

SOUTH-WESTERN
FEDERAL TAXATION

Hoffman
Maloney
Raabe
Young

COMPREHENSIVE VOLUME

2016

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**SOUTH-WESTERN
FEDERAL TAXATION**

2016 EDITION
**COMPREHENSIVE
VOLUME**

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**South-Western Federal Taxation:
Comprehensive Volume, 2016 Edition**

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Preface

COMMITTED TO EDUCATIONAL SUCCESS

South-Western Federal Taxation (SWFT) is the most trusted and best-selling series in college taxation. We are focused exclusively on providing the most useful, comprehensive, and up-to-date tax texts, online study aids, tax preparation tools, and research tools to help instructors and students succeed in their tax courses and beyond.

SWFT is a comprehensive package of teaching and learning materials, significantly enhanced with each edition to meet instructor and student needs and to add overall value to learning taxation.

Comprehensive Volume 2016 Edition provides a dynamic learning experience inside and outside of the classroom. Built with resources and tools that have been identified as the most important, our complete learning system provides options for students to achieve success.

Comprehensive Volume 2016 Edition provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual and business taxpayer, as well as coverage of all major developments in Federal Taxation.

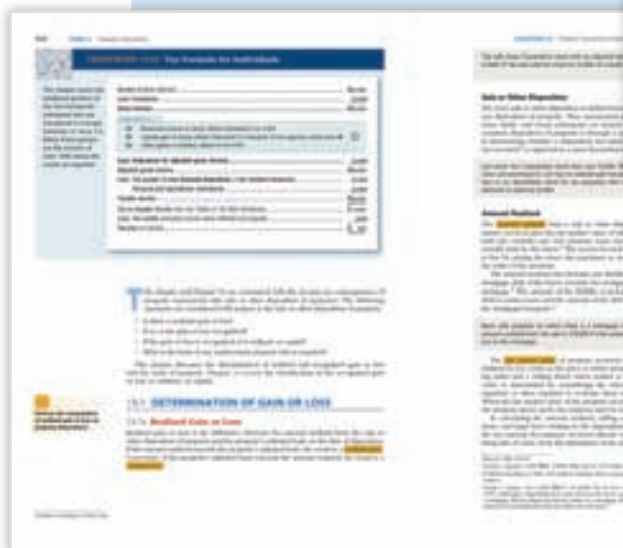
In revising the 2016 Edition, we focused on:

- **Accessibility. Clarity. Substance.** The text authors and editors made this their mantra as they revised the 2016 edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western Federal Taxation* series.
- **CengageNOW as a complete learning system.** Cengage Learning understands that digital learning solutions are central to the classroom. Through sustained research, we continually refine our learning solutions in CengageNOW to meet evolving student and instructor needs. CengageNOW fulfills learning and course management needs by offering a personalized study plan, video lectures, auto-graded homework, auto-graded tests, and a full eBook with features and advantages that address common challenges.

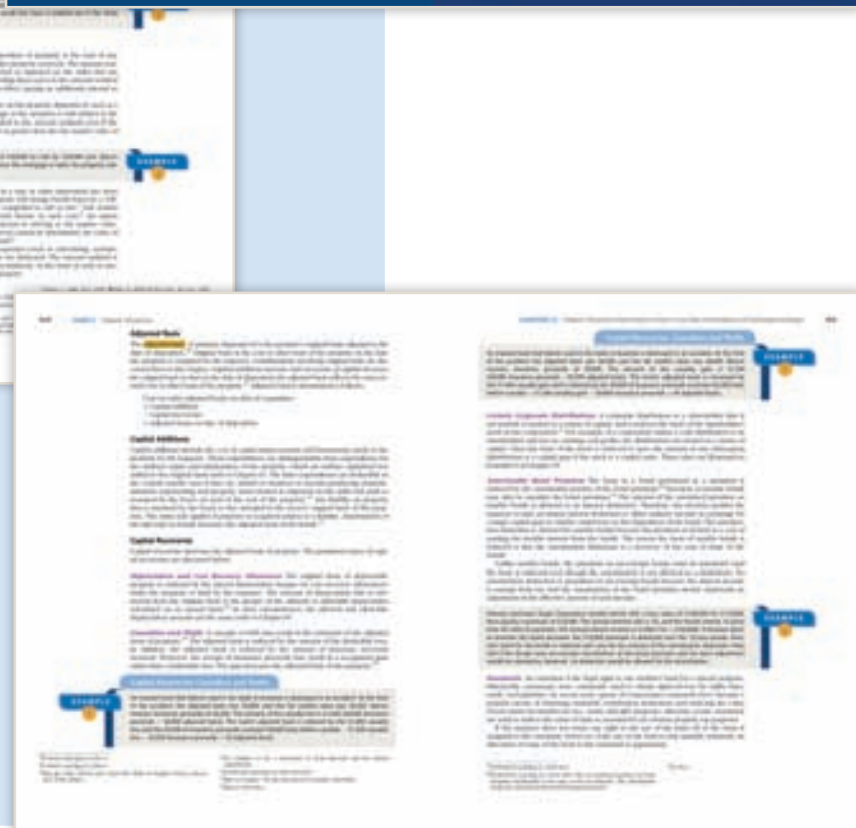
Learning Tools and Features to Help Students Make the Connection

NEW! FULL-COLOR DESIGN: We understand that students struggle with learning difficult tax code concepts and applying them to real-world scenarios. The 2016 edition has been developed with an invigorating use of color that brings the text to life, captures student attention, and presents the tax code in a simple, yet logical format.

- Selected **content has been streamlined** to guide students in focusing on the most important concepts for the CPA exam while still providing in-depth coverage of topics.



- Examples are clearly labeled and directly follow concepts to assist with student application. An **average of over 40 examples in each chapter** use realistic situations to illustrate the complexities of the tax law and allow students to integrate chapter concepts with illustrations and examples.
- Additional **concept summaries** have been added to provide clarification and simplify difficult tax concepts.



NEW! COMPUTATIONAL EXERCISES: Students need lots of practice in computing tax return problems, adjusting rates, etc. We've developed these new exercises to give students practice in calculating the solutions they need to make business decisions.

- Found in end-of-chapter section in the textbook
- CengageNOW provides additional algorithmic versions of these problems

Computational Exercises

16. **LO.1** Sally owns real property for which the annual property taxes are \$8,000. She sells the property to Shelley on February 28, 2015, for \$550,000. Shelley pays the real property taxes for the entire year on October 1.
 - a. How much of the property taxes can be deducted by Sally and how much by Shelley?
 - b. What effect does the property tax apportionment have on Shelley's adjusted basis in the property?
 - c. What effect does the apportionment have on Sally's amount realized from the sale?
 - d. How would the answers in (b) and (c) differ if the taxes were paid by Sally?
17. **LO.1** Melba purchases land from Adrian. Melba gives Adrian \$225,000 in cash and agrees to pay Adrian an additional \$400,000 one year later plus interest at 5%.
 - a. What is Melba's adjusted basis for the land at the acquisition date?
 - b. What is Melba's adjusted basis for the land one year later?
18. **LO.1** On July 1, 2015, Katrina purchased tax-exempt bonds (face value of \$75,000) for \$82,000. The bonds mature in five years, and the annual interest rate is 6%. The market rate of interest is 2%.

NEW! ROGER CPA EXAM REVIEW QUESTIONS: While the SWFT series has always provided the most in-depth coverage of tax concepts, Roger CPA Exam Review questions have been added to further prepare students for success on the CPA Exam.

- Located in selected end-of-chapter sections
- Tagged by concept in CengageNOW
- Similar questions to what students would actually find on the CPA exam

Roger CPA Review Questions

1. In the current year, Harper, a married taxpayer filing jointly, sustained an \$82,000 loss on Code Sec. 1244 stock in WWW Corp., a qualifying small business corporation, and a \$27,000 loss on Code Sec. 1244 stock in RRR Corp., another qualifying small business corporation. What is the maximum amount of loss that Harper can deduct for the current year?
 - a. \$106,000 capital loss and \$5,000 ordinary loss.
 - b. \$9,000 ordinary loss and \$100,000 capital loss.
 - c. \$100,000 ordinary loss and \$9,000 capital loss.
 - d. \$109,000 capital loss.
2. In Year 1 Keller, an individual, purchased depreciable real property for \$80,000. In Year 5 Keller sold the property for \$100,000. At the time of sale the property had a basis of \$50,000 due to \$50,000 depreciation taken during the holding period. Of the



See how the SWFT series helps students understand the big picture and the relevancy behind what they are learning.

THE BIG PICTURE

THE FIRST JOB

After an extensive search, Morgan, a recent college graduate with a major in finance, has accepted a job with Kite Corporation. The job is in sales and will require travel and some entertainment (i.e., business lunches). She will be based in a major metropolitan area in another state. Kite has no available space in the locale, so Morgan will have to maintain her own work facility. In addition to her salary, Morgan will receive a travel allowance. However, Kite has made it clear that the allowance *will not* cover all of her travel expenses.

Morgan is delighted with the new job because it will enable her to maintain a flexible work schedule. Furthermore, working out of her own apartment avoids a time-consuming and costly commute.

What are some of the income tax problems presented by this situation?

Read the chapter and formulate your response.

THE BIG PICTURE: Tax Solutions for the Real World. Taxation comes alive at the start of each chapter as The Big Picture Examples give a glimpse into the lives, families, careers, and tax situations of typical filers. Students will follow this one family, individual, or other taxpayer throughout the chapter showing students how the concept they are learning plays out in the real world.

Finally, to solidify student comprehension, each chapter concludes with a **Refocus on the Big Picture** summary and tax planning scenario. These scenarios apply the concepts and topics from the chapter in a reasonable and professional way.

FRAMEWORK 1040: Fitting it all Together.

This chapter-opening feature demonstrates how individual income tax topics fit together, using the Income Tax Formula for Individuals as the framework. The framework helps students organize their understanding of the chapters and topics to see how they relate to the basic tax formula and then identify where these items are reported on Form 1040. Framework 1040 helps students navigate topics by explaining how tax concepts are organized.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (broadly defined).....	\$xx,xxx
Less: Exclusions.....	(x,xxx)
Gross income.....	\$xx,xxx
<small>FORM 1040 (p. 11)</small>	
12 Business income or (loss). Attach Schedule C or C-EZ.....	(x,xxx)
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	(x,xxx)
14 Other gains or (losses). Attach Form 4797.....	(x,xxx)
Less: Deductions for adjusted gross income.....	(x,xxx)
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction.....	(x,xxx)
Personal and dependency exemptions.....	(x,xxx)
Taxable income.....	\$xx,xxx
Tax on taxable income (see Tax Tables or Tax Rate Schedules).....	\$ x,xxx
Less: Tax credits (including income taxes withheld and prepaid).....	(xxx)
Tax due (or refund).....	\$ xxx

Use this chapter-opening Framework 1040, which shows the topics as they appear in the individual tax formula, to understand where on Form 1040 these chapter topics would appear.

FINANCIAL DISCLOSURE INSIGHTS Tax and Book Depreciation

A common book-tax difference relates to the depreciation amounts that are reported for GAAP and Federal income tax purposes. Typically, tax depreciation deductions are accelerated; that is, they are claimed in earlier reporting periods than is the case for financial accounting purposes.

Almost every tax law change since 1980 has included depreciation provisions that accelerate the related deductions relative to the expenses allowed under GAAP. Accelerated cost recovery deductions represent a means by which the taxing jurisdiction infuses the business with cash flow created by the reduction in the year's tax liabilities.

For instance, recently, about one-quarter of General Electric's deferred tax liabilities related to depreciation differences. For Toyota's and Ford's depreciation differences, that amount was about one-third. And for the trucking firm Ryder Systems, depreciation differences accounted for all but 1 percent of the deferred tax liabilities.

FINANCIAL DISCLOSURE INSIGHTS:

Tax professionals need to understand how taxes affect the income statement and balance sheet. **Financial Disclosure Insights**, appearing throughout the text, use current data about existing taxpayers to highlight book-tax reporting differences, effective tax rates, and trends in reporting conventions.

TAX IN THE NEWS: Drawn from today's business and popular press, **Tax in the News** features enliven class discussions by presenting current issues that illustrate the chapter material and applying them to real life.



TAX IN THE NEWS Losses from Day Trading

Many investors were caught up with "rising market frenzy" during 2014. One such investor made 15,000 trades during the year. No stock was held more than one year, so each transaction resulted in a short-term capital gain or loss. Each trade had to be documented as to the basis for the stock sold, its holding period, and the selling price net of the sales commission. Unfortunately, there was a \$75,000 net short-term capital loss after all transactions were

accounted for. Only \$3,000 of this loss was deductible in 2014 because the investor had no long-term capital gains to offset the loss and there is an annual \$3,000 capital loss deduction limit. The \$72,000 balance of the loss carried forward could be deducted against capital gains of later years. However, the investor had no capital left to invest. Consequently, his annual loss deduction will be limited to \$3,000 for many years to come.



ETHICS & EQUITY Your Turn or Mine?

Natalie (a CPA), Mathew (an attorney), Jacob (a banker), and Avery (an insurance agent) all live and work in the same community. They have been friends since college. Every Friday, they have lunch together and make it a point to discuss some business matters. They take turns

paying for the group's lunches, and each deducts the amount he or she paid for the lunch as an entertainment expense. Presuming that one of the four is audited, do you anticipate any difficulty with the IRS? Explain.

ETHICS AND EQUITY: Most issues do not have just one correct answer. **Ethics & Equity** features will spark critical thinking and invite classroom discussion, enticing students to evaluate their own value system. Suggested answers to Ethics & Equity scenarios appear in the Solutions Manual.

TAX PLANNING: Most chapters include a separate section, with its own Learning Objective, calling attention to how the tax law can be applied to reach the taxpayer's goals. Tax planning applications and suggestions also appear throughout each chapter.

14-14 **TAX PLANNING**

14-14a **Importance of Capital Asset Status**

Why is capital asset status important? Capital asset status enables the taxpayer to be eligible for the alternative tax on net capital gain. Individuals who receive income in the form of long-term capital gains or qualified dividend income have an advantage over taxpayers who cannot receive income in these forms.

Capital asset status is also important because capital gains must be offset by capital losses. If a net capital loss results, the maximum deduction is \$3,000 per year.

Consequently, capital gains and losses must be segregated from other types of gains and losses and must be reported separately on Schedule D of Form 1040.



GLOBAL TAX ISSUES Expatriates and the Moving Expense Deduction

Expatriates, U.S. persons who accept work assignments overseas, enjoy several favorable tax advantages regarding foreign moves. First, the cost of storing household goods qualifies as a moving expense. This could lead to a major tax saving because expatriates do not ship most of their household effects to the foreign location. Furthermore, the cost of storage, particularly in a climate-controlled facility, is not insignificant.

The second advantage expatriates could enjoy is an exemption from the time test. Those who return to the United States to retire are absolved from the 39-week or 78-week work requirement. Thus, the return home expenses are treated as qualified moving expenses.

Source: Internal Revenue Code § 2170.

GLOBAL TAX ISSUES: The **Global Tax Issues** feature gives insight into the ways in which taxation is affected by international concerns and illustrates the effects of various events on tax liabilities across the globe.

Take your students from Motivation to Mastery with CengageNOW

CengageNOW is a powerful course management tool and online homework resource that elevates student thinking by providing superior content designed with the entire student workflow in mind.

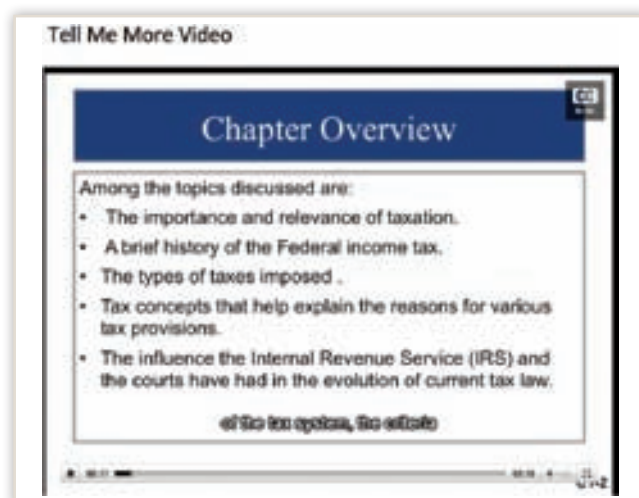


- **MOTIVATION:** engage students and better prepare them for class
- **APPLICATION:** help students learn problem-solving behavior and skills in order to complete taxation problems on their own
- **MASTERY:** help students make the leap from memorizing concepts to actual critical thinking

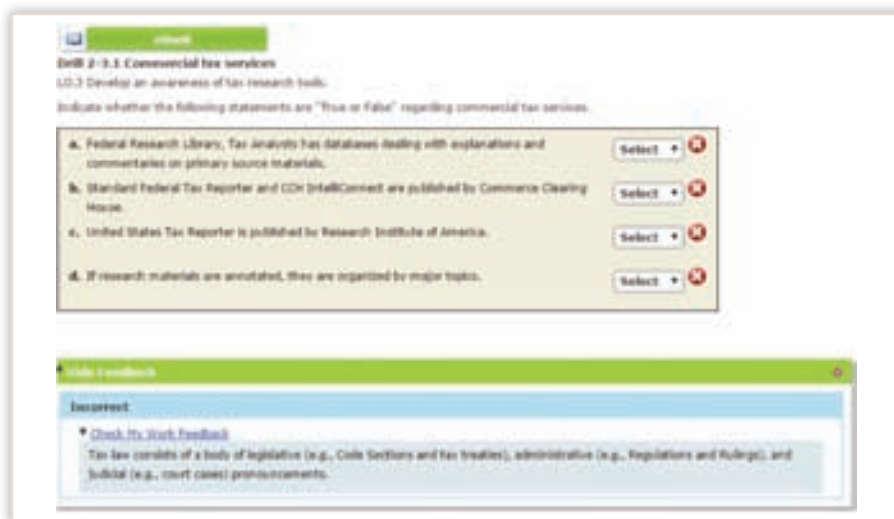
Motivation —

Many instructors find that students come to class unmotivated and unprepared. To help with engagement and preparedness, CengageNOW for SWFT offers the following features:

- **“Tell Me More” videos provide a summary of the chapter at a glance.** These videos help students become familiar with key terms and concepts presented in each chapter, prior to class lectures.
- **“Tax Drills” test students on key concepts and applications.** With three to five questions per learning objective, these “quick-hit” questions help students prepare for class lectures or review prior to an exam.



Application —



Students need to learn problem-solving behavior and skills in order to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need guidance. To help reinforce concepts and keep students on the right track, CengageNOW for SWFT offers the following:

- **End-of-chapter homework from the text** is expanded and enhanced to follow the workflow a professional would use to solve various client scenarios. These enhancements better engage students and encourage them to think like a tax professional.

- **Algorithmic versions** of end-of-chapter homework are available for computational exercises and at least 15 problems per chapter.
- **“Check My Work” Feedback.** Homework questions include immediate feedback so students can learn as they go. Levels of feedback include an option for “check my work” prior to submission of an assignment.
- **Post-Submission Feedback.** After submitting an assignment, students receive even more extensive feedback explaining why their answers were incorrect. Instructors can decide how much feedback their students receive and when, including the full solution.
- **Built-in Test Bank** for online assessment.

Mastery —

- **“What-If” versions of problems** allow students to develop a deeper understanding of the material as they are challenged to use their prior knowledge of the tax situations and critically think through new attributes to determine how the outcome will change.
- **Personalized Study Plan.** Complete with pre-tests, post-tests, an eBook, and practice quizzes. Designed to help give students additional support and prepare them for the exam.



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EXTENSIVELY REVISED. DEFINITELY UP TO DATE.

Each year the *South-Western Federal Taxation* series is updated with thousands of changes to each text. Some of these changes result from the feedback we receive from instructors and students in the form of reviews, focus groups, web surveys, and personal e-mail correspondence to our authors and team members. Other changes come from our careful analysis of the evolving tax environment. **We make sure that every tax law change relevant to the introductory taxation course was considered, summarized, and fully integrated into the revision of text and supplementary materials.**

The *South-Western Federal Taxation* authors have made every effort to keep all of the chapters up to date and accurate. All chapters of the *Comprehensive Volume* contain the following general changes for the 2016 Edition.

- Streamlined chapter content (where applicable) to clarify material and make it easier for students to understand.
- Revised numerous materials as the result of changes caused by indexing of statutory amounts.
- Revised Problem Materials. Added Computational Exercises and CPA Exam problems for additional skill-building by the reader.
- Updated *Tax in the News* items with coverage of recent events.
- Added guideposts to make Examples easier to use.
- Updated Chapter Outlines to provide an overview of the material and to make it easier to locate specific topics.
- Revised *Financial Disclosure Insights* and *Global Tax Issues* as to current developments.

Chapter 1

- Updated materials to reflect inflation indexation including the unified transfer tax credit and exemption amount, annual gift tax exclusion amount, and FICA base amount.
- Updated information related to interest on assessments and refunds.
- Added a Concept Summary on the major types of taxes imposed in the United States and the political jurisdictions that impose these taxes.

Chapter 2

- Updated references and citations throughout the chapter.
- Revised and clarified text and examples throughout the chapter.

Chapter 3

- Updated materials to reflect inflation indexation.
- Expanded discussion of the additional taxes to support the Medicare system.
- Added discussion on Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States.

Chapter 4

- Discussed inversion issue as well as individuals renouncing their U.S. citizenship in a *Global Tax Issues* item.
- Added additional case reference for the alimony and child-related contingency issue.

Chapter 5

- Updated materials to reflect inflation indexation.
- Covered new § 529A ABLE plans, added by legislation late in 2014.
- Added a new *Global Tax Issues* item on a GAO report about lack of evidence that foreign earned income exclusion aids U.S. exports.
- Improved terminology to clarify dividend and other corporate distributions.

Chapter 6

- For ease in reference, placed the more common deductions *for* AGI in Exhibit format.
- Reviewed the facts of a recent case whereby a U.S. taxpayer incurred a large fine for making a foreign bribe in contravention of the Foreign Corrupt Practices Act (FCPA).
- Discussed new rules promulgated by the IRS regarding when repairs and maintenance must be capitalized or can be expensed.

Chapter 7

- Revised and clarified text and examples throughout the chapter, such as for rules on treatment of R&D expenditures.
- Added a new *Tax in the News* item about lost bitcoin.
- Modified material to reflect annual indexation for inflation.

Chapter 8

- Revised and updated text and examples throughout the chapter.

- Streamlined material on MACRS special rules and amortization.
- Updated materials to reflect tax extender legislation involving additional first-year depreciation and § 179 expense election.

Chapter 9

- Updated the standard mileage allowance for 2015.
- Added two Concept Summaries related to moving expenses.
- Added a Concept Summary on the deductibility of regular education expenses.
- Simplified the summary dealing with the many tax provisions involving education.
- Updated various retirement contribution amounts for inflation.

Chapter 10

- Revised and clarified examples throughout the chapter.
- Updated chapter materials for 2015 inflation adjustments and legislative changes.
- Eliminated discussion of rarely used charitable contribution exceptions (i.e., a limitation on the deduction of capital gain property and the reduced deduction election).
- Added two new *Tax in the News* items and updated one regarding the impact of the overall limitation on itemized deductions on President and Mrs. Obama's 2013 tax return.
- Enhanced Concept Summary 10.3 by linking the points in the Concept Summary to particular text examples.
- Streamlined discussion of the interest deduction material.

Chapter 11

- Added a new *Tax in the News* item describing a unique aspect of the tax law definition of passive activities.
- Noted the authority that grants material participation status to an owner of an LLC or LLP based on the taxpayer's general involvement in the business.
- Developed a new Concept Summary that illustrates the relationship of the at-risk and passive activity loss limitations.
- Clarified the meaning of the term "deduction equivalent."
- Provided a new Concept Summary identifying common investment loss limitation provisions contained in the Federal income tax law.
- Converted two tables to Concept Summaries.

Chapter 12

- Updated chapter materials for inflation adjustments.
- Updated various computational formulas and amounts.
- Revised discussion of general business credit.
- Added material concerning Affordable Care Act.

Chapter 13

- Added a discussion of the tax implications of virtual currency (bitcoin) and related IRS Notice 2014–21.
- Simplified discussion of basis allocation related to nontaxable stock rights.
- Clarified discussion of the holding period for gifted property and property acquired from a decedent.
- Updated the *Tax in the News* item related to cost basis reporting.
- Revised and clarified text and examples throughout the chapter.
- Simplified discussion and examples related to like-kind exchanges.
- Updated Form 8824 illustration.
- Simplified the tax planning material on the sale of a principal residence.

Chapter 14

- Revised and clarified text and examples throughout the chapter.
- Revised Concept Summary 14.7.

Chapter 15

- Added the *Tax in the News* item "Does the AMT Accomplish Its Goals?"
- Created new Concept Summaries 12.1 and 12.2.
- Modified and updated the *Tax in the News* item "AMT Liabilities by State."
- Revised discussion of the ACE adjustment.
- Revised tax planning discussion, "Avoiding Preferences and Adjustments."

Chapter 16

- Clarified eligibility for making a § 444 election.
- Broadened discussion of treatment of advance payments received by accrual method taxpayers.
- Explained the concept of positive and negative § 481(a) adjustments.

- Updated to reflect new method change procedures of Revenue Procedures 2015–13 and 2015–14.

Chapter 17

- Placed further emphasis on differences between the income taxation of individuals and C corporations.
- Updated text and problem materials to reflect current indexation.
- Revised and clarified text and numerous examples in the chapter.

Chapter 18

- Developed a new Concept Summary that illustrates the major shareholder consequences of a taxable property transaction as compared to one that is tax deferred under § 351.
- Added a Concept Summary that shows the tax rules that apply when liabilities are transferred in property transactions, including the special rules that apply in a § 351 transaction.
- Provided a new *Tax in the News* item that describes ways in which local and state jurisdictions compete to attract new businesses and employers in exchange for tax breaks.

Chapter 19

- Included a Concept Summary that reflects the tax effect of noncash property distributions made by a corporation.
- Updated several *Tax in the News* items and added one new *Tax in the News* item.
- Added a new Concept Summary that illustrates the fundamental differences between a stock redemption treated as a dividend and a stock redemption treated as a sale or exchange.
- Streamlined the discussion of § 303 stock redemptions.

Chapter 20

- Reduced the discussion of the use of the installment method in a complete liquidation.
- Added the *Financial Disclosure Insights* item “When an Acquisition Fails.”

Chapter 21

- Modified and relocated the discussion of guaranteed payments to clarify their effect on partnership operations.

- Incorporated a Form 1065 as part of the Big Picture example.
- Placed added emphasis on the proper use of Form 1065 as a means of reporting partnership operations.

Chapter 22

- Updated statistics as to S corporation and LLC Federal income tax filings.
- Clarified the treatment of a QSSS.
- Revised explanations concerning straight debt.
- Reduced discussion of the Form 1120S Schedule M-3.
- Revised discussion of effects of losses on stock and debt basis.

Chapter 23

- Revised chapter materials on prohibited transactions, private foundations, unrelated business income definition, debt-financed property, indebtedness and income, and annual filing requirements.
- Updated statistics on the non-profit sector in the U.S. and the data and comments in the *Tax in the News* item “Who Are the Donors?”
- Revised and clarified text and examples throughout the chapter.

Chapter 24

- Updated statistics in the *Tax in the News* item “Paying the States’ Bills.”
- Revised the *Tax in the News* item “Tax Incentives for Hollywood Glitter.”
- Modified the *Tax in the News* item “So Where Did You Work Today?”
- Updated comments about the states’ apportionment factors and treatment of Federal S corporations.
- Revised the *Tax in the News* item “How Do You Tax a Cloud?”
- Reduced coverage of “Other State and Local Taxes.”
- Reduced tax planning materials for “Selecting the Optimal State in Which to Operate.”

Chapter 25

- Revised and clarified text and examples throughout the chapter.
- Revised introductory statistics about the global

economy, modified Exhibit 25.1 to include additional countries and added local taxes to the tax rates, updated the withholding rates in Exhibit 25.4, and updated various indexed amounts and limitations.

- Modified the discussion of the sourcing rules for personal services income, revised the discussion of foreign corporations controlled by U.S. entities, and reduced coverage of overall foreign losses and nonresident aliens engaged in a U.S. trade or business.

Chapter 26

- Updated statistics as to the size and operations of the IRS.
- Revised the *Tax in the News* item “How Big is the Tax Gap?”
- Updated statistics in the *Ethics & Equity* item “Our Taxing System of Self-Assessment.”
- Updated interest rates that apply to underpayments and overpayments.
- Revised the *Tax in the News* item “First-Time Tax Violators Can Get Off with Just a Warning.”
- Updated material concerning the licensing of tax preparers.

- Updated material about Circular 230 treatment of contingent fees.
- Revised tax planning materials concerning penalties.

Chapter 27

- Updated various amounts for indexation.
- Revised material as to the historical background of U.S. transfer taxation.
- Reduced material involving gift loans.
- Reduced discussion of gross estate inclusion of annuities.

Chapter 28

- Modified the contents of Exhibit 28.1.
- Modified the discussion “What Is an Estate?”
- Modified the discussion of the fiduciary entity’s tax year.
- Updated materials regarding indexed tax rate schedules for 2015.
- Expanded discussion of tax planning for additional taxes on the fiduciary’s investment income, and moved it to Tax Planning Considerations.

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Concerns about income inequity and job creation will keep income tax issues at the forefront of Congressional discussions throughout 2015 and 2016. Revenue raisers of all sorts will be considered as Federal budgets are crafted, including those to support the retirement and health care systems. Federal tax treatments of income from overseas sources also may be reviewed. While a comprehensive “tax reform” bill is not likely, there will be serious consideration of various proposals throughout the year involving broad-based tax changes. Expect provisions to be considered involving child tax credits and tax incentives for education, as well as other items to help middle-class taxpayers. Most likely the tax provisions that expired in 2014 will be extended to 2015 on a retroactive basis.

Congress may consider Federal corporate tax law changes during 2015–2016, including a decrease in the top tax rate and a move toward a territorial system in taxing income from overseas sources. Tax deferrals for unrepatriated global profits also may receive Congressional attention. State and local governments also have budget problems, and they are looking for new revenue sources, including an adoption of the unitary concept and a broadening of the income and sales/use tax bases.

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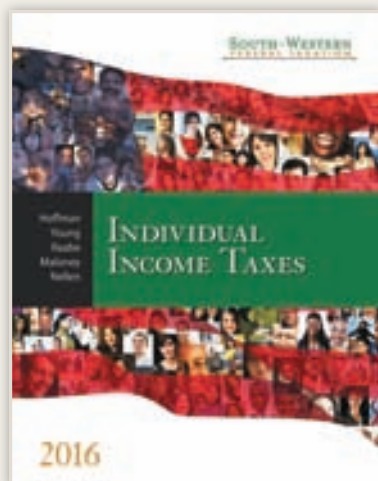
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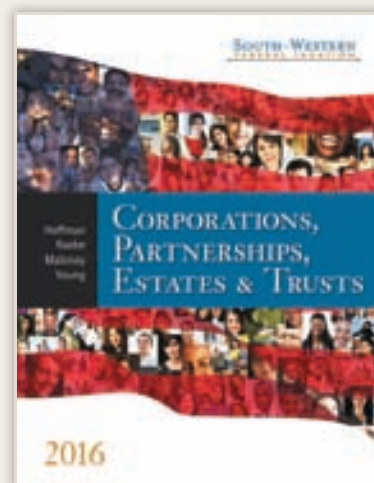
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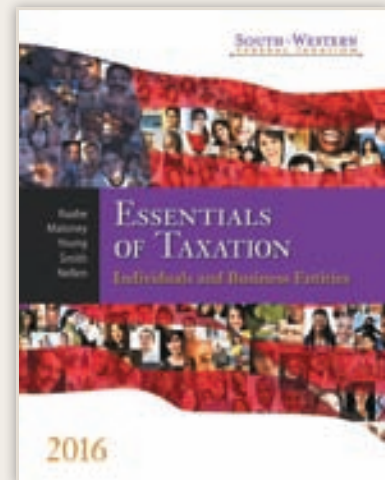
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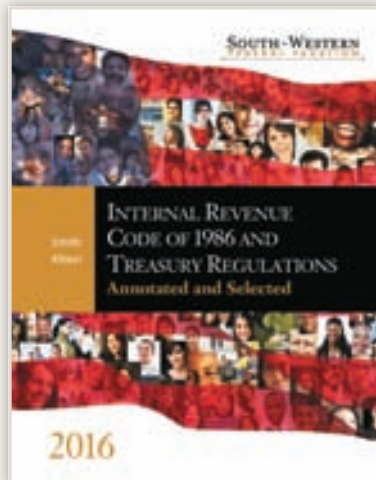
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PART

1

INTRODUCTION AND BASIC TAX MODEL

CHAPTER 1

An Introduction to Taxation and Understanding the Federal Tax Law

CHAPTER 2

Working with the Tax Law

CHAPTER 3

Computing the Tax

Part 1 provides an introduction to taxation in the United States. Although the primary orientation of this text is income taxation, other types of taxes are also discussed briefly. The purposes of the Federal tax law are examined, and the legislative, administrative, and judicial sources of Federal tax law, including their application to the tax research process, are analyzed. Part 1 concludes by introducing the basic tax model for the individual taxpayer and providing an overview of property transactions.

An Introduction to Taxation and Understanding the Federal Tax Law

LEARNING OBJECTIVES: *After completing Chapter 1, you should be able to:*

- LO.1** Demonstrate why taxation is important.
- LO.2** Describe some of the history and trends of the Federal income tax.
- LO.3** Assess some of the criteria for selecting a tax structure; recognize the components of a tax structure.
- LO.4** Identify the different taxes imposed in the United States at the Federal, state, and local levels.
- LO.5** Explain the administration of the tax law, including the audit process utilized by the IRS.
- LO.6** Evaluate some of the ethical guidelines involved in tax practice.
- LO.7** Recognize the economic, social, equity, and political considerations that justify various aspects of the tax law.
- LO.8** Describe the role played by the IRS and the courts in the evolution of the Federal tax system.

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- 1-2 A Brief History of U.S. Taxation, 1-3**
 - 1-2a Early Periods, 1-3
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THE BIG PICTURE

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FAMILY AND TAXES—A TYPICAL YEAR

Travis and Betty Carter are married and live in a state that imposes both a sales tax and an income tax. They have two children, April (age 17) and Martin (age 18). Travis is a mining engineer who specializes in land reclamation. After several years with a mining corporation, Travis established a consulting practice that involves a considerable amount of travel. Betty is a registered nurse who, until recently, was a homemaker. In November of this year, she decided to reenter the job market and accepted a position with a medical clinic. The Carters live only a few blocks from Ernest and Mary Walker, Betty Carter's parents. The Walkers are retired and live on interest, dividends, and Social Security benefits.

Various developments occurring during the year with possible tax ramifications are summarized below.

- The ad valorem property taxes on the Carters' residence are increased, while those on the Walkers' residence are lowered.
- When Travis registers an automobile purchased last year in another state, he is forced to pay a sales tax to his home state.
- As an anniversary present, the Carters gave the Walkers a recreational vehicle (RV).
- When Travis made a consulting trip to Chicago, the client withheld Illinois state income tax from the payment made to Travis for his services.
- Travis employs his children to draft blueprints and prepare scale models for use in his work. Both April and Martin have had training in drafting and topography.
- Early in the year, the Carters are audited by the state on an income tax return filed several years ago. Later in the year, they are audited by the IRS on a Form 1040 they filed for the same year. In each case, a tax deficiency and interest were assessed.
- The Walkers are audited by the IRS. Unlike the Carters, they did not have to deal with an agent, but settled the matter by mail.

Explain these developments and resolve the issues raised.

Read the chapter and formulate your response.

The primary objective of this chapter is to provide an overview of the Federal tax system. Among the topics discussed are the following:

- The importance and relevance of taxation.
- A brief history of the Federal income tax.
- The types of taxes imposed at the Federal, state, and local levels.
- Some highlights of tax law administration.
- Tax concepts that help explain the reasons for various tax provisions.
- The influence the Internal Revenue Service (IRS) and the courts have had in the evolution of current tax law.

LO.1

Demonstrate why taxation is important.

1-1 LEARNING AND COPING WITH TAXATION

The study of taxation is important because taxes permeate our society. Even the simplest of decisions can carry tax implications. Does it matter, for example, which son or daughter pays the medical bills when all of four adult children contribute to the support of their widowed mother? Or when you buy a new car, does it matter whether you finance the purchase through the dealership or with a home equity loan arranged by a bank?

Effectively coping with taxes often involves making decisions based on timing considerations. Does the employee who is trying to decide between a traditional Individual Retirement Account (IRA) and a Roth IRA want the tax benefit up front (i.e., traditional) or at retirement (i.e., Roth)? Timing considerations are paramount when it is deemed desirable to accelerate (or defer) income or accelerate (or defer) deductions for any one year.

Taxation is anything but stagnant. As circumstances change, so does the tax result. Consider, for example, what happens when an investor becomes a dealer—capital gains and losses on the disposition of property now convert to ordinary income and losses. Or consider an employee who becomes self-employed—the safe harbor of withholdings is lost, and new quarterly payments on income and self-employment taxes must be made. Even the purchase of a home can result in significant change—new mortgage interest and property tax deductions cause the standard deduction to be replaced by itemization on Schedule A.

One of the most common changes in circumstance that can affect the tax position of an individual is marital status. Getting married, although usually favorable, can sometimes have negative tax results. Even more diverse and pronounced, however, are the effects of a divorce. Are the payments from one ex-spouse to another ex-spouse deductible? From the standpoint of the recipient, are such payments taxable? Who can claim the children as dependents? Do these issues carry over to same-sex unions and divorces?

The study of taxation teaches us not to overlook the less obvious taxes that can block our intended objective. A grandson inherits his grandmother's personal residence. He has heard that rental property can generate significant income tax benefits. But does he realize that a change of ownership may unlock an appraised-value freeze on the property or that conversion from residential to income-producing use will cause an increase in ad valorem taxes on realty? Thus, an attractive income tax result could be materially diminished by adverse property tax consequences.

It is essential in working with taxation to maintain a balanced perspective. A corporation that is deciding where to locate a new factory does not automatically select the city or state that offers the most generous tax benefits. Nor does the person who is retiring to a warmer climate pick Belize over Arizona because the former has no income tax while the latter does. Tax considerations should not control decisions, but they remain one of many factors to be considered.

The study of taxation involves reviewing a multitude of rules and exceptions and, when possible, trying to understand the justification for them. But the desired goal of this learning process is the ability to recognize issues that carry tax implications. Suppose, for example, that you come upon a situation that involves a discharge of indebtedness. If you know that forgiveness of debt results in income but there are exceptions to this rule, the battle is won! The issue has been identified, and the outcome (i.e., when an exception applies) can easily be resolved by additional research.

1-2 A BRIEF HISTORY OF U.S. TAXATION

1-2a Early Periods

An income tax was first enacted in 1634 by the English colonists in the Massachusetts Bay Colony, but the Federal government did not adopt this form of taxation until 1861. In fact, both the Federal Union and the Confederate States of America used the income tax to raise funds to finance the Civil War.

When the Civil War ended, the need for additional revenue disappeared and the income tax was repealed. Once again the Federal government was able to finance its operations almost exclusively from customs duties (tariffs). It is interesting to note that the courts held that the Civil War income tax was not contrary to the Constitution.

When a new Federal income tax on individuals was enacted in 1894, its opponents were prepared and were able to successfully challenge its constitutionality. In *Pollock v. Farmers' Loan and Trust Co.*, the U.S. Supreme Court found that taxes on the income of real and personal property were the legal equivalent of a tax on the property involved and, therefore, required apportionment.¹

A Federal corporate income tax, enacted by Congress in 1909, fared better in the judicial system. The U.S. Supreme Court found this tax to be constitutional because it was treated as an excise tax.² In essence, it was a tax on the right to do business in the corporate form. As such, it was likened to a form of the franchise tax.³ Since the corporate form of doing business had been developed in the late nineteenth century, it was an unfamiliar concept to the framers of the U.S. Constitution. Because a corporation is an entity created under law, jurisdictions possess the right to tax its creation and operation. Using this rationale, many states still impose franchise taxes on corporations.

The ratification of the Sixteenth Amendment to the U.S. Constitution in 1913 sanctioned both the Federal individual and corporate income taxes and, as a consequence, neutralized the continuing effect of the *Pollock* decision.

1-2b Revenue Acts

Following ratification of the Sixteenth Amendment, Congress enacted the Revenue Act of 1913. Under this Act, the first Form 1040 was due on March 1, 1914. The law allowed various deductions and personal exemptions of \$3,000 for a single individual and \$4,000 for married taxpayers. For those times, these were large exemptions that excluded all but the more wealthy taxpayers from the new income tax. Rates ranged from a low of 2 percent to a high of 6 percent. The 6 percent rate applied only to taxable income in excess of \$500,000!⁴

Various revenue acts were passed between 1913 and 1939. In 1939, all of these revenue laws were codified into the Internal Revenue Code of 1939. In 1954, a similar codification of the revenue law took place. The current law is entitled the Internal Revenue Code of 1986, which largely carries over the provisions of the 1954 Code. To date, the Code has been amended numerous times since 1986. This matter is discussed further in Chapter 2 under Origin of the Internal Revenue Code.

¹3 AFTR 2602, 15 S.Ct. 912 (USSC, 1895). See Chapter 2 for an explanation of the citations of judicial decisions.

²*Flint v. Stone Tracy Co.*, 3 AFTR 2834, 31 S.Ct. 342 (USSC, 1911).

³See the discussion of state franchise taxes later in the chapter.

⁴This should be contrasted with the highest 2015 tax rate of 39.6%, which applies once taxable income exceeds \$413,200 for single taxpayers and \$464,850 for married taxpayers.

LO.2

Describe some of the history and trends of the Federal income tax.

1-2c Historical Trends

The income tax has proved to be a major source of revenue for the Federal government. Exhibit 1.1, which contains a breakdown of the primary sources,⁵ demonstrates the importance of the income tax. *Estimated* income tax collections from individuals and corporations amount to 59 percent of the total receipts.

The need for revenues to finance the war effort during World War II converted the income tax into a *mass tax*. For example, in 1939, less than 6 percent of the U.S. population was subject to the Federal income tax. In 1945, more than 74 percent of the population was subject to the Federal income tax.⁶

Certain changes in the income tax law are of particular significance in understanding the Federal income tax. In 1943, Congress passed the Current Tax Payment Act, which provided for the first pay-as-you-go tax system. A pay-as-you-go income tax system requires employers to withhold for taxes a specified portion of an employee's wages. Persons with income from other than wages may have to make quarterly payments to the IRS for estimated taxes due for the year.

One trend that has caused considerable concern is the increasing complexity of the Federal income tax laws. In the name of tax reform, Congress has added to this complexity by frequently changing the tax laws. Most recent legislation continues this trend. Increasingly, this complexity forces many taxpayers to seek assistance. According to recent estimates, about 56 percent of individual taxpayers who file a return pay a preparer, and one-third purchase tax software. At this time, therefore, substantial support exists for tax law simplification.

LO.3

Assess some of the criteria for selecting a tax structure; recognize the components of a tax structure.

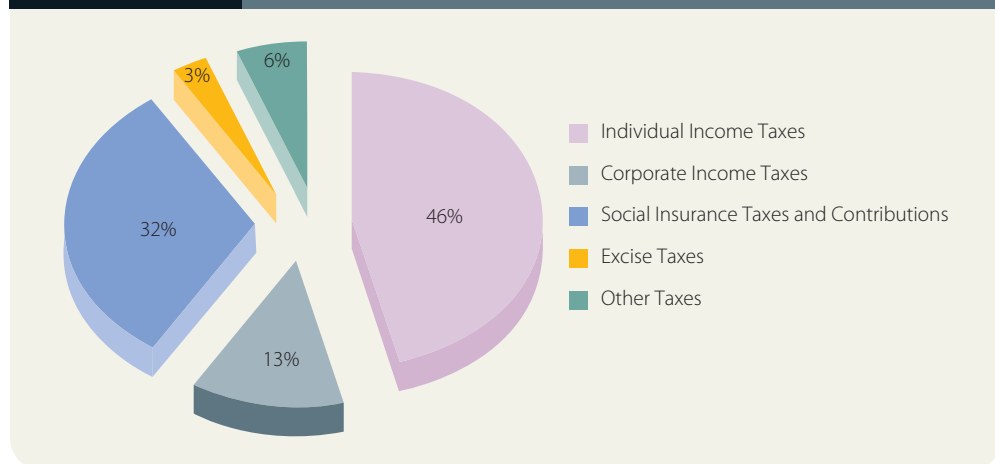
1-3 CRITERIA USED IN THE SELECTION OF A TAX STRUCTURE

In the eighteenth century, Adam Smith identified the following *canons of taxation*, which are still considered when evaluating a particular tax structure:⁷

- *Equality*. Each taxpayer enjoys fair or equitable treatment by paying taxes in proportion to his or her income level. Ability to pay a tax is one of the measures of how equitably a tax is distributed among taxpayers.

EXHIBIT 1.1

Federal Budget Receipts—2015



⁵www.whitehouse.gov/omb.

⁶Richard Goode, *The Individual Income Tax* (Washington, D.C.: The Brookings Institution, 1964), pp. 2–4.

⁷*The Wealth of Nations* (New York: Dutton, 1910), Book V, Chapter II, Part II.



TAX IN THE NEWS Adam Smith Stopped Too Soon

The American Institute of Certified Public Accountants (AICPA) has issued suggestions for Federal tax policy. Titled *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, the monograph sets forth 10 tax principles that are commonly used as indicators of desirable tax policy.

The first four principles are adapted from Adam Smith's *The Wealth of Nations*. The other six are summarized as follows:

- The tax system should be simple.
- The tax should be neutral in terms of its effect on business decisions.

- The tax system should not reduce economic growth and efficiency.
- The tax should be clear and readily understood so that taxpayers know about it and know when it applies.
- The tax should be structured so as to minimize non-compliance.
- The tax system should enable the IRS to predict the amount and timing of revenue production.

Source: Based on a Tax Policy Concept Statement issued by the Tax Division of the AICPA.

- *Convenience.* Administrative simplicity has long been valued in formulating tax policy. If a tax is easily assessed and collected and its administrative costs are low, it should be favored. An advantage of the existing withholding system (pay-as-you-go) is its convenience for taxpayers.
- *Certainty.* A tax structure is *good* if the taxpayer can readily predict when, where, and how a tax will be levied. Individuals and businesses need to know the likely tax consequences of a particular type of transaction.
- *Economy.* A *good* tax system involves only nominal collection costs by the government and minimal compliance costs on the part of the taxpayer.

By these canons, the Federal income tax is a contentious product. *Equality* is present as long as one accepts ability to pay as an ingredient of this component. *Convenience* exists due to a heavy reliance on pay-as-you-go procedures. *Certainty* probably generates the greatest controversy. In one sense, certainty is present because a mass of administrative and judicial guidelines exists to aid in interpreting the tax law. In another sense, however, certainty does not exist because many questions remain unanswered and frequent changes in the tax law by Congress lessen stability. Particularly troublesome in this regard are tax provisions that are given a limited life (e.g., only one year). If not extended by Congress, the provisions expire. All too often, Congress does not give the necessary approval in time, and the extension has to be applied retroactively. *Economy* is present if only the collection procedure of the IRS is considered. Although the government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected, the complexity of our current tax structure imposes substantial taxpayer compliance costs.

1-4 THE TAX STRUCTURE

1-4a Tax Base

A tax base is the amount to which the tax rate is applied. In the case of the Federal income tax, the tax base is *taxable income*. As noted later in the chapter (Exhibit 1.2), taxable income is gross income reduced by certain deductions (both business and personal).

1-4b Tax Rates

Tax rates are applied to the tax base to determine a taxpayer's liability. The tax rates may be proportional or progressive. A tax is *proportional* if the rate of tax remains constant for any given income level. Examples of proportional taxes include most excise taxes, general sales taxes, and employment taxes (FICA and FUTA).

EXAMPLE

1

Bill has \$10,000 of taxable income and pays a tax of \$3,000, or 30%. Bob's taxable income is \$50,000, and the tax on this amount is \$15,000, or 30%. If this constant rate is applied throughout the rate structure, the tax is proportional.

A tax is *progressive* if a higher rate of tax applies as the tax base increases. The Federal income tax, Federal gift and estate taxes, and most state income tax rate structures are progressive.

EXAMPLE

2

If Cora, a married individual filing jointly, has taxable income of \$10,000, her tax for 2015 is \$1,000 for an average tax rate of 10%. If, however, Cora's taxable income is \$50,000, her tax will be \$6,578 for an average tax rate of 13.2%. The tax is progressive because higher rates are applied to greater amounts of taxable income.

1-4c Incidence of Taxation

The degree to which various segments of society share the total tax burden is difficult to assess. Assumptions must be made concerning who absorbs the burden of paying the tax. For example, because dividend payments to shareholders are not deductible by a corporation and are generally taxable to shareholders, the same income is subject to a form of double taxation. Concern over double taxation is valid to the extent that corporations are *not* able to shift the corporate tax to the consumer through higher commodity prices. Many research studies have shown a high degree of shifting of the corporate income tax, converting it into a consumption tax that is borne by the ultimate purchasers of goods.

The progressiveness of the Federal income tax rate structure for individuals has varied over the years. As late as 1986, for example, there were 15 rates, ranging from 0 to 50 percent. These later were reduced to two rates of 15 and 28 percent. Currently, there are seven rates ranging from 10 to 39.6 percent.

LO.4

Identify the different taxes imposed in the United States at the Federal, state, and local levels.

1-5 MAJOR TYPES OF TAXES

Why does a text devoted primarily to the Federal individual income tax discuss state and local taxes? A simple illustration shows the importance of non-Federal taxes.

EXAMPLE

3

Rick is employed by Flamingo Corporation in San Antonio, Texas, at a salary of \$74,000. Rick's employer offers him a chance to transfer to its New York City office at a salary of \$94,000. A quick computation indicates that the additional taxes (Federal, state, and local) involve approximately \$12,000.

Although Rick must consider many nontax factors before he decides on a job change, he should also evaluate the tax climate. How do state and local taxes compare? For example, neither Texas nor San Antonio imposes an income tax, but New York State and New York City do. Consequently, what appears to be a \$20,000 pay increase is only \$8,000 when the additional taxes of \$12,000 are taken into account.

1-5a Property Taxes

Correctly referred to as **ad valorem taxes** because they are based on value, property taxes are a tax on wealth, or capital. In this regard, they have much in common with estate taxes and gift taxes discussed later in the chapter. Although property taxes do not tax income, the income actually derived (or the potential for any income) may be relevant insofar as it affects the value of the property being taxed.

Property taxes fall into *two* categories: those imposed on realty and those imposed on personalty, or assets other than land and buildings. Both have added importance because they usually generate a deduction for Federal income tax purposes (see Chapter 10).

Ad Valorem Taxes on Realty

Property taxes on realty are used exclusively by states and their local political subdivisions, such as cities, counties, and school districts. They represent a major source of revenue for *local* governments, but their importance at the *state* level has waned over the past few years. Some states, for example, have imposed freezes on upward revaluations of residential housing.

How realty is defined can have an important bearing on which assets are subject to tax. This is especially true in jurisdictions that do not impose ad valorem taxes on personalty. Primarily a question of state property law, **realty** generally includes real estate and any capital improvements that are classified as fixtures. Simply stated, a *fixture* is something so permanently attached to the real estate that its removal will cause irreparable damage. A built-in bookcase might well be a fixture, whereas a movable bookcase would not be a fixture. Certain items such as electrical wiring and plumbing cease to be personalty when installed in a building and become realty.

The following are some of the characteristics of ad valorem taxes on realty:

- Property owned by the Federal government is exempt from tax. Similar immunity usually is extended to property owned by state and local governments and by certain charitable organizations.
- Some states provide for lower valuations on property dedicated to agricultural use or other special uses (e.g., wildlife sanctuaries). Reductions in appraised valuations may also be available when the property is subject to a conservation easement (e.g., a limitation on further development).
- Some states partially exempt the homestead, or personal residence, portion of property from taxation.
- Lower taxes may apply to a residence owned by a taxpayer aged 65 or older.
- When non-income-producing property (e.g., a personal residence) is converted to income-producing property (e.g., a rental house), typically the appraised value increases.
- Some jurisdictions extend immunity from tax for a specified period of time (*a tax holiday*) to new or relocated businesses. A tax holiday can backfire, however, and cause more harm than good. If it is too generous, it can damage the local infrastructure (e.g., less funding for public works and education).

The Big Picture

Return to the facts of *The Big Picture* on p. 1-1. Why did the Walkers' property taxes decrease while those of the Carters increased? A likely explanation is that one (or both) of the Walkers achieved senior citizen status. In the case of the Carters, the assessed value of their property was probably increased (see the following discussion). Perhaps they made significant home improvements (e.g., kitchen/bathroom renovation or addition of a sundeck).

EXAMPLE

4

Unlike the ad valorem tax on personalty (see the next section), the tax on realty is difficult to avoid. Because real estate is impossible to hide, a high degree of taxpayer compliance is not surprising. The only avoidance possibility that is generally available is associated with the assessed value of the property. For this reason, the assessed value of the property—particularly, a value that is reassessed upward—may be subject to controversy and litigation.

The history of the ad valorem tax on realty has been marked by inconsistent application due to a lack of competent tax administration and definitive guidelines for assessment procedures. In recent years, however, some significant improvements have occurred. Some jurisdictions, for example, have computerized their reassessment procedures so that they immediately affect all property located within the jurisdiction.

Several jurisdictions provide homeowners with a measure of protection from increased property taxes by “freezing” existing assessments and limiting future upward adjustments. Such restrictions on reassessments, however, do not carry over to the new

owner when the property is sold. Thus, such measures tend to lock in ownership and restrict the mobility of those who might otherwise change residences.

Ad Valorem Taxes on Personalty

Personalty can be defined as all assets that are not realty. It may be helpful to distinguish between the *classification* of an asset (realty or personalty) and the *use* to which it is put. Both realty and personalty can be either business use or personal use property. Examples include a residence (realty that is personal use), an office building (realty that is business use), surgical instruments (personalty that is business use), and regular wearing apparel (personalty that is personal use).⁸

Personalty can also be classified as tangible property or intangible property. For ad valorem tax purposes, intangible personalty includes stocks, bonds, and various other securities (e.g., bank shares).

The following generalizations may be made concerning the ad valorem taxes on personalty:

- Particularly with personalty devoted to personal use (e.g., jewelry and household furnishings), taxpayer compliance ranges from poor to zero. Some jurisdictions do not even attempt to enforce the tax on these items. For automobiles devoted to personal use, many jurisdictions have converted from value as the tax base to arbitrary license fees based on the weight of the vehicle. Some jurisdictions also consider the vehicle's age (e.g., automobiles six years or older are not subject to the ad valorem tax because they are presumed to have little, if any, value).
- For personalty devoted to business use (e.g., inventories, trucks, machinery, equipment), taxpayer compliance and enforcement procedures are measurably better.
- Which jurisdiction possesses the authority to tax movable personalty (e.g., railroad rolling stock) always has been and continues to be a troublesome issue.
- A few states levy an ad valorem tax on intangibles such as stocks and bonds. Taxpayer compliance may be negligible if the state lacks a means of verifying security transactions and ownership.

1-5b Transaction Taxes

Transaction taxes, which characteristically are imposed at the manufacturer's, wholesaler's, or retailer's level, cover a wide range of transfers. Like many other types of taxes (e.g., income taxes, estate taxes, and gift taxes), transaction taxes usually are not within the exclusive province of any one level of taxing authority (Federal, state, or local government). As the description implies, these levies place a tax on transfers of property and normally are determined by multiplying the value involved by a percentage rate.

Federal Excise Taxes

Long one of the mainstays of the Federal tax system, Federal **excise taxes** had declined in relative importance until recently. In recent years, Congress substantially increased the Federal excise taxes on items such as tobacco products, fuel and gasoline sales, and air travel. Other Federal excise taxes include the following:

- Manufacturers' excise taxes on trucks, trailers, tires, firearms, sporting equipment, and coal and the gas guzzler tax on automobiles.⁹
- Alcohol taxes.
- Miscellaneous taxes (e.g., the tax on wagering).

⁸The distinction, important for ad valorem and for Federal income tax purposes, often becomes confused when personalty is referred to as "personal" property to distinguish it from "real" property. This designation does not give a complete picture of what is involved. The description "personal" residence, however, is clearer, because a residence can be identified as being realty. What is meant in this case is realty that is personal use property.

⁹The gas guzzler tax is imposed on the manufacturers of automobiles (both domestic and foreign) and increases in amount as the mileage ratings per gallon of gas decrease. For example, a 2014 Bentley Continental GTC manages 17 miles per gallon in combined city/highway driving and starts at \$178,422. The gas guzzler tax is \$3,000.

The list of transactions covered, although seemingly impressive, has diminished over the years. At one time, for example, there was a Federal excise tax on admission to amusement facilities (e.g., theaters) and on the sale of items such as leather goods, jewelry, furs, and cosmetics.

When reviewing the list of both Federal and state excise taxes, one should recognize the possibility that the tax laws may be trying to influence social behavior. For example, the gas guzzler tax is intended as an incentive for the automobile companies to build fuel-efficient cars.

State and Local Excise Taxes

Many state and local excise taxes parallel the Federal version. Thus, all states tax the sale of gasoline, liquor, and tobacco products; however, unlike the Federal version, the rates vary significantly. For gasoline products, for example, compare the 39.5 cents per gallon imposed by the state of California with the 4.0 cents per gallon levied by the state of Florida. For tobacco sales, contrast the 17 cents per pack of 20 cigarettes in effect in Missouri with the \$4.35 per pack applicable in the state of New York. Given the latter situation, is it surprising that the smuggling of cigarettes for resale elsewhere is so widespread?

Other excise taxes found at some state and local levels include those on admission to amusement facilities, on the sale of playing cards, and on prepared foods. Most states impose a transaction tax on the transfer of property that requires the recording of documents (e.g., real estate sales).¹⁰ Some extend the tax to the transfer of stocks and other securities.

Over the last few years, two types of excise taxes imposed at the local level have become increasingly popular: the hotel occupancy tax and the rental car “surcharge.” Because they tax the visitor who cannot vote, they are a political windfall and are often used to finance special projects that generate civic pride (e.g., convention centers and state-of-the-art sports arenas). These levies can be significant, as demonstrated by Houston’s hotel tax of 17 percent [6 percent (state) + 7 percent (city) + 2 percent (county) + 2 percent (sports authority)].

General Sales Taxes

The distinction between an excise tax and a general **sales tax** is easy to make. One is restricted to a particular transaction (e.g., the 18.4 cents per gallon Federal excise tax on the sale of gasoline), while the other covers a multitude of transactions (e.g., a 5 percent tax on *all* retail sales). In actual practice, however, the distinction is not always that clear. Some state statutes exempt certain transactions from the application of the general sales taxes (e.g., sales of food to be consumed off the premises and sales of certain medicines and drugs). Also, it is not uncommon to find that rates vary depending on the commodity involved. Many states, for example, allow preferential rates for the sale of agricultural equipment or apply different rates (either higher or lower than the general rate) to the sale of automobiles. With many of these special exceptions and classifications of rates, a general sales tax can take on the appearance of a collection of individual excise taxes.

A **use tax** is an ad valorem tax, usually at the same rate as the sales tax, on the use, consumption, or storage of tangible property purchased outside the state but used in the state. The purpose of a use tax is to prevent the avoidance of a sales tax. Every state that imposes a general sales tax levied on the consumer also has a use tax. Alaska, Delaware, Montana, New Hampshire, and Oregon have neither tax. There is no Federal general sales or use tax.

¹⁰This type of tax has much in common with the stamp tax levied by Great Britain on the American colonies during the pre-Revolutionary War period in U.S. history.

The Big Picture

EXAMPLE

5

Return to the facts of *The Big Picture* on p. 1-1. The payment Travis made when he registered the car is probably a use tax. When the car was purchased in another state, likely no (or a lesser) sales tax was levied. The current payment makes up for the amount of sales tax he would have paid had the car been purchased in his home state.

The use tax is difficult to enforce for many purchases; therefore, the purchaser often does not pay it. In some cases, for example, it may be worthwhile to make purchases through an out-of-state mail-order business or the websites of certain vendors. In spite of shipping costs, the avoidance of the local sales tax that otherwise might be incurred can lower the cost of such products as computer components. Some states are taking steps to curtail this loss of revenue. For items such as automobiles (refer to Example 5), the use tax probably will be collected when the purchaser registers the item in his or her home state.

ETHICS & EQUITY Making Good Use of Out-of-State Relatives

Marcus, a resident of Texas, has found the ideal gift for his wife in celebration of their upcoming wedding anniversary—a \$22,000 diamond tennis bracelet. However, Marcus is appalled at the prospect of paying the state and local sales tax of \$1,815 (combined rate of 8.25 percent). He, therefore, asks his aunt, a resident of Montana,

to purchase the bracelet. The jewelry store lists the aunt as the buyer and ships the bracelet to her. Prior to the anniversary, Marcus receives the bracelet from his aunt. Is Marcus able to save \$1,815 on the present for his wife? What can go wrong?

Local general sales taxes, over and above those levied by the state, are common. It is not unusual to find taxpayers living in the same state but paying different general sales taxes due to the location of their residence.

EXAMPLE

6

Pete and Sam both live in a state that has a general sales tax of 3%. Sam, however, resides in a city that imposes an additional general sales tax of 2%. Even though Pete and Sam live in the same state, one is subject to a rate of 3%, while the other pays a tax of 5%.

For various reasons, some jurisdictions will suspend the application of a general sales tax. Frequently, the “sales tax holiday” occurs in late summer when it applies to back-to-school clothing and supplies. Some states use sales tax holidays to encourage the purchase of energy-conserving appliances and hurricane preparedness items.

Severance Taxes

Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources (e.g., oil, gas, iron ore, or coal). Therefore, a tax is imposed when the natural resources are extracted.

For some states, severance taxes can be a significant source of revenue. Due to the severance tax on oil production, Alaska has been able to avoid both a state income tax and a state general sales tax.

1-5C Taxes on Transfers at Death

The right to transfer property or to receive property upon the death of the owner may be subject to estate and/or inheritance taxes. Consequently, such taxes fall into the

category of excise taxes. If the tax is imposed on the right to pass property at death, it is classified as an **estate tax**. If it taxes the right to receive property from a decedent, it is termed an **inheritance tax**. As is typical of other types of excise taxes, the value of the property transferred provides the base for determining the amount of the tax.

The Federal government imposes only an estate tax. Many state governments, however, levy inheritance taxes, estate taxes, or both. Some states (e.g., Florida and Texas) levy neither tax. An estate tax is levied on the estate of the decedent, whereas an inheritance tax is paid from the property received by the heir.

At the time of her death, Wilma lived in a state that imposes an inheritance tax but not an estate tax. Mary, one of Wilma's heirs, lives in the same state. Wilma's estate is subject to the Federal estate tax, and Mary is subject to the state inheritance tax.

EXAMPLE

7

The Federal Estate Tax

The Revenue Act of 1916 incorporated the estate tax into the tax law. The tax was originally intended to prevent large concentrations of wealth from being kept in a family for many generations. Whether this objective has been accomplished is debatable. Like the income tax, estate taxes can be reduced through various planning procedures.

The gross estate includes property the decedent owned at the time of death. It also includes property interests, such as life insurance proceeds paid to the estate or to a beneficiary other than the estate if the deceased-insured had any ownership rights in the policy. Quite simply, the gross estate represents property interests subject to Federal estate taxation.¹¹ All property included in the gross estate is valued as of the date of death or, if the alternate valuation date is elected, six months later.¹²

Deductions from the gross estate in arriving at the taxable estate include funeral and administration expenses; certain taxes; debts of the decedent; casualty losses¹³ incurred during the administration of the estate; transfers to charitable organizations; and, in some cases, the marital deduction. The *marital deduction* is available for amounts actually passing to a surviving spouse (a widow or widower).

Once the taxable estate has been determined and certain taxable gifts made by the decedent during life have been added to it, the estate tax can be computed. From the amount derived from the appropriate tax rate schedules, various credits should be subtracted to arrive at the tax, if any, that is due.¹⁴ Although many other credits are also available, probably the most significant is the *unified transfer tax credit*. The main reason for this credit is to eliminate or reduce the estate tax liability for certain estates. For 2015, the amount of the credit is \$2,117,800. Based on the estate tax rates, the credit exempts a tax base of up to \$5.43 million.

Ned made no taxable gifts before his death in 2015. If Ned's taxable estate amounts to \$5.43 million or less, no Federal estate tax is due because of the application of the unified transfer tax credit. Under the tax law, the estate tax on a taxable estate of \$5.43 million is \$2,117,800.

EXAMPLE

8

State Taxes on Transfers at Death

As noted earlier, some states levy an inheritance tax, an estate tax, or both. The two forms of taxes on transfers at death differ according to whether the tax is imposed on the heirs or on the estate.

¹¹For further information on these matters, see Chapter 27.

¹²See the discussion of the alternate valuation date in Chapter 13.

¹³For a definition of *casualty losses*, see the Glossary in Appendix C.

¹⁴For tax purposes, it is crucial to appreciate the difference between a deduction and a credit. A *credit* is a dollar-for-dollar reduction of tax

liability. A *deduction*, however, benefits the taxpayer only to the extent of his or her tax bracket. A taxpayer in a 50% tax bracket, for example, would need \$2 of deductions to prevent \$1 of tax liability. In contrast, \$1 of credit neutralizes \$1 of tax liability.

Characteristically, an inheritance tax divides the heirs into classes based on their relationship to the decedent. The more closely related the heir, the lower the rates imposed and the greater the exemption allowed. Some states completely exempt from taxation amounts passing to a surviving spouse.

1-5d Gift Taxes

Like taxes on transfers at death, a **gift tax** is an excise tax levied on the right to transfer property. In this case, however, the tax is imposed on transfers made during the owner's life and not at death. A gift tax applies only to transfers that are not offset by full and adequate consideration.

EXAMPLE

9

Carl sells property worth \$50,000 to his daughter for \$1,000. Although property worth \$50,000 has been transferred, only \$49,000 represents a gift, because this is the portion not supported by full and adequate consideration.

