University of California
Santa Cruz

Economics 117B

Tax Factors of Business & Investments

Course Outline

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Chapter 1 DESIGNING TAX SYSTEMS

I. Designing Tax Systems

A. Designing Tax Systems

1. A good tax ought to be equitable, convenient, certain and economical

2. Tax = Tax Base x Rate

B. Major Taxes:

1. Income Taxes: Federal and most states

2. Property Taxes: Taxes based on the value of property are common sources of revenue for local governments

3. Sales Taxes: Vary widely - common source of state and local revenue

4. Employment Taxes: May be paid by employer, employee or both

5. Excise Taxes: Taxes on certain goods or services

6. Wealth Transfer Taxes: Gift and estate taxation

II. Tax Rate Terminology

A. Marginal Tax Rate

1. Percentage at which next $1 of tax-base will be taxed

B. Average Tax Rate:

1. Tax ÷ Tax Base

2. Example: Tax ($22,250) ÷ Taxable Income ($100,000) = Average Tax Rate (22.25%)

C. Effective Tax Rate

1. Tax ÷ Economic Base

2. Example: Tax ($22,250) ÷ Taxable Income ($100,000) + Income Not Taxed ($100,000)—total $200,000

$22,250 ÷ $200,000 = 11.125%

D. Proportional

1. Tax rate remains the same as the tax base increases

2. Example: Sales tax of 8% — Sales of $1,000 taxed at 8%; Sales of $10,000 taxed at 8%

E. Progressive

1. Tax Rate increases as the tax base increases

2. Example: Income Tax Income of $1,000 taxed at 10%
Income of $400,000 taxed at 35%

F. Regressive

1. Tax rate decreases as the tax base increases

2. Example: OASDI tax 6.2% of first $128,400 of wages
0% of wages in excess of $128,400

III. Wealth Transfer Taxes - The Gift Tax

A. The gift tax is based on the value of property given to a donee each year. Property includes real, personal, tangible and intangible property.

B. An annual exclusion of up to $15,000 to each donee is available for 2018. The annual exclusion is indexed for inflation.

C. Gift splitting may be elected by married donors. The impact of gift splitting enables both the husband and wife to claim up to the maximum allowable annual exclusion.

D. Advantages of gifts - appreciation and income of gifted property are transferred to the donee.

E. Calculation of the tax: While the gift tax is computed annually, it is based on the cumulative amount of taxable gifts made over an individual's life

F. Unified Credit (now renamed the "Applicable Credit Amount")

1. This credit is an offset to the gift tax liability.

2. The credit for 2018 is $4,425,800 and is available to each donor.

3. The unified credit exemption amount is $11,200,000 for 2018. Actual payment of gift tax is not required until total taxable cumulative aggregate value of gifts exceeds $11,200,000.

IV. Wealth Transfer Taxes - The Estate Tax

A. Wills (Three basic types)

1. Holographic wills are handwritten documents

2. Statutory wills are generally preprinted forms

3. Formal wills are usually prepared by an attorney

B. Role of a will—A will expresses the wishes of the decedent, including the transfer of the decedent's property.

C. If a decedent does not have a will, state law will determine who will obtain title to the decedent's property.

D. The beneficiaries named in a will do not necessarily obtain title to all of the decedent's property.

1. For example, matters of a contractual nature generally take priority over the terms of a will.

2. If title to property is held in joint tenancy, the surviving joint tenant will obtain title to the property upon the death of the decedent.

3. The trust instrument controls the disposition of trust assets, not a will.

E. Probate is the process of having a court oversee the administration of an estate. It may be costly and time consuming.

F. Computation of the estate tax - Refer to class problem.

G. The Unified Credit for estate tax purposes and the equivalent value of property are reflected below:

	Exemption Equivalent	**Credit**	**Highest Estate Tax Rate**
2009	3,500,000	1,455,800	45%
2010	5,000,000	1,730,800	35%
2011	5,000,000	1,730,800	35%
2012	5,120,000	1,772,800	35%
2013	5,250,000	2,045,800	40%
2014	5,340,000	2,081,800	40%
2015	5,430,000	2,117,800	40%
2016	5,450,000	2,125,800	40%
2017	5,490,000	2,141,800	40%
2018	11,200,000	4,425,800	40%

H. Basic Estate Planning. Current rules allow a surviving spouse to use any unused portion of the $11,200,000 exemption equivalent not used on the first death. For example, assume H dies in 2018. H's estate was valued at $4,000,000. Because $7,200,000 of the $11,200,000 exemption equivalent was not used by H's estate, W's estate may now use $11,200,000 + $7,200,000 (total $18.400,000) as the exemption equivalent when W dies.

K. Basic Concepts of Life Insurance & Living Trusts

1. If the estate is the named beneficiary or if the decedent is considered the owner of the life insurance polity, the proceeds are included in the decedent's estate. Therefore, the decedent should not own the policy.

2. Use of a living trust avoids probate. However, only the assets placed in the trust are covered by its terms.

L. Basis of property acquired from a decedent.

1. Generally, the FMV of property at the date of death is used to determine the basis of property received by reason of death. If the total value of the estate has declined from the date-of-death value, an alternative valuation date may be used (6 months after death).

2. For deaths occurring in 2010, the estate could have opted out of paying any estate tax by using the basis rules in (M) below.

M. Basis of property acquired from a decedent. For 2010 only, a modified carryover basis rule was instituted.

1. Generally, in 2010 the recipient of the decedent's property would use a basis equal to the lower of the decedent's old basis or FMV of the property at the date of death.

2. However, for 2010 the law allows an executor limited ability to increase (step-up) the basis of assets acquired by reason of death. Generally, each decedent's estate is permitted to increase the basis of assets by up to a total of $1.3 million (but never above FMV). The $1.3 million may be increased by any unused capital losses, net operating losses, and certain built-in losses of the decedent. In addition, the basis of property transferred to a surviving spouse may by increased by an additional $3 million. Therefore, property left to a surviving spouse may receive a step-up in basis of up to $4.3 million. The basis increase is allocable on an asset-by-asset basis and but limited to FMV.

3. As indicated in (L) above, for 2010 only, an estate may opt out of paying any estate tax by electing to use these modified carryover basis rules.

V. Employment Taxes

A. FUTA – imposed on employers who:

1. Pay wages of $1,500 or more during a calendar quarter or who employ someone for 20 days during the calendar year

2. Tax rate = 6% of first $7,000 of wages. A credit is allowed for similar state taxes up to 5.4% of first $7,000.

B. FICA – imposed on both employers and employees

1. This tax consists of two parts:

   a. OASDI – Old Age Survivors Disability Insurance
   b. MHI—Medicare Health Insurance

2. OASDI tax rate for employees was returned to 6.2% on wages or up to $128,400 for 2018

3. MHI tax rate is 1.45% applied to all wages

4. Self-employed individuals are subject to FICA taxes at twice the employee rate i.e.—OASDI 12.4% and MHI 2.9% = 15.3%. See (5) below for special rules applicable to 2011 and 2012.

   Note: An income tax deduction is allowed for ½ of the self-employment tax paid

C. Calculation of the self-employment tax

   Refer to class problem

D. MHI tax rate increased for "high income" taxpayers beginning in 2013

The MHI tax rate was increased by .9% for employees, but not for employers for wages and self-employment income in excess of the following thresholds:

MFJ	$250,000
MFS	125,000
All others	200,000

E. Medicare (MHI) Surtax on Net Investment Income beginning in 2013

1. A 3.8% additional tax applies to the lower of:

(a) Net Investment Income
or
(b) MAGI

In excess of the following thresholds:

MFJ	$250,000
MFS	125,000
All others	200,000

Chapter 2 Tax Law, Levels of Authority and Research Papers

I. **Congress**

A. Congress has the authority to tax as granted by the Constitution.

B. 16th Amendment to the Constitution provides authority for the income tax.

C. The legislative process - House Ways & Means Committee and the Senate Finance Committee.

II. **Tax Treaties and the Internal Revenue Code—**Treaty provisions may take priority.

III. **Treasury Department Regulations**

A. Regulations are the Treasury Department's attempt to explain and interpret the law.

B. Types of Regulations

1. Legislative

a. Congress has given the Treasury Department the specific charge to issue regulations

b. Given the force and effect of law.

2. Interpretative

a. Treasury Department's attempt to explain the law

b. Given great weight

3. Procedural regulations deal with a variety of administrative matters, such as deadlines and forms.

C. All regulations must be approved by the Secretary of the Treasury

IV. **Internal Revenue Service Interpretations**

A. Revenue Rulings and Procedures

1. Revenue Rulings and Revenue Procedures usually carry less weight than regulations

2. Revenue Rulings are usually limited to a given set of facts

3. Revenue Procedures deal with administrative matters

B. Letter Rulings

1. Taxpayers may request a letter ruling before they complete a transaction

2. The ruling will give the position of the IRS

3. A letter ruling is meant to apply only to the taxpayer asking the questions. However, they do indicate the official position of the IRS.

C. Technical Advice Memorandum (TAM)

1. Either a taxpayer or the local office of the IRS may request a TAM

2. A TAM request is usually made as a result of an audit.

3. A TAM gives the "official" IRS opinion

4. An advantage of a TAM is that it doesn't really bind the taxpayer

D. Other IRS Pronouncements: Information releases, announcements and notices

E. Appeals Process and Litigation

1. Resolving disputes with the IRS

   a. Audits of tax returns

   b. Administrative Appeals

   C. Litigation

2. Avenues of Appeal (litigation)

   a. The taxpayer elects which trial court is to hear the case. However, as all but the Tax Court requires the payment of the tax first, the choice is limited as a practical matter.

   b. All trial court decisions should be viewed as being of "equal" value

F. Appeals of Decisions

1. As a matter of right, either the government or the taxpayer may appeal a decision of any trial court to the next level with the exception of the Small Claims Tax Court

2. An Appeals Court decision may usually be viewed as being of greater weight than that of a trial court

3. Geographic considerations may play an important role as Appeals Courts may differ on the same issue; i.e.: A 9th Circuit decision may differ from a 5th Circuit decision.

4. The Tax Court may render a different result on the same issue depending upon the Appeals Court holding for that geographic area.

G. IRS Position

1. Is the IRS following the decision of the Court?

2. IRS will announce its position regarding unfavorable decisions - generally regular Tax Court decisions.

   a. Acquiesce - IRS agrees to follow the decision.

   b. Non-acquiesce - IRS will not follow the decision.

3. This process puts the public on notice of the IRS position.

V. Audits of Returns

A. There are three types of Audits conducted by the IRS.

1. Service Center Examinations - These reviews are conducted through correspondence. They are usually very limited in scope.

2. Office Examinations - These reviews are generally handled through correspondence or office interviews. They are usually limited in scope and cover one or two items on the return.

3. Field Examinations - These reviews may be extensive and could involve an audit of all aspects of the return. They are usually conducted at the taxpayer's home or office.

B. Selection of returns for audit

1. Information Reports - This is an internal document, which is used by a local office of the IRS to request an audit of another taxpayer located outside the jurisdiction of the local office.

2. DIF - Returns receive a numerical score using specific formulas. Returns with higher scores have a greater chance of being audited.

3. Projects - Local projects may cause a return to be audited.

4. National Research Study Program (replaced TCMP) - Returns audited under this program are randomly selected. These audits are usually extensive and the results are used by the IRS to evaluate compliance and to modify DIF formulas.

5. Informant - Information received from the public may cause a return to be audited.

6. MACS - returns are selected using a computer database. The selection criteria are determined by the local office.

VI. Tax Research and the Research Paper

A. Communication

1. Communicating the results - the critical step.

2. If the results of the research are ineffectively communicated, the research is for not!

B. Hints

1. To improve your research paper, follow the suggested format specifically.

   a. Facts - make a brief statement of the facts or question being researched.

   b. Tax Issue - Make a clear and concise statement of the key tax questions you are answering.

c. Discussion of the tax law and its application.

   (1) In discussing relevant sections, cases, regulations and rulings, **avoid lengthy quotations**.

   (2) **Brief** quotations are fine. Use your own words as often as possible.

d. Editorial comments

   (1) Not authoritative.

   (2) Do not cite edited text material.

      (a) Incorrect i.e.; "The text indicated on page 2-16..."

      (b) Correct i.e.; "James Pratt, in *Federal Taxation 2019 Edition*, indicated…"

e. Choice of words

   (1) Is your paper easy to read and understand? Clarity, presentation and professional appearance will be graded.

f. Correct Citations - Refer to Chapter 2 for information.

g. Conclusion - indicate your answer, advice or action recommended in a concise statement

h. Do not cite IRS publications or editorial material such as found in Checkpoint. Instead, cite the basic authority the editor's use such as the Code, regulations, rulings and cases.

2. Overall Hints

   a. Papers will be graded on neatness as well as technical information.

   b. Spelling and grammar will be included in overall grade. Read the final product. Have someone else critically read your paper. Clarity of presentation is extremely crucial. Use correct sentence structure and appropriate words to complete your thoughts.

   c. Professional Presentation - your research paper should be typed and be approximately two pages or more in length. Remember to submit the paper as if it was a proposal for a paying client.

Chapter 3 Types of Business Organizations

I. Business Organizations

Types of Business Organizations

Sole Proprietorship	Partnership	'C' Corporation	'S' Corporation
Owner taxed	Owners taxed	Entity taxed	Shareholders taxed
Owner liable	Owners liable (Exception-Limited Partners)	Limited liability	Limited liability
Losses deductible	Losses pass to owners	Losses kept in corporation	Losses pass to owners
Owner subject to SE tax	Partners subject SE tax (Exception-Limited Partners)	Not subject to SE tax	Not subject to SE tax

* Note: Limited Liability Companies (LLC's) and Limited Liability Partnerships (LLP's) are generally treated as partnerships for tax purposes.

** Refer to class problems

II. Determining Net Income

A. Distributions

1. The distribution of earnings is generally not a taxable event unless the distribution is from a "C" corporation.

2. A distribution of earnings by a "C" corporation is generally treated as a dividend.

3. Dividends are not deductible by the paying corporation and are taxable to the receiving shareholder.

4. Distributions from a sole proprietorship, partnership or an "S" corporation are generally not taxable to the receiving owners.

B. Compensation

1. Generally, owners may not be employees of their own businesses. An exception exists for the owners of a corporation.

2. Sole proprietors and partners are not considered employees of their own businesses.

3. However, a shareholder (of a "C" or "S" corporation) may be an employee.

4. Corporations may deduct compensation paid to employees, including compensation paid to shareholder/employees.

III. Additional factors to be considered when selecting an appropriate business entity to be used to operate a business.

A. The tax rate for "C" corporations was reduced to a flat 21% for 2018 and subsequent years. For 2017 and prior years, the corporate tax rates were progressive and the top rate was 35%.

B. For years 2018 through 2025, noncorporate owners of "pass-though" entities (partnerships, "S" corporations, self-employed individuals and certain rental activities) are now entitled to a special deduction generally equal to 20% of "qualified business income."

1. Qualified business income (QBI) is generally net income from partnerships, "S" corporations, and sole-proprietorships.. The amount of the deduction is limited to taxable income before the QBI.

