependent must have less than a stated amount of gross income (e.g., $4,200 for 2019). (**Note:** The IRS has not yet updated this amount for 2020.)

(b) **Support test:** The taxpayer must furnish more than half of the support of the dependent. (Exception—multiple support agreements)

(c) **Relationship test:** The dependent must be a closer relative than a cousin, **or** if not related must live in the taxpayer's household for the entire tax year.

(d) **Joint return test:** The dependent must not have filed a joint return in a situation where a tax return was required.

(e) **Citizenship test:** The dependent must be a U.S. citizen or resident of the United States, or a resident of Canada or Mexico.

(2) **Qualifying nonrelative:** A qualifying nonrelative must meet all of the following tests that apply to relatives.

(a) **Gross income test**

(b) **Support test**

(c) **Joint return test**

(d) **Citizenship test**

(e) In addition, an unrelated person must live with the taxpayer for the entire year.

(3) **Qualifying child:** A qualifying child must meet all the following conditions.

(a) **Relationship:** The child must be the taxpayer's son, daughter, stepson, stepdaughter, eligible foster child or descendant of such a child, **or** the taxpayer's brother, sister, stepbrother, stepsister, half-brother, half-sister, or descendants of such relatives.

(b) **Age:** The child must be under the age of 19, or under the age of 24 and a full-time student for at least part of five calendar months.

(c) **Citizenship:** The child must be a citizen or resident of the United States, or a resident of Canada or Mexico.

(d) **Principal residence:** The child must have the same principal residence as the taxpayer for more than half of the year.

(e) **Not self-supporting:** The child must not have provided more than 50% of their own support during the tax year.

(f) **Joint return:** The child must not have filed a joint return in a situation where a tax return was required.

(g) **Note:** A qualifying child is not subject to the "gross income test" and the "over half support test" that apply to qualifying relatives.

4470.04 **Investment credit (ITC):** This general business credit is based on the amount invested in qualified business properties during the tax year. While there are four separate credits currently included in the calculation of the ITC, only the rehabilitation credit will be discussed. The investment credit is claimed by filing IRS Form 3468, *Investment Credit,* with the taxpayer's return.

a. **A rehabilitation credit** will be allowed to taxpayers for expenditures incurred to rehabilitate old commercial and industrial buildings and certified historic structures. No credit is allowed for personal-use property.

b. The credit is 20% of the expenditures incurred to rehabilitate buildings that were placed in service after 1936.

c. The taxpayer is required to depreciate rehabilitated property using the straight-line method.

d. The basis of rehabilitated buildings must be reduced by 100% of the rehabilitation credit taken.

e. The rehabilitation credit is subject to recapture provisions if the building is disposed of prematurely or ceases to be qualified property.

f. The Tax Cuts and Jobs Act (TCJA), signed December 22, 2017, affects the rehabilitation tax credit for amounts that taxpayers pay or incur for qualified expenditures after December 31, 2017. The credit is a percentage of expenditures for the rehabilitation of qualifying buildings in the year the property is placed in service. The legislation:

(1) requires taxpayers take the 20% credit ratably over five years instead of in the year they placed the building into service.

(2) eliminates the 10% rehabilitation credit for pre-1936 buildings.

g. A transition rule provides relief to owners of either a certified historic structure or a pre-1936 building by allowing owners to use the prior law if the project meets these conditions:

(1) The taxpayer owns or leases the building on January 1, 2018, and at all times thereafter.

(2) The 24- or 60-month period selected for the substantial rehabilitation test begins by June 20, 2018.

4470.05 **Work opportunity credit** (a general business credit): Employers hiring employees from 1 of 10 selected high unemployment groups are allowed a special credit. After completing and filing IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit,* the work opportunity credit is claimed by completing and attaching IRS Form 5884, *Work Opportunity Credit,* to the tax return.

a. The credit is equal to 40% of the first $6,000 of first-year wages paid or accrued to each qualified employee who is hired during the year. That first-year wage amount can be as much as $24,000 for certain qualified veterans.

(1) To qualify for the 40% rate, an employee must complete 400 or more hours of service.

(2) Employees completing less than 400 hours of service, but at least 120 hours, qualify for a rate of only 25%.

b. The work opportunity tax credit is elective. If taken, the employer's deduction for wages must be reduced by the amount of the credit.

4470.06 **Research activities credit** (a general business credit): To encourage technical research and development (R&D), a tax credit is available for qualified R&D expenditures. The credit is based on two research components. The research credit is claimed by completing and attaching IRS Form 6765, *Credit for Increasing Research Activities,* to the tax return.

a. **Amount of credit.** The research credit is the sum of (1) 20% of the excess of qualified research expenses for the current year over a base period amount, (2) 20% of the basic research payments made to a qualified research organization, and (3) 20% of the amounts paid to an energy research consortium.

b. **Base amount.** The base amount is determined by a special formula, but it may not be less than 50% of the qualified research expenses for the current year.

c. The research activities credit may be claimed if the taxpayer expenses research expenditures or capitalizes them. However, the deduction for research expenditures must be reduced by the credit taken.

d. This credit expired at the end of 2014; it was then permanently extended, effective January 1, 2015, under the PATH Act. Eligible small businesses may use the credit to offset both regular tax and AMT liabilities, as well as payroll taxes.

4470.07 **Low-income housing credit** (a general business credit): A tax credit may be claimed by owners of low-income rental housing units constructed, rehabilitated, or acquired after 1986. The credit is claimed by completing and attaching IRS Form 8586, *Low-Income Housing Credit,* to the tax return.

a. A credit may be taken in each of 10 years starting with the year the project is placed in service, or the next year if the taxpayer so elects.

b. The annual credit is equal to:

	Qualified basis of low-income rental units
×	Applicable percentage rate
=	Low-income housing credit

(1) The qualified basis is that portion of the building's qualified cost that is attributable to low-income rental units.

(2) The applicable percentages are issued by the IRS for the month the building is placed in service.

c. An owner is required to recapture part of the credits taken if the owner disposes of the interest in the project or violates some aspect of the original entitlement any time within a 15-year period.

4470.08 **Disabled access credit** (a general business credit): Qualified taxpayers have available a nonrefundable tax credit that is based on expenditures incurred to make their business accessible to disabled individuals. IRS Form 8826, *Disabled Access Credit,* is completed and attached to the taxpayer's return to claim the credit.

a. The credit is equal to 50% of the eligible access expenditures for the year that fall between \$250 and \$10,250. Thus, the maximum credit available is \$5,000 (50% × (\$10,250 – \$250)).

b. The credit is available to those small businesses that in the preceding tax year had either:

(1) gross receipts of \$1 million or less or

(2) 30, or fewer, full-time employees.

c. The credit is not available for expenditures paid or incurred on buildings placed in service after November 5, 1990.

d. The adjusted basis is reduced by the full amount of the credit taken.

4470.09 **Employer-provided childcare credit** (a general business credit): To encourage smaller businesses to provide childcare for their employees, a credit is available for childcare expenses paid by the employer. IRS Form 8882, *Credit for Employer-Provided Childcare Facilities and Services,* is completed and attached to the business tax return to claim the credit.

a. A 25% credit is available for expenditures to acquire or prepare property for use as a childcare facility. The 25% credit also applies to:

(1) the operating costs of a childcare facility or

(2) the amount paid to a contracted childcare facility to provide childcare services to the taxpayer's employees.

b. A 10% credit is also available for expenses paid by the employer under a contract to provide childcare resource and referral services to the employees.

c. The total credit cannot exceed \$150,000 per year.

d. Any credit based on the acquisition or improvement of property must be used to reduce the basis of that property. Likewise, any deductible expenses must be reduced by the related tax credit.

e. If a credit is claimed for a property acquisition or improvement, terminating the use of that property as a childcare facility within 10 years will trigger a recapture of some or all of the credit claimed.

4470.10 **Credit for the elderly and the permanently and totally disabled:** Individuals age 65 or over and individuals under 65 who are permanently and totally disabled have a special tax credit available. This credit is claimed on Schedule R of IRS Form 1040.

a. Individuals are permanently and totally disabled when they are expected to be unable to work for a period of 12 continuous months.

b. This credit is equal to 15% of a base figure after certain adjustments.

(1) The base figure available to the taxpayer depends on the following factors:

(a) **Singles:**

i. Age 65—$5,000

ii. Disabled—lesser of $5,000 or disability income

(b) **Married persons filing jointly:**

i. Both 65—$7,500

ii. One 65—$5,000

iii. One 65, one disabled—lesser of $7,500 or $5,000 plus disability income

iv. One disabled—lesser of $5,000 or disability income

v. Both disabled—lesser of $7,500 or sum of spouses' disability income

(c) **Married persons filing separately:**

i. Age 65—$3,750

ii. Disabled—lesser of $3,750 or disability income

(2) Adjustments (deductions) to the base figure are required for the following:

(a) Social Security payments

(b) Railroad Retirement pensions

(c) One-half of adjusted gross income in excess of:

i. $7,500 (single)

ii. $10,000 (married, filing jointly)

iii. $5,000 (married, filing separately)

c. A married taxpayer filing separately may use the credit only if the couple has lived apart the entire tax year.

4470.11 **Foreign tax credit:** A taxpayer may apply income taxes paid to a foreign country or U.S. possession as a credit against United States income tax liability, or may use such taxes as an itemized deduction. This credit is claimed on IRS Form 1116 for an individual and on IRS Form 1118 for a corporation.

a. This treatment is available for taxes paid to a foreign country on income that is taxable in the United States when no foreign income exclusion is taken.

b. The election to use the credit or the deduction is made annually.

c. The taxpayer cannot split foreign taxes between a credit and a deduction.

d. The overall limit for the credit on taxes paid to *all* foreign countries is restricted to that portion of the U.S. income tax which relates to the taxable income from all foreign countries.

$$\frac{\text{Total foreign taxable income}}{\text{Total worldwide taxable income}} = \text{U.S. income tax}$$

e. Excess credits may be carried back 1 year and forward 10 years.

4470.12 Child and dependent care credit: Taxpayers are permitted a nonrefundable tax credit for expenses incurred in caring for dependents so that the taxpayer(s) may be gainfully employed.

a. The credit is available on a three-tiered basis as follows:

(1) Taxpayers with an adjusted gross income of $15,000 or less will be entitled to a credit of 35% of dependent care expenses.

(2) The credit will be reduced by one percentage point for each $2,000 of adjusted gross income, or fraction thereof, above $15,000.

(3) For taxpayers with an adjusted gross income over $43,000, the credit will be 20%.

b. The maximum amount of dependent care expenses that may be considered for the credit is $3,000 if there is one qualifying child or dependent and $6,000 if there are two or more qualifying dependents.

c. Expenditures for dependent care cannot exceed the earned income of the low-income parent.

Special provisions apply where one of the spouses is a full-time student or is incapacitated, and the other spouse works. In this situation, the nonworking spouse is considered to have earned at least $250 per month, where one dependent requires care and $500 per month, where more than one dependent requires care.

d. The dependent must be:

(1) a child under age 13 or

(2) an incapacitated dependent or spouse.

e. Married taxpayers must file a joint return unless they live apart for the last six months of the year.

(1) For divorced or separated parents, the credit is available to the parent having custody of the child for the longer period.

(2) A custodial parent may claim the credit even though the child may not qualify as a dependent. However, two taxpayers filing separate returns cannot claim separate credits for the same child.

f. Expenditures that qualify for the credit include amounts paid for both in-the-home care and out-of-the-home care.

(1) In-the-home care may include expenditures for household services if they were partly for the well-being and protection of a qualifying individual.

(2) Expenditures for out-of-the-home care are eligible for the credit only if incurred for:

(a) a dependent under age 13 or

(b) any other qualifying person who regularly spends at least eight hours each day in the taxpayer's household.

g. Expenditures do not qualify for the credit if they were made to:

(1) a relative who is a dependent of the taxpayer or

(2) the taxpayer's child who is under age 19.

4470.13 **Credit for mortgage interest paid:** Qualified low-income homeowners who hold a mortgage credit certificate (MCC) may claim a credit for a portion of the interest paid on their home mortgage. This credit is claimed by filing IRS Form 8396, *Mortgage Interest Credit.*

a. This credit must be applied for when the taxpayer is qualified by the lender.

b. MCCs are issued by the state to low-income taxpayers who plan to borrow money to purchase or improve a home.

c. The portion of the mortgage interest that can be used as a credit is determined by the state, but it can range from 10% to 50% of the interest paid.

d. If the percentage exceeds 20%, the taxpayer's maximum credit for the year is $2,000.

e. Credits in excess of the tax liability may be carried over for three years.

f. The taxpayer's itemized deduction for mortgage interest must be reduced by the amount of the credit claimed.

4470.14 **Earned income credit:** A special refundable tax credit may be available for low-income workers who have a principal residence in the United States. It represents a form of *negative income tax*—workers may receive money from the government even though they do not have a tax liability. This credit is claimed by filing Schedule EIC of IRS Form 1040 with the taxpayer's return.

a. The earned income credit (EIC) is equal to a percentage of a limited amount of earned income. Taxpayers with qualifying children receive greater benefits—a greater amount of income is eligible for a higher credit percentage.

b. When the taxpayer's adjusted gross income (or earned income, if greater) exceeds a threshold amount, the EIC is phased out.

(1) "Earned income" includes only taxable compensation; it does not include nontaxable employee compensation.

(2) Threshold and phaseout amounts for 2020 are given in the following table. The tax year 2020 earned income and adjusted gross income (AGI) must each be less than:

	Qualifying Children Claimed			
If filing…	**Zero**	**One**	**Two**	**Three or More**
Single, head of household, or widowed	$15,820	$41,756	$47,440	$50,594
Married filing jointly	21,710	47,646	53,330	56,844

(3) No credit is allowed to those with "disqualified income" (i.e., investment income or unearned income) in excess of $3,650 for 2020.

(4) No credit is allowed for those failing to provide correct Social Security numbers for themselves, spouse, and qualifying child.

(5) The maximum amount of credit for 2020 is $6,660 with three or more qualifying children, $5,920 with two qualifying children, $3,584 with one qualifying child, and $538 with no qualifying children.

c. IRC Section 32(d) provides that a married taxpayer who does not file a joint return is not entitled to an EIC. In Action on Decision (AOD) 2017-05, the IRS gave notice it would not follow a Tax Court decision that the taxpayer's filing status was married filing separately, the taxpayer had qualifying children, and therefore the taxpayer was entitled to the EIC. However, there is no mention of IRC Section 32(d) in the court's opinion; therefore, it appears that the Tax Court overlooked the prohibition disallowing the EIC to married taxpayers filing separately. The IRS has stated it *will not follow* the court's opinion in allowing an EIC to a married taxpayer filing separately.

d. **Qualifying children:** To be eligible for the earned income credit, parents must have children that can meet the following tests:

(1) **Relationship:** The child must be a "qualifying child." The child may, however, provide over half of his or her own support.

(2) **Residency:** The child must live in the taxpayer's residence over half of the year; foster children for the entire tax year.

(3) **Age:** The child must be:

(a) under age 19,

(b) a full-time student under age 24, or

(c) permanently and totally disabled.

e. Individuals without qualifying children may be eligible for this credit if:

(1) they (or their spouse) are at least 25 years old, but not more than 64 years old, at the end of the year and

(2) they cannot be claimed as a dependent by another taxpayer.

4470.15 **FICA tax credit on tips:** Proprietors of food and beverage establishments may claim a tax credit for a portion of the employer's share of FICA taxes. The credit is limited to those FICA taxes attributable to reported tips in excess of those treated as wages under the federal minimum wage laws. No deduction is permitted for any of the FICA expense claimed as a credit. The credit is claimed by filing IRS Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips,* with the business tax return.

4470.16 **Credit for withholding and estimated tax payments:** A refundable tax credit is available to the taxpayer for withheld taxes and estimated tax payments.

4470.17 **Adoption credit:** A nonrefundable tax credit is available for qualified adoption expenses paid or incurred in the adoption of a qualified child. Expenses paid before adoption are claimed as a credit in the year the adoption is finalized. The credit is claimed by completing and filing IRS Form 8839, *Qualified Adoption Expenses,* with the taxpayer's return.

a. **Qualified expenses** include reasonable and necessary adoption fees, court costs, attorney fees, and other directly related expenses. For 2020, expenses up to $14,300 may be claimed as a credit. Adoption expenses for a child with special needs are considered to be $14,300, even if actual expenses are less.

b. **Qualifying children** are those under age 18 or those who are physically or mentally handicapped.

c. The credit allowable is phased out ratably as AGI rises from $214,520 to $254,520.

d. Unused credits carry forward five years.

e. Married taxpayers must file jointly, and the child's Social Security number must be reported.

4470.18 **Child tax credit:** The Child Tax Credit under the TCJA (Tax Cuts and Jobs Act of 2017) tax reform is worth up to $2,000 per qualifying child. The age cutoff remains at 17. (The child must be *under* 17 at the end of the year for taxpayers to claim the credit.)

a. **Child dependent:** For 2020, the refundable portion of the credit is limited to $1,400. The beginning credit phaseout for the child tax credit in 2020 is $200,000 ($400,000 for joint filers). The child must have a valid Social Security number (SSN) to qualify for the $2,000 child tax credit.

b. **Other dependents:** This new credit, created under the TCJA, allows for a credit worth $500 for each qualifying dependent who does not qualify for the child credit discussed in *(a)* above; the credit is nonrefundable. For 2020, the phaseout begins for taxpayers with AGI of $200,000 ($400,000 for joint filers). This phaseout applies in combination with the new child tax credit. Unlike the child tax credit, the dependent does not require a valid SSN for the taxpayer to claim the credit for other dependents; an ITIN (Individual Taxpayer Identification Number) or ATIN (Adoption Taxpayer Identification Number) will suffice.

4470.19 **Education tax credits:** Two tax credits available for students pursuing postsecondary college or vocational education are the American Opportunity Tax Credit and the Lifetime Learning Credit. These credits are available for qualified educational expenditures of the taxpayer, spouse, and dependents. If both the Lifetime Learning Credit and the American Opportunity Tax Credit can be claimed for the same student in the same year, only one can be used, not both. Both credits must be supported by an IRS Form 1098-T from the college or other postsecondary institution showing the amount of qualified expenses that were paid during the tax year.

a. **American Opportunity Tax Credit (AOTC):** The AOTC, formerly the Hope Credit, is available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four postsecondary education years instead of two.

(1) The credit is equal to 100% of the first $2,000 and 25% of the next $2,000, not to exceed $4,000. Therefore, the maximum Hope Scholarship Credit allowance is $2,500.

(2) To be eligible for the AOTC, students must:

(a) be enrolled no less than half-time during at least one academic period during the year,

(b) be pursuing a degree or other recognized education credential,

(c) not have completed four years of higher education before the tax year,

(d) not have claimed the AOTC or the former Hope Credit for more than four tax years, and

(e) not have a felony drug conviction at the end of the tax year.

(3) The taxpayer claiming the full credit (not necessarily the student) must have modified adjusted gross income (MAGI) of $80,000 or less for a single taxpayer or $160,000 or less if filing jointly. A partial credit may be available up to MAGI of $90,000 and $180,000, respectively.

(4) A taxpayer can claim the credit for each qualifying student for whom qualifying expenses are paid.

b. **Lifetime Learning Credit:** This nonrefundable credit is equal to 20% of up to $10,000 of tuition expenses paid each year by the taxpayer. Expenses for which the American Opportunity Tax Credit is claimed do not qualify for this credit. In contrast to the American Opportunity Tax Credit, this credit:

(1) does not vary with the number of students in the household,

(2) is available for an unlimited number of years,

(3) applies to undergraduate, graduate, and professional degree expenses,

(4) applies to any course at an eligible institution that helps individuals acquire or improve their job skills, and

(5) does not require half-time enrollment for one semester. (Thus, CPE credit courses and professional seminars provided by eligible educational institutions may qualify for the credit; but see *(c)(3)* below.)

For tax year 2020, the credit phases out between gross income of $59,000 and $69,000 ($118,000 and $138,000 for a joint return) and is used to determine the reduction in the amount of the Lifetime Learning Credit otherwise allowable.

c. Other limitations:

(1) Married taxpayers must file jointly to receive these credits.

(2) In a given tax year, only one of the following benefits may be claimed with respect to each student: (a) the American Opportunity Tax Credit or (b) the Lifetime Learning Credit. However, the American Opportunity Tax or Lifetime Learning credit can be claimed in the same year as distributions from a Coverdell Education IRA, provided that the proceeds from the distribution are not used to pay for the education costs used in claiming the American Opportunity or Lifetime Learning credit.

(3) The credits are not available if the cost of the course may be deducted by the taxpayer as a business expense.

4470.20 **Saver's credit for contributions to qualified retirement plans:** A nonrefundable tax credit is available for contributions, or deferrals, to retirement savings plans. The credit is claimed by completing and attaching IRS Form 8880, *Credit for Qualified Retirement Savings Contributions,* to the taxpayer's return.

a. The credit applies to traditional and Roth IRAs and other qualified retirement plans such as 401(k) plans, 403(b) annuities, 457 plans, SIMPLE plans, and SEP plans.

b. For tax year 2020, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (50%, 20%, or 10%, depending on filing status and AGI) of up to $2,000 of their qualified retirement savings contributions. In other words, the absolute most the credit could be is $1,000.

c. The credit is in addition to any deduction or exclusion relating to the retirement plan contribution.

d. Joint filers with AGI in excess of $65,000 receive no credit. For heads of households, the amount is $48,750, and for all others it is $32,500.

e. The contribution eligible for the credit must be reduced by any distributions received from qualified retirement plans.