The Federal Gift Tax

First enacted in 1932, the Federal gift tax was intended to complement the estate tax. If lifetime transfers by gift were not taxed, it would be possible to avoid the estate tax and escape taxation entirely.

Only taxable gifts are subject to the gift tax. For this purpose, a taxable gift is measured by the fair market value of the property on the date of transfer less the *annual exclusion per donee* and, in some cases, less the *marital deduction*, which allows tax-free transfers between spouses. In 2014 and 2015, each donor is allowed an annual exclusion of \$14,000 for each donee.¹⁵

EXAMPLE

10

On December 31, 2014, Louise (a widow) gives \$14,000 to each of her four married children, their spouses, and her eight grandchildren. On January 2, 2015, she repeats the procedure, again giving \$14,000 to each recipient. Due to the annual exclusion, Louise has not made a taxable gift, although she transferred \$224,000 [$\$14,000$ (annual exclusion) \times 16 (donees)] in 2014 and \$224,000 [$\$14,000$ (annual exclusion) \times 16 (donees)] in 2015, for a total of \$448,000 ($\$224,000 + \$224,000$).

A married couple may make a special election that allows one-half of the gift made by the donor-spouse to a third party to be treated as being made by the nondonor-spouse. This *gift splitting* effectively allows the annual exclusion to double. Also, it allows the use of the nondonor-spouse's unified transfer tax credit and may lower the tax rates that will apply.

The Big Picture

EXAMPLE

11

Return to the facts of *The Big Picture* on p. 1-1. Although the value of the RV is not stated, it is highly likely to exceed the annual exclusion allowed of \$56,000 [$\$14,000$ (annual exclusion) \times two donees (the Walkers) \times two donors (the Carters)]. Thus, a taxable gift results, and a Form 709 (Gift Tax Return) must be filed. Whether any gift tax is due depends on what past taxable gifts the Carters have made and how much of their unified transfer tax credit (see the following discussion) is still available.

The gift tax rate schedule is the same as that applicable to the estate tax. The schedule is commonly referred to as the *unified transfer tax rate schedule*.

¹⁵The purpose of the annual exclusion is to avoid the need to report and pay a tax on *modest* gifts. Without the exclusion, the IRS could face a real problem of taxpayer noncompliance. The annual exclusion is indexed as

the level of inflation warrants. The exclusion was \$13,000 from 2009 through 2012.

The Federal gift tax is *cumulative* in effect. What this means is that the tax base for current taxable gifts includes past taxable gifts. Although a credit is allowed for prior gift taxes, the result of adding past taxable gifts to current taxable gifts could be to force the donor into a higher tax bracket.¹⁶ Like the Federal estate tax rates, the Federal gift tax rates are progressive (see Example 2 earlier in this chapter).

The unified transfer tax credit is available for all taxable gifts. As was the case with the Federal estate tax, the credit for 2014 is \$2,081,800 (which covers taxable gifts up to \$5,340,000) and for 2015 is \$2,117,800 (which covers taxable gifts up to \$5,430,000). There is, however, only one unified transfer tax credit, and it applies to both taxable gifts and the Federal estate tax. In a manner of speaking, therefore, once the unified transfer tax credit has been exhausted for Federal gift tax purposes, it is no longer available to insulate a decedent's transfers from the Federal estate tax, except to the extent of the excess of the credit amount for estate tax purposes over that for gift tax purposes.

Making lifetime gifts of property carries several tax advantages over passing the property at death. If income-producing property is involved (e.g., marketable securities and rental real estate), a gift may reduce income taxes for the family unit by shifting subsequent income to lower-bracket donees. If the gift involves property that is expected to appreciate in value (e.g., life insurance policies, real estate, and artwork), future increases in value will be assigned to the donee and will not be included in the donor's estate. Also important is that due to the annual exclusion (\$14,000 per donee in 2015), some of the gift is not subject to any gift tax. Recall that the gift-splitting election enables married donors to double up on the annual exclusion.

Neither the receipt of a gift nor an inheritance will cause income tax consequences to the donee or heir.

1-5e **Income Taxes**

Income taxes are levied by the Federal government, most states, and some local governments. The trend in recent years has been to place greater reliance on this method of taxation. This trend is not consistent with what is happening in other countries, and in this sense, our system of taxation is somewhat different.

Income taxes generally are imposed on individuals, corporations, and certain fiduciaries (estates and trusts). Most jurisdictions attempt to ensure the collection of income taxes by requiring pay-as-you-go procedures, including withholding requirements for employees and estimated tax prepayments for all taxpayers.

Federal Income Taxes

The Federal income tax imposed on individuals follows the formula set forth in Exhibit 1.2. The formula for the individual income tax establishes the framework followed in the text. Beginning with Chapter 3, each component of the formula is illustrated and explained. In large part, the text coverage of individual taxpayers follows the same order as the components in the formula.

Like its individual counterpart, the Federal corporate income tax is progressive in nature. But its application does not require the computation of adjusted gross income (AGI) and does not provide for the standard deduction and personal and dependency exemptions. All allowable deductions of a corporation fall into the business-expense category. In effect, therefore, the taxable income of a corporation is the difference between gross income and deductions. Chapter 17 discusses the rules relating to the determination of taxable income of corporations.¹⁷

¹⁶For further information on the Federal gift tax, see Chapter 27.

¹⁷For an in-depth treatment of the Federal income tax as it affects corporations, partnerships, estates, and trusts, see Chapters 17 through 21, 27, and 28.

EXHIBIT 1.2

Formula for Federal Income Tax on Individuals

Income (broadly defined)	\$xx,xxx
Less: Exclusions (income that is not subject to tax)	<u>(x,xxx)</u>
Gross income (income that is subject to tax)	\$xx,xxx
Less: Certain deductions (usually referred to as deductions for adjusted gross income)	<u>(x,xxx)</u>
Adjusted gross income	\$xx,xxx
Less: The greater of certain personal and employee deductions (usually referred to as <i>itemized deductions</i>)	
<i>or</i>	
The standard deduction (including any additional standard deduction)	(x,xxx)
<i>and</i>	
Less: Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u><u>\$xx,xxx</u></u>
Tax on taxable income (see the Tax Tables and Tax Rate Schedules in Appendix A)	\$ x,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes)	<u>(xxx)</u>
Tax due (or refund)	<u><u>\$ xxx</u></u>

State Income Taxes

All but the following states impose an income tax on individuals: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire and Tennessee impose an individual income tax only on interest and dividends.

Some of the characteristics of state income taxes are summarized as follows:

- With few exceptions, all states require some form of withholding procedures.
- Most states use as the tax base the income determination made for Federal income tax purposes.
- A minority of states go even further and impose a flat rate on AGI as computed for Federal income tax purposes. Several apply a rate to the Federal income tax liability. This is often referred to as the *piggyback* approach to state income taxation. Although the term *piggyback* does not lend itself to a precise definition, in this context, it means making use, for state income tax purposes, of what was done for Federal income tax purposes.
- Some states are somewhat eroding the piggyback approach by “decoupling” from selected recent tax reductions passed by Congress. The purpose of the decoupling is to retain state revenue that would otherwise be lost. In other words, the state cannot afford to allow its taxpayers the same deductions for state purposes that are allowed for Federal purposes.
- Because of the tie-ins to the Federal return, a state may be notified of any changes made by the IRS upon audit of a Federal return. In recent years, the exchange of information between the IRS and state taxing authorities has increased. Lately, some states (e.g., California) are playing a major role in revealing tax shelter abuses to the IRS.
- Most states allow a deduction for personal and dependency exemptions. Some states substitute a tax credit for a deduction.
- A diminishing minority of states allow a deduction for Federal income taxes.
- Virtually all state income tax returns provide checkoff boxes for donations to various causes. Many are dedicated to medical research and wildlife programs, but

special projects are not uncommon. For example, Oklahoma had one to retire the debt incurred for its new capitol dome, while Wisconsin uses one for maintenance and operating costs of Lambeau Field (home of the Green Bay Packers). These checkoff boxes have been criticized as adding complexity to the returns and misleading taxpayers.¹⁸

- Most states allow their residents some form of tax credit for income taxes paid to other states.

The Big Picture

Return to the facts of *The Big Picture* on p. 1-1. Because the income earned by Travis on his Chicago trip will be subject to tax by his home state, he probably will be able to claim an offsetting tax credit. Whether this negates the double taxation of the same income depends on the amount of credit allowed.

EXAMPLE

12

- The objective of most states is to tax the income of residents and those who regularly conduct business in the state (e.g., nonresidents who commute to work). These states also purport to tax the income of nonresidents who earn income in the state on an itinerant basis. Usually, however, the only visitors actually taxed are highly paid athletes and entertainers. This so-called *jock tax* has been much criticized as being discriminatory due to its selective imposition.
- The due date for filing generally is the same as for the Federal income tax (the fifteenth day of the fourth month following the close of the tax year).
- Some states have occasionally instituted amnesty programs that allow taxpayers to pay back taxes (and interest) on unreported income with no (or reduced) penalty. In many cases, the tax amnesty has generated enough revenue to warrant the authorization of follow-up programs covering future years.¹⁹ Amnesties usually include other taxes as well (e.g., sales, franchise, and severance). One major advantage of amnesty programs is that they uncover taxpayers who were previously unknown to the taxing authority.
- Because many consumers do not pay state and local sales taxes on out-of-state purchases, state income tax returns often contain a separate line for the reporting of the use tax that is due. The instructions to the form may provide tables of suggested amounts based on income levels for those who lack records on the purchases not previously taxed. Thus, the income tax return serves as a means of collecting use taxes.

Nearly all states have an income tax applicable to corporations. It is difficult to determine those that do not because a state franchise tax (discussed later in the chapter) sometimes is based in part on the income earned by the corporation.

Local Income Taxes

Cities imposing an income tax include, but are not limited to, Baltimore, Cincinnati, Cleveland, Detroit, Kansas City (Missouri), New York, Philadelphia, and St. Louis. The application of a city income tax is not limited to local residents.

1-5f Employment Taxes

Classification as an employee usually leads to the imposition of **employment taxes** and to the requirement that the employer withhold specified amounts for income taxes. The material that follows concentrates on the two major employment taxes: FICA (Federal

¹⁸Many taxpayers do not realize that they are paying for the checkoff donation (usually with some of their income tax refund). Unlike the presidential election campaign fund available for Federal income tax purposes (\$3 in this case), the contribution is *not made* by the government.

¹⁹Although the suggestion has been made, no comparable amnesty program has been offered for the Federal income tax. The IRS has, however, offered exemption from certain penalties for taxpayers who disclose offshore bank accounts and participation in certain tax shelters.

Insurance Contributions Act—commonly referred to as the Social Security tax) and FUTA (Federal Unemployment Tax Act). Both taxes can be justified by social and public welfare considerations: FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.

Employment taxes come into play only if two conditions are satisfied. First, is the individual involved an *employee* (as opposed to *self-employed*)? The differences between an employee and a self-employed person are discussed in Chapter 9. Second, if the individual involved is an employee, is he or she covered under FICA or FUTA or both?²⁰

FICA Taxes

The **FICA tax** rates and wage base have increased steadily over the years. It is difficult to imagine that the initial rate in 1937 was only 1 percent of the first \$3,000 of covered wages. Thus, the maximum tax due was only \$30.

The FICA tax has two components: Social Security tax (old age, survivors, and disability insurance) and Medicare tax (hospital insurance). The Social Security tax rate is 6.2 percent for 2015 and generally does not change each year. The base amount does vary and is \$118,500 for 2015 (\$117,000 for 2014).

The Medicare portion of FICA is applied at a rate of 1.45 percent and, unlike Social Security, is not subject to any dollar limitation. An additional .9 percent is imposed on earned income (including self-employment income) above \$200,000 (single filers) or \$250,000 (married filing jointly). Unlike the Social Security tax of 6.2 percent and the regular Medicare portion of 1.45 percent, an employer does not have to match the employees' .9 percent.

A spouse employed by another spouse is subject to FICA. However, children under the age of 18 who are employed in a parent's unincorporated trade or business are exempted.

The Big Picture

EXAMPLE

13

Return to the facts of *The Big Picture* on p. 1-1. Presuming that April and Martin perform meaningful services for Travis (which the facts seem to imply), they are legitimate employees. April is not subject to Social Security tax because she is under the age of 18. However, Martin is 18 and needs to be covered. Furthermore, recall that Betty Carter is now working at a medical clinic and will likewise be subject to Social Security tax. Travis, as an independent contractor, is subject to self-employment tax.

Taxpayers who are not employees (e.g., sole proprietors and independent contractors) may also be subject to Social Security taxes. Known as the self-employment tax, the rates are 12.4 percent for Social Security and 2.9 percent for Medicare, or twice that applicable to an employee. The additional .9 percent Medicare tax also covers situations involving high net income from self-employment. The Social Security tax is imposed on net self-employment income up to a base amount of \$118,500 for 2015. The Medicare portion of the self-employment tax is not subject to any dollar limitation.

To defray the cost of extended medical care, Congress enacted a special tax on investment income.²¹ For this purpose, “investment income” is often referred to as “unearned income” because it is not generated by the performance of services. A tax of 3.8 percent is imposed on investment income when a taxpayer's modified adjusted gross income (MAGI) exceeds certain threshold amounts.²² The threshold amounts, which are not adjusted for inflation each year, are \$250,000 for married taxpayers and

²⁰Chapter 12 includes coverage of the self-employment tax (the Social Security and Medicare taxes for self-employed persons). See also Circular E, *Employer's Tax Guide*, issued by the IRS as Publication 15.

²¹Enacted as part of the Health Care and Education Reconciliation Act of 2010.

²²MAGI is adjusted gross income (see Exhibit 1.2 and the bottom of page 1 of Form 1040) plus any foreign income or excluded foreign housing costs.

\$200,000 for single taxpayers. Investment income generally includes passive income (e.g., taxable interest, dividends, and capital gains). This tax was first assessed in 2013. For an in-depth discussion, see Chapter 12.

FUTA Taxes

The purpose of the **FUTA tax** is to provide funds the states can use to administer unemployment benefits. This leads to the somewhat unusual situation of one tax being handled by both Federal and state governments. The end result of such joint administration is to compel the employer to observe two sets of rules. Thus, state and Federal returns must be filed and payments made to both governmental units.

In 2015, FUTA is 6 percent on the first \$7,000 of covered wages paid during the year to each employee. The Federal government allows a credit for FUTA paid (or allowed under a merit rating system) to the state. The credit cannot exceed 5.4 percent of the covered wages. Thus, the amount required to be paid to the IRS could be as low as .6 percent (6.0% – 5.4%).

States follow a policy of reducing the unemployment tax on employers who experience stable employment. Thus, an employer with little or no employee turnover might find that the state rate drops to as low as .1 percent or, in some states, even to zero. The reason for the merit rating credit is that the state has to pay fewer unemployment benefits when employment is steady.

FUTA, unlike FICA, is paid entirely by the employer. A few states, however, levy a special tax on employees to provide either disability benefits or supplemental unemployment compensation or both.

1-5g Other U.S. Taxes

To complete the overview of the U.S. tax system, some missing links need to be covered that do not fit into the classifications discussed elsewhere in this chapter.

Federal Customs Duties

One tax that has not yet been mentioned is the tariff on certain imported goods.²³ Generally referred to as customs duties or levies, this tax, together with selective excise taxes, provided most of the revenues needed by the Federal government during the nineteenth century. In view of present times, it is remarkable that tariffs and excise taxes alone paid off the national debt in 1835 and enabled the U.S. Treasury to pay a surplus of \$28 million to the states.

In recent years, tariffs have served the nation more as an instrument for carrying out protectionist policies than as a means of generating revenue. Thus, a particular U.S. industry might be saved from economic disaster, so the argument goes, by imposing customs duties on the importation of foreign goods that can be sold at lower prices. Protectionists contend that the tariff thereby neutralizes the competitive edge held by the producer of the foreign goods. History shows that tariffs often lead to retaliatory action on the part of the nation or nations affected.

Miscellaneous State and Local Taxes

Most states impose a franchise tax on corporations. Basically, a **franchise tax** is levied on the right to do business in the state. The base used for the determination of the tax varies from state to state. Although corporate income considerations may come into play, this tax most often is based on the capitalization of the corporation (either with or without certain long-term indebtedness).

Closely akin to the franchise tax are **occupational fees** applicable to various trades or businesses (e.g., a liquor store license; a taxicab permit; or a fee to practice a profession such as law, medicine, or accounting). Most of these are not significant revenue

²³Less-developed countries that rely principally on one or more major commodities (e.g., oil or coffee) are prone to favor *export* duties as well.

producers and fall more into the category of licenses than taxes. The revenue derived is used to defray the cost incurred by the jurisdiction in regulating the business or profession in the interest of the public good.

The Big Picture

EXAMPLE

14

Return to the facts of *The Big Picture* on p. 1-1. Although the facts do not mention the matter, both Travis and Betty will almost certainly pay occupational fees—Travis for engineering and Betty for nursing.

Concept Summary 1.1 provides an overview of the major taxes existing in the United States and specifies which political jurisdiction imposes them.

Concept Summary 1.1

Overview of Taxes in the United States

Type of Tax	Imposed by Jurisdiction		
	Federal	State	Local
Property taxes:			
<i>Ad valorem</i> on realty	No	Yes	Yes
<i>Ad valorem</i> on personalty	No	Yes	Yes
Transaction taxes:			
Excise	Yes	Yes	Few*
General sales	No	Most	Some
Severance	Yes**	Most	No
Estate	Yes	Some	No
Inheritance	No	Some	No
Gift	Yes	Few	No
Income taxes:			
Corporations	Yes	Most	Few
Individuals	Yes	Most	Few
Employment taxes:			
FICA	Yes	No	No
FUTA	Yes	Yes	No
Customs duties	Yes	No	No
Franchise taxes	No	Yes	No
Occupational taxes or fees***	Yes	Yes	Yes

* An example of a local excise tax might be a tax on hotel occupancy.

** For Federal public lands and continental-shelf areas.

*** An example is a fee to operate a beauty salon or barbershop.

1-5h **Proposed U.S. Taxes**

Considerable dissatisfaction with the U.S. Federal income tax has led to several recent proposals that, to say the least, are rather drastic in nature. One proposal, the flat tax, would retain the income tax but with substantial change. Two other proposals, the value added tax and the national sales tax, would replace the Federal income tax with an entirely different system of taxation.

The Flat Tax

One proposal is for a **flat tax** that would replace the current graduated income tax with a single rate of 17 percent. Large personal exemptions (e.g., approximately \$30,000 for



GLOBAL TAX ISSUES VAT in USA? Not Likely!

The United States is the only country in the OECD (Organization of Economic Cooperation and Development) that does not have a value added tax (VAT). Approximately 80 countries around the world use a VAT, ranging from 5 percent in Taiwan to 27 percent in Hungary.

Although the adoption of a VAT by the United States has been suggested, such a move seems unlikely. Because the VAT is an effective generator of revenue, many fear that it

would fuel big government and lead to the expansion of entitlements available to certain sectors of the general public. Also, the VAT is regressive in its effect and, in practice, does not alleviate the burden of the income tax.

Source: United States Council for International Business, www.uscib.org/index.asp, and based on Ernest Christian and Gary Robbins, "A Value-Added Tax Fuels Big Government," *Wall Street Journal*, August 24, 2011, p. A13.

a family of four) would allow many low- and middle-income taxpayers to pay no tax. All other deductions would be eliminated, and no tax would be imposed on income from investments.

Various other versions of the flat tax have been suggested that would retain selected deductions (e.g., interest on home mortgages and charitable contributions) and not exclude all investment income from taxation.

The major advantage of the flat tax is its simplicity. Everyone agrees that the current Federal income tax is inappropriately complex. Consequently, compliance costs are disproportionately high. Proponents of the flat tax further believe that simplifying the income tax will significantly reduce the current "tax gap" (i.e., the difference between the amount of taxes that *should be paid* and what is *actually paid*).

Political considerations are a major obstacle to the enactment of a flat tax in its pure form. Special interest groups, such as charitable organizations and mortgage companies, are likely to strongly oppose the elimination of a tax deduction that benefits their industry. In addition, there is uncertainty as to the economic effects of a flat tax.

Value Added Tax

The **value added tax (VAT)** is one of two proposals that would replace the Federal income tax. Under the VAT, a business would pay the tax (approximately 17 percent) on all of the materials and services required to manufacture its product. In effect, the VAT taxes the increment in value as goods move through production and manufacturing stages to the marketplace. Moreover, the VAT paid by the producer will be reflected in the selling price of the goods. Thus, the VAT is a tax on consumption. In fact, the VAT has been described by some as a "layered sales tax."

In spite of its extensive use by other countries (including Canada), the adoption of a VAT by the United States appears doubtful (see comments under "Global Tax Issues" above).

National Sales Tax

A **national sales tax** differs from a VAT in that it would be collected on the final sale of goods and services. Consequently, it is collected from the consumer, not from businesses that add value to the product. Like the VAT, the national sales tax is intended to replace the Federal income tax.

A current proposal for a national sales tax, called the "Fair Tax," would tax all purchases, including food and medicine, at approximately 23 percent. Exempt items include business expenses, used goods, and the costs of education. The "Fair Tax" would replace not only the income tax (both individual and corporate) but also payroll taxes (including the self-employment tax) and the gift and estate taxes.

Critics contend that both forms of consumption taxes, a VAT and a national sales tax, are regressive. They impose more of a burden on low-income taxpayers who must spend larger proportions of their incomes on essential purchases. The proposals attempt

to remedy this inequity by granting some sort of credit, rebate, or exemption to low-income taxpayers.

In terms of taxpayer compliance, a VAT is preferable to a national sales tax. Without significant collection efforts, a national sales tax could easily be circumvented by resorting to a barter system of doing business. Its high rate would also encourage smuggling and black market activities.

LO.5

Explain the administration of the tax law, including the audit process utilized by the IRS.

1-6 TAX ADMINISTRATION

1-6a Internal Revenue Service

The responsibility for administering the Federal tax laws rests with the Treasury Department. The IRS is part of the Department of the Treasury and is responsible for enforcing the tax laws. The Commissioner of Internal Revenue is appointed by the President and is responsible for establishing policy and supervising the activities of the IRS.

1-6b The Audit Process

Selection of Returns for Audit

Due to budgetary limitations, only a small number of tax returns are audited. The overall audit rate for individuals in 2013 dropped to .96 percent, the lowest percentage since 2005. Personnel cutbacks within the IRS can be expected to further reduce this rate for 2014. Keep in mind, however, that the chance for audit increases for higher-income taxpayers.

The IRS utilizes mathematical formulas and statistical sampling techniques to select tax returns that are most likely to contain errors and to yield substantial amounts of additional tax revenues upon audit. The mathematical formula yields what is called a Discriminant Index Formula (DIF) score. It is the DIF score given to a particular return that may lead to its selection for audit. Periodically, the IRS updates the DIF components by auditing a cross section of returns to determine the most likely areas of taxpayer non-compliance.

Although the IRS does not openly disclose all of its audit selection techniques, the following observations may be made concerning the probability of selection for audit:

- Certain groups of taxpayers are subject to audit much more frequently than others. These groups include individuals with large amounts of gross income, self-employed individuals with substantial business income and deductions, and taxpayers with prior tax deficiencies. Also vulnerable are businesses that receive a large proportion of their receipts in cash (e.g., cafés and small service businesses) and thus have a high potential for tax avoidance.

EXAMPLE

15

Jack owns and operates a liquor store on a cash-and-carry basis. Because all of Jack's sales are for cash, he might well be a prime candidate for an audit by the IRS. Cash transactions are easier to conceal than those made on credit.

- If information returns (e.g., Form 1099 or Form W-2) are not in substantial agreement with reported income, an audit can be anticipated.
- If an individual's itemized deductions are in excess of norms established for various income levels, the probability of an audit is increased.
- Filing of a refund claim by the taxpayer may prompt an audit of the return.
- Information obtained from other sources (e.g., informants and news items) may lead to an audit. Recently, for example, the IRS advised its agents to be on the alert for newspaper accounts of large civil court judgments. The advice was based on the assumption that many successful plaintiffs were not reporting as income the taxable punitive damages portion of awards.



TAX IN THE NEWS Pay or Shame!

States and local jurisdictions are learning that the threat of public humiliation can be rewarding. When someone owes taxes but does not pay, the prospect of having his or her name listed on a public website may make a difference. Often payment is made to avoid the cybershame that comes from being exposed as a tax deadbeat. Numerous states are publishing the names of tax delinquents

online. Some taxing jurisdictions have found the shaming procedure so productive that they maintain separate lists for different types of taxes (e.g., sales taxes and income taxes) or different types of delinquents (e.g., personal and business). As of yet, the IRS has not considered this approach for Federal tax scofflaws. Perhaps the length of the list would be too overwhelming!

The tax law permits the IRS to pay rewards to persons who provide information that leads to the detection and punishment of those who violate the tax laws. The rewards may not exceed 30 percent of the taxes, fines, and penalties recovered as a result of such information.

Information Leading to an IRS Audit

After 15 years of service, Rita is discharged by her employer, Dr. Smith. Shortly thereafter, the IRS receives an anonymous letter stating that Dr. Smith keeps two separate sets of books and that the one used for tax reporting substantially understates his cash receipts.

EXAMPLE

16

During a divorce proceeding, it is revealed that Leo, a public official, kept large amounts of cash in a shoe box at home. This information is widely disseminated by the news media and comes to the attention of the IRS. Needless to say, the IRS is interested in knowing whether these funds originated from a taxable source and, if so, whether they were reported on Leo's income tax returns.

EXAMPLE

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Types of Audits

Once a return is selected for audit, the taxpayer is notified. If the issue involved is minor, the matter often can be resolved simply by correspondence (a **correspondence audit**) between the IRS and the taxpayer.

Other examinations are generally classified as either office audits or field audits. An **office audit** usually is restricted in scope and is conducted in the facilities of the IRS. In contrast, a **field audit** involves an examination of numerous items reported on the return and is conducted on the premises of the taxpayer or the taxpayer's representative.

The Big Picture

Return to the facts of *The Big Picture* on p. 1-1. The audit of the Walkers by the IRS obviously was a correspondence type. The reason for the audit was probably a minor oversight, such as the omission of some interest or dividend income. The audit of the Carters, however, was more serious—probably a field or office type. Because the Federal audit followed a state audit that was productive (i.e., led to the assessment of a deficiency), there may have been an exchange of information between the two taxing authorities—see p. 1-14 in this chapter.

EXAMPLE

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Upon the conclusion of the audit, the examining agent issues a Revenue Agent's Report (RAR) that summarizes the findings. The RAR will result in a refund (the tax was overpaid), a deficiency (the tax was underpaid), or a no change (the tax was correct) finding. If, during the course of an audit, a special agent accompanies (or takes over from) the regular auditor, this means the IRS suspects fraud. If the matter has progressed to an investigation for fraud, the taxpayer should retain competent counsel.

Settlement Procedures

If an audit results in an assessment of additional tax and no settlement is reached with the IRS agent, the taxpayer may attempt to negotiate a settlement with a higher level of the IRS. If an appeal is desired, an appropriate request must be made to the Appeals Division of the IRS. The Appeals Division is authorized to settle all disputes based on the *hazard of litigation* (the probability of favorable resolution of the disputed issue or issues if litigated). In some cases, a taxpayer may be able to obtain a percentage settlement or a favorable settlement of one or more disputed issues.

If a satisfactory settlement is not reached in the administrative appeal process, the taxpayer can litigate the case in the Tax Court, a Federal District Court, or the Court of Federal Claims. However, litigation is recommended only as a last resort because of the legal costs involved and the uncertainty of the final outcome. Tax litigation considerations are discussed more fully in Chapter 2.

1-6C Statute of Limitations

A **statute of limitations** is a provision in the law that offers a party a defense against a suit brought by another party after the expiration of a specified period of time. The purpose of a statute of limitations is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult because witnesses may no longer be available or evidence may have been lost or destroyed. Found at the state and Federal levels, such statutes cover a multitude of suits, both civil and criminal.

For our purposes, the relevant statutes deal with the Federal income tax. The two categories involved cover both the period of limitations applicable to the assessment of additional tax deficiencies by the IRS and the period applicable to claims for refunds by taxpayers.

Assessment by the IRS

Under the general rule, the IRS may assess an additional tax liability against a taxpayer within *three years* of the filing of the income tax return. If the return is filed early, the three-year period begins to run from the due date of the return (usually April 15 for a calendar year individual taxpayer). If the taxpayer files the return late (i.e., beyond the due date), the three-year period begins to run on the date filed.

If a taxpayer omits an amount of gross income in excess of 25 percent of the gross income reported on the return, the statute of limitations is increased to six years.

EXAMPLE

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For 2015, Mark, a calendar year taxpayer, reported gross income of \$400,000 on a timely filed income tax return. If Mark omitted more than \$100,000 ($25\% \times \$400,000$), the six-year statute of limitations would apply to the 2015 tax year.

The six-year provision on assessments by the IRS applies only to the omission of income and does not cover other factors that might lead to an understatement of tax liability, such as overstatement of deductions and credits.

There is *no* statute of limitations on assessments of tax if *no return* is filed or if a *fraudulent* return is filed.

Limitations on Refunds

If a taxpayer believes that an overpayment of Federal income tax was made, a claim for refund should be filed with the IRS. A *claim for refund*, therefore, is a request to the IRS that it return to the taxpayer excessive income taxes paid.²⁴

A claim for refund generally must be filed within *three years* from the date the return was filed *or* within *two years* from the date the tax was paid, whichever is later. Income tax returns that are filed early are deemed to have been filed on the date the return was due.

²⁴Generally, an individual filing a claim for refund should use Form 1040X.

1-6d Interest and Penalties

Interest rates are determined quarterly by the IRS based on the existing Federal short-term rate. Currently, the rates for tax refunds (overpayments) for individual taxpayers are the same as those applicable to assessments (underpayments). For the first quarter (January 1–March 31) of 2015, the rates are 3 percent for refunds and assessments.²⁵

For assessments of additional taxes, the interest begins running on the unextended due date of the return. With refunds, however, no interest is allowed if the overpayment is refunded to the taxpayer within 45 days of the date the return is filed. For this purpose, returns filed early are deemed to have been filed on the due date.

In addition to interest, the tax law provides various penalties for lack of compliance by taxpayers. Some of these penalties are summarized as follows:

- For *failure to file* a tax return by the due date (including extension), a penalty of 5 percent per month up to a maximum of 25 percent is imposed on the amount of tax shown as due on the return. Any fraction of a month counts as a full month.
- A penalty for *failure to pay* the tax due as shown on the return is imposed in the amount of .5 percent per month up to a maximum of 25 percent. Again, any fraction of a month counts as a full month. During any month in which both the failure to file penalty and the failure to pay penalty apply, the failure to file penalty is reduced by the amount of the failure to pay penalty.

Adam files his tax return 18 days after the due date of the return. Along with the return, he remits a check for \$1,000, which is the balance of the tax he owed. Disregarding the interest element, Adam's total penalties are as follows:

Failure to pay penalty (.5% × \$1,000)		\$ 5
Plus:		
Failure to file penalty (5% × \$1,000)	\$50	
Less failure to pay penalty for the same period	<u>(5)</u>	
Failure to file penalty		<u>45</u>
Total penalties		<u>\$50</u>

Note that the penalties for one full month are imposed even though Adam was delinquent by only 18 days. Unlike the method used to compute interest, any part of a month is treated as a whole month.

- A *negligence* penalty of 20 percent is imposed if any of the underpayment was for intentional disregard of rules and regulations without intent to defraud. The penalty applies to just that portion attributable to the negligence.

Cindy underpaid her taxes for 2013 in the amount of \$20,000, of which \$15,000 is attributable to negligence. Cindy's negligence penalty is \$3,000 (20% × \$15,000).

- Various penalties may be imposed in the case of *fraud*. Fraud involves specific intent on the part of the taxpayer to evade a tax. In the case of *civil* fraud, the penalty is 75 percent of the underpayment attributable to fraud. In the case of *criminal* fraud, the penalties can include large fines as well as prison sentences. The difference between civil and criminal fraud is one of degree. Criminal fraud involves the presence of willfulness on the part of the taxpayer. Also, the burden of proof, which is on the IRS in both situations, is more stringent for criminal fraud than for civil fraud. The negligence penalty is not imposed when the fraud penalty applies. For possible fraud situations, refer to Examples 16 and 17.

²⁵The rates applicable after March 31, 2015, were not available when this text went to press.

EXAMPLE

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EXAMPLE

21

1-6e Tax Practice

If a practitioner is a member of a profession such as law or public accounting, he or she must abide by certain ethical standards. Furthermore, the Internal Revenue Code imposes penalties upon the preparers of Federal tax returns who violate proscribed acts and procedures.

LO.6

Evaluate some of the ethical guidelines involved in tax practice.

Ethical Guidelines

The American Institute of CPAs has issued numerous pronouncements, called the “Statements on Standards for Tax Services,” dealing with CPAs engaged in tax practice. These pronouncements are *enforceable* as part of its Code of Professional Conduct. They include the following summarized provisions:

- Do not take questionable positions on a client’s tax return in the hope that the return will not be selected for audit by the IRS. Any positions taken should be supported by a good-faith belief that they have a realistic possibility of being sustained if challenged. The client should be fully advised of the risks involved and of the penalties that will result if the position taken is not successful.
- A practitioner can use a client’s estimates if they are reasonable under the circumstances. If the tax law requires receipts or other verification, the client should be so advised. In no event should an estimate be given the appearance of greater accuracy than is the case. For example, an estimate of \$1,000 should not be deducted on a return as \$999.
- Every effort should be made to answer questions appearing on tax returns. A question need not be answered if the information requested is not readily available, the answer is voluminous, or the question’s meaning is uncertain. The failure to answer a question on a return cannot be justified on the grounds that the answer could prove disadvantageous to the taxpayer.
- Upon learning of an error on a past tax return, advise the client to correct it. Do not, however, inform the IRS of the error. If the error is material and the client refuses to correct it, consider withdrawing from the engagement. This will be necessary if the error has a carryover effect and prevents the current year’s tax liability from being determined correctly.

Statutory Penalties Imposed on Tax Return Preparers

In addition to ethical constraints, a tax return preparer may be subject to certain statutorily sanctioned penalties, including the following:

- Various penalties involving procedural matters. Examples include failing to furnish the taxpayer with a copy of the return, endorsing a taxpayer’s refund check, failing to sign the return as a preparer, failing to furnish one’s identification number, and failing to keep copies of returns or maintain a client list.
- Penalty for understatement of a tax liability based on a position that lacks any realistic possibility of being sustained. If the position is not frivolous, the penalty can be avoided by disclosing it on the return.
- Penalty for any willful attempt to understate taxes. This usually results when a preparer disregards or makes no effort to obtain pertinent information from a client.
- Penalty for failure to exercise due diligence in determining eligibility for, or the amount of, an earned income tax credit.



GLOBAL TAX ISSUES Outsourcing of Tax Return Preparation

The use of foreign nationals to carry out certain job assignments for U.S. businesses is an increasingly popular practice. Outsourcing such activities as telemarketing to India, for example, usually produces the same satisfactory result as having the work done in the United States but at a much lower cost.

Outsourcing is also being applied to the preparation of tax returns. Not only can this practice be expected to continue, but it probably will increase in volume. Outsourcing tax return preparation does not violate Federal law and is compatible with accounting ethical guidelines as long as three safeguards are followed: First, the practitioner must

make sure client confidentiality is maintained. Second, the practitioner must verify the accuracy of the work that has been outsourced. Third, the practitioner must inform clients, preferably in writing, when any third-party contractor is used to provide professional services.

Practitioners justify outsourcing as a means of conserving time and effort that can be applied toward more meaningful tax planning on behalf of their clients.

Source: AICPA Ethics Ruling No. 1 (under Rule 301); see www.aicpa.org/research/standards/codeofconduct/pages/et_391.aspx.

1-7 UNDERSTANDING THE FEDERAL TAX LAW

The Federal tax law is a mosaic of statutory provisions, administrative pronouncements, and court decisions. Anyone who has attempted to work with this body of knowledge would have to admit to its complexity. For the person who has to trudge through a mass of rules to find the solution to a tax problem, it may be of some consolation to know that the law's complexity can generally be explained. Whether sound or not, there is a reason for the formulation of every rule. Knowing these reasons, therefore, is a considerable step toward understanding the Federal tax law.

The Federal tax law has as its *major objective* the raising of revenue. But although the fiscal needs of the government are important, other considerations explain certain portions of the law. Economic, social, equity, and political factors also play a significant role. Added to these factors is the marked impact the IRS and the courts have had and will continue to have on the evolution of Federal tax law. These matters are treated in the remainder of the chapter, and wherever appropriate, the discussion is referenced to subjects covered later in the text.

1-7a Revenue Needs

The foundation of any tax system has to be the raising of revenue to cover the cost of government operations. Ideally, annual outlays should not exceed anticipated revenues, thereby leading to a balanced budget with no resulting deficit.

When enacting tax legislation, a deficit-conscious Congress often has been guided by the concept of **revenue neutrality**. Also referred to as “pay-as-you-go” (“paygo”), the concept means that every new tax law that lowers taxes must include a revenue offset that makes up for the loss. Revenue neutrality does not mean that any one taxpayer's tax liability will remain the same. Because the circumstances involved will differ, one taxpayer's increased tax liability could be another's tax savings. Although revenue-neutral tax reform does not reduce deficits, at least it does not aggravate the problem.

In addition to making revenue-neutral changes in the tax law, several other procedures can be taken to mitigate any revenue loss. When tax reductions are involved, the full impact of the legislation can be phased in over a period of years. Or as an alternative, the tax reduction can be limited to a period of years. When the period expires, the prior law is reinstated through a **sunset provision**. Most of the major tax bills recently passed by Congress have contained numerous sunset provisions. They provide some semblance of revenue neutrality as some of the bills include tax cuts that were not offset by new sources of revenue. It remains to be seen, however, whether Congress will allow the sunset provisions to take effect and, thereby, kill the tax cuts that were enacted.

LO.7

Recognize the economic, social, equity, and political considerations that justify various aspects of the tax law.

1-7b Economic Considerations

Using the tax system in an effort to accomplish economic objectives has become increasingly popular in recent years. Generally, proponents of this goal use tax legislation to amend the Internal Revenue Code in ways designed to help control the economy or encourage certain activities and businesses.

Control of the Economy

Congress has used depreciation write-offs as a means of controlling the economy. Theoretically, shorter asset lives and accelerated methods should encourage additional investment in depreciable property acquired for business use. Conversely, longer asset lives and the required use of the straight-line method of depreciation dampen the tax incentive for capital outlays.

Another approach that utilizes depreciation as a means of controlling capital investment is the amount of write-off allowed upon the acquisition of assets. This is the approach followed by the § 179 election to expense assets.

A change in the tax rate structure has a more immediate impact on the economy. With lower tax rates, taxpayers are able to retain additional spendable funds. If lower tax rates are accompanied by the elimination of certain deductions, exclusions, and credits, however, the overall result may not be lower tax liabilities.

Encouragement of Certain Activities

Without passing judgment on the wisdom of any such choices, it is quite clear that the tax law encourages certain types of economic activity or segments of the economy. For example, providing favorable treatment for research and development expenditures can be explained by the desire to foster technological progress. Under the tax law, these expenditures can be either deducted in the year incurred or capitalized and amortized over a period of 60 months or more. Given the time value of money, the tax savings from a current deduction usually is preferable to capitalizing the cost with a write-off over the estimated useful life of the asset created. If the asset developed has an indefinite useful life, no write-off would be available without the two options allowed by the tax law.

Part of the tax law addresses the energy crisis—in terms of both our reliance on foreign oil and the need to ease the problem of climate change. For example, a tax credit is allowed for installation of solar and small wind energy equipment. In addition, tax credits are available to those who purchase new plug-in electric drive motor vehicles. Residential energy credits are allowed for home improvements that conserve energy or make its use more efficient (e.g., solar hot water and geothermal heat pumps). Ecological considerations justify a tax provision that permits a more rapid expensing of the costs of installing pollution control facilities. Measures such as these that aid in maintaining a clean air environment and conserving energy resources can also be justified under social considerations.

Is it wise to stimulate U.S. exports of services? Along this line, Congress has deemed it advisable to establish incentives for U.S. citizens who accept employment overseas. Such persons receive generous tax breaks through special treatment of their foreign-source income.

Is saving desirable for the economy? Saving leads to capital formation and thereby makes funds available to finance home construction and industrial expansion. The tax law encourages saving by according preferential treatment to private retirement plans. Besides contributions to Keogh (H.R. 10) plans and certain IRAs being deductible, income from the contributions accumulates free of tax. The encouragement of private-sector pension plans can also be justified under social considerations.

Encouragement of Certain Industries

Because a sound agricultural base is necessary for a well-balanced national economy, farmers are accorded special treatment under the Federal tax system. Among the

benefits are the election to expense rather than capitalize certain soil and water conservation expenditures and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.

To stimulate the manufacturing industry, Congress enacted a domestic production activities deduction. The provision provides a tax benefit in the form of a deduction for profits derived from manufacturing activities conducted in the United States. By restricting the deduction to manufacturing income attributable to wages reportable to the IRS, new U.S. jobs will result and the outsourcing of labor is discouraged. Thus, the tax system is used to encourage both domestic manufacturing and job growth.

Encouragement of Small Business

At least in the United States, a consensus exists that what is good for small business is good for the economy as a whole. Whether valid or not, this assumption has led to a definite bias in the tax law favoring small business.

In the corporate tax area, several provisions can be explained by the desire to benefit small business. One provision permits the shareholders of a small business corporation to make a special election that generally avoids the imposition of the corporate income tax.²⁶ Furthermore, such an election enables the corporation to pass through its operating losses to its shareholders.

1-7c Social Considerations

Some provisions of the Federal tax law, particularly those dealing with the income tax of individuals, can be explained by social considerations. Some notable examples and their rationales include the following:

- Certain benefits provided to employees through accident and health plans financed by employers are nontaxable to employees. Encouraging such plans is considered socially desirable because they provide medical benefits in the event of an employee's illness or injury.
- Most premiums paid by an employer for group term insurance covering the life of the employee are nontaxable to the employee. These arrangements can be justified on social grounds in that they provide funds for the family unit to help it adjust to the loss of wages caused by the employee's death.
- A contribution made by an employer to a qualified pension or profit sharing plan for an employee may receive special treatment. The contribution and any income it generates are not taxed to the employee until the funds are distributed. Such an arrangement also benefits the employer by allowing a tax deduction when the contribution is made to the qualified plan. Private retirement plans are encouraged to supplement the subsistence income level the employee otherwise would have under the Social Security system.²⁷
- A deduction is allowed for contributions to qualified charitable organizations. The deduction attempts to shift some of the financial and administrative burden of socially desirable programs from the public (the government) to the private (the citizens) sector.
- A tax credit is allowed for amounts spent to furnish care for certain minor or disabled dependents to enable the taxpayer to seek or maintain gainful employment. For those employees who do not choose home care for their children, employers are allowed a credit for child care provided at the workplace. Who could deny the social desirability of encouraging taxpayers to provide care for their children while they work?
- To encourage taxpayers to join the workforce even though their wages may be marginal, an earned income tax credit can be claimed. The credit varies depending

²⁶Known as the S election, it is discussed in Chapter 22.

²⁷The same rationale explains the availability of similar arrangements for self-employed persons (the H.R. 10, or Keogh, plan).

on the number of qualifying children being claimed and the level of wages earned. Because it stimulates employment, the earned income tax credit can also be justified on economic grounds.

- Due to the usual impairment in earning potential, certain credits are made available to elderly and disabled persons. Credits also are allowed to businesses that incur expenditures to make their facilities more accessible to the disabled.
- Various tax credits, deductions, and exclusions are designed to encourage taxpayers to obtain additional education.²⁸
- A tax deduction is not allowed for certain expenditures deemed to be contrary to public policy. This disallowance extends to such items as fines, penalties, illegal kickbacks, bribes to government officials, and gambling losses in excess of gains. Social considerations dictate that the tax law should not encourage these activities by permitting a deduction.

Although many other examples could be identified, these examples demonstrate that social considerations do explain a significant part of the Federal tax law.

1-7d **Equity Considerations**

The concept of equity is relative. Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is most often tied to a particular taxpayer's personal situation. To illustrate, compare the tax positions of those who rent their personal residences with those who own their homes. Renters receive no Federal income tax benefit from the rent they pay. For homeowners, however, a large portion of the house payments they make may qualify for the Federal interest and property tax deductions. Although renters may have difficulty understanding this difference in tax treatment, the encouragement of home ownership can be justified on both economic and social grounds.

In the same vein, compare the tax treatment of a corporation with that of a partnership. Although the two businesses may be equal in size, similarly situated, and competitors in the production of goods or services, they are not treated comparably under the tax law. The corporation is subject to a separate Federal income tax; the partnership is not. Whether the differences in tax treatment can be justified logically in terms of equity is beside the point. The point is that the tax law can and does make a distinction between these business forms.

Equity, then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. Some recognition of equity does exist, however, and explains part of the law. The concept of equity appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax. Provisions that mitigate the effect of the application of the annual accounting period concept and help taxpayers cope with the eroding results of inflation also reflect equity considerations.

Alleviating the Effect of Multiple Taxation

The income earned by a taxpayer may be subject to taxes imposed by different taxing authorities. If, for example, the taxpayer is a resident of New York City, income might generate Federal, state of New York, and city of New York income taxes. To compensate for this apparent inequity, the Federal tax law allows a taxpayer to claim a deduction for state and local income taxes. The deduction does not, however, neutralize the effect of multiple taxation because the benefit derived depends on the taxpayer's Federal income tax rate. Only a tax credit, not a deduction, would eliminate the effects of multiple taxation on the same income.

²⁸These provisions can also be justified under the category of economic considerations because a better-educated workforce carries a positive economic impact.

Equity considerations can explain the Federal tax treatment of certain income from foreign sources. Because double taxation results when the same income is subject to both foreign and U.S. income taxes, the tax law permits the taxpayer to choose between a credit and a deduction for the foreign taxes paid.

The Wherewithal to Pay Concept

The **wherewithal to pay** concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax. It is particularly suited to situations in which the taxpayer's economic position has not changed significantly as a result of the transaction.

An illustration of the wherewithal to pay concept is the provision of the tax law dealing with the treatment of gain resulting from an involuntary conversion. An involuntary conversion occurs when property is destroyed by a casualty or taken by a public authority through condemnation. If gain results from the conversion, it need not be recognized if the taxpayer replaces the property within a specified period of time. The replacement property must be similar or related in service or use to that involuntarily converted.

Some of the pasture land belonging to Ron, a rancher, is condemned by the state for use as a game preserve. The condemned pasture land cost Ron \$120,000, but the state pays him \$150,000 (its fair market value). Shortly thereafter, Ron buys more pasture land for \$150,000.

EXAMPLE

22

In Example 22, Ron has a realized gain of \$30,000 [\$150,000 (condemnation award) – \$120,000 (cost of land)]. It would be inequitable to force Ron to pay a tax on this gain for two reasons. First, without disposing of the property acquired (the new land), Ron would be hard-pressed to pay the tax. Second, his economic position has not changed.

A warning is in order regarding the application of the wherewithal to pay concept. If the taxpayer's economic position changes in any way, tax consequences may result.

Assume the same facts as in Example 22, except that Ron reinvests only \$140,000 of the award in new pasture land. Now Ron has a taxable gain of \$10,000. Instead of ending up with only replacement property, Ron has \$10,000 in cash.

EXAMPLE

23

Mitigating the Effect of the Annual Accounting Period Concept

For purposes of effective administration of the tax law, all taxpayers must report to and settle with the Federal government at periodic intervals. Otherwise, taxpayers would remain uncertain as to their tax liabilities, and the government would have difficulty judging revenues and budgeting expenditures. The period selected for final settlement of most tax liabilities, in any event an arbitrary determination, is one year. At the close of each year, therefore, a taxpayer's position becomes complete for that particular year. Referred to as the annual accounting period concept, its effect is to divide each taxpayer's life, for tax purposes, into equal annual intervals.

The finality of the annual accounting period concept could lead to dissimilar tax treatment for taxpayers who are, from a long-range standpoint, in the same economic position.

José and Alicia, both sole proprietors, have experienced the following results during the past three years:

Year	Profit (or Loss)	
	José	Alicia
2013	\$50,000	\$150,000
2014	60,000	60,000
2015	60,000	(40,000)

EXAMPLE

24

continued

Although José and Alicia have the same total profit of \$170,000 over the period from 2013 to 2015, the finality of the annual accounting period concept places Alicia at a definite disadvantage for tax purposes. The net operating loss procedure offers Alicia some relief by allowing her to apply some or all of her 2015 loss to the earlier profitable years (in this case, 2013). Thus, with a net operating loss carryback, Alicia is in a position to obtain a refund for some of the taxes she paid on the \$150,000 profit reported for 2013.

The same reasoning used to support the deduction of net operating losses can explain the special treatment the tax law accords to excess capital losses and excess charitable contributions.²⁹ Carryback and carryover procedures help mitigate the effect of limiting a loss or a deduction to the accounting period in which it was realized. With such procedures, a taxpayer may be able to salvage a loss or a deduction that might otherwise be wasted.

The installment method of recognizing gain on the sale of property allows a taxpayer to spread tax consequences over the payout period.³⁰ The harsh effect of taxing all of the gain in the year of sale is thereby avoided. The installment method can also be explained by the wherewithal to pay concept because recognition of gain is tied to the collection of the installment notes received from the sale of the property. Tax consequences, then, tend to correspond to the seller's ability to pay the tax.

Coping with Inflation

Because of the progressive nature of the income tax, a wage adjustment to compensate for inflation can increase the income tax bracket of the recipient. Known as *bracket creep*, its overall impact is an erosion of purchasing power. Congress recognized this problem and began to adjust various income tax components, such as tax brackets, standard deduction amounts, and personal and dependency exemptions, through an indexation procedure. **Indexation** is based on the rise in the consumer price index over the prior year.

1-7e Political Considerations

A large segment of the Federal tax law is made up of statutory provisions. Because these statutes are enacted by Congress, is it any surprise that political considerations influence tax law? For purposes of discussion, the effect of political considerations on the tax law is divided into the following topics: special interest legislation, political expediency situations, and state and local government influences.

Special Interest Legislation

There is no doubt that certain provisions of the tax law can largely be explained by the political influence some pressure groups have had on Congress. Is there any other realistic reason that, for example, prepaid subscription and dues income is not taxed until earned while prepaid rents are taxed to the landlord in the year received?

A recent provision, sponsored by a senator from Georgia, suspended the import duties on ceiling fans. The nation's largest seller of ceiling fans is Home Depot, which is based in Atlanta, Georgia. Another provision, sponsored by a congressman from Illinois, reduced the excise taxes on fishing tackle boxes. The representative's district includes Plano Molding, a major manufacturer of tackle boxes. The justification for this change was that it placed tackle boxes on a more level playing field with toolboxes (which are not subject to tax). Allegedly, fishermen had been buying and converting toolboxes to avoid the excise tax.

Special interest legislation is not necessarily to be condemned if it can be justified on economic, social, or some other utilitarian grounds. In most cases, however, it is

²⁹The tax treatment of these items is discussed in Chapters 7, 10, and 14.

³⁰Under the installment method, each payment received by the seller represents both a recovery of capital (the nontaxable portion) and profit from

the sale (the taxable portion). The tax rules governing the installment method are discussed in Chapter 16.

objectionable in that it adds further complexity to an already cluttered tax law. It is, however, an inevitable product of our political system.

Political Expediency Situations

Various tax reform proposals rise and fall in favor with the shifting moods of the American public. That Congress is sensitive to popular feeling is an accepted fact. Therefore, certain provisions of the tax law can be explained by the political climate at the time they were enacted.

Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment have always had popular appeal and, consequently, the support of Congress. A direct approach bars the benefit completely and explains such provisions as the imputed interest rules and the limitations on the deductibility of interest on investment indebtedness. More subtle are provisions that phase out tax breaks as income rises. Because taxpayers may be unaware of what is causing the shift to higher marginal tax rates, these phaseouts are often called “stealth taxes.” The tax law contains several dozen such phaseout provisions. Examples include the earned income credit, the child tax credit, the lifetime learning credit, and the credit for first-time home purchases. At least for the immediate future, the use of these stealth taxes can be expected to increase.

Other changes, explained at least partially by political expediency, include the lowering of individual income tax rates, the increase in the personal and dependency exemptions, and the increase in the amount of the earned income credit.

State and Local Government Influences

Political considerations have played a major role in the nontaxability of interest received on state and local obligations. In view of the furor that state and local political figures have raised every time any modification of this tax provision has been proposed, one might well regard it as next to sacred.

Somewhat less apparent has been the influence that state law has had in shaping our present Federal tax law. Such was the case with community property systems. The nine states with community property systems are Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, and Wisconsin. The rest of the states are classified as common law jurisdictions.³¹ The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse.

Al and Fran are husband and wife, and their only income is the \$80,000 annual salary Al receives. If they live in New Jersey (a common law state), the \$80,000 salary belongs to Al. If, however, they live in Arizona (a community property state), the \$80,000 is divided equally, in terms of ownership, between Al and Fran.

EXAMPLE

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At one time, the tax position of the residents of community property states was so advantageous that many common law states adopted community property systems. Needless to say, the political pressure placed on Congress to correct the disparity in tax treatment was considerable. To a large extent, this was accomplished in the Revenue Act of 1948, which extended many of the community property tax advantages to residents of common law jurisdictions.

The major advantage extended was the provision allowing married taxpayers to file joint returns and compute their tax liability as if one-half of the income had been earned

³¹In Alaska, spouses can choose to have the community property rules apply. Otherwise, property rights are determined under common law rules.

by each spouse. This result is automatic in a community property state, because half of the income earned by one spouse belongs to the other spouse. The income-splitting benefits of a joint return are now incorporated as part of the tax rates applicable to married taxpayers. See Chapter 3.

LO.8

Describe the role played by the IRS and the courts in the evolution of the Federal tax system.

1-7f Influence of the Internal Revenue Service

The influence of the IRS is apparent in many areas beyond its role in issuing the administrative pronouncements that make up a considerable portion of our tax law. In its capacity as the protector of the national revenue, the IRS has been instrumental in securing the passage of much legislation designed to curtail the most flagrant tax avoidance practices (to close *tax loopholes*). As the administrator of the tax law, the IRS has sought and obtained legislation to make its job easier (to attain administrative feasibility).

The IRS as Protector of the Revenue

Innumerable examples can be given of provisions in the tax law that stem from the direct influence of the IRS. Usually, such provisions are intended to prevent a loophole from being used to avoid the tax consequences intended by Congress. Working within the letter of existing law, ingenious taxpayers and their advisers devise techniques that accomplish indirectly what cannot be accomplished directly. As a consequence, legislation is enacted to close the loopholes that taxpayers have located and exploited. Some tax law can be explained in this fashion and is discussed in the chapters to follow.

In addition, the IRS has secured from Congress legislation of a more general nature that enables it to make adjustments based on the substance, rather than the formal construction, of what a taxpayer has done. For example, one such provision permits the IRS to make adjustments to a taxpayer's method of accounting when the method used by the taxpayer does not clearly reflect income.³²

EXAMPLE

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Tina, a cash basis taxpayer, owns and operates a pharmacy. All drugs and other items acquired for resale, such as cosmetics, are charged to the purchases account and written off (expensed) for tax purposes in the year of acquisition. As this procedure does not clearly reflect income, it would be appropriate for the IRS to require that Tina establish and maintain an ending inventory account.

Administrative Feasibility

Some tax law is justified on the grounds that it simplifies the task of the IRS in collecting the revenue and administering the law. With regard to collecting the revenue, the IRS long ago realized the importance of placing taxpayers on a pay-as-you-go basis. Elaborate withholding procedures apply to wages, while the tax on other types of income may be paid at periodic intervals throughout the year. The IRS has been instrumental in convincing the courts that accrual basis taxpayers should, in most cases, pay taxes on prepaid income in the year received and not when earned. The approach may be contrary to generally accepted accounting principles, but it is consistent with the wherewithal to pay concept.

Of considerable aid to the IRS in collecting revenue are the numerous provisions that impose interest and penalties on taxpayers for noncompliance with the tax law. Provisions such as the penalties for failure to pay a tax or to file a return that is due, the negligence penalty for intentional disregard of rules and regulations, and various penalties for civil and criminal fraud serve as deterrents to taxpayer noncompliance.

One of the keys to an effective administration of our tax system is the audit process conducted by the IRS. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation and therefore simplify the audit effort that is necessary. An increase in the amount of the standard deduction, for example, reduces the number of individual taxpayers who will choose the alternative of

³²See Chapter 16.

itemizing their personal deductions.³³ With fewer deductions to check, the audit function is simplified.³⁴

1-7g Influence of the Courts

In addition to interpreting statutory provisions and the administrative pronouncements issued by the IRS, the Federal courts have influenced tax law in two other respects.³⁵ First, the courts have formulated certain judicial concepts that serve as guides in the application of various tax provisions. Second, certain key decisions have led to changes in the Internal Revenue Code.

Judicial Concepts Relating to Tax

A leading tax concept developed by the courts deals with the interpretation of statutory tax provisions that operate to benefit taxpayers. The courts have established the rule that these relief provisions are to be narrowly construed if there is any doubt about their application.

Important in this area is the *arm's length* concept. Particularly in dealings between related parties, transactions may be tested by looking to whether the taxpayers acted in an arm's length manner. The question to be asked is: Would unrelated parties have handled the transaction in the same way?

Rex, the sole shareholder of Silver Corporation, leases property to the corporation for a yearly rent of \$60,000. To test whether the corporation should be allowed a rent deduction for this amount, the IRS and the courts will apply the arm's length concept. Would Silver Corporation have paid \$60,000 a year in rent if it had leased the same property from an unrelated party (rather than from Rex)? Suppose it is determined that an unrelated third party would have charged an annual rent for the property of only \$50,000. Under these circumstances, Silver Corporation will be allowed a deduction of only \$50,000. The other \$10,000 it paid for the use of the property represents a non-deductible dividend. Accordingly, Rex will be treated as having received rent income of \$50,000 and dividend income of \$10,000.

EXAMPLE

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Judicial Influence on Statutory Provisions

Some court decisions have been of such consequence that Congress has incorporated them into statutory tax law. For example, many years ago the courts found that stock dividends distributed to the shareholders of a corporation were not taxable as income. This result was largely accepted by Congress, and a provision in the tax statutes now covers the issue.

On occasion, however, Congress has reacted negatively to judicial interpretations of the tax law.

Nora leases unimproved real estate to Wade for 20 years. At a cost of \$400,000, Wade erects a building on the land. The building is worth \$150,000 when the lease terminates and Nora takes possession of the property. Does Nora have any income either when the improvements are made or when the lease terminates? In a landmark decision, a court held that Nora must recognize income of \$150,000 upon the termination of the lease.

EXAMPLE

28

Congress believed that the result reached in Example 28 was inequitable in that it was not consistent with the wherewithal to pay concept. Consequently, the tax law was amended to provide that a landlord does not recognize any income either when the improvements are made (unless made in lieu of rent) or when the lease terminates.

³³For a discussion of the standard deduction, see Chapter 3.

³⁴The same justification was given by the IRS when it proposed to Congress the \$100 limitation on personal casualty and theft losses. Imposition of the limitation eliminated many casualty and theft loss deductions and, as a consequence, saved the IRS considerable audit time. Later legislation, in

addition to retaining the \$100 feature, limits deductible losses to those in excess of 10% of a taxpayer's adjusted gross income. See Chapter 7.

³⁵A great deal of case law is devoted to ascertaining congressional intent. The courts, in effect, ask: What did Congress have in mind when it enacted a particular tax provision?

1-8 SUMMARY

In addition to its necessary revenue-raising objective, the Federal tax law has developed in response to several other factors:

- *Economic considerations.* The emphasis here is on tax provisions that help regulate the economy and encourage certain activities and types of businesses.
- *Social considerations.* Some tax provisions are designed to encourage (or discourage) certain socially desirable (or undesirable) practices.
- *Equity considerations.* Of principal concern in this area are tax provisions that alleviate the effect of multiple taxation, recognize the wherewithal to pay concept, mitigate the effect of the annual accounting period concept, and recognize the eroding effect of inflation.
- *Political considerations.* Of significance in this regard are tax provisions that represent special interest legislation, reflect political expediency, and exhibit the effect of state and local law.
- *Influence of the IRS.* Many tax provisions are intended to aid the IRS in the collection of revenue and the administration of the tax law.
- *Influence of the courts.* Court decisions have established a body of judicial concepts relating to tax law and have, on occasion, led Congress to enact statutory provisions to either clarify or negate their effect.

These factors explain various tax provisions and thereby help in understanding why the tax law developed to its present state. The next step involves learning to work with the tax law, which is the subject of Chapter 2.

REFOCUS ON THE BIG PICTURE

FAMILY AND TAXES—A TYPICAL YEAR



The explanation given for the difference in the ad valorem property taxes—the Carters' increase and the Walkers' decrease—seems reasonable (see Example 4). It is not likely that the Carters' increase was due to a *general* upward assessment in valuation, as the Walkers' taxes on their residence (located nearby) dropped. More business use of the Carters' residence (presuming that Travis conducts his consulting practice from his home) might be responsible for the increase, but capital improvements appear to be a more likely cause.

The imposition of the use tax when Travis registered the new automobile illustrates one of the means by which a state can preclude the avoidance of its sales tax (see Example 5).

When gifts between family members are material in amount (e.g., an RV) and exceed the annual exclusion, a gift tax return needs to be filed (see Example 11). Even though no gift tax may be due because of the availability of the unified transfer tax credit, the filing of a return starts the running of the statute of limitations.

The imposition of the “jock tax” on nonathletes is unusual but not improper. The Carters must recognize that some of their income is subject to income taxes in two states and take advantage of whatever relief is available to mitigate the result (see Example 12).

Employment within and by the family group (e.g., children, other relatives, and domestics) has become a priority item in the enforcement of Social Security tax and income tax withholdings. Thus, the Carters must be aware of the need to cover their son, Martin (see Example 13).

Because of the double audit (i.e., both state and Federal) and the deficiency assessed, the Carters need to make sure that future returns do not contain similar errors (see Example 18). As the text suggests, taxpayers with prior deficiencies are among those whose returns may be selected for audit.

Key Terms

Ad valorem taxes, 1-6	FUTA tax, 1-17	Revenue neutrality, 1-25
Correspondence audit, 1-21	Gift tax, 1-12	Sales tax, 1-9
Employment taxes, 1-15	Indexation, 1-30	Severance taxes, 1-10
Estate tax, 1-11	Inheritance tax, 1-11	Statute of limitations, 1-22
Excise taxes, 1-8	National sales tax, 1-19	Sunset provision, 1-25
FICA tax, 1-16	Occupational fees, 1-17	Use tax, 1-9
Field audit, 1-21	Office audit, 1-21	Value added tax (VAT), 1-19
Flat tax, 1-18	Personalty, 1-8	Wherewithal to pay, 1-29
Franchise tax, 1-17	Realty, 1-7	

Discussion Questions

- LO.1** In the following independent situations, is the tax position of the taxpayer likely to change? Explain why or why not.

 - John used to make casual purchases and sales of real estate as an investor. Currently, he does so on a regular basis and has obtained a license as a dealer.
 - Theresa quit her job as a staff accountant and has established her own practice as a CPA.
 - After saving enough for a down payment, Paul has purchased a personal residence.
- LO.1** Marvin is the executor and sole heir of his aunt's estate. The estate includes her furnished home, which Marvin is considering converting to rental property to generate additional cash flow. What are some of the tax problems Marvin may confront? Issue ID
- LO.2** The Sixteenth Amendment to the U.S. Constitution was passed to overturn a Supreme Court decision that had invalidated the Federal income tax. Do you agree? Why or why not?
- LO.2** World War II converted the Federal income tax into a *mass tax*. Explain.
- LO.2** How does the pay-as-you-go procedure apply to wage earners? To persons who have income from sources other than wages?
- LO.3** Using Adam Smith's canon on *economy*, evaluate the Federal income tax.
- LO.3** Distinguish between taxes that are *proportional* and those that are *progressive*.
- LO.4** Several years ago Ethan purchased the former parsonage of St. James Church to use as a personal residence. To date, Ethan has not received any ad valorem property tax bills from either the city or the county tax authorities. Issue ID

 - What is a reasonable explanation for this oversight?
 - What should Ethan do?
- LO.4** The Adams Independent School District wants to sell a parcel of unimproved land that it does not need. Its three best offers are as follows: from the state's Department of Public Safety (DPS), \$2.3 million; from the Second Baptist Church, \$2.2 million; and from Baker Motors, \$2.1 million. DPS would use the property for a new state highway patrol barracks; Second Baptist would start a church school; and Baker would open a car dealership. If you are the financial adviser for the school district, which offer would you prefer? Why? Issue ID

10. **LO.4** The commissioners for Walker County are actively negotiating with Falcon Industries regarding the location of a new manufacturing plant in the area. As Falcon is considering several other sites, a “generous tax holiday” may be needed to influence the final choice. The local school district is opposed to any “generous tax holiday.”
 - a. What would probably be involved in a generous tax holiday?
 - b. Why would the school district be opposed?
 11. **LO.4** Sophia lives several blocks from her parents in the same residential subdivision. Sophia is surprised to learn that her ad valorem property taxes for the year were raised, while those of her parents were lowered. What is a possible explanation for the difference?
 12. **LO.4** The Morgan family lives in Massachusetts. They moor their sailboat in Rhode Island. What might be a plausible reason for the possible inconvenience?
 13. **LO.4** Is the breadth and number of Federal excise taxes increasing or decreasing? Explain.
 14. **LO.4** After his first business trip to a major city, Herman is alarmed when he reviews his credit card receipts. Both the hotel bill and the car rental charge are in excess of the price he was quoted. Was Herman overcharged, or is there an explanation for the excess amounts?
 15. **LO.4** What is the difference between an excise tax and a general sales tax?
 - a. Do all states impose a general sales tax?
 - b. Does the Federal government impose a general sales tax?
 16. **LO.4** The Grays live in Clay County, which is adjacent to Jackson County. Although the retail stores in both counties are comparable, the Grays usually drive a few extra miles to shop in Jackson County. As to why the Grays might do this, consider the following:
 - a. Clay County is in a different state than Jackson County.
 - b. Clay County and Jackson County are in the same state.
- Issue ID**
17. **LO.4** During a social event, Muriel and Earl are discussing the home computer each recently purchased. Although the computers are identical makes and models, Muriel is surprised to learn that she paid a sales tax, while Earl did not. Comment as to why this could happen.
 18. **LO.4** Distinguish between an estate tax and an inheritance tax.
 - a. Do some states impose both? Neither?
 - b. Which, if either, does the Federal government impose?
- Issue ID**
19. **LO.4** Jake (age 72) and Jessica (age 28) were recently married. To avoid any transfer taxes, Jake has promised to leave Jessica all of his wealth when he dies. Is Jake under some misconception about the operation of the Federal gift and estate taxes? Explain.
 20. **LO.4** Address the following issues:
 - a. What is the purpose of the unified transfer tax credit?
 - b. Is the same amount available for both the Federal gift tax and the estate tax? Explain.
 - c. Does the use of the credit for a gift affect the amount of credit available for the estate tax? Explain.
 21. **LO.4** Elijah and Anastasia are husband and wife who have five married children and nine minor grandchildren. For 2015, what is the maximum amount they can give to their family (including the sons- and daughters-in-law) without using any of their unified transfer tax credit?