2. For partnerships and "S" corporations, the deduction is allowed on the owner's return.

3. A separate computation of QBI along with other limitations is required for each qualified trade or business.

4. Limitations may be applicable to further limit the amount of the deduction. If interested, see chapter 22, pages 22-21 through 22-25 for more details. Note: This topic will be covered in more detail in Econ. 117A.

C. The amount of net business losses from a sole proprietorship, partnership, or "S" corporation that can be deducted on an owner's return is limited to $250,000 ($500,000 on a joint return).

Chapter 5 Gross Income

I. Gross Income

A. Section 61 provides the following sweeping concept: *"gross income means all income from whatever source derived"* unless it is specifically excluded, exempted or otherwise not taxed.

B. The receipt of cash is not necessary in order to have taxable income.

C. whose income is it?

* Key case ***Lucas v. Earl*** where the Supreme Court noted:
  "The fruit belongs to the tree from which it grew".
  (The income belongs to the one who earned it.)

* In ***Helvering v. Horst*** the Supreme Court noted:
  "...income from property belongs
  to the person who owns the property."

D. Accounting Methods

1. No matter what method is used it must clearly reflect income.

2. Under the tax laws the proper matching of revenue and expense does not always follow GAAP.

E. Cash Method

1. **For years beginning in 2018, the cash method may be used by all taxpayers whose average gross receipts do not exceed $25,000,000**. (The average is calculated using the prior three-year period.) This rule applies to all forms of business and may be applicable to businesses selling inventory. Qualified personal service corporates may use the cash method irrespective of gross receipts.

   Qualified personal service corporations may ignore the gross receipts test. A qualified personal service corporation is one that meets both of the following:

   (1) **Functional Test** - substantially all activities are in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts and consulting and

   (2) **Ownership Test** - at least 95% of the stock is owned by employees providing the services

2. **For 2018 and subsequent years, the cash method may not be used by:**

   a. "C" corporations or (partnerships with a "C" corporation as a partner) with average gross receipts exceeding $25 million

   b. Entities that are "tax shelters"

3. **Old rules for 2017 and prior years**, a taxpayer could **not** use the cash method if:

   a. Inventory is a material income producing factor (an exception is made for small businesses)

   b. The taxpayer is a "C" Corporation (or a partnership with a "C" Corporation as a partner) with gross receipts over $5,000,000. For this purpose, annual gross receipts for 3 prior years are averaged

   c. Entities that are "tax shelters"

F. Constructive Receipt Doctrine—Requires the recognition of income that is available to the taxpayer even though the income may not have actually been received.

G. Accrual Method

1. Income is recognized when earned whether or not received.

2. Exceptions to the accrual method of income recognition are:

   a. Prepaid interest, rents or royalties must be recognized as income when received.

   b. Prepaid service income—per Notice 2002-79 & Rev. Proc. 2004-34:

      (1) Accrual method taxpayers may use the "deferral method"

      (2) The proposal allows advanced payments to be deferred for up to one year. Advance payments for services to be rendered beyond the end of the next tax year must be reported in income as earned, but no later than the end of the next tax year.

      (3) For example, assume a taxpayer is in the business of rendering music lessons and receives an advanced payment on November 1, 2017, for a 2-year contract. Assume further that the contract calls for a total of 48 lessons. 8 lessons are to be provided in 2017, and an additional 20 in 2018. The taxpayer should report 8/48's of the payment in gross receipts in 2017 and 40/48's of the payment in gross receipts in 2018.

   c. Prepaid dues and subscriptions—Taxpayers may elect to recognize income ratably over the subscription or membership period.

   d. Advance payment for goods—Recognized when earned if the taxpayer uses the same method for financial statement purposes. The maximum deferral period is 2 years.

H. Dividends:

1. The tax rates imposed on dividend income have been reduced to 15% for most noncorporate taxpayers. However, for taxpayers whose dividend income falls in the 10% or 12% ordinary income tax rate brackets, the dividend tax rate is currently 0%. The new dividend tax rates are virtually the same as that imposed on net long-term capital gains. Starting in 2013 the maximum tax rate applicable to dividend income of high-income taxpayers was increased from 15% to 20%.

2. The reduced rates generally apply to dividends from domestic corporations and foreign corporations whose stock is readily tradable on an established U.S. securities market.

Chapter 7 Expenses

I. Expenses

A. General Rule—Expenses are not deductible unless specifically authorized by Congress.

B. Business Expenses

1. Section 162 allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business.

2. Reasonableness of the expenditure is implied.

C. Business Expenses Limitations Resulting 2018 Changes:

1. The deductible portion of business meals is still allowed for 50% of the cost, but no deduction is allowed for entertainment expenses.

2. No deduction is allowed for club dues.

3. No deduction is allowed for lobbying expenses

4. The deduction allowable for compensation paid or accrued with respect to the top five executives of a publicly held corporation may not exceed more than $1 million per year.

   a. The top five executives are the principal executive officer, principal finance officer and the three other most highly paid officers.

   b. The limitation applies even if the compensation is linked to performance.

5. No deduction is allowed for amounts paid for sexual harassment subject to nondisclosure agreements

6. The deduction for business interest expense is now limited. The limitation applies to all business entities, regardless of form. Generally, net interest expense in excess of 30% of the business's adjusted taxable income is not allowed as a deduction. For years 2018 through 2021, adjusted taxable income is computed without regard to deductions allowed for depreciation, amortization, or depletion.

II. Methods of Accounting - Cash Method

A. General Rule—The cash method of accounting generally allows a deduction when expenses are paid.

B. Exceptions arise for:

1. Prepaid rent expense—the prepayment may be deductible using the 12-month rule and economics performance has occurred.

2. Prepaid insurance—Revenue Ruling 70-413 provides that prepaid insurance is deductible only over the policy period, unless the prepayment complies with the 12-month rule.

3. Prepaid interest must be deducted over the period of time covered by the loan (Exception: "points" paid to purchase or improve a personal residence).

4. Other prepayments are generally deductible if the asset will be consumed by the close of the following year, there was a business purpose for prepaying and the amount does not materially distort income.

C. The 12-month rule is contained in §1.446 of the Regulations. These Regulations provide that a deduction may be claimed for prepaid expenses if the rights and benefits do not extend beyond the earlier of:

1. 12 months after the first date on which the taxpayer realizes the benefit or
2. The end of the tax year following the year in which the payment was made

III. Methods of Accounting—Accrual Method

A. General rule—expenses are deductible when:

1. The "All Events" test is satisfied and

2. Economic performance has occurred

B. Certain liabilities

1. Regulations identify certain liabilities for which only payment is considered economic performance.

2. No deduction may be obtained by an accrual taxpayer until payment is made for the following:

a. Worker's compensation, tort or breach of contract

b. Refunds and rebates

c. Awards, prizes and jackpots

d. Insurance

e. Warranty or service work

f. Real estate, personal property or income taxes and licensing or permit fees

C. Recurring item exception

1. A deduction is allowed for recurring items which meet all of the following:

a. The "All Events" test is satisfied

b. Economic performance occurs within a reasonable time not to exceed the earlier of 8 ½ months after the close of the year or the filing of the return.

c. Consistent treatment of the recurring item and either the amount is immaterial or a better matching of income will result.

IV. Related Party Transactions

A. Section 267 prohibits or limits certain tax benefits involving transactions between related parties

1. A loss on the sale of property between related parties is not deductible

2. An accrued expense owed to a cash basis related party is not deductible until paid

3. Related parties are:

a. Family members-spouse, ancestors, lineal descendants, brothers and sisters

b. Corporations and a shareholder who owns (directly or indirectly) more than 50% of the stock

c. For purposes of accrued expenses—a personal service corporation and an owner-employee, a partner and a partnership, or a shareholder of an "S" corporation

d. Certain other relationships involving partnerships, trusts, corporations and individuals

Note: A person may be considered to own stock actually owned by another. For example, stock owned by a family member, a corporation, partnership or trust may be considered as owned by the taxpayer.

V. Capital Expenditures

A. Generally, no deduction may be claimed for the cost of permanent improvements made to property. Instead these costs must be added to the basis of the property. A similar rule is applicable to expenditures that add value, substantially prolong the useful life, or adapt the property to a new or different use.

B. The Treasury issued regulations that apply to years starting in 2014. The regulations indicate that if an expenditure is a betterment, an adaptation, or a restoration, it is generally an improvement. The rules focus on a "unit of property" with a variety of illustrations and "safe harbor" examples in an effort to provide guidance. For example, *de minimis* expenditures may be expensed ($2,500 for most small businesses and $5,000 for most large businesses) even though it is a capital expenditure. The regulations also allow a deduction for the unrecovered cost of an asset that is replaced. For example, if the roof of a building is replaced the cost of the new roof would generally be capitalized. However, now the unrecovered cost of the old roof (remaining depreciable basis) may be claimed as a loss in the year of replacement.

Chapter 9 Depreciation and Cost Recovery

I. Property subject to depreciation includes

A. Property used in a trade or business or held for the production of income that is subject to exhaustion, wear, tear or obsolescence.

B. Property that has a definite life.

C. Dual purpose property - only the business portion is subject to depreciation.

II. MACRS depreciation: This method is generally used for all tangible property (new and used) acquired after 1986

A. MACRS may NOT be used for:

1. Property owned or used by the taxpayer or a related party prior to 1987

2. Automobiles, if the standard mileage rate was previously used

3. Certain other property

B. Costs are recovered over statutory “recovery periods”.

Example: 3, 5, 7, 10, 15, 20, 27.5 or 39 years

C. Salvage value is ignored

D. Depreciation is calculated using the appropriate recovery period, method and accounting convention

1. Recovery period - the appropriate recovery period depends on the class of the property

2. Method - depends on the appropriate recovery period and the election made by the taxpayer

Recovery Period	Method
3, 5, 7, 10 years	200% or 150% DB** or S/L
15 or 20 years	150% DB** or S/L
27.5 or 39 years	S/L

** With switch to S/L when that method yields a greater deduction

3. Conventions - apply to the year of acquisition and disposition

   a. 1/2 year - applies to personal property - 1/2 year depreciation in the year of acquisition and disposition

   b. Mid-month - applies to buildings - 1/2 month depreciation in the month of acquisition and disposition plus full month for any additional months of use.

   c. Mid-quarter - applies to personal property only if more than 40% of all personal property placed in service during the year is in the last 3 months of the year.

   (1) If it applies, it replaces the 1/2 year convention for all personal property placed in service during the year.

   (2) All personal property is treated as being placed in service in the middle of the quarter it was actually placed in service

III. Alternative Depreciation system (ADS)

A. This system is similar to MACRS except the recovery periods may be longer

   1. The accounting conventions are the same as MACRS

   2. This method is elective by class for personal property and on a property by property basis for real property

   3. If the 150% declining balance method is elected for qualified tangible personal property, the appropriate MACRS recovery period must be used

   3. ADS must be used for the following:

      a. Foreign use property

      b. In calculating the alternative minimum tax and “earnings and profits”

      c. “Listed property” used 50% or less for business (S/L only)

      d. Certain other property

IV. Sec. 179 Expensing – For 2018 a taxpayer may elect to expense up to $1,000,000 of assets placed in service.

A. Qualified property includes:

   1. New or used depreciable property which is tangible personal property or certain real property, other than buildings, used in a trade or business and
   2. Acquired by purchase other than from a related party
   3. Qualified property now includes certain personal property even though it is used to furnish lodging.
   4. Qualified property now includes certain improvements made to nonresidential real property after the date such property was first placed in service including roofs, heating, ventilation, air-conditioning, fire protection, alarms, and security systems.

B. Property used by a tax-exempt organization generally does not qualify

C. Limitations:

1. In 2018 the total cost of eligible property may not exceed $3,500,000. Otherwise the allowable expensing deduction is reduced ($ for $) if the cost of eligible property placed in service during the year exceeds $2,500,000.

2. Sec. 179 expensing may not exceed business taxable income before considering 179 expensing - if the limit is exceeded, the nondeductible amount may be carried over to future years

D. Recapture:

If Sec. 179 property is converted to nonbusiness use, the difference between the 179 expensing and MACRS depreciation that would have been allowed is "recaptured" as income.

E. The amount eligible to be expensed under §179 expensing is limited amounts shown below: See below:

2015	$500,000 (Retroactively changed)
2016	500,000
2017	510,000
2018	1,000,000

V. Bonus Depreciation: For qualified property placed in service after September 27, 2017 before January 1, 2023, bonus depreciation may be claimed for 100% of the cost of qualified assets.

A. Qualified property placed in service that is new or used tangible depreciable property (other than buildings) with a recovery period of 20 years or less

B. For qualified property placed in service in 2023, bonus depreciation will be equal to 80% and further reduced as follows:

For property placed in service in 2024	60%
For property placed in service in 2025	40%
For property placed in service in 2026	20%

C. Bonus depreciation is scheduled to terminate after 2026.

D. For the first tax year ending after September 27, 2017, a taxpayer can elect to claim 50% bonus depreciation instead of 100%

D. For property that is required to be depreciated using ADS, bonus depreciation is not allowed. However, if ADS is elected, but not required, bonus depreciation may also be used

VI. Listed Property

A. Sec. 280F limits depreciation for certain property that is not used more than 50% for business

B. Listed property includes:

1. Passenger autos and certain other motor vehicles

2. Property generally used for entertainment, recreation or amusement, unless used exclusively at a business office

C. For employees using their own property, business use must be for the convenience of the employer and be required as a condition of employment in order to qualify

D. Listed property not used more than 50% for business in the year it is placed in service is not eligible for §179 expensing and the ADS S/L depreciation method must be used to calculate depreciation

E. If listed property was used more than 50% for business in the year it was placed in service, but that use drops to 50% or less in a subsequent year, the difference between the depreciation claimed and what would have been claimed using ADS S/L must be recaptured

F. Special rule for autos - the maximum annual depreciation deduction, including Sec. 179 expensing is limited as follows:

Year	2018	If Bonus Depreciation is Elected
Year #1	$10,000	$18,000
Year #2	$16,000	$16,000
Year #3	$9,600	$9,600
Year #4 (+)	$5,760	$5,760

Further, if the auto is used less than 100% for business the above maximums are further reduced

VII. Standard Mileage Rate

A. Rather than deducting the cost of gas, oil, repairs, insurance and depreciation a taxpayer may elect to use the standard mileage rate of 54.5 cents for 2018.

B. Certain conditions must be met in order to use this method

VIII. Amortization of goodwill and certain other intangible assets

Uniform straight-line amortization for certain acquired intangible assets, including goodwill, is allowed. Note the intangible asset must be amortized over a 15-year period irrespective of the asset's actual life. For example, a 5-year covenant not to compete must be amortized over 15 years.

Chapter 10 Bad Debts

I. Bad Debts - Business and Nonbusiness

A. Business Bad Debts: Debts that are classified as business are generally those that arise in the course of a trade business with customers, employers, employees or suppliers.

B. Nonbusiness Bad Debts: Debts that are classified as nonbusiness are generally those that arise from transactions with friends, relatives or loans to protect investments.

C. Tax Treatment of Bad Debts

1. Business

a. Deductible in full without dollar limitation.

b. A deduction for partial worthlessness is allowed if the debt is also written off for financial statement purposes.

2. Nonbusiness Bad Debts

a. Deductible only as a short-term capital loss and therefore eligible to offset capital gains and up to $3,000 of other income.

b. No deduction is allowed for partial worthlessness.