(1) Such distributions include those paid out during (a) the current year, (b) the two preceding tax years, and (c) the period before the due date (including extensions) of the current return.

(2) Distributions received by a spouse are considered as distributions to the taxpayer if a joint return is filed.

f. Qualifying taxpayers must be at least 18 years old.

g. Dependents and full-time students are not eligible for the credit.

4470.21 Domestic employees:

a. Gross amounts of domestic wages paid in cash (in excess of $2,200 for 2020), and payroll taxes thereon, must be reported to the taxing authorities.

b. Usually, Social Security and Medicare withholdings are reported on IRS Form 941. Form 1040, Schedule H, may be used to report federal employment taxes on cash wages paid to household employees. Federal employment taxes that may be paid with Schedule H include Social Security, Medicare, withheld federal income, and federal unemployment (FUTA) taxes.

(1) The CARES (Coronavirus Aid, Relief, and Economic Security) Act allows employers and self-employed individuals to defer payment of the employer share of the payroll tax that they are otherwise responsible for paying to the federal government with respect to their employees.

(2) The payroll tax deferral period began on March 27, 2020, and ended on December 31, 2020. The deferred payroll tax payment must be paid over the following two years, with half of the total deferred payment to be paid by December 31, 2021, and the remaining half of the deferred payment to be paid by December 31, 2022.

(3) The IRS released a revised Form 941 and accompanying instructions to account for the new CARES Act provisions.

c. Wages paid for domestic services are subject to federal unemployment tax if they exceed $1,000 per quarter for 2020, aggregating wages paid to all employees. The employer's required payment for federal unemployment (FUTA) tax cannot be withheld from the employee's wages; it must be paid from the employer's own funds.

d. The employee's share of the Social Security and Medicare tax can be withheld from the domestic service employee's wages.

e. Withholding federal income taxes for household employees is required only if requested by the employee and agreed to by the employer. Such withholding would be reported on Schedule H and filed with Form 1040.

4470.22 Employee Retention Tax Credit (ERTC):

a. The CARES (Coronavirus Aid, Relief, and Economic Security) Act provided a refundable employee retention credit for employers subject to closure due to COVID-19. Eligible employers are comprised of:

(1) employers that fully or partially suspended operation during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings for commercial, social, religious, or other purposes due to COVID-19.

(2) employers that experienced a significant decline in gross receipts during the calendar year, defined as a decline in gross receipts by more than 50% when compared to the same quarter in the prior year.

b. Employers were eligible to receive a payroll tax credit for 50% of wages paid by employers to employees during the COVID-19 crisis, after March 12, 2020, and before January 1, 2021. The payroll credit was provided for the first $10,000 of compensation, including health benefits, paid to an eligible employee. In other words, the maximum employer credit was $5,000 per employee.

4480 Alternative Minimum Tax

4480.01 **Alternative minimum tax:** A special alternative minimum tax (AMT) is payable to the extent that it exceeds the taxpayer's regular tax before credits.

a. For 2020, the exemption amounts are $113,400 for joint returns or qualifying widow(er)s with dependent child, $72,900 for unmarried individuals, $56,700 for married individuals filing separate returns, and $25,000 for estates and trusts.

b. For 2020, the above exemption amounts are reduced (not below zero) to an amount equal to 25% of the amount by which the AMTI (alternative minimum taxable income) of the taxpayer exceeds the phaseout amounts, increased for joint and qualifying widow(er)s with dependent child to $1,036,800 and to all others (other than trusts and estates) to $518,400.

c. Basically, the alternative minimum tax is computed as follows:

	Regular taxable income
+ or –	Adjustments
+	Tax preferences
=	**AMT base**
–	Exemption amount
=	**AMTI**
×	26% under threshold (28% over threshold)
=	Tentative tax before foreign credit
–	Foreign tax credit
=	**Tentative minimum tax**
–	Regular tax (less foreign tax credit)
=	Alternative minimum tax

d. Threshold amounts and AMT rates for 2020:

(1) Married filing separately: 26% AMTI up to $98,950, 28% AMTI above $98,950

(2) All other filers: 26% on AMTI up to $197,900, 28% on AMTI above $197,900

(3) Adjustments (plus or minus) include such items as the following:

(a) Itemized deductions

(b) Standard deduction

(c) Excess ACRS deductions (accelerated depreciation)

(d) Circulation expenditures (magazines and newspapers)

(e) Research and experimental expenditures

(f) Mining exploration and development costs

(g) Passive activity losses

(h) Certain installment sales

(i) Long-term construction contracts

(j) Incentive stock options

(k) Alternative tax net operating loss

(4) Tax preferences may arise in the following areas:

   (a) Percentage depletion

   (b) Intangible drilling costs

   (c) Seven percent (7%) of excluded gain on qualified small business stock

   (d) Accelerated depreciation

   (e) Certain tax-exempt interest

e. An AMT tax credit may be available when regular taxable income is greater than AMTI (alternative minimum taxable income). The regular tax liability, in this situation, may be offset by a credit representing minimum tax liabilities from prior years attributable to timing differences. The AMT credit carries forward indefinitely.

4480.02 **Self-employment tax** must be paid as an addition to the tax if net earnings from self-employment are $400 or more. A completed Schedule SE (IRS Form 1040) is included with the self-employed person's income tax return.

Although the net self-employment earnings base changes annually, the tax rate remains constant at 15.3%. This is 12.4% for Old Age, Survivor, and Disability Insurance (OASDI) and 2.9% for the Hospital Insurance Plan (HIP). The maximum amount of income subject to this tax varies according to the type of insurance.

Type of Insurance		2020 Maximum Base
OASDI	at 12.4%	$137,700
HIP	at 2.9%	No Limit

An additional Medicare (HI) surtax of 0.9% is imposed on individual taxpayers on self-employment income for the tax year in excess of:

$250,000	for married persons filing jointly
$125,000	for married persons filing separately
$200,000	in all other cases

Section 4500
Federal Taxation of Entities
(28% - 38%)

4505 Tax Planning

Alternative Treatments

4505.01 When engaging in tax planning, the tax practitioner researches the tax consequences of various potential courses of action. In certain situations, conflicting sources of tax authority may be found. If this is the case, there should be a thorough analysis of the alternative tax treatments that could result.

4505.02 Alternative tax outcomes should be communicated to the taxpayer so that they can make a fully informed decision as to the course of action they wish to take.

Projections of Tax Consequences

4505.03 Part of the tax planning process is developing alternative courses of action for the taxpayer. As potential courses of action are developed, the tax planner also develops projections of the tax consequences that will result from each option. As a result, the taxpayer can make an informed decision as to the option that will provide them with the optimal after-tax result.

Implications of Different Business Entities

4505.04 One of the major issues in tax planning is often determining the best form in which to operate a business. When making this determination, tax factors play a significant part in the final decision. However, nontax factors such as limiting legal liability and the ability to raise capital in the future are also major factors in deciding which type of entity is ultimately chosen.

Impact of Proposed Tax Audit Adjustments

4505.05 It is important to factor the impact of proposed tax audit adjustments into the tax planning process. If a taxpayer follows a particular course of action, is audited, and audit adjustments result, this will generally result in additional costs to the taxpayer. Not only will the taxpayer be liable for the back taxes due, but they also will be liable for interest on the tax deficiency. Additionally, the taxpayer may be liable for penalties.

4505.06 A major part of tax planning is to be sure that any course of action taken by the taxpayer can be justified if the taxpayer is audited and adjustments are proposed. Planning for any potential IRS challenges to the position taken by the taxpayer will minimize the impact of any potential tax audit adjustments.

Impact of Estimated Tax Payment Rules on Planning

4505.07 Part of the tax planning process is determining the tax liability that will result for the taxpayer from various courses of action. This is especially important for the particular course of action that is actually chosen by the taxpayer.

4505.08 By properly projecting the tax liability that will be due, the appropriate estimated tax payments that will be due throughout the tax year can be calculated. This will allow the taxpayer to plan ahead to be sure that the resources are available to make the required estimated tax payments. This in turn will allow the taxpayer to avoid the imposition of any penalties that could result from the failure to pay the correct amount of estimated tax as the payments come due throughout the year.

Role of Taxes in Decision Making

4505.09 In the decision-making process, the role of taxes should play a significant part. Whether the decision is being made in a personal or business context, one of the goals of tax planning should be to minimize the taxpayer’s tax liability as much as possible. However, the ultimate goal should be to optimize the taxpayer’s after-tax result. This may not in all cases result in the lowest tax liability for the taxpayer.

4505.10 In making decisions, taxes should be a factor, but not the only factor. In certain cases, nontax considerations may be as important, or more important, than the tax considerations. Therefore, in decision making, all factors, tax and nontax, should be considered. Generally, no decision should be made based on the tax considerations alone if the personal or business considerations involved would point to not making the same decision.

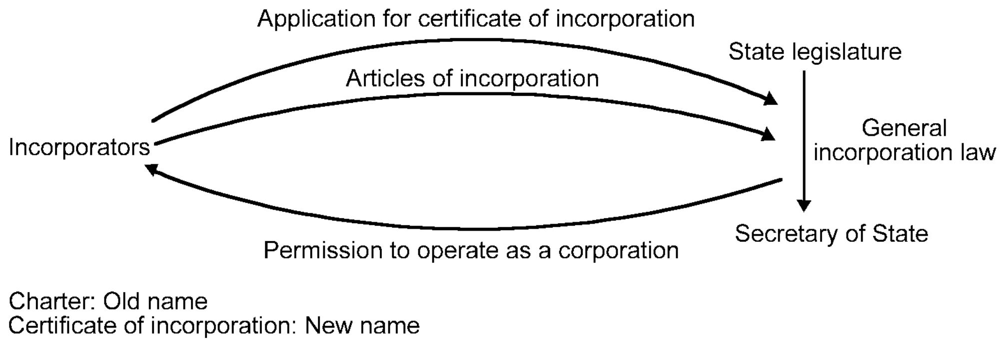
4510 Tax Treatment of Formation and Liquidation of Business Entities

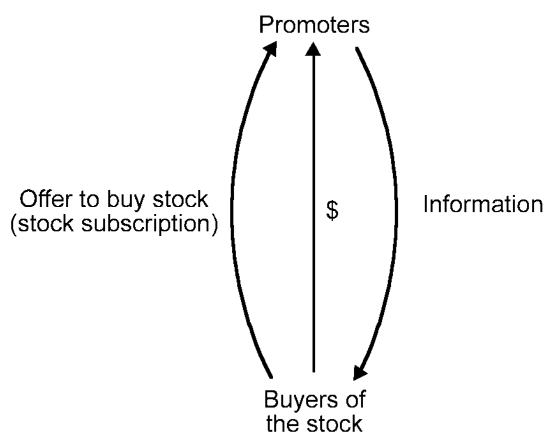
4511 Formation

4511.01 **C corporation**

- **a.** The corporation is a creation of the state. The incorporated entity must be chartered under the laws of a specific state. Issuance of a certificate of incorporation by the secretary of state is the start of corporate existence.
- **b.** Regular corporations report federal taxes under Subchapter C of the Internal Revenue Code. The tax year of a regular corporation is generally unrestricted.
- **c.** A C corporation is a tax-paying entity under federal tax laws.

d. The following diagram shows the activities that occur when a corporation is formed. Note that the incorporators do the paperwork with the state, while the promoters sell the stock.





4511.02 S corporation

a. An S corporation is a creature of federal tax law.

b. An S corporation may be treated as a regular corporation under state law; the S corporation elects special tax status for federal tax and the state may follow the federal reporting of income to the S shareholders.

c. S corporations report their income and other tax attributes to their shareholders on Schedule K-1 of IRS Form 1120S. The shareholder reports those items on his or her Form 1040.

d. The S corporation is a pass-through entity and generally does not pay federal income tax.

(1) When applicable, an S corporation will pay a built-in gains tax. (IRC Section 1374)

(2) When applicable, an S corporation will pay an excess net passive investment income tax. (IRC Section 1375)

e. The S corporation taxable year is the calendar year unless IRS approval is obtained for a fiscal year. (IRC Section 1378)

f. To prevent a deferral of income due to a difference between the tax year of the entity and its owners, S corporations are limited in the choice of their tax years.

g. S corporations can generally elect to use a tax year other than their required tax year if:

(1) a business purpose for the tax year can be shown (a business purpose will be considered to exist if the entity can show that the requested tax year conforms to the natural business year of the entity) or

(2) the tax year selected results in a deferral of income of not more than three months from the required tax year and the entity agrees to make required tax deposits (a Section 444 election). The deposit due is computed by multiplying the income deferred under the elective tax year by the highest individual tax rate plus 1%. The amount to be deposited is reduced by the amount already on deposit from the prior tax year.

4511.03 General partnership

a. A general partnership must meet the definition of a partnership: two or more persons working as co-owners of a business with an intention to make a profit.

b. A general partnership is not a taxable entity; tax attributes are passed through to the partners.

c. To prevent a deferral of income due to a difference between the tax year of the entity and its members, partnerships are generally limited in the choice of their tax years. A partnership must generally adopt a tax year under the majority partner rule. Under this rule, the partnership must use the same tax year as that which is used by any partner or partners who hold more than a 50% interest in the partnership capital and profits.

d. If the majority partner rule does not apply, the partnership must use the same tax year as all of its principal partners. A principal partner is a partner who holds a 5% or more interest in partnership capital or profits. For this rule to apply, all of the principal partners must have the same tax year.

e. If the principal partner rule does not apply, the partnership must use the tax year that results in the least aggregate deferral of income. Under the least aggregate deferral rule, the different tax years of the principal partners are tested to see which of those tax years results in the least aggregate deferral overall for the partnership. This year is then the required partnership tax year.

f. Partnerships may be permitted to use a tax year other than their required tax year if:

(1) a business purpose for the tax year can be shown (a business purpose will be considered to exist if the entity can show that the requested tax year conforms to the natural business year of the entity) or

(2) the tax year selected results in a deferral of income of not more than three months from the required tax year and the entity agrees to make required tax deposits (a Section 444 election). The deposit due is computed by multiplying the income deferred under the elective tax year by the highest individual tax rate plus 1%. The amount to be deposited is reduced by the amount already on deposit from the prior tax year.

4511.04 Limited partnership

a. The limited partnership has the same definition as a general partnership (two or more persons working as co-owners of a business for profit).

b. A limited partnership has at least one general partner and at least one limited partner.

c. Limited partnerships are authorized under the laws of a particular state.

d. Some states require the limited partnership to register with the state in order to be allowed to sell interests to limited partners.

4511.05 Personal service corporations

a. A personal service corporation (PSC) is a corporation in which shareholder-employees provide personal services in the area of health, law, accounting, actuarial science, consulting, engineering, architecture, or performing arts.

b. Generally, a personal service corporation is required to use a calendar year.

c. A personal service corporation can elect a fiscal year if:

(1) a business purpose exists for the fiscal tax year or

(2) the following occurs:

(a) the fiscal tax year of the personal service corporation results in a deferral of no more than three months of income,

(b) the personal service corporation pays the shareholder-employee's salary during the part of the calendar year after the close of its fiscal tax year, and

(c) the salary for that period is proportionate to the shareholder-employee's salary for the previous fiscal tax year.

If the salary tests above are not satisfied, the personal service corporation can still retain its fiscal year. However, the corporation's deduction for the salary paid to the shareholder-employee for the fiscal year will be limited.

4511.06 Limited liability company (LLC)

a. A limited liability company (LLC) is organized under state law and will have:

(1) a certificate of organization issued by the state,

(2) articles of organization containing basic information about the business such as the business name, business purpose, address, registered agent, and members (usually on a state form),

(3) an operating agreement, similar to a partnership agreement, containing allocation of profits and losses, duties of owners, rules for maintaining capital accounts, etc., and

(4) perhaps an election as to how it will be taxed, to default to partnership rules, or possibly elect to be treated as a corporation, perhaps even making an S election.

b. Such issues as selection of a tax reporting year and method as well as accounting methods will be controlled, to some extent, by the form of business operation selected.

c. An LLC will probably be treated as a corporation for state purposes.

d. Members of an LLC are protected against personal liability by operation of state law.

e. Along with that liability protection, the LLC offers the benefit of partnership pass-through of items of income, deduction, gain, loss, and credit.

f. A single-member LLC (SMLLC) is an LLC with only one member. It is a disregarded entity for tax purposes and taxed as a pass-through entity.

4511.07 Limited liability partnership (LLP)

- **a.** An LLP is a general partnership.
- **b.** Partners may be protected from tort liabilities of other partners.
- **c.** An LLP is now used often for legal, accounting, and other professional partnerships.
- **d.** There is no uniformity among states.

4511.08 Sole proprietorship

- **a.** A sole proprietorship is a business entity with no separate identity from the owner.
- **b.** There can only be one owner, but a husband and wife can be treated as one owner based on an election to be so classified.
- **c.** The entity can do business under an assumed name (dba).
- **d.** The tax year of a sole proprietorship is restricted to the tax year of the owner.

4511.09 Formation of entities

- **a.** A corporation is relatively simple to form:
  - (1) The incorporators must file articles of incorporation with the secretary of state where the entity is formed. The filing puts third parties on notice that a corporation exists, with the attendant limitation on liabilities.
  - (2) Articles of incorporation can be generic or specific to the plans and objectives of the venture.
  - (3) A corporation generally is governed by a set of bylaws, which do not require approval by the secretary of state.
- **b.** A general partnership can be formed by simple oral agreements; however:
  - (1) for their protection, partners should prepare a partnership agreement in writing before a transfer of assets or a start of the business activities.
  - (2) since the acts of one partner can bind all of the partners, creating liabilities for them, partners should consult legal counsel for a written partnership agreement.
  - (3) even without a written partnership agreement, the act of two or more persons carrying on a venture for profit may create a legally binding partnership under state law and for federal tax purposes.
  - (4) beginning with 2018 returns, new partnership audit rules require a partnership to elect out in order to avoid new audit rules that make the partnership, not the partners, liable for any tax deficiency. A partnership with fewer than 100 partners is eligible to make the election.
- **c.** Limited partnerships are more complicated than general partnerships:
  - (1) Limited partnerships must register with the state of formation. See *a.(1)* above (limitation on liabilities).
  - (2) The partnership agreement must be filed with the state.
  - (3) Limited partners are often given preference in distributions and tax allocations.
  - (4) Special allocations to limited partnerships must have a business purpose and substantial economic effect. (IRC Section 704(b))

(5) The partnership agreement must contain provisions specified in IRS Regulation Section 1.704-1(b)(2).

(6) Each special provision makes the limited partnership more complex.

(7) Beginning with 2018 returns, limited partnerships will be subject to the same "centralized partnership audit regime" as general partnerships and any LLC or LLP that is treated as a partnership for federal tax purposes.

d. A limited liability company (LLC) also must file articles of organization with the state. LLCs are governed by an operating agreement that looks much like a partnership agreement.

e. A limited liability partnership (LLP) is formed by filing articles of organization with the state. See *a.(1)* above (limitation on liabilities).

f. A sole proprietorship is simple to form. It starts up when an individual begins conducting business without incorporating or starting a partnership of any kind.

g. Buy-sell agreements for partnerships, LLCs, and closely held corporations (especially S corporations) are useful and important to provide for an orderly transfer of interests.

h. Income tax regulations provide a procedure for some entities to select classification as either a partnership or a corporation (see section **4512.14**).

4511.10 Cost of formation

a. Sole proprietorship cost of formation is minimal. Typically, there is no cost unless the name is registered.

b. Corporations (subchapter C) should be inexpensive to form.

(1) Corporate articles and bylaws should be very inexpensive.

(2) Attorney fees and state filing fees may not exceed a few hundred dollars.

c. The general partnership cost of formation varies with the complexity of the agreement.

(1) With equal sharing ratios for all the partners, a simple partnership agreement should cost no more than formation of a corporation.

(2) Often partnership agreements are more complex, with loss ratios different from profit ratios, leading to additional legal fees.

d. Limited partnership cost of formation rises with an increase in complexity.

e. LLC and LLP formation costs are affected by the complexity of the agreement. The cost may resemble that for partnerships. Articles of organization filed with the state should not be an expensive document.

4511.11 Organization expenses and start-up costs

a. An election may be made to amortize organizational expenses over a period of 15 years (180 months) or more. A special rule allows an immediate expensing of the first $5,000 of these costs. However, this immediate expensing is phased out dollar-for-dollar if total organizational expenses exceed $50,000. Thus, if total organizational expenses are $55,000 or greater, none of the organizational expenses can be immediately expensed.

(1) This election will be deemed made if the taxpayer deducts and amortizes the organizational expenses on the corporation's first tax return.