22. **LO.4** What is the difference between the Federal income tax on individuals and that imposed on corporations?
23. **LO.4** As to those states that impose an income tax, comment on the following:
- “Piggyback” approach and possible “decoupling” from this approach.
 - Deductibility of Federal income taxes.
 - Credit for taxes paid to other states.
24. **LO.4** In May 2015, Hernando, a resident of California, has his 2013 Federal income tax return audited by the IRS. An assessment of additional tax is made because he had inadvertently omitted some rental income. In October 2015, California audits his state return for the same year. Explain the coincidence.
25. **LO.4** Mike Barr was an outstanding football player in college and expects to be drafted by the NFL in the first few rounds. Mike has let it be known that he would prefer to sign with a club located in Florida, Texas, or Washington. Mike sees no reason why he should have to pay state income tax on his player’s salary. Is Mike under any delusions? Explain. Issue ID
26. **LO.4, 5** A question on a state income tax return asks the taxpayer if he or she made any out-of-state Internet or mail-order catalog purchases during the year. The question requires a yes or no answer, and if the taxpayer answers yes, the amount of such purchases is to be listed. Issue ID
- Does such an inquiry have any relevance to the state income tax? If not, why is it being asked?
 - Your client, Harriet, wants to leave the question unanswered. As the preparer of her return, how do you respond?
27. **LO.4** Many state income tax returns contain checkoff boxes that allow taxpayers to make donations to a multitude of local charitable causes. On what grounds has this procedure been criticized?
28. **LO.4** Many states have occasionally adopted amnesty programs that allow taxpayers to pay back taxes with reduced penalties.
- Besides the revenue generated, how are these programs advantageous?
 - Could an amnesty program be used by a state that does not levy an income tax?
 - Does the IRS utilize this approach?
29. **LO.4** Contrast FICA and FUTA as to the following:
- Purpose of the tax.
 - Upon whom imposed.
 - Governmental administration of the tax.
 - Reduction of tax based on a merit rating system.
30. **LO.4** In connection with the Medicare component of FICA, comment on the following:
- Any dollar limitation imposed.
 - The applicability of the .9% increase in the 1.45% regular tax rate.
31. **LO.4** One of the tax advantages of hiring family members to work in your business is that FICA taxes are avoided. Do you agree with this statement? Explain.
32. **LO.4** Describe the nature and purpose of the following taxes:
- Severance taxes.
 - Franchise taxes.
 - Occupational fees.
 - Customs duties.
 - Export duties.

33. **LO.4** Regarding the value added tax (VAT), comment on the following:
- Popularity of this type of tax.
 - Nature of the tax.
 - Effect on government spending.
34. **LO.4** Both a value added tax (VAT) and a national sales tax have been criticized as being *regressive* in their effect.
- Explain.
 - How could this shortcoming be remedied in the case of a national sales tax?
35. **LO.4, 5** Serena operates a lawn maintenance service in Southern California. As most of her employees are itinerant, they are paid on a day-to-day basis. Because of cash-flow problems, Serena requires her customers to pay cash for the services she provides.
- What are some of the tax problems Serena might have?
 - Assess Serena's chances of audit by the IRS.
36. **LO.5** With regard to the IRS audit process, comment on the following:
- The audit is resolved by mail.
 - The audit is conducted at the office of the IRS.
 - A "no change" RAR results.
 - A special agent joins the audit team.
37. **LO.5** Aldo has just been audited by the IRS. He does not agree with the agent's findings but believes that he has only two choices: pay the proposed deficiency or resort to the courts. Do you agree with Aldo's conclusion? Why or why not?
38. **LO.5** What purpose is served by a statute of limitations? How is it relevant in the case of tax controversies?
39. **LO.5** Regarding the statute of limitations on additional assessments of tax by the IRS, determine the applicable period in each of the following situations. Assume a calendar year individual with no fraud or substantial omission involved.
- The income tax return for 2014 was filed on February 21, 2015.
 - The income tax return for 2014 was filed on June 25, 2015.
 - The income tax return for 2014 was prepared on April 4, 2015, but was never filed. Through some misunderstanding between the preparer and the taxpayer, each expected the other to file the return.
 - The income tax return for 2014 was never filed because the taxpayer thought no additional tax was due.
40. **LO.5** Brianna, a calendar year taxpayer, files her income tax return for 2014 on February 3, 2015. Although she makes repeated inquiries, she does not receive her refund from the IRS until May 28, 2015. Is Brianna entitled to interest on the refund? Explain.
41. **LO.5, 6** On a Federal income tax return filed five years ago, Andy inadvertently omitted a large amount of gross income.
- Andy seeks your advice as to whether the IRS is barred from assessing additional income tax in the event he is audited. What is your advice?
 - Would your advice differ if you were the person who prepared the return in question? Explain.
 - Suppose Andy asks you to prepare his current year's return. Would you do so? Explain.

42. **LO.5** Isabella files her income tax return 35 days after the due date of the return without obtaining an extension from the IRS. Along with the return, she remits a check for \$40,000, which is the balance of the tax she owes. Disregarding the interest element, what are Isabella's penalties for failure to file and for failure to pay?
43. **LO.5** For tax year 2012, the IRS assesses a deficiency against David for \$500,000. Disregarding the interest component, what is David's penalty if the deficiency is attributable to:
- Negligence?
 - Fraud?
44. **LO.5, 6** In March 2015, Jim asks you to prepare his Federal income tax returns for tax years 2012, 2013, and 2014. In discussing this matter with him, you discover that he also has not filed for tax year 2011. When you mention this fact, Jim tells you that the statute of limitations precludes the IRS from taking any action as to this year.
- Is Jim correct about the application of the statute of limitations? Why or why not?
 - If Jim refuses to file for 2011, should you prepare returns for 2012 through 2014? Explain.
45. **LO.5, 6** The Benson CPA firm is considering utilizing an offshore service provider to prepare many of its tax returns. In this regard, what ethical considerations must be taken into account?
46. **LO.7** In terms of tax policy, what do the following mean?
- Revenue neutrality.
 - Pay-as-you-go, or "paygo."
 - Sunset provision.
 - Indexation.
47. **LO.7** Some tax rules can be justified on multiple grounds (e.g., economic and social). In this connection, comment on the possible justification for the rules governing the following:
- Pension plans.
 - Education.
 - Home ownership.
48. **LO.7, 8** Discuss the probable justification for each of the following aspects of the tax law:
- A tax credit is allowed for amounts spent to furnish care for minor children while the parent works.
 - Deductions for interest on home mortgage and property taxes on a personal residence.
 - The income-splitting benefits of filing a joint return.
 - Gambling losses in excess of gambling gains.
 - Net operating losses of a current year can be carried back to profitable years.
 - A taxpayer who sells property on an installment basis can recognize gain on the sale over the period the payments are received.
 - The exclusion from Federal tax of certain interest income from state and local bonds.
 - Prepaid income is taxed to the recipient in the year received and not in the year it is earned.

49. **LO.7** Mia owns a warehouse that has a cost basis to her of \$80,000. The city condemns the warehouse to make room for a new fire station. It pays Mia \$400,000 for the property, its agreed-to fair market value. Shortly after the condemnation, Mia purchases another warehouse as a replacement. What is her recognized gain if the new property cost:
- \$280,000?
 - \$444,000?
 - \$80,000?
 - What, if any, is the justification for deferring the recognition of gain on the involuntary conversion?
50. **LO.8** A mother sells a valuable collection of antiques to her daughter for \$1,000. What judicial concept might the IRS invoke to question this transaction?

Working with the Tax Law

LEARNING OBJECTIVES: *After completing Chapter 2, you should be able to:*

- LO.1** Distinguish between the statutory, administrative, and judicial sources of the tax law and understand the purpose of each source.
- LO.2** Locate and work with the appropriate tax law sources.
- LO.3** Develop an awareness of tax research tools.
- LO.4** Describe the tax research process.
- LO.5** Communicate the results of the tax research process in a client letter and a tax file memorandum.
- LO.6** Apply tax research techniques and planning procedures.
- LO.7** Be aware of taxation on the CPA examination.

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THE BIG PICTURE

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IMPORTANCE OF TAX RESEARCH

Early in December 2015, Fred and Megan Samuels review their financial and tax situation with their son, Sam, and daughter-in-law, Dana, who live with them. Fred and Megan are in the 28% tax bracket in 2015. Both Sam and Dana are age 21. Sam, a student at a nearby university, owns some publicly traded stock that he inherited from his grandmother. A current sale would result in approximately \$8,000 of gross income (\$19,000 amount realized – \$11,000 adjusted basis). At this point, Fred and Megan provide about 55% of Sam and Dana's support. Although neither is now employed, Sam has earned \$960 and Dana has earned \$900. The problem: Should the stock be sold, and would the sale prohibit Fred and Megan from claiming Sam and Dana as dependents? Would the stock sale in 2015 result in a tax liability for Sam and Dana?

Read the chapter and formulate your responses.

Federal tax law is a mixture of statutory provisions, administrative pronouncements, and court decisions. Anyone who has attempted to work with this body of knowledge is familiar with its complexity. Tax research provides the vehicle by which one makes sense out of this complexity.

LO.1

Distinguish between the statutory, administrative, and judicial sources of the tax law and understand the purpose of each source.

2-1 TAX SOURCES

Understanding taxation requires a mastery of the sources of the *rules of tax law*. These sources include not only legislative provisions in the form of the Internal Revenue Code but also congressional Committee Reports, Treasury Department Regulations, other Treasury Department pronouncements, and court decisions. Thus, the *primary sources* of tax information include pronouncements from all three branches of government: legislative, executive, and judicial.

In addition to being able to locate and interpret the sources of the tax law, a tax professional must understand the relative weight of authority within these sources. The tax law is of little significance, however, until it is applied to a set of facts and circumstances. This chapter, therefore, both introduces the statutory, administrative, and judicial sources of tax law and explains how the law is applied to individual and business transactions. It also explains how to apply research techniques and use planning procedures effectively. A large part of tax research focuses on determining the intent of Congress.

Frequently, uncertainty in the tax law causes disputes between the Internal Revenue Service (IRS) and taxpayers. Due to these *gray areas* and the complexity of the tax law, a taxpayer may have more than one alternative for structuring a financial transaction. In structuring financial transactions and engaging in other tax planning activities, the tax adviser must be cognizant that the objective of tax planning is not necessarily to minimize the tax liability. Instead, a taxpayer should maximize his or her after-tax return, which may include maximizing nontax as well as noneconomic benefits.

2-1a Statutory Sources of the Tax Law

Statutory sources of law include the Constitution (Article I, Sections 7, 8, and 10), tax treaties (agreements between countries to mitigate the double taxation of taxpayers subject to the tax laws of those countries), and the Internal Revenue Code. The Constitution grants Congress the power to impose and collect taxes and authorizes the creation of treaties with other countries. The power of Congress to implement and collect taxes is summarized in the Internal Revenue Code, the official title of U.S. tax law, and it is the basis for arriving at solutions to all tax questions.

Origin of the Internal Revenue Code

Before 1939, the statutory provisions relating to Federal taxation were contained in the individual revenue acts enacted by Congress. Because dealing with many separate acts was inconvenient and confusing, Congress codified all of the Federal tax laws in 1939. Known as the Internal Revenue Code of 1939, the codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes. A further rearrangement took place in 1954 and resulted in the Internal Revenue Code of 1954, which continued in effect until 1986, when it was replaced by the Internal Revenue Code of 1986. Although Congress did not recodify the law in the Tax Reform Act (TRA) of 1986, the magnitude of the changes made by TRA of 1986 did provide some rationale for renaming the Federal tax law the Internal Revenue Code of 1986.

The following observations help clarify the codification procedure:

- Neither the 1939 nor the 1954 Code substantially changed the tax law existing on the date of its enactment. Much of the 1939 Code, for example, was incorporated into the 1954 Code; the major change was the reorganization and renumbering of the tax provisions.



TAX IN THE NEWS Tax Freedom Day

In income tax history, 1913 was an important year. In that year, the Sixteenth Amendment to the Constitution was ratified:

The Congress shall have power to tax and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The first income tax legislation that definitely was constitutional was passed that same year.

According to the Tax Foundation, in 2014, Tax Freedom Day fell on April 21, three days later than in 2013. Tax Freedom Day is the date on which an average taxpayer through

working has paid off his or her taxes for the year. If annual Federal borrowing is included, Tax Freedom Day occurred on May 6, 15 days later.

Nevertheless, Americans still paid more in taxes in 2014 than they spent on food, clothing, and shelter combined. Of course, if you lived in Connecticut and New Jersey with the heaviest total tax burden, Tax Freedom Day fell on May 19. Louisiana celebrated Tax Freedom Day the earliest—on March 30, the 89th day of the year.

Source: Tax Foundation, "America Celebrates Tax Freedom Day," www.taxfoundation.org/taxfreedomday.html.

- Although the 1986 Code resulted in substantial changes, only a minority of the statutory provisions were affected.¹
- Statutory amendments to the tax law are integrated into the Code. For example, over the past few years, the American Taxpayer Relief Act of 2012, as well as several other Acts, all became part of the Internal Revenue Code of 1986. In view of the frequency with which tax legislation has been enacted in recent years, it appears that the tax law will continue to be amended frequently.

The Legislative Process

Federal tax legislation generally originates in the House of Representatives, where it is first considered by the House Ways and Means Committee. It is also possible for tax bills to originate in the Senate when they are attached as riders to other legislative proposals.² If acceptable to the House Ways and Means Committee, the proposed bill is referred to the entire House of Representatives for approval or disapproval. Approved bills are sent to the Senate, where they are considered by the Senate Finance Committee.

The next step is referral from the Senate Finance Committee to the entire Senate. Assuming no disagreement between the House and Senate, passage by the Senate results in referral to the President for approval or veto. If the bill is approved or if the President's veto is overridden, the bill becomes law and part of the Internal Revenue Code of 1986.

House and Senate versions of major tax bills frequently differ. One reason bills are often changed in the Senate is that each senator has considerable latitude to make amendments when the Senate as a whole is voting on a bill referred to it by the Senate Finance Committee.³ In contrast, the entire House of Representatives either accepts or rejects what is proposed by the House Ways and Means Committee, and changes from the floor are rare. When the Senate version of the bill differs from that passed by the House, the Joint Conference Committee, which includes members of both the House Ways and Means Committee and the Senate Finance Committee, is called upon

¹This point is important in assessing judicial decisions interpreting provisions of the Internal Revenue Code of 1939 and the Internal Revenue Code of 1954. If the same provision was included in the Internal Revenue Code of 1986 and has not been subsequently amended, the provision and the related judicial decision have continuing validity.

²The Tax Equity and Fiscal Responsibility Act of 1982 originated in the Senate, and its constitutionality was unsuccessfully challenged in the courts.

The Senate version of the Deficit Reduction Act of 1984 was attached as an amendment to the Federal Boat Safety Act.

³During the passage of the Tax Reform Act of 1986, Senate leaders tried to make the bill *amendment proof* to avoid the normal amendment process.

to resolve the differences. The deliberations of the Joint Conference Committee usually produce a compromise between the two versions, which is then voted on by both the House and the Senate. If both bodies accept the bill, it is referred to the President for approval or veto. Former Senator Daniel Patrick Moynihan observed that in the last hours of Congress, the White House and lawmakers often agree on a “1,200-page monster, we vote for it; nobody knows what is in it.” Exhibit 2.1 summarizes the typical legislative process for tax bills.

The role of the Joint Conference Committee indicates the importance of compromise in the legislative process. As an example of the practical effect of the compromise process, consider Exhibit 2.2, which shows what happened with amendments to the earned income threshold for determining when the child tax credit becomes refundable.

Referrals from the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee are usually accompanied by Committee Reports. These Committee Reports often explain the provisions of the proposed legislation and are a valuable source for ascertaining the *intent of Congress*. What Congress had in mind when it considered and enacted tax legislation is, of course, the key to interpreting such legislation by taxpayers, the IRS, and the courts. Because Regulations normally are not issued immediately after a statute is enacted, taxpayers often look to Committee Reports to determine congressional intent.

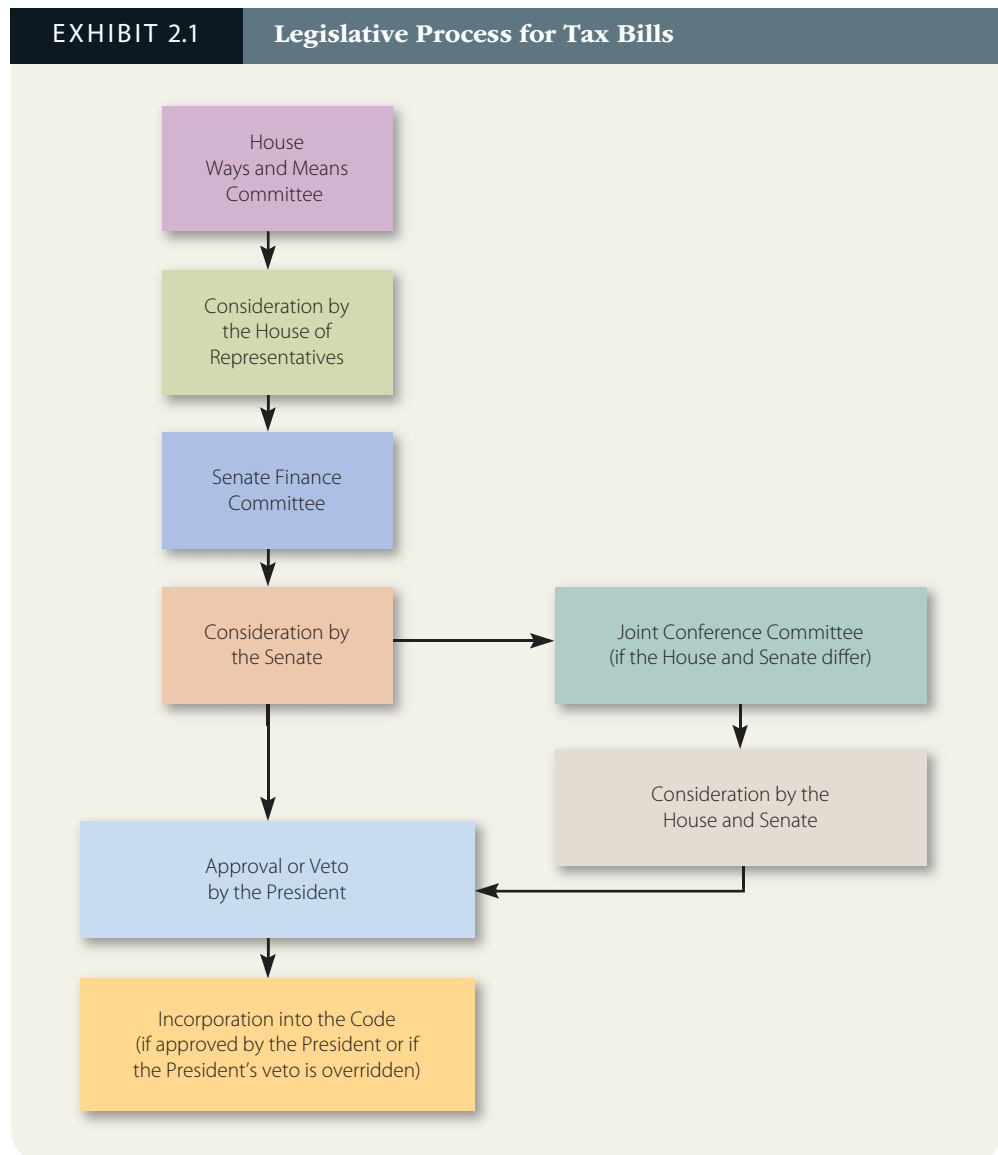
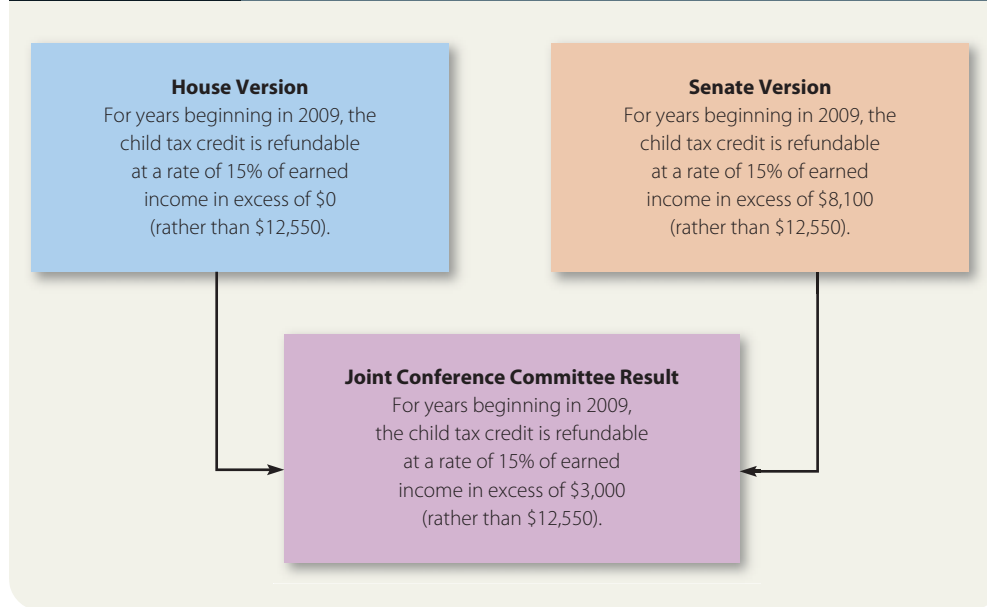


EXHIBIT 2.2

Example of Compromise in the Joint Conference Committee



Arrangement of the Code

The Internal Revenue Code of 1986 is found in Title 26 of the U.S. Code. In working with the Code, it helps to understand the format. Note, for example, the following partial table of contents:

- Subtitle A. Income Taxes
 - Chapter 11. Normal Taxes and Surtaxes
 - Subchapter A. Determination of Tax Liability
 - Part I. Tax on Individuals
 - Sections 1–5
 - Part II. Tax on Corporations
 - Sections 11–12

In referring to a provision of the Code, the *key* is usually the Section number. In citing Section 2(a) (dealing with the status of a surviving spouse), for example, it is unnecessary to include Subtitle A, Chapter 1, Subchapter A, Part I. Merely mentioning Section 2(a) will suffice, because the Section numbers run consecutively and do not begin again with each new Subtitle, Chapter, Subchapter, or Part. Not all Code Section numbers are used, however. Notice that Part I ends with Section 5 and Part II starts with Section 11 (at present, there are no Sections 6, 7, 8, 9, and 10).⁴

Tax practitioners commonly refer to some specific areas of income tax law by their Subchapters. Some of the more common Subchapter designations include Subchapter C (“Corporate Distributions and Adjustments”), Subchapter K (“Partners and Partnerships”), and Subchapter S (“Tax Treatment of S Corporations and Their Shareholders”). In the last situation in particular, it is much more convenient to describe the subject of the applicable Code provisions (Sections 1361–1379) as S corporation status rather than as the “Tax Treatment of S Corporations and Their Shareholders.”

⁴When the 1954 Code was drafted, some Section numbers were intentionally omitted so that later changes could be incorporated into the Code without disrupting its organization. When Congress does not leave enough space,

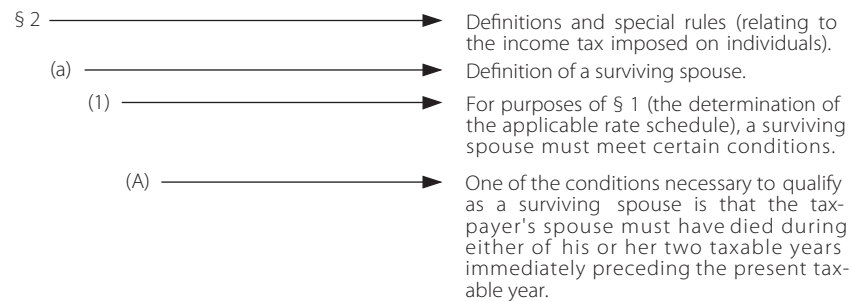
subsequent Code Sections are given A, B, C, etc., designations. A good example is the treatment of §§ 280A through 280H.

Citing the Code

Code Sections often are broken down into subparts.⁵ Section 2(a)(1)(A) serves as an example.



Broken down by content, § 2(a)(1)(A) becomes:



Throughout the text, references to the Code Sections are in the form given above. The symbols "§" and "§§" are used in place of "Section" and "Sections," respectively. Unless otherwise stated, all Code references are to the Internal Revenue Code of 1986. The following table summarizes the format that will be used:

Complete Reference	Text Reference
Section 2(a)(1)(A) of the Internal Revenue Code of 1986	§ 2(a)(1)(A)
Sections 1 and 2 of the Internal Revenue Code of 1986	§§ 1 and 2
Section 2 of the Internal Revenue Code of 1954	§ 2 of the Internal Revenue Code of 1954
Section 12(d) of the Internal Revenue Code of 1939 ⁷	§ 12(d) of the Internal Revenue Code of 1939

2-1b Administrative Sources of the Tax Law

The administrative sources of the Federal tax law can be grouped as follows: Treasury Department Regulations, Revenue Rulings and Revenue Procedures, and various other administrative pronouncements (see Exhibit 2.3). All are issued by either the U.S. Treasury Department or the IRS.

⁵Some Code Sections do not require subparts. See, for example, §§ 211 and 241.

⁶Some Code Sections omit the subsection designation and use the paragraph designation as the first subpart. See, for example, §§ 212(1) and 1222(1).

⁷Section 12(d) of the Internal Revenue Code of 1939 is the predecessor to § 2 of the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986. Keep in mind that the 1954 Code superseded the 1939 Code and the 1986 Code has superseded the 1954 Code. Footnote 1 of this chapter explains why references to the 1939 or 1954 Code are included.

EXHIBIT 2.3

Administrative Sources

Source	Location	Authority**
Regulations	<i>Federal Register*</i>	Force and effect of law.
Temporary Regulations	<i>Federal Register*</i> <i>Internal Revenue Bulletin</i> <i>Cumulative Bulletin</i>	May be cited as a precedent.
Proposed Regulations	<i>Federal Register*</i> <i>Internal Revenue Bulletin</i> <i>Cumulative Bulletin</i>	Preview of final Regulations.
Revenue Rulings	<i>Internal Revenue Bulletin</i>	Do not have the force and effect of law.
Revenue Procedures	<i>Cumulative Bulletin</i>	
Treasury Decisions		
Actions on Decisions		
General Counsel Memoranda	Tax Analysts' <i>Tax Notes</i> ; RIA's <i>Internal</i>	May not be cited as a precedent.
Technical Advice Memoranda	<i>Memoranda of the IRS</i> ; Commerce Clearing House's <i>IRS Position Reporter</i>	
Letter Rulings	Research Institute of America and Commerce Clearing House tax services	Applicable only to taxpayer addressed. No precedential force.

* Finalized, Temporary, and Proposed Regulations are published in soft-cover form by several publishers.

** Each of these sources may be substantial authority for purposes of the accuracy-related penalty in § 6662 (discussed on pages 2-27 and 2-29; Notice 90-20, 1990-1 C.B. 328).

Treasury Department Regulations

Regulations are issued by the U.S. Treasury Department under authority granted by Congress.⁸ Interpretive by nature, they provide taxpayers with considerable guidance on the meaning and application of the Code. Regulations, which may be issued in *proposed*, *temporary*, or *final* form, carry considerable authority as the official interpretation of tax statutes. They are an important factor to consider in complying with the tax law.

Because Regulations interpret the Code, they are arranged in the same sequence as the Code. A number is added at the beginning, however, to indicate the type of tax or administrative, procedural, or definitional matter to which they relate. For example, the prefix 1 designates the Regulations under the income tax law. Thus, the Regulations under Code § 2 are cited as Reg. § 1.2, with subparts added for further identification. The numbering patterns of these subparts often have no correlation with the Code subsections. The prefix 20 designates estate tax Regulations, 25 covers gift tax Regulations, 31 relates to employment taxes, and 301 refers to procedure and administration. This list is not all-inclusive.



ETHICS & EQUITY Is It Ethical for the IRS to Ideologically Profile Nonprofit Advocacy Groups?

In 2013, the Treasury Department Inspector General issued a report that concluded that the IRS scrutinized nonprofit advocacy groups in different ways, with some advocacy groups targeted for additional scrutiny based on their

political views. Is this type of scrutiny appropriate for the IRS? Why or why not? What do you think about the missing e-mails of some of the involved employees?

⁸§ 7805.

New Regulations and changes to existing Regulations are usually issued in proposed form before they are finalized. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal. **Proposed Regulations** under Code § 2, for example, are cited as Prop.Reg. § 1.2. The Tax Court indicates that Proposed Regulations carry little weight. **Finalized Regulations** have the force and effect of law.⁹

Sometimes the Treasury Department issues **Temporary Regulations** relating to matters where immediate guidance is important. These Regulations are issued without the comment period required for Proposed Regulations. Temporary Regulations have the same authoritative value as final Regulations and may be cited as precedents. However, Temporary Regulations must also be issued as Proposed Regulations and automatically expire within three years after the date of issuance.¹⁰ Temporary Regulations and the simultaneously issued Proposed Regulations carry more weight than traditional Proposed Regulations. An example of a Temporary Regulation is Temp.Reg. § 1.337(d)-2T, which allows an extension of time to determine the amount of an allowable loss.

Proposed, Temporary, and final Regulations are published in the *Federal Register*, in the *Internal Revenue Bulletin* (I.R.B.), and by major tax services. Final Regulations are issued as Treasury Decisions (TDs).

Regulations may also be classified as *legislative*, *interpretive*, or *procedural*. This classification scheme is discussed under Assessing the Validity of a Treasury Regulation later in the chapter.

Revenue Rulings and Revenue Procedures

Revenue Rulings are official pronouncements of the National Office of the IRS.¹¹ They typically provide one or more examples of how the IRS would apply a law to specific fact situations. Like Regulations, Revenue Rulings are designed to provide interpretation of the tax law. However, they do not carry the same legal force and effect as Regulations and usually deal with more restricted problems. Regulations are approved by the Secretary of the Treasury, whereas Revenue Rulings generally are not.

Although letter rulings (discussed in the next section) are not the same as Revenue Rulings, a Revenue Ruling often results from a specific taxpayer's request for a letter ruling. If the IRS believes that a taxpayer's request for a letter ruling deserves official publication because of its widespread impact, the letter ruling will be converted into a Revenue Ruling and issued for the information and guidance of taxpayers, tax practitioners, and IRS personnel. Names, identifying descriptions, and money amounts are changed to conceal the identity of the requesting taxpayer. Revenue Rulings also arise from technical advice to District Offices of the IRS, court decisions, suggestions from tax practitioner groups, and various tax publications.

Revenue Procedures are issued in the same manner as Revenue Rulings but deal with the internal management practices and procedures of the IRS. Familiarity with these procedures can increase taxpayer compliance and help the IRS administer the tax laws more efficiently. A taxpayer's failure to follow a Revenue Procedure can result in unnecessary delay or, in a discretionary situation, can cause the IRS to decline to act on behalf of the taxpayer.

Both Revenue Rulings and Revenue Procedures serve an important function by providing *guidance* to IRS personnel and taxpayers in handling routine tax matters. For example, one recent Revenue Procedure provided inflation-adjusted amounts for various Code provisions. Revenue Rulings and Revenue Procedures generally apply retroactively and may be revoked or modified by subsequent rulings or procedures, Regulations, legislation, or court decisions.

Revenue Rulings and Revenue Procedures are published weekly by the U.S. Government in the *Internal Revenue Bulletin* (I.R.B.).

⁹*F. W. Woolworth Co.*, 54 T.C. 1233 (1970); *Harris M. Miller*, 70 T.C. 448 (1978); and *James O. Tomerlin Trust*, 87 T.C. 876 (1986).

¹¹§ 7805(a).

¹⁰§ 7805(e).



TAX IN THE NEWS Origin of the April 15 Tax Day

April 15 has not always been the tax return due date in the United States. Congress originally established March 15 as the due date of personal income tax returns. This date selection was apparently based upon the date of the Sixteenth Amendment. According to Jessica Sung, “when the Sixteenth Amendment, which allows Congress to institute the income tax, was adopted on Feb. 3, 1913, Congress chose March 1—one year and a few dozen days later—as the deadline for filing returns.”

In order to give taxpayers more time to deal with the complexity of the tax laws, the Internal Revenue Code of 1954 changed the deadline to April 15.

Sources: Based on Jessica Sung, Tax Clinic, “Why Is Tax Day April 15?” *Fortune*, April 15, 2002, available at http://money.cnn.com/magazines/fortune/fortune_archive/2002/04/15/321414/index.htm; J. J. Thorndike, “Why Is Tax Day April 15?” *Tax Notes*, April 16, 2012, pp. 247–248.

The proper form for citing Revenue Rulings is as follows. Revenue Procedures are cited in the same manner, except that “Rev.Proc.” is substituted for “Rev.Rul.”

Rev.Rul. 2014–4, 2014–7 I.R.B. 523.

Explanation: Revenue Ruling Number 4, appearing on page 523 of the 7th weekly issue of the *Internal Revenue Bulletin* for 2014.

Revenue Rulings and other tax resources may be found in the *Tax Almanac*, a free online resource from Intuit at www.taxalmanac.org.¹²

Letter Rulings

Letter rulings are issued for a fee upon a taxpayer’s request and describe how the IRS will treat a *proposed* transaction for tax purposes. They apply only to the taxpayer who asks for and obtains the ruling, but post-1984 letter rulings may be substantial authority for purposes of the accuracy-related penalty.¹³ Letter rulings can be useful to taxpayers who want to be certain of how a transaction will be taxed before proceeding with it. Letter rulings also allow taxpayers to avoid unexpected tax costs. Although the procedure for requesting a ruling can be quite cumbersome, sometimes requesting a ruling is the most effective way to carry out tax planning. Nevertheless, the IRS limits the issuance of individual rulings to restricted, preannounced areas of taxation. The main reason the IRS will not rule in certain areas is that they involve fact-oriented situations. Thus, a ruling may not be obtained on many of the problems that are particularly troublesome for taxpayers.¹⁴ The IRS issues more than 2,500 letter rulings each year.

The law now requires the IRS to make individual rulings available for public inspection after identifying details are deleted.¹⁵ Published digests of private letter rulings can be found in *Private Letter Rulings* (published by RIA), Bloomberg BNA’s *Daily Tax Reports*, and *Tax Analysts’ Tax Notes*. In addition, computerized databases of letter rulings are available through several private publishers.

Letter rulings are issued multidigit file numbers that indicate the year and week of issuance as well as the number of the ruling during that week. Consider, for example, Ltr.Rul. 201432030, which involves a request of a waiver for the rollover period of an IRA.

¹²Commercial sources for Revenue Rulings and Revenue Procedures are available, usually requiring a subscription fee. Older Revenue Rulings and Revenue Procedures are often cited as being published in the *Cumulative Bulletin* (C.B.) rather than in the *Internal Revenue Bulletin* (I.R.B.).

¹³See pages 2-27 and 2-29; Notice 90–20, 1990–1 C.B. 328. In this regard, letter rulings differ from Revenue Rulings, which are applicable to *all* taxpayers. A letter ruling may later lead to the issuance of a Revenue Ruling if the holding affects many taxpayers. In its *Agents’ Manual*, the IRS indicates that letter

rulings may be used as a guide with other research materials in formulating a District Office position on an issue. The IRS is required to charge a taxpayer a fee for letter rulings, determination letters, etc.

¹⁴Rev.Proc. 2015–3, 2015–1 I.R.B. 129 contains a list of areas in which the IRS will not issue advance rulings. From time to time, subsequent Revenue Procedures are issued that modify or amplify Rev.Proc. 2015–3.

¹⁵§ 6110.

2014	32	030
Year 2014	32nd week of 2014	30th ruling issued during the 32nd week

Other Administrative Pronouncements

Treasury Decisions (TDs) are issued by the Treasury Department to promulgate new Regulations, amend or otherwise change existing Regulations, or announce the position of the Government on selected court decisions. Like Revenue Rulings and Revenue Procedures, TDs are published in the *Internal Revenue Bulletin* and subsequently transferred to the *Cumulative Bulletin*.

The IRS also publishes other administrative communications in the *Internal Revenue Bulletin*, such as Announcements, Notices, IRs (News Releases), Legal Memoranda (ILMs), Chief Counsel Notices (CC), and Prohibited Transaction Exemptions.

Like letter rulings, **determination letters** are issued at the request of taxpayers and provide guidance on the application of the tax law. They differ from letter rulings in that the issuing source is the Area Director rather than the National Office of the IRS. Also, determination letters usually involve *completed* (as opposed to proposed) transactions. Determination letters are not published and are made known only to the party making the request.

The following examples illustrate the distinction between letter rulings and determination letters:

Difference between Letter Rulings and Determination Letters

EXAMPLE

1

The shareholders of Red Corporation and Green Corporation want assurance that the consolidation of the corporations into Blue Corporation will be a nontaxable reorganization. The proper approach is to request that the National Office of the IRS issue a letter ruling concerning the income tax effect of the proposed transaction.

EXAMPLE

2

Chris operates a barbershop in which he employs eight barbers. To comply with the rules governing income tax and payroll tax withholdings, Chris wants to know whether the barbers working for him are employees or independent contractors. The proper procedure is to request a determination letter on their status from the appropriate Area Director.

Several internal memoranda that constitute the working law of the IRS are released. These General Counsel Memoranda (GCMs), Technical Advice Memoranda (TAMs), Internal Legal Memorandum (ILM), and Field Service Advices (FSAs) are not officially published, and the IRS indicates that they may not be cited as precedents by taxpayers.¹⁶ However, these working documents do explain the IRS's position on various issues.

The National Office of the IRS releases **Technical Advice Memoranda (TAMs)** weekly. TAMs resemble letter rulings in that they give the IRS's determination of an issue. However, they differ in several respects. Letter rulings deal with proposed transactions and are issued to taxpayers at their request. In contrast, TAMs deal with completed transactions. Furthermore, TAMs arise from questions raised by IRS personnel during audits and are issued by the National Office of the IRS to its field personnel. TAMs are often requested for questions relating to exempt organizations and employee plans. TAMs are not officially published and may not be cited or used as precedent.¹⁷ They are assigned file numbers according to the same procedure used for letter rulings. For example, TAM 201436056 refers to the 56th TAM issued during the 36th week of 2014.

¹⁶These are unofficially published by the publishers listed in Exhibit 2.3. Such internal memoranda for post-1984 transactions may be substantial authority for purposes of the accuracy-related penalty (see pages 2-27 and 2-29; Notice 90-20, 1990-1 C.B. 328).

¹⁷§ 6110(j)(3). Post-1984 TAMs may be substantial authority for purposes of avoiding the accuracy-related penalty. Notice 90-20, 1990-1 C.B. 328.

The Office of Chief Counsel prepares Field Service Advice (FSAs) to help IRS employees. They are issued in response to requests for advice, guidance, and analysis on difficult or significant tax issues. FSAs are not binding on either the taxpayer to whom they pertain or the IRS. For example, FSA 200233016 states that § 269 may be used to disallow foreign tax credits and deductions that arise from a series of reorganizations if the underlying transaction's principal purpose is to secure tax benefits.

Field Service Advices are being replaced by a new form of field guidance called Technical Expedited Advice Memoranda (TEAMs). The purpose of TEAMs is to expedite legal guidance to field agents as disputes are developing. FSAs are reverting to their original purpose of case-specific development of facts.

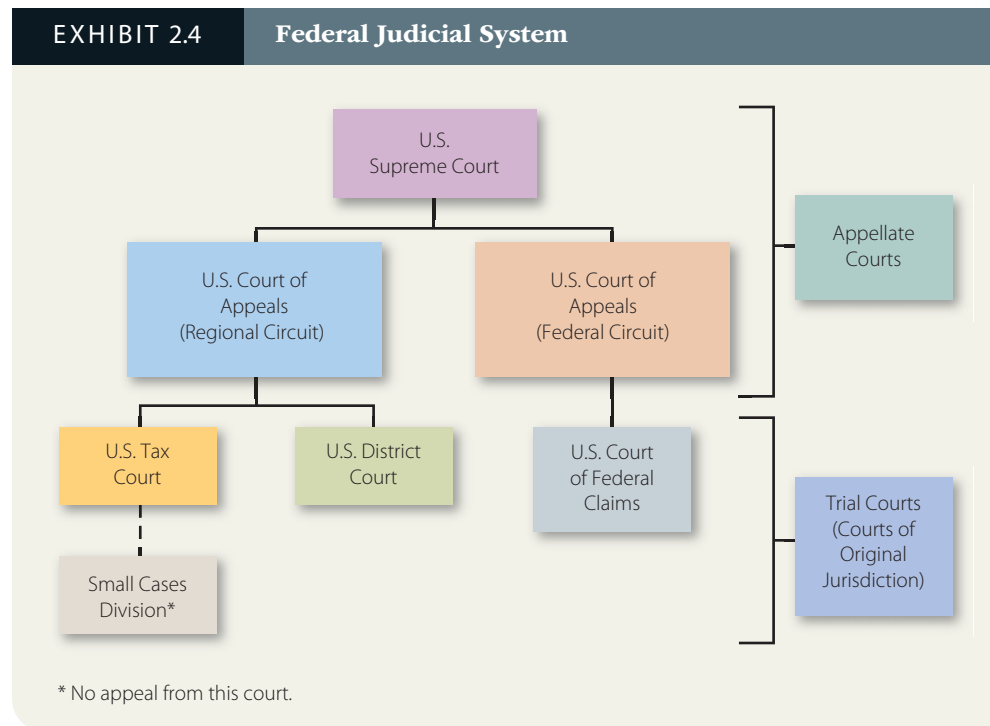
A TEAM guidance differs from a TAM in several ways, including a mandatory presubmission conference involving the taxpayer. In the event of a tentatively adverse conclusion for the taxpayer or the field agent, a conference of right is offered to the taxpayer and to the field agent; once the conference of right is held, no further conferences are offered.

2-1c Judicial Sources of the Tax Law

Five Federal courts have jurisdiction over tax disputes between the IRS and taxpayers: the U.S. Tax Court, the U.S. District Court, the U.S. Court of Federal Claims, the U.S. Court of Appeals, and the U.S. Supreme Court.

The Judicial Process in General

After a taxpayer has exhausted some or all of the remedies available within the IRS (i.e., no satisfactory settlement has been reached at the agent or at the Appeals Division level), the dispute can be taken to the Federal courts. The dispute is first considered by a **court of original jurisdiction** (known as a trial court) with any appeal (either by the taxpayer or the IRS) taken to the appropriate appellate court. In most situations, the taxpayer has a choice of any of *four trial courts*: a **Federal District Court**, the **U.S. Court of Federal Claims**, the **U.S. Tax Court**, or the **Small Cases Division** of the U.S. Tax Court. The trial and appellate court system for Federal tax litigation is illustrated in Exhibit 2.4.



The broken line between the U.S. Tax Court and the Small Cases Division indicates that there is no appeal from the Small Cases Division. The jurisdiction of the Small Cases Division is limited to cases involving amounts of \$50,000 or less. The proceedings of the Small Cases Division are informal (e.g., no necessity for the taxpayer to be represented by a lawyer or other tax adviser). Special trial judges rather than Tax Court judges preside over these proceedings. The decisions of the Small Cases Division are not precedents for any other court decision and are not reviewable by any higher court. Proceedings can be more timely and less expensive in the Small Cases Division. Some of these cases can now be found on the U.S. Tax Court website.

American law, following English law, is frequently *created* by judicial decisions. Under the doctrine of *stare decisis*, each case (except in the Small Cases Division) has precedential value for future cases with the same controlling set of facts. Most Federal and state appellate court decisions and some decisions of trial courts are published. Published court decisions are organized by jurisdiction (Federal or state) and level of court (trial or appellate).

A decision of a particular court is called its holding. Sometimes a decision includes *dicta* or incidental opinions beyond the current facts. Such passing remarks, illustrations, or analogies are not essential to the current holding. Although the holding has precedential value under *stare decisis*, *dicta* are not binding on a future court.

Knowledge of several terms is important in understanding court decisions. The term *plaintiff* refers to the party requesting action in a court, and the *defendant* is the party against whom the suit is brought. Sometimes a court uses the terms *petitioner* and *respondent*. In general, *petitioner* is a synonym for *plaintiff*, and *respondent* is a synonym for *defendant*. At the trial court level, a taxpayer is normally the plaintiff (or petitioner), and the Government is the defendant (or respondent). If the taxpayer wins and the Government appeals as the new petitioner (or appellant), the taxpayer becomes the new respondent.

Trial Courts

The differences among the various trial courts (courts of original jurisdiction) can be summarized as follows:

- *Number of courts.* There is only one Court of Federal Claims and only one Tax Court, but there are many Federal District Courts. The taxpayer does not select the District Court that will hear the dispute, but must sue in the one that has jurisdiction where the taxpayer resides.
- *Number of judges.* District Courts have various numbers of judges, but only one judge hears a case. The Court of Federal Claims has 16 judges, and the Tax Court has 19 regular judges. The entire Tax Court, however, reviews a case (the case is sent to court conference) only when more important or novel tax issues are involved. Many cases will be heard and decided by one of the 19 regular judges. If a case is reviewed by the full Tax Court, such an *en banc* decision has compelling authority.
- *Location.* The Court of Federal Claims meets most often in Washington, D.C., whereas a District Court meets at a prescribed seat for the particular district. Each state has at least one District Court, and many of the more populous states have more than one. Choosing the District Court usually minimizes the inconvenience and expense of traveling for the taxpayer and his or her counsel. Although the Tax Court is officially based in Washington, D.C., the various judges travel to different parts of the country and hear cases at predetermined locations and dates. This procedure eases the distance problem for the taxpayer, but it can mean a delay before the case comes to trial and is decided.
- *Jurisdiction of the Court of Federal Claims.* The Court of Federal Claims has jurisdiction over any claim against the United States that is based upon the Constitution, any Act of Congress, or any regulation of an executive department. Thus, the Court of Federal Claims hears nontax litigation as well as tax cases. This forum



TAX IN THE NEWS Dispute Alternatives within the IRS

If a taxpayer disagrees with the findings of a Revenue Agent, the taxpayer may appeal to the Appeals Division. This Appeals Division is an independent division within the IRS that provides a forum for a taxpayer to contest a compliance action by any part of the IRS.

If the taxpayer decides not to go to the Appeals Division, the taxpayer may take advantage of several arbitration and mediation alternatives. Under a Fast Track Mediation option,

an Appeals Officer or team case leader trained in mediation techniques will help speed up the IRS settlement process. A Fast Track Settlement attempts to resolve disputes through a mediated settlement within 170 days.

Source: Based on Leah Fontaine, Tax Clinic, "Overview of IRS Pre-Appeals Alternative Dispute Resolution Methods," *The Tax Adviser*, April 2012, pp. 229–231.

appears to be more favorable for issues having an equitable or pro-business orientation (as opposed to purely technical issues) and for those requiring extensive discovery of evidence.¹⁸

- *Jurisdiction of the Tax Court and District Courts.* The Tax Court hears only tax cases and is the most popular forum. The District Courts hear a wide variety of nontax cases, including drug crimes and other Federal violations, as well as tax cases. Some Tax Court judges have been appointed from IRS or Treasury Department positions. For these reasons, some people suggest that the Tax Court has more expertise in tax matters.
- *Jury trial.* The only court in which a taxpayer can obtain a jury trial is a District Court. But because juries can decide only questions of fact and not questions of law, even taxpayers who choose the District Court route often do not request a jury trial. In that event, the judge will decide all issues. Note that a District Court decision applies only in the district in which the court has jurisdiction.
- *Payment of deficiency.* For the Court of Federal Claims or a District Court to have jurisdiction, the taxpayer must pay the tax deficiency assessed by the IRS and sue for a refund. A taxpayer who wins (assuming no successful appeal by the Government) recovers the tax paid plus appropriate interest. For the Tax Court, however, jurisdiction is usually obtained without first paying the assessed tax deficiency. In the event the taxpayer loses in the Tax Court (and does not appeal or an appeal is unsuccessful), the deficiency must be paid with appropriate interest. With the elimination of the deduction for personal (consumer) interest (see Chapter 10), the Tax Court route of delaying payment of the deficiency can become expensive. By paying the tax, a taxpayer limits underpayment interest and penalties on the underpayment.
- *Termination of running of interest.* A taxpayer who selects the Tax Court may deposit a cash bond to stop the running of interest. The taxpayer must deposit both the amount of the tax and any accrued interest. If the taxpayer wins and the deposited amount is returned, the Government does not pay interest on the deposit.
- *Appeals.* Appeals from a District Court or a Tax Court decision are to the U.S. Court of Appeals for the circuit in which the taxpayer resides. Appeals from the Court of Federal Claims go to the Court of Appeals for the Federal Circuit. Few Tax Court cases are appealed, and when appeals are made, most are filed by the taxpayer rather than the IRS.
- *Bankruptcy.* When a taxpayer files a bankruptcy petition, the IRS, like other creditors, is prevented from taking action against the taxpayer. Sometimes a bankruptcy court may settle a tax claim.

For a summary of various attributes of the Federal trial courts, see Concept Summary 2.1.

¹⁸T. D. Peyser, "The Case for Selecting the Claims Court to Litigate a Federal Tax Liability," *The Tax Executive* (Winter 1988): 149.



Concept Summary 2.1

Federal Judicial System: Trial Courts

Issue	U.S. Tax Court	U.S. District Court	U.S. Court of Federal Claims
Number of judges per court	19*	Varies	16
Payment of deficiency before trial	No	Yes	Yes
Jury trial available	No	Yes	No
Types of disputes	Tax cases only	Most criminal and civil issues	Claims against the United States
Jurisdiction	Nationwide	Location of taxpayer	Nationwide
IRS acquiescence policy	Yes	Yes	Yes
Appeal route	U.S. Court of Appeals	U.S. Court of Appeals	U.S. Court of Appeals for the Federal Circuit

*Normally; there are also 5 special trial judges and 15 senior judges.

Appellate Courts

The losing party can appeal a trial court decision to a **Circuit Court of Appeals**. The 11 geographic circuits, the circuit for the District of Columbia, and the Federal Circuit¹⁹ appear in Exhibit 2.5. The appropriate circuit for an appeal depends on where the litigation originated. For example, an appeal from New York goes to the Second Circuit.



¹⁹The Court of Appeals for the Federal Circuit was created, effective October 1, 1982, by P.L. No. 97-64 (4/2/82) to hear decisions appealed from the Claims Court (now the Court of Federal Claims).

If the Government loses at the trial court level (District Court, Tax Court, or Court of Federal Claims), it need not (frequently does not) appeal. The fact that an appeal is not made, however, does not indicate that the IRS agrees with the result and will not litigate similar issues in the future. The IRS may decide not to appeal for a number of reasons. First, if the current litigation load is heavy, the IRS may decide that available personnel should be assigned to other more important cases. Second, the IRS may determine that this case is not a good one to appeal. Perhaps the taxpayer is in a sympathetic position or the facts are particularly strong in his or her favor. In that event, the IRS may wait to test the legal issues involved with a taxpayer who has a much weaker case. Third, if the appeal is from a District Court or the Tax Court, the Court of Appeals of jurisdiction could have some bearing on whether the IRS chooses to go forward with an appeal. Based on past experience and precedent, the IRS may conclude that the chance for success on a particular issue might be more promising in another Court of Appeals. If so, the IRS will wait for a similar case to arise in a different jurisdiction.

The Federal Circuit at the appellate level provides the taxpayer with an alternative forum to the Court of Appeals for his or her home circuit. Appeals from both the Tax Court and the District Court go to a taxpayer's home circuit. When a particular circuit has issued an adverse decision in a similar case, the taxpayer may prefer the Court of Federal Claims route, because any appeal will be to the Federal Circuit.

The Appellate Process

The *role* of the appellate court is limited to a review of the trial record compiled by the trial court. Thus, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision. Rarely will an appellate court question a lower court's fact-finding determination.

Both the Code and the Supreme Court indicate that Federal appellate courts are bound by findings of facts unless they are clearly erroneous.²⁰ This aspect of the appellate process is illustrated by a decision of the Court of Appeals for the District of Columbia involving whether a taxpayer was engaged in an activity for profit under § 183.²¹ This appeals court specifically held that the "Tax Court's findings of facts are binding on Federal courts of appeals unless clearly erroneous." The court applauded the Tax Court for the thoroughness of its factual inquiry but could "not place the stamp of approval upon its eventual legal outcome." In reversing and remanding the decision to the Tax Court, the appellate court said that "the language of § 183, its legislative history and the applicable Treasury Regulation combine to demonstrate that the court's [Tax Court's] standard is erroneous as a matter of law." The appeals court held that this taxpayer's claims of deductibility were to be evaluated by proper legal standards.

An appeal can have any of a number of possible outcomes. The appellate court may approve (affirm) or disapprove (reverse) the lower court's finding, or it may send the case back for further consideration (remand). When many issues are involved, a mixed result is not unusual. Thus, the lower court may be affirmed (*aff'd*) on Issue A and reversed (*rev'd*) on Issue B, while Issue C is remanded (*rem'd*) for additional fact finding.

When more than one judge is involved in the decision-making process, disagreements are not uncommon. In addition to the majority view, one or more judges may concur (agree with the result reached but not with some or all of the reasoning) or dissent (disagree with the result). In any one case, of course, the majority view controls. But concurring and dissenting views can have an influence on other courts or at some subsequent date when the composition of the court has changed.

Appellate Precedents and the Tax Court District Courts, the Tax Court, and the Court of Federal Claims must abide by the **precedents** set by the Court of Appeals of jurisdiction. A particular Court of Appeals need not follow the decisions of another Court of Appeals. All courts, however, must follow the decisions of the **U.S. Supreme Court**.

²⁰ §§ 7482(a) and (c). *Comm. v. Duberstein*, 60-2 USTC ¶9515, 5 AFTR 2d 1626, 80 S.Ct. 1190 (USSC, 1960). See Rule 52(a) of the Federal Rules of Civil Procedure.

²¹ *Dreicer v. Comm.*, 81-2 USTC ¶9683, 48 AFTR 2d 5884, 665 F.2d 1292 (CA-DC, 1981).

This pattern of appellate precedents raises an issue for the Tax Court. Because the Tax Court is a national court, it decides cases from all parts of the country. For many years, the Tax Court followed a policy of deciding cases based on what it thought the result should be, even though its decision might be appealed to a Court of Appeals that had previously decided a similar case differently. A number of years ago, this policy was changed in the *Golsen*²² decision. Now the Tax Court will decide a case as it believes the law should be applied *only* if the Court of Appeals of appropriate jurisdiction has not yet passed on the issue or has previously decided a similar case in accord with the Tax Court's decision. If the Court of Appeals of appropriate jurisdiction has previously held otherwise, the Tax Court will conform under the *Golsen* rule even though it disagrees with the holding.

EXAMPLE

3

Emily lives in Texas and sues in the Tax Court on Issue A. The Fifth Circuit Court of Appeals is the appellate court of appropriate jurisdiction. It has already decided, in a case involving similar facts but a different taxpayer, that Issue A should be resolved against the Government. Although the Tax Court believes that the Fifth Circuit Court of Appeals is wrong, under its *Golsen* policy, it will render judgment for Emily. Shortly thereafter, Rashad, a resident of New York, in a comparable case, sues in the Tax Court on Issue A. Assume that the Second Circuit Court of Appeals, the appellate court of appropriate jurisdiction, has never expressed itself on Issue A. Presuming that the Tax Court has not reconsidered its position on Issue A, it will decide against Rashad. Thus, it is entirely possible for two taxpayers suing in the same court to end up with opposite results merely because they live in different parts of the country.

Appeal to the U.S. Supreme Court Appeal to the U.S. Supreme Court is by **Writ of Certiorari**. If the Court agrees to hear the case, it will grant the Writ (*Cert. granted*). Most often, it will deny jurisdiction (*Cert. denied*). For whatever reason or reasons, the Supreme Court rarely hears tax cases. The Court usually grants certiorari to resolve a conflict among the Courts of Appeals (e.g., two or more appellate courts have assumed opposing positions on a particular issue) or where the tax issue is extremely important. The granting of a Writ of Certiorari indicates that at least four of the nine members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

LO.2

Locate and work with the appropriate tax law sources.

Judicial Citations

Having briefly described the judicial process, it is appropriate to consider the more practical problem of the relationship of case law to tax research. As previously noted, court decisions are an important source of tax law. The ability to cite and locate a case is, therefore, a must in working with the tax law. Judicial citations usually follow a standard pattern: case name, volume number, reporter series, page or paragraph number, court (where necessary), and year of the decision (see Concept Summary 2.2).

Judicial Citations—The U.S. Tax Court A good starting point is with the Tax Court, which issues two types of decisions: Regular and Memorandum, based on the Chief Judge's determination. The distinction between the two involves both substance and form. In terms of substance, *Memorandum* decisions deal with situations necessitating only the application of already established principles of law. *Regular* decisions involve novel issues not previously resolved by the court. In actual practice, however, this distinction is not always preserved. Not infrequently, Memorandum decisions will be encountered that appear to warrant Regular status and vice versa. At any rate, do not conclude that Memorandum decisions possess no value as precedents. Both represent the position of the Tax Court and, as such, can be relied on.

The Regular and Memorandum decisions issued by the Tax Court also differ in form. Memorandum decisions are made available but are not published by the government. Regular decisions are published by the U.S. Government in a series entitled *Tax Court*

²²Jack E. Golsen, 54 T.C. 742 (1970).



Concept Summary 2.2

Judicial Sources

Court	Location	Authority
U.S. Supreme Court	S.Ct. Series (West) U.S. Series (U.S. Gov't.) L.Ed.2d (Lawyer's Co-op.) AFTR (RIA) USTC (CCH)	Highest authority
U.S. Courts of Appeal	Federal 3d (West) AFTR (RIA) USTC (CCH)	Next highest appellate court
Tax Court (Regular decisions)	U.S. Gov't. Printing Office RIA/CCH separate services	Highest trial court*
Tax Court (Memorandum decisions)	RIA T.C.Memo. (RIA) TCM (CCH)	Less authority than Regular T.C. decision
U.S. Court of Federal Claims**	Federal Claims Reporter (West) AFTR (RIA) USTC (CCH)	Similar authority as Tax Court
U.S. District Courts	F.Supp.2d Series (West) AFTR (RIA) USTC (CCH)	Lowest trial court
Small Cases Division of Tax Court	U.S. Tax Court website***	No precedent value

*Theoretically, the Tax Court, Court of Federal Claims, and District Courts are on the same level of authority. But some people believe that because the Tax Court hears and decides tax cases from all parts of the country (i.e., it is a national court), its decisions may be more authoritative than a Court of Federal Claims or District Court decision.

** Before October 29, 1992, the U.S. Claims Court.

*** Starting in 2001.

of the *United States Reports* (T.C.). Each volume of these *Reports* covers a six-month period (January 1 through June 30 and July 1 through December 31) and is given a succeeding volume number. But there is usually a time lag between the date a decision is rendered and the date it appears in bound form. A temporary citation may be necessary to help the researcher locate a recent Regular decision. Consider, for example, the temporary and permanent citations for *B.V. Belk, Jr.*, a decision filed on January 28, 2013:

Temporary Citation { *B.V. Belk, Jr.*, 140 T.C. ____, No. 1 (2013).
 { *Explanation:* Page number left blank because not yet known.

Permanent Citation { *B.V. Belk, Jr.*, 140 T.C. 1 (2013).
 { *Explanation:* Page number now available.

Both citations tell us that the case will ultimately appear in Volume 140 of the *Tax Court of the United States Reports*. But until this volume is bound and made available to the general public, the page number must be left blank. Instead, the temporary citation identifies the case as being the 1st Regular decision issued by the Tax Court since Volume 139 ended. With this information, the decision can easily be located in either of the special Tax Court services published by Commerce Clearing House (CCH) or Research Institute of America (RIA). Once Volume 140 is released, the permanent citation can be substituted and the number of the case dropped. Starting in 1999, both Regular decisions and Memorandum decisions are published on the U.S. Tax Court website (www.ustaxcourt.gov).

Before 1943, the Tax Court was called the Board of Tax Appeals, and its decisions were published as the *United States Board of Tax Appeals Reports* (B.T.A.). These 47 volumes cover the period from 1924 to 1942. For example, the citation *Karl Pauli*, 11 B.T.A. 784 (1928), refers to the 11th volume of the *Board of Tax Appeals Reports*, page 784, issued in 1928.

If the IRS loses in a decision, it may indicate whether it agrees or disagrees with the results reached by the court by publishing an **acquiescence** (“A” or “Acq.”) or **nonacquiescence** (“NA” or “Nonacq.”), respectively. Until 1991, acquiescences and nonacquiescences were published only for certain Regular decisions of the Tax Court, but the IRS has expanded its acquiescence program to include other civil tax cases where guidance is helpful. The acquiescence or nonacquiescence is published in the *Internal Revenue Bulletin* and the *Cumulative Bulletin* as an *Action on Decision*. The IRS can retroactively revoke an acquiescence.

Most often, the IRS issues nonacquiescences to adverse decisions that are not appealed. In this manner, the Government indicates that it disagrees with the result reached, despite its decision not to seek review of the matter in an appellate court. A nonacquiescence provides a warning to taxpayers that a similar case cannot be settled administratively. A taxpayer will incur fees and expenses while the case moves through the IRS even though the IRS may be unwilling to litigate a fact pattern similar to a nonacquiescence decision.²³

Although Memorandum decisions were not published by the U.S. Government until recently, they have been and are published by CCH and RIA. Consider, for example, the three different ways the *Nick R. Hughes* case can be cited:

Nick R. Hughes, T.C.Memo. 2009–94

Explanation: The 94th Memorandum decision issued by the Tax Court in 2009.

Nick R. Hughes, 97 TCM 1488

Explanation: Page 1488 of Vol. 97 of the CCH *Tax Court Memorandum Decisions*.

Nick R. Hughes, 2009 RIA T.C.Memo. ¶2009,094

Explanation: Paragraph 2009,094 of the RIA *T.C. Memorandum Decisions*.

Note that the third citation contains the same information as the first. Thus, ¶2009,094 indicates the following information about the case: year 2009, 94th T.C.Memo. decision. Before the Prentice Hall Information Services division was incorporated into Research Institute of America, PH was used instead of RIA for the third citation.²⁴

U.S. Tax Court Summary Opinions relate to decisions of the Tax Court’s Small Cases Division.²⁵ These opinions are published commercially, and on the U.S. Tax Court website, with the warning that they may not be treated as precedent for any other case. For example, *John Erwin Smith*, filed on February 19, 2014, is cited as follows:

John Erwin Smith, T.C. Summary Opinion 2014–13.

Judicial Citations—The U.S. District Court, Court of Federal Claims, and Courts of Appeals District Court, Court of Federal Claims, Court of Appeals, and Supreme Court decisions dealing with Federal tax matters are reported in both the CCH *U.S. Tax Cases* (USTC) and the RIA *American Federal Tax Reports* (AFTR) series. Federal District Court decisions, dealing with *both* tax and nontax issues, also are published by West in its *Federal Supplement Series* (F.Supp.). Volume 999, published in 1998, is the last volume of the *Federal Supplement Series*. It is followed by the *Federal*

²³G. W. Carter, “Nonacquiescence: Winning by Losing,” *Tax Notes* (September 19, 1988): 1301–1307.

²⁴In this text, the RIA citation for Memorandum decisions of the U.S. Tax Court is omitted. Thus, *Nick R. Hughes* will be cited as 97 TCM 1488, T.C. Memo. 2009–94.

²⁵In 2005, the U.S. Supreme Court held that decisions of the Small Cases Division must be made public.

Supplement Second Series (F.Supp.2d). The following examples illustrate three different ways of citing a District Court case:

Turner v. U.S., 2004–1 USTC ¶60,478 (D.Ct. Tex., 2004).

Explanation: Reported in the first volume of the *U.S. Tax Cases* published by Commerce Clearing House for calendar year 2004 (2004–1) and located at paragraph 60,478 (¶60,478).

Turner v. U.S., 93 AFTR 2d 2004–686 (D.Ct. Tex., 2004).

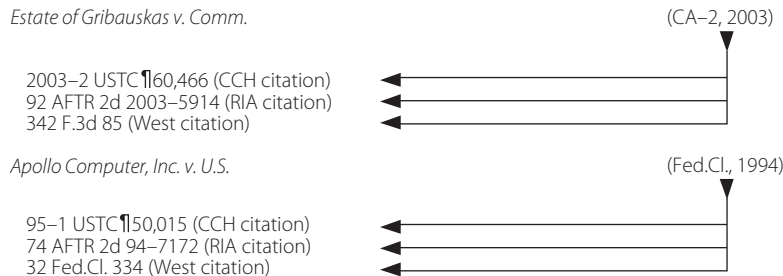
Explanation: Reported in the 93rd volume of the second series of the *American Federal Tax Reports* (AFTR 2d) published by RIA and beginning on page 686.