D. Sales: Bad debts arising from sales are deductible only if the sale has been reported in income. For example, no deduction is allowed for a cash basis taxpayer.

E. Business Bad Debts

1. The "direct write-off" method is used.

2. The financial accounting method of using an "allowance" account is not permitted.

F. There must be a valid debtor/creditor relationship.

II. Net Operating Losses

A. In the past, the NOL provisions are designed to allow a refund of prior taxes, as well as an offset to future income, to keep the business going.

B. Generally, in 2018 and subsequent years an NOL may not be carried back to prior years. Instead, an NOL may only be carried forward indefinitely to future years.

D. While individuals must modify and adjust taxable income to calculate the NOL, generally a corporation needs only to remove an NOL from other years in calculating the current net loss.

E. The amount of the NOL that may be deducted on a future return is limited to 80% of taxable income. NOLs existing prior to 2018 are not subject of the 80% rule.

III. Inventories

A. If inventories are a material income producing factor, the accrual method of accounting must be used. An exception is available for “small businesses”. For 2018 and subsequent years, a small business is generally defined as a taxpayer with average gross receipts of $25 million or less. Small taxpayers may treat inventory as (1) non-incidental materials and supplies or (2) conform to the taxpayer’s financial accounting method.

B. Determining which costs must be capitalized and which costs are treated as period costs is an important factor.

C. Uniform Capitalization Rules

1. Under the Tax Cut Act, any producer or re-seller (other than certain tax shelters) that meets the $25 million gross receipt test is exempt from the application of the UNICAP rules.

2. All retailers and wholesalers not meeting the $25 million gross receipts test must capitalize the direct costs of inventory.

3. All manufacturers must capitalize direct and indirect costs regardless of the size of the business. In addition, manufacturers must capitalize “mixed service” costs by allocating these costs between “production” and “policy and management”.

4. The application of these rules tend to increase the “value” of inventories and therefore increase taxable income.

D. Lower of Cost or Market

1. This method of valuing inventory is elective.

2. If the value of ending inventory falls below cost, inventory may generally be written down to “market value”.

3. The method allows a deduction before the inventory is sold.

E. Inventory Shrinkage: A business that normally takes a physical count of its inventories on a regular, and consistent basis and that appropriately adjusts inventories and its methods of estimation, does not have to take an actual year-end count in order to determine whether shrinkage has occurred. Shrinkage is inventory loss attributable to undetected theft.

IV. Excess Business Losses: This new provision limits the amount that may be deducted as an excess net business loss to $500,000 for individuals filing a joint return and $250,000 for others. Net losses in excess of these amounts become part of a taxpayer’s NOL and would be carried forward under the NOL rules.

An excess business loss is the excess of all business deductions from active businesses over the sum of (gross business income from those businesses plus $500,000 or $250,000).

This provision is applied separately from the passive activity loss rules covered in Economics 117A.

Chapter 13 Alternative Minimum Tax and Tax Credits

I. Alternative Minimum Tax—Note the alternative minimum tax no longer applies to corporations for 2018 and subsequent years.

Now corporations are allowed to use any previously unused AMT credits to reduce or eliminate regular tax liability and obtain refunds to the extent the AMT credit carryover exceeds the regular tax liability. For years beginning after 2017 and before 2022, the AMT credit carryover is generally refundable and can be used to obtain a refund of up to 50% of the excess that the credit exceed the regular tax (up to 100% for years after 2021).

Although the AMT is no longer applicable to corporations, the older rules reflected below are presented for informational purposes:

II. Tax Credits

A. Tax credits are important as they directly reduce the tax liability on a dollar for dollar basis

B. Tax credits are a means by which Congress encourages certain expenditures

C. Some tax credits are refundable (credit may be due the taxpayer whether or not tax was actually paid)

D. Refundable credits generally do not apply to corporate taxpayers

III. General Business Credit and Other Tax Credits

A. The General Business Credit consists of numerous tax credits—Refer to the textbook for a detailed list. A number of the tax credits listed below were scheduled to expire.

1. The Regular Investment Tax Credit was designed to encourage the purchase of depreciable property but was allowed to expire

2. Rehabilitation Investment Credit was designed to encourage rebuilding and remodeling of older structures

3. Energy Investment Credit was designed to encourage the conservation of energy and to promote the use of solar energy to generate electricity

4. Work Opportunity Credit was designed to encourage selective employment practices by hiring new workers who are members of certain targeted groups

5. Alcohol Fuel Credit was designed to encourage the production of gasohol

6. Research Credit was designed to encourage certain research activities

7. Disabled Access Credit was designed to encourage modifications to older buildings to better accommodate disabled persons

8. Low Income Housing Credit was designed to encourage the building of housing for low income persons

9. Renewable Electricity Production Credit was designed to encourage the production of electricity from qualified energy sources

10. Enhanced Oil Recovery Credit was designed to encourage certain oil recovery projects

11. Empowerment Zone or Enterprise Community Incentives allows qualified businesses operating in these zones to be eligible for favorable tax-exempt bond financing and certain other tax benefits.

12. Credit for Employer Provided Child-Care was designed to encourage employers to provide child care for employees.

13. Indian Employment Credit was designed to encourage the hiring of Native Americans

14. Employer Social Security Credit was designed to allow employers, operating food and beverage businesses, a credit for a portion of the FICA tax paid on tips

15. Credit for Clinical Testing of Certain Drugs

16. New Markets Tax Credit designed to encourage business expansion

17. Numerous other credits not shown here

B. Unused credits may be carried back and carried forward

C. Other Credits

1. Electric Vehicle Credit was designed to encourage the purchase of electric vehicles

2. Foreign Tax Credit was designed to eliminate double taxation of foreign income

Chapter 14 Property Transactions

I. Property Transactions

A. General Rule:

1. All gains are taxable unless specifically excluded, exempted or deferred. However, losses are not deductible unless authorized by Congress.

2. Losses resulting from the disposition of business property, investment property and qualifying casualties are deductible.

B. Determination of gain or loss:

1. The "amount realized" is compared to the tax basis (adjusted basis) of the property to determine the gain or loss on its disposition.

2. The "amount realized" may include cash, the FMV of other property and liability relief. The amount realized is reduced by selling expenses.

3. Adjusted basis generally represents the cost of the property plus capital improvements, less depreciation.

4. Exceptions include:
   a. The basis of property received as a gift is generally equal to the donor's basis. Basis is increased by any gift tax paid attributed to appreciation in value before the transfer by gift. Basis may not be increased above the FMV of the property as of the date of the gift.

   b. Sale of gifted property at a loss—if the FMV of the gifted property is less than the donor's basis on the date of the gift, subsequent dispositions of the property at a loss will result in basis being limited to FMV. Also, subsequent dispositions between FMV and the donor's basis result in no gain or loss recognized.

   c. Inherited property—In 2011 and subsequent years, basis is equal to the FMV of the property as of the date of death or the alternative valuation date. In 2010, the basis of inherited property could be FMV at death or the decedent's old basis depending upon the facts.

   d. Personal use property converted to business use—basis generally equals its cost. Exceptions are as follows:

      (1) Basis equals FMV at the date of conversion if the FMV is less than basis and the property is disposed of at a loss. Dispositions of such property at a price which falls between FMV and basis results in no gain or loss. However, subsequent dispositions at a gain may result in using the higher of (1) FMV or (2) basis, to determine the gain recognized.

      (2) Basis for depreciation purposes may not exceed the FMV of the property at the date of conversion.

C. Installment Sales

1. Allows the gain to be recognized as payments are received

2. Gain to be reported in the current year equals: Payments Received (X) Gross Profit %

3. Payments received equal cash and FMV of other property received

4. Gross Profit % equals: Gross Profit ÷ Contract Price

5. Contract Price equals: Payments to be received. Generally, the contract price is equal to the sales price less liabilities transferred.

6. The installment sales method may not be used to report gain from the sale of inventory, stock or securities traded on an established market and certain sales between related parties.

Chapter 15 Conversions and Exchanges

I. Conversions:

A. Involuntary Conversions: Sec. 1033 allows gains from involuntary conversions to be deferred. Involuntary conversions usually involve a condemnation, seizure, casualty or theft.

B. Replacement property must be similar or related in service or use to the old property. An exception is made for condemned real estate where replacement property may be "like-kind."

C. Presidential Disaster Areas: Replacement of business property need not be with property which is similar or related in service or use. Instead, replacement property qualifies if it is simply tangible business property.

D. Gain recognized:

1. No gain is recognized if the cost of the replacement property exceeds the "amount realized."

2. Gain is recognized if the cost of the replacement property is less than the "amount realized."

3. Qualifying replacement property may not be acquired by gift or inheritance.

E. The basis of replacement property equals its cost less the deferred gain.

F. Involuntary conversion rules are elective.

II. Exchanges

A. Sec. 1031 provides for the deferral of gains and losses if business or investment real estate is exchanged solely for "like-kind" property. Exchanges of other business or investment property are no longer eligible for "like-kind" treatment. The exchange rules are not applicable to personal use assets.

B. "Like-kind" property refers to the nature or character of the property (real estate for real estate).

C. Stocks, bonds, securities, interests in partnerships and inventories do not qualify for this provision. Under new rules, in 2018 and subsequent years the exchange provisions also do not apply to personal property used in business or held for investment purposes.

D. Qualifying exchanges will result in no gain or loss being recognized. However, gain may result if "boot" is received in addition to like-kind property.

E. "Boot" is cash or other property which is not like-kind. Liability relief may also qualify as boot received.

F. Basis of property acquired in an exchange:

1. The basis of boot = FMV.

2. The basis of like-kind property is its FMV less the deferred gain or plus the deferred loss.

G. Special rules:

1. Boot paid may generally not be netted with boot received. An exception is made for boot paid in the form of liabilities assumed or cash paid. In this case, liability relief may be offset by the boot paid.

2. The exchange provisions are mandatory and are not elective.

3. Special rules apply to “delayed exchanges”—the replacement property must be identified within 45 days of the exchange and be received within 180 days.

4. Special rules apply to certain related party exchanges.

Chapter 16 Capital Assets

I. Capital Assets

A. Definition

1. Any asset other than:

   a. Inventory

   b. Business receivables

   c. Depreciable property and land used in a business

   d. Supplies used in business

   e. A copyright, literary, musical, artistic composition, letter, memorandum, or similar property held by:

      (1) the person who created the property or,
      (2) in the case of a letter or memorandum or similar property, held by the person for whom the property was prepared or produced or,
      (3) a taxpayer in whose hands the basis of such property is determined by reference to a taxpayer described in (1) or (2) above.

   f. As of 2018, gains and losses from selling or otherwise disposing of self-created assets no longer qualify for capital gain or loss treatment, whether or not subject to patent. Self-created assets include inventions, models, designs, secret formulas or processes, and certain patents. (Section 1235 may allow capital gain treatment for certain patents.)

B. Impact of Capital Gains and Losses

1. **Individuals** - long-term capital gains may be taxed at a maximum rate of 28%, 25%, 15%, or even 0%, depending upon the circumstances. Starting in 2013 a new 20% tax rate is applicable to higher income taxpayers.

2. **Individuals** - capital losses may offset capital gains plus a maximum of $3,000 with an unlimited carry forward of unused losses.

3. **Corporations** - long-term capital gains taxed at the same rates as other income.

4. **Corporations** - capital losses may only offset capital gains. Unused losses are subject to a 3 year carry back and 5 year carry forward.

C. Maximum Tax Rate: Generally, 15% for net long-term capital gains of **individuals.** However, for higher income taxpayers the maximum rate is 20% starting in 2013. The rate is 0% for taxpayers in the 10% or 15% tax rate bracket and 20% for gains of higher income taxpayers.

D. Special rates for net long-term capital gains for individual taxpayers:

1. 28% remains the maximum rate for long-term collectibles such as art, antiques, stamps, coins and similar items.

2. 25% is the maximum rate for long-term real estate to the extent of prior depreciation claimed on the property.

3. Starting with 2013, 20% for higher income taxpayers other than for (1) or (2) above. For 2018, the 20% maximum rate would apply long-term capital gains to the extent that taxable income exceeds:

	2018
(a) MFJ	$479,000
(b) Head of Household	452,400
(c) Single	425,800
(d) MFS	239,500

4. For 2018, taxpayers with net long-term capital gains falling within the range shown below would be taxed at 0%. Net long-term capital gains above the thresholds shown below would generally be taxed at 15%, unless (1), (2), or (3) above is applicable.

(a) MFJ	$0 - $77,200
(b) Head of Household	0 - 51,700
(c) Single	0 - 38,600
(d) MFS	0 - 38,600

E. Distinguishing Between Long-term and Short-term Classification

1. Holding period: To qualify for long-term treatment the asset must have been held for more than one year.

2. In computing the holding period, the day of acquisition is not counted while the day of disposition is counted.

3. The holding period may include the previous holder's time where the basis of the newly acquired property is determined by reference to the old basis.

F. Capital Gains and Losses Must Be Netted: Net long-terms separately from short-terms. Arrive at a net capital gain or loss.

G. Special rules for certain capital gains--§1202 stock

1. Retroactive changes now make gains from qualified small business stock eligible for 100% exclusion for stock acquired after September 27, 2010.

   a. The stock must be held more than five years and

   b. The amount of gain eligible for the exclusion is limited to the greater of:
      (1) 10 times the basis of the stock or
      (2) $10 million of gain. Various eligibility requirements must be satisfied for stock of a corporation to qualify for this special treatment including limitations regarding the corporation's size ($50 million gross assets), the nature of the corporation's business, and the manner in which the stock was acquired (i.e., the stock must have been acquired as stock originally issued by the corporation.)

c. For stock acquired before September 28, 2010, eligible exclusions generally varied between 50% and 75%.

2. Deferral of gain on publicly traded stock:

For sales after 2017, the Tax Cut Act repeals the tax-free rollover of gain from the sale of publicly traded securities.

H. Sale of a Business

1. Defined - the treatment of the resulting gain or loss differs depending upon the type of business interest being sold.

2. Sole Proprietorship - treated as the sale of separate assets

3. Partnerships

a. Generally treated as the sale of a capital asset

b. An exception is made for gains or losses related to the disposition of “751” or “hot” asset.

c. “751” assets involve “unrealized receivables” and “appreciated inventory”.

d. Gains or losses related to these special assets may be treated as ordinary gains or losses.

4. Corporation

a. A capital gain or loss generally results from the sale of stock.

b. An exception may result from the sale of “1244” stock.

I. Section 1244 Stock

1. Losses up to $50,000 per year may receive ordinary loss treatment for qualifying stock ($100,000 for married filing jointly).

2. Section 1244 loss may create a net operating loss - balance of loss receives capital loss treatment.

3. Qualifying stock

a. Domestic corporation

b. Issued for money or property to individuals as original holders of the stock.

c. Corporation qualifies as a small business corporation - capital not to exceed $1,000,000 and meeting certain other requirements

J. Tax Rate Reduction for Dividend Income

1. The maximum tax rate imposed on most qualified dividend income was reduced to 15% for most individual taxpayers. However, for taxpayers whose dividend income falls in the 10% or 15% ordinary income tax rate brackets, the dividend tax rate is 0%. For higher income taxpayers the dividend tax rate is 20%. The rules generally apply to dividends received from domestic corporations and certain foreign corporations whose stock is readily tradable on an established U.S. securities market. The new dividend tax rates are virtually the same as that imposed on net long-term capital gains. See (D) above.