(2) Corporations not making this election receive no deduction for organization costs until the company is liquidated.

b. Organization costs include expenditures incidental to organizing the business, such as accounting and legal fees, expenses of organizational meetings, and fees paid to the state to obtain a corporate charter.

c. The expenses of issuing stock are not amortizable; they must be netted against the proceeds of the stock sale. These expenses include printing costs, professional fees, commissions, and charges for listing the stock on an exchange.

d. A similar but separate election must be made to amortize start-up expenses as well. Start-up expenses are those costs related to the creation of a business prior to the time the activity becomes an active trade or business.

e. Effective August 16, 2011, a taxpayer can elect to deduct up to $5,000 of business start-up costs as a current business expense. The $5,000 deduction is reduced by the amount the taxpayer's total start-up costs exceed $50,000. Any remaining costs must be amortized ratably over a 180-month period as a Section 197 intangible. Organization costs are amortized separately.

f. A partnership can amortize an organizational cost only if it satisfies all of these five tests:

(1) It is for the creation of the partnership and not for starting or operating the partnership.

(2) It is chargeable to a capital account.

(3) It could be amortized over the life of the partnership if the partnership had a fixed life.

(4) It is incurred by the due date of the partnership return (excluding extensions) for the first tax year.

(5) It is for a type of item normally expected to benefit the partnership throughout its entire life.

Some expenses cannot be amortized (regardless of how the partnership characterizes them), including expenses connected with:

(1) acquiring assets for the partnership or transferring assets to the partnership,

(2) admitting or removing partners other than at the time the partnership is first organized,

(3) making a contract relating to the operation of the partnership trade or business (even if the contract is between the partnership and one of its members), and

(4) syndicating the partnership.

4512 Operation

4512.01 In the process of choosing the entity to use for the operation of a business, the need for limiting the liability of the owners of the business may be the most important factor to consider. The objective of this choice is to reduce or eliminate the exposure to personal liability for torts and claims against the entity.

4512.02 A limited liability entity should be used if a judgment for personal injury to a third party could exceed normal insurance coverage for a given business.

4512.03 Additional personal liability for the business owner could result from a variety of causes:

- **a.** Debts and expenses of the entity
- **b.** Personal or professional services provided
- **c.** Dangerous activities (construction, machinery, vehicles)
- **d.** Providing food service
- **e.** Environmental risks
- **f.** Actions of employees

4512.04 The limited liability company (LLC) combines features of both partnerships and corporations.

- **a.** From the partnership form there is a complete pass-through of tax attributes generated by operations and great operational flexibility.
- **b.** From the state law, the LLC has the same limitation of personal liability as held by a corporation.
- **c.** Through the operating agreement there may be participation by all of the members, if that is desired.

4512.05 **Limited liability company attributes**

- **a.** Liability protection for all members
- **b.** Legal entity created by state law
- **c.** LLC may own property, incur debts, enter into contracts, and sue or be sued.
- **d.** Members shielded from LLC's debts

4512.06 General partnerships offer no liability protection for general partners.

4512.07 Limited partnerships have liability protection for limited partners, but general partners have full liability.

4512.08 A limited liability partnership provides protection against torts by other partners, but no protection against general liability.

4512.09 **IRC Section 448:** The accounting method used by any entity to report income and deductions is extremely important. There are two basic accounting methods that are used:

1. The cash method generally recognizes income on the cash basis when cash is received and recognizes deductions when the expenses are paid. Individual taxpayers typically use the cash method for their tax returns. Qualified personal service corporations are allowed to use the cash basis of accounting.
2. The accrual method of accounting generally recognizes income on the accrual basis when it is earned and deductions when they are incurred. The following entities must use the accrual basis of accounting, unless they qualify for use of the cash method: C corporations, any partnerships that have a C corporation as a partner, certain trusts, and tax shelters.

However, virtually any entity can use the cash method if it clearly reflects income and the entity's average annual gross receipts do not exceed $26 million in 2020 (subject to annual inflation adjustments).

4512.10 Any taxable entity needs to know the effect of the rules related to passive activity losses. The passive activity rules apply to individuals, estates, trusts, personal service corporations, and closely held C corporations. The passive activity loss rules do not apply to partnerships, widely held C corporations, or S corporations. For partnerships and S corporations, the passive activity loss rules are applied at the partner/shareholder level.

4512.11 Accounting methods for small businesses

a. Method of accounting: The cash method of accounting allows businesses to recognize income and deduct expenses when the cash is received or paid, rather than having to accrue income and expense. Corporations and partnerships (with a corporate partner) may use the cash method of accounting if their average annual gross receipts for the three-year period preceding the current year do not exceed $26 million in 2020 (subject to annual inflation adjustments).

b. Accounting for inventories: A business that is required to use an inventory method (if the production, purchase, or sale of merchandise is a material income-producing factor to the business) must also use the accrual method of accounting, unless average annual gross receipts are not more than $26 million, in which case it may use the cash method of accounting and account for inventory as non-incidental materials and supplies, or it may use the method of accounting currently reflected on its financial statements.

c. Valuation methods for inventories: Unless a taxpayer uses the LIFO (last in, first out) method, inventories may be valued at the lower of cost or market. A taxpayer using the LIFO method is generally required to value inventory at cost. In determining cost, a taxpayer may generally use specific identification, FIFO (first in, first out), or LIFO (specific goods or dollar-value LIFO) as long as the method selected is applied consistently from tax year to tax year. A taxpayer does not have to request IRS approval to change to the LIFO method. However, once the election is made, it cannot be revoked by the taxpayer. If a taxpayer wishes to change from the LIFO method to any other method, IRS approval must be obtained. If the taxpayer elects to use the LIFO method for tax purposes, the taxpayer's financial reports must also be prepared using the LIFO method.

d. Uniform capitalization: The uniform capitalization (UNICAP) rules require certain direct and indirect costs associated with both real and personal property acquired for resale or manufactured to be included in either inventory or capitalized into the basis of such property. Businesses with $26 million or less in 2020 (subject to annual inflation adjustments) of average annual gross receipts are not subject to the UNICAP rules.

e. Accounting for long-term contracts: A long-term contract is a contract for the manufacture, building, installation, or construction of property if the contract is not completed within the taxable year in which it starts. A manufacturing contract is not a long-term contract unless it involves the manufacture of (1) a unique item of a type that is not normally included in the finished goods inventory of the taxpayer or (2) any item that normally requires more than 12 calendar months to complete (without regard to the period of the contract). The taxable income from a long-term contract generally is determined under the percentage-of-completion method. An exception is provided for certain businesses with average annual gross receipts of $26 million or less in 2020 (subject to annual inflation adjustments) over the preceding three years. Under this exception, a business may use the completed-contract method or the accrual method with respect to contracts that are expected to be completed within a two-year period.

f. Business interest deduction: The Tax Cuts and Jobs Act of 2017 (TCJA) amended IRC Section 163(j) to reflect a limitation on the deduction for business interest expense for certain taxpayers in tax years beginning after 2017. In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the business interest income, plus 30% of the adjusted taxable income of the taxpayer for the taxable year, plus any floor plan interest expense of the taxpayer for the taxable year. An exception applies for the $26 million in 2020 (subject to annual inflation adjustments) gross receipts test, so this limitation will not apply to most taxpayers. Any amount of business interest expense that is not allowed as a deduction under Section 163(j) for the tax year is carried forward to the following year as a disallowed business interest expense carryforward. The disallowed Section 163(j) deduction may be carried forward indefinitely.

The CARES (Coronavirus Aid, Relief, and Economic Security) Act temporarily amended the TCJA Section 163(j) limitation by retroactively increasing the limitation on the deductibility of interest expense from 30% to 50% for tax years beginning after December 31, 2018, and before January 1, 2021. In the event that the business did not have taxable income in 2020, such business may elect to use its 2019 adjusted taxable income in computing its 2020 limitation.

4512.12 Tax Cuts and Jobs Act of 2017 (TCJA)

a. The TCJA provides that taxpayers, other than tax shelters, that satisfy the $26 million in 2020 (subject to annual inflation adjustments) *gross receipts test* may use the cash method of accounting whether or not the purchase, production, or sale of merchandise is an income-producing factor.

The TCJA retains the exceptions to the accrual method for qualified personal service corporations, partnerships without C corporations as partners, S corporations, and other pass-throughs. Such entities can use the cash method whether they meet the gross receipts test if the use of the cash method clearly reflects income.

b. The TCJA exempts certain taxpayers that meet the gross receipts test from accounting for inventories under IRC Section 471. These taxpayers may use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies or (2) conforms to the taxpayer’s financial accounting treatment of inventories.

c. The TCJA expands the exception for small taxpayers from the uniform capitalization rules of IRC Section 263A if such taxpayers meet the gross receipts test.

d. The TCJA also expands the exception for small construction contracts from the requirement to use the percentage-of-completion method. The exception is for construction or improvement of real estate if the contract (1) is expected to be completed within two years of the commencement of the contract and (2) is performed by a taxpayer that meets the gross receipts test.

4512.13 Tax return elections (in general)

The Internal Revenue Code provides for numerous tax elections that can be made by a taxpayer and impact the taxpayer’s tax return. The following material highlights some of the tax elections available to a taxpayer.

4512.14 Check the box

a. Under the “check the box” income tax regulations at 26 CFR Section 301.7701-1 through 301.7701-3, certain entities are permitted to elect or change how they wish to be treated for federal tax purposes. This eliminates the need for taxpayers to artificially shape business organizations to produce a desired entity classification.

b. In order to fall under the check-the-box regulations, the entity must meet three requirements:

(1) First, it must be separate from its owners or members.

(2) Second, the entity must be a business entity and not classified as a trust or otherwise subject to special treatment under the Internal Revenue Code.

(3) Finally, the entity must be an eligible entity. An eligible entity is one not organized under either a state or federal incorporation statute. That means an eligible entity must be a partnership, an LLC (limited liability company), or an LLP (limited liability partnership).

c. Such an entity with at least two members will default to partnership status, unless the entity elects to be taxed as a corporation for federal tax purposes.

(1) An entity that elected to be treated as a corporation may then also elect to be treated as an S corporation and pass all items of income, deduction, etc. through to its owners, who must all be qualified S shareholders.

(2) Members of an entity electing to be treated as an S corporation should assure there are no provisions in a partnership agreement or limited liability company operating agreement that would cause automatic termination of the S election.

d. A single member entity will be treated as not separate from the owner (i.e., if the member is an individual, it will be treated as a sole proprietorship), unless there is an affirmative election to be treated as a corporation.

e. An entity that wishes to elect out of its default classification, or change its classification, can do so by filing IRS Form 8832 (*Entity Classification Election*).

f. An entity can file its initial election at any time. However, an entity is generally prohibited from filing more than one election to change the entity's classification during any 60-month period.

g. If there is a more than 50% change in ownership of the entity, the IRS may waive the 60-month waiting period for a new election.

4512.15 Depreciation elections

a. In depreciating property for federal income tax purposes, a number of elections are available to a taxpayer. Revenue Procedures 87-56 and 87-57 provide information on various cost recovery or depreciation options.

b. For personal property, a taxpayer may elect to use the modified accelerated cost recovery system (MACRS). Under this method, cost recovery is computed using a declining-balance method in the early years, switching to straight-line for the later years.

c. Another option for personal property that can be selected by the taxpayer is using a straight-line method of cost recovery over the applicable class life (3-, 5-, 7-, 10-, 15-, or 20-year class period).

d. A final option for personal property is to elect to recover the cost using the alternative depreciation system (ADS) method. The ADS method recovers the cost of the property using a straight-line method, but the recovery period is generally longer than under the straight-line method.

e. For personal property, the taxpayer must elect one of the above cost recovery methods and use that method for all of the assets in a particular class (3, 5, 7, 10, 15, or 20 years) put in service during the tax year.

f. For real property placed in service during the year, the taxpayer generally has two cost recovery options. One is to use the MACRS method. Under MACRS, cost recovery is done using a straight-line method over a period of 27.5 years for residential rental real estate or 39 years for nonresidential real estate.

g. The other option that may be selected for real estate is the ADS method of cost recovery. Under ADS, the cost of the real estate (residential and nonresidential) is recovered using a straight-line method over 40 years.

h. The election of cost recovery method for real estate is done on a per-property basis.

i. The Tax Cuts and Jobs Act of 2017 (TCJA) introduced a number of modifications of depreciation options as well as 100% bonus depreciation for tangible personal property used in a trade or business and optional depreciable lives and methods for real property when the taxpayer agreed to limit deductions for interest in a real property trade or business.

4512.16 Section 179 election and bonus depreciation

a. Internal Revenue Code (IRC) Section 179 provides a taxpayer with the election to immediately expense the cost of qualified property rather than recovering the cost over the property's recovery period.

b. The Tax Cuts and Jobs Act of 2017 (TCJA) increased the maximum "Section 179 deduction" to $1.04 million in 2020 (adjusting for inflation). That deduction phases out, dollar for dollar, when the cost of qualifying property acquired during 2020 exceeds $2.59 million, an amount referred to as the "phaseout threshold."

c. The TCJA expanded the definition of Section 179 property to include the following improvements made to nonresidential real property after the date when the property was first placed in service:

(1) Qualified improvement property (improvement to a building's interior): improvements do not qualify if they are attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

(2) Roofs, HVAC, fire protection systems, alarm systems, and security systems

d. The bonus depreciation percentage was increased to 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The TCJA added qualified film, television, and live theatrical productions as types of qualified property that are eligible for 100% bonus depreciation. Special rules apply for longer production period property and certain aircraft.

The TCJA did not reflect the intended 15-year recovery period for qualified improvement property (QIP) due to a drafting error, and instead assigned it a tax life of 39 years. The CARES (Coronavirus Aid, Relief, and Economic Security) Act reclassifies QIP as 15-year property (20-year alternative depreciation system (ADS) life) and allows businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life. The CARES Act QIP fix is effective for property placed in service after December 31, 2017.

e. The TCJA changed depreciation limits for passenger vehicles placed in service after December 31, 2017. If the taxpayer does not claim bonus depreciation, the greatest allowable depreciation deduction is:

(1) $10,000 for the first year,

(2) $16,000 for the second year,

(3) $9,600 for the third year, and

(4) $5,760 for each later taxable year in the recovery period.

If a taxpayer does claim 100% bonus depreciation, the greatest allowable depreciation deduction is:

(1) $18,000 for the first year,

(2) $16,000 for the second year,

(3) $9,600 for the third year, and

(4) $5,760 for each later taxable year in the recovery period.

f. In practice, the dollar limitation of IRC Section 280F(a), the additional first-year amount allowable by IRC Section 168(k), and the 100% additional first-year deduction allowed by IRC Section 179 could not be easily reconciled. The IRS provides a “safe harbor” method for computing the allowable depreciation for a passenger automobile used in a trade or business in Revenue Procedure 2019-13.

g. The new law also removes computer or peripheral equipment from the definition of listed property. This change applies to property placed in service after December 31, 2017.

4513 Distributions

4513.01 Corporation’s distribution of property to a shareholder:

a. If the property distributed to a shareholder has a fair market value in excess of the adjusted basis on the corporate books, a gain is recognized by the corporation (IRC Section 311(b)).

b. The distribution to the shareholder is a dividend to the shareholder to the extent of the earnings and profits of the corporation. The difference between fair market value and the basis in the corporation may be taxable to the shareholder.

c. Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until the taxpayer makes the payment and the corresponding amount is includible in the related person's gross income. An individual is considered related to a corporation when the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.

Example: Megan, a cash-basis taxpayer, owned 35% of Vincent, Inc., stock. Vincent files a calendar-year IRS Form 1120 under the accrual method of accounting. Megan loaned Vincent $200,000 at the beginning of 20X8. The accrued interest on this loan was $10,000 as of December 31, 20X8. Vincent paid Megan the $10,000 in January 20X9. Since Megan owns less than 50% of Vincent, Inc., a related party transaction does not exist and therefore the interest would be reported as follows: Vincent, Inc., reports the expense in 20X8 and Megan reports the income in 20X9.

4513.02 S corporation's distribution of property to a shareholder: When an S corporation distributes appreciated property, it also triggers a gain recognition at the corporate level. The gain is passed through to all shareholders pro-rata to be taxed at that level.

4513.03 Partnership's distribution of property to a partner:

a. When a partner receives a distribution, it is only taxable to the extent that cash or securities exceed the partner's basis.

b. Distributions of noncash appreciated property are tax free.

c. The partner's basis in the partnership is reduced by the basis in the property but not below zero.

d. This treatment applies to general partnerships, limited partnerships, and LLCs (limited liability companies) taxed as partnerships.

4513.04 Nonliquidating distributions of a corporation:

a. reduce the earnings and profits (E&P) of the corporation and

b. are taxable as dividends to the shareholder to the extent of E&P.

4513.05 Nonliquidating distributions of a partnership:

a. are taxed as a capital gain to the partner only when the fair market value of property distributed exceeds the partner's basis and

b. result in a reduction in the partner's capital account.

This tax treatment applies to general partnerships, limited partnerships, and LLCs (limited liability companies) taxed as partnerships.

4513.06 Nonliquidating distributions of an S corporation:

a. are taxed as capital gain to the shareholder only on the excess fair market value over the shareholder's basis in S corporation stock,

b. reduce the S corporation's accumulated adjustments account, and

c. reduce the shareholder's stock basis.

4514 Liquidation

4514.01 Liquidating dividend from a corporation:

a. The corporation (either C or S) recognizes a gain or a loss when a corporation is liquidated.

b. The corporation recognizes gain or loss as if the property were sold at its fair market value.

4514.02 Liquidating distributions from a partnership:

a. If a partner received cash or marketable securities (cash equivalents) in excess of the partner's adjusted basis in the partnership, then gain is recognized on that excess.

b. If no cash equivalents are distributed, no gain is recognized. (IRC Section 731(a)(1))

c. If a partner receives cash, unrealized receivables, or inventory in a liquidating distribution, a loss may be recognized by the partner equal to the difference between FMV and the partner's basis. (IRC Section 732)

d. If only other property is received, then no loss may be recognized.

4515 Advantages, Disadvantages, Implications, and Constraints

Corporations

4515.01 Classifications of corporations

a. **De jure.** A corporation that has generally complied with all the statutory regulations for incorporation except for an insignificant deviation from the statute that causes no harm to the public interest. Corporate existence can generally not be challenged.

b. **De facto.** A corporation that has failed to comply with some provision of the incorporation law. There must be a valid statute under which the corporation could be formed, a good faith attempt to organize under the statute, and an actual use of corporate power. If so, a de facto corporation has the same rights and powers of a de jure corporation insofar as any person or entity, other than the state, is concerned. This recognition prevents harsh rules making the individual owners liable.

c. **Corporation by estoppel.** An organization representing itself to be a corporation or a person contracting with an organization as if it were a corporation is estopped from later denying the corporate existence

d. **Private.** Organized for private purposes by private parties

e. **Public (or governmental).** Created by the state to fulfill governmental purposes

   Example: Federal Deposit Insurance Corporation (FDIC)

f. **Quasi-public.** A private corporation furnishing service upon which the public is dependent, such as a public service corporation or utility. It is usually given a special franchise and power.

g. **Profit.** Organized primarily to make a profit for the owners

h. **Nonprofit.** Formed for religious, charitable, social, educational, or mutual-benefit purposes. They are called eleemosynary (related to, or supported by charity). Examples are athletic clubs, fraternities, hospitals, and private universities. They may be carried on at a profit if the profit is incidental to the main purpose. They must be nonstock.

i. **Domestic.** A corporation is referred to as being a domestic corporation in the state in which it is incorporated.

j. **Foreign.** A corporation is referred to as foreign in a state other than the one in which it is incorporated.

k. **Alien.** Incorporated in a foreign country

l. **Closely held, closed, close.** A corporation with one or only a few shareholders whose shares are not generally available to the public

m. **Publicly held.** A corporation whose shares are publicly traded and are generally held by a large number of shareholders

n. **Professional corporation.** A corporation organized to carry on a profession with stock owned by members of that profession. Most often these are physicians, CPAs, engineers, architects, consultants, or lawyers.

o. **Stock.** Ownership is evidenced by shares of stock.

p. **Nonstock.** Stock is not issued by the corporation—done only for social or charitable corporations.

4515.02 Constitutional rights of a corporation

a. A corporation has the following constitutional rights:

(1) To be secure from unreasonable searches and seizures

(2) Not to be deprived of life, liberty, or property without due process of law

(3) Not to be tried twice for the same criminal offense (called double jeopardy)

(4) Not to be denied equal protection of the laws

(5) First Amendment right of freedom of speech

b. A corporation does not have the constitutional right against self-incrimination. This right applies only to real persons.

4515.03 Powers of a corporation

a. A corporation has only the powers expressly given in the law adopted by the legislature (such as the Model Business Corporation Act (MBCA)). Individuals, on the other hand, have any power not denied to them by the Constitution.

b. Corporations derive their power from three sources, as follows:

(1) **Statutory:** From the state's corporation laws. Examples of this power include the following:

(a) Having a corporate name

(b) Purchasing and holding property for corporate purposes

(c) Making bylaws

(d) Borrowing money

(e) Making contracts

(2) **Express:** From the articles of incorporation and the corporate bylaws; cannot conflict with statutory powers.

(3) **Implied:** Activities needed to carry out the statutory and express powers; these activities fill the gaps that exist in the statutory and express powers.

c. Corporate liability for wrongful conduct:

(1) A corporation is liable under the doctrine of *respondeat superior* for the torts of its employees committed within the course of employment. This fact is true even if the activity is beyond the powers of the corporation.

(2) A corporation can be punished by fine for the criminal conduct of its employees.