Turner v. U.S., 306 F.Supp.2d 668 (D.Ct. Tex., 2004).

Explanation: Reported in the 306th volume of the *Federal Supplement Second Series* (F.Supp.2d) published by West and beginning on page 668.

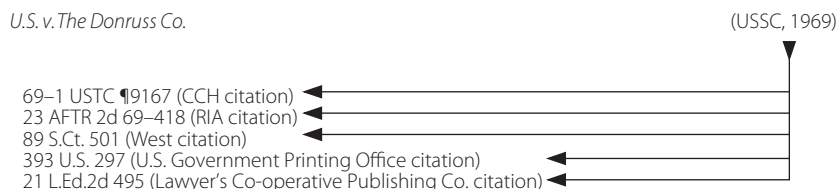
In all of the preceding citations, note that the name of the case is the same (Turner being the taxpayer), as is the reference to the Federal District Court of Texas (D.Ct. Tex.) and the year the decision was rendered (2004).²⁶

Decisions of the Court of Federal Claims²⁷ and the Courts of Appeals are published in the USTCs, the AFTRs, and a West reporter called the *Federal Second Series* (F.2d). Volume 999, published in 1993, is the last volume of the *Federal Second Series*. It is followed by the *Federal Third Series* (F.3d). Beginning with October 1982, the Court of Federal Claims decisions are published in another West reporter entitled the *Claims Court Reporter* (abbreviated Cl.Ct.). Beginning with Volume 27 on October 30, 1992, the name of the reporter changed to the *Federal Claims Reporter* (abbreviated as Fed.Cl.). The following examples illustrate the different forms:



Note that *Estate of Gribauskas v. Comm.* is a decision rendered by the Second Circuit Court of Appeals in 2003 (CA–2, 2003), while *Apollo Computer, Inc.* was issued by the Court of Federal Claims in 1994 (Fed.Cl., 1994).

Judicial Citations—The U.S. Supreme Court Like all other Federal tax decisions (except those rendered by the Tax Court), Supreme Court decisions are published by CCH in the USTCs and by RIA in the AFTRs. The U.S. Government Printing Office also publishes these decisions in the *United States Supreme Court Reports* (U.S.) as does West in its *Supreme Court Reporter* (S.Ct.) and the Lawyer’s Co-operative Publishing Company in its *United States Reports, Lawyer’s Edition* (L.Ed.). The following illustrates the different ways the same decision can be cited:



²⁶In this text, the case would be cited in the following form: *Turner v. U.S.*, 2004–1 USTC ¶60,478, 93 AFTR 2d 2004–686, 306 F.Supp.2d 668 (D.Ct. Tex., 2004).

²⁷Before October 29, 1992, the Court of Federal Claims was called the Claims Court. Before October 1, 1982, the Court of Federal Claims was called the Court of Claims.

The parenthetical reference (USSC, 1969) identifies the decision as having been rendered by the U.S. Supreme Court in 1969. In this text, the citations of Supreme Court decisions will be limited to the CCH (USTC), RIA (AFTR), and West (S.Ct.) versions.

2-1d Other Sources of the Tax Law

Other sources of tax information that a tax practitioner may need to consult include tax treaties and tax periodicals.

Tax Treaties

The United States signs certain tax treaties (sometimes called tax conventions) with foreign countries to render mutual assistance in tax enforcement and to avoid double taxation. Tax legislation enacted in 1988 provided that neither a tax law nor a tax treaty takes general precedence. Thus, when there is a direct conflict between the Code and a treaty, the most recent item takes precedence. A taxpayer must disclose on the tax return any position where a treaty overrides a tax law.²⁸ There is a \$1,000 penalty per failure to disclose for individuals and a \$10,000 per failure penalty for corporations.²⁹

Tax Periodicals

The use of tax periodicals can often shorten the research time needed to resolve a tax issue. If the article is relevant to the issue at hand, it may provide the references needed to locate the primary sources of the tax law that apply (e.g., citations to judicial decisions, Regulations, and other IRS pronouncements). Thus, the researcher obtains a “running start” in arriving at a solution to the problem.

Among the many indexes available for locating tax articles pertinent to a tax problem is CCH’s *Federal Tax Articles*. This multivolume service includes a subject index, a Code Section number index, and an author’s index.

Another is the *Index to Federal Tax Articles* (published by Warren, Gorham, and Lamont). Both of these indexes are updated periodically, but are available only in print form.

The following are some of the more useful tax periodicals:

Journal of Taxation
Journal of International Taxation
Practical Tax Strategies
Estate Planning
Corporate Taxation
Business Entities
Taxation of Exempts
Real Estate Taxation
ria.thomsonreuters.com/journals

The Tax Executive
www.tei.org

The Tax Adviser
aicpa.org/pubs/taxadv

Tax Law Review
www.law.nyu.edu/tax/taxlawreview/index.htm

Journal of the American Taxation Association
aaajournals.org/loi/atax

The ATA Journal of Legal Tax Research
aaajournals.org/loi/jltr

Oil, Gas & Energy Quarterly
www.bus.lsu.edu/accounting/faculty/lcrumbley/oilgas.html

Trusts and Estates
wealthmanagement.com/te-home

Journal of Passtbrough Entities
TAXES—The Tax Magazine
tax.cchgroup.com/books

Tax Notes
taxanalysts.com

²⁸§ 7852(d).

²⁹Reg. §§ 301.6114–1, 301.6712–1, and 301.7701(b)(7).

2-2 WORKING WITH THE TAX LAW— TAX RESEARCH TOOLS

LO.3

Develop an awareness of tax research tools.

Tax law consists of a body of legislative (e.g., Code Sections and tax treaties), administrative (e.g., Regulations and Rulings), and judicial (e.g., court cases) pronouncements. Working with the tax law requires being able to effectively locate and use these sources. A key consideration is the time required to carry out this research and finding activity.

Unless the problem is simple (e.g., the Code Section is known and there is a Regulation on point), the research process should begin with a tax service.

2-2a Commercial Tax Services

Due to various changes, categorizing tax services has become an almost impossible task. Previously, services could be classified as *annotated* (i.e., organized by Internal Revenue Code) or *topical* (i.e., organized by major topics), but this classification system is no longer appropriate for many tax services as their format has been modified. Often, the change is due to the acquisition of what was a competing tax service. For example, the *United States Tax Reporter* (annotated) now has a version that contains the *Federal Tax Coordinator 2d* (topical).

Tax services also can no longer be distinguished based on whether they are available only in hard copy or online versions. Previously, for example, *Tax Management Portfolios* was solely a print publication. Now, like most other tax services, it is also accessible online.

A partial list of the available commercial tax services includes:

- *Standard Federal Tax Reporter*, Commerce Clearing House.
- *CCH IntelliConnect*, Commerce Clearing House. The online version of the *Standard Federal Tax Reporter* (along with other CCH products).
- *United States Tax Reporter*, Research Institute of America.
- Thomson Reuters *Checkpoint*, Research Institute of America. The online versions of RIA's *United States Tax Reporter* and *Federal Tax Coordinator 2d*.
- *ATX/Kleinrock Tax Expert*, CCH/Wolters Kluwer Business services.
- *Tax Management Portfolios*, Bloomberg BNA.
- *Mertens Law of Federal Income Taxation*, West Group.
- Westlaw services—compilations include access to *Tax Management Portfolios*, *Federal Tax Coordinator 2d*, and *Mertens*.
- *TaxCenter*, LexisNexis compilation of primary sources and various materials taken from CCH, Matthew Bender, Kleinrock, and Bloomberg BNA.
- *Federal Research Library*, Tax Analysts (a nonprofit organization) databases dealing with explanations and commentaries on primary source materials.

2-2b Using Online Tax Services

Instructions on how to use a tax service are not particularly worthwhile unless a specific service is involved. Even here, instructions need to be followed by hands-on experience to be effective. For online versions of a tax service, however, following certain procedures can simplify the research process. Because a practitioner's time is valuable and several research services base usage charges on time spent, time is of the essence.

When the principal emphasis is on time, every shortcut helps. The following suggestions (most of which are familiar to any user of the Internet) may be helpful.³⁰

³⁰For a more complete discussion of the use of Thomson Reuters *Checkpoint* and CCH *IntelliConnect* and Internet research in taxation, see Sawyers,

Raabe, Whittenburg, and Gill, *Federal Tax Research*, 10th ed. (Cengage Learning, 2015), Chapters 6 and 7.

- Choose keywords for the search carefully. Words with a broad usage, such as *income*, are worthless when standing alone. If the researcher is interested in qualified dividend income, even *dividend income* is too broad because it will call up stock dividends, constructive dividends, liquidating dividends, and more. By using *qualified dividend income* at the outset, the search is considerably narrowed. In CCH *IntelliConnect*, for example, these two modifications narrowed the search from over 2.7 million items to 30,188 and finally to 1,921. From that point, further contraction will be needed.
- Take advantage of *connectors*, such as “+” and quotation marks, to place parameters on the search and further restrict the output. Although each service has its own set of connectors, many are used by several services. Thus, quotation marks around a phrase mean “exact phrase” in both Thomson Reuters *Checkpoint* and CCH *IntelliConnect* (e.g., “personal service corporation”).
- Be selective in choosing a database. For example, if the research project does not involve case law, there is no point in including the judicial decision component in the search database. Doing so just adds to the output items and will necessitate further screening through a search modification.
- Use a table of contents, index, or citation approach when appropriate. Although the keyword approach is most frequently used, databases can be searched in other ways. Using the table of contents or index is the usual approach with print versions of a tax service. With the citation route, access may be through a statutory (e.g., Code Section), administrative (e.g., Rev.Rul.), or judicial citation (e.g., Tax Court), depending on the tax service. Using just a Code Section number or the taxpayer’s last name, however, can require a significant amount of screening to narrow the information.

2-2c Noncommercial Online Tax Services

The Internet provides a wealth of tax information in several popular forms, sometimes at no direct cost to the researcher. Using so-called browser software that often is distributed with new computer systems and their communication devices, the tax professional can access information provided around the world that aids the research process.

- *Home pages (sites) on the Web* are provided by accounting and consulting firms, publishers, tax academics and libraries, and governmental bodies as a means of making information widely available or of soliciting subscriptions or consulting engagements. The best sites offer links to other sites and direct contact to the site providers. One of the best sites available to the tax practitioner is the Internal Revenue Service’s home page, illustrated in Exhibit 2.6. This site offers downloadable forms and instructions, “plain English” versions of Regulations, and news update items. Exhibit 2.7 lists some of the websites and their Internet addresses as of press date that may be most useful to tax researchers. Particularly useful is the directory at **taxsites.com**, which provides links to accounting and tax sources (including international as well as payroll).
- *Newsgroups* provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group’s services. Newsgroup members can read the exchanges among other members and offer replies and suggestions to inquiries as desired. Discussions address the interpretation and application of existing law, analysis of proposals and new pronouncements, and reviews of tax software.

EXHIBIT 2.6

The IRS's Home Page



© IRS—Internal Revenue Service

In many situations, solutions to research problems benefit from or require the use of various electronic tax research tools. A competent tax professional must become familiar and proficient with these tools and be able to use them to meet the expectations of clients and the necessities of work in the modern world.³¹

2-3 WORKING WITH THE TAX LAW— TAX RESEARCH

Tax research is the method used to determine the best available solution to a situation that possesses tax consequences. In other words, it is the process of finding a competent and professional conclusion to a tax problem. The problem may originate from completed or proposed transactions. In the case of a completed transaction,

LO.4

Describe the tax research process.

³¹For a more detailed discussion of the use of electronic tax research in tax practice, see Sawyers, Raabe, Whittenburg, and Gill, *Federal Tax Research*, 10th ed. (Cengage Learning, 2015).

EXHIBIT 2.7

Tax-Related Websites

Website	Web Address	Description
Accounting firms and professional organizations	For instance, the AICPA's page is at aicpa.org , Ernst & Young is at ey.com , and KPMG is at kpmg.com	Tax planning newsletters, descriptions of services offered and career opportunities, and exchange of data with clients and subscribers
Cengage Learning	cengagebrain.com	Informational updates, newsletters, support materials for students and adopters, and continuing education
Commercial tax publishers	For instance, tax.com , cchgroup.com , tax.thomsonreuters.com , and bn.com	Information about products and services available for subscription and newsletter excerpts
Court opinions	The site at law.justia.com covers state, Federal, and Supreme Court decisions but not the Tax Court	A synopsis of results reached by the court
Internal Revenue Service	irs.gov	News releases, downloadable forms and instructions, tables, Circular 230, and e-mail
Tax Almanac	taxalmanac.org	Smorgasbord of tax research resources
Tax Analysts	taxanalysts.com	Policy-oriented readings on the tax law and proposals to change it, moderated bulletins on various tax subjects
Tax Foundation	taxfoundation.org	Nonprofit educational organization that promotes sound tax policy and measures tax burdens
Tax laws online	Regulations are at law.cornell.edu/cfr , and the Code is at uscode.house.gov and www.law.cornell.edu/uscode	
Tax Sites Directory	taxsites.com	References and links to tax sites on the Internet, including state and Federal tax sites, academic and professional pages, tax forms, and software
U.S. Tax Court decisions	ustaxcourt.gov	Recent U.S. Tax Court decisions

Caution: Web addresses change frequently.

the objective of the research is to determine the tax result of what has already taken place. For example, was the expenditure incurred by the taxpayer deductible or not deductible for tax purposes? When dealing with proposed transactions, the tax research process is directed toward the determination of possible alternative tax consequences. To the extent that tax research leads to a choice of alternatives or otherwise influences the future actions of the taxpayer, it becomes the key to effective tax planning.

Tax research involves the following procedures:

- Identifying and refining the problem.
- Locating the appropriate tax law sources.
- Assessing the validity of the tax law sources.
- Arriving at the solution or at alternative solutions with due consideration given to nontax factors.
- Effectively communicating the solution to the taxpayer or the taxpayer's representative.
- Following up on the solution (where appropriate) in light of new developments.

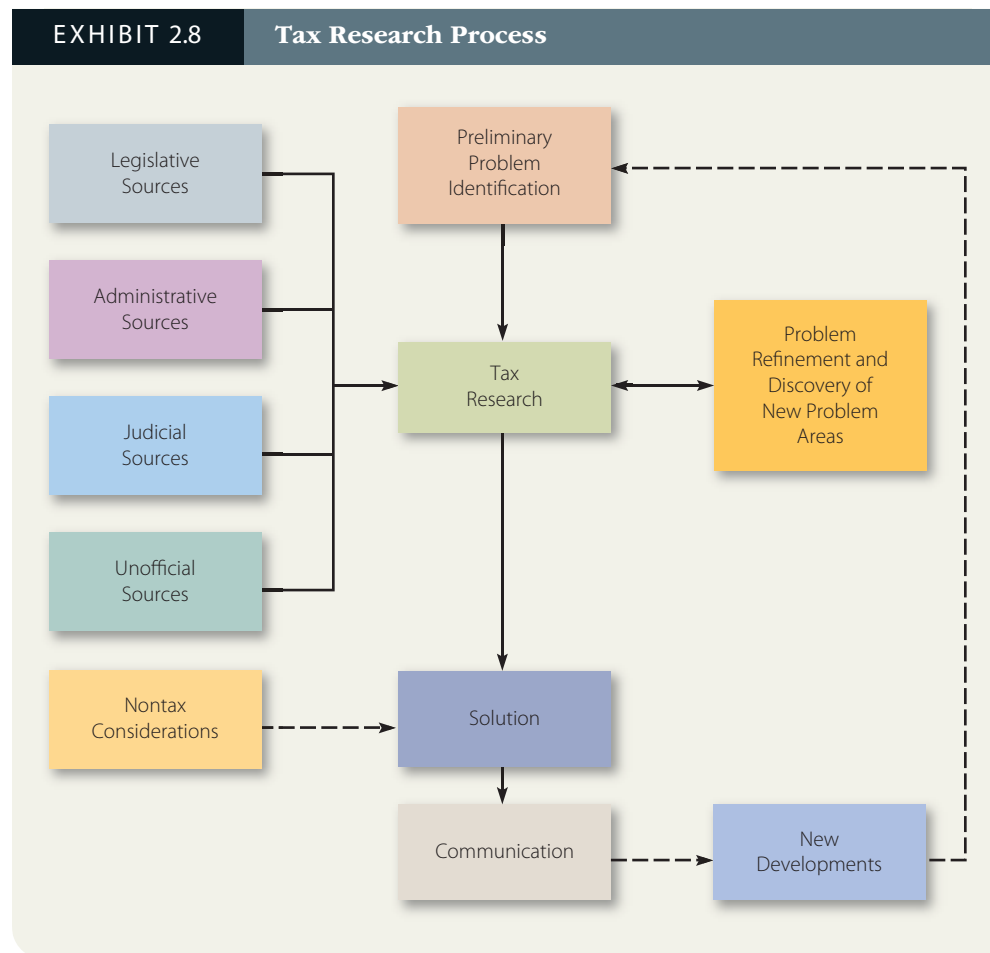
This process is depicted schematically in Exhibit 2.8. The broken lines reflect the steps of particular interest when tax research is directed toward proposed, rather than completed, transactions.

2-3a Identifying the Problem

Problem identification must start with a compilation of the relevant facts involved.³² In this regard, *all* of the facts that may have a bearing on the problem must be gathered because any omission could modify the solution reached. To illustrate, return to the facts of *The Big Picture* on page 2-1 and consider what appears to be a very simple problem: Can Fred and Megan claim Sam and Dana as dependents?

2-3b Refining the Problem

Returning to the facts of *The Big Picture* on page 2-1, the simple question of whether Fred and Megan can claim Sam and Dana as dependents becomes more complicated with the potential stock sale. Initially, it appears that Fred and Megan could *not* claim Sam and Dana as dependents if the stock was sold, because Sam would then have gross income of more than the exemption amount under § 151(d).³³ However, after 2004, the test for whether a child qualifies for dependency status is first conducted under the *qualifying child* requirements. Only if these requirements cannot be satisfied is the test for dependency status conducted under the *qualifying relative* requirements. The gross income test is applicable only



³²For an excellent discussion of the critical role of facts in carrying out tax research, see R. L. Gardner, D. N. Stewart, and R. G. Worsham, *Tax Research Techniques*, 9th ed. (New York: The American Institute of Certified Public Accountants, 2012), Chapter 2.

³³§ 152(d)(2). See the related discussion in Chapter 3.

under the qualifying relative status.³⁴ Thus, Sam could sell the stock without penalizing the parents with respect to the gross income test. Under the qualifying child provision, however, Sam must not have provided more than one-half of his own support.³⁵ Hence, the \$19,000 of proceeds from the sale of the stock might lead to the failure of the “not self-supporting” requirement, depending on how much Sam spends for his support.

Assume, however, that further fact gathering reveals the following additional information:

- Sam does not really need to spend the proceeds from the sale of the stock.
- Sam receives a sizable portion of his own support from a scholarship.

With these new facts, additional research leads to § 152(f)(5) and Regulation § 1.152-1(c), which indicate that a scholarship received by a student is not included for purposes of computing whether Sam is self-supporting under the qualifying child provision. Further, if Sam does not spend the proceeds from the sale of the stock, the unexpended amount is not counted for purposes of the not self-supporting test. Thus, in contrast to the initial conclusion, it appears that the parents will be allowed the dependency exemptions for Sam and Dana, as the qualifying child requirements appear to be satisfied for Sam and the qualifying relative requirements appear to be satisfied for Dana.

2-3c Locating the Appropriate Tax Law Sources

Once the problem is clearly defined, what is the next step? Although the next step is a matter of individual judgment, most tax research begins with the index volume of a hard copy tax service or a keyword search on an online tax service as described earlier. If the problem is not complex, the researcher may bypass the hard copy tax service or online service and turn directly to the Internal Revenue Code and Treasury Regulations. For the beginner, the latter procedure saves time and solves many of the more basic problems. If the researcher does not have a personal copy of the Code or Regulations, resorting to the appropriate volume(s) of a tax service will be necessary.³⁶

2-3d Assessing the Validity of the Tax Law Sources

Once a source has been located, the next step is to assess it in light of the problem at hand. Proper assessment involves careful interpretation of the tax law with consideration given to its relevance and validity. In connection with validity, an important step is to check for recent changes in the tax law.

Interpreting the Internal Revenue Code

The language of the Code often is difficult to comprehend fully. Contrary to many people’s suspicions, the Code is not written deliberately to confuse. Unfortunately, though, it often has that effect. The Code is intended to apply to more than 200 million taxpayers, many of whom are willing to exploit any linguistic imprecision to their benefit—to find a “loophole” in popular parlance. Many of the Code’s provisions are limitations or restrictions involving two or more variables. Expressing such concepts algebraically would be more direct; using words to accomplish this task instead is often quite cumbersome. Among the worst such attempts was former § 341(e) relating to so-called collapsible corporations. One sentence had more than 450 words (twice as many as in Abraham Lincoln’s Gettysburg Address). Within this same subsection was another sentence of 300 words. Research has shown that in one-third of the conflicts reaching the Tax Court, the court could not discern the intent of Congress by simply reading the statute. Yet the overriding attitude of the Tax Court judges is that the statute comes first. Even when the statute is unworkable, the court will not rewrite the law.³⁷

³⁴Compare § 152(c) for qualifying child with § 152(d) for qualifying relative.

³⁵§ 152(c)(1)(D).

³⁶Several of the major tax services publish paperback editions of the Code and Treasury Regulations that can be purchased at modest prices. These editions are usually revised twice each year. For an annotated and abridged version of the Code and Regulations that is published annually,

see James E. Smith and Mark Altieri, *South-Western Federal Taxation: Internal Revenue Code of 1986 and Treasury Regulations: Annotated and Selected* (Cengage Learning, 2016).

³⁷T. L. Kirkpatrick and W. B. Pollard, “Reliance by the Tax Court on the Legislative Intent of Congress,” *The Tax Executive* (Summer 1986): 358–359.

Assessing the Validity of a Treasury Regulation

Treasury Regulations are the official interpretation of the Code and are entitled to great deference. Occasionally, however, a court will invalidate a Regulation or a portion thereof on the grounds that the Regulation is contrary to the intent of Congress. Usually, the courts do not question the validity of Regulations because of the belief that “the first administrative interpretation of a provision as it appears in a new act often expresses the general understanding of the times or the actual understanding of those who played an important part when the statute was drafted.”³⁸

Keep the following observations in mind when assessing the validity of a Regulation:

- IRS agents must give the Code and any related Regulations equal weight when dealing with taxpayers and their representatives.
- Proposed Regulations provide a preview of future final Regulations, but they are not binding on the IRS or taxpayers.
- In a challenge, the burden of proof is on the taxpayer to show that the Regulation varies from the language of the statute and has no support in the Committee Reports.
- If the taxpayer loses the challenge, a 20 percent negligence penalty may be imposed.³⁹ This accuracy-related penalty applies to any failure to make a reasonable attempt to comply with the tax law and any disregard of rules and Regulations.⁴⁰
- Final Regulations can be classified as procedural, interpretive, or legislative. **Procedural Regulations** neither establish tax laws nor attempt to explain tax laws. Procedural Regulations are *housekeeping-type instructions* indicating information that taxpayers should provide the IRS, as well as information about the internal management and conduct of the IRS itself.
- Some **interpretive Regulations** rephrase and elaborate what Congress stated in the Committee Reports that were issued when the tax legislation was enacted. Such Regulations are *hard* and *solid* and almost impossible to overturn because they clearly reflect the intent of Congress. An interpretive Regulation is given less deference than a legislative Regulation, however. The Supreme Court has told lower courts to analyze Treasury Regulations carefully before accepting the Treasury’s interpretation.⁴¹
- In some Code Sections, Congress has given the *Treasury Secretary or his delegate* the authority to prescribe Regulations to carry out the details of administration or to otherwise complete the operating rules. Under such circumstances, Congress effectively is delegating its legislative powers to the Treasury Department. Regulations issued pursuant to this type of authority possess the force and effect of law and are often called **legislative Regulations** (e.g., consolidated return Regulations).
- Courts tend to apply a legislative reenactment doctrine. A particular Regulation is assumed to have received congressional approval if the Regulation was finalized many years earlier and Congress has not amended the Code Section pertaining to that Regulation.

Assessing the Validity of Other Administrative Sources of the Tax Law

Revenue Rulings issued by the IRS carry less weight than Treasury Department Regulations. Revenue Rulings are important, however, in that they reflect the position of the IRS on tax

³⁸*Augustus v. Comm.*, 41-1 USTC ¶9255, 26 AFTR 612, 118 F.2d 38 (CA-6, 1941).

³⁹§§ 6662(a) and (b)(1).

⁴⁰§ 6662(c). The term *reasonable* is not defined in the Code; the IRS looks at all the facts and circumstances surrounding the effort of the taxpayer to report the correct tax liability.

⁴¹*U.S. v. Vogel Fertilizer Co.*, 82-1 USTC ¶9134, 49 AFTR 2d 82-491, 102 S.Ct. 821 (USSC, 1982); *National Muffler Dealers Assn., Inc.*, 79-1 USTC ¶9264, 43 AFTR 2d 79-828, 99 S.Ct. 1304 (USSC, 1979).

matters. In any dispute with the IRS on the interpretation of tax law, therefore, taxpayers should expect agents to follow the results reached in any applicable Revenue Rulings. A 1986 Tax Court decision, however, indicated that Revenue Rulings “typically do not constitute substantive authority for a position.”⁴² Most Revenue Rulings apply retroactively unless a specific statement indicates the extent to which a ruling is to be applied without retroactive effect.⁴³

Actions on Decisions further tell the taxpayer the IRS’s reaction to certain court decisions. Recall that the IRS follows a practice of either acquiescing (agreeing) or nonacquiescing (not agreeing) with selected judicial decisions. A nonacquiescence does not mean that a particular court decision is of no value, but it does indicate that the IRS may continue to litigate the issue involved.

Assessing the Validity of Judicial Sources of the Tax Law

The judicial process as it relates to the formulation of tax law has already been described. How much reliance can be placed on a particular decision depends upon the following variables:

- The higher the level of the court that issued a decision, the greater the weight accorded to that decision. A decision rendered by a trial court (e.g., a Federal District Court) carries less weight than one issued by an appellate court (e.g., the Fifth Circuit Court of Appeals). Unless Congress changes the Code, decisions by the U.S. Supreme Court represent the last word on any tax issue.
- More reliance is placed on decisions of courts that have jurisdiction in the area where the taxpayer’s legal residence is located. If, for example, a taxpayer lives in Texas, a decision of the Fifth Circuit Court of Appeals (which would hear an appeal from a Texas trial court) means more than one rendered by the Second Circuit Court of Appeals.⁴⁴
- A Tax Court Regular decision carries more weight than a Memorandum decision because the Tax Court does not consider Memorandum decisions to be binding precedents.⁴⁵ Furthermore, a Tax Court *reviewed* decision (where *all* of the Tax Court judges participate) carries even more weight.
- A Circuit Court decision where certiorari has been requested and denied by the U.S. Supreme Court carries more weight than a Circuit Court decision that was not appealed. A Circuit Court decision heard *en banc* (all of the judges participate) carries more weight than a normal Circuit Court case.
- A decision that is supported by cases from other courts carries more weight than a decision that is not supported by other cases.
- The weight of a decision also can be affected by its status on appeal. For example, was the decision affirmed or overruled?

In connection with the last two variables, the use of a citator is invaluable to tax research.⁴⁶ A **citator** provides the history of a case, including the authority relied on (e.g., other judicial decisions) in reaching the result. Reviewing the references listed in the citator discloses whether the decision was appealed and, if so, with what result (e.g., affirmed, reversed, or remanded). It also reveals other cases with the same or similar issues and how they were decided. Thus, a citator reflects on the validity of a case and may lead to other relevant judicial material.⁴⁷ If one intends to rely on a judicial decision to any significant degree, “running” the case through a citator is imperative.

⁴²*Nelda C. Stark*, 86 T.C. 243 (1986). See also *Ann R. Neuboff*, 75 T.C. 36 (1980). For a different opinion, however, see *Industrial Valley Bank & Trust Co.*, 66 T.C. 272 (1976).

⁴³Rev.Proc. 87–1, 1987–1 C.B. 503.

⁴⁴Before October 1, 1982, an appeal from the then-named U.S. Court of Claims (the other trial court) was directly to the U.S. Supreme Court.

⁴⁵*Severino R. Nico, Jr.*, 67 T.C. 647 (1977).

⁴⁶The major citators are published by CCH; RIA; Westlaw; and Shepard’s Citations, Inc.

⁴⁷The CCH version is available online through the CCH *IntelliConnect* service; for RIA, use Thomson Reuters *Checkpoint*. Shepard’s Internet version is part of LexisNexis.



FINANCIAL DISCLOSURE INSIGHTS Where Does GAAP Come From?

As this chapter has described, the tax law is developed by many entities, including Congress, and the legislators of other countries, the courts, and the IRS. Accounting principles also have many sources. Consequently, in reconciling the tax and financial accounting reporting of a transaction, the tax professional will need to know the hierarchy of authority of accounting principles—in particular, the level of importance to assign to a specific GAAP document. The diagram below presents the sources of GAAP arranged in a general order of authority from highest to lowest.

Professional research is conducted to find and analyze the sources of accounting reporting standards in much the same way a tax professional conducts research on an open tax question. In fact, many of the publishers that provide tax research materials also can be used to find GAAP and International Financial Reporting Standards (IFRS) documents. These include the Research Institute of America (RIA) and the Commerce Clearing House (CCH). The Financial Accounting Standards Board (FASB) also makes its standards and interpretations available by subscription.

Highest Authority

- Financial Accounting Standards and Interpretations of the FASB.
- Pronouncements of bodies that preceded the FASB, such as the Accounting Principles Board (APB).

- FASB Technical Bulletins.
- Audit and Accounting Guides, prepared by the American Institute of CPAs (AICPA) and cleared by the FASB.
- Practice Bulletins, prepared by the American Institute of CPAs (AICPA) and cleared by the FASB.

- Interpretation Guides of the FASB Staff.
- Accounting Interpretations of the AICPA.
- IASB Accounting Standards
- FASB Concepts Standards.
- Widely accepted accounting practices, professional journals, accounting textbooks, and treatises.

Assessing the Validity of Other Sources

Primary sources of tax law include the Constitution, legislative history materials, statutes, treaties, Treasury Regulations, IRS pronouncements, and judicial decisions. In general, the IRS considers only primary sources to constitute substantial authority. However, a researcher might want to refer to *secondary materials* such as legal periodicals, treatises, legal opinions, General Counsel Memoranda, and written determinations. In general, secondary sources are not authority.

Although the statement that the IRS regards only primary sources as substantial authority generally is true, there is one exception. In Notice 90–20,⁴⁸ the IRS expanded the list of substantial authority *for purposes of* the accuracy-related penalty in § 6662 to include a number of secondary materials (e.g., letter rulings, General Counsel Memoranda, and the Bluebook). “Authority” does not include conclusions reached in treatises, legal periodicals, and opinions rendered by tax professionals.

A letter ruling or determination letter is substantial authority *only* for the taxpayer to whom it is issued, except as noted previously with respect to the accuracy-related penalty.

Upon the completion of major tax legislation, the staff of the Joint Committee on Taxation (in consultation with the staffs of the House Ways and Means and Senate Finance Committees) often will prepare a General Explanation of the Act, commonly known as the Bluebook because of the color of its cover. The IRS will not accept this detailed

⁴⁸1990–1 C.B. 328; see also Reg. § 1.6661–3(b)(2).

explanation as having legal effect, except as noted previously with respect to the accuracy-related penalty. The Bluebook does, however, provide valuable guidance to tax advisers and taxpayers until Regulations are issued. Some letter rulings and General Counsel Memoranda of the IRS cite Bluebook explanations.

2-3e Arriving at the Solution or at Alternative Solutions

The Big Picture on page 2-1 raised the question of whether a taxpayer would be denied dependency exemptions for a son and a daughter-in-law if the son sold some stock near the end of the year. A refinement of the problem supplies additional information:

- Sam and Dana anticipate filing a joint return.

Section 152(b)(2) indicates that a taxpayer is not permitted a dependency exemption for a married dependent if the married individual files a joint return. An initial reaction is that a joint return by Sam and Dana would be problematic to the parents. However, more research uncovers two Revenue Rulings that provide an exception if neither the dependent nor the dependent's spouse is required to file a return but does so solely to claim a refund of tax withheld. The IRS asserts that each spouse must have gross income of less than the exemption amount.⁴⁹ Therefore, if Sam sells the stock and he and Dana file a joint return, the parents will lose the dependency exemption for both Sam and Dana.

If the stock is not sold until January 2016, both dependency exemptions are available to the parents in 2015 even if Sam and Dana file a joint return. However, under § 151(d)(2), a personal exemption is not available to a taxpayer who can be claimed as a dependent by another taxpayer (whether actually claimed). Thus, if the parents can claim Sam and Dana as dependents, Sam and Dana would lose their personal exemptions on their tax return.

LO.5

Communicate the results of the tax research process in a client letter and a tax file memorandum.

2-3f Communicating Tax Research

Once the problem has been researched adequately, the researcher may need to prepare a memo, a letter, or an oral presentation setting forth the result. The form such a communication takes could depend on a number of considerations. For example, does the employer or professor recommend a particular procedure or format for tax research memos? Is the memo to be given directly to the client, or will it first go to the researcher's employer? Who is the audience for the oral presentation? How long should you talk? Whatever form it takes, a good tax research communication should contain the following elements:

- A clear statement of the issue.
- In more complex situations, a short review of the facts that raise the issue.
- A review of the pertinent tax law sources (e.g., Code, Regulations, Revenue Rulings, and judicial authority).
- Any assumptions made in arriving at the solution.
- The solution recommended and the logic or reasoning supporting it.
- The references consulted in the research process.

In short, a good tax research communication should tell the audience what was researched, the results of that research, and the justification for the recommendation made.⁵⁰

Illustrations of the memos for the tax file and the client letter associated with the facts of *The Big Picture* appear in Exhibit 2.9, Exhibit 2.10, and Exhibit 2.11.

⁴⁹Rev.Rul. 54-567, 1954-2 C.B. 108; Rev.Rul. 65-34, 1965-1 C.B. 86.

⁵⁰See Chapter 6 of the publication cited in Footnote 32. For oral presentations, see W. A. Raabe and G. E. Whittenburg, "Talking Tax: How to Make a Tax Presentation," *The Tax Adviser* (March 1997): 179-182.

EXHIBIT 2.9

Tax File Memorandum

December 16, 2015

TAX FILE MEMORANDUM

FROM: John J. Jones
 SUBJECT: Fred and Megan Samuels
 Engagement: Issues

Today I talked to Fred Samuels about his December 10, 2015 letter requesting tax assistance. He wants to know if his son, Sam, can sell stock worth \$19,000 (with an \$11,000 adjusted basis) without the parents losing the dependency exemptions for Sam and Sam's wife, Dana. Fred would also like to know the effect on Sam and Dana's tax liability in 2015 if the stock is sold.

Fred Samuels is married to Megan, and Sam is a full-time student at a local university. Sam inherited the stock from his grandmother about five years ago. If he sells the stock, he will save the proceeds from the sale rather than spend them because he receives a \$5,500 scholarship that he uses for his own support (i.e., to pay for tuition, books, and fees). Although neither Sam nor Dana is currently employed, Sam has earned income of \$960 and Dana has earned income of \$900. Fred and Megan are in the 28% tax bracket and furnish approximately 55% of Sam and Dana's support.

ISSUES: If the stock is sold, would the sale prohibit Fred and Megan from claiming Sam and Dana as dependents? What is the effect on Sam and Dana's tax liability if the stock is sold in 2015? Fred would like an answer within two weeks.

EXHIBIT 2.10

Tax File Memorandum

December 18, 2015

TAX FILE MEMORANDUM

FROM: John J. Jones
 SUBJECT: Fred and Megan Samuels
 Engagement: Conclusions

See the Tax File Memorandum dated December 16, 2015, which contains the facts and identifies the tax issues.

Section 152(a) provides that for a taxpayer to take a dependency exemption, the potential dependent must satisfy either the qualifying child requirements or the qualifying relative requirements [see Chapter 3]. Fred and Megan provide about 55% of the support of their son, Sam, and their daughter-in-law, Dana. If Sam should sell the stock in 2015, he would not need to spend the proceeds for support purposes (i.e., would save the proceeds). Thus, the stock sale would not affect his qualifying as not self-supporting under § 152(c)(1)(D). In calculating the percentage of support provided by Fred and Megan, a \$5,500 scholarship received by Sam is not counted in determining the amount of support Sam provides for himself [see § 152(f)(5) and Reg. § 1.152-1(c)]. Note, however, that if the \$5,500 had been provided by student loans, it would have been included in calculating support [*Philip J. McCauley*, 56 T.C. 48 (1971)].

Section 152(d)(1)(B) provides that to qualify for a dependency exemption as a qualifying relative, the potential dependent's gross income must be less than the exemption amount (i.e., \$4,000 in 2015). Without the stock sale, the gross income of both Sam (\$960) and Dana (\$900) will be below the exemption amount in 2015. The \$5,500 Sam receives as a scholarship is excluded from his gross income under § 117(a) because he uses the entire amount to pay for his tuition, books, and fees at a local university.

Although the gross income test is not applicable to Sam (he is a qualifying child), it is applicable to Dana, the daughter-in-law (she is a qualifying relative) [see Concept Summary 3.3]. A key issue is whether the stock sale that produces \$8,000 of recognized gain for Sam and Dana will cause the gross income test to be violated for Dana. Because the \$8,000 recognized gain is from the sale of Sam's separately owned asset and they do not live in a community property state, Dana should qualify as a dependent because her gross income would be only \$900.

The stock sale would result in the parents' loss of the dependency exemptions for Sam and Dana if they file a joint return for 2015 [see § 152(b)(2)]. The joint return requirement does not apply, however, if the dependent files a joint return solely to claim a refund and neither spouse had a tax liability on a separate return (Rev.Rul. 65-34, 1965-1 C.B. 86). However, sale of the stock would keep this exception from applying.

From a tax planning perspective, Sam can choose to sell the stock in 2015. However, if this choice is made, Sam and Dana need to file separate returns so as not to violate the absence of a joint return provision. Under these circumstances, the sale will not interfere with Fred and Megan's ability to claim dependency exemptions for Sam and Dana on their 2015 return. Note, however, that neither Sam nor Dana will be permitted to take a personal exemption deduction on their 2015 tax return because they are claimed as dependents on someone else's return [see § 151(d)(2)]. This disallowance of the personal exemption deduction will not produce any significant negative tax consequences for Dana because her tax liability would be \$0. However, Sam's tax liability would now be \$900 [see the kiddie tax discussion in Chapter 3]. Alternatively, Sam could delay the sale of the stock until 2016. In this case, Sam and Dana's tax liability in 2015 would be \$0. The disallowance of the personal exemption deductions by Sam and Dana will not produce any negative tax consequences because both Sam and Dana's tax liability would be \$0.

EXHIBIT 2.11

Client Letter

Hoffman, Maloney, Raabe, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 21, 2015

Mr. and Mrs. Fred Samuels
111 Boulevard
Williamsburg, VA 23185

Dear Mr. and Mrs. Samuels:

This letter is in response to your request for us to review your family's financial and tax situation. Our conclusions are based upon the facts as outlined in your December 10 letter. Any change in the facts may affect our conclusions.

You provide over 50% of the support for your son, Sam, and his wife, Dana. The scholarship Sam receives is not included in determining support. If the stock is not sold, you will qualify for a dependency exemption for both Sam and Dana.

If the stock is sold, a gain of approximately \$8,000 will result. If Sam and Dana then file a joint return, you will lose the dependency exemption for Sam as a qualifying child and will lose the dependency exemption for Dana as a qualifying relative. You can avoid the loss of these two dependency exemptions if Sam and Dana file separate returns. This would result in a tax liability of \$0 for Dana and \$900 for Sam.

From a family tax planning and tax avoidance perspective, Sam should not sell the stock in 2015. Delaying the stock sale will enable you to claim dependency exemptions for both Sam and Dana and will enable Sam and Dana to have a \$0 tax liability for 2015.

Should you need more information or need to clarify our conclusions, do not hesitate to contact me.

Sincerely yours,

John J. Jones, CPA
Partner

LO.6

Apply tax research techniques and planning procedures.

2-4 WORKING WITH THE TAX LAW—TAX PLANNING

Tax research and tax planning are inseparable. The *primary* purpose of effective *tax planning* is to reduce the taxpayer's total tax bill. This statement does not mean that the course of action selected must produce the lowest possible tax under the circumstances. The minimization of tax liability must be considered in context with the legitimate business goals of the taxpayer.

A *secondary* objective of effective tax planning is to reduce or defer the tax in the current tax year. Specifically, this objective aims to accomplish one or more of the following: eradicating the tax entirely; eliminating the tax in the current year; deferring the receipt of income; converting ordinary income into capital gains; converting active income to passive income; converting passive expense to active expense; proliferating taxpayers (i.e., forming partnerships and corporations or making lifetime gifts to family members); eluding double taxation; avoiding ordinary income; or creating, increasing, or accelerating deductions. However, this second objective should be approached with considerable reservation and moderation. For example, a tax election in one year may reduce taxes currently but saddle future years with a disadvantageous tax position.

2-4a Nontax Considerations

There is an honest danger that tax motivations may take on a significance that does not correspond to the true values involved. In other words, tax considerations may impair the exercise of sound business judgment by the taxpayer. Thus, the tax planning process can become a medium through which to accomplish ends that are socially and economically objectionable. All too often, planning seems to lean toward the opposing

extremes of placing either too little or too much emphasis on tax considerations. The goal should be a balance that recognizes the significance of taxes, but not beyond the point where planning detracts from the exercise of good business judgment.

The remark is often made that a good rule is to refrain from pursuing any course of action that would not be followed were it not for certain tax considerations. This statement is not entirely correct, but it does illustrate the desirability of preventing business logic from being *sacrificed at the altar of tax planning*.

2-4b Components of Tax Planning

The popular perception of tax planning often is restricted to the adage “defer income and accelerate deductions.” Although this timing approach does hold true and is important, meaningful tax planning involves considerably more.

Preferable to deferring income is complete *avoidance*. Consider, for example, the corporate employee who chooses nontaxable fringe benefits (e.g., group term life insurance and health insurance) over a fully taxable future pay increase.⁵¹ Complete avoidance of gain recognition also occurs when the owner of appreciated property transfers it by death. If this “step-up” in basis to fair market value occurs, the built-in appreciation escapes the income tax forever.⁵²

If the recognition of income cannot be avoided, its deferral will postpone income tax consequences. *Deferral* of income can take many forms. Besides like-kind exchanges and involuntary conversions, most retirement plans put off income tax consequences until the payout period. Deferral of gain recognition also can occur when appreciated property is transferred to a newly formed corporation or partnership.⁵³

A corollary to the deferral of income is the acceleration of deductions. For example, an accrual basis, calendar year corporation wants an additional charitable deduction for 2015 but has a cash-flow problem. If the corporation authorizes the contribution in 2015 and pays it on or before March 15, 2016, the deduction can be claimed for 2015.⁵⁴ Taxes can be saved by *shifting* income to lower-bracket taxpayers. Gifts of appreciated property to lower-bracket family members can reduce the applicable capital gain rate on a later sale by 15 percentage points (from 15 percent to 0 percent).⁵⁵ For certain high-income taxpayers, the reduction is 20 percentage points (from 20 percent to 0 percent).

If income cannot be avoided, deferred, or shifted, the nature of the gain can be *converted*. By changing the classification of property, income taxes can be reduced. Thus, a taxpayer who transfers appreciated inventory to a controlled corporation has converted ordinary income property to a capital asset. When the taxpayer’s stock is later sold, preferential capital gain rates apply.

The conversion approach also can work in tax planning for losses. Properly structured, a loan to a corporation that becomes worthless can be an ordinary loss rather than the less desirable capital loss. Likewise, planning with § 1244 permits an investor in qualified small business stock to convert what would be a capital loss into an ordinary loss.⁵⁶

Effective tax planning requires that careful consideration be given to the *choice of entity* used for conducting a business. The corporate form results in double taxation but permits shareholder-employees to be covered by fringe benefit programs. Partnerships and S corporations allow a pass-through of losses and other tax attributes, but transferring ownership interests as gifts to family members may be difficult.⁵⁷

Although the substance of a transaction, rather than its form, generally controls, this rule is not always the case with tax planning. *Preserving formalities*, particularly clear

⁵¹See Section 5-6 and Example 23 in Chapter 5.

⁵²See Chapter 13.

⁵³See Chapters 18 and 21.

⁵⁴See Chapter 17.

⁵⁵See Chapter 13.

⁵⁶See Example 9 in Chapter 7.

⁵⁷See Chapters 21 and 22.

documentation, often is crucial to the result. Is an advance to a corporation a loan or a contribution to capital? The answer may well depend on the existence of a note. Along with preserving formalities, the taxpayer should keep records that support a transaction. Returning to the issue of loan versus contribution to capital, how is the advance listed on the books of the borrower? What do the corporate minutes say about the advance?

Finally, effective tax planning requires *consistency* on the part of taxpayers. A shareholder who treats a corporate distribution as a return of capital cannot later avoid a stock basis adjustment by contending that the distribution was really a dividend.

In summary, the key components of tax planning include the following:

- *Avoid* the recognition of income (usually by resorting to a nontaxable source or nontaxable event).
- *Defer* the recognition of income (or accelerate deductions).
- *Convert* the classification of income (or deductions) to a more advantageous form (e.g., ordinary income into capital gain).
- *Choose* the business *entity* with the desired tax attributes.
- Preserve *formalities* by generating and maintaining supporting documentation.
- Act in a manner *consistent* with the intended objective.

2-4c Tax Avoidance and Tax Evasion

A fine line exists between legal tax planning and illegal tax planning—tax avoidance versus tax evasion. **Tax avoidance** is merely tax minimization through legal techniques. In this sense, tax avoidance is the proper objective of all tax planning. Tax evasion, while also aimed at the elimination or reduction of taxes, connotes the use of subterfuge and fraud as a means to an end. Popular usage—probably because of the common goals involved—has so linked these two concepts that many individuals are no longer aware of the true distinctions between them. Consequently, some taxpayers have been deterred from properly taking advantage of planning possibilities. The now classic words of Judge Learned Hand in *Commissioner v. Newman* reflect the true values the taxpayer should have:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.⁵⁸

As Denis Healy, a former British Chancellor, once said, “The difference between tax avoidance and tax evasion is the thickness of a prison wall.”

The Government Accountability Office estimates that U.S. taxpayers spend at least \$107 billion each year on tax compliance costs. The Treasury Department estimates that individuals spend at least 6.4 billion hours preparing Federal income tax returns. Small businesses, self-employed persons, and taxpayers with the highest marginal tax rates have the highest levels of tax evasion.⁵⁹

2-4d Follow-Up Procedures

Because tax planning usually involves a proposed (as opposed to a completed) transaction, it is predicated upon the continuing validity of the advice based upon the tax research. A change in the tax law (legislative, administrative, or judicial) could alter the

⁵⁸*Comm. v. Newman*, 47-1 USTC ¶9175, 35 AFTR 857, 159 F.2d 848 (CA-2, 1947).

⁵⁹Adapted from J. A. Tackett, Joe Antenucci, and Fran Wolf, “A Criminological Perspective of Tax Evasion,” *Tax Notes* (February 6, 2006): 654-658; L. E.

Burman, “Tax Evasion, IRS Priorities, and the EITC,” *Statement before the United States House of Representatives Committee on the Budget; On Waste, Fraud, and Abuse in Federal Mandatory Programs* (July 9, 2003).

original conclusion. Additional research may be necessary to test the solution in light of current developments (refer to the broken lines at the right in Exhibit 2.8).

2-4e Tax Planning—A Practical Application

Returning to the facts of *The Big Picture* on page 2-1, what could be done to protect the dependency exemptions for the parents? If Sam and Dana refrain from filing a joint return, both could be claimed by the parents.

Another tax planning tool is the installment method. Could the securities be sold using the installment method so that most of the gain is deferred into the next year? Under the installment method (§ 453), certain gains may be postponed and recognized as the cash proceeds are received. The problem is that the installment method is not available for stock traded on an established securities market.⁶⁰

A little more research, however, indicates that Sam might be able to sell the stock and postpone the recognition of gain until the following year by selling short an equal number of substantially identical shares and covering the short sale in the subsequent year with the shares originally held. Selling short means that Sam sells borrowed stock (substantially identical) and repays the lender with the stock held on the date of the short sale. This *short against the box* technique would allow Sam to protect his \$8,000 profit and defer the closing of the sale until the following year.⁶¹ However, additional research indicates that 1997 tax legislation provides that the short against the box technique will no longer produce the desired postponement of recognized gain. That is, at the time of the short sale, Sam will have a recognized gain of \$8,000 from a constructive sale. Note the critical role of obtaining the correct facts in attempting to resolve the proper strategy for the taxpayers.

Throughout this text, most chapters include observations on tax planning. Such observations are not all-inclusive, but are intended to illustrate some of the ways in which the material covered can be effectively utilized to minimize taxes.

2-5 TAXATION ON THE CPA EXAMINATION

The CPA examination has changed from a paper-and-pencil exam to a computer-based exam with increased emphasis on information technology and general business knowledge. The 14-hour exam has four sections, and taxation is included in the 3-hour Regulations section.

In January 2011, the CPA examination was reorganized, with all written communication tasks now concentrated in the Business Environment & Concepts section. Shorter simulations have replaced the longer simulations.

Each exam section includes multiple-choice questions and two other sections that have short task-based simulation (TBS) questions. The Regulations section is 60 percent Taxation and 40 percent Law & Professional Responsibilities (all areas other than Business Structure). The three-hour Regulations section has a new format. It now contains:

- Three multiple-choice question (MCQ) testlets consisting of 72 questions.
- One testlet (i.e., a group of questions prepared to appear together) containing six short task-based simulations with the research question in a new format.

A candidate may review and change answers within each testlet but cannot go back after exiting a testlet. Candidates take different but equivalent exams.

Simulations are small case studies designed to test a candidate's tax knowledge and skills using real-life work-related situations. Simulations include a four-function pop-up calculator, a blank spreadsheet with some elementary functionality, and authoritative literature appropriate to the subject matter. The taxation database includes authoritative

LO.7

Be aware of taxation on the CPA examination.

⁶⁰See Chapter 16 for a discussion of installment sales.

⁶¹§§ 1233(a) and 1233(b)(2). See Chapter 14 for a discussion of short sales.

excerpts that are necessary to complete the tax case study simulations (e.g., Internal Revenue Code, Regulations, IRS publications, and Federal tax forms). Examples of such simulations follow.

CPA Exam Simulation Examples

EXAMPLE

4

The *tax citation type* simulation requires the candidate to research the Internal Revenue Code and enter a Code Section and subsection. For example, Amber Company is considering using the simplified dollar-value method of pricing its inventory for purposes of the LIFO method that is available to certain small businesses. What Code Section is the relevant authority in the Internal Revenue Code to which you should turn to determine whether the taxpayer is eligible to use this method? To be successful, the candidate needs to find § 474.

EXAMPLE

5

A *tax form completion* simulation requires the candidate to fill out a portion of a tax form. For example, Red Company is a limited liability company (LLC) for tax purposes. Complete the income section of the IRS Form 1065 for Red Company using the values found and calculated on previous tabs along with the following data:

Ordinary income from other partnerships	\$ 5,200
Net gain (loss) from Form 4797	2,400
Management fee income	12,000

The candidate is provided with page 1 of Form 1065 on which to record the appropriate amounts.

Any field that requires an entry is a shaded rectangular cell. Some white rectangular cells will automatically calculate based on the entries in the shaded cell.

Candidates can learn more about the CPA examination at www.cpa-exam.org. This online tutorial site's topics include:

- Common tools.
- Navigation.
- Form completion.
- Numeric entry.
- Research questions.
- Authoritative literature search.
- Written communication.

The common tools are a calculator, a spreadsheet, reminder flags, and an examination clock. A 30- to 60-minute sample exam will familiarize a candidate with the types of questions on the examination.

Key Terms

Acquiescence, 2-18

Circuit Court of Appeals, 2-14

Citator, 2-28

Court of original jurisdiction, 2-11

Determination letters, 2-10

Federal District Court, 2-11

Finalized Regulations, 2-8

Interpretive Regulations, 2-27

Legislative Regulations, 2-27

Letter rulings, 2-9

Nonacquiescence, 2-18

Precedents, 2-15

Procedural Regulations, 2-27

Proposed Regulations, 2-8

Revenue Procedures, 2-8

Revenue Rulings, 2-8

Small Cases Division, 2-11

Tax avoidance, 2-34

Tax research, 2-23

Technical Advice Memoranda (TAMs), 2-10

Temporary Regulations, 2-8

U.S. Court of Federal Claims, 2-11

U.S. Supreme Court, 2-15

U.S. Tax Court, 2-11

Writ of Certiorari, 2-16

Discussion Questions

1. **LO.1** A large part of tax research consists of determining what?
2. **LO.1** Why do taxpayers often have more than one alternative for structuring a business transaction?
3. **LO.1** Where does the Federal tax legislation generally originate?
4. **LO.2, 5** Butch Bishop operates a small international firm named Tile, Inc. A new treaty between the United States and Spain conflicts with a Section of the Internal Revenue Code. Butch asks you for advice. If he follows the treaty position, does he need to disclose this on his tax return? If he is required to disclose, are there any penalties for failure to disclose? Prepare a letter in which you respond to Butch. Tile's address is 100 International Drive, Tampa, FL 33620. Communications
5. **LO.1, 2** Interpret this Regulation citation: Reg. § 1.163-10(a)(2).
6. **LO.1** In the citation Notice 90-20, 1990-1 C.B. 328, to what do the 20 and the 328 refer?
7. **LO.1, 4** Rank the following items from the lowest to the highest authority in the Federal tax law system:
 - a. Interpretive Regulation.
 - b. Legislative Regulation.
 - c. Letter ruling.
 - d. Revenue Ruling.
 - e. Internal Revenue Code.
 - f. Proposed Regulation.
8. **LO.1** Interpret each of the following citations:
 - a. Temp.Reg. § 1.956-2T.
 - b. Rev.Rul. 2012-15, 2012-23 I.R.B. 975.
 - c. Ltr.Rul. 200204051.
9. **LO.1, 5** Sally Andrews calls you on the phone. She says that she has found a 2007 letter ruling that agrees with a position she wants to take on her tax return. She asks you about the precedential value of a letter ruling. Draft a memo for the tax files outlining what you told Sally. Communications
10. **LO.1** Where may private letter rulings be found?
11. **LO.1** Dwain receives a 90-day letter after his discussion with an appeals officer. He is not satisfied with the \$101,000 settlement offer. Identify the relevant tax research issues facing Dwain. Issue ID
12. **LO.1** List an advantage and a disadvantage of using the U.S. Court of Federal Claims as the trial court for Federal tax litigation.
13. **LO.1, 5** Eddy Falls is considering litigating a tax deficiency of approximately \$229,030 in the court system. He asks you to provide him with a short description of his alternatives, indicating the advantages and disadvantages of each. Prepare your response to Eddy in the form of a letter. His address is 200 Mesa Drive, Tucson, AZ 85714. Communications
14. **LO.1** List an advantage and a disadvantage of using the U.S. Tax Court as the trial court for Federal tax litigation.

15. **LO.1** A taxpayer lives in Michigan. In a controversy with the IRS, the taxpayer loses at the trial court level. Describe the appeal procedure under the following different assumptions:
 - a. The trial court was the Small Cases Division of the U.S. Tax Court.
 - b. The trial court was the U.S. Tax Court.
 - c. The trial court was a U.S. District Court.
 - d. The trial court was the U.S. Court of Federal Claims.
16. **LO.1** What is meant by the term *petitioner*?
17. **LO.1** A taxpayer living in the following states would appeal a decision of the U.S. District Court to which Court of Appeals?
 - a. Wyoming.
 - b. Nebraska.
 - c. Idaho.
 - d. Louisiana.
 - e. Illinois.
18. **LO.1** What precedents must each of these courts follow?
 - a. U.S. Tax Court.
 - b. U.S. Court of Federal Claims.
 - c. U.S. District Court.
19. **LO.1** What determines the appropriate Circuit Court of Appeals for a particular taxpayer?
20. **LO.1, 4** In assessing the validity of a prior court decision, discuss the significance of the following on the taxpayer's issue:
 - a. The decision was rendered by the U.S. District Court of Wyoming. Taxpayer lives in Wyoming.
 - b. The decision was rendered by the U.S. Court of Federal Claims. Taxpayer lives in Wyoming.
 - c. The decision was rendered by the Second Circuit Court of Appeals. Taxpayer lives in California.
 - d. The decision was rendered by the U.S. Supreme Court.
 - e. The decision was rendered by the U.S. Tax Court. The IRS has acquiesced in the result.
 - f. Same as (e) except that the IRS has issued a nonacquiescence as to the result.
21. **LO.2** In the citation *Schuster's Express, Inc.*, 66 T.C. 588 (1976), *aff'd* 562 F.2d 39 (CA-2, 1977), *nonacq.*, to what do the 66, 39, and *nonacq.* refer?
22. **LO.2** Is there an automatic right to appeal to the U.S. Supreme Court? If so, what is the process?
23. **LO.2** Referring to the citation only, determine which court issued these decisions.
 - a. 716 F.2d 693 (CA-9, 1983).
 - b. 92 T.C. 400 (1998).
 - c. 70 U.S. 224 (1935).
 - d. 3 B.T.A. 1042 (1926).
 - e. T.C.Memo. 1957-169.
 - f. 50 AFTR2d 92-6000 (Ct. Cl., 1992).
 - g. Ltr.Rul. 9046036.
 - h. 111 F.Supp.2d 1294 (S.D. N. Y., 2000).
 - i. 98-50, 1998-1 C.B. 10.

24. **LO.2** Interpret each of the following citations:
- 14 T.C. 74 (1950).
 - 592 F.2d 1251 (CA-5, 1979).
 - 95-1 USTC ¶50,104 (CA-6, 1995).
 - 75 AFTR2d 95-110 (CA-6, 1995).
 - 223 F.Supp. 663 (W.D. Tex., 1963).
25. **LO.2** Give the Commerce Clearing House citation for the following courts:
- Small Cases Division of the Tax Court.
 - Federal District Court.
 - U.S. Supreme Court.
 - U.S. Court of Federal Claims.
 - Tax Court Memorandum decision.
26. **LO.2** Where can you locate a published decision of the U.S. Court of Federal Claims?
27. **LO.3** For her tax class, Yvonne has to prepare a research paper discussing the tax aspects of child support payments. Explain to Yvonne how she can research this topic using various tax research resources. **Issue ID**
28. **LO.4** Where can a researcher find the current Internal Revenue Code of 1986?
29. **LO.2, 4** You inherit a tax problem that was researched five months ago. You believe the answer is correct, but you are unfamiliar with the general area. How would you find recent articles dealing with the subject area? How do you evaluate the reliability of the authority cited in the research report? How do you determine the latest developments pertaining to the research problem? **Decision Making**
30. **LO.6** What is the primary purpose of effective tax planning? Explain.
31. **LO.7** Describe simulation questions on the CPA exam.

Problems

32. **LO.1** In which Subchapter of the Internal Revenue Code would one find information about corporate distributions?
- Subchapter S.
 - Subchapter C.
 - Subchapter P.
 - Subchapter K.
 - Subchapter M.
33. **LO.1, 4** Rank the items below from most reliable to least reliable:
- Letter Ruling.
 - Legislative Regulation.
 - Code Section.
 - Revenue Ruling.
 - Proposed Regulation.
 - Interpretive Regulation.
 - Recent Temporary Regulation.

34. **LO.4** Using the legend provided, classify each of the following tax sources:

Legend

P = Primary tax source
 S = Secondary tax source
 B = Both
 N = Neither

- a. Sixteenth Amendment to the U.S. Constitution.
 - b. Tax treaty between the United States and India.
 - c. Revenue Procedure.
 - d. General Counsel Memoranda (1989).
 - e. U.S. District Court decision.
 - f. *Yale Law Journal* article.
 - g. Temporary Regulations (issued 2013).
 - h. U.S. Tax Court Memorandum decision.
 - i. Small Cases Division of the U.S. Tax Court decision.
 - j. House Ways and Means Committee report.
35. **LO.1, 2** Using the legend provided, classify each of the following citations as to publisher:

Legend

RIA = Research Institute of America
 CCH = Commerce Clearing House
 W = West
 U.S. = U.S. Government
 O = Others

- a. 83-2 USTC ¶9600.
 - b. 52 AFTR 2d 83-5954.
 - c. 67 T.C. 293 (1976).
 - d. 39 TCM 32 (1979).
 - e. 416 U.S. 938.
 - f. RIA T.C. Memo. ¶80,582.
 - g. 89 S.Ct. 501.
 - h. 2 Cl.Ct. 600.
 - i. 415 F.2d 488.
 - j. 592 F.Supp. 18.
 - k. 77-37, 1977-2 C.B. 568.
 - l. S. Rep. No. 1622, 83rd Cong., 2d Sess. 42 (1954).
36. **LO.6** Using the legend provided, classify each of the following statements:

Legend

A = Tax avoidance
 E = Tax evasion
 N = Neither

- a. Sue writes a \$707 check for a charitable contribution on December 28, 2015, but does not mail the check to the charitable organization until January 10, 2016. She takes a deduction in 2015.
- b. Sam decides not to report interest income from a bank because the amount is only \$19.75.
- c. Harry pays property taxes on his home in December 2015 rather than waiting until February 2016.

- d. Variet switches her investments from taxable corporate bonds to tax-exempt municipal bonds.
- e. Mel encourages his mother to save most of her Social Security benefits so that he will be able to claim her as a dependent.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.



Research Problem 1. Determine the missing data in these court decisions and rulings.

- a. *Higgins v. Comm.*, 312 U.S. ____ (1941).
- b. *Talen v. U.S.*, 355 F.Supp.2d 22 (D.Ct. D.C., ____).
- c. Rev.Rul. 2008–18, 2008–13 I.R.B. ____.
- d. *Pabl v. Comm.*, 150 F.3d 1124 (CA–9, ____).
- e. *Veterinary Surgical Consultants PC*, 117 T.C. ____ (2001).
- f. *Yeagle Drywall Co.*, T.C.Memo. 2001 ____.

Research Problem 2. When Oprah gave away Pontiac G6 sedans to her TV audience, was the value of the cars taxable? On Labor Day weekend in 2006, World Furniture Mall in Plano, Illinois, gave away \$275,000 of furniture because the Chicago Bears shut out the Green Bay Packers in the team's football season opener at Lambeau Field in Green Bay (26–0). Was the free furniture in the form of a discount or rebate taxable, or should the furniture company have handed the customers a Form 1099–MISC?

Decision Making

Research Problem 3. You are interviewing a client before preparing his tax return. He indicates that he did not list as income \$96,000 received as a recovery for false imprisonment. What should you do with respect to this significant recovery?

Decision Making

Partial list of research aids:

CCA 200809001.

Daniel and Brenda Stadnyk, T.C.Memo. 2008–289.

Rev.Rul. 2007–14, 2007–1 C.B. 747.

§ 104.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet Activity

Research Problem 4. (1) Go to www.taxalmanac.org, and use the website to find § 61(a).

What is defined in this Code Section? Is the definition broad or narrow?

(2) Go to www.legalbitstream.com, and find the case in which Mark Spitz, the former Olympic gold medalist, is the petitioner. Answer the following questions about the case:

- a. What tax years are at issue in the case?
- b. In what year was the case decided?
- c. Did the court decide in favor of Mr. Spitz or the IRS?
- d. Were any penalties imposed on Mr. Spitz? Why or why not?

Research Problem 5. Go to the U.S. Tax Court website (www.ustaxcourt.gov).

- a. What different types of cases can be found on the site?
- b. What is a Summary Opinion? Find one.
- c. What is a Memorandum Opinion? Find one.
- d. Find the “Rules of Practice and Procedure.”

Computing the Tax

LEARNING OBJECTIVES: *After completing Chapter 3, you should be able to:*

- | | |
|---|---|
| <p>LO.1 Recognize and apply the components of the Federal income tax formula.</p> <p>LO.2 Explain the use of the standard deduction in computing taxable income.</p> <p>LO.3 Apply the rules for arriving at personal exemptions.</p> <p>LO.4 Apply the rules for determining dependency exemptions.</p> <p>LO.5 List the filing requirements and choose the proper filing status.</p> | <p>LO.6 Use the proper method for determining the tax liability.</p> <p>LO.7 Identify and work with kiddie tax situations.</p> <p>LO.8 Describe the tax treatment of property transactions.</p> <p>LO.9 Identify tax planning opportunities associated with the individual tax formula.</p> |
|---|---|

CHAPTER OUTLINE

- | | |
|--|---|
| <p>3-1 Tax Formula, 3-3</p> <p>3-1a Components of the Tax Formula, 3-3</p> <p>3-1b Standard Deduction, 3-7</p> <p>3-1c Application of the Tax Formula, 3-10</p> <p>3-2 Personal Exemptions, 3-10</p> <p>3-3 Dependency Exemptions, 3-11</p> <p>3-3a Qualifying Child, 3-11</p> <p>3-3b Qualifying Relative, 3-13</p> <p>3-3c Other Rules for Dependency Exemptions, 3-16</p> <p>3-3d Qualifying for Dependency Exemptions, 3-16</p> <p>3-3e Phaseout of Exemptions, 3-17</p> <p>3-3f Child Tax Credit, 3-18</p> <p>3-4 Filing the Return, 3-18</p> <p>3-4a Filing Status, 3-18</p> <p>3-4b Filing the Return, 3-22</p> <p>3-5 Tax Computations, 3-25</p> <p>3-5a Tax Rates, 3-25</p> <p>3-5b Tax Table Method, 3-25</p> | <p>3-5c Tax Rate Schedule Method, 3-26</p> <p>3-5d Computation of Net Taxes Payable or Refund Due, 3-26</p> <p>3-5e Unearned Income of Children Taxed at Parents' Rate, 3-27</p> <p>3-6 Gains and Losses from Property Transactions—In General, 3-29</p> <p>3-7 Gains and Losses from Property Transactions—Capital Gains and Losses, 3-29</p> <p>3-7a Capital Assets, 3-30</p> <p>3-7b Taxation of Net Capital Gain, 3-30</p> <p>3-7c Determination of Net Capital Gain, 3-31</p> <p>3-7d Treatment of Net Capital Loss, 3-31</p> <p>3-8 Tax Planning, 3-31</p> <p>3-8a Maximizing the Use of the Standard Deduction, 3-31</p> <p>3-8b Dependency Exemptions, 3-32</p> <p>3-8c Taking Advantage of Tax Rate Differentials, 3-33</p> <p>3-8d Unearned Income of Certain Children, 3-33</p> |
|--|---|



THE BIG PICTURE

A DIVIDED HOUSEHOLD

Polly maintains a household in which she lives with her unemployed husband (Nick), stepdaughter (Paige), and a family friend (Maude). Polly provides more than one-half of the support for both Paige and Maude. Maude was fatally injured in an automobile accident in February, and Polly paid for Maude's hospitalization and funeral expenses. Paige, an accomplished gymnast, graduated from high school last year. Paige has a part-time job but spends most of her time training and looking for an athletic scholarship to the "right" college. In March, Nick left for parts unknown and has not been seen or heard from since. Polly was more surprised than distressed over Nick's unexpected departure. One reaction, however, was to sell her wedding rings to a cousin who was getting married. The rings cost \$11,800 and were sold for their approximate value of \$9,000.