2. To be eligible for the reduced rates, the stock must be held for more than 60 days.

L. Options

1. Treatment by Buyer:

   a. The cost of the option is added to the basis of the property acquired through the exercise of an option.

   b. The sale of the option by the buyer may result in gain or loss. The character of the gain or loss depends upon the character of the underlying property.

   c. The lapse of an option is treated as a sale or exchange of property on the date the option expires. The cost of an expired option would result in a loss for the buyer. The character of the loss and whether or not the loss is deductible depends upon the character of the underlying property.

2. Treatment by Seller:

   a. The amount received by the seller is generally not taxed until the option is either exercised or is allowed to lapse.

   b. Upon exercise of the option, the seller includes the amount received for the option as part of the selling price of the underlying property.

   c. Upon lapse of the option, the seller includes the amount received for the option in income. Generally, ordinary income must be recognized by the seller for an option that is allowed to expire. However, for options that relate to stock or securities, short-term capital gain treatment may result.

M. Abandonment

1. Generally, the loss that results from abandoning business or investment property (other than stocks or securities) is not considered a sale or exchange. Therefore, the resulting loss is generally treated as an ordinary loss.

2. However, this rule is not applicable to stocks or securities

N. Worthlessness

1. In the event stocks or securities become worthless during the year, the resulting loss is treated as having resulted from a sale or exchange of a capital asset on the last day of the year. Thus long or short-term status is determined accordingly.

2. If securities in an affiliated corporation (at least 80% owned by a parent company) become worthless, the resulting loss is generally treated as an ordinary loss

Chapter 17 1231 Assets

I. 1231 Assets:

A. Definition:

1. 1231 Assets: Property used in business and held more than one year, other than inventory and certain other assets

2. 1231 Assets also include timber, coal, iron ore, unharvested crops and certain livestock, under certain conditions

B. General benefits of Section 1231: Net gains may receive long-term capital gain treatment, while net losses are deductible as ordinary business losses

II. The Netting Process:

A. Step #1: Net all casualty gains and losses of 1231 assets, business capital assets and investment capital assets held for more than one year. Do not include casualty gains and losses of personal use property.

1. If the net result is a gain, include the resulting gain in step #2 of the netting process.

2. If the net result is a loss, do not include the resulting loss in any further netting.

B. Step #2: Net all other 1231 gains and losses with the net casualty gains, if any, from step #1.

1. If the result is a gain, go to step #3.

2. If the result is a loss it is treated as an ordinary business loss.

C. Step #3: Apply the "look-back" rule. This rule requires us to look to the 5 prior years for 1231 ordinary losses that have not been used to offset subsequent year 1231 gains.

1. Current 1231 gains must be reported as "ordinary" income to the extent that ordinary 1231 losses were previously deducted and were not "offset" by subsequent gains.

2. 1231 gains, which do not require ordinary income reporting by the "look-back" rule, are treated as long-term capital gains.

D. Step #4: Any 1231 gains, which are to be treated as long-term capital gains, should be netted with other capital gains and losses.

II. Section 1245 Recapture:

A. Section 1245 assets:

1. Depreciable personal property or Section 179 expensed property.

2. Nonresidential real estate acquired after 1980 and before 1987, which was depreciated using an accelerated method.

3. Property, other than a building, used as an integral part of manufacturing, production or extraction, or furnishing transportation, communications, electrical energy, gas, water or sewage disposal services.

4. Certain other property that is subject to depreciation or amortization.

B. Section 1245 takes priority over Section 1231 as well as many other provisions.

C. Gains from the disposition of 1245 assets are taxed as ordinary income to the extent of any and all prior depreciation.

D. Section 1245 applies only to gains.

E. Certain property transfers, such as gifts, do not trigger 1245 gain recognition.

F. However some dispositions, such as an installment sale of a 1245 asset, require immediate recognition of 1245 gain.

III. Section 1250

A. 1250 property includes all depreciable real property that is not 1245 property.

B. 1250 property disposed at a gain may require the recognition of ordinary income. Section 1250 takes priority over section1231 and certain other provisions.

C. Section 1250 treats as ordinary income the lower of:

1. The gain or

2. The excess depreciation—excess depreciation is all depreciation of 1250 assets held one year or less and depreciation claimed in excess of the S/L method. Therefore, if a 1250 asset has been depreciated using the S/L method and it has been held for more than one year, 1250 recapture is not required.

Note: Buildings acquired after 1986 must be depreciated using the S/L method. Therefore, there is no Section 1250 recapture for buildings acquired after 1986 and held for more than one year.

D. Certain transfers do not trigger the 1250 recapture rules—such as gifts.

E. Certain dispositions, such as an installment sale, may require immediate recognition of 1250 gain.

IV. 291 Recapture

A. Only corporations are subject to 291 recapture rules.

B. 291 may require 20% of the "1231" gain to be reclassified as ordinary income under certain circumstances.

C. 291 applies only where "1250 property" is disposed of at a gain.

D. The amount of gain to be reclassified as "ordinary" is determined as follows:

Amount of "1245 ordinary gain" as if 1245 applied	XXX
Less: "1250 ordinary gain" actually recognized, if any	XXX
Excess amount	XXX
Multiply by 20%	20%
291 ordinary income	XXX

E. 291 recapture applies to all dispositions of 1250 property, even if the S/L method of depreciation was used.

Chapter 19 Corporate Operations

I. Calculation of Taxable Income and Tax:

A. Regular corporate tax—Starting in 2018, corporations are subject to a flat 21% tax rate.

B. "Personal Service Corporations" are also taxed at a flat 21% rate

C. Calculating taxable income—Dividends Received Deduction:

1. Corporate shareholders are generally entitled to deduct a portion of the dividends received from other domestic corporations. This deduction lessens the impact of triple taxation.

2. For years beginning after 2017, the amount of the deduction depends upon the percentage of stock owned in the dividend paying entity.

Percentage of Stock Owned	Percentage Deduction
Less than 20%	50%
20% or more	65%
80% or more	100%

3. Taxable income limitation:

    a. The deduction may not exceed 50% (or 65%) of the lower of:

        (1) The dividends received or

        (2) Taxable income calculated without the DRD, capital loss carryback or NOL carryback

    b. Exception: If the corporation has an NOL for the year or the DRD creates an NOL, the taxable income limitation does not apply.

4. Special Rules:

    a. The dividend paying stock must have been owned for more than 45 days.

    b. Extraordinary dividends:

        (1) Generally, a dividend is extraordinary if it is received in the first two years of stock ownership and is equal to or exceeds 10% of the basis of the stock

        (2) Extraordinary dividends reduce the basis of the stock by the amount of DRD

    c. The DRD is limited where borrowed funds have been used to purchase the stock.

D. Charitable Contributions

1. The deduction is limited to 10% of taxable income (before the DRD and donations)

2. Deduction for appreciated property

    a. Generally, the FMV of the donated property may be claimed as a deduction

    b. Ordinary income property—the deduction is limited to the adjusted basis of the property

    c. Capital gain property—the deduction may be limited to the adjusted basis of the property

E. Organization expenditures are amortizable over 15 years

1. Costs of up to $5,000 may be deducted in the first year. Costs exceeding $5,000 would be amortized over 15 years.

2. If total costs exceed $50,000, the potential first year deduction of $5,000 is reduced $ for $ for costs exceeding $50,000. Any remaining costs would be amortized over 15 years.

F. Special related party transactions:

1. Gain from the sale of property is taxed as ordinary income if the property is depreciable by the acquiring related party.

2. Sales to a related party may not be eligible for installment sales reporting.

G. For years beginning after 2017, the Domestic Production Activities Deduction is no longer available.

II. Section 351 Transfers:

A. No gain or Loss is recognized if property is transferred to a corporation solely for stock and control is held after the exchange.

B. Property and/or services:

1. The exchange of services for stock generally does not qualify for 351 treatment.

2. 351 may apply if both property and services are exchanged for stock.

3. Nominal transfers of property will not qualify for 351 treatment.

C. Control:

1. 351 treatment applies only if control is held after the exchange by the transferors.

2. Control is defined as owning 80% or more of the stock of the transferee corporation.

D. Receipt of "boot"—gain is taxable to the extent of boot received.

E. Shareholder's gain recognized:

1. Qualifying 351 transfers—gain is recognized to the extent of boot received.

2. Nonqualifying 351 transfers—gain is recognized in full.

F. Corporate gain recognized:

1. Generally a corporation would not recognize gain or loss on the exchange of its own stock.

2. Stock given in exchange for services allows the corporation to capitalize, amortize or deduct the value of the stock, depending on the nature of the services rendered.

G. Shareholder's basis in the stock received:

1. Qualifying 351 transactions—basis equals that of the property transferred plus recognized gain less the FMV of any boot received.

2. Nonqualifying 351 transactions—basis equals the FMV of the property transferred

H. Corporation's basis in the assets received—generally the corporation would obtain a basis in the property equal to the shareholder's basis plus any gain the shareholder was required to recognize.

1. For transfers after October 22, 2004, new rules are effective for 351 transfers of "loss Property." If the FMV of the transferred property is less than the shareholder's basis, the corporation's basis in the property will be limited to FMV.

2. Joint election: If "loss property" is transferred to a corporation under 351, both the corporation and the transferor could make a joint election to limit the transferor's basis in the stock to FMV.

3. These new rules effectively eliminate the "doubling" impact of transferring "loss property" under 351.

I. Transfers of substantially appreciated property to a corporation—alternatives to 351 transfers should be considered.

1. Transferring substantially appreciated property to a corporation generally subjects the appreciation unnecessarily to double taxation.

2. Leasing property to a corporation offers a number of tax planning opportunities that should be considered in lieu of making a 351 transfer. The shareholder retains the property avoids double taxation on the appreciation. The shareholder also is able to receive cash from the corporation at one level of tax.

3. Selling the asset to the corporation may be a valid alternative under certain conditions. However, the gain may be subject to immediate recognition and care must be taken to avoid ordinary gain that may result from application of "related party" rules.

J. Transfer of liabilities to the corporation.

1. If personal liabilities of the transferor are assumed by the corporation, all liabilities transferred are treated as boot. This will cause gain to be recognized.

2. If business liabilities of the transferor are assumed by the corporation, boot is considered received by the transferor to the extent that the liabilities exceed the transferor's basis in the assets transferred.

3. If business liabilities of the transferor are assumed by the corporation, no boot is considered to have been received by the transferor if the liabilities are less than the transferor's basis in the assets transferred.

Chapter 20 Distributions, Redemptions and Liquidations:

I. Corporate Distributions:

A. Dividends:

1. Distributions are taxable as a dividend to the extent the corporation has earnings and profits (E & P).

2. Distributions in excess of E & P are a return of capital to the extent of the shareholder's basis in the stock. Distributions in excess of basis represent gain as if the stock was sold.

3. Distributions are considered to have been made from current E & P first and secondarily from accumulated E & P.

4. E & P is somewhat equivalent to the economic income of the corporation. Taxable income is adjusted for certain items to determine current E & P.

B. Property Distributions:

1. The corporation must recognize gain, but not a loss, to the extent the FMV of the property exceeds the corporation's basis at the time of the distribution.

2. The shareholder's basis in the distributed properly is equal to the FMV of the property.

3. Shareholders must recognize dividend income to the extent of the FMV of the property received as long as the corporation has sufficient E & P.

C. Disguised dividends and certain distributions may be treated as dividends even though they were "disguised" as other payments.

D. Stock dividends:

1. Generally a corporation may distribute its own stock as a tax-free transfer.

2. Exceptions exist. For example, if a shareholder may elect to receive property or stock, the dividend will be taxable.

II. Redemptions:

A. General Rules:

1. Redemptions involve property distributions from the corporation to shareholders in exchange for some or all of the shareholder's stock in the corporation. The corporation continues in existence after the redemption.

2. The basic question is whether the redemption qualifies for "sale" or "dividend" treatment.

3. If the redemption is treated as a "sale", the shareholder is entitled to recover basis tax-free and to capital gain treatment on amounts received in excess of basis.

4. If the redemption is treated as a "dividend", the shareholder should report dividend income to the extent of E & P.

B. Sale treatment occurs if the redemption meets any of the following criteria:

1. The redemption is not essentially equivalent to a dividend. This is a subjective test where a "meaningful reduction" in the shareholder's interest must take place.

2. The redemption is substantially disproportionate. This rule involves **two** objective tests:

   a. After the redemption the shareholder must own less than 50% of the stock and

   b. the shareholder's % of ownership must be less than 80% of the % ownership before the redemption.

   c. Special rules of attribution apply.

3. The redemption represents a complete termination of the shareholder's interest. The family ownership rules may be waived under certain conditions.

4. The redemption represents a "partial liquidation."

   a. This rule does not apply to corporate shareholders.

   b. There must be a contraction of the business or the cessation of "qualified" business.

5. The redemption proceeds are used to pay death taxes or certain other expenses. To qualify under this rule, the FMV of the stock must be greater than 35% of the adjusted gross estate.

C. If appreciated property is used to redeem stock, the corporation must recognize gain.

D. Redemptions reduce E & P. If treated as a dividend, follow the dividend rules. If treated as a sale, the charge to E & P is in proportion to the stock redeemed, but may not exceed the amount of the distribution.

III. Complete Liquidations:

A. In a complete liquidation the corporation goes out of business and the shareholders give up all stock in exchange for all remaining corporate assets.

B. The shareholder recognizes gain or loss as if the stock were sold.

C. The cost recovery rule applies if the liquidation takes place over two or more years.

D. The corporation recognizes gain or loss upon liquidation. Certain exceptions may apply to losses.

E. Liquidation of a subsidiary:

1. The parent corporation generally recognizes no gain or loss if:

   a. 80% ownership requirement is met and

   b. All property is distributed.

   c. Exception—distributions to minority shareholders may require gain to be recognized.

2. The parent corporation takes the assets using a carryover basis.

3. The subsidiary corporation recognizes no gain or loss.

IV. Corporate Acquisitions:

A. Purchase of assets:

1. The selling corporation recognizes gain or loss.

2. The acquiring corporation obtains a basis in the assets equal to the amount paid.

3. The tax attributes of the target company are generally not obtained.

B. Purchase of stock:

1. The selling shareholder recognizes gain or loss.

2. The acquiring corporation obtains ownership of the assets by owning the stock. The basis of the assets remains unchanged.

3. The tax attributes of the target company generally remain unchanged.

C. Purchase of stock—Section 338:

1. This provision treats the stock acquisition as if it were an asset purchase.

2. This provision is elective—80% or more of the stock must have been purchased within a 12 month period. The election is generally made by the acquiring corporation.

3. The target corporation must recognize gain as if all assets were sold.

4. The target corporation is treated as a "new" entity.

5. The target Corporation obtains a "new" basis in all the assets. The new basis is equal to the amount the acquiring corporation paid for the stock plus liabilities of the target.

Extra Material—Consolidated Returns and Controlled Groups

I. Consolidated Returns:

A. Although each corporation is required to file a tax return, certain related entities may file one consolidated return which reflects all of the activities of the related corporations.