(3) An *ultra vires* act is one beyond the scope of the powers of the corporation. An *ultra vires* act is not necessarily an illegal act, but an illegal act is always an *ultra vires* act.

d. *Ultra vires* can be used only as a defense in limited cases.

(1) It cannot be used by the corporation to avoid a contract unless it is totally executory.

(2) It can be used by the following:

(a) A shareholder against a corporation to prohibit the corporation from performing a totally executory contract

(b) The corporation, or shareholders acting for the corporation, against former or present officers or directors to recover damages

(c) The state attorney general against the corporation to stop performance of an *ultra vires* contract or to dissolve the corporation

4515.04 S corporation

Certain corporations can elect S corporation status. In order to elect S corporation status, the corporation must be a small business corporation. This means that:

a. the entity must be a domestic corporation organized under the laws of a state or a U.S. territory or an unincorporated entity that has elected to be taxed as a corporation under the check-the-box rules,

b. the corporation must have only individuals, estates, certain trusts, banks, and certain exempt organizations as shareholders,

c. the shareholders must be citizens or permanent residents of the United States,

d. the corporation can have only one class of stock, and

e. an S corporation is limited to 100 shareholders. A married couple can count as 1 shareholder.

For a more detailed discussion of S corporations, see section **4540.**

Partnerships

4515.05 Partnerships

a. A *partnership* is a voluntary legal relationship created, under state law, by two or more persons to carry on, as co-owners, a business for profit. If the profit motive is lacking, it is an unincorporated association for federal tax purposes.

b. Partnerships are governed by the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA). Generally, if the partners do not specifically address particular matters in the partnership agreement, the applicable Act provision will apply.

c. **Trading** (or commercial): Buying and selling or leasing property. A partner in a trading partnership has a great deal of implied authority to act for the partnership.

d. **Nontrading:** Rendering a service; practicing a profession (e.g., CPA, physician, or lawyer). A partner in a nontrading partnership has less implied authority than a partner in a trading partnership.

e. A partnership is not a legal entity (legal existence separate from the persons associated together to create it) for the purpose of insulating the partners from personal liability.

f. It is a legal entity for the purpose of owning property or employing persons to transact business on the partnership's behalf.

4515.06 **Limited partnerships:** Limited partnerships are governed by the Uniform Limited Partnership Act (ULPA) and the Revised Uniform Limited Partnership Act (RULPA). These have been adopted by almost all states.

a. The limited partnership must have one or more general partners and one or more limited partners.

b. The limited partnership must file a certificate with the state that lists the following:

(1) Name of the limited partnership

(2) Type of business and its location

(3) General and limited partners

(4) Contribution of each limited partner (this can be cash or other property)

(5) Other rights, including rights of limited partners to profits

c. The name of the partnership cannot use the last name of a limited partner unless a general partner has the same last name.

d. A limited partner can be given the right to substitute an assignee in their place with no partnership dissolution if the partnership agreement so provides.

e. One limited partner may be given priority over other limited partners in distributing profits.

f. A limited partner who allows the use of his name in the partnership name or who participates in management is liable as a general partner to the creditors of the partnership.

g. A new general or limited partner cannot be added unless all general and limited partners agree or it is provided for in the partnership agreement.

h. Order of distribution of assets on dissolution is as follows:

(1) To creditors

(2) To limited partners for profit

(3) To limited partners for return of capital contribution

(4) To general partners for loans to partnership

(5) To general partners for profits

(6) To general partners for return of capital contribution

i. Sale of a limited partnership interest may be regulated by the federal securities laws.

4515.07 **Limited liability partnership (LLP)**

a. An LLP is generally created by filing the required forms with the secretary of state's office.

b. State LLP statutes also generally require that the LLP maintain some specified level of professional liability insurance and pay an annual fee to the state (usually on a per-partner basis).

c. The unique feature of an LLP is that a partner's liability for a fellow partner's professional malpractice is limited to the partnership's assets. In other words, a partner does not have unlimited personal liability for another partner's malpractice.

d. However, partners in an LLP do retain unlimited personal liability for their own malpractice as well as for any other partnership obligations.

4515.08 Limited liability company (LLC)

a. An LLC is generally created under state law by filing articles of organization with the secretary of state's office.

b. For a discussion of the details regarding LLCs, see section **4560.**

4515.09 Joint ventures

a. Joint ventures are similar to general partnerships in that they involve the co-ownership of a business for profit.

b. Typically, joint ventures are established for conducting a *single* enterprise or transaction and usually continue for a shorter duration than most general partnerships. Because general partnerships can have the same limitations, however, it may be difficult to distinguish the two types of entities.

c. Most courts hold that joint ventures are governed by partnership law.

(1) Joint venturers, therefore, owe each other fiduciary duty.

(2) Joint venturers generally have the same unlimited liability as general partners.

(3) Joint venturers have equal rights to manage the business; however, they may agree to delegate this power to one participant or employ a third-party manager.

(4) The duration of a joint venture can be specified in the agreement of the parties, terminable at will by any participant, or related to the completion of a specific project such as the purchase and development of a tract of land.

(5) Members of a joint venture do not generally have the same broad implied or apparent authority that a general partner may possess due to the usual limited purpose of a joint venture.

(6) The death of a joint venturer, however, does not automatically dissolve the joint venture.

4515.10 Sole proprietorship

a. A sole proprietorship is a form of business that is simply an extension of the sole, individual owner.

b. No formalities are required for the formation of a sole proprietorship. They are formed very easily and inexpensively. If the individual fails to choose another form in which to operate the business, the business is a sole proprietorship by default.

c. A sole proprietorship is not recognized as a legal entity. Plaintiffs must sue the individual owner, not the sole proprietorship. Also, the sole proprietor must individually sue anyone that causes harm to the business.

d. For federal income tax purposes, the sole proprietorship is not a taxable entity. All of the income and expenses of the business are reported on the sole proprietor's individual federal income tax return. (Form 1040, Schedule C)

4515.11 Detailed Comparison of Business Entities - Comparison of Business Entity Table

Characteristics	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company	Limited Liability Partnership	Sole Proprie-torship
Available in all states	Yes	Yes, but state taxation varies	Yes	Yes	Yes	Yes	Yes
Ease of formation	Simple	Simple	Simple to complex	Simple to complex	Simple to complex	More complex	Simple
Governing documents	Articles and bylaws	Articles and bylaws plus "S" elections	Partnership agreement	Partnership agreement	Operating agreement	Partnership agreement	None
Cost of formation	Minimal	Minimal	Moderate to expensive	Moderate to expensive	Moderate to expensive	Moderate to expensive	None
Formal acts required	Yes	Yes	No	Yes; generally must be filed by secretary of state	Yes; generally must be filed by secretary of state	Yes; generally must be filed by secretary of state	No
Existence of uniform act	Yes; Model Business Corporation Act	Not applicable; status as an S corporation is a federal income tax concept	Yes; Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA)	Yes; Uniform Limited Partnership Act (ULPA) and the Revised Uniform Limited Partnership Act (RULPA)	Yes; Uniform Limited Liability Company Act (ULLCA)	No	Not applicable
Limited liability of owners	All shareholders	All shareholders	None	None for general partners; limited partners have limited liability unless they significantly participate in the business	All members unless otherwise provided for by statutes	Generally only for debt and obligations arising from action of another partner	None
Number of owners	No limitations	Limited to 100; family members count as one	Minimum of two; no upper limit	Minimum of two; no upper limit	No upper limit; some states permit single-member LLCs	Minimum of two; no upper limit	One

Characteristics	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company	Limited Liability Partnership	Sole Proprie-torship
Type of owner permitted	No limitations	Basically limited to individual U.S. citizens and permanent residents; some trust ownership permitted	None	No limitations	No limitations	No limitations, except that for professional partnerships each partner may have to be certified or licensed in the profession	No limitations
Multiple classes of ownership	No restrictions	Only one class of stock allowed, but differences in voting rights permitted	No restrictions	No restrictions	No restrictions	No restrictions	No
Permissible businesses	No limitations, except that some states may not allow professional services to be performed through a corporation	No limitations, except that some states may not allow professional services to be performed through a corporation	No limitations	No limitations	No limitations, except that some states may not allow professional services to be performed through an LLC	Most states limit this type of entity to certain professional services	No limitations
Participation in management	No restrictions	No restrictions	No restrictions	Generally restricted to general partners only	No restrictions	No restrictions if formed as a general partnership under state law	No restric-tions
Legal title to property	Corporate name	Corporate name	Generally in the partnership name	Partnership name	LLC or member name	Partnership name	Proprie-tor's name
Transferability of interests	Generally freely transferable	Generally freely transferable, except for limitations as to number and type of shareholders	Transfer generally requires consent of other partners	Transfer generally requires consent of other partners	Limited by state law and operating agreement; may require consent of all members	Transfer generally requires consent of other partners	Freely transfera-ble

Characteristics	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company	Limited Liability Partnership	Sole Proprietorship
Identity of the taxpayer	Corporation	Shareholder, except for built-in gains or passive income	Partners	Partners	Follows corporation or partnership, depending on how it is taxed	Partners	Individual proprietor
Applicable tax rates	Flat rate of 21%; but 20% on taxable personal holding company income and accumulated taxable income	Individual shareholder tax rates; highest corporate rates on built-in gains or excess passive income; 20% deduction per §199A in certain instances	Individual, fiduciary, or corporate tax rates depending on the type of partner; 20% deduction per §199A in certain instances	Individual, fiduciary, or corporate tax rates depending on the type of partner; 20% deduction per §199A in certain instances	Follows corporation or partnership, depending on how it is taxed; 20% deduction per §199A in certain instances	Individual, fiduciary, or corporate tax rates depending on the type of partner; 20% deduction per §199A in certain instances	Individual income tax rates; 20% deduction per §199A in certain instances
Double taxation	Yes	Generally no	No	No	Follows corporation or partnership, depending on how it is taxed	No	No
Election required	No	Form 2553	No	No	Use Form 8832 if prefer to file as a corporation	No	No
Tax year	Any	Calendar year unless §444 election	The same tax year as a majority of its partners; otherwise calendar unless §444 election	Follows partnership or corporate rules, depending on how it is taxed	Follows partnership or corporate rules, depending on how it is taxed	The same tax year as a majority of its partners; otherwise calendar unless §444 election	Calendar year
Contributions of property in exchange for interests in the entity	Generally tax-free under §351	Generally tax-free under §351	Generally tax-free under §721	Generally tax-free under §721	Generally tax-free under §721	Generally tax-free under §721	Not applicable

Characteristics	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company	Limited Liability Partnership	Sole Proprietorship
Contributions of services in exchange for interests in the entity	Taxable unless subject to substantial risk of forfeiture	Taxable unless subject to substantial risk of forfeiture	Generally taxable if made in exchange for capital interest; generally not taxable if made in exchange for profits interest	Generally taxable if made in exchange for capital interest; generally not taxable if made in exchange for profits interest	Follows rules of partnership or corporation, depending on how it is taxed	Generally taxable if made in exchange for capital interest; generally not taxable if made in exchange for profits interest	Not applicable
Method of accounting	Cash method may be permitted except for inventory	Cash method permitted except for inventory	Cash method permitted except for inventory	Cash method generally permitted except for inventory	Generally follows rules for limited partnership unless taxed as a corporation	Generally follows rules for limited partnerships	Cash method permitted except for inventory
Special allocation of tax attributes	Not available	Not available	Very flexible if substantial economic effect	Very flexible if substantial economic effect	Follows corporation or partnership, depending on how it is taxed	Very flexible if substantial economic effect	Not applicable
Limited retroactive modification to agreement	No	No	Yes, if made prior to or at the time of filing the partnership income tax return for the year (IRC 761(c))	Yes, if made prior to or at the time of filing the partnership income tax return for the year (IRC 761(c))	Follows corporation or partnership, depending on how it is taxed	Yes	Not applicable
Timing of income recognition by owners	When distributed	In year in which S corporation's year ends, whether or not distributed	In year in which partnership's year ends, whether or not distributed	In year in which partnership's year ends, whether or not distributed	Follows corporation or partnership, depending on how it is taxed	In year in which partnership's year ends, whether or not distributed	Based on owner's tax year
Deductibility of losses	Deducted at corporate level	Deduction by shareholders limited to basis in stock plus loans to company	Deduction by partners limited to basis in partnership interest	Deduction by partners limited to basis in partnership interest	Follows corporation or partnership, depending on how it is taxed	Deduction by partners limited to basis in partnership interest	Limited to amount at risk

Characteristics	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company	Limited Liability Partnership	Sole Proprietorship
Subject to at-risk provisions	Only if more than 50% of the stock is owned by five or fewer shareholders	Rules applied at shareholder level	Rules applied at partner level	Rules applied at partner level	Follows corporation or partnership, depending on how it is taxed	Rules applied at partner level	Yes
Subject to passive activity rules	Generally no, but exceptions for closely held corporations	Rules applied at shareholder level	Rules applied at partner level	Rules applied at partner level	Follows corporation or partnership, depending on how it is taxed	Rules applied at partner level	Yes, with no limitation
Treatment of capital losses	Can only be used to offset capital gains	Passed through to shareholders	Passed through to partners	Passed through to partners	Follows corporation or partnership, depending on how it is taxed	Passed through to partners	Net $3,000 annual loss allowed after offset of capital gains
Income accumulations within the entity	Reasonable needs of the business	No restrictions	No restrictions	No restrictions	Follows corporation or partnership, depending on how it is taxed	No restrictions	No restrictions
Fringe benefits	No limitations	Owners of more than 2% of the shares cannot receive tax-deductible fringe benefits	Partners are generally not eligible to receive tax-deductible fringe benefits	Partners are generally not eligible to receive tax-deductible fringe benefits	Follows corporation or partnership, depending on how it is taxed	Partners are generally not eligible to receive tax-deductible fringe benefits	Owner is generally not eligible to receive tax-deductible fringe benefits
IRS filing requirements	Files Form 1120	Files Form 1120S and distributes K-1s to shareholders	Files Form 1065 and distributes K-1s to shareholders	Files Form 1065 and distributes K-1s to shareholders	Follows corporation or partnership, depending on how it is taxed	Files Form 1065 and distributes K-1s to shareholders	Proprietor files Schedule C to Form 1040

Characteristics	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company	Limited Liability Partnership	Sole Proprietorship
Effect of transfer of interest on the entity	Transfer of more than 50% ownership over a 3-year testing period may limit corporation's use of net operating loss carryovers and other tax attributes	Transfer to an ineligible shareholder may cause termination of "S" election	None	None	Follows corporation or partnership, depending on how it is taxed	None	Not applicable
Character of gain or loss on sale of interest in the entity	Capital	Capital	Capital, except to the extent of partner's allocable share of partnership's ordinary income assets	Capital, except to the extent of partner's allocable share of partnership's ordinary income assets	Follows corporation or partnership, depending on how it is taxed	Capital, except to the extent of partner's allocable share of partnership's ordinary income assets	Not applicable

4516 Financial Structure, Capitalization, Profit and Loss Allocation, and Distributions

Corporations

4516.01 Initial issue of shares

a. After a corporation is formed and the board of directors meets for the first time, one of the first tasks is to accept offers to buy shares. The board of directors can accept or reject these offers.

b. Pre-incorporation share subscription

(1) **Share subscription:** Offer to buy shares of the corporation not yet formed

(2) Irrevocable for six months unless some other provision exists

(3) These subscriptions are solicited by the promoters while incorporation is in progress.

c. Payment for shares

(1) Payment may be in money, property, or services already performed.

(2) Payment cannot generally be a promise to pay money in the future (promissory note) or a promise to do services in the future.

(3) The money value assigned by the board of directors or shareholders for property or services shall be conclusive as long as the following are true:

(a) They acted as prudent directors would act.

(b) There is a reasonable basis for the valuation (for example, appraisal).

(c) They acted in the corporation's best interest.

d. Shares issued but not fully paid

(1) Corporation or corporation creditors can collect the unpaid portion from the original purchaser even if the original purchaser has sold the shares.

(2) The buyer of not fully paid shares is not liable if shares were purchased in good faith and without knowledge from the first person to whom the shares were originally issued by the corporation.

e. Shareholders are liable to the corporation for the difference in value if they purchase shares from the corporation at a discount. At a minimum, the shareholder should pay as follows:

(1) **Par value shares:** Not less than the par value in dollars for the original issue

(2) **No-par shares:** Not less than the dollar amount fixed by the board of directors for the original issue (stated value)

(3) **Treasury shares:** Any dollar amount fixed by the board of directors (This amount can be less than the par value of the shares as originally issued as long as they are sold for fair market value.)

4516.02 Types of shares

a. **Authorized:** The maximum number of shares a corporation can issue. The limit is stated in the articles of incorporation.

b. **Issued:** The number of shares actually distributed by the corporation

(1) Each issue must be approved by the board of directors.

(2) Each issue must be equal to or less than the total authorized shares.

c. **Outstanding:** The number of shares owned by shareholders of the corporation. Outstanding shares must be equal to or less than the total issued shares.

d. **Treasury:** The number of shares of the corporation owned by the corporation itself

(1) These shares are reacquired shares.

(2) They are considered to be authorized and issued but no longer outstanding since they were purchased on the open market by the corporation.

(3) Treasury shares are often held to give stock options to key officers and employees.

(4) Formula: Issued – Outstanding = Treasury

(5) The number of treasury shares must be less than the total number of outstanding shares of the corporation. The corporation cannot own itself. Such a circumstance would be evidence of a de facto liquidation.

4516.03 Issue of shares

a. Shares may be issued for any of the following:

(1) Money

(2) Property

(3) Services already performed, but not for services to be performed

b. If money is exchanged for shares:

(1) it cannot be less than the par value or the stated value.

(2) the initial shareholder receiving the shares is liable to the corporation and creditors of the corporation if the money is less than par or stated value.

c. If property or services performed is exchanged for shares, the value assigned by the board of directors is conclusive as long as the following are true:

(1) They acted as prudent directors would act.

(2) There is a reasonable basis for the valuation (appraisal, etc.).

(3) They acted in the corporation's best interest.

4516.04 Accounting vs. legal terminology

a. The difference between accounting and legal terminology in the owner's equity section of the balance sheet is shown in the following table:

Accounting Terminology	**Corporate Law Terminology**
Retained Earnings	Earned Surplus
	Earnings and Profits (E&P)
Additional Paid-in Capital	Capital Surplus
Capital in Excess of Stated Value	Capital Surplus
Par Value of Shares	Stated Capital
Stated Value of Shares	Stated Capital

b. Most state corporation laws are written using the corporate law terminology rather than the more commonly used accounting terminology.

4516.05 Amount of stated capital

a. **For par shares.** Par value is the stated capital. Any excess received for the shares would be capital surplus.

b. **For no-par shares.** The entire amount received is stated capital, unless the board of directors allocates between stated capital and capital surplus within 60 days.

Partnerships

4516.06 Partnership property

a. **Partnership capital.** Money and fair market value of property contributed by partners for permanent use by the partnership is called partnership capital.

b. **Tenancy in partnership.** Tenancy in partnership is the term given to the ownership by partners of the partnership's property. All partners have equal rights to use partnership property for partnership purposes.

A partner has no transferable rights in specific partnership property.

c. **Partnership property.** Partnership capital plus retained profits constitute partnership property.

d. **Real property.** A partnership may acquire real property in the name of the partnership. The partnership is a legal entity for this purpose.

4516.07 General partnership

a. Unless the partners agree otherwise, each partner has the right to an equal share in the partnership's profits and losses.

b. If the partnership agreement states how profits are to be shared among the partners but is silent as to how losses are shared, then losses are allocated in the same manner as the profits.

c. If the partnership agreement states how losses are allocated but is silent as to how profits are shared, profits are shared equally.

d. In many cases, a partnership agreement will specify that partnership profits are to be shared in the same ratio as the partner's capital contribution.

4516.08 Limited partnership

a. Unless the partners agree otherwise, the profits and losses of a limited partnership are shared in the same ratio as the capital contributions of each partner.

b. A limited partner, however, can generally not be held liable for the amount of any losses that exceed their capital contribution.

4520 Differences Between Book and Tax Income (Loss)

4521 Reconciliation of Book Income to Taxable Income

4521.01 Required reconciliations:

a. As part of the corporate tax return, corporations must reconcile the difference between taxable income and accounting income on Schedule M-1. As a general rule, corporations are not required to file Schedules L, M-1, and M-2 if their total assets at the end of the taxable year **and** the corporation's total receipts for the tax year are less than $250,000.

(1) Some of the areas where differences may arise include depreciation, life insurance premiums and proceeds, tax-exempt income, expenses of tax-exempt income, capital losses, goodwill, meals and entertainment, penalties, and federal income taxes.

(2) **Summary of Schedule M-1:**

	Net income per books (after taxes)
Add:	Federal income tax
	Net capital loss
	Taxable income not recorded on the books
	Book expenses not deducted on the return
Deduct:	Book income not subject to tax
	Deductions on the return not recorded on the books
=	Taxable income (before net operating loss deduction and dividends-received deduction)

b. Corporate taxpayers must also reconcile the opening and closing balances in retained earnings on Schedule M-2.