Based on these facts, what are Polly's income tax concerns for the current year?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that is introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	(x,xxx)
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income	(x,xxx)
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions <i>or</i> the standard deduction	(x,xxx)

FORM 1040 (p. 1)

Filing Status	1 <input type="checkbox"/> Single	4 <input type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
	2 <input type="checkbox"/> Married filing jointly (even if only one had income)	
Check only one box.	3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ▶	5 <input type="checkbox"/> Qualifying widow(er) with dependent child

Personal and dependency exemptions (x,xxx)

FORM 1040 (p. 2)

39a Check if:	<input type="checkbox"/> You were born before January 2, 1950,	<input type="checkbox"/> Blind.	} Total boxes checked ▶ 39a <input type="text"/>
	<input type="checkbox"/> Spouse was born before January 2, 1950,	<input type="checkbox"/> Blind.	
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>		
40	Itemized deductions (from Schedule A) <i>or</i> your standard deduction (see left margin) . . .		
42	Exemptions. If line 38 is \$152,525 or less, multiply \$3,950 by the number on line 6d. Otherwise, see instructions		

Taxable income \$xx,xxx

FORM 1040 (p. 2)

43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- . . .

Tax on taxable income (*see Tax Tables or Tax Rate Schedules*) \$ x,xxx

FORM 1040 (p. 2)

44 Tax (see instructions). Check if any from: **a** Form(s) 8814 **b** Form 4972 **c** _____

Less: Tax credits (*including income taxes withheld and prepaid*) (xxx)

Tax due (*or refund*) \$ xxx

The framework for the application of the Federal income tax to individuals is the tax formula. As Chapter 1 mentioned, the tax formula is an integral part of our U.S. tax system (i.e., local, state, and Federal), and Chapter 3 provides a summary of its components. In addition, several of its key components—the standard deduction, personal and dependency exemptions, and tax determination—are discussed at length in Chapter 3.

By introducing the tax formula, therefore, Chapter 3 establishes the framework for almost all of the rest of the individual tax materials in the text.¹ The formula and its impact on the chapters to follow are reflected in Concept Summary 3.1.

¹Variations of the framework apply to other taxpayers (e.g., corporations and trusts).

Concept Summary 3.1

Tax Formula for Individuals

		Text Discussion
Income (broadly defined)	\$xx,xxx	Chs. 3, 4
Less: Exclusions	(x,xxx)	Ch. 5
Gross income	\$xx,xxx	Chs. 4, 13, 14
Less: Deductions for adjusted gross income	(x,xxx)	Chs. 6–11, 13, 14
Adjusted gross income	\$xx,xxx	
Less: The greater of—		
Total itemized deductions	} (x,xxx)	Chs. 6, 9, 10, 11
or standard deduction		
Less: Personal and dependency exemptions	(x,xxx)	Ch. 3
Taxable income	\$xx,xxx	Chs. 3, 12, 15
Tax on taxable income	\$ x,xxx	Chs. 3, 12, 15
Less: Tax credits	(xxx)	Ch. 12
Tax due (or refund)	\$ xxx	Chs. 3, 12

3-1 TAX FORMULA

Before illustrating the application of the Concept Summary 3.1 tax formula, a brief discussion of its components is helpful.

3-1a Components of the Tax Formula

Income (Broadly Defined)

In the tax formula, “income” is thought of in very broad terms; it includes all of the taxpayer’s income, both taxable and nontaxable. In general, the courts have defined “income” as any increase in wealth.² As a result, it does not include a return of capital or the receipt of borrowed funds.

Dan decides to quit renting and move into a new house. Consequently, the owner of the apartment building returns to Dan the \$600 damage deposit that Dan previously made. To make a down payment on the house, Dan sells stock for \$20,000 (original cost of \$8,000) and borrows \$50,000 from a bank.

Only the \$12,000 gain from the sale of the stock constitutes gross income to Dan. The \$600 damage deposit and the \$8,000 cost of the stock are a return of capital. The \$50,000 bank loan is not income, as Dan has an obligation to repay that amount.

LO.1

Recognize and apply the components of the Federal income tax formula.

EXAMPLE

1

Exclusions

For various reasons, Congress has chosen to exclude certain types of income from the income tax base. The principal income exclusions are discussed in Chapter 5. A partial list of these exclusions is shown in Exhibit 3.1.

Gross Income

The Internal Revenue Code defines gross income broadly as “except as otherwise provided ..., all income from whatever source derived.”³ The “except as otherwise

²*Comm. v. Glenshaw Glass Co.*, 55–1 USTC ¶9308, 47 AFTR 162, 348 U.S. 426 (USSC, 1955). ³§ 61(a).

EXHIBIT 3.1

Partial List of Exclusions from Gross Income

Accident and health insurance proceeds	Life insurance paid upon death
Annuities (cost element)	Meals and lodging (if furnished for employer's convenience)
Bequests	Military allowances
Child support payments	Minister's dwelling rental value or allowance
Cost-of-living allowance (for military)	Railroad retirement benefits (to a limited extent)
Damages for personal injury or sickness	Scholarship grants (to a limited extent)
Gifts received	Social Security benefits (to a limited extent)
Group term life insurance, premium paid by employer (for coverage up to \$50,000)	Veterans' benefits
Inheritances	Welfare payments
Interest from state and local (i.e., municipal) bonds	Workers' compensation benefits

provided" phrase refers to exclusions. Gross income includes, but is not limited to, the items in the partial list in Exhibit 3.2. It does not include unrealized gains. Gross income is discussed in Chapters 4, 13, and 14.

EXAMPLE

2

Beth received the following amounts during the year.

Salary	\$30,000
Interest on savings account	900
Gift from her aunt	10,000
Prize won in state lottery	1,000
Alimony from ex-husband	12,000
Child support from ex-husband	6,000
Damages for injury in auto accident	25,000
Ten \$50 bills in an unmarked envelope found in an airport lounge (airport authorities could not locate anyone who claimed ownership)	500
Federal income tax refund for last year's tax overpayment	120
Increase in the value of stock held for investment	5,000

Review Exhibits 3.1 and 3.2 to determine the amount Beth must include in the computation of taxable income and the amount she may exclude.⁴

GLOBAL TAX ISSUES **Citizenship Is Not Tax-Free**

Gross income from "whatever source derived" includes income from both U.S. and foreign sources. This approach to taxation, where the government taxes its citizens and residents on their worldwide income regardless of where earned, is referred to as a *worldwide system*.

Income earned by U.S. citizens outside the United States can be subject to additional taxes, however, because all countries maintain the right to tax income earned within their borders. Consequently, the U.S. tax law includes various

mechanisms to alleviate the double taxation that arises when income is subject to tax in multiple jurisdictions. These mechanisms include the foreign tax deduction, the foreign tax credit, the foreign earned income exclusion for U.S. citizens and residents working abroad, and various tax treaty provisions.

Most industrialized countries instead use the *territorial system*, where a government taxes only the income earned within its borders. The UK, Hong Kong, and France, for example, use a territorial approach.

⁴Beth includes \$44,400 in computing taxable income (\$30,000 salary + \$900 interest + \$1,000 lottery prize + \$12,000 alimony + \$500 found property). She excludes \$41,000 (\$10,000 gift from aunt + \$6,000 child support + \$25,000 damages). The \$120 Federal income tax refund is excluded

because it represents a refund of a nondeductible expenditure made in the previous year. The unrealized gain on the stock held for investment is not included in gross income. Such gain is included in gross income only when it is realized upon a disposition of the stock.

EXHIBIT 3.2

Partial List of Gross Income Items

Alimony	Group term life insurance, premium paid by employer (for coverage over \$50,000)
Annuities (income element)	Hobby income
Awards	Interest
Back pay	Jury duty fees
Bargain purchase from employer	Living quarters, meals (unless furnished for employer's convenience)
Bonuses	Mileage allowance
Breach of contract damages	Military pay (unless combat pay)
Business income	Partnership income
Clergy fees	Pensions
Commissions	Prizes
Compensation for services	Professional fees
Death benefits	Punitive damages
Debts forgiven	Rents
Director's fees	Rewards
Dividends	Royalties
Embezzled funds	Salaries
Employee awards (in certain cases)	Severance pay
Employee benefits (except certain fringe benefits)	Strike and lockout benefits
Estate and trust income	Tips and gratuities
Farm income	Travel allowance (in certain cases)
Fees	Treasure trove (found property)
Gains from illegal activities	Unemployment benefits
Gains from sale of property	Wages
Gambling winnings	

Deductions for Adjusted Gross Income

Individual taxpayers have available two categories of deductions: (1) deductions *for* adjusted gross income (i.e., items subtracted from gross income to arrive at adjusted gross income) and (2) deductions *from* adjusted gross income.

Deductions *for* adjusted gross income (AGI) are sometimes known as *above-the-line* deductions because on the tax return, they are taken before the “line” designating AGI. They also can be referred to as *page 1 deductions* because they are claimed, either directly or indirectly (i.e., through supporting schedules), on page 1 of Form 1040. Deductions *for* AGI include, but are not limited to, the following.⁵ Many of these items are subject to computational limitations.

- Expenses incurred in a trade or business.
- Part of any Federal self-employment tax paid.
- Unreimbursed moving expenses.
- Contributions to traditional Individual Retirement Accounts (IRAs) and certain other retirement plans.
- Fees for college tuition and related expenses.
- Contributions to Health Savings Accounts (HSAs).
- Interest on student loans.
- Excess capital losses.
- Alimony payments.

The principal deductions *for* AGI are discussed in Chapters 6 through 11, 13, and 14.

⁵§ 62.

EXAMPLE

3

Mason, age 45, earned a salary of \$78,000 in the current year. He contributed \$4,000 to his traditional Individual Retirement Account (IRA), sold stock held as an investment for a short-term capital loss of \$2,000, and paid \$4,600 in alimony to his ex-wife. His AGI is determined as follows.

Gross income		
Salary		\$ 78,000
Less: Deductions for AGI		
IRA contribution	\$4,000	
Capital loss	2,000	
Alimony paid	<u>4,600</u>	<u>(10,600)</u>
AGI		<u><u>\$ 67,400</u></u>

Deductions from Adjusted Gross Income

As a general rule, personal expenditures are disallowed as deductions in arriving at taxable income. However, Congress allows specified personal expenses as deductions from AGI.

AGI is an important subtotal that is the basis for computing percentage limitations on certain itemized deductions, such as medical expenses, charitable contributions, and certain casualty losses. For example, medical expenses are deductible only to the extent they exceed 10 percent of AGI (7.5 percent for individuals who are at least age 65), and charitable contribution deductions may not exceed 50 percent of AGI. These limitations might be described as a 10 (or 7.5) percent *floor* under the medical expense deduction and a 50 percent *ceiling* on the charitable contribution deduction.

EXAMPLE

4

Assume the same facts as in Example 3. Mason also incurred medical expenses of \$8,000. Medical expenses are included in Mason's itemized deductions to the extent they exceed 10% of AGI. In computing his itemized deductions, Mason includes medical expenses of \$1,260 [\$8,000 medical expenses – \$6,740 (10% × \$67,400 AGI)].

Personal and dependency exemptions are allowed for the taxpayer, for the taxpayer's spouse, and for each dependent of the taxpayer. The 2015 exemption amount is \$4,000, up from \$3,950 for 2014.

Itemized deductions include medical expenses, certain taxes and interest, and charitable contributions. In addition to these personal expenses, taxpayers are allowed itemized deductions for expenses related to (1) the production or collection of income and (2) the management of property held for the production of income.⁶ These expenses, sometimes referred to as *nonbusiness expenses*, differ from trade or business expenses. Trade or business expenses, which are deductions *for* AGI, are incurred in connection with a trade or business. Alternatively, itemized deductions can arise from expenses incurred in connection with an income-producing activity that does not qualify as a trade or business.

EXAMPLE

5

Leo is the owner and operator of a video game arcade. All allowable expenses that he incurs in connection with the arcade business are deductions *for* AGI. In addition, Leo has an extensive portfolio of stocks and bonds. Leo's investment activity is not treated as a trade or business. All allowable expenses that Leo incurs in connection with these investments are itemized deductions.

Itemized deductions include, but are not limited to, the expenses listed in Exhibit 3.3. See Chapter 10 for a detailed discussion of itemized deductions.

⁶§ 212.

EXHIBIT 3.3

Partial List of Itemized Deductions

Medical expenses, usually in excess of 10% (7.5% if at least age 65) of AGI
 State and local income or sales taxes
 Real estate taxes
 Personal property taxes
 Interest on home mortgage
 Investment interest (to a limited extent)
 Charitable contributions (within specified percentage limitations)
 Casualty and theft losses in excess of 10% of AGI
 Miscellaneous expenses (to the extent the total exceeds 2% of AGI)
 Union dues
 Professional dues and subscriptions
 Certain educational expenses
 Tax return preparation fee
 Investment counsel fees
 Unreimbursed employee business expenses (after a percentage reduction
 for meals and entertainment)

Many expenditures are not deductible and, therefore, provide no tax benefit. Examples include, but are not limited to, the following.

- Personal living expenses, including any losses on the sale of personal use property.
- Hobby losses.
- Life insurance premiums.
- Expenses incident to jury duty.
- Gambling losses (in excess of winnings).
- Child support payments.
- Fines and penalties.
- Political contributions.
- Certain passive losses.
- Funeral expenses.
- Expenses paid on another's behalf.
- Capital expenditures.

Most of the nondeductible items in this list are discussed further in Chapter 6. Passive loss limitations are treated in Chapter 11.

3-1b Standard Deduction

The **standard deduction** is specified by Congress and depends on the filing status of the taxpayer. The effect of the standard deduction is to exempt a taxpayer's income, up to the specified amount, from Federal income tax liability. In the past, Congress has attempted to set the tax-free amount represented by the standard deduction approximately equal to an estimated poverty level,⁷ but it has not always been consistent in doing so.

LO.2

Explain the use of the standard deduction in computing taxable income.

Basic and Additional Standard Deduction

The standard deduction is the sum of two components: the *basic* standard deduction and the *additional* standard deduction.⁸ Exhibit 3.4 lists the basic standard deduction

⁷S.Rep. No. 92-437, 92nd Cong., 1st Sess., 1971, p. 54. Another purpose of the standard deduction was discussed in Chapter 1 under Influence of the Internal Revenue Service—Administrative Feasibility. The size of the standard deduction has a direct bearing on the number of taxpayers who can

itemize deductions. Reducing the number of taxpayers who can itemize also reduces the audit effort required from the IRS.

⁸§ 63(c)(1).

EXHIBIT 3.4

Basic Standard Deduction Amounts

Filing Status	Standard Deduction Amount	
	2014	2015
Single	\$ 6,200	\$ 6,300
Married, filing jointly	12,400	12,600
Surviving spouse	12,400	12,600
Head of household	9,100	9,250
Married, filing separately	6,200	6,300

allowed for taxpayers in each filing status. All taxpayers allowed a *full* standard deduction are entitled to the applicable amount listed in Exhibit 3.4. The standard deduction amounts are subject to adjustment for inflation each year.

Certain taxpayers are not allowed to claim *any* standard deduction, and the standard deduction is *limited* for others. These provisions are discussed later in the chapter.

A taxpayer who is age 65 or over *or* blind qualifies for an *additional standard deduction* of \$1,250 or \$1,550, depending on filing status (see amounts in Exhibit 3.5). Two additional standard deductions are allowed for a taxpayer who is age 65 or over *and* blind. The additional standard deduction provisions also apply for a qualifying spouse who is age 65 or over or blind, but a taxpayer may not claim an additional standard deduction for a dependent.

To determine whether it is best to itemize, the taxpayer compares the *total* standard deduction (the sum of the basic standard deduction and any additional standard deductions) with total itemized deductions. Taxpayers can deduct the *greater* of itemized deductions or the standard deduction. Approximately two-thirds of individual tax returns employ the standard deduction every year.

The taxpayer chooses whether to itemize or claim the standard deduction. This is an annual election; the default choice is to use the standard deduction. A taxpayer is not bound by what was done on returns filed for past years. For example, many taxpayers who previously have claimed the standard deduction switch to itemizing after purchasing a home (because of the mortgage interest and property tax deductions). In other circumstances, a taxpayer may switch from itemizing to the standard deduction.

EXAMPLE

6

Prior to 2015, Sara, who is single, always had chosen to itemize. In 2015, however, Sara reaches age 65. Her itemized deductions for the tax year are \$6,500, but her total standard deduction is \$7,850 [\$6,300 (basic standard deduction) + \$1,550 (additional standard deduction)]. Sara should compute her taxable income using the standard deduction, because it exceeds her itemized deductions.

EXHIBIT 3.5

Amount of Each Additional Standard Deduction

Filing Status	2014	2015
Single	\$1,550	\$1,550
Married, filing jointly	1,200	1,250
Surviving spouse	1,200	1,250
Head of household	1,550	1,550
Married, filing separately	1,200	1,250

Individuals Not Eligible for the Standard Deduction

The following individual taxpayers cannot use the standard deduction and therefore must itemize.⁹

- A married individual filing a separate return where either spouse itemizes deductions.
- A nonresident alien.

The death of an individual does not eliminate the standard deduction for the year of death, nor is the deduction allocated to the pre-death portion of the year. If, for example, Sandy (age 80 and single) died on January 14, 2015, his executor could claim a standard deduction of \$7,850 [\$6,300 (basic standard deduction) + \$1,550 (additional standard deduction for age)] on his final income tax return (covering the period from January 1 to January 14, 2015).

Limitations on the Standard Deduction for Individuals Who Can Be Claimed as Dependents

Special rules apply to the standard deduction and personal exemption of an individual who can be claimed as a dependent on another person's tax return.

When filing his or her own tax return, a dependent's basic standard deduction for 2015 is limited to the greater of \$1,050 or the sum of the individual's *earned income* for the year plus \$350.¹⁰ However, this amount cannot exceed the appropriate amount shown in Exhibit 3.4. Earned income includes items such as wages, while unearned income often is in the form of interest, dividends, and capital gains.

These limitations apply only to the basic standard deduction. A dependent who is 65 or over or blind or both also is allowed the additional standard deduction amount on his or her own return (refer to Exhibit 3.5).

Dependent Standard Deduction

Susan, who is 17 years old and single, is claimed as a dependent on her parents' tax return. During 2015, she received \$1,200 interest (unearned income) on a savings account. She also earned \$400 from a part-time job. When Susan files her own tax return, her standard deduction is \$1,050 [the greater of \$1,050 or the sum of earned income plus \$350 (\$400 + \$350 = \$750)].

EXAMPLE

7

Assume the same facts as in Example 7, except that Susan is 67 years old and is claimed as a dependent on her son's tax return. In this case, when Susan files her own tax return, her standard deduction is \$2,600 [\$1,050 (the greater of \$1,050 or the \$750 sum of earned income plus \$350) + \$1,550 (the additional standard deduction allowed because Susan is age 65 or over)].

EXAMPLE

8

Peggy, who is 16 years old and single, earned \$800 from a summer job and no unearned income during 2015. She is claimed as a dependent on her parents' tax return. Her standard deduction is \$1,150 (the greater of \$1,050 or the \$1,150 sum of earned income plus \$350).

EXAMPLE

9

Jack, who is a 20-year-old, single, full-time college student, is claimed as a dependent on his parents' tax return. He worked as a musician during the summer of 2015, earning \$6,500. Jack's standard deduction is \$6,300 (the greater of \$1,050 or the \$6,850 sum of earned income plus \$350, but limited to the \$6,300 standard deduction amount for a single taxpayer).

EXAMPLE

10

⁹§ 63(c)(6).

¹⁰§ 63(c)(5). Both the \$1,050 and the \$350 amounts are subject to adjustment for inflation each year. For 2014, the amounts were \$1,000 and \$350.

3-1c Application of the Tax Formula

The structure of the individual income tax return (Form 1040, 1040A, or 1040EZ) parallels the tax formula in Concept Summary 3.1. Like the formula, the tax return places major emphasis on the adjusted gross income (AGI) and taxable income (TI) subtotals. In arriving at AGI, however, most exclusions are not reported on the tax return.

EXAMPLE

11

Grace, age 25, is single. She lives with her disabled and dependent mother. This qualifies Grace for head-of-household filing status and a standard deduction of \$9,250 in 2015.

Grace earned a \$60,000 salary. Her other income consisted of \$1,100 interest from a bank account and \$500 interest on municipal bonds that she previously had received as a graduation gift. In addition, she sustained a deductible capital loss of \$1,000. Her itemized deductions amount to \$9,500. Grace's taxable income is computed as follows.

Salary	\$62,000
Interest from bank account	1,100
Interest on municipal bonds	500
Income (broadly defined)	<u>\$63,600</u>
Less: Exclusion—Interest on municipal bonds	(500)
Gross income	\$63,100
Less: Deduction for adjusted gross income—capital loss	(1,000)
Adjusted gross income	\$62,100
Less: The greater of total itemized deductions (\$9,500) or the standard deduction for a head of household (\$9,250)	(9,500)
Personal and dependency exemptions (2 × \$4,000)	(8,000)
Taxable income	<u>\$44,600</u>

LO.3

Apply the rules for arriving at personal exemptions.

3-2 PERSONAL EXEMPTIONS

The use of exemptions in the tax system is based in part on the idea that a taxpayer with a small amount of income should be exempt from Federal income taxation. An exemption frees a specified amount of income from tax (\$3,950 for 2014 or \$4,000 for 2015). The exemption amount is adjusted (i.e., indexed) annually for inflation.

Exemptions that are allowed for the taxpayer and spouse are designated as **personal exemptions**. Those exemptions allowed for the care and maintenance of other persons are called dependency exemptions. An individual cannot claim a personal exemption if he or she is claimed as a dependent by another.¹¹

When a husband and wife file a joint return, they claim two personal exemptions. However, when separate returns are filed, a married taxpayer cannot claim an exemption for his or her spouse *unless* the spouse has zero gross income and is not claimed as the dependent of another taxpayer.¹²

The determination of marital status generally is made at the end of the taxable year, except when a spouse dies during the year. Spouses who enter into a legal separation under a decree of divorce or separate maintenance before the end of the year are considered to be unmarried at the end of the taxable year. Exhibit 3.6 illustrates the effect of death or divorce upon marital status.

The amount of the exemption is not reduced due to the taxpayer's death. For example, refer to the case of Helen in Exhibit 3.6. Although she lived for only three days, a full personal exemption is allowed for the tax year. The same rule applies to dependency exemptions. As long as an individual qualified as a dependent at the time of death, the full amount of the exemption is claimed for the year.

¹¹§ 151(d)(2).

¹²§ 151(b).

EXHIBIT 3.6

Marital Status for Filing Status and Exemption Purposes

Taxpayers	Marital Status at Year-End
Walt is the widower of Helen, who died on January 3.	Walt and Helen are married.
Bill and Jane entered into a divorce decree that is effective on December 31.	Bill and Jane are unmarried.

3-3 DEPENDENCY EXEMPTIONS

As is the case with personal exemptions, a taxpayer is permitted to claim an exemption of \$3,950 for 2014 or \$4,000 for 2015 for each person who qualifies as a dependent. A **dependency exemption** is available for either a *qualifying child* or a *qualifying relative*.

LO.4

Apply the rules for determining dependency exemptions.

3-3a Qualifying Child

The term *qualifying child* is used in several Code provisions, including those relating to:

- Dependency exemption.
- Head-of-household filing status.
- Earned income tax credit.
- Child tax credit.
- Credit for child and dependent care expenses.

A **qualifying child** must meet the relationship, abode, age, and support tests.¹³ For dependency exemption purposes, a qualifying child also must satisfy the joint return test and the citizenship or residency test, both discussed in a later section.

Relationship Test

The relationship test is met by a taxpayer's child (son, daughter), adopted child, stepchild, eligible foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a *descendant* of any of these parties (e.g., grandchild, nephew, and niece). Note that *ancestors* of any of these parties (e.g., uncle and aunt) and in-laws (e.g., son-in-law and brother-in-law) are not included.

An adopted child includes a child lawfully placed with the taxpayer for legal adoption even though the adoption is not final. An eligible foster child is one who is placed with the taxpayer by an authorized placement agency or by a judgment decree or other order of any court of competent jurisdiction.¹⁴

Maureen's household includes her mother, grandson, stepbrother, stepbrother's daughter, uncle, and sister. All meet the relationship test for a qualifying child except the mother and uncle.

EXAMPLE

12

Abode Test

A qualifying child must live with the taxpayer for more than half of the year. For this purpose, temporary absences (e.g., school, vacation, medical care, military service, detention in a juvenile facility) are disregarded. Special rules apply in the case of certain kidnapped children.¹⁵

¹³§ 152(c).

¹⁴§ 152(f)(1)(A)(ii).

¹⁵§ 152(f)(6).

Age Test

By the end of the tax year, a qualifying child must be under age 19 (age 24 in the case of a student). A student is a child who, during any part of five months of the year, is enrolled full-time at a school or government-sponsored on-farm training course.¹⁶ An individual cannot be older than the taxpayer claiming him or her as a qualifying child (e.g., a brother cannot claim his older sister as a qualifying child). The age test does not apply to a child who is disabled during any part of the year.

The Big Picture

EXAMPLE

13

Return to the facts of *The Big Picture* on p. 3-1. Does Paige meet the requirements of a qualifying child as to Polly? Paige satisfies the relationship and abode tests, but the application of the age test remains unclear. Because Paige is not a full-time student or disabled, she must be under 19 to meet the age test.

Support Test

A qualifying child cannot be self-supporting (i.e., provide more than one-half of his or her own support). In the case of a child who is a full-time student, scholarships are not considered to be support.¹⁷

EXAMPLE

14

Shawn, age 23, is a full-time student who lives with his parents and an older cousin. Shawn receives his support from the following sources: 30% from a part-time job, 30% from a scholarship, 20% from his parents, and 20% from the cousin. Shawn is not self-supporting, so he can be claimed by his parents as a dependent, even though the parents contribute only 20% of Shawn's support. (Note: Shawn cannot be a qualifying child as to his cousin, due to the relationship test.)

Tiebreaker Rules

In some situations, a child may be a qualifying child for more than one person. In this event, the tax law specifies which person has priority in claiming the dependency exemption.¹⁸ Called "tiebreaker rules," these rules are summarized in Exhibit 3.7 and are illustrated in the examples that follow.

Tiebreaker Rules for Qualifying Child

EXAMPLE

15

Tim, age 15, lives in the same household with his mother and grandmother. As the parent, the mother has priority as to the dependency exemption.

EXAMPLE

16

Jennifer, age 17, lives in the same household with her parents during the entire year. If her parents file separate returns, the one with the higher AGI has priority as to the dependency exemption.

EXAMPLE

17

Carlos, age 12, lives in the same household with his two aunts. The aunt with the higher AGI has priority as to the dependency exemption.

¹⁶§ 152(f)(2).

¹⁷§ 152(f)(5).

¹⁸§ 152(c)(4).

EXHIBIT 3.7

Tiebreaker Rules for Claiming a Qualifying Child

Persons Eligible to Claim Exemption	Person Prevailing
One of the persons is the parent.	Parent
Both persons are the parents, and the child lives with one parent for a longer period.	Parent with the longer period of residence
Both persons are the parents, and the child lives with each the same period of time.	Parent with the higher adjusted gross income (AGI)
None of the persons is the parent.	Person with highest AGI

3-3b **Qualifying Relative**

A **qualifying relative** must meet the relationship, gross income, and support tests.¹⁹ Qualifying relative status also requires that the joint return and nonresident alien tests be met (discussion of both follows). One who does not satisfy the qualifying child definition still may be a qualifying relative.

Inez provides more than half of the support of her son Manuel, age 20, who is neither disabled nor a full-time student. Manuel is not a qualifying child due to the age test, but he is a qualifying relative if the gross income test is met. Consequently, Inez may claim a dependency exemption for Manuel.

EXAMPLE

18

Relationship Test

The relationship test for a qualifying relative is more expansive than for a qualifying child. Also included are:

- Lineal ascendants (e.g., parents and grandparents).
- Collateral ascendants (e.g., uncles and aunts).
- Certain in-laws (e.g., son-, daughter-, father-, mother-, brother-, and sister-in-law).²⁰

The relationship test also includes unrelated parties who live with the taxpayer (i.e., they are members of the same household) for the entire tax year. Member-of-the-household status is not available for anyone whose relationship with the taxpayer violates an enforced local law, or for anyone who was a spouse during any part of the year.²¹ However, an ex-spouse can qualify as a member of the household in a year following that of the divorce.

As the relationship test indicates, the term *qualifying relative* is somewhat misleading. Persons other than relatives can qualify as dependents. Furthermore, not all relatives qualify—notice the absence of “cousin.”²²

The Big Picture

Return to the facts of *The Big Picture* on p. 3-1. Although Maude is unrelated to Polly, Maude qualifies as Polly’s dependent by being a member of the household. Because Maude is a dependent, Polly can claim the medical expenses she paid on Maude’s behalf. The funeral expenses are not deductible. Although Maude lived for only two months this year, the full amount of the dependency exemption is allowed.

EXAMPLE

19

¹⁹§ 152(d).

²⁰Once established by marriage, in-law status continues to exist and survives divorce.

²¹§§ 152(d)(2)(H) and (f)(3).

²²A cousin could be a qualifying relative, though, if he or she is a member of the household.

Gross Income Test

A qualifying relative's gross income must be *less* than the exemption amount—\$3,950 for 2014 and \$4,000 for 2015. Gross income is the amount that the tax law counts as taxable. In the case of scholarships, for example, include the taxable portion (e.g., amounts received for room and board) and exclude the nontaxable portion (e.g., amounts received for books and tuition). In contrast, the qualifying child rule does not contain a gross income test.

Gross Income Test

EXAMPLE

20

Elsie provides more than half of the support of her son, Tom, who does not live with her. Tom, age 26, is a full-time student in medical school, earns \$2,000 from a part-time job, and receives a \$62,000 scholarship covering his tuition. Elsie may claim Tom as a dependent because he is a qualifying relative and his gross income is \$2,000. (Tom is not a qualifying child due to either the abode or the age test.)

EXAMPLE

21

Aaron provides more than half of the support of his widowed aunt, Myrtle, who does not live with him. Myrtle's income for the year is as follows: dividend income of \$1,100, earnings from pet sitting of \$1,200, nontaxable Social Security benefits of \$10,000, and \$4,000 nontaxable interest from City of Milwaukee bonds. Because Myrtle's gross income is only \$2,300 (\$1,100 + \$1,200), she meets the gross income test and can be claimed as Aaron's dependent.

The Big Picture

EXAMPLE

22

Return to the facts of *The Big Picture* on p. 3-1. Assuming that Paige is not a qualifying child (see Example 13), can she be a qualifying relative for dependency exemption purposes? Paige meets the relationship and support tests, but what about the gross income test? If her income from her part-time job is less than \$4,000, she does qualify and can be claimed by Polly as a dependent.

Support Test

Over one-half of the support of the qualifying relative must be furnished by the person claiming the exemption. Support includes food, shelter, clothing, toys, medical and dental care, education, and the like. However, a scholarship (both taxable and nontaxable portions) received by a student is not counted as support.

EXAMPLE

23

Hal contributed \$3,400 (consisting of food, clothing, and medical care) toward the support of his nephew, Sam, who lives with him. Sam earned \$1,300 from a part-time job and used a \$2,000 student loan to attend a local university. Assuming that the other dependency tests are met, Hal can claim Sam as a dependent because Hal has provided more than half of Sam's support (\$3,400 Hal's support > \$3,300 self-support).

Capital expenditures for items such as furniture, appliances, and automobiles are included in total support if the item does, in fact, constitute support.

EXAMPLE

24

Norm purchased a television set costing \$950 and gave it to his mother, Vera, who lives with him. The television set was placed in Vera's bedroom and was used exclusively by her. Norm should include the cost of the television set in determining Vera's support.

Multiple Support Agreements An exception to the support test involves a **multiple support agreement**. A multiple support agreement permits one person in a group of

taxpayers who furnish support for a qualifying relative to claim a dependency exemption for that individual, even if no one person provides more than 50 percent of the support.²³ The group together must provide more than 50 percent of the support.

Any person who contributed *more than 10 percent* of the support is entitled to claim the exemption if each person in the group who contributed more than 10 percent agrees in a written consent. This provision frequently enables one of the children of aged dependent parents to claim an exemption when none of the children individually meets the 50 percent support test.

Each person who is a party to the multiple support agreement must meet all other tests (except the support requirement) for claiming the exemption. A person who does not meet the relationship or member-of-the-household requirement, for instance, cannot claim the dependency exemption, even under a multiple support agreement.

Wanda, who resides with her son, Adam, received \$24,000 from various sources during the year. This constituted her entire support for the year.

EXAMPLE**25**

	Support Received	Percentage of Total
Adam, son	\$10,000	42
Bob, son	1,200	5
Carol, daughter	9,200	38
Diane, friend	3,600	15
	<u>\$24,000</u>	<u>100</u>

If Adam and Carol file a multiple support agreement, either may claim the dependency exemption for Wanda. Bob may not claim Wanda because he did not contribute more than 10% of her support. Bob's consent is not required for Adam and Carol to file a multiple support agreement. Diane does not meet the relationship or member-of-the-household test and cannot be a party to the agreement.

The decision as to who claims Wanda rests with Adam and Carol. If Adam agrees, Carol can claim Wanda, even though Adam furnished more of Wanda's support.

The individual claiming the exemption must complete Form 2120 (Multiple Support Declaration) and file it with his or her tax return. In addition, every other person who qualifies under the more-than-10 percent rule must submit a signed statement waiving his or her right to the exemption to the person who is claiming the exemption. The person claiming the exemption retains all of these written statements for his or her records.



ETHICS & EQUITY Discovering Lost Dependency Exemptions

For the six years prior to his death, Jesse lived with his daughter, Hannah. Because he had no source of income, Jesse was supported by equal contributions from Hannah and his two sons, Bill and Bob. At Jesse's funeral, his surviving children are amazed to discover that none of them has been claiming Jesse as a dependent.

Upon the advice of the director of the funeral home, they decide to divide among themselves the dependency

exemptions for the past six years. Multiple Forms 2120 are executed, and each of the three children files amended returns for different past years. As Jesse died late in the current year, none of the children plans to claim him for this tax year.

Comment on the tax expectations of the parties involved.

²³§ 152(d)(3).

Children of Divorced or Separated Parents Another exception to the support test applies when parents with children are divorced or separated under a decree of separate maintenance. Generally, the parent having custody of the child (children) for the greater part of the year (i.e., the custodial parent) is entitled to the dependency exemption(s). A special rule applies if the now-unmarried parents live apart for the last six months of the year, and:²⁴

- They would have been entitled to the dependency exemption(s) had they been married and filed a joint return.
- They have custody (jointly or singly) of the child (children) for more than half of the year.

The special rule grants the dependency exemption(s) to the noncustodial parent if the divorce (or separate maintenance) decree so specifies *or* if the custodial parent issues a waiver on Form 8332.²⁵

If the special rule does not apply (i.e., the divorce decree is silent or the custodial parent does not sign Form 8332), the dependency exemption(s) for the child (children) is awarded in accordance with the qualifying child or qualifying relative rules. When support of the child is determined, alimony received by the custodial parent does not count as support by the payor parent, but child support received probably does.²⁶

3-3c Other Rules for Dependency Exemptions

In addition to fitting into either the qualifying child or the qualifying relative category, a dependent must meet the joint return and the citizenship or residency tests.

Joint Return Test

If a dependent is married, the supporting taxpayer (e.g., the parent of a married child) generally is not permitted a dependency exemption if the married individual files a joint return with his or her spouse.²⁷ The joint return rule does not apply, however, if the following conditions are met.

- The reason for filing is to claim a refund for tax withheld.
- No tax liability would exist for either spouse on separate returns.
- Neither spouse is required to file a return. See Exhibit 3.8 later in the chapter.

EXAMPLE

26

Paul provides over half of the support of his son Quinn. He also provides over half of the support of Vera, who is Quinn's wife. During the year, both Quinn and Vera hold part-time jobs. To recover the taxes withheld, they file a joint return. If Quinn and Vera are not required to file a return, Paul can claim both as dependents.

Citizenship or Residency Test

To be a dependent, the individual must be a U.S. citizen, a U.S. resident, or a resident of Canada or Mexico for some part of the calendar year in which the taxpayer's tax year begins.²⁸

3-3d Qualifying for Dependency Exemptions

Concept Summary 3.2 sets forth the tests for the two categories of dependency exemptions. In contrasting the two categories, the following observations are in order.

- As to the relationship tests, the qualifying relative category is considerably more expansive. Besides including those prescribed under the qualifying child grouping, other relatives are added. Nonrelated persons who are members of the household are also included.

²⁴§ 152(e)(1).

²⁵§§ 152(e)(2) and (5).

²⁶§ 152(d)(5)(A).

²⁷§ 152(b)(2).

²⁸§ 152(b)(3).

Concept Summary 3.2

Tests for Dependency Exemption

Category	
Qualifying Child ¹	Qualifying Relative
Relationship ²	Support
Abode	Relationship ³ or member of household
Age	Gross income
Support	
Joint return ⁴	Joint return ⁴
Citizenship or residency ⁵	Citizenship or residency ⁵

¹ These tests also are used by other tax rules.

² Children and their descendants, and siblings and stepsiblings and their descendants.

³ Children and their descendants, siblings and their children, parents and their ascendants, uncles and aunts, stepparents and stepsiblings, and certain in-laws.

⁴ The joint return rules are the same for each category.

⁵ The citizenship or residency rules are the same for each category.

- The support tests are entirely different. In the case of a qualifying child, support is not necessary. What is required in that case is that the child not be self-supporting.
- The qualifying child category has no gross income limitation, whereas the qualifying relative category has no age restriction.

3-3e Phaseout of Exemptions

To increase the effective tax rate of upper-income individuals, personal and dependency exemptions are phased out by 2 percent for each \$2,500 (or fraction thereof) by which the taxpayer's AGI exceeds the following threshold amounts. For a married taxpayer filing separately, the phaseout is 2 percent for each \$1,250 (or fraction thereof). The threshold amounts are indexed annually for inflation.

Filing Status	2014	2015
Married, filing jointly	\$305,050	\$309,900
Head of household	279,650	284,050
Single	254,200	258,250
Married, filing separately	152,525	154,950

The allowable exemption amount can be determined with the following steps.

1. $\text{AGI} - \text{threshold amount} = \text{excess amount}$.
2. $\text{Excess amount} \div \$2,500 = \text{reduction factor}$ [rounded up to the next whole number (e.g., 18.1 = 19)] $\times 2 = \text{phaseout percentage}$.
3. $\text{Phaseout percentage (from step 2)} \times \text{exemption amount} = \text{phaseout amount}$.
4. $\text{Exemption amount} - \text{phaseout amount} = \text{allowable exemption deduction}$.

Brad files as a single individual in 2015. His AGI is \$290,900. He is entitled to one personal exemption. Brad's allowable exemption amount is determined as follows.

1. $\$290,900 - \$258,250 = \$32,650$ excess amount.
2. $[(\$32,650 \div \$2,500) = 13.06; \text{rounded to } 14]; 14 \times 2 = 28\%$ (phaseout percentage).
3. $28\% \times \$4,000 = \$1,120$ phaseout amount.
4. $\$4,000 - \$1,120 = \$2,880$ allowable exemption deduction.

EXAMPLE

27

The exemption amount is completely phased out when the taxpayer's AGI exceeds the threshold amount by more than \$122,500 (\$61,250 for a married taxpayer filing a separate return).

3-3f Child Tax Credit

In addition to providing a dependency exemption, a taxpayer's child also may generate a **child tax credit**. A \$1,000 credit is allowed for each dependent child (including stepchildren and eligible foster children) under the age of 17.²⁹ For a more complete discussion of the child tax credit, see Chapter 12.



ETHICS & EQUITY Whose Qualifying Child Is He?

The Rands are successful professionals and have combined AGI of approximately \$400,000. Their household includes two children: Henry (age 16) and Belinda (age 22). Belinda is not a student; she holds a job in which she earns \$15,000 a year.

After a short family meeting in early April, the parties decide that Belinda should claim Henry as her qualifying child. As a result, Belinda is able to deduct a full

dependency exemption and claim a child tax credit and an earned income tax credit for a tax savings of more than \$3,000. Had the Rands claimed Henry on their joint return, no child tax credit or earned income credit would have been available.

As noted in Chapter 13, these credits are phased out for higher-bracket taxpayers. Has the Rand family acted properly?

LO.5

List the filing requirements and choose the proper filing status.

3-4 FILING THE RETURN

3-4a Filing Status

The amount of tax varies considerably depending on which filing status³⁰ the taxpayer uses.

EXAMPLE

28

The following amounts of tax are computed using the 2015 Tax Rate Schedules for a taxpayer (or taxpayers in the case of a joint return) with \$60,000 of taxable income (see Appendix A).

Filing Status	Amount of Tax
Single	\$10,794
Married, filing joint return	8,078
Married, filing separate return	10,794
Head of household	9,323

Single Taxpayers

State law governs whether a taxpayer is considered married, divorced, or legally separated. A taxpayer who is unmarried or separated from his or her spouse by a decree of divorce or separate maintenance and does not qualify for another filing status must use the rates for single taxpayers. Marital status is determined as of the last day of the tax year, except when a spouse dies during the year. In that case, marital status is determined as of the date of death.

Under a special relief provision, however, married persons who live apart may be able to qualify as single. Married taxpayers who are considered single under the *abandoned spouse rules* are allowed to use the head-of-household rates. This filing status is discussed later in the chapter.

²⁹§ 24(a).

³⁰§§ 1 and 2. Recall that the filing status also is used to determine the amount of the taxpayer's standard deduction.

Married Individuals

The *joint return* was enacted in 1948 to establish equity between married taxpayers in community property states and those in common law states. Before the joint return was available, taxpayers in community property states were in an advantageous position relative to taxpayers in common law states because they could split their income. For instance, if one spouse earned \$100,000 and the other spouse was not employed, each spouse could report \$50,000 of income. Splitting the income in this manner caused the total income to be subject to lower marginal tax rates.

Taxpayers in common law states did not have this income-splitting option, so their taxable income was subject to higher marginal rates. This inconsistency in treatment was remedied by the joint return provisions. The progressive rates in the joint return Tax Rate Schedule are constructed based on the assumption that income is earned equally by the two spouses.

If married individuals elect to file *separate returns*, each reports only his or her own income, exemptions, deductions, and credits, and each must use the Tax Rate Schedule for married taxpayers filing separately.

It generally is advantageous for married individuals to file a joint return, because the combined amount of tax is lower. However, special circumstances (e.g., significant medical expenses incurred by one spouse subject to the AGI limitation) may warrant the election to file separate returns. It may be necessary to compute the tax under both assumptions to determine the most advantageous filing status.

Once a joint return has been filed and the due date has passed, the spouses cannot switch to separate returns for that year. However, if married persons file separately, they can change later to a joint return.

The Code places some limitations on married persons who file separate returns. Some examples of these limitations are listed below. In such cases, being single would be preferable to being married and filing separately.

- If either spouse itemizes deductions, the other spouse must also itemize.
- The earned income credit and the credit for child and dependent care expenses cannot be claimed (see Chapter 12).
- No deduction is allowed for interest paid on qualified education loans (see Chapter 10).
- Only \$1,500 of excess capital losses can be claimed by each spouse for the tax year (see Chapter 14).

Duke and Carla are in the process of divorcing. They qualify this year for a \$4,000 earned income credit. If the taxpayers stay married but file separate returns this year, neither party can claim the credit. If instead a joint return is filed, the credit is available, presumably to be divided with the couple's other assets. If the divorce is finalized this year, both parties will file Forms 1040 using single filing status, and either of them can claim the credit.

EXAMPLE

29

A same-sex couple who is legally married in a state or jurisdiction that recognizes same-sex marriages is treated as married for Federal tax purposes (no matter where they live). To the contrary, registered domestic partners are not “spouses” under Federal law, nor are those who are part of a civil union. Therefore, those parties must file Federal tax returns as single individuals.

Surviving Spouse

The joint return rates also apply for two years following the death of one spouse, if the surviving spouse maintains a household for a dependent child. The child must be a son, stepson, daughter, or stepdaughter who qualifies as a dependent of the taxpayer. This is referred to as **surviving spouse** status.³¹

³¹§ 2(a). The IRS label for surviving spouse status is “Qualifying Widow(er) with Dependent Child.”

GLOBAL TAX ISSUES Filing a Joint Return

John Garth is a U.S. citizen and resident, but he spends a lot of time in London, where his employer sends him on frequent assignments. John is married to Victoria, a citizen and resident of the United Kingdom.

Can John and Victoria file a joint return for U.S. Federal income tax purposes? Although § 6013(a)(1) specifically precludes the filing of a joint return if one spouse is a nonresident alien, another Code provision permits an exception. Under § 6013(g), the parties can elect to treat the nonqualifying spouse as a “resident” of

the United States. This election would allow John and Victoria to file jointly.

But should John and Victoria make this election? If Victoria records considerable income of her own (from non-U.S. sources), the election could be ill-advised. As a nonresident alien, Victoria’s non-U.S. source income *would not* be subject to the U.S. income tax. If she is treated as a U.S. resident, however, her non-U.S. source income *will be subject to U.S. tax*. Under the U.S. global approach to taxation, all income (regardless of where earned) of anyone who is a *resident or citizen* of the United States is subject to tax.

EXAMPLE

30

Fred dies in 2014, leaving Ethel with a dependent child. For 2014, Ethel files a joint return with Fred (presuming that the consent of Fred’s executor is obtained). For the next two tax years (2015 and 2016), Ethel, filing as a surviving spouse, may use the joint return rates. In subsequent years, Ethel uses the head-of-household rates if she continues to maintain a household as her home that is the domicile of the child.

Head of Household

An unmarried individual who maintain a household for one or more dependents may qualify to use the **head-of-household** rates.³² The tax liability using the head-of-household rates falls between the liability using the joint return Tax Rate Schedule and the liability using the Tax Rate Schedule for single taxpayers.

To qualify for head-of-household rates, a taxpayer must pay more than half the cost of maintaining a household as his or her home. The household also must be the principal home of a dependent. The dependent must be either a qualifying child or a qualifying relative who meets the relationship test.³³

Except for temporary absences (e.g., school, hospitalization), the dependent must live in the taxpayer’s household for more than half the year. Head-of-household status still may be claimed if the taxpayer maintains a *separate home* for his or her *parent or parents*, if at least one parent qualifies as a dependent of the taxpayer.³⁴

The Big Picture

EXAMPLE

31

Return to the facts of *The Big Picture* on p. 3-1. Assuming that Polly can be treated as single (i.e., not married), can Maude qualify Polly for head-of-household filing status? The answer is no. Even though Maude can be claimed as Polly’s dependent (see Example 19), she does not meet the relationship test to be a qualifying relative.

Head of Household Rules

EXAMPLE

32

Emma, a widow, maintains a household in which she and her aunt live. If the aunt qualifies as a dependent, Emma may file as head of household. An aunt meets the relationship test.

³²§ 2(b).

³⁴§ 2(b)(1)(B).

³³§ 2(b)(3)(B). The member-of-the-household test cannot be used for this purpose.

Head of Household Rules

Nancy maintains a household in which she and her daughter, Bernice, live. Bernice, age 27, is single and earns \$9,000 from a part-time job. Nancy does not qualify for head-of-household filing status, as she cannot claim Bernice as a dependent (due to the gross income test).³⁵

EXAMPLE

33

Rick, an unmarried individual, lives in New York City and maintains a household in Scottsdale for his dependent parents. Rick may use the head-of-household rates, even though his parents do not reside in his New York home.

EXAMPLE

34

Abandoned Spouse Rules

When married persons file separate returns, several unfavorable tax consequences result. For example, the taxpayer likely must use the very expensive Tax Rate Schedule for married taxpayers filing separately. To mitigate such harsh treatment for some individuals, Congress enacted provisions commonly referred to as the **abandoned spouse** rules. These rules allow a married taxpayer to file as *not married*, and thus as head of household, if all of the following conditions are satisfied.³⁶

- The taxpayer does not file a joint return.
- The taxpayer paid more than one-half the cost of maintaining his or her home for the tax year.
- The taxpayer's spouse did not live in the home during the last six months of the tax year.
- The home was the principal residence of the taxpayer's son, daughter, stepson, stepdaughter, foster child, or adopted child for more than half the year, and the child can be claimed as a dependent.³⁷

The Big Picture

Return to the facts of *The Big Picture* on p. 3-1. Can Polly qualify as an abandoned spouse? Yes, if she can claim Paige as a dependent—either as a qualifying child (see Example 13) or as a qualifying relative (see Example 22). If so, Polly can use head-of-household filing status. If not, her filing status is married person filing separately.

EXAMPLE

35



ETHICS & EQUITY Abandoned Spouse?

Bob and Carol have been in and out of marital counseling for the past few years. Early in the current tax year, they decide to separate. However, because they are barely able to get by on their current incomes, they cannot afford separate housing or the legal costs of a divorce. So Bob moves out of their house in March and takes up residence in their detached garage (which

has an enclosed workshop and bathroom). Carol stays in the house with their two children and pays more than half of the costs of maintaining their residence. Bob does not enter the house for the remainder of the year.

Can Carol qualify as an abandoned spouse when filing her Federal income tax return for the year?

³⁵Can Bernice be a dependent under the qualifying child rules? Even though the gross income test is inapplicable for a qualifying child, Bernice does not meet the age test.

³⁶§ 7703(b).

³⁷§ 152(f)(1). The dependency requirement does not apply, however, if the taxpayer could have claimed a dependency exemption except for the fact that the exemption was claimed by the noncustodial parent under a written agreement.

3-4b Filing the Return

General Rules

An individual must file a tax return if certain minimum amounts of *gross income* have been received. The general rule is that a tax return is required for every individual who has gross income that equals or exceeds the sum of the exemption amount plus the applicable standard deduction.³⁸ For example, a single taxpayer under age 65 must file a tax return in 2015 if gross income equals or exceeds \$10,300 (\$4,000 exemption plus \$6,300 standard deduction). Exhibit 3.8 lists the income levels³⁹ that require the filing of tax returns.

The additional standard deduction for those age 65 or older is considered in applying the gross income filing requirements. For example, note in Exhibit 3.8 that the 2015 filing requirement for a single taxpayer age 65 or older is \$11,850 (\$6,300 basic standard deduction + \$1,550 additional standard deduction + \$4,000 exemption). The additional standard deduction for blindness is not taken into account for this purpose.

A self-employed individual with net earnings of \$400 or more from a business or profession must file a tax return regardless of the amount of gross income.

Even though an individual records gross income below the filing level amounts and therefore does not owe any tax, he or she must file a return to obtain a tax refund of amounts withheld. A return is also necessary to obtain the benefits of the earned income credit allowed to taxpayers with little or no tax liability. Chapter 12 discusses the earned income credit.

Filing Requirements for Dependents

Computation of the gross income filing requirement for an individual who can be claimed as a dependent on another person's tax return is subject to more complex rules. Such an individual must file a return if he or she has *any* of the following.

EXHIBIT 3.8		Income Levels When a Form 1040 Must Be Filed	
Filing Status	2014 Gross Income	2015 Gross Income	
Single			
Under 65 and not blind	\$10,150	\$10,300	
65 or older	11,700	11,850	
Married, filing joint return			
Both spouses under 65	\$20,300	\$20,800	
One spouse 65 or older	21,500	22,050	
Both spouses 65 or older	22,700	23,300	
Married, filing separate return			
All	\$ 3,950	\$ 4,000	
Head of household			
Under 65	\$13,050	\$13,250	
65 or older	14,600	14,800	
Qualifying widow(er)			
Under 65	\$16,350	\$16,600	
65 or older	17,550	17,850	

³⁸The gross income amounts for determining whether a tax return must be filed are adjusted for inflation each year.

³⁹§ 6012(a)(1).



TAX IN THE NEWS Filing Status Data

For a recent tax year, taxpayers used the following Form 1040 filing status options.

Filing Status	Number of Returns (Millions)
Married, filing jointly	53.76
Married, filing separately	2.66
Head of household	21.81
Surviving spouse	0.04
Single	66.66
Total	144.93

- Earned income only and gross income that is more than the total standard deduction (including any additional standard deduction) that the individual is allowed for the year.
- Unearned income only and gross income of more than \$1,050 plus any additional standard deduction that the individual is allowed for the year.
- Both earned and unearned income and gross income of more than the larger of \$1,050 or the sum of earned income plus \$350 (but limited to the applicable basic standard deduction), plus any additional standard deduction that the individual is allowed for the year.

Thus, the filing requirement for a dependent who has no unearned income is the total of the *basic* standard deduction plus any *additional* standard deduction, which includes both the additional deduction for blindness and the deduction for being age 65 or older. For example, the 2015 filing requirement for a single dependent who is under age 65 is \$6,300, the amount of the basic standard deduction.

Selecting the Proper Form

The 2015 tax forms had not been released at the date of publication of this text. The following comments apply to the 2014 forms. It is possible that some provisions will change for the 2015 forms.

Although a variety of forms are available to individual taxpayers, the use of some of these forms is restricted. For example, Form 1040EZ cannot be used if the:

- Taxpayer claims any dependents;
- Taxpayer (or spouse) is 65 or older or blind; or
- Taxable income is \$100,000 or more.

Taxpayers who itemize deductions *from* AGI cannot use Form 1040A, but must file Form 1040 (the long form).

E-Filing

The **e-file** program is the means by which the vast majority of taxpayers file their Federal income tax returns. Most tax preparers are required to file their clients' returns in this manner as well.

When e-filing is used, the required tax information is transmitted to the IRS electronically either directly from the taxpayer (i.e., an "e-file online return") or indirectly



GLOBAL TAX ISSUES Tracking Down Tax Dollars

Non-U.S. persons who earn income within the United States may need to file a Federal income tax return, but they may not have a Social Security number for filing purposes. If not, they can use a nine-digit Individual Tax Identification Number (ITIN) instead. The IRS issues ITINs upon the submission of an application and proof of identification (e.g., a driver's license). As the IRS does not require an applicant to show that he or she is in the United States legally, the ITINs are freely available to undocumented persons (i.e., illegal immigrants). The use of an ITIN also can enable the holder to carry out other financial transactions (e.g., establish a bank account, secure a credit card, and obtain a loan).

The position of the IRS is that the current ITIN procedure brings in revenue that otherwise would not be forthcoming. Some undocumented workers want to comply with the law and pay the income taxes they owe. This practice should not be discouraged, as the tax law applies with equal force to legal and illegal residents of the United States.

However, ITINs have been criticized for their use by illegal immigrants and undocumented workers. A recent report from the Treasury Inspector General for Tax Administration found that individuals who are not authorized to work in the United States were paid \$4.2 billion in refundable tax credits, such as the child tax credit, because they were able to file tax returns using an ITIN.

through tax professionals who have been accepted into the electronic filing program by the IRS. Such parties hold themselves out to the general public as “authorized IRS e-file providers.”

For direct e-filing, a taxpayer uses a personal computer and tax preparation software with the capability of conveying the information online to an electronic return transmitter.

A taxpayer then can use the free smartphone app “IRS2Go” to check the status of a refund.

Through an arrangement with the IRS, about 15 software providers offer free e-filing services. These services are available only to lower-income taxpayers. A list of these “Free-File” providers and their eligibility requirements can be obtained at www.irs.gov.

All e-filing taxpayers and tax return preparers must attest to the returns they file. For most taxpayers, this attesting can be done through an electronic return signature using a personal identification number.

E-filing has two major advantages. First, compliance with the format required by the IRS eliminates many math and clerical errors that would otherwise occur. Second, the time required for processing a refund usually is reduced to three weeks or less.

When and Where to File

Tax returns of individuals are due on or before the fifteenth day of the fourth month following the close of the tax year. For the calendar year taxpayer, the usual filing date is on or before April 15 of the following year.⁴⁰ When the due date falls on a Saturday, Sunday, or legal holiday, the last day for filing falls on the next business day. The return should be e-filed or sent to an IRS Service Center.⁴¹

If the return is mailed to the proper address with sufficient postage and is post-marked on or before the due date, it is deemed timely filed. The IRS has issued rules governing the filing of returns using various private delivery services (e.g., FedEx and UPS).⁴²

If a taxpayer is unable to file the return by the specified due date, a six-month extension of time is obtained by filing Form 4868 (Application for Automatic Extension of Time to File U.S. Individual Income Tax Return) by no later than the due date of the return.⁴³

⁴⁰§ 6072(a).

⁴¹The Service Centers and the geographic area each covers are illustrated at www.irs.gov/file.

⁴²§ 7502(f).

⁴³Reg. § 1.6081-4.



TAX IN THE NEWS Special Rules for Military Personnel

Certain members of the military are granted more time to file their Federal income tax returns. If they are outside the United States and Puerto Rico *but not* in a combat zone, the filing date is extended to June 15. If additional taxes are due, however, interest still begins to accrue after April 15.

For those deployed in a designated combat zone, the filing date is postponed until 180 days after the last day of combat service. Furthermore, in such cases, interest *does not* accrue during the deferral period. These filing dates are equally applicable when the military person is married and files a joint return.

Although obtaining an extension excuses a taxpayer from a penalty for failure to file, it does not insulate against the penalty for failure to pay the corresponding tax. If more tax is owed, the filing of Form 4868 should be accompanied by an additional remittance to cover the balance due. The failure to file and failure to pay penalties are discussed in Chapter 1.

If an individual taxpayer needs to file an amended return (e.g., because of a failure to report income or to claim an additional deduction or tax credit), Form 1040X is filed. The form generally is filed within three years of the filing date of the original return or within two years from the time the tax was paid, whichever is later.

Mode of Payment

A Federal tax payment can be made by check, made out to “United States Treasury.” More commonly, the taxpayer elects on the Form 1040 a direct payment of the amount due, or a direct deposit of a refund receivable, using an indicated bank account. Payments by debit or credit card or through an electronic fund transfer also are allowed.

3-5 TAX COMPUTATIONS

The computation of income tax due (or refund) involves applying the proper set of tax rates to taxable income and then adjusting for available credits. In certain cases, however, the application of the kiddie tax will cause a modification of the means by which the tax is determined.

3-5a Tax Rates

The basic Federal income tax rate structure is progressive, with current rates ranging from 10 percent to 39.6 percent. By way of comparison, the lowest Federal income tax rates, in effect in 1913–1915, ranged from 1 to 7 percent; the highest, in effect during 1944–1945, ranged from 23 to 94 percent.

3-5b Tax Table Method

The tax liability is computed using either the Tax Table method or the Tax Rate Schedule method. Most taxpayers compute their tax using the **Tax Table**. Eligible taxpayers compute taxable income (as shown in Concept Summary 3.1) and *must* determine their tax by reference to the Tax Table. Taxpayers, however, may not use the Tax Table method when taxable income exceeds \$100,000.

The IRS does not release the Tax Tables until late in the year to which they apply. The Tax Rate Schedules, however, are released at the end of the year preceding their applicability.⁴⁴ For purposes of estimating tax liability and making quarterly prepayments, the Tax Rate Schedules usually are consulted.

LO.6

Use the proper method for determining the tax liability.

⁴⁴The 2015 Tax Table was not available from the IRS at the date of publication of this text. The Tax Table for 2014 and the Tax Rate Schedules for

2014 and 2015 are reproduced in Appendix A. For quick reference, the Tax Rate Schedules also are reproduced inside the front cover of this text.

EXHIBIT 3.9

2015 Tax Rate Schedule for Single Taxpayers

If Taxable Income Is		The Tax Is:	Of the Amount Over
Over	But Not Over		
\$ -0-	\$ 9,225	10%	\$ -0-
9,225	37,450	\$ 922.50 + 15%	9,225
37,450	90,750	5,156.25 + 25%	37,450
90,750	189,300	18,481.25 + 28%	90,750
189,300	411,500	46,075.25 + 33%	189,300
411,500	413,200	119,401.25 + 35%	411,500
413,200		119,996.25 + 39.6%	413,200

3-5c Tax Rate Schedule Method

The 2015 tax rate schedule for single taxpayers is reproduced in Exhibit 3.9.⁴⁵

EXAMPLE

36

Pat is single and reported \$5,870 of taxable income in 2015. His tax is \$587 ($\$5,870 \times 10\%$).

Several terms are used to describe tax rates. The rates in the Tax Rate Schedules often are referred to as *statutory* (or nominal) rates. The *marginal* rate is the highest rate that is applied in the tax computation for a particular taxpayer. In Example 36, both the statutory rate and the marginal rate are 10 percent.

EXAMPLE

37

Chris is single and recorded taxable income of \$110,000 in 2015. Her tax is \$23,871.25 [$\$18,481.25 + 28\%(\$110,000 - \$90,750)$].

The *average* rate is equal to the tax liability divided by taxable income. In Example 37, Chris is subject to statutory rates of 10 percent, 15 percent, 25 percent, and 28 percent. Her marginal income tax rate is 28 percent. Chris's average rate is 17.2 percent ($\$18,931.25$ tax liability \div $\$110,000$ taxable income).

A special computation limits the effective tax rate on qualified dividends (see Chapter 4) and net long-term capital gain (see Chapter 14).

3-5d Computation of Net Taxes Payable or Refund Due

The pay-as-you-go feature of the Federal income tax system requires payment of all or part of the taxpayer's income tax liability during the year. These payments take the form of Federal income tax withheld by employers or estimated tax paid by the taxpayer, or both.⁴⁶ The payments are applied against the tax from the Tax Table or Tax Rate Schedules to determine whether the taxpayer will receive a refund or pay additional tax.

Employers are required to withhold income tax on compensation paid to their employees and to pay this tax to the government. The employer notifies the employee of the amount of income and tax withholdings on Form W-2 (Wage and Tax Statement). The employee should receive this form by January 31 after the year in which the income tax is withheld.

If taxpayers receive income that is not subject to withholding or income from which not enough tax is withheld, they may need to pay estimated tax. These individuals must

⁴⁵§ 1(i).

⁴⁶§ 3402 for withholding; § 6654 for estimated payments.

file Form 1040-ES (Estimated Tax for Individuals) and pay in quarterly installments the income tax and self-employment tax estimated to be due.

The income tax from the Tax Table or the Tax Rate Schedules is reduced first by the individual's tax credits. There is an important distinction between tax credits and tax deductions. Tax credits reduce the tax liability dollar-for-dollar. Tax deductions reduce taxable income on which the tax liability is based.

Gail is a taxpayer in the 25% tax bracket. As a result of incurring \$1,000 in child care expenses (see Chapter 12 for details), she is entitled to a \$200 child care credit (\$1,000 child care expenses \times 20% credit rate). She also contributed \$1,000 to the American Cancer Society and included this amount in her itemized deductions. The child care credit results in a \$200 reduction of Gail's tax liability for the year. The contribution to the American Cancer Society reduces taxable income by \$1,000 and results in a \$250 reduction in Gail's tax liability (\$1,000 reduction in taxable income \times 25% tax rate).

EXAMPLE**38**

Tax credits are discussed in Chapter 12. The following are several of the more commonly encountered credits.

- Earned income credit.
- Credit for child and dependent care expenses.
- Foreign tax credit.
- Child tax credit.

Return to the facts of Example 11. Grace's taxable income is \$44,600. Now further assume that Grace reports the following: income tax withheld, \$2,300; estimated tax payments, \$3,000; and a credit for child care expenses, \$200. Grace's net tax payable is computed as follows.

Income tax (from 2015 Tax Rate Schedule for Head of Household, Appendix A, rounded)		\$ 6,033
Less: Tax credits and prepayments—		
Credit for dependent care expenses	\$ 200	
Income tax withheld	2,300	
Estimated tax payments	3,000	(5,500)
Net taxes payable (or refund due if negative)		<u>\$ 533</u>

EXAMPLE**39**

3-5e Unearned Income of Children Taxed at Parents' Rate

To reduce the tax savings that might result from shifting income from parents to children (and their lower tax rates), the net **unearned income** (commonly called investment income) of certain children is taxed as if it were the parents' income. This provision, commonly referred to as the **kiddie tax**, applies to any child who has not reached age 19 by the close of the taxable year (age 24 if a full-time student), if that person reports 2015 unearned income of more than \$2,100.⁴⁷

The kiddie tax does not apply if the child's earned income exceeds half of his or her support, if both parents are deceased, or if the child is married and files a joint return.

Net Unearned Income

Unearned income includes such income as taxable interest, dividends, capital gains, rents, royalties, pension and annuity income, and income (other than earned income)

LO.7

Identify and work with kiddie tax situations.

⁴⁷§ 1(g)(2). This amount is indexed for inflation. It was \$2,000 for 2013 and 2014.

received as the beneficiary of a trust. The 2015 net unearned income of a dependent child is computed as follows.⁴⁸

Unearned income

Less: \$1,050

Less: The greater of

- **\$1,050 of the standard deduction or**
- **The amount of allowable itemized deductions directly connected with the production of the unearned income**

Equals: Net unearned income

If the amount of net unearned income is positive, the net unearned income is taxed at the parents' rate, even if the parents did not transfer the income to the child. The child's remaining taxable income is taxed at the child's rate. If net unearned income is zero (or negative), the child's tax is computed using only the child's rate.