B. Eligibility for filing a consolidated return—Members of an affiliated group may elect to file a consolidated return. A corporation is a member of an affiliated group if certain stock ownership tests are met. These tests are:

1. Includible corporations—To be eligible as a member of an affiliated group a corporation other than the following entities are eligible:

    a. A foreign corporation

    b. An "S" corporation

    c. A corporation exempt from taxation

    d. Certain other entities

2. Stock ownership test—The stock ownership test requires that a group have a common parent and at least one includible subsidiary corporation.

    a. An includible parent corporation must own directly at least 80% of the stock of at east one other includible corporation and

    b. An includible subsidiary corporation must have at least 80% of its stock owned by one or more corporations in the affiliated group.

C. Advantages of filing a consolidated return include:

1. Unused losses and credits of one corporation may be used to offset the income and tax of another member of the group.

2. Inter-company profits may be deferred.

3. Inter-company dividends are not taxed.

D. Disadvantages of filing a consolidated return include:

1. The election is binding for future years.

2. A subsidiary member of the group may be required to change its tax year to conform to that of the parent corporation.

II. Controlled Groups:

A. General application

1. Controlled groups of corporations are treated as one corporation for many tax purposes. For example, members of a controlled group may not obtain a tax advantage by filing multiple corporate returns in an attempt to utilize the lower tax rates that are available below the top marginal rate.

2. Instead, these members must allocate the use of the lower tax rates between themselves as if they were one taxable entity.

3. There are two basic types of controlled groups:

(1) a parent-subsidiary group

(2) a brother-sister group

B. A "Parent-Subsidiary Controlled Group"

1. PSCG exists if one corporation owns directly 80% or more of the stock of another corporation.

2. Additional corporations are included in the group if at least 80% of their stock is directly owned by other members of the controlled group. A parent-subsidiary controlled group is similar to an affiliated group which is eligible to file a consolidated return.

C. Brother-Sister Controlled Group

1. For tax years beginning after October 22, 2004, new rules are applicable. A brother-sister group exists if five or fewer individuals, estates or trusts own more than 50% of the stock of each corporation.

Example using the new rules:

Individual Shareholders	Corp A	Corp B	Corp C	Combined
#1 James	40%	20%	30%	20%
#2 Susan	30%	40%	20%	20%
#3 Carol	30%	40%	50%	30%
Total:				70%

Under the new rules, because more than 50% of the stock of each corporation is owned by 5 or fewer individual shareholders, all 3 entities are brother-sister corporations.

2. Old rules that were applicable before October 22, 2004, a brother-sister controlled group consists of two or more corporations connected through stock ownership. A brother-sister group exists if:

   a. Five or fewer individuals, estates or trusts own at least 80% of the stock of each corporation and

   b. Those shareholders collectively own more than 50% of the stock of each corporation.

   c. For tax years beginning after October 22, 2004, the 80% stock ownership test was eliminated for most purposes. However, the old rules continue to have limited application.

3. Example using the old rules:

Individual Shareholders	Corp A	Corp B	Corp C	Combined
#1 James	40%	20%	30%	20%
#2 Susan	30%	40%	20%	20%
#3 Carol	30%	40%	50%	30%
Totals:	100%	100%	100%	70%

Because 5 or fewer individuals own at least 80% of the stock and collectively they own more than 50% of the stock of each corporation, all 3 entities are brother-sister corporations.

D. Combined Controlled Group

1. A combined controlled group exists where three or more corporations are either members of a parent-subsidiary controlled group or a brother-sister controlled group and at least one corporation is both the common parent and a member of a brother-sister controlled group.

III. Corporate Reorganizations

A. General Application

1. Generally, Congress wanted corporations to be able to restructure and change methods of operations without recognition of gain or loss.

2. Therefore, the reorganization provisions were enacted to provide for non-recognition of gain or loss in a variety of corporate reorganizations.

3. To qualify for non-recognition, generally a reorganization must meet the following requirements:

   a. Continuity of Interest

   This doctrine requires the transferor or its shareholders to maintain their ownership in the properties transferred. For ruling purposes, the IRS requires at least 50% of the consideration given must be stock of the acquiring corporation.

b. Continuity of Business Enterprise

Generally, the regulations require a continuity of the business enterprise. Therefore, the acquiring corporation must either continue the target corporation's business or use a significant portion of its assets in a business.

c. Control

Often reorganization provisions also require control. Either the acquiring corporation or its shareholders must have control of the target corporation after the reorganization. Control is defined as owning at least 80% of the stock.

d. Business Purpose

There must be a business purpose to qualify as a nontaxable reorganization. Therefore the transaction must be related to business needs such as expansion of business activity or acquiring new products or supply sources in order to qualify. It must be remembered that tax avoidance is not a business purpose.

e. Plan of Reorganization

The reorganization plan must be adopted by each corporation involved in the transaction.

f. Patterns of Reorganization

In order to qualify as a reorganization the transaction must fit into one of **seven** different patterns.

Type A - A statutory merger or consolidation (two corporations into one).
In a merger there is a survivor whereas in a consolidation there is none.
(i.e. - a new corporate entity results).

Advantages: No requirement that consideration be voting stock. As much as 50% of the consideration may be cash without tax consequences for the receipt of stock (the receipt of cash or other property will be taxed).

Disadvantages: State law must be followed. Dissenters rights and required approvals may present problems. All liabilities of the target corporation are assumed by the acquiring corporation.

Type B: An exchange of stock of the acquiring corporation for stock of the target corporation.

Advantages: The stock of the target may be acquired directly from the shareholders. The procedures to accomplish the reorganization are not complex.

Disadvantages: Only voting stock of the acquiring corporation may be used. The acquiring corporation must have at least 80% control of the target. Also, there may be a minority interest remaining in the target corporation.

Type C: An exchange of stock of the acquiring corporation for assets of the target corporation.

Advantages: A Type C reorganization is less complex under state law than Type A. Cash or other property may be used as consideration as long as its value is less than 20% of the total FMV of the property transferred.

Disadvantages: Substantially all assets of the target must be transferred. Liabilities count as "other" property for purposes of the 20% rule (in advantages above) if any consideration other than stock and liabilities is used. Also, the target must distribute the stock and other property it receives in the reorganization to its shareholders.

Type D: Acquisitive - an exchange of stock of the acquiring corporation for assets of the target. The stock is then distributed to the shareholders of the target corporation.

Divisive - an exchange of assets of the distributing corporation for stock of the controlled corporation. The stock is then distributed to the shareholders of the distributing corporation.

Advantages: Permits corporate division without tax consequences if no boot is involved.

Disadvantages: Requirements of Sections 354, 355, and 356 must be met.

Type E: Commonly known as a recapitalization. A change in the priority or amount of capital of a corporation's stock or bonds or to change its capitalization or debt, or both.

Advantages: Allows for major changes in the makeup of shareholders' equity without tax consequences.

Disadvantages: Must be careful that the provisions of Section 305 are not violated.

Type F: A change in name, form, or place of organization of a single corporation. The survivor corporation is treated the same as the predecessor, therefore, the tax attributes remain.

Type G: A transfer by a corporation of all or part of its assets to another corporation in bankruptcy reorganization. Using a Type G reorganization, creditors may exchange notes for stock without tax consequences. Also, state merger laws need not be followed.

G. Tax impact of a reorganization:

1. Generally, the acquiring corporation does not recognize gain or loss when it gives its own stock or securities as consideration. However, if the acquiring corporation transfers "boot" or other property, then gain or loss is usually recognized.

   a. For example, if the acquiring corporation, in a "Type C" reorganization, transfers only stock to the target company in exchange for all of the assets, no gain or loss is recognized.

   b. However, if in addition to stock, land worth $200,000 (basis $50,000) is also transferred to the target company, the acquiring corporation must recognize gain of $150,000.

2. The acquiring corporation obtains a basis in the assets equal to the target's basis, increased by any gain recognized by the target corporation on the transfer. For example, in a statutory merger (Type A reorganization) if the target company transfers all of its assets worth $500,000 (basis $400,000) to the acquiring corporation for stock worth $500,000, the acquiring corporation's basis in the assets would be $400,000.

3. Target corporation's recognition of gain or loss. In most acquisitive reorganizations, the target corporation transfers its assets to the acquiring corporation in exchange for stock, securities or "boot." Generally, the target corporation will not recognize gain or loss on the receipt of stock or securities. Also, the target will not recognize gain or loss on the receipt of "boot" if the "boot" is distributed to the target's shareholders. For example, if the target, in a "Type C" reorganization, receives stock worth $700,000 and cash of $100,000 from the acquiring corporation in exchange for all of the target's assets, worth $800,000 (basis $600,000), the target will not recognize gain as long as the cash is distributed to the target's shareholders.

4. Target corporation—basis: In many cases the target corporation is not concerned about basis as it will distribute the stock, securities or cash it receives to its shareholders in liquidation. The target corporation's basis in property it receives, other than stock, securities or cash, is equal to the acquiring corporation's basis increased by gain and decreased by loss recognized by the acquiring corporation. Therefore, its basis generally equals FMV. For example, referring back to the situation above where the acquiring corporation transferred land worth $200,000 (basis $50,000), the target's basis in the land would be $200,000 (the acquiring corporation's basis plus gain recognized by the acquiring corporation.

5. Shareholders—recognition of gain or loss: Generally, shareholders do not recognize gain or loss if they exchange stock or securities solely for stock and securities as part of the plan of reorganization. However, the shareholders receipt of "boot" causes gain, but not loss, to be recognized.

   a. For example, if a shareholder receives only stock of the acquiring corporation, no gain is recognized.

Value of stock received	$10,000
Shareholder's basis in target's stock	1,000
Gain realized but not recognized	$ 9,000

   b. If a shareholder receives both stock and cash, gain must be recognized to the extent of the "boot" received.

Value of stock received	$ 8,000
Cash received	2,000
Total received	$10,000
Shareholder's basis in target's stock	1,000
Gain realized	$ 9,000
Gain recognized	$ 2,000

6. The shareholders of the target generally obtain a substituted basis if the receive only stock or securities in exchange for stock and securities. However, the basis of any "boot" is generally equal to its FMV.

Overheads for Chapter 1:

Designing a Tax System:
1. Equitable
2. Convenient
3. Certain
4. Economical

Historical Perspective:
1. 1789 U.S. Constitution
2. 1861 Civil War
3. 1890 Second Attempt
4. 1913 16th Amendment

Gift Tax:
1. Tax on Transfer of Property
2. Donor is Subject to Tax
3. Tax is Based on the Value of Property Given

Gifts Not Taxable:
1. Services
2. Support for Dependents
3. Medical or Educational Expenses
4. Gifts to Charities
5. Gifts to Spouse

Annual Exclusion:
1. $15,000
2. For Each Donee
3. Each Year

Gift Splitting:
1. Elective
2. Married Individuals
3. Annual Exclusion Used by Each Spouse

Advantages of Gifts:
1. Lowers Value of Estate
2. Transfers Future Appreciation
3. Transfers Income from Property

Gift Tax Unified Credit:
1. Same Credit for Estate Tax
2. Every Individual Entitled to Credit
3. Statutory Amount for 2018 = $4,425,800
4. FMV Equivalent for 2018 = $11.2 million

Calculation of Gift Tax:
1. FMV of Current Gifts
2. Less: Exclusion
3. Add: Prior Taxable Gifts
4. Taxable Gifts
5. Tentative Tax
6. Less: Prior Tax and Unified Credit
7. Tax Due

Gift Tax:

1. Form 709
2. Calendar Year
3. Due April 15

Estate Tax:

1. Form 706
2. Due 9 Months After Death

Will:

1. Holographic
2. Statutory
3. Formal

A Will is Not Controlling:

1. Contracts
2. Title to Property
3. Property in Trust

Probate:

1. Appoint Representative
2. Inventory Assets
3. Notify Creditors
4. Pay Debts
5. Notify Beneficiaries
6. Transfer Property

Calculation of Estate Tax:

1. FMV of Assets Less
2. Expenses & Losses
3. Liabilities & Charity
4. Marital Deduction
5. Taxable Estate
6. Add: Taxable Gifts
7. Taxable Transfers
8. Gross Tax
9. Less: Credits
10. Net Tax

Employment Taxes:

1. Employer—FUTA, FICA
2. Employee—FICA, SDI

FICA:

1. OASDI 6.2% x $128,400 for 2018
2. MHI 1.45% x Income
3. Self-employment Tax
    a. OASDI – 12.4% x $128,400 for 2018
    b. MHI—2.9% x Income

Definitions:

1. Marginal = Rate at Which Next $ of Tax Base is Taxed
2. Average = Tax/Taxable Income
3. Effective = Tax/Economic Income

Definitions:

1. Proportional
   $1,000 x 10%
   $10,000 x 10%
2. Progressive
   $1,000 x 10%
   $10,000 x 20%

3. Regressive
   $1,000 x 10%
   $10,000 x 5%

Chapter 2 Overheads

How Tax Laws are Passed:

1. House Ways and Means Committee
2. Senate Finance Committee
3. Joint Conference Committee

Regulations:

1. Legislative
2. Interpretative
3. Procedural

Levels of Importance:

1. Code—Congress
2. Regulations—Treasury
3. Rulings—IRS
4. Private Rulings—IRS
5. Technical Advice—IRS

Audits:

1. Service Center—Correspondence
2. Office—Correspondence or Interview
3. Field—At Home or Place of Business or Correspondence or Interview

How Returns are Selected for Audit:

1. Processing
2. Matching of Documents
3. DIF
4. Projects
5. Information Reports
6. National Research Program
7. MACS
8. Informants

Dispute Resolution:

1. Tax Court	District Court	Court of Federal Claims
2. U.S. Court of Appeals		
3. U.S. Supreme Court		

Tax Court:

1. Do Not Pay Tax
2. Trial by Judge
3. Tax Cases Only
4. Nationwide Court
5. 19 Judges
6. Decisions may be Appealed

Small Claims Tax Court:

1. $50,000 or Less
2. Do Not Pay Tax
3. Trial by Judge
4. Tax Cases Only
5. Nationwide Court
6. Decisions my Not be Appealed

U.S. District Court:

1. Pay Tax First
2. Trial by Judge or Jury
3. 95 Courts
4. 1 Judge
5. Decisions may be appealed

U. S. Court of Federal Claims:

1. Pay Tax First
2. Trial by Judge
3. Nationwide Court
4. Decisions may be appealed

U.S. Court of Appeals:

1. Appeals from Tax Court & District Court
2. 12 Courts
3. 3 Judges
4. Appeal Possible but not Assured

U.S. Supreme Court:

1. Selects Cases
2. Decisions Final

Golsen Rule:

1. Tax Court Decisions May Vary
2. Follows Circuit Court of

Tax Court:

1. Types of Decisions—Regular or Memorandum
2. Acquiesce
3. Non-acquiesce

Chapter 3 Overheads:

Types of Entities

Sole Proprietorship
Partnership
Corporation

Sole Proprietorship

One Owner
Easy to Form
Unlimited Liability
Income Taxed to Owner
Losses Deductible by Owner
Self-employment Tax

Partnership

General	Limited
2+ Owners	2+ Owners
Unlimited Liability	Limited Liability
Income Taxed to Owners	Income Taxed to Owners
Losses Deductible by Owners	Losses Deductible by Owners
Self-employment Tax	No Self-employment Tax for Limited Partners