4521.02 Reconciling items:

Item	Book	Tax
Interest earned on municipal bonds	Include in revenues	Nontaxable
Interest expense on debt to finance the purchase of municipal bonds	Include as an expense	Nondeductible
Life insurance proceeds payable to the entity	Include in revenues	Nontaxable
Life insurance premiums on officers	Expensed	Nondeductible
Fines and penalties	Expensed	Nondeductible
Depletion	Cost depletion only	Percentage depletion
Dividends-received deduction	None	A percent of the dividend received is allowed as a deduction
Gross profit on installment sales	Income in the year of sale	Income as cash is collected
Investment income	Recognized as income under the equity method	Recognized as dividends are received
Depreciation	Expensed over a longer period of time	Expensed over a shorter period of time using MACRS
Prepaid rent, interest, royalties	Income when earned	Income when received
Warranty expenses, bad debt expense	Estimated and expensed	Deducted as actually incurred
Lobbying expenses	Expensed	Generally nondeductible
Patents	Amortized over 20 years with full deduction in the year it becomes obsolete	Amortized over 15 years beginning in the month acquired
Copyrights	Amortized over the life of the author plus 70 years with full deduction in the year it becomes obsolete	Amortized over 15 years beginning in the month acquired
Goodwill	Carrying value adjusted only when goodwill is impaired	Amortized over 15 years beginning in the month acquired
Business meals	100% deductible	50% deductible
Capital losses	Deductible	Nondeductible; only can offset capital gains; carry back 3 years, carry forward 5 years

4522 Disclosures on Schedule M-3

4522.01 Corporations, and related groups of corporations, with total assets between $10 million and $50 million are allowed to file Schedule M-1 in place of Parts II and III of Schedule M-3. Corporations and related groups of corporations with more than $50 million in assets must reconcile financial statement net income to the net income or loss of the corporation reported for U.S. taxable income using Schedule M-3. (IRS Form 1120, Schedule M-3 is used instead of M-1.)

4522.02 Check-off of types of return for the corporation:

a. Nonconsolidated return

- **b.** Consolidated return (IRS Form 1120 only)
- **c.** Mixed 1120/L/PC group
- **d.** Dormant subsidiaries attached

4522.03 Part 1, Schedule M-3: Type of report filed by the corporation:

- **a.** SEC Form 10-K
- **b.** Income statement that was:
  - (1) certified audited and
  - (2) nontax basis
- **c.** Income statement that was:
  - (1) not certified audited and
  - (2) nontax basis
- **d.** Enter the date for the income statement period:
  - (1) Has the income statement been restated?
  - (2) Has the income statement been restated in the previous five periods?
- **e.** Is any of the corporation's voting common stock publicly traded?
- **f.** Enter the symbol for the corporation's stock that is:
  - (1) the primary corporate stock,
  - (2) U.S. publicly traded, and
  - (3) voting common stock.
- **g.** Enter the nine-digit CUSIP number of the corporation's stock that is:
  - (1) the primary corporate stock,
  - (2) publicly traded in the United States, and
  - (3) voting common stock.

4522.04 Part 1, continued: Reconciliation of statement income to taxable income:

- **a.** Post the worldwide consolidated net income.
- **b.** Check off the accounting standard used:
  - (1) GAAP
  - (2) IFRS
  - (3) Statutory
  - (4) Tax-basis
  - (5) Other
- **c.** Nonincludible foreign entities:
  - (1) Net income
  - (2) Net loss

d. Nonincludible U.S. entities:

(1) Net income

(2) Net loss

e. Net income or loss from other includible:

(1) Foreign disregarded entities

(2) U.S. disregarded entities

(3) Other includible entities

f. Adjustments to eliminations of transactions between includible and nonincludible entities

g. Other adjustments

4522.05 Part II: Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations with Taxable Income per Return—Income (Loss) items: Part II includes lines for reconciling income items.

4522.06 Part III: Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations with Taxable Income per Return—Expense/Deduction Items: Part III includes lines for reconciling expense items.

4523 Reporting Uncertain Tax Positions on Schedule UTP

4523.01 Since tax year 2010, IRS Schedule UTP has been required from some corporations to report uncertain tax positions.

4523.02 Corporations filing Forms 1120, 1120-F, 1120-L, or 1120-PC must file Schedule UTP if total assets equal or exceed the applicable asset threshold for the tax year and the corporation reserved for a tax position in audited financial statements.

4523.03 For tax years beginning in 2014 and later, the asset threshold for reporting uncertain tax positions on Schedule UTP (Form 1120) is $10 million.

4523.04 Corporations meeting all Schedule UTP filing requirements must file a Schedule UTP and provide “concise descriptions” of uncertain tax positions and the nature of the issues, including a description of the relevant facts.

For further guidance on Schedule UTP, see sections **4132.04–.06.** Guidance for “concise descriptions” for Schedule UTP can be found at the IRS website (**www.irs.gov**).

4530 C Corporations

4531 Computation of Taxable Income (Loss)

4531.01 Corporations are taxable entities—they must file tax returns and pay taxes.

a. Other organizations taxed as a corporation include insurance companies, business trusts, associations, and joint stock companies.

b. An unincorporated organization can be taxed as a corporation if it elects to be taxed as a corporation. The election is made on IRS Form 8832 (*Entity Classification Election*).

c. Certain corporations are tax-exempt.

d. C corporations not expressly exempt from income tax must file an annual tax return (Form 1120) by the 15th day of the **fourth** month after the end of the tax year. (The former deadline was the 15th day of the third month, so this amounts to an extension of one month for C corporation returns.)

e. The deadline changes generally went into effect for tax years beginning after December 31, 2015. However, for C corporations with a June 30 year-end, the changes were not effective until tax years beginning after December 31, 2025.

f. Estimated tax payments for corporations are due on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year. The total estimated payments should equal the lesser of 100% of the tax shown on its prior-year return or 100% of the tax due on its current-year return.

4531.02 The following tax formula is for corporations. Each step in the formula must be completed before the succeeding step is considered.

	Total income
–	Exclusions
=	Gross income
–	Deductions (other than charitable contributions and the dividends-received deduction)
=	Taxable income before special deductions
–	Charitable contributions (limited to 10% of taxable income before charitable contribution deduction; 25% for 2020 only)
=	Taxable income before the dividends-received deduction
–	Dividends-received deduction
=	Taxable income
×	Tax rate (a flat 21% under the Tax Cuts and Jobs Act of 2017)
=	Tax liability before additions and credits
+	Additions to tax
–	Credits against tax
=	Tax liability

4531.03 **Gross income** for the corporation is determined in approximately the same manner as for the individual.

a. A corporation must include in gross income 100% of the dividends received from other corporations.

b. No gain or loss is recognized on the sale or acquisition of the corporation's own capital stock.

c. A corporation distributing appreciated property to its shareholders will be taxed on the appreciation.

d. If the corporation is on the accrual basis, income must be reported in the year all events have occurred that determine the corporation has the right to receive it **and** the amount can be determined with reasonable accuracy, even though some or all of it is received in a later year. To calculate the amount to be included in income, the rule is:

(1) the right to receive the income is not contingent on a future event,

(2) the amount can be reasonably estimated, and

(3) there must be a reasonable expectation that it will be received in due course.

4531.04 **Deductions from gross income** (other than contributions and dividends received) include expenses that are normally deducted from gross income by an individual. However, no deduction is allowed for capital losses in excess of capital gains.

a. Losses can only be used to offset capital gains in carryover years.

(1) Corporate capital losses carry back three years and forward five years as short-term capital losses.

(2) Capital loss carrybacks and carryforwards are short term.

b. Net operating loss is calculated the same way as taxable income.

(1) There is no deduction allowed for a carryforward from other years.

(2) A dividends-received deduction may be taken without any limitation.

(3) Small businesses are those whose average annual gross receipts in the last three years were $26 million or less in 2020 (subject to annual inflation adjustments). (Tax Cuts and Jobs Act of 2017 (TCJA))

c. A deduction for compensation paid or accrued with respect to a "covered employee" of a publicly held corporation is limited to no more than $1 million per year.

d. For tax years beginning after 2017, no deduction is allowed for "entertainment" expenses, and while 50% of business meals are deductible, that cost should be clearly separated from entertainment. (Tax Cuts and Jobs Act of 2017 (TCJA))

4531.05 **Special deductions for corporations:**

a. Charitable contributions:

(1) The corporate limit for charitable contributions is 10% of taxable income computed before the deductions for contributions and the dividends-received deduction and before consideration of any capital loss *carryback.* (The CARES (Coronavirus Aid, Relief, and Economic Security) Act increased that amount to 25% for tax year 2020 only.)

(2) Contributions in excess of the 10% (25% for tax year 2020 only) limit may be carried forward five years.

(a) The total contribution deduction for any year into which an unused contribution is carried is still limited to 10% (25% for tax year 2020 only) of the applicable income figure for that year.

(b) Carryovers are considered in the order in which they arose.

(3) Accrual-basis corporations may accrue contributions if the commitment was made before year-end and the contribution is paid within 2-1/2 months after the close of the tax year.

(4) Cash-basis corporations may deduct only those amounts actually paid out, increased by any carryovers that might be available.

b. Dividends-received deduction:

(1) A corporation may deduct a percentage of the dividends it receives from taxable domestic corporations. The amount of the dividends-received deduction is based on the shareholder corporation's percentage of ownership in the corporation making the dividend distribution. The percentage of the dividend received that is deductible is determined as follows in tax years beginning after December 31, 2017:

Ownership	Deduction Percentage
Less than 20%	50%
20% or more, but less than 80%	65%
80% or more	100%

(a) The deduction for shareholders that qualify for either the 50% or 65% deduction is further limited to 50% or 65% of taxable income computed before the deduction for dividends received and before any deduction for net operating loss carryforwards.

(b) This limit does not apply, however, if in deducting 50% or 65% of the dividends received, a net operating loss is either created or increased.

(c) If corporations owning shares are entitled to both 50% and 65% deductions for dividends received from different companies, the 65% dividends-received deduction is calculated first. When calculating the 50% deduction limitation, the *total* amount of dividends received from 20%-owned companies is subtracted from taxable income.

(2) The dividends-received deduction for dividends received from an affiliated company is equal to 100% of the dividends received.

(a) An affiliated group exists where:

i. a parent company owns at least 80% of the stock in at least one other corporation in the group or

ii. at least 80% of the stock of other companies in the group is owned directly by one or more companies in the affiliated group. (The 80% stock ownership test does not apply to nonvoting stock that is limited and preferred as to dividends.)

(b) Members of an affiliated group may elect to file a consolidated return if all members consent. In this situation, dividends paid among the members are eliminated from income.

(3) Dividends qualify for the dividends-received deduction only if the 46-day (or 91-day) holding period is met for **each** dividend received. The holding period must be met within the 91-day period beginning 45 days before the ex-dividend date of the stock. If the stock is cumulative preferred stock with an arrearage of dividends, it must be held at least 91 days during the 181-day period beginning 90 days before the ex-dividend date.

Days when the corporation is protected from loss on the stock by put options do not count toward the holding period requirement. The holding period requirement must be met for each dividend viewed over time.

4531.06 Tax rates for corporations:

a. Taxable corporations are subject to a 21% tax on taxable income in tax years beginning after December 31, 2017, per the Tax Cuts and Jobs Act of 2017 (TCJA). This rate change affected a number of other provisions, including the treatment of accumulated earnings, capital gains, tax normalization by public utilities, and dividends received from other corporations.

b. The tax rate for qualified personal service corporations is a flat 21% on all taxable income.

4532 Tax Computations and Credits

4532.01 C corporations are *not* subject to the alternative minimum tax (AMT) under the Tax Cuts and Jobs Act of 2017 (TCJA). While an AMT credit is allowed to offset the regular tax liability for any taxable year, it was partially refundable in years before 2022 and any remaining balance was fully refundable in 2022.

The CARES (Coronavirus Aid, Relief, and Economic Security) Act accelerated the ability of companies to recover such AMT credits established by the TCJA. Taxpayers could either elect to receive a 50% AMT credit for 2018 and a 100% credit for 2019 or could claim the entire AMT credit for 2018.

4532.02 The corporate minimum tax is computed as follows:

	Taxable income (before NOL)
+ or –	Adjustments
+	Preferences
=	AMTI (before ACE adjustment and NOL)
+ or –	ACE adjustment
=	AMTI (before NOL)
–	NOL (limited to 90% of AMTI)
=	AMTI
–	Exemption ($40,000, subject to phaseout as income increases)
=	Tentative minimum tax base
×	20%
=	Tentative minimum tax before foreign tax credit
–	Foreign tax credit
=	Tentative minimum tax
–	Regular tax (less foreign tax credit)
=	Alternative minimum tax

4532.03 **Personal holding company (PHC) (IRC Sections 541–547):**

a. The second of two penalty taxes on corporate accumulations is the personal holding company (PHC) tax.

b. Two tests must be satisfied to be considered a PHC:

(1) Stock ownership test: More than 50% of the value of the outstanding stock must be owned by five or fewer individuals at any time during the last half of the taxable year.

(2) Gross income test: 60% or more of the gross income must consist of personal holding company income (PHCI). PHCI is passive types of income such as dividends, interest, rents, and royalties.

c. For tax years beginning after December 31, 2017, the tax rate is 21% of undistributed PHCI.

	Taxable income
+	Net operating loss
+	Dividends-received deductions
–	Corporate income tax
–	Excess charitable contributions
–	Long-term capital gains (net of tax)
–	Dividends paid
=	Undistributed personal holding company income

- **d.** The personal holding company tax can be avoided by paying enough in dividends (thus, not accumulating earnings). Both the actual dividends paid and the consent dividends are considered dividends paid.
- **e.** If both penalty taxes apply to one corporation, then the PHC tax will be the only one imposed.

4532.04 Personal service corporation (PSC):

- **a.** The tax rate for qualified personal service corporations is a flat 21% on all taxable income.
- **b.** A personal service corporation cannot deduct passive losses against active or portfolio income.
- **c.** Personal service corporations are those that perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

4533 Net Operating Losses and Capital Loss Limitations

4533.01 A corporation's net operating loss (NOL), arising in tax years beginning after December 31, 2017, may be carried forward an unlimited number of years at 80% of taxable income per year. The Tax Cuts and Jobs Act of 2017 (TCJA) repeals the two-year carryback for most businesses. An exception is provided to allow a two-year carryback for farming and casualty insurance businesses.

The CARES (Coronavirus Aid, Relief, and Economic Security) Act amended the TCJA and provides that NOLs arising in a tax year beginning after December 31, 2017, and before January 1, 2021, may be carried back to each of the five tax years preceding the tax year of such loss. It also temporarily suspends the taxable income limitation in the TCJA to allow an NOL to fully offset income. For taxable years beginning before 2021, taxpayers are eligible for an NOL deduction equal to 100% of taxable income. For taxable years beginning after 2021, the taxpayer will be eligible for a 100% deduction of NOLs arising in tax years prior to 2018 and will be eligible for a deduction limited to 80% of modified taxable income for NOLs arising in tax years after 2017.

A taxpayer may elect to forgo the five-year carryback of NOLs arising in tax years beginning in 2018 and 2019. The election must be made by the due date (including extensions) for filing the taxpayer's return for the first tax year ending after March 27, 2020, the date the CARES Act was signed into law.

4533.02 A corporation's NOL is the excess of ordinary deductions over gross income (negative taxable income) without considering capital gains and losses.

4533.03 As with many complex parts of federal tax law, the IRS has prepared guidance in the form of a publication devoted to explaining how to comply. In this case, Publication 536 provides step-by-step instructions for calculation of an NOL.

4533.04 A C corporation's capital losses are determined separately from NOLs and may only offset capital gains. IRS Publication 542 includes instructions for determining and accounting for a corporation's capital loss.

4533.05 An excess of capital loss over capital gain in a "loss year" may be carried back to each of the three tax years preceding the year of loss and forward to the five years following the "loss year." In each case, the loss is absorbed by the oldest gain first.

4533.06 Losses from expropriation of corporate assets by a foreign government are calculated separately and subject to different carryover rules.

4534 Entity/Owner Transactions, Including Contributions, Loans, and Distributions

4534.01 Tax-free contributions to form a new corporation (IRC Section 351)

a. Property must be contributed by investors to the corporation.

b. The investors must receive control of the corporation under the 80% rule.

c. Control by the investors must exist immediately after the exchange.

d. The investors must receive only stock in the corporation for their investment.

e. An investor of property in the corporation recognizes no gain or loss if the investor receives only stock in the corporation in return. (IRC Section 351(a))

f. If the stockholder receives cash or other property (boot) in the exchange, then gain is recognized up to the smaller of the boot received or the gain realized. (IRC Section 351(b))

g. The new corporation takes an adjusted basis in the property received equal to the adjusted basis in the hands of the contributing shareholder plus any cash paid to the shareholder.

h. The formula for determining the shareholder's basis in the stock received is:

	Adjusted basis of property transferred
+	Gain recognized
–	Boot received (including any liabilities transferred)
–	Election to adjust property for loss
=	Adjusted basis of stock received

4534.02 Recognition of gain resulting from boot

a. **General rule:** If an investor is relieved of a liability or transfers property subject to a liability, that is considered boot equal to the amount of liability.

Exception to the general rule (IRC Section 357(a)): If another party to an IRC Section 351 or Section 361 exchange assumes a liability as part of an IRC Section 351/361 tax-free exchange, then no gain will be recognized by the contributor.

b. Nonqualified preferred stock is treated as boot.

(1) Nonqualified preferred stock includes redeemable stock.

(2) Nonqualified preferred stock also includes stock where the dividend varies according to the movements of an outside index.

c. The character of gain recognized when boot is received under IRC Section 351 depends on the type of asset transferred:

(1) Ordinary income if inventory is transferred

(2) Capital gain if a capital asset is transferred

(3) Section 1231 gain if there is gain on property used in a trade or business (after depreciation recapture)

4534.03 **Definition of corporate control**

- **a.** **Control** is defined by an individual or a small group of stockholders holding 80% of the total combined voting power of all classes of voting stock and 80% of the total number of shares of each class of nonvoting stock.
- **b.** The voting power test applies to all voting stock in the total.
- **c.** The number-of-shares test is applied separately to each class of stock.
- **d.** When using the control test, count only issued and outstanding stock.
- **e.** A test for control of a corporation must use only direct ownership.
- **f.** Constructive ownership or stock attribution rules cannot be used.
- **g.** Stock rights or stock warrants are not included with stock.

4534.04 **Definition of property**

- **a.** Property includes the following:
  - (1) Cash
  - (2) Intangible assets such as stocks and patents
  - (3) Tangible property such as buildings and equipment
- **b.** Property does **not** include the following:
  - (1) Services
  - (2) Indebtedness of the corporation
  - (3) Interest on that debt

4534.05 **Can loss be recognized in a Section 351 transaction?**

- **a.** Originally, loss could never be recognized in an IRC Section 351 transaction.
- **b.** **1998 Tax Act amendment:** If the transferor received only nonqualified preferred stock, a loss may be recognized.

4534.06 In a liquidation, the corporation generally disposes of its assets for cash and distributes the proceeds to its shareholders in exchange for their capital stock. The corporation may also distribute its assets directly to the shareholders in exchange for the stock. Problems arise in accounting for both the shareholder's and the corporation's treatment of such a transaction.

4534.07 **Shareholder concerns:**

- **a.** Cash or property received by shareholders in exchange for their capital stock will generally result in capital gain or loss to the shareholder. The basis of any property received is fair market value.
- **b.** **Exception:** When a subsidiary distributes property to its parent corporation (80% ownership), no gain or loss is recognized by the parent. Generally, the property received by the parent has the same basis that it had in the hands of the subsidiary.

4534.08 **Corporation concerns:**

- **a.** Liquidating corporations are required to recognize a gain or loss on both liquidating sales and liquidating distributions.

b. **Exception:** No gain or loss will be recognized by a liquidating subsidiary on the distribution of any property in a complete liquidation to an 80% corporate parent. However, distributions to minority interests will generally trigger gain recognition. Losses in this situation are not recognized.

c. The general rule for a liquidating distribution by a corporation is that the corporation recognizes a gain or loss on the distribution of property in a complete liquidation. The property is treated "as if" it was sold at its fair market value. When property distributed is subject to a liability, the amount realized (deemed fair market value) from the "as if" sale cannot be less than the amount of the liability.

d. When a parent corporation liquidates a subsidiary, any carryovers the subsidiary had can now be used by the parent corporation.

4534.09 **Nonliquidating distributions:**

a. Effect on shareholder:

(1) Amount distributed = FMV (fair market value) on the date of distribution

(2) To the extent of earnings and profits, the distribution is a dividend.

(3) Any excess is a return of capital and then a capital gain.

b. Effect on corporation:

(1) Nonliquidating distributions of appreciated property generate gain to the corporation.

(2) Losses are nondeductible.

(3) Corporate distributions reduce earnings and profits by the greater of the FMV or the adjusted basis of the property distributed.