Tax Determination

If a child is subject to the kiddie tax, there are two options for computing the tax on the income. A separate return may be filed for the child, or the parents may elect to report the child's income on their own return (discussed below). If a separate return is filed for the child, the tax on net unearned income is computed on Form 8615 as though the income had been included on the parents' return.

EXAMPLE

40

Olaf and Olga have a child, Hans (age 10). In 2015, Hans received \$3,200 of interest income and paid investment-related fees of \$200. Olaf and Olga had \$70,000 of taxable income, not including their child's investment income. The parents have no qualified dividends or capital gains. Olaf and Olga do not make the parental election.

1. Determine Hans's net unearned income

Gross income (unearned)	\$ 3,200
Less: \$1,050	(1,050)
Less: The greater of	
• \$1,050 or	
• Investment expense (\$200)	(1,050)
	<u>(1,050)</u>
Equals: Net unearned income (to be taxed at parents' rate)	<u>\$ 1,100</u>

2. Kiddie tax at parents' rates

Parents' taxable income	\$70,000
Plus: Hans's net unearned income	1,100
Equals: Revised taxable income	<u>\$71,100</u>
Tax on revised taxable income	\$ 9,743
Less: Tax on parents' taxable income	(9,578)
Tax on Hans's income at parents' rates	<u>\$ 165</u>

3. Tax at Hans's rate

Hans's AGI	\$ 3,200
Less: Standard deduction	(1,050)
Less: Personal exemption	<u>(-0-)</u>
Equals: Taxable income	\$ 2,150
Less: Net unearned income	<u>(1,100)</u>
Nonparental taxable income	<u>\$ 1,050</u>
Equals: Tax (\$1,050 × 10% rate)	<u>\$ 105</u>

4. Determine Hans's total tax liability

Tax at Hans's rate (step 3)	\$ 105
Kiddie tax (step 2)	<u>165</u>
Total tax	<u>\$ 270</u>

⁴⁸The \$1,050 amounts in the formula are subject to adjustment for inflation. For 2013 and 2014, the amounts were \$1,000.

Other Provisions

If parents have more than one child subject to the tax on net unearned income, the tax for the children is computed as shown in Example 40 and then allocated to the children based on their relative amounts of income. For children of divorced parents, the taxable income of the custodial parent is used to determine the allocable parental tax. This parent is the one who may elect to report the child's unearned income. For married individuals filing separate returns, the individual with the greater taxable income is the applicable parent.

3-6 GAINS AND LOSSES FROM PROPERTY TRANSACTIONS—IN GENERAL

Gains and losses from property transactions are discussed in detail in Chapters 13 and 14. Because of their importance in the tax system, however, they are introduced briefly at this point.

When property is sold or otherwise disposed of, gain or loss may result. Such gain or loss has an effect on the income tax position of the party making the sale or other disposition when the *realized* gain or loss is *recognized* for tax purposes. Without realized gain or loss, there generally can be no recognized gain or loss.

$$\begin{array}{rcccl} \text{Amount realized} & & \text{Adjusted basis of} & & \text{Realized gain} \\ \text{from the sale} & - & \text{the property} & = & \text{(or loss)} \end{array}$$

The amount realized is the selling price of the property less any costs of disposition (e.g., brokerage commissions) incurred by the seller. The adjusted basis of the property is determined as follows.

Cost (or other original basis) at date of acquisition

Add: Capital additions

Subtract: Depreciation (if appropriate) and other capital recoveries (see Chapter 8)

Equals: Adjusted basis at date of sale or other disposition

All realized gains are recognized (taxable) unless some specific part of the tax law provides otherwise (e.g., see Chapter 13 dealing with certain nontaxable exchanges). Realized losses may or may not be recognized (deductible) for tax purposes, depending on the circumstances involved. Generally, losses realized from the disposition of personal use property (property neither held for investment nor used in a trade or business) are not recognized.

Ted sells his sailboat (adjusted basis of \$4,000) for \$5,500. Ted also sells one of his personal automobiles (adjusted basis of \$8,000) for \$5,000. Ted's realized gain of \$1,500 from the sale of the sailboat is recognized. On the other hand, the \$3,000 realized loss on the sale of the automobile is not recognized and will not provide Ted with any deductible tax benefit.

EXAMPLE

41

Once it has been determined that the disposition of property results in a recognized gain or loss, the next step is to classify the gain or loss as capital or ordinary. Although ordinary gain is fully taxable and ordinary loss is fully deductible, the same may not hold true for capital gains and capital losses.

3-7 GAINS AND LOSSES FROM PROPERTY TRANSACTIONS—CAPITAL GAINS AND LOSSES

Capital gains and losses can generate unique tax consequences, as summarized in this section. For in-depth treatment of property transactions (including capital gains and losses), refer to Chapters 13 and 14.

LO.8

Describe the tax treatment of property transactions.

3-7a Capital Assets

Capital assets include any property held by the taxpayer *other than* inventory, accounts receivable, and depreciable property or real estate used in a business. Thus, the sale or exchange of assets in these categories usually results in ordinary income or loss treatment (see Chapter 14).

The principal capital assets held by an individual taxpayer include assets held for personal (rather than business) use, such as a personal residence or an automobile, and assets held for investment purposes (e.g., corporate securities and land). Capital assets also include **collectibles**, which include art, antiques, gems, metals, stamps, some coins and bullion, and alcoholic beverages that are held as investments.

When an individual sells a capital asset, a capital gain or loss results. Capital gains are taxable, and capital losses are netted against them, resulting in a net capital gain or loss. Special tax rates apply to most capital asset sales, but an individual cannot deduct a capital loss that results from the sale of a personal use asset.

EXAMPLE

42

Kelly owns a pizza parlor. During the current year, she sells two automobiles. The first automobile, which had been used as a pizza delivery car for three years, was sold at a loss of \$1,000. Because this automobile is an asset used in her business, Kelly claims an ordinary loss deduction of \$1,000, rather than a capital loss deduction. The second automobile, which Kelly had owned for two years, was her personal use car. It was sold for a gain of \$800. The personal use car is a capital asset. Therefore, Kelly recognizes a capital gain of \$800.

3-7b Taxation of Net Capital Gain

Net capital gains are classified and taxed as follows.

Classification	Maximum Rate
Short-term gains (held for one year or less)	Applicable rate for ordinary income (e.g., 39.6%)
Long-term gains (held for more than one year)—	
Certain depreciable realty used in a trade or business (known as unrecaptured § 1250 gain and discussed in Chapter 14)	25%
Collectibles	28%
All other long-term capital gains	20%, 15%, or 0%

The special tax rate applicable to long-term capital gains is called the alternative tax computation. It is used only if the taxpayer's regular tax rate *exceeds* the applicable alternative tax rate. Specifically, the 0 percent rate applies only if the taxpayer's regular tax rate is 15 percent or less.⁴⁹ The 20 percent rate applies if the taxpayer's regular tax rate is 39.6 percent. All other taxpayers use the 15 percent rate on long-term capital gains.

Tax on Net Capital Gain

EXAMPLE

43

Polly is in the 15% tax bracket and reports the following capital gains.

Robin Corporation stock (held for 6 months)	\$1,000
Crow Corporation stock (held for 13 months)	1,000

Polly's tax on these transactions is \$150 ($\$1,000 \times 15\%$) as to Robin and \$0 ($\$1,000 \times 0\%$) as to Crow.

⁴⁹§ 1(h)(1).

Tax on Net Capital Gain

Assume the same facts as in Example 43, except that Polly's regular tax bracket for the year is 33% (not 15%). Polly's tax on these transactions becomes \$330 ($\$1,000 \times 33\%$) as to Robin and \$150 ($\$1,000 \times 15\%$) as to Crow.

EXAMPLE

44

3-7c Determination of Net Capital Gain

To arrive at a *net* capital gain, capital losses are taken into account. The capital losses are aggregated by holding period (short-term and long-term) and applied against the gains in that category. If excess losses result, they are shifted to the category carrying the *highest* tax rate. A *net capital gain* occurs if the net long-term capital gain (NLTCG) exceeds the net short-term capital loss (NSTCL).

Colin is in the 35% tax bracket and reports the following capital transactions.

Penguin Corporation stock (held for 8 months)	\$ 1,000
Owl Corporation stock (held for 10 months)	(3,000)
Stamp collection (held for 5 years)	2,000
Land (held as an investment for 3 years)	4,000

The Penguin short-term capital gain (STCG) of \$1,000 is offset by the Owl short-term capital loss (STCL) of \$3,000. The remaining STCL of \$2,000 then is applied against the collectible gain of \$2,000, as that is the capital gain that is subject to the highest tax rate. The end result is a net long-term capital gain of \$4,000 from the land sale, taxed at a 15% rate.

EXAMPLE

45

3-7d Treatment of Net Capital Loss

For individual taxpayers, net capital loss can be used to offset ordinary income of up to \$3,000 (\$1,500 for married persons filing separate returns). If a taxpayer reports both short- and long-term capital losses, the short-term category is used first to arrive at the \$3,000. Any remaining net capital loss is carried forward indefinitely until exhausted. When carried forward, the excess capital loss retains its classification as short or long term.

Tina reports a short-term capital loss of \$2,000, a long-term capital loss of \$2,500, and no capital gains. She can deduct \$3,000 ($\$2,000$ short-term + $\$1,000$ long-term) of this amount as an ordinary loss. The remaining \$1,500 is carried forward to future tax years as a long-term capital loss.

EXAMPLE

46

The Big Picture

Return to the facts of *The Big Picture* on p. 3-1. Polly's sale of her wedding rings resulted in a realized capital loss of \$7,000 [$\$8,000$ (selling price) – $\$15,000$ (cost basis)]. However, because they were personal use property, Polly cannot deduct any part of the loss.

EXAMPLE

47

3-8 TAX PLANNING

3-8a Maximizing the Use of the Standard Deduction

In most cases, the choice between using the standard deduction and itemizing deductions *from* AGI is a simple matter—pick whichever yields the larger tax benefit. Families in the initial stages of home ownership, for example, will invariably make the itemization choice due to the substantial mortgage interest and property tax payments involved. Older

LO.9

Identify tax planning opportunities associated with the individual tax formula.

taxpayers, however, may have paid for their homes or are enjoying senior citizen property tax exemptions. For them, the more attractive choice is the standard deduction, plus the additional amount based on their age.

In some cases, the difference between using the standard deduction and itemizing may not be a significant amount. Here, taxes might be saved by alternating between the two options. The taxpayer does this by using the cash method to concentrate multiple years' deductions in a single year (e.g., paying off a five-year church pledge in one year). Then the standard deduction is used in alternate years.

3-8b Dependency Exemptions

The Joint Return Test

A married person can be claimed as a dependent only if that individual does not file a joint return with his or her spouse. If a joint return has been filed, the damage may be undone if separate returns are substituted on a timely basis (on or before the due date of the return). The latest-filed timely return prevails.⁵⁰

Keep in mind that the filing of a joint return is not fatal to the dependency exemption if the parties are filing solely to recover all income tax withholdings, they are not required to file a return, and no tax liability would exist on separate returns.

Support Considerations

The support of a qualifying child becomes relevant only if the child is self-supporting. In cases where the child has an independent source of funds, planning could help prevent an undesirable result. When a qualifying relative is involved, meeting the support test is essential, as the dependency exemption is not otherwise available.

EXAMPLE

48

Emily maintains a household that she shares with her son and mother. The son, Barry, is 23 years of age and a full-time student in law school. The mother, Gladys, is 68 years old, and she is active in charitable causes. Barry works part-time for a local law firm, while Gladys earns income from investments. In resolving the support issue (or self-support in the case of Barry), one must compare Emily's contribution with that made by Barry and Gladys.

In this connection, what Barry and Gladys do with their funds becomes crucial. The funds that are used for nonsupport purposes (e.g., purchase of investments) or not used at all (e.g., deposited in a bank) should not be considered. Limiting how much Barry and Gladys contribute to their own support enhances Imogene's chances of claiming them as dependents. Records should be maintained showing the amount of support and its source.

Example 48 does not mention the possible application of the gross income test. Presuming that Barry is a qualifying child, the amount he earns does not matter, as the gross income test does not apply. Gladys, however, comes under the qualifying relative category, where the gross income test applies. Therefore, for her to be claimed as a dependent, her income that is taxable will have to be less than \$4,000.

Community Property Ramifications

In certain cases, state law can affect the availability of a dependency exemption.

Dependency Exemptions in a Community Property State

EXAMPLE

49

Mitch provides more than half of the support of his son, Ross, and daughter-in-law, Connie, who live with him. Ross, age 22, is a full-time student, while Connie earns \$5,000 from a part-time job. Ross and Connie do not file a joint return. All parties live in New York, a common law state. Mitch can claim Ross as a dependent, as he is a qualifying child. Connie is not a dependent because she does not meet the gross income test under the qualifying relative category.

⁵⁰Reg. § 1.6013-1(a)(1).

Dependency Exemptions in a Community Property State

Assume the same facts as in Example 49, except that all parties live in Arizona, a community property state. Now Connie also qualifies as a dependent. Because Connie's gross income is only \$2,500 (one-half of the community income), she satisfies the gross income test.

EXAMPLE

50

Relationship to the Deduction for Medical Expenses

Generally, medical expenses are deductible only if they are paid on behalf of the taxpayer, his or her spouse, and their dependents. Thus, effective tax planning is important in identifying dependents when using multiple support agreements.

Linda will be supported next year by her two sons (Vern and Vito) and her daughter (Maria). Each will furnish approximately one-third of the required support. If the parties decide that the dependency exemption should be claimed by the daughter under a multiple support agreement, any medical expenses incurred by Linda should be paid by Maria.

EXAMPLE

51

In planning a multiple support agreement, take into account which of the parties is most likely to exceed the AGI limitation on medical expense deductions (see Chapter 10). In Example 51, for instance, Maria might be a poor choice if she and her family do not expect to incur many medical and drug expenses of their own.

3-8c Taking Advantage of Tax Rate Differentials

It is natural for taxpayers to be concerned about the tax rates they are paying. How does a tax practitioner communicate information about rates to clients? There are several possibilities.

The marginal tax rate (refer to Examples 36 and 37) provides information that can help a taxpayer evaluate a particular course of action or structure a transaction in the most advantageous manner. For example, a taxpayer who is in the 15 percent bracket this year and expects to be in the 28 percent bracket next year should, if possible, defer payment of deductible expenses until next year, to maximize the tax benefit of the deduction.

A note of caution is in order with respect to shifting income and expenses between years. Congress has recognized the tax planning possibilities of such shifting and has enacted many provisions to limit a taxpayer's ability to do so. The kiddie tax is one example. More of these limitations on the shifting of income are discussed in Chapters 4, 5, and 16. Limitations that affect a taxpayer's ability to shift deductions are discussed in Chapters 6 through 11 and in Chapter 16.

A taxpayer's *effective rate* can be an informative measure of the effectiveness of tax planning. The effective rate is computed by dividing the taxpayer's tax liability by the total amount of income. A low effective rate can be considered an indication of effective tax planning.

One way of lowering the effective rate is to exclude income from the tax base. For example, a taxpayer might consider investing in tax-free municipal bonds rather than taxable corporate bonds. Although pre-tax income from corporate bonds is usually higher, after-tax income may be higher if the taxpayer invests in tax-free municipal bonds.

3-8d Unearned Income of Certain Children

Taxpayers can use several strategies to avoid or minimize the effect of the kiddie tax rules. Parents should consider giving a younger child assets that defer taxable income until the child is free of the kiddie tax. For example, U.S. government Series EE savings bonds can be used to defer income until the bonds are cashed in (see Chapter 4).

Growth stocks typically pay little in the way of dividends. However, the capital gain on an astute investment may more than offset the lack of dividends. The stock can be held and then sold only when the child's own tax rates apply.

Taxpayers in a position to do so can employ their children in their business and pay them a reasonable wage for the work they actually perform (e.g., light office help such as data entry). The child's earned income is sheltered by the standard deduction, and the parents' business is allowed a deduction for the wages. The kiddie tax rules have no effect on earned income, and the income can be sheltered further if it is contributed to a retirement plan.

REFOCUS ON THE BIG PICTURE

A DIVIDED HOUSEHOLD



Of major concern to Polly is her filing status. If she qualifies as an abandoned spouse, she is entitled to file as head of household. If not, she is considered to be a married person filing separately. Moreover, to be an abandoned spouse, Polly must be able to claim Paige as a dependent. To be a dependent, Paige must meet the requirements of a qualifying child *or* a qualifying relative.

For qualifying child purposes, Paige must meet either the age (i.e., under age 19) or the full-time student (under age 24) test. Because Paige currently is not a full-time student, is she under age 19? If so, she is a qualifying child. If Paige is not a qualifying child, is she a qualifying relative? Here, the answer depends on meeting the gross income test. How much did Paige earn from her part-time job? If her earnings are under \$4,000, she satisfies the gross income test. Thus, if Paige can be claimed as a dependent as either a qualifying child or a qualifying relative, Polly is an abandoned spouse entitled to head-of-household filing status. If not, she is a married person filing separately.

Maude can be claimed as Polly's dependent because Maude is a member of the household. It does not matter that Maude died in February; her dependency exemption amount is allowed in full. Because Maude is her dependent, Polly can claim the medical expenses she paid on Maude's behalf. The funeral expenses, however, are not deductible (see Example 19).

Does Maude qualify Polly for head-of-household filing status? Although Maude is Polly's dependent, Maude does not meet the relationship test (see Example 31).

The sale of the wedding rings results in a capital loss of \$2,800 (\$9,000 – \$11,800). Because the loss is for personal use property, it cannot be deducted for tax purposes.

What If?

Assume that Nick left for parts unknown in August (not March). Now Polly cannot qualify as an abandoned spouse. Her husband lived in the home during part of the last six months of the year. Consequently, Polly is treated as married and cannot qualify for head-of-household filing status. She is a married person filing separately. When Nick left does not affect the dependency issue regarding Paige, however.

Key Terms

Abandoned spouse, 3-21	Itemized deductions, 3-6	Standard deduction, 3-7
Child tax credit, 3-18	Kiddie tax, 3-27	Surviving spouse, 3-19
Collectibles, 3-30	Multiple support agreement, 3-14	Tax Table, 3-25
Dependency exemption, 3-11	Personal exemptions, 3-10	Unearned income, 3-27
E-file, 3-23	Qualifying child, 3-11	
Head of household, 3-20	Qualifying relative, 3-13	

Discussion Questions

- LO.1, 5, 8, 9** During the year, Addison is involved in the following transactions. What are the possible Federal income tax effects of these transactions? Issue ID

 - Lost money gambling on a trip to a casino.
 - Helped pay for her neighbor Howie's dental bills. Howie is a good friend who is unemployed.
 - Received from the IRS a tax refund due to Addison's overpayment of last year's Federal income taxes.
 - Paid a traffic ticket received while double parking to attend a business meeting.
 - Contributed to the mayor's reelection campaign. The mayor had promised Addison to rezone some of her land.
 - Borrowed money from a bank to make a down payment on an automobile.
 - Sold a houseboat and a camper on eBay. Both were personal use items, and the gain from one offset the loss from the other.
 - Her dependent Aunt Katherine died on June 3 of the year.
 - Paid for Katherine's funeral expenses.
 - Paid premiums on her dependent son's life insurance policy.
- LO.1** Which of the following items can be *inclusions* in gross income?

 - a. During the year, shares of stock that the taxpayer had purchased as an investment doubled in value.
 - b. Amount an off-duty motorcycle police officer received for escorting a funeral procession.
 - c. While his mother Shirley was in the hospital, the taxpayer sold Shirley's jewelry and gave the money to his girlfriend, Serena.
 - d. Child support payments received.
 - e. A damage deposit the taxpayer recovered when he vacated the apartment he had rented.
 - f. Interest received by the taxpayer on an investment in school bonds issued by IBM.
 - g. Amounts received by the taxpayer, a baseball "Hall of Famer," for autographing sports equipment (e.g., balls and gloves).
 - h. Tips received by Matt, a bartender, from patrons. (Matt is paid a regular salary by the cocktail lounge that employs him.)
 - i. Sherri sells her Super Bowl tickets for three times what she paid for them.
 - j. Jefferson receives a new BMW from his grandmother when he passes the CPA exam.

3. **LO.1** Which of the following items can be *exclusions* from gross income?
 - a. Alimony payments received.
 - b. Award received by the taxpayer for compensatory damages from her broken leg.
 - c. A new golf cart won in a church raffle.
 - d. Amount collected on a loan previously made to a college friend.
 - e. Insurance proceeds paid to the taxpayer on the death of her uncle—she was the designated beneficiary under the policy.
 - f. Interest income on City of Chicago bonds.
 - g. Jury duty fees.
 - h. Stolen funds that the taxpayer ostensibly had collected for a local food bank drive.
 - i. Reward paid by the IRS for information provided that led to the conviction of the taxpayer's former employer for tax evasion.
 - j. Rare coins worth \$8,000 found in an old trunk purchased by the taxpayer at a garage sale.

- Decision Making** 4. **LO.1, 8, 9** Late in the tax year, the Polks come to you for tax advice. They are considering selling some stock investments for a loss and making a contribution to a traditional IRA. In reviewing their situation, you note that they have large medical expenses and a casualty loss, with neither being covered by insurance. What advice would you give to the Polks?

- Issue ID** 5. **LO.2** In choosing between the standard deduction and itemizing deductions *from* AGI, what effect, if any, does each of the following variables have?
- a. The age of the taxpayer(s).
 - b. The health (i.e., physical condition) of the taxpayer(s).
 - c. Whether the taxpayer(s) rent or own their personal residence.
 - d. Taxpayer's filing status (e.g., single; married, filing jointly).
 - e. Whether married taxpayers decide to file separate returns.
 - f. The taxpayer's uninsured personal residence that recently was destroyed by fire.
 - g. The number of personal and dependency exemptions the taxpayer(s) can claim.
6. **LO.2, 3, 5** David is age 78, is a widower, and is being claimed as a dependent by his son. How does this situation affect the following?
- a. David's own individual filing requirement.
 - b. David's personal exemption.
 - c. The standard deduction allowed to David.
 - d. The availability of any additional standard deduction.

- Issue ID** 7. **LO.4** Patsy maintains a household that includes her eldest son (age 30) and one of Patsy's cousins (age 28). She can claim the cousin as a dependent but not her son. Explain.
8. **LO.4** Heather, age 12, lives in the same household with her mother, grandmother, and uncle.
- a. Who can claim Heather as a dependent on a Federal income tax return?
 - b. Which of Heather's relatives takes precedence in claiming the exemption?
9. **LO.4** Camden and Lily are divorced on March 3, 2014. For financial reasons, however, Lily continues to live in Camden's apartment and receives her support from him. Camden does not claim Lily as a dependent on his 2014 Federal income tax return, but he does so on his 2015 return. Explain.

10. **LO.4** Isabella, Emma, and Jacob share equally in the support of their parents. Jacob tells his sisters that they should split the dependency exemptions among themselves. Explain what Jacob means. **Issue ID**
11. **LO.4** Mark and Lisa were divorced in 2014. In 2015, Lisa has custody of their children, but Mark provides nearly all of their support. Who is entitled to claim the children as dependents?
12. **LO.4** Peter maintains a household in which his 18-year-old son Kip and Kip's wife Kerry live. Although Peter provides most of their support, he does not claim them as dependents because Kip and Kerry file a joint return. Is Peter correct? Explain. **Issue ID**
13. **LO.4** Mario, who is single, is a U.S. citizen and resident. He provides almost all of the support of his parents and two aunts, who are citizens and residents of Guatemala. Mario's parents and aunts are seriously considering moving to and becoming residents of Mexico. Would such a move have any income tax effect on Mario? Why or why not? **Issue ID**
14. **LO.4, 5** Comment on the availability of head-of-household filing status in each of the following independent situations.
- Al lives alone but maintains the household of his parents. In July, the parents use their savings to purchase a Lexus automobile for \$62,000.
 - Bree maintains a home in which she and her father live. The father then enters a nursing facility for treatment for a mental illness.
 - Chloe a single parent, maintains a home in which she and Dean, Chloe's unmarried son, live. Dean, age 18, earns \$5,000 from a part-time job.
 - Assume the same facts as in (c), except that Dean is age 19, not 18.
 - Chee is married and maintains a household in which he and his dependent stepson live.
 - Evie lives alone but maintains the household where her dependent daughter Zoe lives.
 - Frank maintains a household that includes Georgia, an unrelated friend who qualifies as his dependent.
15. **LO.5** Several years ago, after a particularly fierce argument, Fran's husband moved out and has not been heard from or seen since. Because Fran cannot locate her husband, she uses a "married, filing separate" income tax return. Comment on Fran's Federal filing status. **Issue ID**
16. **LO.6** Jayden calculates his Federal income tax by using both the Tax Tables and the Tax Rate Schedules. Because the Tax Rate Schedules yield a slightly lower tax liability, he plans to pay this amount.
- Why is there a difference?
 - Is Jayden's approach permissible?
17. **LO.7** In connection with the application of the kiddie tax, comment on the following.
- The child generates only earned income.
 - The child reports a modest amount of unearned income.
 - The child is age 20, not a student, and not disabled.
 - The child is married.
 - A parental election is made.
 - A parental election is made, and the married parents file separate returns.

18. **LO.8** During the year, Hernando recorded the following transactions. How should Hernando treat these transactions for income tax purposes?
- Gain on the sale of stock held as an investment for 10 months.
 - Gain on the sale of land held as an investment for 4 years.
 - Gain on the sale of a houseboat owned for 2 years and used for family vacations.
 - Loss on the sale of a reconditioned motorcycle owned for 3 years and used for recreational purposes.

- Issue ID** 19. **LO.4, 5, 9** Marcie is divorced, and her married son, Jamie (age 25), and his wife, Audrey (age 18), live with her. During the year, Jamie earned \$4,800 from a part-time job and filed a joint return with Audrey to recover his withholdings. Audrey reports zero gross income.

Marcie can prove that she provided more than 50% of Jamie and Audrey's support. Marcie does not plan to claim Jamie as a dependent because Jamie earns too much gross income. She does not plan to claim Audrey as a dependent because Audrey signed the joint return with Jamie. In fact, Marcie plans to use single filing status, as none of the persons living in her household qualifies as her dependent.

Comment on Marcie's intentions based on the following assumptions.

- a. All parties live in Indiana (a common law state).
- b. All parties live in California (a community property state).

Computational Exercises

- Issue ID** 20. **LO.2** Sam and Abby are dependents of their parents, and each earns gross income of \$2,100 for the year. Sam's standard deduction for the year is \$1,050, while Abby's is \$2,450. As their income is the same, what causes the difference in the amount of the standard deduction?
21. **LO.2** Compute the 2015 standard deduction for the following taxpayers.
- a. Margie is 15 and claimed as a dependent by her parents. She reports \$800 in dividends income and \$1,400 in wages from a part-time job.
 - b. Ruby and Woody are married and file a joint tax return. Ruby is age 66 and Woody is 69. Their taxable retirement income is \$10,000.
 - c. Shonda is age 68 and single. She is claimed by her daughter as a dependent. Her earned income is \$500, and her interest income is \$125.
 - d. Frazier, age 55, is married but is filing a separate return. His wife Emma itemizes her deductions.
22. **LO.4** In 2015, Dominique and Felix are married and file a joint Federal income tax return. Their AGI is \$312,650, and they claim three dependency exemptions. Compute the taxpayers' total deduction for exemptions for the year.
- Issue ID** 23. **LO.5, 9** Paul and Sonja, who are married, reported 2015 itemized deductions of \$8,200 and \$400, respectively. Paul suggests that they file their Federal income tax returns separately—he will itemize his deductions *from* AGI, and she will claim the standard deduction.
- a. Evaluate Paul's suggestion.
 - b. What should they do?
24. **LO.6** Compute the 2015 Federal income tax liability and the marginal and effective tax rates in each of the following independent cases. Use the 2015 tax rate schedules in Appendix A for this purpose.
- a. Chandler is single and reports taxable income of \$91,000.
 - b. Lazar, a head of household, records taxable income of \$56,000.

25. **LO.7** Simon, age 12, generates \$800 interest income and \$4,000 dividend income for 2015. He incurs no investment expenses. His parents report \$80,200 taxable income and file a joint tax return. Determine the following.
- Simon's net unearned income.
 - Simon's allocable parental tax.
 - Simon's total Federal income tax liability.
26. **LO.8** Rebecca sells her personal scooter for \$550. She purchased the scooter for \$700 three years ago. In addition, Rebecca sells a painting for \$1,200 that she acquired five years ago for \$900. What are the tax implications attributable to these sales?
27. **LO.8** Determine the net effect on Tamara's adjusted gross income with regard to these capital asset transactions that occurred this year.
- Sold ABCCo stock, acquired 2 years ago, for a \$1,500 loss.
 - Sold collectible coins, held for 17 months, for a \$2,000 gain.
 - Sold XYZCo shares, acquired 6 months ago, for a \$4,100 loss.
 - Sold LMNCo stock, acquired 3 years ago, for a \$500 gain.

Problems

28. **LO.1** Compute 2015 taxable income in each of the following independent situations.
- Drew and Meg, ages 40 and 41 respectively, are married and file a joint return. In addition to four dependent children, they have AGI of \$65,000 and itemized deductions of \$15,000.
 - Sybil, age 40, is single and supports her dependent parents, who live with her. Sybil also supports her grandfather, who lives in a nursing home. She has AGI of \$80,000 and itemized deductions of \$8,000.
 - Scott, age 49, is a surviving spouse. His household includes two unmarried stepsons who qualify as his dependents. He has AGI of \$75,000 and itemized deductions of \$10,100.
 - Amelia, age 33, is an abandoned spouse and maintains a household for her three dependent children. She has AGI of \$58,000 and itemized deductions of \$9,500.
 - Dale, age 42, is divorced but maintains the home in which he and his daughter, Jill, live. Jill is single and qualifies as Dale's dependent. Dale has AGI of \$64,000 and itemized deductions of \$9,900.

Note: Problems 29 and 30 can be solved by referring to Concept Summary 3.1, Exhibits 3.1 through 3.5, and the discussion under Deductions for Adjusted Gross Income in this chapter.

29. **LO.1, 8** Compute Emily's 2015 taxable income on the basis of the following information. Her filing status is single.

Salary	\$85,000
Interest income from bonds issued by Xerox	1,100
Alimony payments received	6,000
Contribution to traditional IRA	5,500
Gift from parents	25,000
Capital gain from stock investment, held for 7 months	2,000
Amount lost in football office betting pool	500
Number of potential dependents (two cousins, who live in Canada)	?
Age	40

30. **LO.1** Compute Aiden's 2015 taxable income on the basis of the following information. Aiden is married but has not seen or heard from his wife for over three years.

Salary	\$ 80,000
Interest on bonds issued by City of Boston	3,000
Interest on CD issued by Wells Fargo Bank	2,000
Cash dividend received on Chevron common stock	2,200
Life insurance proceeds paid due to the death of Aunt Margie (Aiden was the designated beneficiary of the policy)	200,000
Inheritance received on death of Aunt Margie	100,000
Jackson (a cousin) repaid a loan Aiden made to him in 2012 (no interest was provided for)	5,000
Itemized deductions (state income tax, property taxes on residence, interest on home mortgage, charitable contributions)	9,700
Number of dependents (children, ages 17 and 18; mother-in-law, age 60)	3
Age	43

31. **LO.2** Determine the amount of the 2015 standard deduction allowed in the following independent situations. In each case, assume that the taxpayer is claimed as another person's dependent.
- Curtis, age 18, has income as follows: \$700 interest from a certificate of deposit and \$6,100 from repairing cars.
 - Mattie, age 18, has income as follows: \$600 cash dividends from a stock investment and \$4,700 from handling a paper route.
 - Mel, age 16, has income as follows: \$675 interest on a bank savings account and \$800 for painting a neighbor's fence.
 - Lucy, age 15, has income as follows: \$400 cash dividends from a stock investment and \$500 from grooming pets.
 - Sarah, age 67 and a widow, has income as follows: \$500 from a bank savings account and \$3,200 from babysitting.
32. **LO.4** Using the legend provided below, classify each statement as to the taxpayer for dependency exemption purposes.

Legend

QC	=	Could be a qualifying child
QR	=	Could be a qualifying relative
B	=	Could satisfy the definition of both a qualifying child and a qualifying relative
N	=	Could not satisfy the definition of <i>either</i> a qualifying child or a qualifying relative

- Taxpayer's son has gross income of \$7,000.
 - Taxpayer's niece has gross income of \$3,000.
 - Taxpayer's uncle lives with him.
 - Taxpayer's daughter is age 25 and disabled.
 - Taxpayer's daughter is age 18 but does not live with him. Her gross income is \$8,000.
 - Taxpayer's cousin does not live with her.
 - Taxpayer's brother does not live with her.
 - Taxpayer's sister lives with him. She is age 17 and has dropped out of school.
 - Taxpayer's older nephew is age 23 and a full-time student.
 - Taxpayer's grandson lives with her. His gross income is \$7,000.
33. **LO.3, 4** Determine the number of personal and dependency exemptions in each of the following independent situations.
- Leo and Amanda (ages 48 and 46, respectively) are husband and wife and furnish more than 50% of the support of their two children, Elton (age 18) and

- Trista (age 24). During the year, Elton earns \$4,500 providing transportation for elderly persons with disabilities, and Trista receives a \$5,000 scholarship for tuition at the law school she attends.
- b. Audrey (age 45) is divorced this year. She maintains a household in which she, her ex-husband, Clint, and his mother, Olive, live. Audrey furnishes more than 50% of the household's support. Olive is age 91 and blind.
 - c. Crystal, age 45, furnishes more than 50% of the support of her married son, Andy (age 18), and his wife, Paige (age 19), who live with her. During the year, Andy earned \$8,000 from a part-time job. All parties live in Iowa (a common law state).
 - d. Assume the same facts as in (c), except that all parties live in Washington (a community property state).
34. **LO.3, 4** Determine the number of personal and dependency exemptions in each of the following independent situations.
- a. Reginald, a U.S. citizen and resident, contributes 100% of the support of his parents, who are citizens of Canada and live there.
 - b. Pablo, a U.S. citizen and resident, contributes 100% of the support of his parents, who are citizens of Panama. Pablo's father is a resident of Panama, and his mother is a legal resident of the United States.
 - c. Gretchen, a U.S. citizen and resident, contributes 100% of the support of her parents, who are U.S. citizens but are residents of Germany.
35. **LO.3, 4** Determine how many personal and dependency exemptions are available in each of the following independent situations. Specify whether any such exemptions would come under the qualifying child or the qualifying relative category.
- a. Andy maintains a household that includes a cousin (age 12), a niece (age 18), and a son (age 26). All are full-time students. Andy furnishes all of their support.
 - b. Jackie provides all of the support of a family friend's son (age 20) who lives with her. She also furnishes most of the support of her stepmother, who does not live with her.
 - c. Raul, a U.S. citizen, lives in Costa Rica. Raul's household includes his friend Helena, who is age 19 and a citizen of Costa Rica. Raul provides all of Helena's support.
 - d. Karen maintains a household that includes her ex-husband, her mother-in-law, and her brother-in-law (age 23 and not a full-time student). Karen provides more than half of all of their support. Karen is single and was divorced last year.
36. **LO.4** Jenny, age 14, lives in a household with her father, uncle, and grandmother. The household is maintained by the uncle. The parties, all of whom file their own Federal income tax returns, report AGI as follows: father (\$30,000), uncle (\$50,000), and grandmother (\$40,000).
- a. Who is eligible to claim Jenny as a dependent on a Federal income tax return?
 - b. Which of Jenny's relatives takes precedence in claiming the exemption? Explain.
37. **LO.3, 4** Sam and Elizabeth Jefferson file a joint return. They have three children, all of whom qualify as dependents. If the Jeffersons report 2015 AGI of \$332,000, what is their allowable deduction for personal and dependency exemptions?

38. **LO.4, 9** Wesley and Myrtle (ages 90 and 88, respectively) live in an assisted care facility and for years 2015 and 2016 received their support from the following sources.

	Percentage of Support
Social Security benefits	16%
Son	20
Niece	29
Cousin	12
Brother	11
Family friend (not related)	12

- a. Who is eligible to claim the Federal income tax dependency exemptions under a multiple support agreement?
- b. Must Wesley and Myrtle be claimed as dependents by the same person(s) for both tax years? Explain.
- c. Who, if anyone, can claim an itemized deduction for paying the medical expenses of Wesley and Myrtle?
39. **LO.5** In each of the following independent situations, determine Winston's filing status. Winston is not married.
- a. Winston lives alone, but he maintains a household in which his parents live. The mother qualifies as Winston's dependent, but the father does not.
- b. Winston lives alone, but he maintains a household in which his married daughter, Karin, lives. Both Karin and her husband (Winston's son-in-law) qualify as Winston's dependents.
- c. Winston maintains a household in which he and a family friend, Ward, live. Ward qualifies as Winston's dependent.
- d. Winston maintains a household in which he and his mother-in-law live. Winston's wife died last year.
- e. Same as (d), except that Winston's wife disappeared (i.e., she did not die) two years ago.
40. **LO.4, 5** Christopher died in 2013 and is survived by his wife, Chloe, and their 18-year-old son, Dylan. Chloe is the executor of Christopher's estate and maintains the household in which she and Dylan live. All of their support is furnished by Chloe. Dylan saves his earnings. Dylan reports the following information.

Year	Earnings	Student?
2013	\$5,000	Yes
2014	7,000	No
2015	6,000	Yes

What is Chloe's Federal income tax filing status for:

- a. 2013?
- b. 2014?
- c. 2015?
41. **LO.3, 4, 5** Nadia died in 2014 and is survived by her husband, Jerold (age 44); her married son, Travis (age 22); and her daughter-in-law, Macy (age 18). Jerold is the executor of his wife's estate. He maintains the household where he, Travis, and Macy live, and Jerold furnished all of their support. During 2014 and 2015, Travis is a full-time student, while Macy earns \$7,000 each year from a part-time job. Travis and Macy do not file jointly during either year.
- What is Jerold's Federal income tax filing status for 2014 and 2015 if all parties reside in:
- a. Idaho (a community property state)?
- b. Kansas (a common law state)?

42. **LO.4, 9** Walter and Nancy provide 60% of the support of their daughter Irene (age 18) and son-in-law John (age 22). John is a full-time student at a local university, while Irene holds various part-time jobs from which she earns \$11,000. Walter and Nancy engage you to prepare their tax return for 2015. During a meeting with them in late March 2016, you learn that John and Irene have filed a joint return. What tax advice would you give based on the following assumptions?
- All parties live in Louisiana (a community property state).
 - All parties live in New Jersey (a common law state).
43. **LO.1, 2, 3, 4, 5, 6** Using the Tax Rate Schedules, compute the 2015 tax liability for Charlotte. Charlotte (age 40) is a surviving spouse and provides all of the support of her four minor children, who live with her. Charlotte also maintains the household in which her parents live, and she furnished 60% of their support. Besides interest on City of Miami bonds in the amount of \$5,500, Charlotte's father received \$2,400 from a part-time job. Charlotte earns an \$80,000 salary, a short-term capital loss of \$2,000, and a cash prize of \$4,000 at a church raffle. Charlotte reports itemized deductions of \$10,500.
44. **LO.1, 2, 3, 4, 5, 6, 8** Use the Tax Rate Schedules to compute Morgan's 2015 Federal income tax liability. Morgan (age 45) is single and provides more than 50% of the support of Rosalyn (a family friend, age 36), Flo (a niece, age 18), and Jerold (a nephew, age 18). Both Rosalyn and Flo live with Morgan, but Jerold (a citizen of France) lives in Canada. Morgan earns a \$95,000 salary, contributes \$5,000 to a traditional IRA, and receives sales proceeds of \$15,000 for an RV that cost \$60,000 and was used only for vacations. She has \$8,200 in itemized deductions.
45. **LO.5** Which of the following individuals are required to file a 2015 Federal income tax return? Should any of these individuals file a return even if filing is not required? Why or why not?
- Patricia, age 19, is a self-employed single individual with gross income of \$5,200 from an unincorporated business. Business expenses amounted to \$4,900.
 - Mike is single and is 67 years old. His gross income from wages was \$10,800.
 - Ronald is a dependent child under age 19 who received \$6,500 in wages from a part-time job.
 - Sam is married and files a joint return with his spouse, Lana. Both Sam and Lana are 67 years old. Their combined gross income was \$24,250.
 - Quinn, age 20, is a full-time college student who is claimed as a dependent by his parents. Quinn reports taxable interest and dividends of \$2,500.
46. **LO.5, 6, 9** Roy and Brandi are engaged and plan to get married. Roy is a full-time student and earns \$9,000 from a part-time job. With this income, student loans, savings, and nontaxable scholarships, he is self-supporting. For the year, Brandi is employed and reports \$61,000 in wages. How much Federal income tax, if any, can Brandi save if she and Roy marry in 2015 and file a joint return?
47. **LO.1, 3, 6, 7** Taylor, age 18, is claimed as a dependent by her parents. For 2015, she records the following income: \$4,000 wages from a summer job, \$1,800 interest from a money market account, and \$2,000 interest from City of Boston bonds.
- What is Taylor's taxable income?
 - What is Taylor's Federal income tax? Her parents file a joint return and report taxable income of \$130,000 (no dividends or capital gains).
48. **LO.1, 3, 6, 7** Paige, age 17, is claimed as a dependent on her parents' 2015 Federal income tax return, on which they report taxable income of \$120,000 (no qualified dividends or capital gains). Paige earned \$3,900 pet sitting and \$4,100 in interest on a savings account. What are Paige's taxable income and tax liability?

Issue ID
Decision Making

Decision Making

49. **LO.1, 3, 6, 7** Terri, age 16, is claimed as a dependent on her parents' 2015 Federal income tax return. During the year, Terri earned \$5,000 in interest income and \$3,000 from part-time jobs.
- What is Terri's taxable income?
 - How much of Terri's income is taxed at her own tax rate? At her parents' rate?
50. **LO.6, 8** During the year, Inez recorded the following transactions involving capital assets.

Gain on the sale of unimproved land (held as an investment for 3 years)	\$ 3,000
Loss on the sale of a camper (purchased 2 years ago and used for family vacations)	(5,000)
Gain on the sale of ADM stock (purchased 9 months ago as an investment)	4,000
Gain on the sale of a fishing boat and trailer (acquired 18 months ago at an auction and used for recreational purposes)	1,000

- If Inez is in the 35% Federal income tax bracket, how much tax results?
 - If Inez is in the 15% bracket?
51. **LO.6, 8** During the year, Chester incurred the following transactions involving capital assets.

Gain on the sale of an arrowhead collection (acquired as an investment at different times but all pieces have been held for more than one year)	\$ 6,000
Loss on the sale of IBM stock (purchased 11 months ago as an investment)	(4,000)
Gain on the sale of a city lot (acquired 5 years ago as an investment)	2,000

- If Chester is in the 33% Federal income tax bracket, how much tax results?
- If Chester is in the 15% bracket?

Decision Making Communications

52. **LO.9** Each year, Tom and Cindy Bates report itemized deductions of \$10,000, including a \$4,000 pledge payment to their church. Upon the advice of a friend, they do the following: in early January 2015, they pay their 2014 pledge; during 2015, they pay the 2015 pledge; and in late December 2015, they prepay their 2016 pledge.
- Explain what the Bateses are trying to accomplish.
 - What will be the tax saving if their marginal tax bracket is 25% for all three years? (Assume that the standard deduction amounts for 2015 and 2016 are the same.)
 - Write a letter to Tom and Cindy Bates (8212 Bridle Court, Reston, VA 20194) summarizing your analysis.

Cumulative Problems

Tax Return Problem



53. Lance H. and Wanda B. Dean are married and live at 431 Yucca Drive, Santa Fe, NM 87501. Lance works for the convention bureau of the local Chamber of Commerce, while Wanda is employed part-time as a paralegal for a law firm. During 2014, the Deans recorded the following receipts.

Salaries (\$60,000 for Lance, \$41,000 for Wanda)	\$101,000
Interest income	
City of Albuquerque general purpose bonds	\$1,000
Ford Motor Company bonds	1,100
Ally Bank certificate of deposit	<u>400</u>
Child support payments from John Allen	7,200
Annual gifts from parents	26,000
Settlement from Roadrunner Touring Company	90,000
Lottery winnings	600
Federal income tax refund (for tax year 2013)	400

Wanda previously was married to John Allen. When they divorced several years ago, Wanda was awarded custody of their two children, Penny and Kyle. (Note: Wanda has never issued a Form 8332 waiver.) Under the divorce decree, John was obligated to pay alimony and child support—the alimony payments were to terminate if Wanda remarried.

In July, while going to lunch in downtown Santa Fe, Wanda was injured by a tour bus. As the driver was clearly at fault, the owner of the bus, Roadrunner Touring Company, paid her medical expenses (including a one-week stay in a hospital). To avoid a lawsuit, Roadrunner also transferred to her \$90,000 cash in settlement of the personal injuries she sustained.

The Deans made the following 2014 expenditures.

Medical expenses (not covered by insurance)		\$7,200
Taxes		
Property taxes on personal residence	\$3,600	
State of New Mexico income tax (includes amount withheld from wages during 2014)	<u>4,200</u>	7,800
Interest on home mortgage		6,000
Paid church pledge		3,600
Life insurance premiums (policy on Lance's life)		1,200
Contribution to traditional IRA (on Wanda's behalf)		5,000
Traffic fines		300
Contribution to the reelection campaign fund of the mayor of Santa Fe		500
Funeral expenses for Wayne Boyle		6,300

The life insurance policy was taken out by Lance several years ago and designates Wanda as the beneficiary. As a part-time employee, Wanda is excluded from coverage under her employer's pension plan. Consequently, she provides for her own retirement with a traditional IRA obtained at a local trust company. Because the mayor is a member of the local Chamber of Commerce, Lance felt compelled to make the political contribution.

The Dean household includes the following, for whom they provide more than half of the support.

	Social Security Number	Birth Date
Lance Dean (age 42)	123-45-6786	12/16/1972
Wanda Dean (age 40)	123-45-6787	08/08/1974
Penny Allen (age 19)	123-45-6788	10/09/1995
Kyle Allen (age 17)	123-45-6789	05/03/1997
Wayne Dean (age 75)	123-45-6785	06/15/1938

Penny graduated from high school on May 9, 2014, and is undecided about college. This year, she earned \$8,500 (placed in a savings account) playing a harp in the lobby of a local hotel. Wayne is Lance's widower father who died on January 20, 2014. For the past few years, Wayne qualified as a dependent of the Deans.

Federal income tax withheld is \$5,200 (Lance) and \$3,100 (Wanda). The proper amount of Social Security and Medicare tax was withheld. All members of the family were covered by health insurance for all of 2014.

Determine the 2014 Federal income tax for the Deans on a joint return by completing the appropriate forms. They do not want to contribute to the Presidential Election Campaign Fund. If an overpayment results, it is to be refunded to them. Suggested software: H&R BLOCK Tax Software.

Tax Return Problem
Decision Making
Communications



54. Logan B. Taylor is a widower whose wife, Sara, died on June 6, 2012. He lives at 4680 Dogwood Lane, Springfield, MO 65801. He is employed as a paralegal by a local law firm. During 2014, he reported the following receipts.

Salary		\$ 80,000
Interest income		
Money market account at Omni Bank	\$ 300	
Savings account at Bosne State Bank	1,100	
City of Springfield general purpose bonds	<u>3,000</u>	4,400
Inheritance from Daniel		60,000
Life insurance proceeds		200,000
Amount from sale of St. Louis lot		80,000
Proceeds from estate sale		9,000
Federal income tax refund (for 2013 tax overpayment)		700

Logan inherited securities worth \$60,000 from his uncle, Daniel, who died in 2014. Logan also was the designated beneficiary of an insurance policy on Daniel's life with a maturity value of \$200,000. The lot in St. Louis was purchased on May 2, 2009, for \$85,000 and held as an investment. As the neighborhood has deteriorated, Logan decided to cut his losses and sold the lot on January 5, 2014, for \$80,000. The estate sale consisted largely of items belonging to Sara and Daniel (e.g., camper, boat, furniture, and fishing and hunting equipment). Logan estimates that the property sold originally cost at least twice the \$9,000 he received and has declined or stayed the same in value since Sara and Daniel died.

Logan's other 2014 expenditures include the following.

Medical expenses (including \$10,500 for dental services)		\$11,500
Taxes		
State of Missouri income tax (includes withholdings)	\$3,200	
Property taxes on personal residence	<u>4,500</u>	7,700
Interest on home mortgage		4,600
Contribution to church (paid pledges for 2014 and 2015)		4,800

Logan and his dependents were covered by his employer's health insurance policy for all of 2014. However, he is subject to a deductible, and dental care is not included. The \$10,500 dental charge was for Helen's implants. Helen is Logan's widowed mother, who lives with him (see below). Logan normally pledges \$2,400 (\$200 per month) each year to his church. On December 5, 2014, upon the advice of his pastor, he prepaid his pledge for 2015.

Logan's household, all of whom he supports, includes the following.

	Social Security Number	Birth Date
Logan Taylor (age 48)	123-45-6787	08/30/1966
Helen Taylor (age 70)	123-45-6780	01/13/1944
Asher Taylor (age 23)	123-45-6783	07/18/1991
Mia Taylor (age 22)	123-45-6784	02/16/1992

Helen, Logan's mother, receives a modest Social Security benefit. Asher, a son, is a full-time student in dental school and earns \$4,500 as a part-time dental assistant. Mia, a daughter, does not work and is engaged to be married.

Part 1—Tax Computation

Using the appropriate forms and schedules, compute Logan's 2014 Federal income tax. Federal income tax of \$5,500 was withheld from his wages. If Logan has any overpayment on his income tax, he wants the refund sent to him. Assume that the proper amounts of Social Security and Medicare taxes were withheld. Logan does not want to contribute to the Presidential Election Campaign Fund. Suggested software: H&R BLOCK Tax Software.

Part 2—Follow-Up Advice

In early 2015, the following events take place.

- Helen decides that she wants to live with one of her daughters and moves to Arizona.
- Asher graduates from dental school and joins an existing practice in St. Louis.
- Mia marries, and she and her husband move in with his parents.
- Using the insurance proceeds he received on Daniel's death, Logan pays off the mortgage on his personal residence.

Logan believes that these events may have an effect on his tax position for 2015. Therefore, he requests your advice.

Write a letter to Logan explaining in general terms how the 2015 events will affect his Federal income tax liability. Assume that Logan's salary and other factors not mentioned (e.g., property and state income taxes) will remain the same. Use the Tax Rate Schedules in projecting Logan's tax for 2015.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.



Research Problem 1. John and Janet Baker are husband and wife and maintain a household in which the following persons live: Calvin and Florence Carter and Darin, Andrea, and Morgan Baker.

Decision Making

- Calvin and Florence are Janet's parents, who are retired. During the year, they receive \$19,000 in nontaxable funds (e.g., disability income, interest on municipal bonds, and Social Security benefits). Of this amount, \$8,000 is spent equally between them for clothing, transportation, and recreation (e.g., gym fees and travel), and the balance of \$11,000 is invested in tax-exempt securities. Janet paid \$1,000 for her mother's dental work, and she paid the \$1,200 premium on an insurance policy that her father owned on his own life. Calvin also incurred medical expenses, but he insisted on paying for them with his own funds.
- Darin is the Bakers' 18-year-old son who is not a student but operates a pool-cleaning service on a part-time basis. During the year, he earns \$14,000 from the business, which he places in a savings account for later college expenses.
- Andrea is the Bakers' 19-year-old daughter who does not work or go to school. Tired of the inconvenience of borrowing and sharing the family car, she purchased a Camaro for \$21,000 during the year. Andrea used funds from a savings account that she had established several years ago with an inheritance from her paternal grandfather.
- Morgan is the Bakers' 23-year-old daughter. To attend graduate school at a local university, she applied for and obtained a student loan of \$20,000. She uses the full amount of the loan to pay her college tuition.

The Bakers' fair rental value of their residence, including utilities, is \$14,000, while their total food expense for the household is \$10,500.

- How many dependency exemptions are the Bakers entitled to claim for the year? Explain your answer.
- From an income tax planning standpoint, how might the Bakers have improved the tax result?

Partial list of research aids:

Reg. §§ 1.152-1(a) and -1(c).

Decision Making Communications

Research Problem 2. Kathy and Brett Ouray married in 1996. They began to experience marital difficulties in 2013 and, in the current year, although they are not legally separated, consider themselves completely estranged. They have contemplated getting a divorce. However, because of financial concerns and because they both want to remain involved in the lives of their three sons, they have not yet filed for divorce. In addition, their financial difficulties have meant that Kathy and Brett cannot afford to live in separate residences. So Kathy, Brett, and their three sons all reside in a single-family home in Chicago.

Although Brett earns significantly more annual income than does Kathy, both parties contribute financially to maintaining their home and supporting their teenage sons. In one of their few, brief conversations this year, they determined that Brett had contributed far more consideration than had Kathy to the maintenance of their home and the support of their sons.

Thus, Brett has decided that for the current tax year, he and Kathy will file separate Federal income tax returns and he will claim head-of-household filing status. Even though they live under the same roof, Brett believes that he and Kathy should “maintain separate households.” Therefore, Brett believes that he is eligible for head-of-household filing status.

Advise Brett on which filing status is most appropriate for him in the current year in a letter to him at 16 Lahinch, Chicago, IL 60608.

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Communications

Research Problem 3. When taxpayers pay Federal income taxes by means of a credit or debit card, they are charged “convenience fees” by the issuer of the card. How are these fees determined? Are these fees themselves deductible? Explain. Summarize your findings in a memo for the tax research file.

Communications

Research Problem 4. Send to your instructor a table showing the amounts of the standard deduction and personal exemption for a single individual as they have changed over the last 10 years.

Communications

Research Problem 5. Prepare a graph for your school’s Accounting Club of the Federal income tax rates that apply at taxable income levels up to \$200,000 for each filing status.

Communications

Research Problem 6. Prepare a pie chart for the last tax year with complete data for the Federal Forms 1040. Indicate how many of each type of tax return was filed, as a percentage of the total. Send the graph to your instructor.

a. By form type (e.g., Form 1040 or 1040EZ).

b. By filing status (e.g., single or surviving spouse).

Communications

Research Problem 7. Prepare for a talk with your school’s Accounting Club by crafting no more than four PowerPoint slides. The slides should trace, in five-year time periods starting with 1990, the number of Forms 1040 filed for the tax year using each filing status (e.g., single or head of household). Using the Slide Notes feature, add a few comments about what you found. Send the slide deck to your instructor.

Roger CPA Review Questions

1. For “qualifying widow(er)” filing status, which of the following requirements must be met?
 - I. The surviving spouse does not remarry before the end of the current year
 - II. The surviving spouse was eligible to file a joint tax return in the year of the spouse’s death
 - III. The surviving spouse maintains the cost of the principal residence for six months
 - a. I, II, and III
 - b. I and II, but not III
 - c. I and III, but not II
 - d. I only

2. Which of the below prevents a husband and wife from filing a joint tax return?
 - I. The spouses have different accounting methods
 - II. The spouses have different tax years, provided that both spouses are alive at the end of the year
 - III. One spouse was a nonresident alien for three months during the year and no proper election was made
 - a. I and II only
 - b. II and III only
 - c. I and III only
 - d. II only

3. Parker and his wife Marie would have been filing a joint tax return for 20X1; however, Marie died in October of 20X1. Parker has not remarried and continues to maintain a home for himself and his two children during 20X1, 20X2, 20X3, and 20X4. Parker’s filing statuses for 20X1, 20X2, 20X3, and 20X4 are as follows.

	20X1	20X2	20X3	20X4
a.	Qualifying widower	Married filing joint return	Qualifying widower	Head of household
b.	Married filing joint return	Married filing joint return	Head of household	Qualifying widower
c.	Married filing joint return	Qualifying widower	Qualifying widower	Head of household
d.	Qualifying widower	Qualifying widower	Head of household	Qualifying widower

4. Which of the following items are included in determining the total support of a dependent?
 - I. Medical expenditures paid on behalf of the dependent
 - II. Life insurance premiums paid on behalf of the dependent
 - III. Fair rental value of dependent’s lodging
 - a. All of the above
 - b. I and II only
 - c. I and III only
 - d. I only

5. Kyle and Elena Smith contributed to the support of their two children, Alexandra and Matthew, and Elena’s divorced father Nick. For 2014, Alexandra, a twenty-two-year-old full-time college student, earned \$1,700 from a part-time job. Matthew, a twenty-seven-year-old full-time graduate student, earned \$23,000 from his job as a teaching assistant. Nick received \$12,000 in capital gains income and \$7,000 in non-taxable Social Security benefits. Alexandra, Matthew, and Nick are U.S. citizens; more than half of their support was provided by Kyle and Elena. How many exemptions can Kyle and Elena claim on their 2014 joint income tax return?
 - a. 2
 - b. 3
 - c. 4
 - d. 5



PART

2

GROSS INCOME

CHAPTER 4

Gross Income: Concepts and Inclusions

CHAPTER 5

Gross Income: Exclusions

Part 2 presents the income component of the basic tax model. Included in this presentation are the determination of what is income and the statutory exclusions that are permitted in calculating gross income. Because the taxpayer's accounting method and accounting period affect when income is reported, an introductory discussion of these topics is also included.

Gross Income: Concepts and Inclusions

LEARNING OBJECTIVES: *After completing Chapter 4, you should be able to:*

- LO.1** Explain the concepts of gross income and realization and distinguish between the economic, accounting, and tax concepts of gross income.
- LO.4** Apply the Internal Revenue Code provisions on alimony, loans made at below-market interest rates, annuities, prizes and awards, group term life insurance, unemployment compensation, and Social Security benefits.
- LO.2** Describe the cash and accrual methods of accounting and the related effects of the choice of taxable year.
- LO.5** Identify tax planning strategies for minimizing gross income.
- LO.3** Identify who should pay the tax on a particular item of income in various situations.

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- 4-1b Recovery of Capital Doctrine, 4-3
- 4-1c Economic and Accounting Concepts, 4-3
- 4-1d Comparison of the Timing of Income Rules for Tax and Accounting, 4-4
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BOB DAEMMRICH/PHOTODIT

THE BIG PICTURE

CALCULATION OF GROSS INCOME

In 2015, Dr. Cliff Payne, age 27, opened his dental practice as a sole proprietorship with a December 31 year-end. By the beginning of February, construction on his medical building was completed. He also leased an office building and entered into a contract to make improvements. In addition, early in the year, he used \$12,000 of extra money to purchase some stock.

The following financial information shows the results of Dr. Payne's first year of operation. The accounts receivable represent the amounts billed to patients.

Revenues (amounts billed patients for dental services)	\$385,000
Accounts receivable: January 1	–0–
Accounts receivable: December 31	52,000

During the year, Sam Jones, a contractor who owed Dr. Payne \$4,000 for dental services, satisfied the account by installing solar panels on the roof of Dr. Payne's new medical building.

As an undergraduate student, Cliff took an accounting course in which he learned that the accrual method of accounting provides a better measure of the income and expenses of a business. Therefore, based on the above financial information, Cliff concludes that the gross income for Federal income tax purposes is the \$385,000 he billed his patients for the dental services rendered.

Has Dr. Payne correctly calculated the gross income of this dental practice?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income.....	\$xx,xxx

FORM 1040 (p. 1)

7	Wages, salaries, tips, etc. Attach Form(s) W-2		
8a	Taxable interest. Attach Schedule B if required		
b	Tax-exempt interest. Do not include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		
b	Qualified dividends	9b	
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		
20a	Social security benefits	20a	b Taxable amount
21	Other income. List type and amount		

Less: Deductions for adjusted gross income.....	<u>(x,xxx)</u>
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	<u>(x,xxx)</u>
Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

This chapter is concerned with the first step in the computation of taxable income—the determination of gross income. Questions that are addressed include the following:

- What is income?
- When is the income recognized?
- Who must include the gross income?

The Code provides an all-inclusive definition of gross income in § 61. Chapter 5 presents items of income that are specifically excluded from gross income (exclusions).

LO.1
Explain the concepts of gross income and realization and distinguish between the economic, accounting, and tax concepts of gross income.

4-1 GROSS INCOME—WHAT IS IT?

4-1a Definition

Section 61(a) of the Internal Revenue Code defines the term **gross income** as follows:

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.

This definition is based on the language of the Sixteenth Amendment to the Constitution.

Supreme Court decisions have made it clear that all sources of income are subject to tax unless Congress specifically excludes a type of income.¹

¹James v. U.S., 61-1 USTC ¶9449, 7 AFTR 2d 1361, 81 S.Ct. 1052 (USSC, 1961).



GLOBAL TAX ISSUES From “All Sources” Is a Broad Definition

When § 61 refers to “income from whatever source derived,” the taxing authorities are reaching far beyond the borders of the United States. Although one interpretation of “source” in this context is type of income (wages, interest, etc.), a broader interpretation revolves around the place where the income is generated. In this context, citizens and residents of the United States are subject to taxation on income earned from sources both inside and outside the country. This “worldwide income” tax base can cause potential double taxation problems, with other countries also taxing income earned within their borders, but mechanisms such as the foreign tax credit can alleviate these tax burdens.

Recently, some U.S. corporations have relocated to other countries to avoid the higher U.S. tax rates on income earned abroad. In 2013, nearly 3,000 individuals renounced their United States citizenship to avoid taxes. Congress is considering ways of stopping this “flight of capital and tax base.” See “Why More Americans Are Renouncing U.S. Citizenship” by Ari Shapiro, NPR, Feb. 20, 2014; www.npr.org/blogs/parallels/2014/02/20/275937138/why-more-americans-are-renouncing-u-s-citizenship. Once per quarter, the Department of State publishes the names of U.S. citizens who have renounced their citizenship. Some of these individuals may owe Federal taxes upon renouncing. See § 877A.

Congress left it to the judicial and administrative branches to specifically determine the meaning of *income*.

4-1b Recovery of Capital Doctrine

While the Constitution grants Congress the power to tax income, it does not define the term. Thus, it would seem that Congress could simply tax gross receipts. Although Congress does allow certain deductions, none are constitutionally required. On the other hand, the Supreme Court has held that there is no income subject to tax until the taxpayer has recovered the capital invested.² This concept is known as the **recovery of capital doctrine**.

In its simplest application, this doctrine means that sellers can reduce their gross receipts (selling price) by the adjusted basis of the property sold to determine the amount of gross income.³

The Big Picture

Return to the facts of *The Big Picture* on p. 4-1. Assume that Dr. Payne receives \$15,000 when he sells the common stock he had purchased for \$12,000. His gross receipts are \$15,000, which consist of a \$12,000 recovery of capital and \$3,000 of gross income.

EXAMPLE

1

4-1c Economic and Accounting Concepts

The term **income** is used in the Code but is not separately defined. Thus, the courts were required to interpret “the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.”⁴ Early in the development of the income tax law, a choice had to be made between two competing models: economic income and accounting income. In determining the definition of income, the Supreme Court rejected the economic concept of income.

Economists measure income (**economic income**) by first determining the fair market value of the individual’s net assets (assets minus liabilities) at the beginning and end of the year (change in net worth). Then to arrive at economic income, this change in net

²*Doyle v. Mitchell Bros. Co.*, 1 USTC ¶17, 3 AFTR 2979, 38 S.Ct. 467 (USSC, 1916).

³Reg. § 1.61-3. For a definition of *adjusted basis*, see the Glossary in Appendix C.

⁴*Merchants Loan and Trust Co. v. Smietanka*, 1 USTC ¶42, 3 AFTR 3102, 41 S.Ct. 386 (USSC, 1921).

worth is increased by the value of the goods and services that person actually consumed during the period. Economic income also includes imputed values for such items as the rental value of an owner-occupied home and the value of food a taxpayer might grow for personal consumption.⁵

EXAMPLE

2

Helen has economic income as follows:

Fair market value of Helen's assets on December 31, 2015	\$220,000	
Less liabilities on December 31, 2015	<u>(40,000)</u>	
Net worth on December 31, 2015		\$ 180,000
Fair market value of Helen's assets on January 1, 2015	\$200,000	
Less liabilities on January 1, 2015	<u>(80,000)</u>	
Net worth on January 1, 2015		<u>(120,000)</u>
Increase in net worth		\$ 60,000
Consumption		
Food, clothing, and other personal expenditures		25,000
Imputed rental value of the home Helen owns and occupies		<u>12,000</u>
Economic income		<u>\$ 97,000</u>

The need to value assets annually would make compliance with the tax law burdensome and would cause numerous controversies between the taxpayer and the IRS over valuation. In addition, using market values to determine income for tax purposes could result in liquidity problems. The taxpayer's assets may increase in value even though they are not readily convertible into the cash needed to pay the tax (e.g., commercial real estate). Thus, the IRS, Congress, and the courts have rejected the economic concept of income as impractical.

In contrast, the accounting concept of income is founded on the realization principle.⁶ According to this principle, income (**accounting income**) is not recognized until it is realized. For realization to occur, (1) an exchange of goods or services must take place between the accounting entity and some independent, external party and (2) in the exchange, the accounting entity must receive assets that are capable of being objectively valued. Thus, income is recognized when an employee embezzles his or her employer's funds, when the income from an illegal business is realized, and when a person discovers buried treasure.⁷ On the other hand, the appreciation in the market value of an asset owned is not realized and thus is not included in gross income until the asset is sold. Income is not realized when an individual creates assets for his or her own use (e.g., vegetables grown in a personal garden) because there is no exchange transaction with another party.

The Supreme Court expressed an inclination toward the accounting concept of income when it adopted the realization requirement in *Eisner v. Macomber*.⁸

In summary, *income* represents an increase in wealth recognized for tax purposes only upon realization.⁹

4-1d Comparison of the Timing of Income Rules for Tax and Accounting

Although income tax rules frequently parallel financial accounting measurement concepts, differences do exist. Of major significance, for example, is the fact that unearned

⁵See Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1933), Chapters 2–3.

⁶See the American Accounting Association Committee Report on the "Realization Concept," *The Accounting Review* (April 1965): 312–322.