Corporation

“C”	“S”
Limited Liability	Limited Liability
Income Taxed to Corporation	Income Taxed to Shareholders
Losses Deductible by Entity	Losses Deductible by Shareholders
No Self-employment Tax	No Self-employment Tax

Limited Liability Company

Not All Businesses Eligible
Generally Taxed as Partnership
Income Taxed to Owners
Losses Deductible by Owners
Self-employment Tax
Limited Liability

Limited Liability Partnership

Generally Taxed as Partnership
Income Taxed to Owners
Losses Deductible by Owners
Limited Liability
Self-employment Tax

Chapter 5 Overheads:

1. Methods of Accounting:
    - Cash
    - Accrual
    - Other
    - Hybrid

2. Accrual Method:
    - Inventory
    - C Corporations
    - Partnerships –with a corporate partner
    - Tax Shelters

3. Cash Method:
    - C Corporations – Gross Receipts Under $25 Million
    - Partnerships – C Corporation Partner & Gross Receipts Under $25 Million
    - PSC
    - Partnerships Without Corporate Partner
    - S Corporations

4. Prepaid Income – Accrual
    - Interest, Rents, or Royalties
    - Service
    - Dues & Subscriptions
    - Sale of Goods

5. Prepaid Interest, Rents, or Royalties
    - Taxable When Received

6. Prepaid Service Income
    - Taxable When Earned, But No Deferral Beyond The End Of The Next Year

7. Dues & Subscriptions
    - Recognize Over Membership Period
    - Recognize Over Subscription Period

8. Goods
    - Report When Earned If Same Method Used For Financial Statements

Chapter 7 Overheads:

1. Deductible Expenditures
   Expenses
   Ordinary & Necessary

2. Prepaid Expenses—Cash Method
   Rents
   Insurance
   Interest
   Other

3. Prepaid Rents
   Deductible When Paid If
      12 Month Rule Met

4. Prepaid Insurance
   Deductible if 12 Month Rule Met

5. 12-Month Rule
   Benefits Do Not Extend Beyond Earlier of:
      A. 12 months after first benefit
      B. End of next tax year

6. Prepaid Interest
   Deductible Over Loan Period
   Exception for Points

7. Other Prepayments
   Deductible If
      Asset Consumed by End of Next Year
      Business Purpose
      & Does Not Distort Income

8. Related Party Transactions
   Loss of Sale
   Accrual of Expense

9. Related Parties
   Family Members
   Shareholders & Corporation
   Shareholders & PSC
   Other Relationships

10. Family Members
    Spouse
    Ancestors
    Lineal Descendants
    Brothers & Sisters

11. Shareholder & Corporation
    Shareholder Owns More Than 50% of Stock

12. Shareholder & PSC
    Accrued Expenses—Any Stock Ownership

Chapter 9 Overheads:

Cost Allocation:

1. Depreciation—Tangible Assets
2. Amortization—Intangible Assets
3. Depletion—Natural Resources

MACRS:

1. Deemed Useful Lives
   3, 5, 7, 10, 15, 20, 27.5, 39 years
2. Salvage Value Ignored
3. Calculation
   Recovery Period
   Method
   Convention

Method:

3 to 10 years 200%, 150%, or SL	½ Year or Mid-Quarter
15 to 20 years 150%, or SL	½ Year or Mid-Quarter
27.5 to 39 years S/L	Mid-Month

Recovery Period:

1. Depends of Class of Property
2. 3 to 39 Years

Conventions:

1. ½ Year	Personal Property
2. Mid-Quarter	If More Than 40%
3. Mid-Month	Real Estate (Buildings)

Alternative Depreciation System:

1. Election
2. Longer Recovery Periods
3. Use Required Under Certain Conditions

179 Expensing—Eligible Property:

1. New or Used
2. Primarily Tangible Personal Property
3. Business Property
4. Acquired by Purchase—Not From Related Party

Limitations on 179 Expensing 2018:

1. Purchase of Eligible Property May Not Exceed $3,500,000
2. Reduced deduction for Purchases Over $2,500,000
3. Deduction May Not Exceed Taxable Income
4. Maximum Deduction $1,000,000

Bonus Depreciation:

1. New or used MACRS Property
2. Primarily Tangible Personal Property
3. Placed in Service after Sept. 27, 2017 – 100%

Listed Property:

1. Autos & Other Motor Vehicles
2. Property Used for Entertainment, Recreation, & Amusement

Listed Property:

1. If Not Used More Than 50% for Business
   179 Expensing Not Allowed
   ADS (SL) Must be Used
2. Special Recordkeeping Rules

Overheads Chapter 10:

Net Operating Losses:

1. Net Business Loss
2. No Carryback – Unlimited Carryforward
3. Deduction on future returns limited to 80% maximum

UNICAP:

1. Manufactures
2. Large Retailers ($25 Million)

UNICAP Rules:

1. Direct Costs
2. Indirect Costs
3. Mixed Service Costs

Bad Debts:

1. Business Debts
2. Nonbusiness Debts

Business Debts:

1. Customers, Suppliers, Employment
2. Fully Deductible
3. Partial Worthlessness

Nonbusiness Debts:

1. Friends, Relatives, Investments
2. Deductible as Short-term Capital Loss
3. No Deduction if Partially Worthless

Bad Debts:

Cash Basis—Generally No Deduction

Chapter 14:

1. Property Transactions:

   A. Gains—All Taxable
   B. Losses—Deductible Only if
      Business Property
      Investment Property
      Casualty Loss

2. Basis:
   Cost
   \+ Improvements
   \- <u>Depreciation</u>
   Adjusted Basis

3. Basis of Gift:
   A. Donor's Basis
   B. Exception:
      FMV less than donor's basis and
      Property sold at price less than donor's basis

4. Basis of Inherited Property:
   Fair market value at decedent's death

5. Personal Use to Business Use
   A. Depreciation: Lower of FMV or basis at time of conversion
   B. Sale: Loss basis or gain basis

6. Installment Sales:
   A. Report gain as payments received
   B. Spread tax impact to future
   C. Time value of money

7. Installment Sales:
   May not be used for—Sale of Inventory, stock, or securities

Chapter 15:

1. Key Concepts:
   A. Involuntary Conversions
   B. Like-kind exchanges

2. Involuntary Conversions:
   A. Condemnations
   B. Casualty gains

3. Involuntary Conversions:
   A. Deferral of gain—Acquisition of replacement property
   B. Election
   C. Replacement period—Generally 2 years

4. Involuntary Conversions:
   Basis of replacement property = Cost less deferred gain

5. Like-kind Exchanges:
   A. Mandatory
   B. Business or investment real estate only

6. Like-kind Exchanges:
   Property that does not qualify
      Not like-kind
      Inventory
      Stocks, bonds, or securities
      Tangible personal property

7. Like-kind Exchanges:
   A. No gain or loss recognized
   B. Gain recognized to extent of boot
   C. Boot = cash or FMV of nonqualified property

8. Like-kind Exchanges:
   Basis of property received
      Boot = FMV
      Like-kind property = FMV less deferred gain

Chapter 16:

1. Capital Gains and Losses:

2. Individuals:
   A. Net long-term gains taxed at favorable rates
   B. Net capital loss is deductible up to $3,000
   C. Unused losses are carried forward indefinitely

3. Maximum Individual LTCG Tax Rates:
   A. 0% for lower income taxpayers
   B. 15% for most taxpayers
   C. 20% for higher income taxpayers
   D. Special rates apply to certain transactions

4. Capital Assets:
   A. All assets other than
   B. Inventory
   C. Accounts receivable
   D. Depreciable property or land used in business
   E. Copyrights and similar property
   F. U.S. publications
   G. Supplies
   H. Self-created property

5. Special Individual Rates:
   A. 28% maximum for collectibles
   B. 25% maximum for unrecaptured depreciation on real estate

6. Netting:
   A. Total all short-term transactions
   B. Total all long-term transactions
   C. Net positives and negatives

7. Corporate:
   A. Taxed at regular rates
   B. Losses not deductible
   C. Unused losses carried back 3 years and forward 5 years

8. 1244 Stock:
   A. Losses up to $50,000 ($100,000 MFJ)
   B. Ordinary loss
   C. NOL
   D. Excess losses = capital losses

9. 1244 Stock:
   A. Stock of a domestic corporation
   B. Issued for money or other property
   C. Small business corporation—capital of $1 million or less

10. Sale of a Business:
    A. Corporation—Capital gain or loss
    B. Partnership—Generally, capital gain or loss
    C. Proprietorship—Ordinary and capital gain or loss

11. 1202 Small Business Stock:
    A. Exclude 100% of gain
    B. Noncorporate original investor
    C. Stock held 5 years

12. 1202 Small Business Stock:
    A. Domestic corporation
    B. Stock issued for money, property, or services
    C. Business not providing personal services

13. Maximum Exclusion
    Greater of--$10 million or
    10 times adjusted basis

Chapter 17:

1. Key Concepts:
   - A. Property transactions
   - B. Depreciation recapture

2. 1231 Assets:
   - A. Net gains taxed as capital gains
   - B. Net losses treated as ordinary business deductions

3. 1231 Assets:
   - A. Property used in business
   - B. Held for more than 1 year
   - C. Not inventory
   - D. Not copyright or similar property
   - E. Includes coal, timber, and certain other property

4. Netting Process:
   - A. Net 1231 gains and losses
   - B. If net loss—fully deductible
   - C. If net gain apply look-back rule, any remaining net gain is capital gain

5. Look-back Rule:
   - A. Look to previous 5 years
   - B. Net 1231 losses
   - C. Cumulative loss account

6. Depreciation Recapture:
   - A. 1245 recapture
   - B. 1250 recapture
   - C. 291 recapture

7. 1245 Recapture:
   Ordinary income to the extent of prior depreciation

8. 1245 Assets:
   - A. Depreciable personal property
   - B. 179 expensed property
   - C. Non-residential real estate acquired after 1980 and before 1987 and depreciated using an accelerated method
   - D. Manufacturing property (not buildings)

9. 1250 Recapture:
   - A. Partial recapture
   - B. Ordinary gain to extent of—gain or excess depreciation

10. 1250 Assets:
    Real property used in business that is not 1245 property

11. 291 Recapture:
    - A. Applies only to corporations
    - B. Applies only to 1250 assets

12. 291 Recapture:
    A. Fiction—Calculate 1245 gain
    B. Calculate 1250 recapture
    C. Excess amount X 20% = recapture

13. 291 Recapture:
    A. Applies even if no 1250 gain
    B. Applies even if S/L depreciation used

Chapter 19 Overheads:

Key Concepts:
- Forming a corporation
- Corporate operations

351 Transfers:
- No gain or loss
- Property for stock
- 80% ownership

351 Transfers:
- Shareholder's basis in stock
- Same as basis in asset
- Add gain recognized
- Subtract FMV of boot

351 Transfers:
- Shareholder's basis in boot
- FMV

351 Transfers:
- Corporation's basis in asset
- Shareholder's basis
- Add shareholder's gain recognized

Corporate Gain:
- No gain to corporation regarding stock transferred

Stock for Services:
- 351 does not apply
- Shareholder must recognize gain
- FMV of stock
- Shareholder's basis in stock (FMV)

Property and Services:
- FMV of stock for services always taxable
- Corporation capitalizes or deducts the value of stock for services

Property and Services:
- Count stock if property is > 10%
- Do not count stock if property < 10%
- Goal is 80% ownership

Stock for Services:
- Corporation capitalizes or deducts FMV of stock
- Treatment depends on nature of services

Appreciated Property:
- 351 transfer
- Sale
- Lease

Dividends Received Deduction:

- DRD 50% < 20% ownership
- DRD 65% > 20% ownership
- DRD 100% > 80% ownership

Dividends Received Deduction:

- Domestic corporation
- Taxable income limitation
- 45 day rule
- Extraordinary dividend
- Borrowed funds

Calculation of Tax:

- Regular corporation

Schedule M-1:

- Reconciles accounting income and taxable income
- Expenses not deductible
- Income not taxable
- Taxable income not accounting income
- Deductible expenses not accounting expenses

Related Party Transactions:

- Gain is ordinary if property is depreciable
- Usually not eligible for installment sales treatment

Chapter 20 Overheads:

Dividends:

- Dividends only if earnings and profits
- Current E & P
- Accumulated E & P

Current E & P:

- Taxable income adjusted
- Items included in E & P
- Items excluded from E & P
- Timing differences
- Items deductible from E & P

Distributions:

- First from current E & P
- Second from accumulated E & P

Corporate Gain or Loss:

- FMV of property distributed less
- Basis of property

Property Distributions:

- General Utilities Doctrine
- Section 311 requires gain recognition
- Losses not recognized

Property Distributions:

- Shareholder's basis of property received
- Impact to corporate earnings & profits

Disguised Dividends:

- Excessive compensation
- Loans
- Free use of property
- Purchase of property below market value
- Payment of personal expenses

Corporate Liquidations:

- Shareholder recognizes gain or loss
- Shareholder's basis = FMV
- Corporation recognizes gain or loss

Shareholder Gain:

- FMV of property received less
- Shareholder's basis in stock

Liquidation of Subsidiary:

- Parent company recognizes no gain
- Basis of property does not change
- Liquidating subsidiary recognizes no gain

Liquidation of Subsidiary:

- Minority shareholder recognizes gain
- Parent recognizes no gain
- Minority shareholder's basis = FMV
- Parent's basis unchanged
- Subsidiary recognizes gain on assets distributed to minority shareholders

Corporate Acquisitions:

- Purchase of stock
- Purchase of assets

Purchase of Stock:

- Selling shareholders recognize gain
- Target recognizes no gain
- Target's basis in assets unchanged
- Tax attributes acquired
- Potential for future liabilities

Purchase of Assets:

- Shareholders recognize no gain
- Target company recognizes gain
- Basis of acquired assets = FMV
- Tax attributes do not transfer

Section 338:

- Stock acquired
- Treated as asset purchase

Section 338:

- Elected by acquiring corporation
- 80% of stock acquired in 12 months

338 Elected:

- Selling shareholder recognizes gain
- Target recognizes gain
- Basis of assets changed
- New tax attributes
- Target is "new corporation"

Extra Material Overheads:

Consolidated Tax Returns:

Includible Corporation--Omit:

- Tax-exempt corporation
- Foreign corporation
- S corporation

Stock Ownership:

- Parent must own 80% of another corporation
- Non-parent must have 80% of its stock owned by group members

Advantages:

- Offset losses
- Use of tax credits
- Use of deductions otherwise limited
- Intercompany profits deferred

Disadvantages:

- Binding and change of year

Controlled Groups:

Controlled Groups:

- File separate returns but treated as one return

Types of Controlled Groups:

- Parent-Subsidiary
- Brother-Sister

Parent-Subsidiary:

- One corporation owns 80% of another

Brother-Sister:

- 5 or fewer individuals collectively own more than 50% of the stock

Review Questions Chapter 1:

1. H gave his wife $1,000,000. Would a gift tax return need to be filed?

2. H gave his nondependent daughter $500,000. What is the amount of the taxable gift, if any?

3. In order to calculate the potential gift tax, the donor would need to add taxable gifts made in prior years to the taxable gifts made in the current year.