4535 Consolidated Tax Returns

4535.01 IRC Section 368(a)(1) lists seven types of corporate reorganizations. They are identified by the following capital letters:

A. A statutory merger or consolidation

B. The acquisition by a corporation of another using solely stock of each corporation (voting stock for stock exchange)

C. The acquisition by a corporation of substantially all of the property of another corporation in exchange for voting stock (voting stock for asset exchange)

D. The transfer of all or part of a corporation's assets to another corporation when the original corporation's shareholders are in control of the new corporation immediately after the transfer (acquisitive or divisive exchange: spin-off, split-off, or split-up)

E. A recapitalization

F. A mere change in identity, form, or place of organization

G. A transfer by a corporation of all or a part of its assets to another corporation in a bankruptcy or receivership proceeding

4535.02 Election to file a consolidated corporate income tax return:

a. IRC Section 1501 requires that:

(1) all corporate members of the group must agree to be included for each tax reporting period,

(2) all corporate members must agree to follow all the regulations issued concerning IRC Section 1502,

(3) a consent form must be signed before the last day for filing the return,

(4) the parent company must file copies of the consent form from all of the affiliated corporations in the group, and

(5) a schedule must be attached listing all of the affiliated corporations in the group.

b. IRC Section 1502 gives the Secretary of the Treasury the authority to issue and prescribe regulations for consolidated corporate tax returns. These are "legislative" regulations, meaning they are provided for in the statute, have the force of law, and are not just administrative or "advisory."

c. IRC Section 1503 states that the income tax liability of a consolidated corporate group will be determined by the regulations that exist on the last day for filing the return as provided by law.

d. IRC Section 1504 defines the "affiliated group" that qualifies for the privilege for filing a consolidated corporate income tax return.

e. IRC Section 1504 also identifies those qualified as "includible corporations."

f. IRC Section 1552 defines the general rule for allocating the tax liability among the members of the affiliated group.

4535.03 Why elect to file a consolidated corporate tax return? Generally, the combined group will reduce the net taxable income and the tax due to a minimum. This is done by taking full advantage of losses reported by some group members to offset profits reported by other members of the group.

4535.04 Affiliated group requirements:

a. The common parent directly owns at least 80% of the voting power of the stock of another corporation.

b. The common parent directly owns at least 80% of the value of all of the stock of that corporation.

c. Other stock may be owned directly by one or more of the other corporations in the affiliated group.

4535.05 An includible corporation for consolidation purposes is described in IRC Section 1504(b), which says that any domestic corporation can be part of a consolidated group except for:

a. a tax-exempt corporation under IRC Section 501,

b. an insurance company under IRC Section 801,

c. foreign corporations, except for some Canadian or Mexican corporations as listed in IRC Section 1504(d),

d. corporations electing the possessions tax credit under IRC Section 936,

e. regulated investment companies,

f. domestic international sales corporations (DISCs), and

g. S corporations.

4535.06 An affiliated group is at least two corporations:

a. One corporation must be the parent, owning one or more subsidiaries.

b. One corporation must be a subsidiary at least 80% owned by the parent.

c. This is a parent-subsidiary group.

4535.07 IRC Section 1563 defines a different group: a brother-sister controlled group, where two corporations are owned by five or fewer individuals, estates, or trusts. Brother-sister controlled groups do not file consolidated returns. Such groups must allocate tax attributes, such as the Section 179 limit, among group members by filing an allocation schedule with each group member's income tax return. Where members of a brother-sister controlled group have different fiscal years, the allocation of tax attributes made on the last return filed will control.

4535.08 Consolidated return election:

a. The election to file a consolidated return is a privilege.

b. The parent company must file IRS Form 1122 in the first consolidated year as prescribed in IRS Regulation Section 1.1502-75(h)(2).

4535.09 Extension of time to file corporate income tax returns:

a. File IRS Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information and Other Returns.*

b. Calendar-year C corporations are permitted an automatic extension of up to six months (October 15).

c. For C corporations with tax years ending on June 30, the current-law filing date (September 15) remains in effect until tax years beginning after December 31, 2025, and will be extended to October 15 thereafter.

4535.10 Relationship of parent and the subsidiaries concerning tax affairs:

a. The common parent is the sole agent for each subsidiary in the group, authorized to act on all matters. (IRS Regulation Section 1.1502-77(a))

b. The common parent and each subsidiary of the consolidated group are severally liable for the consolidated tax liability of the entire group—for any taxable year that they are members. (IRS Regulation Section 1.1502-6(a))

4535.11 Consolidations: Unique tax issues

a. Accounting methods and periods

b. Consolidated taxable income framework

c. Separate return limitations year (SRLY)

4535.12 Accounting methods and periods

a. Each subsidiary must adopt the common parent's annual period for the first year of consolidation. (IRS Regulation Section 1.1502-76(a))

b. The subsidiary's original taxable year ends at the close of the day that it became a member of the consolidated group. The subsidiary must file a short-period return for the period ending that day. (IRS Regulation Section 1.1502-76(b)(1)(ii))

4535.13 The consolidated tax return will include the following:

a. The common parent's tax items for the entire year:

(1) Income

(2) Gains

(3) Deductions

(4) Losses

(5) Credits

b. Each subsidiary's items are included for the part of the year that the subsidiary was a member of the group. (IRS Regulation Section 1.1502-76(b))

4535.14 Preparing the consolidated tax return:

a. Compute each corporate member's separate taxable income.

b. Use the member corporation's income to prepare the consolidated income and balance sheet.

c. Eliminate the intercompany transactions from the consolidated return. When consolidated tax returns are filed, any sales between the members of the affiliated group are eliminated. Only when a sale is made to an outside third party is any gain or loss recognized.

d. Separate the items that are subject to special tax treatment:

(1) Capital gains and losses

(2) Section 1231 gains and losses

(3) NOL deductions

(4) Charitable contributions deduction

(5) Dividends-received deduction

4536 Multijurisdictional Tax Issues (Local, State, and International)

4536.01 Taxpayers often focus on the impact of federal taxation and taxes imposed by state and local jurisdictions. Nonresidents are taxed on their U.S. income. A state cannot tax a nonresident unless the nonresident has a necessary connection with the state. The connection necessary for a state to tax a nonresident is called "nexus."

4536.02 Apportionment is required when an entity does business in more than one state. Rules or laws are created to allocate or apportion the taxes to the correct states according to how the tax should be distributed.

a. Apportionment is a four-step process:

(1) Determine federal taxable income.

(2) Determine the percent of income to be apportioned to each state.

(3) For each state to which income must be apportioned, make adjustments to federal taxable income to apply state rules to such items as recognition of the IRC Section 179 deduction, use of the cash method of accounting, and limitations on deduction of fringe benefits to determine income subject to apportionment according to that state's rules on what is income.

(4) Apply the apportionment percentage to the state's taxable income.

b. This can, and frequently does, result in total taxable income for state purposes being more or less than federal taxable income.

4536.03 State and local taxes

a. Local jurisdictions in all 50 states impose real estate taxes on the real property located within the boundaries of the jurisdiction. This tax is generally imposed on an annual basis, based on the real estate tax year, and is computed based on the value of the property.

b. Most of the states also allow local jurisdictions to impose a local tax on personal property. These personal property taxes vary significantly from state to state as to the rate of taxation as well as to the type of personal property subject to the tax. Typical types of property that may be subject to a personal property tax include:

(1) automobiles,

(2) stocks and bonds, and

(3) tangible business property such as inventory, machinery, or equipment.

c. State governments generally impose a statewide general sales tax on the sale of personal property and, in some cases, certain types of services. This tax is usually based on a percentage of the retail sales price of the goods or services.

d. States that impose a general sales tax also impose a use tax. The state use tax applies when a taxpayer purchases goods outside the state and therefore did not pay the home state's sales tax. Generally, a taxpayer may receive a credit against the use tax for the amount of sales tax paid out of state.

e. Most states also impose some type of personal income tax on individuals. The rates of these taxes vary greatly and the manner in which the state income tax is computed varies from state to state. Many states also allow local jurisdictions to impose a personal income tax.

f. Corporate income tax is also imposed by most states. The tax is generally imposed on the corporation's income that is attributable to that particular state. State corporate income tax rates vary greatly, with most states having a flat rate structure.

U.S. Taxation of Multinational Transactions

4536.04 Foreign jurisdictions can create a significant tax burden on the taxpayer. The U.S. government taxes citizens and permanent residents on their worldwide income.

4536.05 Foreign taxes

a. If a taxpayer conducts business internationally, the taxpayer will be subject to numerous taxes imposed by various foreign jurisdictions.

b. These taxes can range from foreign income taxes, real and personal property taxes, and sales tax. These taxes vary widely from jurisdiction to jurisdiction as to the types of tax imposed and the rate of tax.

c. Often a treaty that has been entered between the United States and the foreign country will have an impact on the rate of tax or type of tax imposed.

d. Often a taxpayer will encounter some type of value-added tax (VAT) in the foreign jurisdiction. This type of tax is computed based on the incremental value that has been added to the goods.

4540 S Corporations

4541 Eligibility and Election

4541.01 Certain domestic corporations may elect not to be taxed. Instead, the income is passed through to the shareholders, who are taxed on their share of the corporation's earnings.

a. Shareholders who held stock during the taxable year must consent to the election.

b. All shareholders on the date of the election must consent to the election.

c. The election will be considered timely if it is made within 2-1/2 months of the first day of its taxable year.

d. Effect of election:

(1) Shareholders are taxed on their share of the earnings even though the earnings are not distributed.

(2) In S corporations, FICA taxes apply only to designated salaries, and the corporation is responsible for paying the taxes. No FICA taxes are paid on the remaining ordinary income that passes to the owners.

(3) S corporations must file IRS Form 1120S each year before the 15th day of the third month following the close of the taxable year.

(a) Filing IRS Form 7004 will automatically extend the filing date for six months.

(b) If estimated tax liability is expected to be $500 or more, an estimated tax payment must be paid.

(4) S corporations may be part of an affiliated group, but a consolidated return is prohibited.

4541.02 The following requirements must be met before a corporation is eligible to elect S corporation status:

a. S corporations are limited to a maximum of 100 shareholders. Family members can elect to be treated as one shareholder.

(1) Family members include a common ancestor, his or her descendants, and the spouses (or former spouses) of the descendants.

(2) The common ancestor cannot be more than six generations removed from the youngest generation of shareholders.

(3) Two spouses are counted as a single shareholder.

(4) The individual, not the trust, is considered as the shareholder. This is considered when a trust is owned by an individual.

b. All shareholders must agree to the S corporation election.

c. Only one class of stock may be issued and outstanding. Differences in voting rights among shares of common stock will be allowed, however.

d. Only individuals, estates, certain trusts, and charitable organizations may be shareholders.

(1) Certain qualified retirement plan trusts and certain charitable organizations that are exempt from tax are eligible to be shareholders. The income from these will pass through to the shareholder as unrelated business taxable income (UBTI).

(2) A qualified Subchapter S trust (QSST) may be shareholder for two years beginning with the date of death of the owner.

e. The election (IRS Form 2553) may be made at any time during the prior year or on or before the 15th day of the third month of the election year. However, the IRS has the authority to waive this requirement.

f. Only eligible domestic corporations may qualify. Ineligible corporations include the following:

(1) Certain financial institutions, but not banks

(2) Most insurance companies

(3) A current or former domestic international sales corporation (DISC)

(4) A company electing the Puerto Rico and possessions tax credit

g. Nonresident aliens are not allowed as shareholders.

4541.03 S corporation status may be terminated voluntarily or involuntarily (i.e., revoked by operation of law).

a. *Voluntary termination, or revocation,* may take place if shareholders owning more than 50% of the *outstanding* shares (including nonvoting shares) consent and file notice of revocation. If a company has both voting and nonvoting shares of the same type of stock, then more than 50% of the *total* number of outstanding shares is required for voluntary termination.

(1) If the notice is filed on or before the 15th day of the third month of the taxable year, it can be effective for the entire year or as of some specified date.

(2) If filed after this date, the termination becomes effective the following year.

(3) A new shareholder owning more than 50% of the voting stock may terminate S corporation status within 60 days of becoming a shareholder. This termination is effective on the day it occurs.

b. *Involuntary termination* (revocation by operation of law) becomes effective on the day when any of the following events occur:

(1) The number of stockholders exceeds the limit allowed by law.

(2) More than one class of stock is outstanding.

(3) A corporation, nonpermitted trust, or partnership becomes a shareholder.

(4) A complex trust becomes a shareholder.

(5) A nonresident alien becomes a shareholder.

c. Since termination or revocation is effective as of the date the corporation ceases to qualify as an S corporation, the result is ordinarily two short tax years. That will require a short-period Form 1120S and a short-period Form 1120. The corporation's year-end will not change as a result of a change in status.

d. Generally, there is no passive investment income limitation for S corporations; however:

(1) if an S corporation has C corporation (regular corporation) earnings and profits and more than 25% of its gross receipts for three successive years is from certain forms of passive income, S corporation status will be terminated as of the first day of the fourth year.

(2) excess net passive investment income is also subject to income tax levied on the corporation at the highest corporate tax rate in effect.

e. If S corporation status is voluntarily terminated there is a five-year waiting period, or consent of the IRS must be secured, before the S status may be reelected.

4541.04 An S corporation must generally use the calendar year as its tax year. A fiscal year may be adopted if the corporation can establish a sound business purpose for such a year or show that the tax deferral would not exceed three months.

4542 Determination of Ordinary Income (Loss) and Separately Stated Items

4542.01 Generally, the S corporation is not subject to income tax. The company's nonseparately stated taxable income or loss flows through to the shareholders, is reported to them on Schedule K-1 of IRS Form 1120S, and is also reported by them on their individual income tax returns.

4542.02 Taxable income items for the S corporation are determined in almost the same way as for a partnership. Allowable deductions are similar to those available to individuals, with the following exceptions:

a. Itemized deductions

b. Net operating loss deductions

c. Charitable contributions

d. Foreign taxes

e. Oil and gas depletion

4542.03 Certain items, the "separately stated items," are reported to the individual shareholders to be included in their income tax returns because they are subject to special treatment, most often limitations. These items include the following:

a. Tax-exempt income

b. IRC Section 1231 gains and losses

c. Long-term and short-term capital gains and losses

d. Charitable contributions

e. Passive income (loss)

f. Portfolio income (loss)

g. IRC Section 179 expense deduction

h. Nonbusiness income or loss

i. Intangible drilling costs

j. Mining exploration expenditures

k. Depletion

l. Amortization of reforestation expenditures

m. Discharge of indebtedness

n. Investment income and expenses

o. Recoveries of prior taxes, bad debts, and delinquency amounts

p. Wagering gains or losses

q. Gain or loss on sale of collectibles

r. IRC Section 199A income (income from any and/or each qualified trade or business (QTB))

s. IRC Section 199A W-2 wages (wages paid to persons working in a QTB)

t. IRC Section 199A unadjusted basis (original cost of tangible property used in a QTB)

u. IRC Section 199A REIT dividends (any ordinary dividends received from a real estate investment trust)

v. IRC Section 199A PTP income (any item of income from a publicly traded partnership)

4542.04 Also listed separately are the following:

a. Tax credits

b. Tax preferences and AMT (alternative minimum tax) adjustment items

c. Foreign taxes

4542.05 The Tax Cuts and Jobs Act of 2017 (TCJA) includes a special deduction: the IRC Section 199A qualified business income deduction (QBID). The deduction, equal to 20% of qualified business income from the S corporation's trade or business income, is claimed on the individual shareholder's federal income tax return (IRS Form 1040). The last five items in the list in section **4542.03** relate to this new deduction.

4542.06 Each shareholder must include on their personal tax return the share of the corporation's income or loss and special items from the corporate tax year that has ended with or within the personal tax year. Thus, income is recognized on a basis similar to that of partnerships.

a. When ownership has changed during the year, each owner must recognize a pro rata share of the income or loss allocated on a daily basis.

b. Loss pass-throughs in excess of the taxpayer's basis in the corporation may be carried forward indefinitely and deducted when the taxpayer's basis has increased sufficiently to absorb the loss.

4543 Basis of Shareholder's Interest

4543.01 A shareholder's tax basis in an S corporation is increased by any stock purchases and capital contributions. The following items also cause an adjustment to basis. However, a shareholder's basis in an S corporation can never go below zero.

a. Upward adjustments (shareholder's share of the following items):

(1) Taxable income

(2) Separately stated income items

(3) Depletion in excess of the property's basis

b. Downward adjustments (shareholder's share of the following items):

(1) Loss from operations

(2) Separately stated loss items

(3) Nontaxable distributions (return of capital)

(4) Nondeductible loss items

c. The qualified business income deduction (IRC Section 199A) does not affect the basis of a shareholder's interest.

4544 Entity/Owner Transactions, Including Contributions, Loans, and Distributions

4544.01 Distributions of cash and property are basically given the same treatment. Shareholders must recognize as a distribution the amount of cash and the fair market value of any property distributed.

a. The taxability of a distribution is determined by its source.

b. Distributions come from the following sources in the order listed:

(1) Distributions are first considered to come from an "accumulated adjustments account" (AAA).

(a) The AAA represents income earned after 1982 adjusted by any additions and subtractions that shareholders were required to make to the basis of their stock for this period. However, no adjustment is made for the following:

i. Tax-exempt income

ii. Corporate expenses not deductible in computing taxable income and not chargeable to a capital account

(b) Distributions from the AAA are nontaxable.

(2) Distributions are then considered as dividends to the extent of any accumulated earnings and profits (E&P).

(3) Beyond accumulated E&P, distributions represent a return of capital and then a capital gain.

c. If an S corporation distributes appreciated property to its shareholders, the transfer is treated as if the property had been sold at fair market value.

(1) A gain is recognized at the corporate level.

(2) The gain is subsequently reported to the shareholders pro-rata based on their percentage ownership of the S corporation's shares.

4545 Built-In Gains Tax

4545.01 After a regular C corporation converts to S corporation status, the corporation becomes subject to a tax (a built-in gains tax) that may be imposed on the net appreciation that took place on the assets during the time they were held by the C corporation.

a. The tax is imposed on the S corporation when it disposes of property at a gain within five years after the S election took effect.

b. The tax is levied on the pre-S corporation appreciation only. Independent appraisals of the assets should be obtained when converting a C corporation to an S corporation.

4545.02 When a C corporation using LIFO (last in, first out) inventory converts to an S corporation, the C corporation must recapture, as income, the excess of FIFO (first in, first out) inventory basis over LIFO inventory basis in the final C corporation return. The corporation gets a stepped-up basis for its inventory and a LIFO recapture tax on the step-up. While the corporation could resume use of the LIFO method with a new base year, most will choose to take advantage of the opportunity to go forward with the simpler FIFO method.

4545.03 The income tax liability attributable to the "LIFO recapture amount" is separately calculated and paid in five annual installments, beginning with the first C corporation year.

4550 Partnerships

4551 Determination of Ordinary Income (Loss) and Separately Stated Items

Administrative Development

4551.01 The Bipartisan Budget Act of 2015 (BBA) introduced a new system for tax audits of partnerships and for partnerships to report their income, including requiring a partnership representative to deal with the IRS during an audit of the partnership. The BBA audit regime, generally effective for partnership tax years beginning after December 31, 2017, is a change from the TEFRA (Tax Equity and Fiscal Responsibility Act) partnership audit procedures it replaced. The BBA regime replaces TEFRA.

a. The new rules apply to all partnerships in tax years beginning after December 31, 2017, unless the partnership has fewer than 100 partners and elects out of the new rules.

b. Rules discussed in this section (section **4550**) relating to accounting for partnership items, maintenance of capital accounts, determining a partner's basis, and transactions between a partner and the partnership are not changed by the new rules.

c. What is changed is that the partnership can be the taxpayer, accounting for after-tax income to the partners. An IRS audit can now focus on income adjustments and collection of any additional tax assessed at the partnership level unless the partnership has elected to remain subject to the TEFRA rules.

Partnerships under the centralized partnership audit regime are not able to file amended returns, and instead must file administrative adjustment requests (AARs). When an AAR results in an underpayment, the partnership can pay the amount due or can push out the amount due to partners at the partner level. On the other hand, if an

AAR results in an overpayment, refunds generally are not available, and partners must take into account adjustments in the year they received them.

Partnership Characteristics (Before the Bipartisan Budget Act of 2015)

4551.02 Partnerships have not generally been thought of as taxable entities. They have been reporting entities. Partnerships have functioned as a conduit for income tax purposes.

a. Ordinary income and losses along with special gain and loss items flow through the partnership down to the individual partners, who report these items on their personal tax returns.

b. The partnership must report each partner's distributive share of the ordinary gain or loss as well as any separately stated items required to properly calculate taxable income in the partner's return.

c. Self-employment taxes apply to all ordinary income passing to the owners.

d. The partnership may owe a penalty for late filing of the partnership return. The amount of the penalty is $205 per partner for each fraction of a month the return is late up to a maximum of 12 months.

4551.03 **A partnership** is created when two or more persons join together to conduct a business activity, the expected profits and losses of which will be shared in some manner by those persons.

a. Organizations qualifying as a trust, estate, or corporation will not be treated as a partnership.

b. Unincorporated entities that are eligible to be treated as a partnership include the following:

(1) Syndicate

(2) Pool

(3) Group

(4) Joint venture

c. In general, entities that qualify for partnership treatment also qualify for electing out of partnership treatment under the check-the-box regulations. If a business entity is not required to be treated as a corporation for federal tax purposes, it may choose its own classification. An entity with two or more members can be classified as either a partnership or an association taxed as a corporation. An entity with only one member can be classified as an association or can be disregarded as an entity separate from its owner. A single-member limited liability company cannot elect partnership status. The default classification for a new entity with two or more members is a partnership, and the default classification for an entity with one member requires the entity to be "disregarded"—treated as a proprietorship for an individual or trust and as a branch or division for a corporation or another partnership.