⁷*Rutkin v. U.S.*, 52–1 USTC ¶9260, 41 AFTR 2d 596, 72 S.Ct. 571 (USSC, 1952); Rev.Rul. 61, 1953–1 C.B. 17.

⁸1 USTC ¶32, 3 AFTR 3020, 40 S.Ct. 189 (USSC, 1920).

⁹*Glenshaw Glass Co.*, 348 U.S. 426, 429–430, 75 S.Ct. 473, 99 L.Ed. 483 (1955).



TAX IN THE NEWS Bartering Gets Organized

Bartering was the only way to conduct commerce before money was invented. But bartering has experienced a revival as a result of the creation of “barter trade exchanges.” Advertisements appear on the Internet encouraging individuals to form “barter trade exchanges,” which operate like a local eBay, except services are exchanged (rather than sold for cash) among members.

Bartering may be a part of the “underground economy.” The individuals who exchange services informally often do not report their income from these transactions, and it is

very difficult for the IRS to discover the unreported income. However, the organized exchanges should provide the IRS with a source for discovering the taxable income from bartering. Brokers in the trade or business of facilitating barter exchanges are required to use Form 1099-B to provide the IRS and participants with information regarding the exchange.

Source: See, for example, Start Your Own Barter Trade Exchange Using Tom McDowell's Proven Barter System, www.bartrtrainer.com/clubs.asp.

(prepaid) income received by an accrual basis taxpayer often is taxed in the year of receipt. For financial accounting purposes, such prepayments are not treated as income until earned.¹⁰ Because of this and other differences, many corporations report financial accounting income that is substantially different from the amounts reported for tax purposes (see Reconciliation of Corporate Taxable Income and Accounting Income in Chapter 17).

The Supreme Court provided an explanation for some of the variations between accounting and taxable income in a decision involving inventory and bad debt adjustments:

The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that ‘possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.’ In view of the Treasury’s markedly different goals and responsibilities, understatement of income is not destined to be its guiding light.

... Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty.¹¹

4-1e Form of Receipt

Gross income is not limited to cash received. “It includes income realized in any form, whether in money, property, or services. Income may be realized [and recognized], therefore, in the form of services, meals, accommodations, stock or other property, as well as in cash.”¹²

Form of Receipt

Ostrich Corporation allows Bill, an employee, to use a company car for his vacation. Bill realizes income equal to the rental value of the car for the time and mileage.

EXAMPLE

3

¹⁰Similar differences exist in the deduction area.

¹²Reg. § 1.61-1(a).

¹¹*Thor Power Tool Co. v. Comm.*, 79-1 USTC ¶9139, 43 AFTR 2d 79-362, 99 S.Ct. 773 (USSC, 1979).

Form of Receipt

EXAMPLE

4

Terry owes \$10,000 on a mortgage. The creditor accepts \$8,000 in full satisfaction of the debt. Terry realizes income of \$2,000 from retiring the debt.¹³

EXAMPLE

5

Sam began his law practice in a building in need of repairs. Sam decided to list his services on a barter exchange. He offered to provide an hour of legal services in exchange for building repairs. A qualified carpenter performed the repairs in eight hours. The carpenter normally charges \$50 an hour. Sam formed a corporation for the carpenter in exchange for the carpenter's services. Sam realized \$400 (8 hours × \$50) in gross income for his services.

LO.2

Describe the cash and accrual methods of accounting and the related effects of the choice of taxable year.

4-2 YEAR OF INCLUSION

4-2a Taxable Year

The annual accounting period, or **taxable year**, is a basic component of our tax system.¹⁴ Generally, an entity must use the *calendar year* to report its income. However, a *fiscal year* (a period of 12 months ending on the last day of any month other than December) can be elected if the taxpayer maintains adequate books and records. This fiscal year option generally is not available to partnerships, S corporations, and personal service corporations, as discussed in Chapter 16.¹⁵

In determining a person's tax liability, it is important that the income be placed in the correct tax year. The tax on the income is dependent on the applicable tax rates. The applicable rates can change between years for the following reasons:

- With a progressive rate system, a taxpayer's marginal tax rate can change from year to year.
- Congress may change the tax rates.
- The relevant rates may change because of a change in the entity's status (e.g., a person may marry or a business may be incorporated).
- Several provisions in the Code are dependent on the taxpayer's gross income for the year (e.g., whether the person can be claimed as a dependent, as discussed in Chapter 3).

Even when the rates do not change between tax years, the longer payment of the tax can be postponed, the lower the present value of the tax.

4-2b Accounting Methods

The year an item of income is subject to tax often depends upon which acceptable **accounting method** the taxpayer regularly employs.¹⁶ The three primary methods of accounting are (1) the cash receipts and disbursements method, (2) the accrual method, and (3) the hybrid method. Most individuals use the cash receipts and disbursements method of accounting, while large corporations use the accrual method. The Regulations require the accrual method for determining purchases and sales when inventory is an income-producing factor.¹⁷ Some businesses use a hybrid method that is a combination of the cash and accrual methods of accounting.

In addition to these overall accounting methods, a taxpayer may choose to spread the gain from an installment sale of property over the collection periods by using the

¹³Reg. § 1.61-12. See *U.S. v. Kirby Lumber Co.*, 2 USTC ¶814, 10 AFTR 458, 52 S.Ct. 4 (USSC, 1931). Exceptions to this general rule are discussed in Chapter 5.

¹⁴See Accounting Periods in Chapter 16.

¹⁵§ § 441(a) and (d).

¹⁶See Accounting Methods in Chapter 16.

¹⁷Reg. § 1.446-1(c)(2)(i). Other circumstances in which the accrual method must be used are presented in Chapter 16. For the small business exception to the inventory requirement, see Rev.Proc. 2002-28, 2002-1 C.B. 815.

installment method of income recognition. Contractors may either spread profits from contracts over the periods in which the work is done (the *percentage of completion method*) or defer all profit until the year in which the project is completed (the *completed contract method*, which can be used only in limited circumstances).¹⁸

The IRS has the power to prescribe the accounting method to be used by the taxpayer. Section 446(b) grants the IRS broad powers to determine whether the accounting method used *clearly reflects income*:

If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary ... does clearly reflect income.

A change in method of accounting requires the consent of the IRS.¹⁹

Cash Receipts Method

Under the **cash receipts method**, property or services received are included in the taxpayer's gross income in the year of actual or constructive receipt by the taxpayer or agent, regardless of whether the income was earned in that year.²⁰ The income received need not be reduced to cash in the same year. All that is necessary for income recognition is that property or services received have a fair market value—a cash equivalent.²¹ Thus, a cash basis taxpayer who receives a note in payment for services has income in the year of receipt equal to the fair market value of the note. However, a creditor's mere promise to pay (e.g., an account receivable), with no supporting note, usually is not considered to have a fair market value.²² Thus, the cash basis taxpayer defers income recognition until the account receivable is collected.

Dana, an accountant, reports her income using the cash method. In 2015, she performed an audit for Orange Corporation and billed the client for \$5,000, which was collected in 2016. In 2015, Dana also performed an audit for Blue Corporation. Because of Blue's precarious financial position, Dana required Blue to issue an \$8,000 secured negotiable note in payment of the fee. The note had a fair market value of \$6,000. Dana collected \$8,000 on the note in 2016. Dana's gross income for the two years is as follows:

	2015	2016
Fair market value of note received from Blue	\$6,000	
Cash received		
From Orange on account receivable		\$ 5,000
From Blue on note receivable		8,000
Less: Recovery of capital		(6,000)
Total gross income	<u>\$6,000</u>	<u>\$ 7,000</u>

EXAMPLE

6

Generally, a check received is considered a cash equivalent and, upon receipt, must be recognized as income by a cash basis taxpayer. An exception to this rule is if the person paying with the check requests that the check not be cashed until a subsequent date, the income is deferred until that later date.²³

Accrual Method

Under the **accrual method**, an item is generally included in gross income for the year in which it is earned, regardless of when it is collected. The income is earned when (1) all

¹⁸§§ 453 and 460. See Chapter 16 for limitations on the use of the installment method and the completed contract method.

¹⁹§ 446(e).

²⁰*Julia A. Strauss*, 2 B.T.A. 598 (1925). See the Glossary in Appendix C for a discussion of the terms *cash equivalent doctrine* and *constructive receipt*.

²¹Reg. §§ 1.446-1(a)(3) and (c)(1)(i).

²²*Bedell v. Comm.*, 1 USTC ¶359, 7 AFTR 8469, 30 F.2d 622 (CA-2, 1929).

²³*Charles F. Kabler*, 18 T.C. 31 (1952); *Bright v. U.S.*, 91-1 USTC ¶50, 142, 67 AFTR 2d 91-673, 926 F.2d 383 (CA-5, 1991).

events have occurred that fix the right to receive such income and (2) the amount to be received can be determined with reasonable accuracy.²⁴

Generally, the taxpayer's rights to the income accrue when title to property passes to the buyer or the services are performed for the customer or client.²⁵ If the rights to the income have accrued but are subject to a potential refund claim (e.g., under a product warranty), the income is reported in the year of sale and a deduction is allowed in subsequent years when actual claims accrue.²⁶

Where the taxpayer's right to the income is contested (e.g., when a contractor fails to meet specifications), the year in which the income is subject to tax depends upon whether payment has been received. If payment has not been received, no income is recognized until the claim is settled. Only then is the right to the income established.²⁷ However, if the payment is received before the dispute is settled, a **claim of right doctrine** requires the taxpayer to recognize the income in the year of receipt.²⁸

The Big Picture

EXAMPLE

7

Return to the facts of *The Big Picture* on p. 4-1. On completing the construction improvements to Dr. Payne's medical office building in 2015, assume that the contractor, who uses the accrual method, submitted a bill. Dr. Payne refused to pay the bill, however, claiming that the contractor had not met specifications. The contractor did not reach a settlement with Dr. Payne until 2016. No income accrues to the contractor until 2016. If Dr. Payne had paid for the work and then filed suit for damages, the contractor could not defer the income (the income would be taxable in 2015).

The measure of accrual basis income is generally the amount the taxpayer has a right to receive. Unlike the cash basis, the fair market value of the customer's obligation is irrelevant in measuring accrual basis income.

EXAMPLE

8

Assume the same facts as in Example 6, except that Dana is an accrual basis taxpayer. Dana must recognize \$13,000 (\$8,000 + \$5,000) gross income in 2015, the year her rights to the income accrued.

Hybrid Method

The **hybrid method** is a combination of the accrual method and the cash method. Generally, when the hybrid method is used, inventory is an income-producing factor. The Regulations require use of the accrual method for determining sales of inventory and cost of goods sold. Thus, the taxpayer accounts for inventory using the accrual method and uses the cash method for all other income and expense items (e.g., services and interest income). The hybrid method is primarily used by small businesses.

4-2c Exceptions Applicable to Cash Basis Taxpayers

Constructive Receipt

Income that has not actually been received by the taxpayer is taxed as though it had been received—the income is constructively received—under the following conditions:

- The amount is made readily available to the taxpayer.
- The taxpayer's actual receipt is not subject to substantial limitations or restrictions.²⁹

²⁴Reg. § 1.451-1(a).

²⁵*Lucas v. North Texas Lumber Co.*, 2 USTC ¶484, 8 AFTR 10276, 50 S.Ct. 184 (USSC, 1930).

²⁶*Brown v. Helvering*, 4 USTC ¶1222, 13 AFTR 851, 54 S.Ct. 356 (USSC, 1933).

²⁷*Burnet v. Sanford and Brooks*, 2 USTC ¶636, 9 AFTR 603, 51 S.Ct. 150 (USSC, 1931).

²⁸*North American Oil Consolidated Co. v. Burnet*, 3 USTC ¶943, 11 AFTR 16, 52 S.Ct. 613 (USSC, 1932).

²⁹Reg. § 1.451-2(a).

The rationale for the **constructive receipt** doctrine is that if the income is available, the taxpayer should not be allowed to postpone the income recognition. For instance, a taxpayer is not permitted to defer income for December services by refusing to accept payment until January. However, determining whether the income is *readily available* and whether *substantial limitations or restrictions exist* necessitates a factual inquiry.³⁰ Following are some examples of the application of the constructive receipt doctrine.

Ted is a member of a barter club. In 2015, Ted performed services for other club members and earned 1,000 points. Each point entitles him to \$1 in goods and services sold by other members of the club; the points can be used at any time. In 2016, Ted exchanged his points for a new high-definition TV. Ted must recognize \$1,000 gross income in 2015 when the 1,000 points were credited to his account.³¹

EXAMPLE

9

The Big Picture

Return to the facts of *The Big Picture* on p. 4-1. On December 31, Dr. Payne has \$10,000 in patients' checks that have not been deposited. They include a check for \$3,000 from a patient who asked Dr. Payne not to deposit the check until after January 4 of next year because her account did not contain sufficient funds to pay the debt. Under the cash method, Dr. Payne must recognize \$7,000 income from the \$7,000 in checks on hand in the current year because the checks are a cash equivalent that is actually received. The income from the \$3,000 check is neither actually nor constructively received in the current year because an insufficient account means that the funds are not available.³²

EXAMPLE

10

Rick has a savings account with Eagle Savings and Loan Association. Under the terms of the account, interest accrues monthly and the depositor can withdraw the funds (including accrued interest) at any time. The interest for the year is constructively received by Rick even though he does not withdraw the funds.³³

EXAMPLE

11

The constructive receipt doctrine does not reach income the taxpayer is not yet entitled to receive even though the taxpayer could have contracted to receive the income at an earlier date.³⁴

The Big Picture

Return to the facts of *The Big Picture* on p. 4-1. Assume that Dr. Payne adopted the cash basis of accounting. If he allowed patients to pay by credit card, Dr. Payne would receive immediate credit in his bank account for 96% of the charge. The other 4% would be retained by the credit card issuer. To avoid the 4% charge, Dr. Payne chose not to accept credit card payments. Instead, he established a policy of requiring all bills to be paid within 30 days after the dental services were provided. He communicated this policy to patients before he performed the services. At the end of the year, several patients who owed a combined \$2,000 offered to pay with credit cards, but his office rejected their offers.

The \$2,000 was not constructively received at the end of the year. Although Dr. Payne could have received payment by credit card in the current year before the dental services were performed, he contracted to receive payment at a later date. Moreover, the 4% charge by the credit card company would be a "substantial limitation."³⁵

EXAMPLE

12

³⁰*Baxter v. Comm.*, 87-1 USTC ¶9315, 59 AFTR 2d 87-1068, 816 F.2d 493 (CA-9, 1987).

³¹Rev.Rul. 80-52, 1980-1 C.B. 100.

³²*L. M. Fischer*, 14 T.C. 792 (1950).

³³Reg. § 1.451-2(a).

³⁴*Baxter v. Comm.*, 816 F.2d 493, 59 AFTR 2d 87-1068, 87-1 USTC ¶9315(CA-9, 1997).

³⁵*Cowden v. Comm.*, 61-1 USTC ¶9382, 7 AFTR 2d 1160, 289 F.2d 20 (CA-5, 1961).

Income set apart or made available is not constructively received if its actual receipt is subject to *substantial restrictions*. The life insurance industry has used substantial restrictions as a cornerstone for designing life insurance contracts with favorable tax features. Ordinary life insurance policies provide (1) current protection—an amount payable in the event of death—and (2) a savings feature—a cash surrender value payable to the policyholder if the policy is terminated during the policyholder’s life. The annual increase in cash surrender value is not taxable because the policyholder must cancel the policy to actually receive the increase in value. Because the cancellation requirement is a substantial restriction, the policyholder does not constructively receive the annual increase in cash surrender value.³⁶ Employees often receive from their employers property subject to substantial restrictions. Generally, no income is recognized until the restrictions lapse.³⁷

EXAMPLE
13

Carlos is a key employee of Red, Inc. The corporation gives stock with a value of \$10,000 to Carlos. The stock cannot be sold, however, for five years. Carlos is not required to recognize income until the restrictions lapse at the end of five years.

Original Issue Discount

Lenders frequently make loans that require a payment at maturity of more than the amount of the original loan. The difference between the amount due at maturity is actually interest but is referred to as **original issue discount**. In such an arrangement, the Code requires the original issue discount to be reported when it is earned, regardless of the taxpayer’s accounting method.³⁸ The interest “earned” is calculated by the effective interest rate method.

EXAMPLE
14

On January 1, 2015, Mark, a cash basis taxpayer, pays \$82,645 for a 24-month certificate. The certificate is priced to yield 10% (the effective interest rate) with interest compounded annually. No interest is paid until maturity, when Mark receives \$100,000. Thus, Mark’s gross income from the certificate is \$17,355 (\$100,000 – \$82,645). Mark’s income earned each year is calculated as follows:

2015 (.10 × \$82,645) =	\$ 8,264
2016 [.10 × (\$82,645 + \$8,264)] =	9,091
	\$17,355

The original issue discount rules do not apply to U.S. savings bonds (discussed in the following paragraphs) or to obligations with a maturity date of one year or less from the date of issue.³⁹ See Chapter 14 for additional discussion of the tax treatment of original issue discount.

Series E and Series EE Bonds

Certain U.S. government savings bonds (Series E before 1980 and Series EE after 1979) are issued at a discount and are redeemable for fixed amounts that increase at stated intervals. No interest payments are actually made. The difference between the purchase price and the amount received on redemption is the bondholder’s interest income from the investment.

The income from these savings bonds is generally deferred until the bonds are redeemed or mature. Furthermore, Series E bonds previously could be exchanged within one year of their maturity date for Series HH bonds, and the interest on the Series E bonds could be further deferred until maturity of the Series HH bonds.⁴⁰ Thus, U.S.

³⁶Theodore H. Cohen, 39 T.C. 1055 (1963).

³⁷§ 83(a).

³⁸§ § 1272(a)(3) and 1273(a).

³⁹§ 1272(a)(2).

⁴⁰Treas. Dept. Circulars No. 1–80 and No. 2–80, 1980–1 C.B. 714, 715. Note that interest is paid at semiannual intervals on the Series HH bonds and must be included in income as received. Refer to Chapter 5 for a discussion of the savings bond interest exclusion. This exchange opportunity applied through August 31, 2004.

savings bonds have attractive income deferral features not available with corporate bonds and certificates of deposit issued by financial institutions.

Of course, the deferral feature of government bonds issued at a discount is not an advantage if the investor has insufficient income to be subject to tax as the income accrues. In fact, the deferral may work to the investor's disadvantage if the investor has other income in the year the bonds mature or the bunching of the bond interest into one tax year creates a tax liability. Fortunately, U.S. government bonds have a provision for these investors. A cash basis taxpayer can elect to include in gross income the annual increment in redemption value.⁴¹

Kate purchases Series EE U.S. savings bonds for \$500 (face value of \$1,000) on January 2 of the current year. If the bonds are redeemed during the first six months, no interest is paid. At December 31, the redemption value is \$519.60.

If Kate elects to report the interest income annually, she must report interest income of \$19.60 for the current year. If she does not make the election, she will report no interest income for the current year. When the bond matures, Kate may receive a 1099 from the bank for all of the interest. She should keep good records to prove that she paid the tax on the interest income over the life of the bond.

EXAMPLE

15

When a taxpayer elects to report the income from the bonds on an annual basis, the election applies to all such bonds the taxpayer owns at the time of the election and to all such securities acquired subsequent to the election. A change in the method of reporting the income from the bonds requires permission from the IRS.



ETHICS & EQUITY Should the Tax Treatment of Government Bonds and Corporate Bonds Be Different?

Taxpayers are permitted to defer the original issue discount earned on U.S. Government Series EE bonds until the bonds mature, but the original issue discount on a corporate bond must be taken into gross income each year the bond is

held. Is this difference in the tax treatment of income earned on government and corporate bonds defensible in terms of equity? Why or why not?

Amounts Received under an Obligation to Repay

The receipt of funds with an obligation to repay that amount in the future is the essence of borrowing. Because the taxpayer's assets and liabilities increase by the same amount, no income is realized when the borrowed funds are received. Thus, if an obligation to repay the funds exists, the receipt of deposited or borrowed funds is not a taxable event.

A landlord receives a damage deposit from a tenant. The landlord does not recognize income until the deposit is forfeited because the landlord has an obligation to repay the deposit if no damage occurs.⁴² However, if the deposit is in fact a prepayment of rent, it is taxed in the year of receipt.

EXAMPLE

16

4-2d Exceptions Applicable to Accrual Basis Taxpayers

Prepaid Income

For financial reporting purposes under accrual accounting, advance payments received from customers are reflected as prepaid income and as a liability of the seller. However, for tax purposes, the prepaid income often is taxed in the year of receipt.

⁴¹§ 454(a).

⁴²*John Mantell*, 17 T.C. 1143 (1952).

GLOBAL TAX ISSUES Tax Credit Neutralizes Foreign Income Taxes

When a U.S. taxpayer invests in a foreign country, that investment income is subject to tax in the United States and may also be subject to tax in the foreign country. However, the taxpayer is allowed a credit on his or her U.S. Federal income tax return for income taxes paid to the foreign country. The credit system allows the taxpayer to treat the taxes paid to the foreign country as though they were paid to the United States.

If the foreign taxes paid are less than the U.S. tax on the income, the foreign taxes have cost the taxpayer nothing. On the other hand, if the foreign taxes are greater than the U.S. tax on the income, the credit is limited to the amount of the U.S. tax on the income. In this case, the taxes paid by the taxpayer will exceed what they would have been if the income had been earned in the United States.

EXAMPLE

17

In December 2015, a tenant pays his January 2016 rent of \$1,000. The accrual basis landlord must include the \$1,000 in her 2015 gross income for tax purposes, although the unearned rent income is reported as a liability on the landlord's December 31, 2015 financial accounting balance sheet.

Taxpayers have repeatedly argued that deferral of income until it is actually earned properly matches revenues and expenses. Moreover, a proper matching of income with the expenses of earning the income is necessary to clearly reflect income, as required by the Code. The IRS responds that § 446(b) grants it broad powers to determine whether an accounting method clearly reflects income. The IRS further argues that generally accepted financial accounting principles should not dictate tax accounting for prepaid income because of the practical problems of collecting Federal revenues. Collection of the tax is simplest in the year the taxpayer receives the cash from the customer or client.

After a number of years of continual disputes between the IRS and taxpayers, the IRS relented and modified its rules on the prepaid income issue in some situations, as explained below.

Deferral of Advance Payments for Goods

Generally, a taxpayer can elect to defer recognition of income from *advance payments for goods* if the method of accounting for the sale is the same for tax and financial reporting purposes.⁴³

EXAMPLE

18

Brown Company will ship goods only after payment for the goods has been received. In December 2015, Brown received \$10,000 for goods that were not shipped until January 2016. Brown can elect to report the income for tax purposes in 2016, assuming that the company reports the income in 2016 for financial reporting purposes.

Deferral of Advance Payments for Services

Revenue Procedure 2004-34⁴⁴ permits an accrual basis taxpayer to defer recognition of income for *advance payments for services* to be performed after the end of the tax year of receipt. The portion of the advance payment that relates to services performed in the tax year of receipt is included in gross income in the tax year of receipt, matching what was reported in the taxpayer's financial statements. The portion of the advance payment that relates to services to be performed after the tax year of receipt is included in gross income in the subsequent tax year. This method of accounting may also be used for advance payments received for goods, as well as licensing of intellectual property, and the sale, lease, or license of software.

⁴³Reg. § 1.451-5(b). See Reg. § 1.451-5(c) for exceptions to this deferral opportunity. The financial accounting conformity requirement is not applicable to contractors who use the completed contract method.

⁴⁴2004-1 C.B. 991.

Yellow Corporation, an accrual basis calendar year taxpayer, sells its services under 12-month, 24-month, and 36-month contracts. The corporation provides services to each customer every month. On May 1, 2015, Yellow Corporation sold the following customer contracts:

Length of Contract	Total Proceeds
12 months	\$3,000
24 months	4,800
36 months	7,200

Yellow may defer until 2016 all of the income that will be earned after 2015.

Length of Contract	Income Recorded in 2015	Income Recorded in 2016
12 months	\$2,000 (\$3,000 × 8/12)	\$1,000 (\$3,000 × 4/12)
24 months	1,600 (\$4,800 × 8/24)	3,200 (\$4,800 × 16/24)
36 months	1,600 (\$7,200 × 8/36)	5,600 (\$7,200 × 28/36)

EXAMPLE

19

Revenue Procedure 2004-34 *does not* apply to prepaid rent or prepaid interest. Advance payments for these items are always taxed in the year of receipt.

4-3 INCOME SOURCES

4-3a Personal Services

It is a well-established principle of taxation that income from personal services must be included in the gross income of the person who performs the services. This principle was first established in a Supreme Court decision, *Lucas v. Earl*.⁴⁵ Mr. Earl entered into a binding agreement with his wife under which Mrs. Earl was to receive one-half of Mr. Earl's salary. Justice Holmes used the celebrated **fruit and tree metaphor** to explain that the fruit (income) must be attributed to the tree from which it came (Mr. Earl). A mere **assignment of income** does not shift the liability for the tax.

Services of an Employee

Services performed by an employee for the employer's customers are considered performed by the employer. Thus, the employer is taxed on the income from the services provided to the customer, and the employee is taxed on any compensation received from the employer.⁴⁶

LO.3

Identify who should pay the tax on a particular item of income in various situations.

The Big Picture

Return to the facts of *The Big Picture* on p. 4-1. Assume that instead of operating his dental practice as a sole proprietorship, Dr. Payne incorporated his dental practice in an attempt to limit his liability. He entered into an employment contract with his corporation and was to receive a salary. All patients contract to receive their services from the corporation, and those services are provided through the corporation's employee, Dr. Payne. Thus, the corporation earned the income from patients' services and must include the patients' fees in its gross income. Dr. Payne must include his salary in his gross income. The corporation is allowed a deduction for the reasonable salary paid to Dr. Payne. (See the discussion of unreasonable compensation in Chapter 6.)

EXAMPLE

20

⁴⁵2 USTC ¶496, 8 AFTR 10287, 50 S.Ct. 241 (USSC, 1930).

⁴⁶*Sargent v. Comm.*, 91-1 USTC ¶50,168, 67 AFTR 2d 91-718, 929 F.2d 1252 (CA-8, 1991).

Services of a Child

In the case of a child, the Code specifically provides that amounts earned from personal services must be included in the child's gross income. This result applies even though the income is paid to other persons (e.g., the parents).⁴⁷

4-3b Income from Property

The courts have used the fruit and tree metaphor to determine who should pay the tax on the income from property. The "tree" is the property, and income is its "fruit." The owner of the tree has control over the fruit; therefore, the owner of the property should pay tax on the income the property produces. Thus, if a father clips interest coupons associated with corporate bonds shortly before the interest payment date and gives the coupons to his son, the interest will still be taxed to the father. And a father who assigns to his daughter the right to collect the rent from his rental property will be taxed on the rent because he retains ownership of the property.⁴⁸

Interest

According to the IRS, interest accrues daily. Therefore, the interest for the period that includes the date of the transfer is allocated between the transferor and transferee based on the number of days during the period that each owned the property.

EXAMPLE

21

Floyd, a cash basis taxpayer, gave his son, Ethan, corporate bonds with a face amount of \$12,000 and a 5% stated annual interest rate. The gift was made on February 28, 2015, and the interest was paid on the last day of each quarter. Floyd must recognize \$100 of interest income ($5\% \times \$12,000 \times 3/12 \times 2/3$) accrued at the time of the gift.

For the transferor, the timing of the recognition of the income from the property depends upon the accounting method and the manner in which the property was transferred. In the case of a gift of income-producing property, the donor must recognize his or her share of the accrued income at the time it would have been recognized had the donor continued to own the property.⁴⁹ However, if the transfer is a sale, the transferor must recognize the accrued income at the time of the sale. This results because the accrued interest will be included in the sales proceeds.

EXAMPLE

22

Mia purchased a corporate bond at its face amount of \$10,000 on January 1, 2015. The bond pays 5% interest on each December 31. On March 31, 2015, Mia sold the bond for \$10,600. Mia must recognize \$125 interest income in 2015 ($5\% \times \$10,000 \times 3/12$). She must also recognize a \$475 capital gain from the sale of the bond:

Amount received from sale	\$ 10,600
Less accrued interest income	(125)
Selling price of bond less interest	\$ 10,475
Less cost of the bond	(10,000)
Gain on sale	<u>\$ 475</u>

Dividends

A corporation is taxed on its earnings, and the shareholders are taxed on the dividends paid to them from the corporation's after-tax earnings.

⁴⁷§ 73. For circumstances in which the child's unearned income is taxed at the parents' rate, see Kiddie Tax—Unearned Income of Children Taxed at Parents' Rate in Chapter 3.

⁴⁸*Galt v. Comm.*, 54-2 USTC ¶9457, 46 AFTR 633, 216 F.2d 41 (CA-7, 1954); *Helvering v. Horst*, 40-2 USTC ¶9787, 24 AFTR 1058, 61 S.Ct. 144 (USSC, 1940).

⁴⁹Rev.Rul. 72-312, 1972-1 C.B. 22.

GLOBAL TAX ISSUES Do Dividends from Foreign Corporations Warrant Special Treatment?

The special rates on dividends are intended to mitigate the double-tax burden—taxing income at the corporate level then taxing the dividends to the shareholder. The United States taxes foreign corporations only on the income the corporation earns in this country. Therefore, if the corporation does no business in the United States but pays dividends to shareholders subject to U.S. taxes, the corporation's income is only taxed once.

Nevertheless, special rates apply to the foreign corporation's dividends if (1) the foreign corporation's stock is

traded on an established U.S. securities market or (2) the foreign corporation is eligible for the benefits of an income tax treaty between its country of incorporation and the United States. The apparent reason for the first exception is that if the corporation is listed on an established U.S. securities market, it probably does enough business in the United States to be subject to its tax. The second exception is a reciprocal arrangement: The United States confers a benefit to corporations formed in countries that exempt U.S. corporations from taxes.

Corporations are permitted a dividend received deduction of from 70 percent to 100 percent of the dividends received from another domestic corporation. This is discussed in Chapter 17.

Partial relief from double taxation is provided by taxing qualified dividends received by individuals at the same rate as capital gains.⁵⁰ Individuals otherwise subject to the 10 or 15 percent marginal tax rate are eligible for a 0 percent tax on qualified dividends received. Individuals subject to the 25, 28, 33, or 35 percent marginal tax rate pay a 15 percent tax on qualified dividends received. Beginning in 2013, the maximum tax rate applied to qualified dividends increased from 15 percent to 20 percent for high-income taxpayers—those subject to the 39.6 percent marginal tax rate.

A holding period requirement must be satisfied for the special rates to apply: The stock must have been held for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date.⁵¹ The purpose of this requirement is to prevent the taxpayer from buying the stock shortly before the dividend is paid, receiving the dividend, and then selling the stock at a loss (a short-term capital loss) after the stock goes ex-dividend. A stock's price often declines after the stock goes ex-dividend.

Note that qualified dividends are not included as capital gains in the gains and losses netting process; thus, they are *not* reduced by capital losses. Qualified dividend income is merely taxed at the rates that would apply to the taxpayer if he or she had an excess of net long-term capital gain over net short-term capital loss.

Stock Holding Period

In June 2015, Green Corporation pays a dividend of \$1.50 on each share of its common stock. Madison and Daniel, two unrelated shareholders, each own 1,000 shares of the stock. Consequently, each receives a dividend of \$1,500 (1,000 shares \times \$1.50). Assume that Daniel satisfies the 60/121-day holding period rule but Madison does not. The \$1,500 that Daniel receives is subject to preferential 0%/15%/20% treatment in 2015. The \$1,500 that Madison receives, however, is not. Because Madison did not comply with the holding period rule, her dividend is not a *qualified dividend* and is taxed at ordinary income rates.

EXAMPLE

23

⁵⁰§ 1(h)(11).

⁵¹The ex-dividend date is the date before the record date on which the corporation finalizes the list of shareholders who will receive the dividends.

Stock Holding Period

EXAMPLE

24

Assume that both Madison and Daniel in Example 23 are in the 35% tax bracket. Consequently, Madison pays a tax of \$525 ($35\% \times \$1,500$) on her dividend, while Daniel pays a tax of \$225 ($15\% \times \$1,500$) on his. The \$300 saving that Daniel enjoys underscores the advantages of qualified dividend treatment.

Unlike interest, dividends do not accrue on a daily basis because the declaration of a dividend is at the discretion of the corporation's board of directors. Generally, dividends are taxed to the person who is entitled to receive them—the shareholder of record as of the corporation's record date.⁵² Thus, if a taxpayer sells stock after a dividend has been declared but before the record date, the dividend generally will be taxed to the purchaser.

This rule differs in the case of a gift of stock. If a donor makes a gift of stock to someone (e.g., a family member) after the declaration date but before the record date, the Tax Court has held that the donor does not shift the dividend income to the donee. The *fruit* has sufficiently ripened as of the declaration date to tax the dividend income to the donor of the stock.⁵³ In a similar set of facts, the Fifth Circuit Court of Appeals concluded that the dividend income should be included in the gross income of the donee (the owner at the record date). In this case, the taxpayer gave stock to a qualified charity (a charitable contribution) after the declaration date and before the record date.⁵⁴ Thus, gifts to charities and gifts to family members are treated differently.

EXAMPLE

25

On June 20, the board of directors of Black Corporation declares a \$10 per share dividend. The dividend is payable on June 30 to shareholders of record on June 25. As of June 20, Maria owned 200 shares of Black Corporation's stock. On June 21, Maria sold 100 of the shares to Norm for their fair market value and gave 100 of the shares to Sam (her son). Both Norm and Sam are shareholders of record as of June 25. Norm (the purchaser) will be taxed on \$1,000 because he is entitled to receive the dividend. However, Maria (the donor) will be taxed on the \$1,000 received by Sam (the donee) because the gift was made after the declaration date but before the record date of the dividend.

4-3c Income Received by an Agent

Income received by the taxpayer's agent is considered to be received by the taxpayer. A cash basis principal must recognize the income at the time it is received by the agent.⁵⁵

EXAMPLE

26

Jack, a cash basis taxpayer, delivered cattle to the auction barn in late December. The auctioneer, acting as the farmer's agent, sold the cattle and collected the proceeds in December. The auctioneer did not pay Jack until the following January. Jack must include the sales proceeds in his gross income for the year the auctioneer received the funds.

4-3d Income from Partnerships, S Corporations, Trusts, and Estates

A **partnership** is not a separate taxable entity. Rather, the partnership merely files an information return (Form 1065), which serves to provide the data necessary for determining the character and amount of each partner's distributive share of the partnership's income and deductions. Each partner must then report his or her distributive share of the

⁵²Reg. § 1.61-9(c). The record date is the cutoff for determining the shareholders who are entitled to receive the dividend.

⁵³*M. G. Anton*, 34 T.C. 842 (1960).

⁵⁴*Caruth Corp. v. U.S.*, 89-1 USTC ¶9172, 63 AFTR 2d 89-716, 865 F.2d 644 (CA-5, 1989).

⁵⁵Rev.Rul. 79-379, 1979-2 C.B. 204.



TAX IN THE NEWS The Attorney's Fee Was the Plaintiff's Income

Mr. Banks sued his employer for employment discrimination and received a settlement. Banks's attorney received approximately one-third of the settlement, and Banks reasoned that he should include only the remaining amount in his gross income.

The U.S. Supreme Court disagreed. The Court applied "assignment of income" and "principal-agent" reasoning to conclude that Banks was required to include the entire settlement amount in his gross income. The Court considered the lawsuit a property interest. Banks controlled the lawsuit and diverted some of the proceeds to the attorney; that is, Banks assigned a portion of his income to the attorney. The Court rejected Banks's argument that he and the attorney were partners pursuing the lawsuit. Instead, the Court concluded that Banks and his attorney maintained a

"quintessential principal-agent relationship," with the attorney-agent pursuing the rights of his principal, Banks. Under well-settled principles of tax law, the amount received as a result of the agent's efforts nevertheless belonged to Banks, the principal. According to the Court, the tax treatment of the amount due the attorney would have to be addressed through the tax deduction rules. For Mr. Banks, this deduction was classified as a miscellaneous itemized deduction subject to the 2 percent floor under § 67. Because of the rather harsh result, § 67 was modified. Under the modification, Mr. Banks could have claimed a deduction *for* AGI as to the attorney's portion and thereby avoided the need to itemize. As noted in Chapter 1 (Example 28), Congress can and does sometimes intervene to rectify an undesirable Supreme Court holding.

partnership's income and deductions for the partnership's tax year ending in or with the partner's tax year. The income must be reported by each partner in the year it is earned, even if such amounts are not actually distributed to the partners. Because a partner pays tax on income as the partnership earns it, a distribution by the partnership to the partner is treated under the recovery of capital rules.⁵⁶

Tara owns a one-half interest in the capital and profits of T & S Company (a calendar year partnership). For tax year 2015, the partnership earned revenue of \$150,000 and had operating expenses of \$80,000. During the year, Tara withdrew from her capital account \$2,500 per month (for a total of \$30,000). For 2015, Tara must report \$35,000 as her share of the partnership's profits [$\frac{1}{2} \times (\$150,000 - \$80,000)$] even though she received distributions of only \$30,000.

EXAMPLE

27

Contrary to the general provision that a corporation must pay tax on its income, a *small business corporation* may elect to be taxed similarly to a partnership. Thus, the shareholders rather than the corporation pay the tax on the corporation's income.⁵⁷ The electing corporation is referred to as an **S corporation**. The shareholders report their proportionate shares of the corporation's income and deductions for the year, regardless of whether the corporation actually makes any distributions to the shareholders.

The *beneficiaries of estates and trusts* generally are taxed on the income earned by the estates or trusts that is actually distributed or required to be distributed to them.⁵⁸ Any income not taxed to the beneficiaries is taxable to the estate or trust.

4-3e Income in Community Property States

General

State law in Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, and Wisconsin is based upon a community property system. In Alaska, spouses can choose to have the community property rules apply. All other states have a common law property system. The basic difference between common law and community property systems centers around the property rights of married persons. Questions

⁵⁶§ 706(a) and Reg. § 1.706-1(a)(1). For further discussion, see Chapter 21.

⁵⁷§ § 1361(a) and 1366. For further discussion, see Chapter 22.

⁵⁸§ § 652(a) and 662(a). For further discussion of the taxation of income from partnerships, S corporations, trusts, and estates, see Chapters 21, 22, and 28.

about community property income most frequently arise when the husband and wife file separate returns.

Under a **community property** system, all property is deemed either to be separately owned by the spouse or to belong to the marital community. Property may be held separately by a spouse if it was acquired before marriage or received by gift or inheritance following marriage. Otherwise, any property is deemed to be community property. For Federal tax purposes, each spouse is taxed on one-half of the income from property belonging to the community.

The laws of Texas, Louisiana, Wisconsin, and Idaho distinguish between separate property and the income it produces. In these states, the income from separate property belongs to the community. Accordingly, for Federal income tax purposes, each spouse is taxed on one-half of the income. In the remaining community property states, separate property produces separate income that the owner-spouse must report on his or her Federal income tax return.

What appears to be income, however, may really represent a recovery of capital. A recovery of capital and gain realized on separate property retain their identity as separate property. Items such as nontaxable stock dividends, royalties from mineral interests, and gains and losses from the sale of property take on the same classification as the assets to which they relate.

EXAMPLE

28

Bob and Jane are husband and wife who reside in California. Among other transactions during the year, the following occurred:

- Nontaxable stock dividend received by Jane on stock that was given to her by her mother after Jane's marriage.
- Gain of \$10,000 on the sale of unimproved land purchased by Bob before his marriage.
- Oil royalties of \$15,000 from a lease Jane acquired with her separate funds after marriage.

Because the stock dividend was distributed on stock held by Jane as separate property, it also is her separate property. The same result occurs for the oil royalties Jane receives. All of the proceeds from the sale of the unimproved land (including the gain of \$10,000) are Bob's separate property.

In all community property states, income from personal services (e.g., salaries, wages, and income from a professional partnership) is generally treated as if one-half is earned by each spouse.

EXAMPLE

29

Fred and Wilma are married but file separate returns. Fred received \$25,000 of salary and \$300 of taxable interest on a savings account he established in his name. All deposits to the savings account were made from Fred's salary that he earned since the marriage. Wilma collected \$2,000 taxable dividends on stock she inherited from her father. Wilma's gross income is computed as follows under three assumptions as to the state of residency of the couple:

	California	Texas	Common Law States
Dividends	\$ 2,000	\$ 1,000	\$2,000
Salary	12,500	12,500	-0-
Interest	150	150	-0-
	<u>\$14,650</u>	<u>\$13,650</u>	<u>\$2,000</u>

Note that the savings account is a community asset because it was created with community funds (i.e., Fred's salary).



TAX IN THE NEWS Tax Law and Marital Property

Before the joint return rules were enacted in 1948, married couples in community property states were treated more favorably than couples living in the other states. This result occurred because in the community property states, the couple's income was taxed as though each spouse earned one-half of their combined income, whereas in the other states, each spouse paid tax on only his or her own income. Thus, if one spouse earned most of the income, as was the case in most households, the income for the couple that did not live in a community property state would be subjected to

higher marginal tax rates than the income of an identical couple living in a community property state. In effect, half of the income in the community property states was shifted from the higher-income earner to the lower-income spouse.

Some states changed their marital property laws from a common law system to a community property system, primarily so that their residents could enjoy the Federal tax benefits of residents of community property states. In 1948, Congress enacted the joint return rules so that such state actions would be unnecessary.

Do not confuse community property with jointly owned property, as a number of differences can exist.

- Jointly owned property (i.e., tenants in common, joint tenants) is not limited to husband and wife.
- More than two owners can be involved. Thus, three brothers can be joint owners of a tract of land.

Ownership interests need not be equal. Of the three brothers who own a tract of land, one can hold a one-half interest, while each of the other two brothers owns a one-quarter interest.

Community Property Spouses Living Apart

The general rules for taxing the income from services performed by residents of community property states can create complications and even inequities for spouses who are living apart.

Mason and Lily, husband and wife, have always lived in a community property state. After a bitter argument in December 2014, Lily moves in with her parents, where she remains for all of 2015. When Lily files her separate return for 2015, must she include one-half of Mason's salary? No, if she meets the requirements set forth below.

EXAMPLE

30

Congress has developed a simple solution to this problem. A spouse (or former spouse) is taxed only on his or her actual earnings from personal services if the following conditions are met:⁵⁹

- The individuals live apart for the entire year.
- They do not file a joint return with each other.
- No portion of the earned income is transferred between the individuals.

4-4 ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

As discussed earlier, the general principles of gross income determination have occasionally yielded results that Congress found unacceptable. Thus, Congress has provided more specific rules for determining the gross income from certain sources. Some of these special rules appear in §§ 71–90 of the Code.

LO.4

Apply the Internal Revenue Code provisions on alimony, loans made at below-market interest rates, annuities, prizes and awards, group term life insurance, unemployment compensation, and Social Security benefits.

⁵⁹§ 66. See Form 8958.

4-4a **Alimony and Separate Maintenance Payments**

When a married couple divorce or become legally separated, state law generally requires a division of the property accumulated during the marriage. In addition, one spouse may have a legal obligation to support the other spouse. The Code distinguishes between the support payments (alimony or separate maintenance) and the property division in terms of the tax consequences.

Alimony and separate maintenance payments are *deductible* by the party making the payments and are *includible* in the gross income of the party receiving the payments.⁶⁰ Thus, income is shifted from the income earner to the income beneficiary, who is better able to pay the tax on the amount received.

EXAMPLE

31

Pete and Tina are divorced, and Pete is required to pay Tina \$15,000 of alimony each year. Pete earns \$61,000 a year. The tax law presumes that because Tina receives the \$15,000, she is better able than Pete to pay the tax on that amount. Therefore, Tina must include the \$15,000 in her gross income, and Pete is allowed to deduct \$15,000 from his gross income.

Property Settlements

A transfer of property *other than cash* to a former spouse under a divorce decree or agreement is not a taxable event. The transferor is not entitled to a deduction and does not recognize gain or loss on the transfer. The transferee does not recognize income and has a cost basis equal to the transferor's basis.⁶¹

EXAMPLE

32

Paul transfers stock to Rosa as part of a divorce settlement. The cost of the stock to Paul is \$12,000, and the stock's value at the time of the transfer is \$15,000. Rosa later sells the stock for \$16,000. Paul is not required to recognize gain from the transfer of the stock to Rosa, and Rosa has a realized and recognized gain of \$4,000 (\$16,000 – \$12,000) when she sells the stock.

Requirements for Alimony

To clarify whether payments are classified as support obligations (alimony) or as property of the other spouse (property settlements), Congress developed the following objective rules. Payments made under agreements and decrees are *classified as alimony* only if the following conditions are satisfied:

1. The payments are in cash. (This clearly distinguishes alimony from a property division.)
2. The agreement or decree does not specify that the payments are not alimony. (This allows the parties to determine by agreement whether the payments will be alimony.)
3. The payor and payee are not members of the same household at the time the payments are made. (This ensures the payments are for maintaining two households.)
4. There is no liability to make the payments for any period after the death of the payee.

Front-Loading

As a further safeguard against a property settlement being disguised as alimony, special rules apply if payments in the first or second year exceed \$15,000. If the change in the amount of the payments exceeds statutory limits, **alimony recapture** results to the extent of the excess alimony payments. In the *third* year, the payor must include

⁶⁰§ 71 and 215.

⁶¹§ 1041, added to the Code in 1984 to repeal the rule of *U.S. v. Davis*, 62–2 USTC ¶9509, 9 AFTR 2d 1625, 82 S.Ct. 1190 (USSC, 1962). Under the *Davis*

rule, which applied to pre-1985 divorces, a property transfer incident to divorce was a taxable event.

the excess alimony payments for the first and second years in gross income, and the payee is allowed a deduction for these excess alimony payments. The mechanics involved in computing recapture are unduly complex and beyond the scope of this text. Worksheets for computing the recapture are provided in *Divorced or Separated Individuals* (IRS Publication 504).

Child Support

A taxpayer does not realize income from the receipt of child support payments made by his or her former spouse. This result occurs because the money is received subject to the duty to use the money for the child's benefit. The payor is not allowed to deduct the child support payments because the payments are made to satisfy the payor's legal obligation to support the child.

In many cases, it may be difficult to determine whether the payments are intended to be alimony or child support. The tax law resolves this issue in many cases with the following rule: If the amount of the payments would be reduced upon the happening of a contingency related to a child (e.g., the child attains age 21 or dies), the amount of the future reduction in the payment is deemed child support.⁶² The rule is applied even though the divorce agreement specifies other amounts for the support of the child.⁶³

Under the divorce agreement, Matt is required to make periodic alimony payments of \$500 per month to Grace. However, when Matt and Grace's child reaches age 21, marries, or dies (whichever occurs first), the payments will be reduced to \$300 per month. Grace has custody of the child. Because the required contingency is the cause for the reduction in the payments, from \$500 to \$300, child support payments are \$200 per month and alimony is \$300 per month.

EXAMPLE

33

The tax rules relating to marital disputes are reviewed in Concept Summary 4.1.



Concept Summary 4.1

Tax Treatment of Payments and Transfers Pursuant to Divorce Agreements and Decrees

	Payor	Recipient
Alimony	Deduction from gross income.	Included in gross income.
Alimony recapture	Included in gross income of the third year.	Deducted from gross income of the third year.
Child support	Not deductible.	Not includible in gross income.
Property settlement	No income or deduction.	No income or deduction; basis for the property is the same as the transferor's basis.

4-4b Imputed Interest on Below-Market Loans

As discussed earlier in the chapter, generally no income is recognized unless it is realized. Realization usually occurs when the taxpayer performs services or sells goods, thus becoming entitled to a payment from the other party. It follows that no income is realized if the goods or services are provided at no charge (i.e., not in exchange for property or services). Under this interpretation of the realization requirement, before 1984, interest-free loans were used to shift income between taxpayers.

⁶²§ 71(c)(2).

⁶³*Johnson v. Commissioner*, T.C.Memo. 2014-67.

EXAMPLE

34

Kareem (father) is in the 50% marginal tax bracket, and Veneia (daughter) is in the 20% marginal tax bracket. Kareem has \$400,000 that he does not need, and Veneia could use the income from Kareem's excess cash. Before 1984, Kareem could transfer the cash to Veneia in exchange for a non-interest bearing demand note. Veneia could invest the cash and income that would be taxed at her 20% tax rate. Thus, the income that Kareem could have earned and that could be taxed at 50% became Veneia's income taxed at 20%. Furthermore, Kareem retained control over the principal because he could demand payment on the note at any time.

Kareem in Example 34 is required to recognize **imputed interest** income.⁶⁴ Veneia is deemed to have incurred interest expense equal to Kareem's imputed interest income. Veneia's interest may be deductible on her return as investment interest if she itemizes deductions (see Chapters 10 and 11). In addition, Kareem is then deemed to have given Veneia the amount of the imputed interest she did not pay. The gift received by Veneia is not subject to income tax (see Chapter 5), although Kareem may be subject to the gift tax on the amount deemed given to Veneia (refer to Chapters 1 and 27).

Imputed interest is calculated using the rate the Federal government pays on new borrowings and is compounded semiannually. This Federal rate is adjusted monthly and is published by the IRS.⁶⁵ There are three Federal rates: short-term (not over three years and including demand loans), mid-term (over three years but not over nine years), and long-term (over nine years).⁶⁶

EXAMPLE

35

Assume that the Federal rate applicable to the loan in Example 34 is 3.5% through June 30 and 4% from July 1 through December 31. Kareem made the loan on January 1, and the loan is still outstanding on December 31. Kareem must recognize interest income of \$15,140, and Veneia has interest expense of \$15,140. Kareem is deemed to have made a gift of \$15,140 to Veneia.

Imputed interest calculations:

January 1–June 30—.035(\$400,000) ($\frac{1}{2}$ year)	\$ 7,000
July 1–December 31—.04(\$400,000 + \$7,000) ($\frac{1}{2}$ year)	<u>8,140</u>
	<u>\$15,140</u>

If interest is charged on the loan, but is less than the Federal rate, the imputed interest is the difference between the amount that would have been charged at the Federal rate and the amount actually charged.

EXAMPLE

36

Assume the same facts as in Example 35, except that Kareem charged 3% interest, compounded annually.

Interest at the Federal rate	\$ 15,140
Less interest charged (.03 × \$400,000)	<u>(12,000)</u>
Imputed interest	<u>\$ 3,140</u>

The imputed interest rules apply to the following *types* of below-market loans:⁶⁷

1. Gift loans (made out of love, affection, or generosity, as in Example 34).
2. Compensation-related loans (employer loans to employees).
3. Corporation-shareholder loans (a corporation's loans to its shareholders).

The effects of these loans on the borrower and lender are summarized in Concept Summary 4.2.

⁶⁴§ 7872(a)(1).

⁶⁵§ 7872(b)(2) and (f)(2).

⁶⁶§ 1274(d).

⁶⁷§ 7872(c).

Concept Summary 4.2

Effect of Certain Below-Market Loans on the Lender and Borrower

Type of Loan	Lender	Borrower
Gift	Interest income	Interest expense
	Gift made	Gift received
Compensation-related	Interest income	Interest expense
	Compensation expense	Compensation income
Corporation to shareholder	Interest income	Interest expense
	Dividend paid	Dividend income

Exceptions and Limitations

No interest is imputed on total outstanding *gift loans* of \$10,000 or less between individuals, unless the loan proceeds are used to purchase income-producing property.⁶⁸ This exemption eliminates immaterial amounts that do not result in apparent shifts of income. However, if the proceeds of such a loan are used to purchase income-producing property, the limitations discussed in the following paragraphs apply instead.

On loans of \$100,000 or less between individuals, the imputed interest cannot exceed the borrower's net investment income for the year (gross income from all investments less the related expenses).⁶⁹ Thus, the income imputed to the lender is limited to the borrower's net investment income. In addition, if the borrower's net investment income for the year does not exceed \$1,000, no interest is imputed on loans of \$100,000 or less. However, these limitations for loans of \$100,000 or less do not apply if a principal purpose of a loan is tax avoidance.⁷⁰

Vicki made interest-free gift loans as follows:

Borrower	Amount	Borrower's Net Investment Income	Purpose
Susan	\$ 8,000	\$ -0-	Education
Dan	9,000	500	Purchase of stock
Bonnie	25,000	-0-	Purchase of a business
Megan	90,000	15,000	Purchase of a residence
Olaf	120,000	-0-	Purchase of a residence

Assume that tax avoidance is not a principal purpose of any of the loans. The loan to Susan is not subject to the imputed interest rules because the \$10,000 exception applies. The \$10,000 exception does not apply to the loan to Dan because the proceeds were used to purchase income-producing assets. However, under the \$100,000 exception, the imputed interest is limited to Dan's investment income (\$500). Because the \$1,000 exception also applies to this loan, no interest is imputed.

No interest is imputed on the loan to Bonnie because the \$100,000 exception applies. Interest is imputed on the loan to Megan based on the lesser of (1) the borrower's \$15,000 net investment income or (2) the interest as calculated by applying the Federal rate to the outstanding loan. None of the exceptions apply to the loan to Olaf because the loan was for more than \$100,000.

continued

EXAMPLE

37

⁶⁸§ 7872(c)(2).

⁶⁹§ 7872(d).

⁷⁰*Deficit Reduction Tax Bill of 1984: Explanation of the Senate Finance Committee* (April 2, 1984), p. 484.

Assume that the relevant Federal rate is 10% and that the loans were outstanding for the entire year. Vicki would recognize interest income, compounded semiannually, as follows:

Loan to Megan:	
First 6 months ($.10 \times \$90,000 \times \frac{1}{2}$ year)	\$ 4,500
Second 6 months ($.10 \times \$94,500 \times \frac{1}{2}$ year)	<u>4,725</u>
	<u>\$ 9,225</u>
Loan to Olaf:	
First 6 months ($.10 \times \$120,000 \times \frac{1}{2}$ year)	\$ 6,000
Second 6 months ($.10 \times \$126,000 \times \frac{1}{2}$ year)	<u>6,300</u>
	<u>\$12,300</u>
Total imputed interest ($\$9,225 + \$12,300$)	<u>\$21,525</u>

As with gift loans, there is a \$10,000 exemption for *compensation-related loans* and *corporation-shareholder loans*. However, the \$10,000 exemption does not apply if tax avoidance is one of the principal purposes of a loan.⁷¹ This vague tax avoidance standard makes practically all compensation-related and corporation-shareholder loans suspect. Nevertheless, the \$10,000 exemption should apply when an employee's borrowing was necessitated by personal needs (e.g., to meet unexpected expenses) rather than tax considerations.

These exceptions to the imputed interest rules are summarized in Concept Summary 4.3.

Concept Summary 4.3

Exceptions to the Imputed Interest Rules for Below-Market Loans

Exception	Eligible Loans	Ineligible Loans and Limitations
<i>De minimis</i> —aggregate loans of \$10,000 or less	Gift loans	Proceeds are used to purchase income-producing assets.
	Employer-employee	Principal purpose is tax avoidance.
	Corporation-shareholder	Principal purpose is tax avoidance.
Aggregate loans of \$100,000 or less	Between individuals	Principal purpose is tax avoidance. For all other loans, interest is imputed to the extent of the borrower's net investment income if that income exceeds \$1,000.

ETHICS & EQUITY Taxing "Made-Up" Income

Under the imputed interest rules, the taxpayer who makes a below-market loan may be required to recognize income he or she did not actually receive. For example, assume that Christian loans \$200,000 to Mia, his daughter, to start a business (income-producing property).

Christian does not charge interest because Mia needs the funds to operate a struggling startup business. Why should Christian be required to pay tax on a "made-up" number (i.e., the interest he did not charge)? This type of income is sometimes referred to as "phantom" income.

⁷¹§ 7872(c)(3).

4-4c Income from Annuities

Annuity contracts generally require the purchaser (the annuitant) to pay a fixed amount for the right to receive a future stream of payments. Typically, the issuer of the contract is an insurance company and will pay the annuitant a cash value if the annuitant cancels the contract. The insurance company invests the amounts received from the annuitant, and the income earned serves to increase the cash value of the annuity. No income is recognized by the annuitant at the time the cash value of the annuity increases because the taxpayer has not actually received any income. The income is not constructively received because, generally, the taxpayer must cancel the policy to receive the increase in value (the increase in value is subject to substantial restrictions).

Jean, age 50, pays \$30,000 for an annuity contract that is to pay her \$500 per month beginning when she reaches age 65 and continuing until her death. If Jean should cancel the policy after one year, she would receive \$30,200 and would include \$200 (\$30,200 – \$30,000) in her gross income. However, if she does not cancel the policy, the \$200 increase in value is not includible in her gross income, as long as she does not actually receive the \$200.

EXAMPLE

38

The tax accounting problem associated with receiving payments under an annuity contract is one of apportioning the amounts received between recovery of capital and income. The statutory solution to this problem depends upon whether the payments began before or after the annuity starting date and upon when the policy was acquired.

Computing the Exclusion Amount

The annuitant can exclude from income (as a recovery of capital) the proportion of each payment that the investment in the contract bears to the expected return under the contract. The *exclusion amount* is calculated as follows:

$$\frac{\text{Investment}}{\text{Expected return}} \times \text{Annuity payment} = \text{Exclusion amount}$$

The *expected return* is the annual amount to be paid to the annuitant multiplied by the number of years the payments will be received. The payment period may be fixed (a *term certain*) or for the life of one or more individuals. When payments are for life, the taxpayer generally must use the annuity table published by the IRS to determine the expected return (see Exhibit 4.1). This is an actuarial table that contains life expectancies.⁷² The expected return is calculated by multiplying the appropriate multiple (life expectancy) by the annual payment.

A taxpayer, age 60, purchases an annuity from an insurance company for \$90,000. She is to receive \$500 per month for life. Her life expectancy (from Exhibit 4.1) is 24.2 years from the annuity starting date. Thus, her expected return is $\$500 \times 12 \times 24.2 = \$145,200$, and the exclusion amount is \$3,719 [$(\$90,000 \text{ investment} / \$145,200 \text{ expected return}) \times \$6,000 \text{ annual payment}$]. The \$3,719 is a nontaxable return of capital, and \$2,281 ($\$6,000 - \$3,719$) is included in gross income.

EXAMPLE

39

The *exclusion ratio* (investment \div expected return) applies until the annuitant has recovered his or her investment in the contract. Once the investment is recovered, the entire amount of subsequent payments is taxable. If the annuitant dies before recovering the investment, the unrecovered cost (adjusted basis) is deductible in the year the payments cease (usually the year of death).⁷³

⁷²The life expectancies in Exhibit 4.1 apply for annuity investments made on or after July 1, 1986. See *General Rules for Pensions and Annuities*, IRS Publication 939 (Rev. April 2003), p. 25. See also *Pension and Annuity Income*, IRS Publication 575.

⁷³§ 72(b).

EXHIBIT 4.1

Ordinary Life Annuities: One Life—Expected Return Multiples

Age	Multiple	Age	Multiple	Age	Multiple
5	76.6	42	40.6	79	10.0
6	75.6	43	39.6	80	9.5
7	74.7	44	38.7	81	8.9
8	73.7	45	37.7	82	8.4
9	72.7	46	36.8	83	7.9
10	71.7	47	35.9	84	7.4
11	70.7	48	34.9	85	6.9
12	69.7	49	34.0	86	6.5
13	68.8	50	33.1	87	6.1
14	67.8	51	32.2	88	5.7
15	66.8	52	31.3	89	5.3
16	65.8	53	30.4	90	5.0
17	64.8	54	29.5	91	4.7
18	63.9	55	28.6	92	4.4
19	62.9	56	27.7	93	4.1
20	61.9	57	26.8	94	3.9
21	60.9	58	25.9	95	3.7
22	59.9	59	25.0	96	3.4
23	59.0	60	24.2	97	3.2
24	58.0	61	23.3	98	3.0
25	57.0	62	22.5	99	2.8
26	56.0	63	21.6	100	2.7
27	55.1	64	20.8	101	2.5
28	54.1	65	20.0	102	2.3
29	53.1	66	19.2	103	2.1
30	52.2	67	18.4	104	1.9
31	51.2	68	17.6	105	1.8
32	50.2	69	16.8	106	1.6
33	49.3	70	16.0	107	1.4
34	48.3	71	15.3	108	1.3
35	47.3	72	14.6	109	1.1
36	46.4	73	13.9	110	1.0
37	45.4	74	13.2	111	.9
38	44.4	75	12.5	112	.8
39	43.5	76	11.9	113	.7
40	42.5	77	11.2	114	.6
41	41.5	78	10.6	115	.5

EXAMPLE

40

Assume that the taxpayer in Example 39 receives annuity payments for 25.2 years (302 months). For the last 12 months [$302 - (12 \times 24.2) = 12$], the taxpayer will include \$500 each month in gross income. If instead the taxpayer dies after 36 months, she is eligible for a \$78,843 deduction on her final tax return.

Cost of the contract	\$ 90,000
Cost previously recovered $\$90,000/\$145,200 \times 36(\$500) =$	<u>(11,157)</u>
Deduction	<u>\$ 78,843</u>

Simplified Method for Annuity Distributions from Qualified Retirement Plans

A simplified method is required for allocating basis to the annuity payments received under a qualified retirement plan. The portion of each annuity payment that is excluded as a return of capital is the employee's investment in the contract divided by the number of anticipated monthly payments determined in accordance with Exhibit 4.2.⁷⁴

Andrea, age 62, receives an annuity distribution of \$500 per month for life from her qualified retirement plan beginning in January 2015. Her investment in the contract is \$100,100. The excludable amount of each payment is \$385 (\$100,100 investment/260 monthly payments). Thus, \$115 (\$500 – \$385) of each annuity payment is included in Andrea's gross income.

EXAMPLE

41

The rules for annuity payments received after the basis has been recovered by the annuitant and for the annuitant who dies before the basis is recovered are the same as under the exclusion ratio method discussed earlier.

4-4d Prizes and Awards

The fair market value of prizes and awards (other than scholarships exempted under § 117, to be discussed subsequently) must be included in gross income.⁷⁵ Therefore, TV giveaway prizes, magazine publisher prizes, door prizes, and awards from an employer to an employee in recognition of performance are fully taxable to the recipient.

A narrow exception permits a prize or an award to be excluded from gross income if *all* of the following requirements are satisfied:

- The prize or award is received in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement (e.g., Nobel Prize, Pulitzer Prize, or faculty teaching award).
- The recipient transfers the prize or award to a qualified governmental unit or non-profit organization.
- The recipient was selected without any action on his or her part to enter the contest or proceeding.
- The recipient is not required to render substantial future services as a condition for receiving the prize or award.⁷⁶

Because the transfer of the property to a qualified governmental unit or nonprofit organization ordinarily would be a charitable contribution (an itemized deduction as

EXHIBIT 4.2

Number of Anticipated Monthly Annuity Payments under the Simplified Method

Age	Number of Anticipated Monthly Payments
55 and under	360
56–60	310
61–65	260
66–70	210
71 and over	160

⁷⁴§ 72(d).

⁷⁵§ 74.

⁷⁶§ 74(b).

presented in Chapter 10), the exclusion produces beneficial tax consequences in the following situations:

- The taxpayer does not itemize deductions and thus would receive no tax benefit from the charitable contribution.
- The taxpayer's charitable contributions exceed the annual statutory ceiling on the deduction.
- Including the prize or award in gross income would reduce the amount of deductions the taxpayer otherwise would qualify for because of gross income limitations (e.g., the gross income test for a dependency exemption or the adjusted gross income limitation in calculating the medical expense deduction).

The taxpayer can avoid including prizes and awards in gross income by refusing to accept the prize or award.⁷⁷

Another exception is provided for certain *employee achievement awards* in the form of tangible personal property (e.g., a gold watch). The awards must be made in recognition of length of service or safety achievement. Generally, the ceiling on the excludible amount for an employee is \$400 per taxable year. However, if the award is a qualified plan award, the ceiling on the exclusion is \$1,600 per taxable year.⁷⁸

4-4e Group Term Life Insurance

For many years, the IRS did not attempt to tax the value of life insurance protection provided to an employee by the employer. Some companies took undue advantage of the exclusion by providing large amounts of insurance protection for executives. Therefore, Congress enacted § 79, which created a limited exclusion for **group term life insurance**. The premiums on the first \$50,000 of group term life insurance protection are excludible from the employee's gross income.

The benefits of this exclusion are available only to employees. Proprietors and partners are not considered employees. The Regulations generally require broad-scale coverage of employees to satisfy the *group* requirement (e.g., shareholder-employees would not constitute a qualified group). The exclusion applies only to term insurance (protection for a period of time but with no cash surrender value) and not to ordinary life insurance (lifetime protection plus a cash surrender value that can be drawn upon before death).

As mentioned, the exclusion applies to the first \$50,000 of group term life insurance protection. For each \$1,000 of coverage in excess of \$50,000, the employee must include the amounts indicated in Exhibit 4.3 in gross income.⁷⁹

EXAMPLE

42

Finch Corporation has a group term life insurance policy with coverage equal to the employee's annual salary. Keith, age 52, is president of the corporation and receives an annual salary of \$350,000. Keith must include \$828 in gross income from the insurance protection for the year.

$$\frac{\$350,000 - \$50,000}{\$1,000} \times \$23 \times 12 \text{ months} = \$828$$

Generally, the amount that must be included in gross income, computed from Exhibit 4.3, is much less than the price an individual would pay an insurance company for the same amount of protection. Thus, even the excess coverage provides some tax-favored income for employees when group term life insurance coverage in excess of \$50,000 is desirable.

If the plan discriminates in favor of certain key employees (e.g., officers), the key employees are not eligible for the exclusion. In such a case, the key employees must include in gross income the *greater* of actual premiums paid by the employer or the amount calculated from the Uniform Premiums in Exhibit 4.3. The other employees are still eligible for the \$50,000 exclusion and continue to use the Uniform Premiums table to compute the income from excess insurance protection.⁸⁰

⁷⁷See Rev.Rul. 57-374, 1957-2 C.B. 69 and Rev.Proc. 87-54, 1987-2 C.B. 669.

⁷⁸§ 74(c). Qualified plan awards are defined in § 274(j) and explained in *Business Expenses*, Chapter 2 (IRS Publication 535).