True____ False____

4. What is the form number to be used to report taxable gifts and when is it due?

5. What is the form number to be used to report estate tax and when is it due?

6. W died in the current year. H, W's husband, is still living. The value of W's estate was $8,000,000. No prior taxable gifts were made.

A. Must an estate tax return be filed?

B. Should an estate tax return be filed?

7. Does a will always control the disposition of a decedent's property?

8. Does having a will avoid probate?

9. Under what conditions must the proceeds of a life insurance policy be included in the decedent's estate?

10. If a decedent had made taxable gifts in the past, what impact would the gifts have on the decedent's estate tax return?

11. If the net profit from a sole proprietorship were $100,000, how much of that income would be subject to self-employment tax?

12. In calculating self-employment tax, what is the tax rate for the OASDI portion of the tax? What is the MHI tax rate?

13. What additional Medicare taxes may applicable for 2018?

Review Questions Chapter 2:

1. Rank the following from highest to lowest level of authority:

   ____ Regulations
   ____ Revenue rulings
   ____ The Internal Revenue Code
   ____ Articles in profession journals
   ____ Technical advice memorandums

2. Indicate one unique feature of the U.S. Tax Court:

3. Indicate one unique feature of a U.S. District Court:

4. A citation of Rev. Proc. 2012-70 is referring to __________________________.

5. According to the AICPA, if an error is discovered on a return that has already been filed, the CPA should ____.

6. The DIF scoring system refers to _______________________________________.

7. The losing party has an automatic right to appeal a case from the following court(s).

   ____ Regular U.S. Tax Court
   ____ The Supreme Court
   ____ A district court
   ____ The Court of Federal Claims
   ____ The Small Claims Division of the Tax Court

8. The USTC volumes contain cases from the following courts:

9. The Golsen Rule refers to ____.

10. The term acquiesce refers to ____.

Review Questions Chapter 3:

1. A shareholder may not be held personally liable for debts of the corporation.
True ____ False ____

2. Generally, a partner may not be an employee of his or her own partnership.
True ____ False ____

3. A shareholder of an "S" corporation would be subject to self-employment tax on his or her share of corporate earnings. True ____ False ____

4. Double taxation may well occur if the business is operated as: (Select all that apply)

A. A sole proprietorship
B. A general partnership
C. An "S" corporation
D. A "C" corporation
E. A limited partnership
F. A limited liability company

5. If Carol owns 10% of the stock of an "S" corporation, Carol should be allocated 10% of the profits.
True ____ False ____

6. R and S agree to split partnership profits equally. If the partnership had $50,000 of net profit each partner should be allocated $25,000 of income even if no partnership distributions have been made.
True ____ False ____

7. List some of the advantages an "S" corporation would have over a "C" corporation:

8. The shareholders of a "C" corporation may deduct their share of corporate losses each year. However, they should not report any corporate profits on their individual tax returns.
True ____ False ____

9. John owns 50% of the business. Although no distributions were made to John during the year, the business earned $30,000 of net profit. Given this information, indicate the amount of income John should report on his personal tax return assuming the business is operated as:

A. An "S" corporation__________________
B. A general partnership__________________
C. A limited liability company_________________
D. A "C" corporation ___________________

Review Questions for Chapter 5:

1. RX Corporation, a qualified personal service corporation, has averaged $30 million in gross receipts for the past several years. May the corporation use the cash method of accounting?

2. Karen operates her business as a sole proprietorship. She is engaged in selling inventory. Gross receipts have never exceeded $900,000. May Karen use the cash method of accounting?

3. James filed his 2017 personal income tax return on March 10, 2018. It was not due until April 15, 2018. When will the normal statute of limitations expire?

4. If James (in 3 above) had filed his return on October 4, 2018, when would the normal statute of limitations expire?

5. Under what conditions would there be no statute of limitations?

6. The Thor Power Tool case dealt with which of the following topics?

A. The constructive receipt doctrine
B. Accounting rules v. tax rules
C. The statute of limitations
D. None of the above

7. Susan received $20,000 of prepaid rental income on December 20, 2018. The prepayment represented the rent for due for 2019. If Susan used the cash method of accounting, when should she report the income?

8. Assume the same facts a indicated in (7) above except that Susan used the accrual method of accounting. When should she report the income?

9. Carol received prepaid service income on December 20, 2018. The prepayment was received for services to be rendered in 2019. If Carol used the cash method of accounting, when should she report the income?

10. What would be your answer to (9) above if Carol used the accrual method?

Review Questions for Chapter 7:

1. Generally prepaid interest not deductible.

True ____ False ____

2. V Corporation purchased a 12-month insurance policy on November 1, 2018 for $24,000. The corporation paid the insurance premiums for the year 2019 at the time of purchase. Indicate the amount of the premiums that are deductible in each year assuming the corporation used the cash method.

The amount deductible in 2018 would be ____________________

The amount deductible in 2019 would be ____________________

3. Assume the same facts in (2) above except that the corporation used the accrual method of accounting.

The amount deductible in 2018 would be ____________________

The amount deductible in 2019 would be ____________________

4. Assume the same facts in (2) above except that the prepayment involved rent and not insurance. Indicate the amount of rent the corporation may deduct if the corporation used the cash method of accounting.

The amount deductible in 2018 would be ____________________

The amount deductible in 2019 would be ____________________

5. Assume the same facts in (4) except that the corporation used the accrual method of accounting.

The amount deductible in 2018 would be ___________________

The amount deductible in 2019 would be ___________________

6. In 2018 Amanda sold stock for $20,000 to D, her daughter. Amanda originally paid $25,000 for the stock a few years ago.

A. The loss that Amanda may use in 2018 would be __________________________

B. If D sold the stock for $28,000 the gain or loss would be____________________

C. If D sold the stock for $18,000 the gain or loss would be ___________________

7. T and M are equal business partners in an unrelated partnership. T owns 200 shares of X Corporation stock. M owns 100 shares of X Corporation stock. In applying the related party rules, all of the stock owned by M would be considered as also owned by T.

True ____ False ____

Review Question Chapter 9:

1. Using MACRS, what methods of depreciation may be used for 10-year property?

2. Using MACRS, what methods of depreciation may be used for buildings?

3. The appropriate convention to be used to calculate depreciation for an office building is ____________________.

4. X Corporation purchased and placed into service the following assets in 2018:
(Ignore 179 expensing and bonus depreciation)

Equipment on March 2	5 year property	$30,000
A warehouse on November 10	39 year property	$500,000
A delivery truck on October 9	5 year property	$60,000
Office furniture on April 22	7 year property	$200,000

Given this information, what is the appropriate convention to be used for each asset?

5. What is the maximum amount of 179 expensing that may be claimed for 2018?

6. If RS Corporation placed equipment into service in 2018 that cost $2,000,000, how much of the cost may be expensed using 179 expensing? What is your answer assuming the cost of the equipment was $3,600,000?

7. May used property qualify for 179 expensing?

8. What is the maximum amount of bonus depreciation that may be claimed in 2018?

9. BTC Corporation had taxable income of $20,000 before considering bonus depreciation. The corporation qualified for $100,000 of bonus depreciation. May BTC Corporation claim the full $100,000 in 2018?

Review Questions for Chapter 10:

1. The UNICAP rules generally require more categories of costs to be capitalized as inventory costs than were required in the past. True____ False ____

2. Nonbusiness bad debts are not deductible because they are personal losses.
True____ False____

3. Business bad debts would be deductible as:

A. An ordinary business loss
B. A short-term capital loss
C. A long-term capital loss
D. An ordinary business loss, but only if the loan was made more than 5 years ago
E. None of the above

4. Nonbusiness bad debts would be deductible as:

A. An ordinary business loss
B. A short-term capital loss
C. A long-term capital loss
D. An ordinary business loss, but only if the loan was made more than 5 years ago
E. None of the above

5. A bad debt deduction may be claimed for partially uncollectible debts if:

A. The debt was a business debt and was written off on the financial statements as well
B. The debt was either business or nonbusiness and was written off on the financial statements as well
C. The debt was nonbusiness and was written off on the financial statements as well
D. The debt was a business debt. It does not matter whether or not it was written off on the financial statements
E. None of the above

6. The same rules that apply to financial accounting for inventories also apply for tax purposes
True____ False____

7. Only corporate taxpayers are eligible to use the net operating loss rules. Individual taxpayers are not allowed to claim a net operating loss deduction.
True____ False____

8. A net operating loss should be carried back 2 years and carried forward for up to 20 years.
True____ False____

9. A net operating loss may be used to offset any income (ordinary or capital gain) in the carryforward year. True____ False____

Review Questions Chapter 14:

1. Ron received stock as a gift in 2018. The stock was worth $10,000 when it was received and the donor's basis in the stock was $4,000. Calculate the gain or loss Ron should recognize assuming the stock was sold in 2019 at prices indicated below:

A. Sold for $15,000

B. Sold for $8,000

C. Sold for $3,000

2. Susan inherited stock from her mother. Her mother's basis in the stock at the time of her death was $9,000 and the stock was worth $14,000 at that time. Calculate the gain or loss Susan should recognize assuming the stock was sold at prices indicated below:

A. Sold for $15,000

B. Sold for $8,000

C. Sold for 3,000

3. ABC Corporation sold vacant land that was being held for investment purposes. The land was sold for $100,000 and the corporation's basis in the land was $40,000. The corporation received $10,000 as a down payment in the current year and the balance was to be paid in equal installments over the next 3 years. Calculate the taxable gain the corporation should report using the installment sales method of reporting. (Ignore interest)

4. Ted sold 100 shares of Intel stock on December 31, 2018 for $40,000. Ted purchased the stock several years ago for $50,000. On January 10, 2019 Ted purchased 100 shares of Intel stock for $38,000 be included in his investment portfolio. Determine the amount of the loss that Ted may deduct on his 2018 tax return and calculate Ted's basis in the Intel stock acquired in 2019.

5. Jennifer has acquired shares of Chevron stock over a period of years. The amount paid for the stock has varied with each purchase. If Jennifer sells less than her entire holdings of Chevron stock in the current year, how may she determine her basis in the shares sold?

Review Questions for Chapter 15:

1. Only business or investment real estate may qualify for like-kind exchange treatment.

True ____ False ____

2. If a business warehouse is destroyed by fire, the taxpayer may purchase an apartment building with the insurance proceeds and qualify to defer the recognition of income using the involuntary conversion rules.

True ____ False ____

3. On July 1, 2018 the City of San Jose condemned your client's office building in order to build a new park. Your client received $500,000 for the building and had an adjusted basis in the property of $300,000. Generally, your client would need to acquire appropriate replacement property on or before July 1, 2021 to qualify to defer the recognition of gain.

True ____ False ____

4. Vacant land held for investment purposes may be exchanged for an apartment building to be used to generate rental income and qualify for like-kind exchange treatment.

True ____ False ____

5. If a taxpayer incurs a loss when engaging in a qualified like-kind exchange, the loss is deductible.

True ____ False ____

6. The receipt of cash in a like-kind exchange of real estate would cause gain realized to be recognized.

True ____ False ____

7. The entire gain that results from an involuntary conversion may be deferred as long as the cost of the replacement property exceeds the gain realized. True ____ False ____

Review Questions Chapter 16:

1. The maximum tax rate that a corporation would pay related to net long-term capital gains is __________________.

2. If an individual incurs an overall $20,000 net long-term capital loss during the year, the amount of loss that may be deductible is __________________.

3. Generally, the maximum tax rate for individual taxpayers related to net long-term capital gains from selling stock is 37%.

True ____ False ____

4. Laura had the following capital gains and losses in the current year. Calculate the net capital gain or loss and determine if the net result is short-term or long-term:

	Short-term	Long-term
Gains	$5,000	$20,000
Losses	($8,000)	($4,000)

5. If an individual taxpayer had the following net capital gains and losses, indicate the amount that would be taxed at favorable rates for each independent situation:

	Net Short-term	Net Long-term
A.	$4,000	$9,000
B.	($4,000)	$9,000
C.	($4,000)	($9,000)
D.	$15,000	($9,000)

6. Personal use furniture would be a capital asset.

True ____ False ____

7. The gain from selling gold that has been held for several years would be taxed at a maximum rate of 20%.

True ____ False ____

8. Inheriting 1244 stock from a relative would allow the new owner to also treat the stock as 1244 stock.

True ____ False ____

9. The maximum amount of 1244 loss that a single individual taxpayer may claim in any one year is ________________.

10. If stock was purchased on July 25, 2018, what is the first day the stock may be sold and have the gain be eligible for long-term capital gain treatment?

11. Generally, dividends received by individuals are taxed at ordinary income tax rates.

True ____ False ____

12. R purchased an option to buy real estate to be held for investment purposes. However, if R sold the option to an unrelated party before the expiration date the resulting gain or loss should be reported as ordinary income.

True ____ False ____

13. If in (12) above R allowed the option to expire the resulting loss should be reported as a capital loss.

True ____ False ____

14. T sold an option to R related to investment real estate for $20,000. If R acquires the property by exercising the option, how should T report the option on her tax return?

15. If in (14) above R allowed the option to expire, how should T report the option on her return?

16. A new Medicare add-on tax may be applicable to higher income taxes starting in 2013. Briefly explain how that add-on tax is to be calculated.

Review Questions Chapter 17:

1. A good "working definition" of a 1231 asset is ________________________________
___________________________________.

2. SC Corporation sold two 1231 assets in 2018, as indicated below. Determine the net amount of 1231 gain or loss and indicate the character of the gain or loss for each independent situation.

A.	Asset #1	$30,000 gain
	Asset #2	(20,000) loss
B.	Asset #1	$25,000 gain
	Asset #2	(40,000) loss

3. WTR Corporation had a balance in its loss account of ($10,000) at the end of 2017. In 2018 the net result of its 1231 transactions was a gain of $12,000. Indicate the character of the $12,000 gain to be reported by the corporation in 2018:

Ordinary gain ______________________
Capital gain ________________________

4. Identify the 1231 assets from the list below. Assume all assets have been held for more than one year.

Inventory _________
Land held for investment _________
Stock ________
Business equipment ________
A business automobile _________
A business office building ________
Gold held for investment _______
An employee parking lot _______

5. Identify the 1245 assets listed below:

Inventory _______
A business warehouse _______
Stock ______
Business office furniture ______
A business truck _______
Vacant land held for investment ______
Business equipment ______
Vacant land used for business ______

6. 1245 recapture may apply irrespective of the method of depreciation used.
True ____ False ____

7. 1250 recapture is only applicable if an accelerated method of depreciation was used to depreciate an asset that has been held for more than 1 year.
True ____ False ____

8. The depreciation recapture provisions would be applicable to an asset sold at a gain or a loss.
True ____ False ____

Review Questions Chapter 19:

1. What is the purpose of the Schedule M-1?

2. If X Corporation owns 10% of the stock of Div. Corporation, the percentage of the dividends received deduction that X Corporation would be allowed to use is ___________.

3. George and Carol would like to form a new corporation. After the transfer each will own 50% of the stock.

George will transfer equipment worth $100,000 (basis $30,000)

Carol will transfer real estate worth $100,000 (basis $90,000)

A. Will the transfers qualify under 351?

B. How much gain or loss will each shareholder recognize?

C. What would be George's basis in his stock?

D. What would be Carol's basis in her stock?

E. What is the corporation's basis in each asset?

4. Assume the same facts as indicated in (3) above except that George rendered services to the corporation for his 50% and did not transfer any property. Answer questions A through E again.