4551.04 The partnership return (IRS Form 1065), filed under TEFRA (Tax Equity and Fiscal Responsibility Act) procedures, is strictly an informational return. It is not an income tax return because partnerships do not pay income taxes; however, a return is required even though the firm has no gross income. If the partnership is subject to BBA (Bipartisan Budget Act of 2015) procedures, then it will report income and pay income tax on behalf of the partners.

a. Partnerships are required to file their returns by the 15th day of the **third** month after the end of the tax year.

b. A calendar-year partnership will have to file its return by March 15 of the following year.

c. The maximum extension for partnership returns is a seven-month period ending on October 15 for calendar-year taxpayers.

Reporting Partnership Income

4551.05 The ordinary gain or loss of a partnership must be computed and then allocated to the partners according to the agreed-upon method for distributing profits and losses.

a. **Gross income:** The general rule is any item of gross income that receives special consideration on an individual's return must be excluded from ordinary gain or loss and shown as a separate item on Schedule K of IRS Form 1065. One exception is guaranteed payments, which are both deductible by the partnership and included as a separately stated item on IRS Form 1065, Schedule K-1, *Partner's Share of Income, Deductions, Credits, Etc.*

b. **Business deductions:** Partnership deductions are basically the same as an individual's deductions to determine adjusted gross income.

(1) Any deduction that receives special consideration on a partner's return must be shown as a separate item on Schedule K. Such deductions do not enter the computation of ordinary gain or loss.

(2) Included as allowable deductions are guaranteed payments to the partners for salaries and interest. Any guaranteed payment to a partner for services performed will be taxed as ordinary income and subject to self-employment tax at the partner level. (IRC Section 707)

c. **Nonbusiness deductions:** Partnerships do not include any nonbusiness deductions (e.g., standard deduction) in the computation of ordinary gain or loss.

d. **Tax accounting elections:** The following elections are made by the partnership (IRC Section 703(b)):

(1) Taxable year and accounting method

(2) Cost recovery methods and assumptions

(3) IRC Section 179 deductions

(4) Inventory method

(5) Cost or percentage depletion method for all but oil and gas wells

(6) Treatment of research and experimental expenditures

(7) Amortization of start-up expenditures and amortization period

(8) Determination of qualified production activities income (QPAI) and production-related wages for purposes of the domestic production activities deduction (DPAD)

e. **Tax accounting elections:** The following elections are made by the individual partner:

(1) The decision to reduce the basis of depreciable property when first excluding income from discharge of indebtedness

(2) The decision to claim cost or percentage depletion for oil and gas wells

(3) The decision to take a deduction or credit for taxes paid to foreign countries and U.S. possessions

4551.06 Items receiving special treatment must be separately listed in Schedule K.

a. Specially treated items in the partnership retain the same character on the tax return of the individual partners.

b. Following are some of the partnership items that must be separately listed on Schedule K:

(1) First-year IRC Section 179 expensing deduction of business assets

(2) Dividends, interest, and royalties

(3) Net short-term capital gain (loss)

(4) Net long-term capital gain (loss)

(5) Net gain (loss) from casualty and theft

(6) Net gain (loss) for sale or exchange of "Section 1231 assets"

(7) Contributions

(8) Foreign taxes

(9) Income or loss from real estate rentals

(10) Income or loss from other rentals

(11) Expenses related to portfolio income

(12) Tax-exempt interest

(13) Recoveries of items previously deducted

(14) AMT preference items

(15) Nonbusiness and personal items

(16) W-2 wages paid to workers in a qualified business

(17) IRC Section 199A income

(18) IRC Section 199A W-2 wages

(19) IRC Section 199A unadjusted basis

(20) IRC Section 199A REIT (real estate investment trust) dividends

(21) IRC Section 199A PTP (publicly traded partnership) income

c. In general, separate treatment must be accorded to any partnership item which, when treated separately, would result in a different tax liability than the partner would experience if the item had not been separately treated.

d. Using a special schedule (Schedule K-1), the partnership must disclose each partner's distributive share of the Schedule K items. Guaranteed payments (salaries/interest) are also included.

(1) The profit and loss sharing ratio is used to distribute these special items.

(2) If the income ratio is different from the loss ratio, the special items are distributed accordingly, depending on whether the partnership has a profit or loss.

4551.07 Gains, losses, depreciation, and depletion on property contributed by a partner to a partnership must be allocated in a way that takes into account the difference between the partnership's basis for the contributed property and the property's fair market value at the time of contribution to the partnership. These items cannot be allocated to the partners in accordance with each partner's interest in the partnership, but must be specially allocated to burden, or benefit, the contributing partner for the difference.

4551.08 Partnership tax years

a. Reporting year: Each partner must include in its tax return a share of those partnership items from the partnership tax year that ends with or within the partner's tax year.

(1) Generally, the death, retirement, or withdrawal of a partner, the sale of a partnership interest, or the addition of a new partner will not terminate the partnership tax year. However, these events will close the tax year for the individual partner affected.

Prior to passage of the Tax Cuts and Jobs Act of 2017 (TCJA), the partnership year would terminate with the sale or exchange of an aggregate interest of 50% or more in partnership capital or profits. That is no longer the case after December 31, 2017.

(a) There may, however, be adjustments to both tax basis and partners' capital accounts required by IRC Section 704(b) when a new partner is admitted to the partnership.

(b) The new partner participates in income from the time of admission to the partnership.

(c) Capital accounts of existing partners may be adjusted to reflect fair market values of partnership property when the new partner is admitted.

(d) Treasury Regulations at Section 1.704-1(b) explain these adjustments. They are considered among the most complex Treasury Regulations. Given the popularity of the partnership form of business entity, understanding those regulations is critical for any tax practitioner.

(2) Income and losses will be allocated to a new partner only for that portion of the year during which the new partner was a member of the partnership. Allocation of income and losses will not be made retroactive to a period prior to the new partner's entry into the partnership.

b. Establishing the tax year:

(1) Generally, the tax year of a partnership must be determined by reference to the tax years of the partners.

(a) If the majority partners (over 50% of the ownership) all have the same tax year, the partnership must adopt that tax year.

(b) If the majority partners have different tax years, the partnership must adopt as its taxable year the tax year of the principal partners. Principal partners are partners with at least a 5% interest in capital or profits.

(c) If neither the majority partners nor the principal partners have the same tax year, the partnership must adopt the tax year that results in the least aggregate deferral of income to the partners.

(d) **Exceptions:**

i. The partnership may establish that a business purpose exists for selecting another tax year.

ii. If a partnership recognizes 25% or more of its gross receipts in the last 2 months of the same 12-month period for three consecutive years, it may adopt that 12-month period as its fiscal year.

(2) Partnerships may elect to use a different tax year than the one required if the income deferral is three months or less. To make this election, the partnership must make a noninterest-bearing deposit with the government in an amount calculated to deny the partners any financial benefit from deferring recognition of income for the fiscal year.

(3) The noninterest-bearing deposit required by IRC Section 7519 to elect or retain a fiscal year that defers recognition of income for three months or less is calculated on IRS Form 8752 (*Required Payment or Refund Under Section 7519*), which is attached to the IRS Form 1065.

4552 Basis of Partner's Interest and Basis of Assets Contributed to the Partnership

4552.01 The basis of a partner's interest in a partnership is computed without regard to the capital account balance as shown on the partnership books.

a. A partner's basis is increased by the investment of property or cash.

(1) The increase in a partner's basis for contributed property is limited to the partner's basis in that property, resulting in a carryover basis and a carryover holding period.

(2) In addition, the basis of a partner's interest is increased by the distributive share of the following partnership items:

(a) Taxable income

(b) Tax-exempt income

(c) Excess depletion deductions

b. A partner's basis is decreased by the partner's withdrawals of money and by the adjusted basis of all other property distributed to the partner.

(1) A partner's basis is further decreased by the distributive share of the following partnership items:

(a) Partnership losses (including capital losses)

(b) Nondeductible partnership expenditures

(2) The basis of a partner's interest may not be decreased below zero.

(3) Losses and negative adjustments in excess of a partner's basis are accounted for as "limited losses." Such losses can offset future taxable income or can be claimed when basis is restored, for example, by a partner's contribution of money or property.

4552.02 The basis of contributed property is the same in the hands of the partnership as it was in the hands of the partner who contributed it.

a. As to the contribution of personal assets (nonbusiness property) to the partnership, however, the partnership basis will be the lesser of:

(1) the adjusted basis to the contributing partner or

(2) the fair market value at the time the property was contributed to the partnership.

b. Except for triggering recognition of limited losses, no gain or loss is recognized by either the partner or the partnership when a partner increases an investment through the contribution of property.

(1) Income must be recognized by a partner who receives a capital interest in the partnership in exchange for services rendered.

(2) The fair market value of the capital interest received shall be considered as compensation (ordinary income).

c. An increase in the basis for the fair market value of services contributed to a partnership by one of the partners is taxable to that partner.

d. A built-in gain or loss on the date of contribution must be allocated to the contributing partner when the property is subsequently disposed of by the partnership in a taxable transaction.

4552.03 Increases in the liabilities of the partnership are treated as though the partner contributed money for a share of those liabilities. The basis of the partner's investment increases accordingly.

a. Assumption by the partnership of a partner's personal liability is treated as a distribution of money to the partner. The partner's basis decreases by the amount of the liability assumed by the other partners.

b. Generally, the ratio for sharing *losses* is used in the calculation to determine a partner's share of the partnership liabilities.

4552.04 Partnership losses reduce the basis of the partner's investment in the partnership.

a. The TEFRA (Tax Equity and Fiscal Responsibility Act) system permits a partner to deduct the distributive share of partnership losses on the partner's return to the extent of the basis of the partner's interest in the partnership. A similar limitation will result under the BBA (Bipartisan Budget Act of 2015) system which will calculate partnership income and loss, and pay tax at the partnership level.

(1) For purposes of computing a partner's loss absorption ability, the basis of a partner's investment will not include any partnership liability for which the partner has no personal liability.

(2) This provision is designed to limit the loss that may be passed through to a *limited partner.* General partners are personally liable for the debts of the partnership, but limited partners are not liable beyond the amount of their contributed capital.

b. Any disallowed loss remains available to the partner in future years when the basis has increased so as to absorb some or all of the loss.

4552.05 The withdrawal of money or property from the partnership decreases the basis of the partner's investment by the partnership's adjusted basis in that property.

a. Generally, no gain or loss is recognized by either party when property is distributed in something other than the liquidation of a partner's interest. However, if a partner has contributed appreciated property to the partnership, the following rules may apply:

(1) If the appreciated property is distributed within seven years to another partner, the contributing partner must recognize the precontribution gain as income.

(2) If other property (other than cash) is distributed to the contributing partner within seven years, the contributing partner recognizes gain equal to the lesser of the precontribution gain or the excess of the distributed property's fair market value (FMV) over the partner's basis in the partnership.

b. The basis of the property received by the partner is the same as it was while in the partnership's possession.

c. When the partnership's adjusted basis for the property distributed exceeds the basis of a partner's investment in the partnership, the basis of the property to the partner is limited to the basis of the investment in the partnership.

(1) The basis of the partner's investment in the partnership is consequently reduced to zero.

(2) The partnership's excess property basis will be treated as a basis decrease to the partner.

(a) Distributions of unrealized receivables and inventory take the partnership's basis. Any shortfall is handled as described in (b) and (c) following.

(b) The basis decrease is first allocated to property with unrealized depreciation to the extent that basis exceeds FMV. If insufficient basis is available to reduce the partner's basis by the full amount of depreciation, available basis is allocated to the properties in proportion to their respective amounts of unrealized depreciation (Basis – FMV).

(c) Any remaining decrease is allocated to the properties in proportion to their adjusted bases.

4553 Partnership and Partner Elections

4553.01 Special adjustments to the basis of partnership assets are available in certain situations.

a. The partnership may elect to adjust the basis of its property for the benefit of a new partner. (IRC Section 754)

(1) Such an adjustment is possible under the following circumstances:

(a) An established interest is sold, exchanged, or inherited.

(b) There is a difference between the new partner's *cost* for the interest and the partnership's basis for the share of the property.

(2) If the election is exercised, those partnership assets that are adjusted will carry a special basis strictly for the benefit of the new partner. The new partner's depreciation, depletion, and gain or loss will be determined separately on this special basis.

Example: X, an equal partner in XYZ, sells his interest to W for $50,000. The partnership's basis for one-third of its assets is only $35,000, however. To avoid the inequities created by this situation, the partnership may elect to increase the basis of its assets by $15,000 for the sole benefit of W.

b. A similar election is available to the partnership as a result of the complete or partial liquidation of a partner's interest.

(1) Such an adjustment is available when money or other property is distributed to a partner so as to reduce or terminate the partner's capital interest in the partnership.

(2) The adjustment is designed to reflect the difference between the basis of the partner's interest and the partnership's basis in the property used to terminate that interest.

4553.02 Elections made by the partnership:

a. Taxable year and accounting method

b. Cost recovery methods and assumptions

c. Treatment of research and development costs

d. Amortization of organization costs and start-up costs

e. Opt-out of BBA (Bipartisan Budget Act of 2015) partnership audit regime rules

4553.03 Elections made by the partner:

a. Cost or percentage depletion for oil and gas wells

b. Reduction of basis of depreciable property when excluding income from discharge of indebtedness

c. Take a deduction or credit for foreign taxes paid

4554 Transactions Between a Partner and the Partnership

4554.01 Sale or exchange of a partnership interest:

a. The sale or exchange of a partnership interest is generally treated as the sale or exchange of a capital asset. To determine the gain or loss, subtract the adjusted basis from the amount realized. The amount realized is the sum of the cash received plus the fair market value of any other property received. The partner's share of the partnership liabilities that the selling partner will no longer be responsible for is considered part of the amount realized. The adjusted basis of the partner's interest in the partnership also includes his or her share of the partnership liabilities.

(1) To the extent that the partner is disposing of a share of unrealized receivables and inventory, the gain associated with these items must be treated as ordinary income.

(a) **Unrealized receivables** include the following:

i. Receivables not previously included in gross income

ii. Property holding ordinary income potential under the depreciation recapture provisions of the Internal Revenue Code

iii. A franchise, trademark, or trade name

(b) **Inventory** includes all noncapital assets other than IRC Section 1231 assets.

(2) In computing ordinary income on the disposition of a partnership interest, a portion of the selling price must be allocated to the unrealized receivables and the

inventory. In an arm's-length transaction, the portion that the buyer and the seller agree to allocate to such property will generally be regarded as correct.

(3) The remainder of the selling price is considered as the amount realized for the partner's capital interest in the partnership.

b. The capital gain or loss from the sale or exchange of a partnership interest will be long term or short term depending on the length of the period during which the seller had owned the partnership interest. Generally, this holding period will include the holding period of any property contributed by the partner.

c. If a partner sells the entire interest in the partnership, profits and losses up to the date of sale must be considered.

(1) If the partner withdraws the share of the earnings up to the date of sale, they are taxed to the partner accordingly.

(2) If these earnings are not withdrawn, the basis of the partnership interest will be increased by the profits not withdrawn. In addition, the partner must include a share of the profits up to the date of sale as ordinary income on the tax return.

4554.02 Liquidation and retirement of a capital interest:

a. Generally, no gain or loss is recognized by the partnership on the distribution of money or other property to a partner.

b. A partner realizes a gain on the liquidation of a partnership interest when the partnership's basis in the property distributed is more than the partner's investment in the partnership.

(1) A partner recognizes a gain only if the amount of cash received exceeds the basis of the partnership interest.

(a) If a gain is recognized, the basis of all other property received is zero.

(b) The gain recognized is capital gain, except to the extent of the unrealized receivables and inventory. The gain on these items is ordinary income.

(2) If the cash received is less than the basis of the partner's interest, no gain is recognized.

(a) If no gain is recognized, the basis of all other property received is equal to the basis of the partner's interest minus the cash received.

(b) This remainder is first allocated to any unrealized receivables and inventory items to the extent of their basis in the hands of the partnership. Basis is then allocated to other properties as follows:

i. To appreciated properties, basis is allocated up to the full extent of the appreciation. (Allocation of an amount less than the full appreciation requires a proportional allocation based on the respective amounts of unrealized appreciation.)

ii. If the basis increase has not been fully allocated, the remainder is allocated to all of the properties (other than the unrealized receivables and inventory) in proportion to the properties' respective fair market values.

c. A partner realizes a loss on the liquidation of the partnership interest when the partnership's basis in the property distributed is less than the partner's investment in the partnership.

(1) A partner may recognize a loss if cash, unrealized receivables, and inventory items are the only assets received for the partnership interest.

(a) In this situation, *inventory* refers to all inventory items, not just those that have appreciated in value.

(b) The basis of the receivables and the inventory to the partner is the same as it was in the possession of the partnership.

(2) When the partner receives property other than cash, unrealized receivables, and inventory, no loss is recognized.

(a) The basis of the receivables and the inventory to the partner is the same as it was in the possession of the partnership.

(b) The basis of the other property received is equal to its basis in the partnership increased by the loss not recognized.

d. An exception to the general rule covering the distribution of property applies where a disproportionate distribution of unrealized receivables or substantially appreciated inventories takes place. Special rules provide for the possible recognition of a gain or loss to both the partner and the partnership in such a situation.

e. Certain future payments to a retiring partner may not qualify as proceeds from the sale of the partnership interest. These additional payments are taxable as ordinary income.

(1) **Guaranteed payments:** If these future payments can be determined without reference to future income, they will be treated as guaranteed payments—ordinary income to the retiring partner and a deductible expense to the partnership.

(2) **Distribution share:** If these future payments are going to be based on the partnership's future income, they will be treated as a distribution of partnership income—ordinary income to the retiring partner and a reduction in the distributive shares of the other partners.

f. When payments are made to a deceased partner's successor, the successor generally "steps into the shoes of the decedent." Any amounts received by the successor are taxed in the same way they would have been taxed to the deceased partner.

g. Generally, the property distributed to a partner maintains the same character as it had in the partnership.

(1) On the sale of noncapital assets received from the partnership, ordinary gain or loss treatment is limited to a period of five years, extending from the date of distribution.

(2) Sales of noncapital assets taking place after five years produce capital gains and losses if these items are being held as capital assets by the former partner.

4554.03 Sale of property to the partnership by a partner:

a. Generally, the sale of a partner's property to the partnership will be recognized as an arm's-length transaction.

(1) Gains and losses on such transactions will be recognized by the partner.

(2) The basis of such property to the partnership is its cost to the partnership.

b. Exceptions include the following:

(1) No loss is recognized in the following circumstances:

(a) A transaction between the partnership and a partner with more than 50% interest

(b) A transaction between two partnerships, each of which is more than 50% owned by the same person

(c) The disallowed loss remains available to the buyer to offset any recognized gain on a future disposal of the asset.

(2) Capital gain treatment is denied on the sale of IRC Section 1231 property in the following circumstances:

(a) A transaction between the partnership and a partner with more than a 50% interest

(b) A transaction between two partnerships, each of which is more than 50% owned by the same person

4554.04 Merger or split-up of partnership:

a. When two or more partnerships merge, the resulting partnership is a continuation of that prior partnership whose members own more than 50% of the capital and profits in the resulting partnership.

(1) If this test cannot be satisfied, the resulting partnership will be a continuation of that prior partnership providing the greatest dollar value of assets to the resulting partnership.

(2) If neither of these tests can be satisfied, all of the merged partnerships will be terminated and a new partnership will result.

b. When a partnership is split up into two or more partnerships, the following guidelines apply:

(1) A resulting partnership will be a continuation of the original partnership if its members had more than 50% of the capital and profits in the original partnership.

(2) Any resulting partnership that cannot meet this test will be treated as a new partnership.

(3) If none of the resulting partnerships can meet this test, the original partnership will be terminated, and all of the resulting partnerships will be treated as new partnerships.

4555 Partnership Liabilities

4555.01 Liabilities and their effect on basis

a. A partner's share of the partnership's liabilities is added to the partner's capital account to calculate the partner's basis.

b. Liabilities recorded on the partnership's books are considered to be the obligations of the partners (the aggregate or conduit concept).

c. Any time the pool of liabilities increases, the partners are treated as having contributed money to the partnership because they obligate themselves to future payments (the aggregate theory).

d. When partnership liabilities are reduced by repayment of loans or accounts payable, the partners are treated as having a distribution of money from the partnership, used to retire future debts.

e. When a partnership's liabilities increase, each partner's basis in his partnership interest increases in proportion to his respective share of such debts.

f. Correspondingly, each partner's basis decreases proportionally when the partnership's liabilities decrease.

4555.02 Types of debt

a. **Recourse debt** is debt where the partnership and at least one partner are personally liable for the debt.

b. **Nonrecourse debt** is debt where there is no personal liability for the debt by the partnership or any partner. With nonrecourse debt, the lender must rely on repayment from the value of the pledged assets.

4555.03 Types of partners

a. A **general partner** is personally liable for recourse partnership debts when the partnership cannot pay.

b. A **limited partner** is not liable for debts of the partnership beyond his or her partnership investment. This amount is increased by any future contributions the partner has agreed to.