A. Will the transfers qualify under 351?

B. How much gain or loss will each shareholder recognize?

C. What would be George's basis in his stock?

D. What would be Carol's basis in her stock?

E. What is the corporation's basis in each asset?

5. Dividends are deductible by the paying corporation.

True ____ False ____

6. A qualified personal service should not use the normal corporate tax rate schedule.

True ____ False ____

7. Robert owns all of the stock of ST Corporation. If Robert sold unimproved land held as an investment to the corporation at a gain, the gain should be reported as ordinary income under the related party rules.

True ____ False ____

8. Charitable contributions made by a corporation are deductible, but the amount deductible in the current year is limited to ____.

9. C Corporation was formed in the current year. The corporation paid $55,000 in organizational costs. How much of the organizational costs would be deductible in the current year, assuming the corporation started business on January 1?

10. Calculate the tax liability T Corporation assuming the corporation's taxable income for the current year was $200,000 before considering dividend income of $10,000 and charitable donations of $30,000. The dividends were received from a corporation in which T Corporation owns 30% of the stock.

Review Questions Chapter 20:

1. RX Corporation distributed $20,000 to its only shareholder in the current year. Indicate the amount and character of the income to be reported by the shareholder given the following independent situations:

	Current E & P	Accumulated E & P	Shareholder's basis in the stock
A.	$4,000	$5,000	$1,000
B.	$4,000	($5,000) Deficit	$9,000
C.	($4,000) Deficit	($30,000) Deficit	$8,000

2. G Corporation distributed land to its only shareholder in the current year. The land was worth $100,000 and the corporate basis in the land was $40,000 at the time of the distribution. The corporation had $500,000 in current E & P prior to considering the distribution. Given these facts answer the following questions:

A. How much gain, if any, should be corporation recognize?

B. How much dividend income, if any, should the shareholder recognize?

C. What is the shareholder's basis in the land?

D. What impact would the distribution have on corporate E & P?

3. Marie owns 100 shares of stock of ABC Corporation. In the current year the corporation gave each shareholder 200 shares of stock to replace the 100 shares owned in a 2 for 1 stock split. Because Marie now owns 200 shares of stock, the receipt of the additional 100 shares would be a taxable event.
True ____ False _____

4. Joe owned all of the stock of X Corporation. The corporation liquidated in 2018 by transferring its only asset (land) to Joe. The land was worth $200,000 and the corporation's basis in the land was $50,000 at the time of the liquidation. Joe's basis in the stock was $100,000.
The corporation had $125,000 in earnings and profits at the time of liquidation. (Ignore taxes).

A. Should the corporation recognize gain as a result of the liquidation? If so, how much?

B. Should Joe recognize gain or dividend income as a result of receiving the land? If so, how much?

C. What is Joe's basis in the land?

5. X Corporation owns all of the stock of Subsidiary Corporation. In 2018 Subsidiary Corporation liquidated by transferring its only asset (land) to X Corporation. The land was worth $200,000 and the corporation's basis in the land was $50,000 at the time of the liquidation. X Corporation's basis in the stock was $100,000. The corporation had $125,000 in earnings and profits at the time of liquidation. (Ignore taxes).

A. Should Subsidiary Corporation recognize gain as a result of the liquidation? If so, how much?

B. Should X Corporation recognize gain or dividend income as a result of receiving the land? If so, how much?

C. What is X Corporation's basis in the land?

<u>§351 Practical Exercise:</u>

1. Facts: Individuals A and B formed RX Corporation in the current year. Each individual contributed the following assets to the corporation in exchange for stock. Shareholder A received 75% of the stock and B received 25%.

	FMV	Basis
A contributed Land	$60,000	$40,000
B contributed Equipment	$20,000	$10,000

A. Determine the gain, if any, to be recognized by A and B as a result of the exchange.

B. Determine the basis that each shareholder would have in the stock of RX Corporation.

C. Determine RX Corporation's basis in the each asset received from A and B.

D. Determine the gain to be recognized by RX Corporation as a result of the exchange.

2. Assume the same facts as above except that B rendered services worth $20,000 for her 25% interest in the corporation, instead of transferring equipment. Answer questions A through D again.

3. Assume the same facts as indicated in question #2 except that B did two things to obtain her stock. B rendered services worth $15,000 and transferred equipment worth $5,000 to the corporation in exchange for $20,000 worth of stock (25% interest in the corporation). B's basis in the equipment was $3,000. Answer the questions again.

Consolidated Returns and Controlled Groups:

Class Exercise--Consolidated Returns and Controlled Groups: Unless otherwise indicated, assume unidentified stock is owned by several unrelated taxpayers each owning less than one percent interest in the corporations.

1. Gary, an individual, owns all of the stock of X Corporation. X Corporation owns stock in other corporate entities as indicated below:

X Corporation owns 70% of S1
X Corporation owns 100% of R1
X Corporation owns 90% of W1
R1 owns 10% of W1

Which of the entities are eligible to file a consolidated income tax return?

2. Gary, an individual owns all of the stock of A Corporation, B Corporation, and C Corporation. Which of the entities are eligible to file a consolidated income tax return?

3. C Corporation owns 100% of the stock of S1, 60% of S2, 80% of S3, and 100% of the stock of S5. S1 owns 30% of S2. S3 owns 100% of S4. S5 is a tax-exempt corporation. Which of the entities are eligible to file a consolidated income tax return?

4. The following individuals own stock in the corporations as indicated below:

	Corp.A	Corp.B	Corp.C	Corp. D
James	40%	20%	30%	40%
Susan	10%	10%	20%	30%
Carol	30%	40%	50%	30%

Which of the entities above are brother-sister corporations and therefore members of a controlled group?

5. Indicate which of the entities below are brother-sister corporations and therefore members of a controlled group?

	Corp.A	Corp.B	Corp.C	Corp. D
James	40%	0%	40%	40%
Susan	10%	30%	10%	30%
Carol	50%	10%	10%	30%

6. Would Corporations A and B be considered brother-sister entities and therefore members of a controlled group?

A.

	Corp. A	Corp. B
James	100%	0%
Susan	0%	100%

B.

	Corp. A	Corp. B
James	100%	50%
Susan	0%	50%

C.

	Corp. A	Corp. B
James	100%	100%

D.

	Corp. A	Corp. B
James	30%	70%
Susan	70%	30%

E.

	Corp. A	Corp. B
James	25%	75%
Susan	75%	25%

7. Assume 3 unrelated individuals want to form as many corporations as possible without creating a brother-sister controlled group. They also want no other shareholders to own any of the stock. How many corporations may they form and indicate the stock ownership structure that produces the most entities.

James
Susan
Carol

2018 Individual Tax Rate Schedule: (only $ shown)

Single:

Over	Not Over	Tax	+	% of Excess	Of Amount Over
$ 0	$9,525	$ 0	+	10%	$ 0
9,525	38,700	952	+	12%	9,525
38,700	82,500	4,453	+	22%	38.700
82,500	157,500	14,089	+	24%	82,500
157,500	200,000	32,089	+	32%	157,500
200,000	500.000	45,689	+	35%	200,000
500,000		150,689	+	37%	500,000

Married Filing Jointly:

$ 0	$19,050	$ 0	+	10%	$ 0
19,050	77,400	1,905	+	12%	19,050
77,400	165,000	8,907	+	22%	77,400
165,000	315,000	28,179	+	24%	165,000
315,000	400,000	64,179	+	32%	315,000
400,000	600,000	91,379	+	35%	400,000
600,000		161,379	+	37%	600,000

Head of Household:

$ 0	$13,600	$ 0	+	10%	$ 0
13,600	51,800	1,360	+	12%	13, 600
51,800	82,500	5,944	+	22%	51,800
82,500	157,500	12,698	+	24%	82,500
157,500	200,000	30,698	+	32%	157,500
200,000	500,000	44,298	+	35%	200,000
500,000		149,298	+	37%	500,000

Highlights of Changes made by the Tax Cuts and Jobs Act:

Many of the changes that impact individuals are for tax years 2018 through 2025 and are therefore considered "temporary." The list is not comprehensive, but is merely an attempt to give you basic information regarding changes related to topics normally covered in Economics 117A and B. The brief summary does not cover changes made to topics outside of those covered in our two tax classes.

1. New individual income tax rates. The seven tax rate brackets range from 10% at the low end to 37% at the high end. The rate brackets differ depending upon filing status.

2. The standard deduction was increased as follows:

MFJ	$24,000
H of H	18,000
All Others	12,000

3. Both personal and dependency exemptions were reduced to zero. The old rules for determining dependency exemptions are still applicable, but the dollar amount of the deduction is $0. For example, the rules for determining if a taxpayer qualifies to use the Head of Household filing status generally still require the taxpayer if they may claim a dependency exemption for someone in order to use that filing status.

4. The "Kiddie Tax" has been modified in that the child's in unearned income subject to the tax, is now taxes at the rates applicable to trusts and estates, instead of the "parents' rate of tax."

5. The Casualty Loss deduction will no longer be allowed for losses related to personal use property, except for losses incurred in a federally-declared disaster. Also, special rules apply to a taxpayer who has personal casualty gains.

6. The child tax credit was increased to $2,000 per qualifying child and the levels at which the credit is phased out were increased to $400,000 for MFJ and $200,000 for all others. Also, the credit is refundable up to $1,400 per child under certain conditions. Finally, a nonrefundable credit of up to $500 may be claimed for certain non-child dependents.

7. Itemized deductions have been changes as follows:

   A. State and local tax deduct is limited to no more than $10,000.
   B. Mortgage interest was altered to eliminate the deduction for interest related to home equity loans. Also the acquisition indebtedness, only interest related to loans of up to $750,000 ($375,000 for MFS) qualifies. However, the old rules continue to apply to acquisition indebtedness in existence before the new law.
   C. Medical expenses are deductible to the extent that they exceed 7.5% of AGI.
   D. Individual charitable contributions deductions are now subject to an overall limitation of 60% of AGI, not 50%.
   E. Miscellaneous itemized deductions (subject to the 2% rule) are no longer deductible.

8. The 3% cut-back rule applicable to higher income taxpayers has been eliminated.

9. Alimony is no longer deductible and the recipient no longer needs to report it as income for agreements executed after December 31, 2018.

10. Except for members of the armed services, moving expenses are no longer deductible and the exclusion from income for reimbursements has been removed.

11. The exclusion from income of bicycle commuting reimbursements has been removed.

12. The deduction of living expenses for members of Congress while they are away from home has been eliminated.

13. The alternative minimum tax (AMT) has been altered by increasing the alternative minimum taxable income amount that is exempt from the AMT to $109,400 for MFJ and SS, $70,300 for single, and $54,700 for MFS taxpayers. The threshold for the 25% reduction for amounts exceeding the individual's AMTI has been increased to $1 million for MFJ and SS, and to $500,000 for all other taxpayers.

14. Student loans discharged due to death or permanent disability are now excluded from income.

15. Patents, inventions, models or designs, and secret formulas or possesses, which are either held by the creator or by a person for whom the property was created or by a person who obtains a substituted basis from the creator (or from the person for whom the property was created) are no longer considered to be "capital assets." Therefore, gains or losses would no longer be considered capital gains or losses.

Business Changes:

1. The corporate tax rate is now a flat 21%.

2. The dividends received deduction was reduced from 70% to 50% and the 80% deduction was reduced to 60%.

3. The corporate alternative minimum tax was repealed.

4. The deduction allowed under section 179 was increased to $1 million and the phase-out threshold was increase to $2.5 million. The definition of qualified property was expanded to income property used to furnish lodging, and certain improvements to nonresidential real estate such as roofs, heating, ventilation, air-conditioning, fire protection and security alarm systems. Also, other building improvements to nonresidential real property (other than elevators or escalators, building enlargements, or internal structural framework) now qualify.

5. The deduction allowed for "bonus deprecation" has been expanded to include both new and used property. The deductible percentage of cost allowed decreases over time as follows:

A. Now through 2022	100%
B. 2023	80%
C. 2024	60%
D. 2025	40%
E. 2026	20%

6. The maximum amount of per year depreciation allowed for "luxury automobiles" was increased to:

First year	$10,000 or $18,000 if bonus depreciation elected
Second year	$16,000
Third year	$9,600
Fourth year and later	$5,760

7. Computers are no longer consider to be "listed property."

8. Limits on deduction of business interest expense. In general, the deduction for interest on business loans is limited to amounts up to 30% of "business adjusted taxable income." This limitation generally applies at the taxpayer level. However, it applies at the entity level for partnerships and S corporations. Small businesses are exempt from this limitation. A small business is defined as one that had average gross receipts of $25 million or less for the three prior years.

9. The rules related to net operating losses (NOL's) have been changed. The carryback provisions have been eliminated. However, an NOL deduction may be carried forward indefinitely. The amount of the NOL deduction is limited to 80% of taxable income.

10. The section 199 domestic production deduction has been repealed.

11. The like-kind exchange rules were modified to allow the rules to be applicable only with respect of real property that is not held for business or investment purposes.

12. Amount paid for entertainment are no longer deductible. Also, a deduction is no longer allowed for employee transportation, but the exclusion from income for those benefits has been retained.

13. The 50% deduction for meals was expanded to include meals provided through in-house cafeterias or otherwise "on the premises of the employer."

14. Generally, no deduction is allowed for transportation expenses that are the equivalent of commuting for employees (home to office).

15. For years after 2025, employer's will no longer be able to deduct the cost of meals provided for the convenience of the employer on the premises.

16. No deduction is allowed for any settlement, payout or attorney's fees related to sexual harassment if the payments are subject to a nondisclosure agreement.

17. No deduction is allowed for local lobbying expenses.

18. The cash method of accounting may be used by taxpayers with average gross receipts of $25 million or less, even if they have inventory. This rule applies to all taxpayers other than tax shelters. This change also exempts "small taxpayers" from the rules applicable to section 263A (UNICAP).

19. Pass-Through Entities (sole proprietorships, Partnerships and S corporations) are allowed a new deduction that reduces taxable income (rather than AGI). This is an extremely complex area that needs future guidance. However, generally a 20% deduction of "qualified business income" is allowed. (Certain types of investment-related items are excluded). The deduction is also phased-out for certain service related businesses if income levels exceed certain amounts.

20. New limitations on business losses. Section 461 now limits the amount of losses from a sole proprietorship, partnership, or S corporation that can be deducted in any given year from an active business is limited to $500,000 for MFJ and $250,000 for all others. Any losses in excess of the maximum amount allowed is to be treated as a "net operating loss" (NOL). The NOL would be carried forward indefinitely until it is used up.

An excess business loss for the year is the excess of aggregate deductions of the taxpayer attributed to businesses over the sum of aggregate gross income or gain from those businesses, plus the $500,000 or $250,000 amount above. These numbers will be adjusted for inflation annually.

The basic calculation may be illustrated as follows:

Business losses
<u>Business income + $500,000 or $250,000</u>
Excess business losses to be treated as NOL to be carried forward

Estates and Gift Taxes:
Generally, the lifetime estate and gift tax exemption for decedents dying after 2017 has been increased to $11,200,000. This increase eliminates the tax of many estates and taxable and taxable gifts made in 2018 and subsequent years. For gifts the annual exclusion is $15,000 for 2018.