4555.04 Partner's basis

a. A general partner is allowed to increase partnership basis by his or her share of all recourse debt. The partner's share is calculated using the ratio for sharing losses.

b. Limited partners are allowed to increase partnership basis for their share of recourse debt if they share in partnership losses. A limited partner's share of partnership liabilities cannot exceed the total contributions the partner is obligated to make under the limited partnership agreement.

c. All recourse debt of the partnership is allocated to the partners in calculating the tax basis of their partnership investment.

d. If a limited partner is denied a share of recourse debt due to a lack of obligation, the general partner's allocation of debt must be adjusted upward to offset the limited partner's reduced allocation.

4556 Distribution of Partnership Assets

4556.01 Following are the types of nonliquidating partnership distributions:

a. Nonliquidating distributions of cash and other property that will not end in the liquidation of the distributee partner's interest

b. Disproportionate distributions, which affect the partner's share of ordinary income property of the partnership

4556.02 IRC Section 731: Gain or loss recognition

a. General rule: No gain or loss is recognized by the partner or partnership in a distribution of cash or property.

b. Exception for cash distributions: If a cash distribution is received in excess of the partner's basis, then the amount that exceeds the basis is treated as a capital gain to the partner.

c. Beginning in 1995, marketable securities are treated as cash for purposes of IRC Section 731(a)(1). This applies to the calculation of a gain, but not to the calculation of a loss.

4556.03 IRC Section 732: Partner's basis in property received, distribution of property:

a. The partner receives the same basis in property as the partnership held.

b. In a current distribution, the partner's outside basis is reduced by any money distributed and the basis of any other property distributed.

c. The partner's basis cannot be reduced below zero.

4556.04 IRC Section 733: Basis of distributee partner's interest:

a. The partner's basis in a partnership is first reduced by the amount of money distributed to the partner.

b. The partner's remaining basis in a partnership is reduced by the value of any property distributed to the partner.

c. A distribution cannot reduce a partner's basis in the partnership below zero.

d. Other effects of distributions:

(1) Holding period: IRC Section 735(b) tacks on the holding period of the partnership so that it is included with the holding period of the partner.

(2) The partnership recognizes no gain or loss on current or liquidating distributions to a partner.

(3) The partner can have a gain or loss on a distribution that is considered the same as a gain or loss on sale of a partnership interest.

(4) Actual interest: Even when distributions or allocation of partnership losses may reduce a partner's basis to zero, the partner still retains the same capital and profits interest in the partnership.

4557 Liquidation and Termination

4557.01 Liquidating distributions

a. Liquidating distributions are made to a partner in order to terminate the partner's entire interest in the partnership.

b. The forms of liquidating distributions can be:

(1) cash distributions,

(2) distributions in kind,

(3) a lump-sum distribution, or

(4) a series of distributions.

c. The categories of liquidating distributions are:

(1) general liquidating distributions and

(2) distributions to retiring or deceased partners.

d. Recognition of loss

(1) Losses may be recognized with a liquidating distribution.

(2) The distribution must consist solely of cash and IRC Section 751 ordinary income assets ("hot assets").

(3) Loss is recognized if the partner's basis is greater than the total of the cash and IRC Section 751 properties received.

e. Adjusted basis of property received

(1) For liquidating distributions, the basis of property received is the adjusted basis less any cash received.

(2) If two or more properties are received, then the basis is allocated between the properties based on their fair market value.

f. **Allocation of basis.** Allocations are to be made under IRC Section 732(c) as follows:

(1) Step 1:

(a) Allocate to unrealized receivables and inventory items equal to the inside basis.

(b) If there is any leftover outside basis, go to Step 2.

(c) If there is insufficient outside basis to allow "hot assets" to receive basis equal to inside bases, allocate the deficiency as follows.

(d) First, allocate in proportion to built-in losses.

(e) Then, allocate to the hot assets in proportion to their adjusted bases.

(2) Step 2:

(a) Any basis left after Step 1(a) is allocated to cold assets (non-hot assets) equal to their inside basis.

(b) If there is any leftover outside basis, go to Step 3.

(c) If there is insufficient outside basis to allow all "cold assets" to receive an outside basis equal to the inside basis, allocate the deficiency as follows.

(d) First, allocate to cold assets with an excess of basis over value, based on built-in losses.

(e) Second, allocate to cold assets in proportion to the adjusted bases.

(3) Step 3:

(a) Any basis left over from Step 2(a) is allocated to cold assets based on the excess of fair market value over basis.

(b) Any remaining outside basis is allocated under Step 4.

(4) Step 4: The remaining basis is allocated to cold assets based on fair market value.

4557.02 Distributions to retiring or deceased partners

a. The death of a partner does not terminate the partnership.

b. The deceased partner's successor in interest is a partner until the interest is liquidated.

c. A retiring partner is recognized as a partner until his/her retirement is complete.

d. Winding-down payments (IRC Section 736(a)):

(1) These payments are treated as distributions of income or guaranteed payments.

(2) Payments are taxable either to the retiring partner or deceased partner's successor in interest as ordinary income.

(3) These payments reduce the other partners' distributive shares of income.

e. Payments for interest in the partnership (IRC Section 736(b)):

(1) These are payments made for a partner's interest in partnership property.

(2) These payments are for the interest in capital gain or loss properties.

(3) These payments are considered as a distribution by the partnership.

4557.03 Partnership terminations

a. A partnership exists for tax purposes until it is terminated (IRC Section 708(b)):

(1) by the end of any business or financial operations.

(2) by certain sales or exchanges of partnership interests in a 12-month period. (This technical termination provision was repealed by the Tax Cuts and Jobs Act of 2017 (TCJA).)

b. Cessation of business:

(1) A partnership is terminated when no part of any business, financial operation, or venture is carried on by any of the partners.

(2) When all partners agree to the state law dissolution of the partnership, it is terminated for tax purposes.

4560 Limited Liability Companies

4560.01 Limited liability company (LLC)

a. An LLC is generally created under state law by filing articles of organization with the secretary of state's office. The articles must include such information as the following:

(1) The name of the LLC

(2) The duration of its existence

(3) The name and address of the LLC's registered agent (for such purposes as service of process)

b. The LLC's name must generally include the words "limited liability company" or similar words that indicate to third parties that the owners of the entity have limited liability.

c. Owners of the interests in an LLC are referred to as members. Most statutes require an LLC to have two or more members; however, some states do allow single-member LLCs. Generally, members of an LLC can be individuals, partnerships, corporations, or other LLCs.

d. An LLC is treated as a separate legal entity. Members have no personal liability for any of the LLC's debts simply by reason of being a member.

e. The members of an LLC have a right to manage that which is proportionate to their capital contributions. Members who actually engage in management owe fiduciary duties to the LLC.

f. If the actual authority of a member is not restricted, a member generally may have implied and apparent authority to bind the LLC on contracts entered in the ordinary course of the LLC's business.

g. State LLC statutes generally allow an LLC interest to be transferred as provided in the member's operating agreement.

h. If an LLC interest is transferred, the transferee generally has no right to become a member unless the other LLC members consent. A transferee who does not become a member is still entitled to receive either the return of their capital contribution or the fair market value of their LLC interest.

i. An LLC will generally dissolve upon the death, retirement, bankruptcy, or dissolution of a member. Liquidation of an LLC, however, can generally be avoided by unanimous consent of the remaining members to continue the LLC's business.

j. An LLC is treated as a partnership for federal income tax purposes unless an election is made on IRS Form 8832 to treat it as a corporation. A single-member LLC cannot be taxed as a partnership. A single-member LLC is mostly used by individuals to shield their personal assets from business liabilities. For income tax purposes, a single-member LLC is a sole proprietorship with the reporting of income or loss on Schedule C of IRS Form 1040, unless the single member elects to be treated as a corporation.

4570 Trusts and Estates

4571 Types of Trusts

4571.01 Living (*inter vivos*) versus testamentary trust:

a. Living (*inter vivos*) trust: A trust created by a grantor who is still alive at the time the trust is created

b. Testamentary trust: A trust created by an individual's will at or following the date of the grantor's death

4571.02 Revocable versus irrevocable trust:

a. Revocable trust: A trust that may be amended, altered, or revoked by its grantor at any time, provided the grantor is not mentally incapacitated

b. Irrevocable trust: A trust that may not be amended, altered, or revoked by its grantor at any time until the terms or purposes of the trust have been completed

4571.03 Simple versus complex trust:

a. Simple trust: All net income must be distributed to beneficiaries on an annual basis, does not generally distribute from corpus, and does not have a charitable deduction. The exemption amount for a simple trust is $300.

b. Complex trust: All or part of income may be accumulated and taxed at the trust level. Income may or may not be distributed on an annual basis. Taxable income may be reduced by charitable contributions. The exemption amount for a complex trust is $100.

4571.04 Trusts classified according to purpose:

a. Bypass trust:

(1) When the first spouse dies, the will of the decedent provides that a portion of the estate remainder (after estate taxes) is paid into a bypass trust for the surviving spouse.

(2) If the surviving spouse follows the rules provided by the IRS, estate tax will not be paid again on those funds.

(3) The surviving spouse must have only limited power to access the trust while alive.

(4) The surviving spouse must not have an unrestricted right to withdraw principal from the trust.

(5) The surviving spouse can be given the right to withdraw principal for health, education, maintenance, or support.

(6) The spouse may also be given the right to withdraw up to $5,000 of principal each year, or 5% of the total principal, whichever is greater.

(7) The spouse may also be given the right to withdraw all of the interest and dividends each year earned by the trust.

(8) Beyond the asset withdrawals listed above, the spouse cannot have the right to give trust assets to himself, his creditors, his estate, or his estate's creditors.

(9) The settlor of the trust can name a successor beneficiary to receive the trust after the death of the spouse, or give the survivor a list of persons such as family members to choose to receive the assets.

b. Charitable remainder trust: Irrevocable trusts established by a donor to provide an income stream to the income beneficiary, while the public charity or private foundation receives the remainder value when the trust terminates

c. Qualified terminable interest property trust (QTIP):

(1) The surviving spouse will receive a stream of income for life.

(2) Income must be distributed at least annually.

(3) Income may be paid only to the surviving spouse.

(4) The executor of the estate makes the election for a QTIP on the estate tax return.

(5) At the death of the second spouse, the property in the trust passes to a different heir.

(6) The heir is chosen by the spouse who established the trust.

(7) The value of the trust is included in the estate of the surviving spouse.

d. Generation-skipping trust: A trust agreement in which the contributed assets are passed directly to the grantor's grandchildren, not the grantor's children. The generation to which the grantor's children belong skips the opportunity to receive the assets in order to avoid the estate taxes that would apply if the assets were transferred to them.

e. Grantor trust: A trust in which the grantor retains control over the income and/or corpus and is treated as the owner of the property and its income for tax purposes.

f. Spendthrift trust: A trust created for a person who cannot control their spending; or, a trust created so the creditors of the beneficiary cannot get to the trust assets. The independent trustee is to make decisions that are in the best interest of the beneficiary.

4572 Income and Deductions

4572.01 Estates and trusts are separate taxable entities. The taxable income from these entities, however, is taxed to either the entity or to its beneficiaries according to the income allocable to each party.

4572.02 IRS Form 1041 (*U.S. Income Tax Return for Estates and Trusts*) must generally be filed if an estate's gross income is $600 or more. However, a trust files when it has either $600 of gross income or any amount of taxable income.

- **a.** The return is due by the 15th day of the fourth month following the close of the entity's tax year.
- **b.** Trusts must use the calendar year as their tax year. Estates may use either a fiscal or a calendar year.
- **c.** Estimated tax payments are generally required from both estates and trusts. However, an estate may be exempt from making such payments during its first two tax years.

4572.03 **Gross income** for an estate or trust is basically the same as for an individual.

- **a.** Gains and losses will be recognized by estates and trusts when property is transferred to a beneficiary in lieu of cash to satisfy a specific cash bequest.
- **b.** No gain or loss will be recognized when specified property is transferred to a beneficiary under a specific bequest. However, the estate or trust may elect to recognize the gains and losses on all such distributions during the year.
- **c.** Income in respect of a decedent (IRD) is included in the gross income of the trust, estate, or survivor of the decedent qualified to receive it. IRD is income that was earned by the decedent at the time of death but was not reportable on the decedent's final income tax return because of the accounting method utilized.
- **d.** Trust receipts that are normally allocated to principal would be any receipts that are one-time in nature, such as stock splits, stock dividends, and settlement of claims on property damage.
- **e.** Trust receipts that are normally allocated to income would be any receipts that are routine in nature and usually received on an annual basis, such as cash dividends, royalties, rents, and interest.

4572.04 **Deductions** for an estate or trust are similar to those of an individual.

- **a.** Expenses associated with income in respect of a decedent (IRD) that were not reported on the decedent's final income tax return may be claimed by the taxpayer receiving the IRD. Such expenses are deductible on both the estate tax return (IRS Form 706) and on the income tax return of the recipient of the IRD.
- **b.** An estate may elect to claim administration expenses and casualty losses as either an estate tax deduction (IRS Form 706) or as an income tax deduction (IRS Form 1041). These expenses cannot be claimed on both returns.
- **c.** A personal exemption is allowed as follows:
  - (1) $600 for estates
  - (2) $300 for a trust that is required to distribute all of its income currently, does not distribute from corpus, and does not have a charitable deduction (simple trusts)

(3) $4,300 for "qualified disability trusts" in 2020

(4) $100 for all other trusts (complex trusts)

d. An unlimited charitable contribution deduction is allowed to an estate or complex trust if the contribution is paid out of gross income.

(1) No deduction is available for contributions paid from tax-exempt income.

(a) The will or trust agreement may dictate the specific income source from which the contribution is to be paid.

(b) Contributions not identified as to source are considered to be made proportionately from each element of income received by the trust or estate. Such contributions must be allocated between taxable and tax-exempt income.

(2) No contribution deduction is available to simple trusts.

e. Distributions of income to beneficiaries are allowed as a deduction to both estates and trusts. This deduction, however, cannot exceed distributable net income (DNI).

(1) The DNI amount serves several roles:

(a) DNI sets a limit on the amount distributed that is deductible by the estate or trust for the tax year.

(b) DNI also determines the amount and character of income to be reported by the beneficiaries.

(2) The DNI amount is basically the entity's taxable income before any distribution deduction with the following adjustments:

(a) Additions:

i. The personal exemption

ii. Net tax-exempt interest

iii. Net capital loss deduction

(b) Subtractions:

i. Net capital gains taxable to the entity

ii. For simple trusts, dividends allocable to corpus

f. Medical expenses and funeral expenses of a decedent are deductible on the estate's income tax return under the following rules:

(1) Medical expenses of a decedent that are paid within 12 months of the decedent's death are deductible on the decedent's final income tax return if they are not claimed as an estate tax deduction.

(2) Medical expenses that are not paid within one year of death are deductible only on the estate tax return (IRS Form 706).

(3) Funeral expenses may be deducted on the estate tax return (IRS Form 706).

g. Neither a capital loss nor a business loss sustained by a decedent may be carried forward and deducted on the estate's income tax return.

h. Trust payments normally allocated to principal would be monthly mortgage principal payments.

i. Trust payments normally allocated to income would be normal, ordinary, and necessary payments that occur every year or month, such as insurance and taxes, and monthly mortgage interest payments.

4572.05 Taxable income of estates and trusts is taxed at the following rates:

	2020	
Over	**But Not Over**	**Rate**
$ 0	$ 2,600	10.0%
2,600	9,450	$260 plus 24% of the excess over $2,600
9,450	12,950	$1,940 plus 35% of the excess over $9,450
12,950		$3,129 plus 37% of the excess over $12,950

4573 Determination of Beneficiary's Share of Taxable Income

4573.01 Beneficiaries are generally taxed on income distributions they receive.

a. The character of the income distributed is the same to the beneficiary as it was to the estate or trust.

b. In a simple trust, beneficiaries are taxed on the income that is required to be distributed to them, whether or not it is actually distributed during the taxable year. The amount that is taxable, however, is limited to the trust's distributable net income (DNI).

c. Beneficiaries of estates and complex trusts must also pay taxes on the income required to be distributed currently (whether or not it is actually distributed) *plus* any other amounts that are paid, credited, or required to be distributed for the year.

(1) Distributions in excess of DNI are generally not taxable.

(a) When a distribution from a complex trust exceeds the trust's DNI for the year, the beneficiary may be required to pay an additional income tax.

(b) This additional tax applies only when a complex trust has not distributed all of its DNI in prior years.

(c) The tax on this accumulation distribution is determined under special "throwback" rules.

(d) Beneficiaries of estates and simple trusts are not subject to the throwback rules.

(e) In general, special throwback rules apply to trust distributions made in tax years beginning before August 6, 1997. The throwback rules have been repealed for most trusts, but they continue to apply to trusts created before March 1, 1984, that would be treated as multiple trusts under IRC Section 643(f) and to foreign trusts and domestic trusts that were once treated as foreign trusts.

(2) When there is more than one beneficiary receiving a distribution from the trust or estate, DNI is divided between the beneficiaries using a two-tier system of allocation.

(a) First tier—DNI is allocated proportionately between all required income distributions.

(b) Second tier—Any remaining DNI is allocated proportionately between all other income distributions.

(c) Distributions from DNI are taxable. Additional distributions are generally not taxed.

(3) When there are multiple beneficiaries, the different income elements comprising DNI must be allocated to each beneficiary in proportion to the amount of DNI allocated to each.

4573.02 When an estate or trust terminates, special tax treatment of several attributes is possible:

a. No personal exemption may be claimed on the final income tax return of an estate or trust.

b. Unused carryovers of capital losses and net operating losses pass through to the beneficiaries who succeed to the estate or trust property. These carryovers will be used as deductions for AGI by the beneficiaries (individuals).

c. In the last tax year of existence, current deductions in excess of gross income will be allowed to the beneficiaries as miscellaneous itemized deductions.

4573.03 Special tax situations for trusts include the following:

a. When the grantor of a trust retains beneficial enjoyment or substantial control over the trust property or income, the trust is disregarded and the grantor is taxed on the trust income.

b. When appreciated property is transferred to a trust and subsequently sold at a gain within two years, a special tax applies. The gain (to the extent of the original built-in gain) will be taxed to the trust at the grantor's applicable tax rate for the year of sale.

4573.04 "Crummey trusts" allow a donor to transfer property to a minor. These types of trusts last for as long as the donor requests.

a. A Crummey trust transfer qualifies for the annual gift tax exclusion if the trust is properly structured where the beneficiary has the power to withdraw annual contributions.

b. The right to the trust income is only up to $15,000 in 2020 per donee, per year.

4580 Tax-Exempt Organizations

4581 Types of Organizations

4581.01 The Internal Revenue Code (IRC) includes rules that exempt specified nonprofit organizations from income taxation in most situations.

a. The organization must qualify as one of the specified classes of exempt organizations provided for in the IRC.

b. Examples of these organizations include charities, churches, educational institutions, social clubs, political organizations, employees' pension or profit-sharing trusts, certain cooperatives, and private foundations.

4582 Obtaining and Maintaining Tax-Exempt Status

4582.01 Exemption from taxation is not automatic. The entity seeking exemption must have been organized as a not-for-profit entity. An application for exemption must be filed with the IRS. That application includes the organization's organizing documents such as charter and bylaws. Those documents establish the operating rules the entity will follow in order to be exempt from federal income tax.

a. If an exempt organization engages in a prohibited transaction, part or all of its income will be subject to tax. It may also lose its exempt status. Prohibited transactions include the following:

(1) Failure to maintain qualification requirements

(2) Attempting to influence legislation and participating in political campaigns (certain exempt organizations may engage in lobbying activities on a *limited* basis)

b. Feeder organizations will be taxed. These are organizations that carry on a trade or business and turn over all of their profits to an exempt organization.

c. Private foundations may be partially subject to tax.

(1) Private foundations are exempt organizations that are not broadly supported by the general public. They are supported by and responsive to a limited number of donors.

(2) Private foundations may be subject to the following taxes:

(a) Tax on investment income

(b) Tax on self-dealing

(c) Tax on failure to distribute income for exempt purposes

(d) Tax on excess business holdings

(e) Tax on speculative investments that jeopardize the foundation's assets

(f) Tax on expenditures that should not be made by private foundations

4582.02 Private foundations must file annual information returns. Other exempt organizations, except for churches, must file an annual information return (IRS Form 990) if their gross receipts exceed $50,000 for the year. Churches are exempt from filing information returns.

a. Returns must report the total annual contributions received and identify all substantial contributors.

b. The return is due by the 15th day of the fifth month after the end of the accounting period.

4583 Unrelated Business Income

4583.01 Although these organizations are generally tax exempt, their unrelated business income may be taxed.

a. Unrelated business income (UBI) is net income derived from:

(1) the regular operation of a business activity that is unrelated to the organization's exempt purpose (includes earnings from ownership in an S corporation) or

(2) debt-financed property.

b. If the organization's UBI is taxed, trust rates apply if it is a trust and corporate rates apply if it is a corporation.

(1) The first $1,000 of UBI is exempt from tax.

(2) The tax does not apply to investment income—dividends, interest, royalties, capital gains, most rents, and similar items that are accepted as proper sources of income for a charity or trust. Income from debt-financed investments will be taxed, however.

(3) Quarterly estimated tax payments for any UBI tax are required in the same manner as the estimated tax payments for regular corporations.

4583.02 The income from "qualified" bingo games is exempt from tax if the following three requirements are met:

1. The bingo game is legal in the state.

2. The bingo game is legal in the locality.

3. Commercial bingo games are not allowed in the locality.