⁷⁹Reg. § 1.79-3(d)(2).

⁸⁰§ 79(d).

EXHIBIT 4.3

Uniform Premiums for \$1,000 of Group Term Life Insurance Protection

Attained Age on Last Day of Employee's Tax Year	Cost per \$1,000 of Protection for One-Month Period*
Under 25	\$.05
25–29	.06
30–34	.08
35–39	.09
40–44	.10
45–49	.15
50–54	.23
55–59	.43
60–64	.66
65–69	1.27
70 and above	2.06

*Reg. § 1.79–3, effective for coverage after June 30, 1999.

4-4f Unemployment Compensation

The unemployment compensation program is sponsored and operated by the states and Federal government to provide a source of income for people who have been employed and are temporarily (hopefully) out of work. In a series of rulings over a period of 40 years, the IRS exempted unemployment benefits from tax. These payments were considered social benefit programs for the promotion of the general welfare. After experiencing dissatisfaction with the IRS's treatment of unemployment compensation, Congress amended the Code to make the benefits taxable.⁸¹

4-4g Social Security Benefits

If a taxpayer's income exceeds a specified base amount, as much as 85 percent of Social Security retirement benefits must be included in gross income. The taxable amount of benefits is determined through the application of one of two formulas that utilize a unique measure of income—*modified adjusted gross income (MAGI)*.⁸² MAGI is, for this purpose, the taxpayer's adjusted gross income from all sources (other than Social Security) plus the foreign earned income exclusion and any tax-exempt interest income.

In the formulas, two sets of base amounts are established. The first set is as follows:

- \$32,000 for married taxpayers who file a joint return.
- \$0 for married taxpayers who do not live apart for the entire year but file separate returns.
- \$25,000 for all other taxpayers.

The second set of base amounts is as follows:

- \$44,000 for married taxpayers who file a joint return.
- \$0 for married taxpayers who do not live apart for the entire year but file separate returns.
- \$34,000 for all other taxpayers.

⁸¹§ 85.

⁸²§ 86. The rationale for taxing 85% of the Social Security benefits is as follows: For the average Social Security recipient, 15% of the amount received

is a recovery of amounts that the individual paid into the program, and the remainder of the benefits is financed by the employer's contribution and interest earned by the Social Security trust fund.



TAX IN THE NEWS Social Security Benefits as a Source of Federal Revenue

Recipients' Social Security benefits are indexed for inflation, but the base amounts used in the formula to calculate the taxable portion of the benefits are not indexed. The \$25,000 and \$32,000 base amounts were established in 1984. If they

were indexed for inflation, these nontaxable amounts would have doubled by 2010. Thus, as income and Social Security benefits rise with inflation, taxable income increases more than the related increase in "real" benefits.

If MAGI plus one-half of Social Security benefits exceeds the first set of base amounts but not the second set, the taxable amount of Social Security benefits is the *lesser* of the following:

- $.50(\text{Social Security benefits})$.
- $.50[\text{MAGI} + .50(\text{Social Security benefits}) - \text{first base amount}]$.

EXAMPLE

43

A married couple with adjusted gross income of \$30,000, no tax-exempt interest, and \$11,000 of Social Security benefits who file jointly must include \$1,750 of the benefits in gross income. This works out as the lesser of the following:

1. $.50(\$11,000) = \$5,500$.
2. $.50[\$30,000 + .50(\$11,000) - \$32,000] = .50(\$3,500) = \$1,750$.

If instead the couple had adjusted gross income of \$15,000 and their Social Security benefits totaled \$5,000, none of the benefits would be taxable because $.50[\$15,000 + .50(\$5,000) - \$32,000]$ is not a positive number.

If MAGI plus one-half of Social Security benefits exceeds the second set of base amounts, the taxable amount of Social Security benefits is the *lesser* of 1 or 2 below:

1. $.85(\text{Social Security benefits})$.
2. Sum of:
 - a. $.85[\text{MAGI} + .50(\text{Social Security benefits}) - \text{second base amount}]$, and
 - b. Lesser of:
 - Amount included through application of the first formula.
 - \$4,500 (\$6,000 for married filing jointly).

EXAMPLE

44

A married couple who file jointly have adjusted gross income of \$72,000, no tax-exempt interest, and \$12,000 of Social Security benefits. Their includible Social Security benefits will be \$10,200.

Include the lesser of the following:

1. $.85(\$12,000) = \$10,200$.
2. Sum of:
 - a. $.85[\$72,000 + .50(\$12,000) - \$44,000] = \$28,900$, and
 - b. Lesser of:
 - Amount calculated by the first formula, which is the lesser of:
 - $.50(\$12,000) = \$6,000$.
 - $.50[\$72,000 + .50(\$12,000) - \$32,000] = \$23,000$.
 - \$6,000.

The sum equals \$34,900 ($\$28,900 + \$6,000$).

Because 85% of the Social Security benefits received is less than this amount, \$10,200 is included in the couple's gross income.⁸³

⁸³To compute taxable benefits, a worksheet is provided in the instructions to Form 1040 at lines 20a and 20b and to Form 1040A at lines 14a and 14b, as

well as in *Social Security and Railroad Retirement Benefits* (IRS Publication 915).

4-5 TAX PLANNING

The materials in this chapter have focused on the following questions:

- What is income?
- When is the income recognized?
- Who is the taxpayer?

Planning strategies suggested by these materials include the following:

- Maximize economic benefits that are not included in gross income.
- Defer the recognition of income.
- Shift income to taxpayers who are in a lower marginal tax bracket.

Some specific techniques for accomplishing these strategies are discussed in the following paragraphs.

4-5a Tax Deferral

General

Because deferred taxes are tantamount to interest-free loans from the government, the deferral of taxes is a worthy goal of the tax planner. However, the tax planner must also consider the tax rates for the years the income is shifted from and to. For example, a one-year deferral of income from a year in which the taxpayer's tax rate was 28 percent to a year in which the tax rate will be 35 percent would not be advisable if the taxpayer expects to earn less than a 7 percent after-tax return on the deferred tax dollars.

The taxpayer can often defer the recognition of income from appreciated property by postponing the event triggering realization (the final closing on a sale or exchange of property). If the taxpayer needs cash, obtaining a loan by using the appreciated property as collateral may be a less costly alternative than selling the property.

Ira owns 100 shares of Pigeon Company common stock with a cost of \$20,000 and a fair market value of \$50,000. Although the stock's value has increased substantially in the past three years, Ira thinks the growth days are over. If he sells the Pigeon stock, Ira will invest the proceeds from the sale in other common stock. Assuming that Ira's marginal tax rate on the sale is 15%, he will have only \$45,500 [$\$50,000 - .15(\$50,000 - \$20,000)$] to reinvest. The alternative investment must substantially outperform Pigeon in the future for the sale to be beneficial.

EXAMPLE

45

Selection of Investments

Because no tax is due until a gain has been recognized, the law favors investments that yield appreciation rather than annual income.

Vera can buy a corporate bond or an acre of land for \$10,000. The bond pays \$1,000 of interest (10%) each year, and Vera expects the land to increase in value 10% each year for the next 10 years. She is in the 40% (combined Federal and state) tax bracket for ordinary income and 26% for qualifying capital gains. Assuming that the bond would mature or the land would be sold in 10 years and Vera would reinvest the interest at a 10% before-tax return, she would accumulate the following amount at the end of 10 years:

EXAMPLE

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continued

LO.5

Identify tax planning strategies for minimizing gross income.

		Bond	Land
Original investment		\$10,000	\$10,000
Annual income	\$ 1,000		
Less tax	(400)		
	<u>\$ 600</u>		
Compound amount reinvested for 10 years at 6% after-tax	<u>×13.18</u>	<u>7,908</u>	
		<u>\$17,908</u>	
Compound amount, 10 years at 10%			× 2.59
			<u>\$25,900</u>
Less tax on sale:			
26%(\$25,900 – \$10,000)			(4,134)
			<u>\$21,766</u>

Therefore, the value of the deferral that results from investing in the land rather than in the bond is \$3,858 (\$21,766 – \$17,908).

Series EE bonds can also be purchased for long-term deferrals of income. In situations where the taxpayer's goal is merely to shift income one year into the future, bank certificates of deposit are useful tools. If the maturity period is one year or less, all interest is reported in the year of maturity. Bank certificates of deposit are especially useful for a taxpayer who realizes an unusually large gain from the sale of property in one year (and thus is in a high tax bracket) but expects his or her gross income to be less the following year.

Cash Basis

The timing of income from services can often be controlled through the use of the cash method of accounting. Although taxpayers are somewhat constrained by the constructive receipt doctrine (they cannot turn their backs on income), seldom will customers and clients offer to pay before they are asked. The usual lag between billings and collections (e.g., December's billings collected in January) will result in a continuous deferring of some income until the last year of operations. A salaried individual approaching retirement may contract with the employer before the services are rendered to receive a portion of compensation in the lower tax bracket retirement years.

Prepaid Income

For the accrual basis taxpayer who receives advance payments from customers, the transactions should be structured to avoid payment of tax on income before the time the income is actually earned. Revenue Procedure 2004-34 provides the guidelines for deferring the tax on prepayments for services, and Regulation § 1.451-5 provides the guidelines for deferrals on sales of goods. In addition, both cash and accrual basis taxpayers can sometimes defer income by stipulating that the payments are deposits rather than prepaid income. For example, a landlord should require an equivalent damage deposit rather than prepayment of the last month's rent under the lease. Of course, the arrangement must meet the definition of a deposit for Federal tax purposes.⁸⁴

⁸⁴See *Commissioner v. Indianapolis Power and Light*, 494 U.S. 203 (1990).

4-5b Reporting Conflicts

The IRS relies upon businesses to report the amounts they paid to individuals for services. Employees receive a Form W-2, and independent contractors receive a Form 1099-MISC. The IRS attempts to match the forms they receive to the individual's income tax return. If the form submitted by the business and the individual's tax return are not in agreement, the individual has a problem, but innocent differences can occur.

Dr. Anders, a college professor on a cash basis, performs consulting services for Dove Corporation in early December 2015. In late December, Dove mailed a check in payment, but Anders did not receive the check until early January 2016. Dove sent Anders a Form 1099-MISC showing the payment date as 2015. If Anders did not report the income on his 2015 return, he could have a problem. Dr. Anders should attach a note to his tax return explaining the discrepancy.

EXAMPLE

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4-5c Shifting Income to Relatives

The tax liability of a family can be minimized by shifting income from higher- to lower-bracket family members. This can be accomplished through gifts of income-producing property. Furthermore, in many cases, income can be shifted with no negative effect on the family's investment plans.

Adam, who is in the 28% tax bracket, would like to save for his children's education. All of the children are under 19 years of age and are dependents of Adam. Adam could transfer income-producing properties to the children, and the children could each receive up to \$1,000 of income each year (refer to Chapter 3) with no tax liability. The next \$1,000 would be taxed at the child's tax rate. After a child has more than \$2,000 of unearned income, there is no tax advantage to shifting more income to the child (because the income will be taxed at the parents' rate) until the child is 19 years old (or age 24 if a full-time student), when all income will be taxed according to the child's tax rate.

EXAMPLE

48

The Uniform Gifts to Minors Act, a model law adopted by all states (but with some variations among the states), facilitates income shifting. Under the Act, a gift of intangibles (e.g., bank accounts, stocks, bonds, and life insurance contracts) can be made to a minor but with an adult serving as custodian. Usually, a parent who makes the gift is also named as custodian. The state laws allow the custodian to sell or redeem and reinvest the principal and to accumulate or distribute the income, practically at the custodian's discretion provided there is no commingling of the child's income with the parent's property. Thus, the parent can give appreciated securities to the child, and the donor custodian can then sell the securities and reinvest the proceeds, thereby shifting both the gain and the annual income to the child. Such planning is limited by the tax liability calculation provision for a child under the age of 19 (or age 24 if a full-time student) (refer to Chapter 3).

U.S. government bonds (Series EE) can be purchased by parents for their children. When this is done, the children generally should file a return and elect to report the income on the accrual basis.

Abby pays \$7,500 for Series EE bonds in 2015 and immediately gives them to Wade (her son), who will enter college the year of original maturity of the bonds. The bonds have a maturity value of \$10,000. Wade elects to report the annual increment in redemption value as income for each year the bonds are held. The first year the increase is \$250, and Wade includes that amount in his gross income. If Wade has no other income, no tax will be due on the \$250 bond interest because such an amount will be more than offset by his available standard deduction. The following year, the increment is \$260, and Wade includes this amount in income. Thus, over the life of the bonds, Wade will include \$2,500 in income (\$10,000 - \$7,500), none of which will result in a tax liability, assuming that he has no other income. However, if the election had not been made, Wade would have been required to include \$2,500 in income on the bonds in the year of original maturity, if they had been redeemed as planned. This amount of income might result in a tax liability.

EXAMPLE

49

In some cases, it may be advantageous for the child not to make the accrual election. For example, a child under age 19 (or age 24 if a full-time student) with investment income of more than \$2,000 each year and parents in the 25, 28, 33, 35, or 39.6 percent tax bracket would probably benefit from deferring the tax on the savings bond interest. The child would also benefit from the use of the usually lower tax rate (rather than subjecting the income to the parents' tax rate) if the bonds mature after the child is age 19 or older (or age 24 or older if a full-time student).

4-5d Accounting for Community Property

The classification of income as community or separate property becomes important when either of two events occurs:

- Husband and wife, married taxpayers, file separate income tax returns for the year.
- Husband and wife obtain a divorce and therefore have to file separate returns for the year (refer to Chapter 3).

For planning purposes, it behooves married persons to keep track of the source of income (community or separate). To be in a position to do this effectively when income-producing assets are involved, it may be necessary to distinguish between separate and community property.⁸⁵

4-5e Alimony

The person making the alimony payments favors a divorce settlement that includes a provision for deductible alimony payments. On the other hand, the recipient prefers that the payments not qualify as alimony. If the payor is in a higher tax bracket than the recipient, both parties may benefit by increasing the payments and structuring them so that they qualify as alimony.

EXAMPLE

50

Carl and Polly are negotiating a divorce settlement. Carl has offered to pay Polly \$10,000 each year for 10 years, but payments would cease upon Polly's death. Polly is willing to accept the offer if the agreement will specify that the cash payments are not alimony. Carl is in the 35% tax bracket, and Polly's marginal rate is 15%.

If Carl and Polly agree that Carl will pay Polly \$12,000 of alimony each year, both will have improved after-tax cash flows.

	Annual Cash Flows	
	Carl	Polly
Nonalimony payments	<u>(\$10,000)</u>	<u>\$10,000</u>
Alimony payments	(\$12,000)	\$12,000
Tax effects		
Tax saving [.35(\$12,000)]	4,200	
Tax cost [.15(\$12,000)]		(1,800)
After-tax cash flows	<u>(\$ 7,800)</u>	<u>\$10,200</u>
Benefit of alimony option	<u>\$ 2,200</u>	<u>\$ 200</u>

Both parties benefit at the government's expense if the \$12,000 alimony option is used.

⁸⁵Being able to distinguish between separate and community property is crucial to the determination of a property settlement incident to a divorce. It also is vital in the estate tax area (refer to Chapters 1 and 27) because the

surviving wife's or husband's share of the community property is not included in the gross estate of the deceased spouse.

REFOCUS ON THE BIG PICTURE

CALCULATION OF GROSS INCOME

Using the accrual method of accounting, Dr. Cliff Payne has correctly calculated the gross income of his sole proprietorship. He will report the \$385,000 amount on his tax return (Schedule C of Form 1040).

What If?

From a tax planning perspective, what can Dr. Payne do to decrease his gross income from the first year of operating his dental practice and thereby produce better financial results for him?

Rather than adopt the accrual method of accounting, Dr. Payne should adopt the cash method of accounting because his dental practice is a service entity rather than a merchandising entity. His gross income for Federal income tax purposes under the cash method is calculated as follows:

Revenues	\$385,000
Plus: Accounts receivable: January 1	-0-
Less: Accounts receivable: December 31	(52,000)
Gross income	<u>\$333,000</u>

The cash method of accounting enables Dr. Payne to defer paying Federal income taxes on the unpaid accounts receivable. Furthermore, each year that Dr. Payne has accounts receivable at the end of the tax year, that income is continuously deferred. Thus, if his accounts receivable remain at \$52,000 at the end of each tax year, by using the cash method of accounting rather than the accrual method, he will defer that amount of income until he terminates his practice.



BOB D'AMICO/PHOTODISC

Key Terms

Accounting income, 4-4	Claim of right doctrine, 4-8	Imputed interest, 4-22
Accounting method, 4-6	Community property, 4-18	Income, 4-3
Accrual method, 4-7	Constructive receipt, 4-9	Original issue discount, 4-10
Alimony and separate maintenance payments, 4-20	Economic income, 4-3	Partnership, 4-16
Alimony recapture, 4-20	Fruit and tree metaphor, 4-13	Recovery of capital doctrine, 4-3
Annuity, 4-25	Gross income, 4-2	S corporation, 4-17
Assignment of income, 4-13	Group term life insurance, 4-28	Taxable year, 4-6
Cash receipts method, 4-7	Hybrid method, 4-8	

Discussion Questions

- LO.1** According to the Supreme Court, would it be good tax policy to use income as computed by financial accounting principles as the correct measure of income for Federal income tax purposes? Explain.
- LO.1** Compare and contrast the economist's concept used to recognize income with the concept employed in measuring taxable income.

- Issue ID** 3. **LO.1** Allen visits Reno, Nevada, once a year to gamble. This year his gambling loss was \$25,000. He commented to you, “At least I didn’t have to pay for my airfare and hotel room. The casino paid that because I am such a good customer. That was worth at least \$3,000.” What are the relevant tax issues for Allen?
4. **LO.1** Ben lost his job when his employer moved its plant. During the year, he collected unemployment benefits for three months, a total of \$1,800. While he was waiting to hear from prospective employers, he painted his house. If Ben had paid someone else to paint his house, the cost would have been \$3,000. The cost of the paint Ben used was \$800. What is Ben’s gross income for tax purposes from the above events?
- Issue ID** 5. **LO.1** Howard buys wrecked cars and stores them on his property. Recently, he purchased a 1990 Ford Taurus for \$400. If he can sell all of the usable parts, his total proceeds from the Taurus will be over \$2,500. As of the end of the year, he has sold only the radio for \$75 and he does not know how many, if any, of the remaining parts will ever be sold. What are Howard’s income recognition issues?
6. **LO.2, 3** On December 29, 2015, an employee received a \$5,000 check from her employer’s client. The check was payable to the employer. The employee did not remit the funds to the employer until December 30, 2015. The employer deposited the check on December 31, 2015, but the bank did not credit the employer’s bank account until January 2, 2016. When is the cash basis employer required to include the \$5,000 in gross income?
7. **LO.2** What is the purpose of the constructive receipt doctrine?
8. **LO.2** A Series EE U.S. government savings bond accrues 3.5% interest each year. The bond matures in three years, at which time the principal and interest will be paid. The bank will pay the taxpayer at a 3.5% interest rate each year if he agrees to leave money on deposit for three years. What tax advantage does the Series EE bond offer that is not available with the bank deposit?
9. **LO.2** The taxpayer performs services with payment due from the customer within 30 days. All customers pay within the time limit. What would be the benefit to the taxpayer using the cash method of accounting rather than the accrual method?
10. **LO.3, 5** Wade paid \$7,000 for an automobile that needed substantial repairs. He worked nights and weekends to restore the car and spent \$2,400 on parts for it. He knows that he can sell the car for \$13,000, but he is very wealthy and does not need the money. On the other hand, his daughter, who has very little income, needs money to make the down payment on a house.
- Would it matter, after taxes, whether Wade sells the car and gives the money to his daughter or whether he gives the car to his daughter and she sells it for \$13,000? Explain.
 - Assume that Wade gave the car to his daughter after he had arranged for another person to buy it from his daughter. The daughter then transferred the car to the buyer and received \$13,000. Who is taxed on the gain?
11. **LO.3** Anita, a cash basis taxpayer, sued her former employer for wage discrimination. Her attorney agreed to pursue the case on a contingent fee basis—the attorney would receive one-third of any settlement or court award. The parties reached a settlement, and the attorney for Anita’s former employer wrote a check payable to Anita for \$320,000 and a check payable to her attorney for \$160,000. Anita reasons that she and the attorney were partners in the lawsuit who shared profits two-thirds and one-third, respectively. Therefore, she includes \$320,000 in her gross income. Is Anita’s analysis correct? Explain.
12. **LO.3** Rex became a partner with a 30% interest in the partnership profits when he invested \$200,000. In 2015, the partnership generated \$400,000 of taxable

income, and Rex withdrew \$100,000. In 2016, the partnership had \$600,000 of taxable income, and Rex withdrew \$200,000. What is Rex's gross income from the partnership in 2015 and 2016?

13. **LO.4** The divorce agreement requires Alice to pay her former spouse \$50,000 a year for the next ten years. Will the payments qualify as alimony? Why or why not?
14. **LO.4, 5** William and Abigail, who live in San Francisco, have been experiencing problems with their marriage. They have a 3-year-old daughter, April, who stays with William's parents during the day because both William and Abigail are employed. Abigail worked to support William while he attended medical school, and now she has been accepted by a medical school in Mexico. Abigail has decided to divorce William and attend medical school. April will stay in San Francisco because of her strong attachment to her grandparents and because they can provide her with excellent day care. Abigail knows that William will expect her to contribute to the cost of raising April. Abigail also believes that to finance her education, she must receive cash for her share of the property they accumulated during their marriage. In addition, she believes that she should receive some reimbursement for her contribution to William's support while he was in medical school. She expects the divorce proceedings to take several months. Identify the relevant tax issues for Abigail.
15. **LO.4, 5** Patrick and Eva are planning to divorce. Patrick has offered to pay Eva \$12,000 each year until their 11-year-old daughter reaches age 21. Alternatively, Patrick will transfer to Eva common stock that he owns with a fair market value of \$100,000. What factors should Eva and Patrick consider in deciding between these two options?
16. **LO.4** In the current year, the Rose Corporation made a \$400,000 interest-free loan to John Rose, the corporation's controlling shareholder. Mr. Rose is also the corporation's chief executive officer and receives a salary of \$300,000 a year. What are the tax consequences of classifying the loan as a compensation-related loan rather than as a corporation-shareholder loan?
17. **LO.4** Connor purchased an annuity that was to pay him a fixed amount each month for the remainder of his life. He began receiving payments in 1999, when he was 65 years old. In 2015, Connor was killed in an automobile accident. What are the effects of the annuity on Connor's final tax return?
18. **LO.4** An employer provides all of his employees with life insurance protection equal to twice the employee's annual salary. Melba, age 42, has an annual salary of \$70,000. Is Melba required to recognize income even though she is still alive at the end of the year and thus nothing has been collected on the life insurance policy? Explain.
19. **LO.4** For a person who receives Social Security benefits, what effect, if any, can an increase in other income have on that person's taxable income?

Issue ID

Decision Making

Issue ID

Computational Exercises

20. **LO.2** On January 1, 2015, Kunto, a cash basis taxpayer, pays \$46,228 for a 24-month certificate. The certificate is priced to yield 4% (the effective interest rate) with interest compounded annually. No interest is paid until maturity, when Kunto receives \$50,000. In your computations:
 - a. Compute Kunto's gross income from the certificate for 2015.
 - b. Compute Kunto's gross income from the certificate for 2016.

Round any amounts to the nearest dollar.

21. **LO.2** Bigham Corporation, an accrual basis calendar year taxpayer, sells its services under 12-month, and 24-month contracts. The corporation provides services to each customer every month. On July 1, 2015, Bigham sold the following customer contracts:

Length of Contract	Total Proceeds
12 months	\$14,000
24 months	\$24,000

Determine the income to be recognized in taxable income in 2015 and 2016.

Length of Contract	2015 Income	2016 Income
12 months	a. \$ _____	c. \$ _____
24 months	b. \$ _____	d. \$ _____

22. **LO.3** Simba and Zola are married but file separate returns. Simba received \$80,000 of salary and \$1,200 of taxable dividends on stock he purchased in his name and paid from the salary that he earned since the marriage. Zola collected \$900 in taxable interest on certificate of deposit that she inherited from her aunt. Compute Zola's gross income under two assumptions as to the state of residency of the couple. If an amount is zero, enter "\$0."

	Idaho (Community Property State)	South Carolina (Common Law State)
Dividends	a. \$ _____	d. \$ _____
Interest	b. \$ _____	e. \$ _____
Salary	c. \$ _____	f. \$ _____

23. **LO.4** Casper and Cecile are divorced this year. As part of the divorce settlement, Casper transferred stock to Cecile. Casper purchased the stock for \$25,000, and it had a market value of \$43,000 on the date of the transfer. Cecile sold the stock for \$40,000 a month after receiving it. In addition Casper is required to pay Cecile \$1,500 a month in alimony. He made five payments to her during the year.

What are the tax consequences for Casper and Cecile regarding these transactions?

- How much gain or loss does Casper recognize on the transfer of the stock?
 - Does Casper receive a deduction for the \$7,500 alimony paid?
 - How much income does Cecile have from the \$7,500 alimony received?
 - When Cecile sells the stock, how much does she report?
24. **LO.4** Elizabeth made the following interest-free loans during the year. Assume that tax avoidance is not a principal purpose of any of the loans. Assume that the relevant Federal rate is 5% and that the loans were outstanding for the last six months of the year.

Borrower	Amount	Borrower's Net Investment Income	Purpose of Loan
Richard	\$ 5,000	\$800	Gift
Woody	8,000	600	Purchase stock
Irene	105,000	-0-	Purchase residence

What are the effects of the imputed interest rules on these transactions? Compute Elizabeth's gross income from each loan:

- a. Richard
 - b. Woody
 - c. Irene
25. **LO.4** A taxpayer, age 64, purchases an annuity from an insurance company for \$50,000. She is to receive \$300 per month for life. Her life expectancy 20.8 years from the annuity starting date. Assuming that she receives \$3,600 this year, what is the exclusion percentage and how much is included in her gross income? Round the exclusion percentage to two decimal places. Round the final answer for the income to the nearest dollar.
26. **LO.4** Compute the taxable Social Security benefits in each of the following situations:
- a. Erwin and Eleanor are married and file a joint tax return. They have adjusted gross income of \$46,000, no tax-exempt interest, and \$12,400 of Social Security benefits.
 - b. Erwin and Eleanor have adjusted gross income of \$12,000, no tax-exempt interest, and \$16,000 of Social Security benefits.
 - c. Erwin and Eleanor have adjusted gross income of \$85,000, no tax-exempt interest, and \$15,000 of Social Security benefits.

Problems

27. **LO.1** Determine the taxpayer's current-year (1) economic income and (2) gross income for tax purposes from the following events:
- a. Sam's employment contract as chief executive of a large corporation was terminated, and he was paid \$500,000 not to work for a competitor of the corporation for five years.
 - b. Elliot, a 6-year-old child, was paid \$5,000 for appearing in a television commercial. His parents put the funds in a savings account for the child's education.
 - c. Valery found a suitcase that contained \$100,000. She could not determine who the owner was.
 - d. Winn purchased a lottery ticket for \$5 and won \$750,000.
 - e. Larry spent \$1,000 to raise vegetables that he and his family consumed. The cost of the vegetables in a store would have been \$2,400.
 - f. Dawn purchased an automobile for \$1,500 that was worth \$3,500. The seller was in desperate need of cash.
28. **LO.1, 2, 5** Harper is considering three alternative investments of \$10,000. Assume that the taxpayer is in the 28% marginal tax bracket for ordinary income and 15% for qualifying capital gains in all tax years. The selected investment will be liquidated at the end of five years. The alternatives are:
- A taxable corporate bond yielding 5% before tax and the interest can be reinvested at 5% before tax.
 - A Series EE bond that will have a maturity value of \$12,200 (a 4% before-tax rate of return).
 - Land that will increase in value.

Decision Making

The gain on the land will be classified and taxed as a long-term capital gain. The income from the bonds is taxed as ordinary income. How much must the land increase in value to yield a greater after-tax return than either of the bonds?

Given: Compound amount of \$1 and compound value of annuity payments at the end of five years:

Interest Rate	\$1 Compounded for 5 Years	\$1 Annuity Compounded for 5 Years
5%	\$1.28	\$5.53
4%	1.22	5.42
3.6%	1.19	5.37

29. **LO.1** Determine the taxpayer's gross income for tax purposes in each of the following situations:
- Deb, a cash basis taxpayer, traded a corporate bond with accrued interest of \$300 for corporate stock with a fair market value of \$12,000 at the time of the exchange. Deb's cost of the bond was \$10,000. The value of the stock had decreased to \$11,000 by the end of the year.
 - Deb needed \$10,000 to make a down payment on her house. She instructed her broker to sell some stock to raise the \$10,000. Deb's cost of the stock was \$3,000. Based on her broker's advice, instead of selling the stock, she borrowed the \$10,000 using the stock as collateral for the debt.
 - Deb's boss gave her two tickets to the Rabid Rabbits rock concert because she met her sales quota. At the time she received the tickets, each ticket had a face price of \$200 and was selling on eBay for \$300. On the date of the concert, the tickets were selling for \$250 each. Deb and her son attended the concert.
30. **LO.1, 2** Determine Amos's gross income in each of the following cases:
- In the current year, Amos purchased an automobile for \$25,000. As part of the transaction, Amos received a \$1,500 rebate from the manufacturer.
 - Amos sold his business. In addition to the selling price of the stock, he received \$50,000 for a covenant not to compete—an agreement that he will not compete with his former business for five years.
 - Amos owned some land he held as an investment. As a result of a change in the zoning rules, the property increased in value by \$20,000.

Decision Making

31. **LO.2, 5** Al is a medical doctor who conducts his practice as a sole proprietor. During 2015, he received cash of \$280,000 for medical services. Of the amount collected, \$40,000 was for services provided in 2014. At the end of 2015, Al had accounts receivable of \$60,000, all for services rendered in 2015. In addition, at the end of the year, Al received \$12,000 as an advance payment from a health maintenance organization (HMO) for services to be rendered in 2016. Compute Al's gross income for 2015:
- Using the cash basis of accounting.
 - Using the accrual basis of accounting.
 - Advise Al on which method of accounting he should use.
32. **LO.2** Selma operates a contractor's supply store. She maintains her books using the cash method. At the end of the year, her accountant computes her accrual basis income that is used on her tax return. For 2015, Selma had cash receipts of \$1.4 million, which included \$200,000 collected on accounts receivable from 2014 sales. It also included the proceeds of a \$100,000 bank loan. At the end of 2015, she had \$250,000 in accounts receivable from customers, all from 2015 sales.
- Compute Selma's accrual basis gross receipts for 2015.
 - Selma paid cash for all of the purchases. The total amount paid for merchandise in 2014 was \$1.3 million. At the end of 2014, she had merchandise on hand with a cost of \$150,000. At the end of 2015, the cost of merchandise on hand was \$300,000. Compute Selma's gross income from merchandise sales for 2015.

33. **LO.2, 3, 5** Your client is a partnership, ARP Associates, which is an engineering consulting firm. Generally, ARP bills clients for services at the end of each month. Client billings are about \$50,000 each month. On average, it takes 45 days to collect the receivables. ARP's expenses are primarily for salary and rent. Salaries are paid on the last day of each month, and rent is paid on the first day of each month. The partnership has a line of credit with a bank, which requires monthly financial statements. These must be prepared using the accrual method. ARP's managing partner, Amanda Sims, has suggested that the firm also use the accrual method for tax purposes and thus reduce accounting fees by \$600. Assume that the partners are in the 35% (combined Federal and state) marginal tax bracket. Write a letter to your client explaining why you believe it would be worthwhile for ARP to file its tax return on the cash basis even though its financial statements are prepared on the accrual basis. ARP's address is 100 James Tower, Denver, CO 80208.
34. **LO.2** Trip Garage, Inc. (459 Ellis Avenue, Harrisburg, PA 17111), is an accrual basis taxpayer that repairs automobiles. In late December 2015, the company repaired Samuel Mosley's car and charged him \$1,000. Samuel did not think the problem had been fixed and refused to pay; thus, Trip refused to release the automobile. In early January 2016, Trip made a few adjustments and convinced Samuel that the automobile was working properly. At that time, Samuel agreed to pay only \$900 because he did not have the use of the car for a week. Trip said "fine," accepted the \$900, and released the automobile to Samuel. An IRS agent thinks Trip, as an accrual basis taxpayer, should report \$1,000 of income in 2015, when the work was done, and then deduct a \$100 loss in 2016. Prepare a memo to Susan Apple, the treasurer of Trip, with the recommended treatment for the disputed income.
35. **LO.2** Determine the effects of the following on a cash basis taxpayer's gross income for 2015 and 2016.
- On the morning of December 31, 2015, the taxpayer received a \$1,500 check from a customer. The taxpayer did not cash the check until January 3, 2016.
 - The same as part (a), except the customer asked the taxpayer not to cash the check until January 3, 2016, after the customer's salary check could be deposited.
 - The same as part (a), except the check was not received until after the bank had closed on December 31, 2015.
36. **LO.2** Marlene, a cash basis taxpayer, invests in Series EE U.S. government savings bonds and bank certificates of deposit (CDs). Determine the tax consequences of the following on her 2015 gross income:
- On September 30, 2015, she cashed in Series EE bonds for \$10,000. She purchased the bonds in 2005 for \$7,090. The yield to maturity on the bonds was 3.5%.
 - On July 1, 2014, she purchased a CD for \$10,000. The CD matures on June 30, 2016, and will pay \$10,816, thus yielding a 4% annual return.
 - On July 1, 2015, she purchased a CD for \$10,000. The maturity date on the CD was June 30, 2016, when Marlene would receive \$10,300.
37. **LO.2** Drake Appliance Company, an accrual basis taxpayer, sells home appliances and service contracts. Determine the effect of each of the following transactions on the company's 2015 gross income assuming that the company uses any available options to defer its taxes.
- In December 2014, the company received a \$1,200 advance payment from a customer for an appliance that Drake special ordered from the manufacturer. The appliance did not arrive from the manufacturer until January 2015, and Drake immediately delivered it to the customer. The sale was reported in 2015 for financial accounting purposes.
 - In October 2015, the company sold a 6-month service contract for \$240. The company also sold a 36-month service contract for \$1,260 in July 2015.

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Communications

- c. On December 31, 2015, the company sold an appliance for \$1,200. The company received \$500 cash and a note from the customer for \$700 and \$260 interest, to be paid at the rate of \$40 a month for 24 months. Because of the customer's poor credit record, the fair market value of the note was only \$600. The cost of the appliance was \$750.
38. **LO.2, 5** Freda is a cash basis taxpayer. In 2015, she negotiated her salary for 2016. Her employer offered to pay her \$21,000 per month in 2016 for a total of \$252,000. Freda countered that she would accept \$10,000 each month for the 12 months in 2016 and the remaining \$132,000 in January 2017. The employer accepted Freda's terms for 2016 and 2017.
- Did Freda actually or constructively receive \$252,000 in 2016?
 - What could explain Freda's willingness to spread her salary over a longer period of time?
 - In December 2016, after Freda had earned the right to collect the \$132,000 in 2017, the employer offered \$133,000 to Freda at that time, rather than \$132,000 in January 2017. The employer wanted to make the early payment so as to deduct the expense in 2016. Freda rejected the employer's offer. Was Freda in constructive receipt of the income in 2016? Explain.

Decision Making

39. **LO.2, 5** The Bluejay Apartments, a new development, is in the process of structuring its lease agreements. The company would like to set the damage deposits high enough that tenants will keep the apartments in good condition. The company is actually more concerned about damage than about tenants not paying their rent.
- Discuss the tax effects of the following alternatives:
 - \$1,000 damage deposit with no rent prepayment.
 - \$500 damage deposit and \$500 rent for the final month of the lease.
 - \$1,000 rent for the final two months of the lease and no damage deposit.
 - Which option do you recommend? Why?
40. **LO.3** Rusty has been experiencing serious financial problems. His annual salary was \$100,000, but a creditor garnished his salary for \$20,000; so the employer paid the creditor (rather than Rusty) the \$20,000. To prevent creditors from attaching his investments, Rusty gave his investments to his 21-year-old daughter, Rebecca. Rebecca received \$5,000 in dividends and interest from the investments during the year. Rusty transferred some cash to a Swiss bank account that paid him \$6,000 interest during the year. Rusty did not withdraw the interest from the Swiss bank account. Rusty also hid some of his assets in his wholly owned corporation that received \$150,000 rent income but had \$160,000 in related expenses, including a \$20,000 salary paid to Rusty. Rusty reasons that his gross income should be computed as follows:

Salary received	\$ 80,000
Loss from rental property (\$150,000 – \$160,000)	<u>(10,000)</u>
Gross income	<u>\$ 70,000</u>

Compute Rusty's correct gross income for the year, and explain any differences between your calculation and Rusty's.

41. **LO.2, 3** Troy, a cash basis taxpayer, is employed by Eagle Corporation, also a cash basis taxpayer. Troy is a full-time employee of the corporation and receives a salary of \$60,000 per year. He also receives a bonus equal to 10% of all collections from clients he serviced during the year. Determine the tax consequences of the following events to the corporation and to Troy:
- On December 31, 2015, Troy was visiting a customer. The customer gave Troy a \$10,000 check payable to the corporation for appraisal services Troy performed during 2015. Troy did not deliver the check to the corporation until January 2016.

- b. The facts are the same as in (a), except that the corporation is an accrual basis taxpayer and Troy deposited the check on December 31, but the bank did not add the deposit to the corporation's account until January 2016.
- c. The facts are the same as in (a), except that the customer told Troy to hold the check until January 2016 when the customer could make a bank deposit that would cover the check.
42. **LO.3, 4** Faye, Gary, and Heidi each have a one-third interest in the capital and profits of the FGH Partnership. Each partner had a capital account of \$50,000 at the beginning of the tax year. The partnership profits for the tax year were \$270,000. Changes in their capital accounts during the tax year were as follows:

	Faye	Gary	Heidi	Total
Beginning balance	\$ 50,000	\$ 50,000	\$ 50,000	\$150,000
Withdrawals	(20,000)	(35,000)	(10,000)	(65,000)
Additional contributions	–0–	–0–	5,000	5,000
Allocation of profits	90,000	90,000	90,000	270,000
Ending balance	<u>\$120,000</u>	<u>\$105,000</u>	<u>\$135,000</u>	<u>\$360,000</u>

In arriving at the \$270,000 of partnership profits, the partnership deducted \$2,400 (\$800 for each partner) in premiums paid for group term life insurance on the partners. Faye and Gary are 39 years old, and Heidi is 35 years old. Other employees are also eligible for group term life insurance equal to their annual salary. These premiums of \$10,000 have been deducted in calculating the partnership profits of \$270,000. Compute each partner's gross income from the partnership for the tax year.

43. **LO.3, 5** In 2015, Alva received dividends on her stocks as follows:

Amur Corporation (a French corporation whose stock is traded on an established U.S. securities market)	\$60,000
Blaze, Inc., a Delaware corporation	40,000
Grape, Inc., a Virginia corporation	22,000

- a. Alva purchased the Grape stock three years ago, and she purchased the Amur stock two years ago. She purchased the Blaze stock 18 days before it went ex-dividend and sold it 20 days later at a \$5,000 loss. Alva had no other capital gains and losses for the year. She is in the 35% marginal tax bracket. Compute Alva's tax on her dividend income for 2015.
- b. Alva's daughter, who is 25 and not Alva's dependent, had taxable income of \$6,000, which included \$1,000 of dividends on Grape, Inc. stock. The daughter had purchased the stock two years ago. Compute the daughter's tax liability on the dividends.
- c. Alva can earn 5% before-tax interest on a corporate bond or a 4% dividend on a preferred stock. Assuming that the appreciation in value is the same, which investment produces the greater after-tax income?
- d. The same as part (c), except that Alva's daughter is to make the investment.
44. **LO.3** Liz and Doug were divorced on December 31 of the current year after 10 years of marriage. Their current year's income received before the divorce was as follows:

Doug's salary	\$41,000
Liz's salary	55,000
Rent on apartments purchased by Liz 15 years ago	8,000
Dividends on stock Doug inherited from his mother 4 years ago	1,900
Interest on a savings account in Liz's name funded with her salary	2,400

Allocate the income to Liz and Doug assuming that they live in:

- a. California.
- b. Texas.

45. **LO.4** Nell and Kirby are in the process of negotiating their divorce agreement. What should be the tax consequences to Nell and Kirby if the following, considered individually, became part of the agreement?
- a. In consideration for her one-half interest in their personal residence, Kirby will transfer to Nell stock with a value of \$200,000 and \$50,000 of cash. Kirby's cost of the stock was \$150,000, and the value of the personal residence is \$500,000. They purchased the residence three years ago for \$300,000.
 - b. Nell will receive \$1,000 per month for 120 months. If she dies before receiving all 120 payments, the remaining payments will be made to her estate.
 - c. Nell is to have custody of their 12-year-old son, Bobby. She is to receive \$1,200 per month until Bobby (1) dies or (2) attains age 21 (whichever occurs first). After either of these events occurs, Nell will receive only \$300 per month for the remainder of her life.

- Decision Making** 46. **LO.4** Alicia and Rafel are in the process of negotiating a divorce agreement. They both worked during the marriage and contributed an equal amount to the marital assets. They own a home with a fair market value of \$400,000 (cost of \$300,000) that is subject to a mortgage of \$250,000. They have lived in the home for 12 years. They also have investment assets with a cost of \$160,000 and a fair market value of \$410,000. Thus, the net worth of the couple is \$560,000 ($\$400,000 - \$250,000 + \$410,000$). The holding period for the investments is longer than one year. Alicia would like to continue to live in the house. Therefore, she has proposed that she receive the residence subject to the mortgage, a net value of \$150,000. In addition, she would receive \$17,600 each year for the next 10 years, which has a present value (at 6% interest) of \$130,000. Rafel would receive the investment assets. If Rafel accepts this plan, he must sell one-half of the investments so that he can purchase a home. Assume that you are counseling Alicia. Explain to Alicia whether the proposed agreement would be "fair" on an after-tax basis.

- Decision Making** 47. **LO.4, 5** Roy decides to buy a personal residence and goes to the bank for a \$150,000 loan. The bank tells him that he can borrow the funds at 4% if his father will guarantee the debt. Roy's father, Hal, owns a \$150,000 CD currently yielding 3.5%. The Federal rate is 3%. Hal agrees to either of the following:

- Roy borrows from the bank with Hal's guarantee to the bank.
- Cash in the CD (with no penalty) and lend Roy the funds at 2% interest.

Hal is in the 33% marginal tax bracket. Roy, whose only source of income is his salary, is in the 15% marginal tax bracket. The interest Roy pays on the mortgage will be deductible by him. Which option will maximize the family's after-tax wealth?

48. **LO.2, 4** Ridge is a generous individual. During the year, he made interest-free loans to various family members when the Federal rate was 3%. What are the tax consequences of the following loans by Ridge:
- a. On June 30, 2014, Ridge loaned \$12,000 to his cousin, Jim, to buy a used truck. Jim's only source of income was his wages on various construction jobs during the year.
 - b. On August 1, 2014, Ridge loaned \$8,000 to his niece, Sonja. The loan was to enable her to pay her college tuition. Sonja had \$1,200 interest income from CDs her parents had given her.
 - c. On September 1, 2014, Ridge loaned \$25,000 to his brother, Al, to start a business. Al had \$220 of dividends and interest for the year.

- d. On September 30, 2014, Ridge loaned \$150,000 to his mother so that she could enter a nursing home. His mother's only income was \$9,000 of Social Security benefits and \$500 of interest income.
49. **LO.4** Indicate whether the imputed interest rules should apply in the following situations. Assume that all of the loans were made at the beginning of the tax year unless otherwise indicated.
- Mike loaned his sister \$90,000 to buy a new home. Mike did not charge interest on the loan. The Federal rate was 5%. Mike's sister had \$900 of investment income for the year.
 - Sam's employer maintains an emergency loan fund for its employees. During the year, Sam's wife was very ill, and he incurred unusually large medical expenses. He borrowed \$8,500 from his employer's emergency loan fund for six months. The Federal rate was 5.5%. Sam and his wife had no investment income for the year.
 - Jody borrowed \$25,000 from her controlled corporation for six months. She used the funds to pay her daughter's college tuition. The corporation charged Jody 4% interest. The Federal rate was 5%. Jody had \$3,500 of investment income for the year.
 - Kait loaned her son, Jake, \$60,000 for six months. Jake used the \$60,000 to pay off college loans. The Federal rate was 5%, and Kait did not charge Jake any interest. Jake had dividend and interest income of \$2,100 for the tax year.
50. **LO.4** Vito is the sole shareholder of Vito, Inc. He is also employed by the corporation. On June 30, 2015, Vito borrowed \$8,000 from Vito, Inc., and on July 1, 2016, he borrowed an additional \$10,000. Both loans were due on demand. No interest was charged on the loans, and the Federal rate was 4% for all relevant dates. Vito used the money to purchase a boat, and he had \$2,500 of investment income. Determine the tax consequences to Vito and Vito, Inc., in each of the following situations:
- The loans are considered employer-employee loans.
 - The loans are considered corporation-shareholder loans.
51. **LO.4** Pam retires after 28 years of service with her employer. She is 66 years old and has contributed \$42,000 to her employer's qualified pension fund. She elects to receive her retirement benefits as an annuity of \$3,000 per month for the remainder of her life.
- Assume that Pam retires in June 2015 and collects six annuity payments this year. What is her gross income from the annuity payments in the first year?
 - Assume that Pam lives 25 years after retiring. What is her gross income from the annuity payments in the twenty-fourth year?
 - Assume that Pam dies after collecting 160 payments. She collected eight payments in the year of her death. What are Pam's gross income and deductions from the annuity contract in the year of her death?
52. **LO.4** For each of the following, determine the amount that should be included in gross income:
- Peyton was selected the most valuable player in the Super Bowl. In recognition of this, he was awarded an automobile with a value of \$60,000. Peyton did not need the automobile, so he asked that the title be put in his parents' names.
 - Jacob was awarded the Nobel Peace Prize. When he was presented the check for \$1.4 million, Jacob said, "I do not need the money. Give it to the United Nations to use toward the goal of world peace."
 - Linda won the Craig County Fair beauty pageant. She received a \$10,000 scholarship that paid her \$6,000 for tuition and \$4,000 for meals and housing for the academic year.

53. **LO.4** The LMN Partnership has a group term life insurance plan. Each partner has \$150,000 of protection, and each employee has protection equal to twice his or her annual salary. Employee Alice (age 32) has \$90,000 of insurance under the plan, and partner Kay (age 47) has \$150,000 of coverage. Because the plan is a “group plan,” it is impossible to determine the cost of coverage for an individual employee or partner.
- Assuming that the plan is nondiscriminatory, how much must Alice and Kay each include in gross income as a result of the partnership paying the insurance premiums?
 - Assume that the partnership is incorporated. Kay becomes a shareholder and an employee who receives a \$75,000 annual salary. The corporation provides Kay with \$150,000 of group term life insurance coverage under a nondiscriminatory plan. What is Kay’s gross income as a result of the corporation paying the insurance premiums?
54. **LO.2, 4** Herbert was employed for the first six months of 2015 and earned \$90,000 in salary. During the next six months, he collected \$8,800 of unemployment compensation, borrowed \$12,000 (using his personal residence as collateral), and withdrew \$2,000 from his savings account (including \$60 of interest). He received dividends of \$550. His luck was not all bad, for in December, he won \$1,500 in the lottery on a \$5 ticket. Calculate Herbert’s gross income.

Decision Making

55. **LO.4, 5** Linda and Don are married and file a joint return. In 2015, they received \$12,000 in Social Security benefits and \$35,000 in taxable pension benefits and interest.
- Compute the couple’s adjusted gross income on a joint return.
 - Don would like to know whether they should sell for \$100,000 (at no gain or loss) a corporate bond that pays 8% in interest each year and use the proceeds to buy a \$100,000 nontaxable State of Virginia bond that will pay \$6,000 in interest each year.
 - If Linda in (a) works part-time and earns \$30,000, how much will Linda and Don’s adjusted gross income increase?
56. **LO.4** Melissa, who is 70 years old, is unmarried and has no dependents. Her annual income consists of a taxable pension of \$17,000, \$14,000 in Social Security benefits, and \$3,000 of dividend income. She does not itemize her deductions. She is in the 15% marginal income tax bracket. She is considering getting a part-time job that would pay her \$5,000 a year.
- What would be Melissa’s after-tax income from the part-time job, considering Social Security and Medicare tax (7.65%) as well as Federal income tax on the earnings of \$5,000?
 - What would be the effective tax rate (increase in tax/increase in income) on the additional income from the part-time job?
57. **LO.3, 4** Donna does not think she has an income tax problem but would like to discuss her situation with you just to make sure there is no unexpected tax liability. Base your suggestions on the following relevant financial information:
- Donna’s share of the SAT Partnership income is \$150,000, but none of the income can be distributed because the partnership needs the cash for operations.
 - Donna’s Social Security benefits totaled \$8,400, but Donna loaned the cash received to her nephew.
 - Donna assigned to a creditor the right to collect \$1,200 of interest on some bonds she owned.
 - Donna and her husband lived together in California until September, when they separated. Donna has heard rumors that her husband had substantial gambling winnings since they separated.

Cumulative Problems



58. Daniel B. Butler and Freida C. Butler, husband and wife, file a joint return. The Butlers live at 625 Oak Street in Corbin, KY 40701. Dan's Social Security number is 111-11-1111, and Freida's is 123-45-6789. Dan was born on January 15, 1964, and Freida was born on August 20, 1965.

During 2014, Dan and Freida furnished over half of the total support of each of the following individuals, all of whom still live at home:

- Gina, their daughter, age 22, a full-time student, who married on December 21, 2014, has no income of her own and for 2014 did not file a joint return with her husband, Casey, who earned \$10,600 during 2014. Gina's Social Security number is 123-45-6788.
- Sam, their son, age 20, who had gross income of \$6,300 in 2014, dropped out of college in October 2014. He had graduated from high school in May 2014. Sam's Social Security number is 123-45-6787.
- Ben, their oldest son, age 26, is a full-time graduate student with gross income of \$5,200. Ben's Social Security number is 123-45-6786.

Dan was employed as a manager by WJJJ, Inc. (employer identification number 11-1111111, 604 Franklin Street, Corbin, KY 40702), and Freida was employed as a salesperson for Corbin Realty, Inc. (employer identification number 98-7654321, 899 Central Street, Corbin, Ky 40701). Selected information from the W-2 Forms provided by the employers is presented below. Dan and Freida use the cash method.

Line	Description	Dan	Freida
1	Wages, tips, other compensation	\$74,000	\$86,000
2	Federal income tax withheld	11,000	12,400
17	State income tax withheld	2,960	3,440

Freida sold a house on December 30, 2014, and will be paid a commission of \$3,100 (not included in the \$86,000 reported on the W-2) on the January 10, 2015 closing date.

Other income (as reported on 1099 Forms) for 2014 consisted of the following:

Dividends on CSX stock (qualified)	\$4,200
Interest on savings at Second Bank	1,600
Interest on City of Corbin bonds	900
Interest on First Bank CD	382

The \$382 from First Bank was original issue discount. Dan and Freida collected \$16,000 on the First Bank CD that matured on September 30, 2014. The CD was purchased on October 1, 2012, for \$14,995, and the yield to maturity was 3.3%.

Dan received a Schedule K-1 from the Falcon Partnership, which showed his distributive share of income as \$7,000. In addition to the above information, Dan and Freida's itemized deductions included the following:

Paid on 2014 Kentucky income tax	\$ 700
Personal property tax paid	600
Real estate taxes paid	1,800
Interest on home mortgage (Corbin S&L)	4,900
Cash contributions to the Boy Scouts	800

Sales tax from the sales tax table is \$1,860. Dan and Freida made Federal estimated tax payments of \$8,000. All members of the family had health insurance coverage for all of 2014. Dan and Freida do not wish to contribute to the Presidential Election Campaign. The Kentucky income tax rate is 4%.

Tax Return Problem
Decision Making
Communications



Part 1—Tax Computation

Compute Dan and Freida's 2014 Federal income tax payable (or refund due). If you use tax forms for your computations, you will need Form 1040 and Schedules A, B, and E. Suggested software: H&R BLOCK Tax Software.

Part 2—Tax Planning

Dan plans to reduce his work schedule and work only half-time for WJJJ in 2015. He has been writing songs for several years and wants to devote more time to developing a career as a songwriter. Because of the uncertainty in the music business, however, he would like you to make all computations assuming that he will have no income from songwriting in 2015. To make up for the loss of income, Freida plans to increase the amount of time she spends selling real estate. She estimates that she will be able to earn \$90,000 in 2015. Assume that all other income and expense items will be approximately the same as they were in 2014. Assume that Sam will be enrolled in college as a full-time student for the summer and fall semesters. Will the Butlers have more or less disposable income (after Federal income tax) in 2015? Write a letter to the Butlers that contains your advice, and prepare a memo for the tax files.

Tax Computation Problem 59. Cecil C. Seymour is a 64-year-old widower. He had income for 2015 as follows:

Pension from former employer	\$39,850
Interest income from Alto National Bank	5,500
Interest income on City of Alto bonds	4,500
Dividends received from IBM stock held for over one year	2,000
Collections on annuity contract he purchased from Great Life Insurance	5,400
Social Security benefits	14,000
Rent income on townhouse	9,000

The cost of the annuity was \$46,800, and Cecil was expected to receive a total of 260 monthly payments of \$450. Cecil has received 22 payments through 2015.

Cecil's 40-year-old daughter, Sarah C. Seymour, borrowed \$60,000 from Cecil on January 2, 2015. She used the money to start a new business. Cecil does not charge her interest because she could not afford to pay it, but he does expect to eventually collect the principal. Sarah is living with Cecil until the business becomes profitable. Except for housing, Sarah provides her own support from her business and \$1,600 in dividends on stocks that she inherited from her mother.

Other relevant information is presented below:

- Cecil's Social Security number: 123-45-6785
- Address: 3840 Springfield Blvd., Alto, GA 30510
- Sarah's Social Security number: 123-45-6784
- Expenses on rental townhouse:

Utilities	\$2,800
Maintenance	1,000
Depreciation	2,000
Real estate taxes	750
Insurance	700
- State income taxes paid: \$3,500
- County personal property taxes paid: \$2,100
- Payments on estimated 2015 Federal income tax: \$5,900
- Charitable contributions of cash to Alto Baptist Church: \$6,400
- Federal interest rate: 6%
- Sales taxes paid: \$912

Compute Cecil's 2015 Federal income tax payable (or refund due).

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.



Research Problem 1. Tranquility Funeral Home, Inc., your client, is an accrual basis taxpayer that sells preneed funeral contracts. Under these contracts, the customer pays in advance for goods and services to be provided at the contract beneficiary's death. These payments are refundable at the contract purchaser's request, pursuant to state law, anytime until the goods and services are furnished. Tranquility, consistent with its financial accounting reporting, includes the payments in income for the year the funeral service is provided. The IRS agent insists that the payments be prepaid income subject to tax in the year of receipt. Your client believes that the amounts involved are customer deposits. Write a letter to Tranquility that contains your advice about how the issue should be resolved. The client's address is 400 Rock Street, Memphis, TN 38152.

Communications

Research Problem 2. Your client was the beneficiary of an annuity contract purchased by her stepmother. When the stepmother died, the insurance company paid the client \$400,000 and sent her a Form 1099 indicating that the taxable portion (i.e., the amount in excess of the investment in the contract) was \$50,000. However, according to the client, her father fraudulently convinced her that he was the intended beneficiary. She gave her father a check equal to the amount she had received from the insurance company. She did not report any of the annuity proceeds in her income tax return. She later discovered the fraud and filed a lawsuit to collect from her father. The IRS has examined your client's return and has taken the position that she must include the \$50,000 in her gross income.

Evaluate the IRS's position.

Research Problem 3. Your client owns a life insurance policy on his life. He has paid \$6,800 in premiums, and the cash surrender value of the policy is \$30,000. He borrowed \$30,000 from the insurance company, using the cash surrender value as collateral. He is considering canceling the policy in payment of the loan. He would like to know the tax consequences of canceling his policy.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet Activity

Research Problem 4. Lottery winnings are taxable for Federal income tax purposes. What many lottery hopefuls forget to factor into their tax considerations are that lottery winnings are also taxable in many states. Search the Internet to see whether you can determine if lottery winnings are taxable for California residents.

Research Problem 5. Go to the web page of a consulting firm that offers counseling services to individuals as they negotiate the terms of a divorce. What specific tax-related services do these firms offer? Suggest a new tax-related service the consulting firm could offer.

Communications

Roger CPA Review Questions

1. Smith, an individual, is required to pay Goode yearly alimony of \$6,000 and yearly child support of \$18,000. Smith paid Goode \$20,000 in 20X13. Smith's 20X13 W-2 income was \$50,000. Considering only the foregoing facts, what should Smith's adjusted gross income be for 20X13?
 - a. \$30,000
 - b. \$45,000
 - c. \$48,000
 - d. \$50,000
2. Which of the following is excluded from gross income on an individual's 20X14 tax return?
 - a. January 20X15 rent received in December 20X14
 - b. Value arising from personal use of company vehicle in 20X14
 - c. Dividends announced by a C Corporation in December 20X13 and received in January 20X14
 - d. Refundable security deposit received in January 20X14 for a lease ending in July 20X15
3. Doran, a single individual, received \$20,000 in social security benefits in 20X14. Doran's 20X14 provisional income was \$65,000. Considering only these facts, what should Doran report as gross income on Doran's 20X14 tax return?
 - a. \$75,000
 - b. \$72,000
 - c. \$57,000
 - d. \$65,000
4. On October 1, 20X13, Cruz purchased an annuity for \$90,000 in post-tax dollars, effective immediately, that pays Cruz \$500 a month until death. At the date of purchase Cruz's official life expectancy was 25 years. How much of Cruz's 20X13 annuity payments should be included in Cruz's gross income for 20X13?
 - a. \$0
 - b. \$900
 - c. \$600
 - d. \$1,500

Gross Income: Exclusions

LEARNING OBJECTIVES: *After completing Chapter 5, you should be able to:*

- | | |
|--|--|
| <p>LO.1 Be aware that statutory authority is required to exclude an item from gross income.</p> <p>LO.2 Identify the circumstances under which various items are excludible from gross income.</p> <p>LO.3 Determine the extent to which receipts can be excluded under the tax benefit rule.</p> | <p>LO.4 Describe the circumstances under which income must be reported from the discharge of indebtedness.</p> <p>LO.5 Identify tax planning strategies for obtaining the maximum benefit from allowable exclusions.</p> |
|--|--|

CHAPTER OUTLINE

- | | |
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 5-2a Legislative Intent, 5-3
 5-2b Employer Payments to Employees, 5-3
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|---|---|



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THE BIG PICTURE

EXCLUSIONS

Paul is a graduate student in the last semester of an accounting program at State University. This past summer he was an intern with a CPA firm, working in the compliance area. Paul was paid well enough for his work as an intern that he was able to pay for his meals and lodging and to save some for school. The CPA firm was so pleased with Paul's work that at the conclusion of his internship, he was given a bonus of \$1,500 more than the firm had agreed to pay him. The extra amount was intended to help with his graduate school expenses. The CPA firm has offered him a full-time job after he completes his graduate program in December.

Because of his excellent academic record, the university has awarded Paul a graduate assistantship that waives his tuition of \$6,000 per semester and pays him \$400 per month. Paul is required to teach a principles of accounting course each semester. Paul has used the \$400 per month for books and for room and board.

In November, Paul was crossing a street in the pedestrian crosswalk when a delivery van struck him. The driver of the truck had a blood alcohol level of .12. Paul suffered a severe injury to his right arm that has delayed his starting date for work by three months. The delivery company's insurance company settled the case by paying damages, itemized as follows:

Compensatory damages:	
Medical expenses	\$ 30,000
Injury to Paul's right arm	100,000
Pain and suffering	50,000
Loss of income	15,000
Legal fees	25,000
Punitive damages	<u>160,000</u>
	<u>\$380,000</u>

Paul's mother was with him in the crosswalk. Fortunately, the van did not hit her, and she was not physically injured. But she did suffer emotional distress and received \$25,000 in the settlement.

Besides being Paul's friend, you also are a senior accounting major and have a keen interest in taxation. You tell Paul that you will look into the tax consequences of the settlement.

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
<small>FORM 1040 (p. 1)</small>	
8b Tax-exempt interest. Do not include on line 8a	8b | | |
Gross income	\$xx,xxx
<small>FORM 1040 (p. 1)</small>	
10 Taxable refunds, credits, or offsets of state and local income taxes	
19 Unemployment compensation	
21 Other income. List type and amount	
Less: Deductions for adjusted gross income	<u>(x,xxx)</u>
Adjusted gross income	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	<u>(x,xxx)</u>
Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

Chapter 4 discussed the concepts and judicial doctrines that affect the determination of gross income. If an income item is within the all-inclusive definition of gross income, the item can be excluded only if the taxpayer can locate specific authority for doing so. Chapter 5 focuses on the exclusions Congress has authorized.

LO.1
Be aware that statutory authority is required to exclude an item from gross income.

5-1 STATUTORY AUTHORITY

Sections 101 through 150 provide the authority for excluding specific items from gross income. Each exclusion has its own legislative history and reason for enactment. Certain exclusions are intended as a form of indirect welfare payments. Other exclusions prevent double taxation of income or provide incentives for socially desirable activities (e.g., nontaxable interest on certain U.S. government bonds where the owner uses the funds for educational expenses).

In some cases, Congress has enacted exclusions to rectify the effects of judicial decisions or IRS pronouncements.¹ For example, in the past, the IRS and some courts interpreted gross income to include payments the taxpayer received from his or her insurance policy to cover temporary living expenses after the person’s residence was destroyed by fire. Although the IRS’s and the courts’ reasoning may have been a sound interpretation of the meaning of gross income, Congress determined that taxing the person under such dire circumstances was bad policy. Therefore, in 1969, Congress enacted § 123, which exempts from tax the insurance proceeds received for extraordinary living expenses when the taxpayer’s home has been destroyed by fire or other casualty.²

¹See Chapter 1, Example 28.

²P.L. 91–172, Tax Reform Act of 1969, Senate Report No. 91–552.

At times, Congress responds to specific events. For example, in 2001, Congress enacted § 139, Disaster Relief Payment, to ensure that victims of a *qualified disaster* (disaster resulting from a terrorist attack, presidentially declared disaster, or common carrier accident of a catastrophic nature) would not be required to include in gross income payments received for living expenses, funeral expenses, and property damage resulting from the disaster.

5-2 GIFTS AND INHERITANCES

5-2a Legislative Intent

Beginning with the Income Tax Act of 1913 and continuing to the present, Congress has allowed the recipient of a gift to exclude the value of the property from gross income. The exclusion applies to gifts made during the life of the donor (*inter vivos* gifts) and transfers that take effect upon the death of the donor (bequests and inheritances).³ However, as discussed in Chapter 4, the recipient of a gift of income-producing property is subject to tax on the income subsequently earned from the property. Also, as discussed in Chapters 1 and 27, the donor or the decedent's estate may be subject to gift or estate taxes on the transfer.

In numerous cases, gifts are made in a business setting. For example, a salesperson gives a purchasing agent free samples, an employee receives cash from his or her employer upon retirement, or a corporation makes payments to employees who were victims of a natural disaster. In these and similar instances, it is frequently unclear whether the payment was a gift or represents compensation for past, present, or future services.

The courts have defined a gift as “a voluntary transfer of property by one to another without adequate [valuable] consideration or compensation therefrom.”⁴ If the payment is intended to be for services rendered, it is not a gift, even though the payment is made without legal or moral obligation and the payor receives no economic benefit from the transfer. To qualify as a gift, the payment must be made “out of affection, respect, admiration, charity or like impulses.”⁵ Thus, the cases on this issue have been decided on the basis of the donor's intent.

In a landmark case, *Comm. v. Duberstein*,⁶ the taxpayer (Duberstein) received a Cadillac from a business acquaintance. Duberstein had supplied the businessman with the names of potential customers with no expectation of compensation. The Supreme Court concluded:

... despite the characterization of the transfer of the Cadillac by the parties [as a gift] and the absence of any obligation, even of a moral nature, to make it, it was at the bottom a recompense for Duberstein's past service, or an inducement for him to be of further service in the future.

Duberstein was therefore required to include the fair market value of the automobile in gross income.

5-2b Employer Payments to Employees

In the case of cash or other property *received by an employee* from his or her employer, Congress has eliminated any ambiguity. Transfers from an employer to an employee cannot be excluded as a gift.⁷

LO.2

Identify the circumstances under which various items are excludible from gross income.

³§ 102.

⁴*Estate of D. R. Daly*, 3 B.T.A. 1042 (1926).

⁵*Robertson v. U.S.*, 52-1 USTC ¶9343, 41 AFTR 1053, 72 S.Ct. 994 (USSC, 1952).

⁶60-2 USTC ¶9515, 5 AFTR 2d 1626, 80 S.Ct. 1190 (USSC, 1960).

⁷§ 102(c). But see § 139 for qualified disaster situations.



TAX IN THE NEWS Begging as a Tax-Disfavored Occupation

The Tax Court has ruled that amounts received from begging are nontaxable gifts. In a reversal of the normal roles, the beggars contended that the amounts received were earned income while the IRS argued that the taxpayers had merely received gifts. The beggars wanted the fruit of their efforts to be treated as earned income to

qualify them for the earned income credit (see Chapter 12). In all cases addressing the issue, the taxpayers were incarcerated and received the money from relatives and friends who had few prospects for being repaid.

Source: John Walter Wolf, 78 TCM 488, T.C.Memo. 1990-320.

The Big Picture

EXAMPLE

1

Return to the facts of *The Big Picture* on p. 5-1. The \$1,500 paid to Paul by his summer employer was compensation for his services rather than a gift, even though the employer had not contracted to pay this additional amount. This results because the payment was most likely not motivated by the employer's generosity, but rather was made as a result of business considerations. Even if the payment had been made out of generosity, because the payment was received from his employer, Paul could not exclude the "gift."

5-2c Employee Death Benefits

Frequently, an employer makes payments (**death benefits**) to a deceased employee's surviving spouse, children, or other beneficiaries. If the decedent had a nonforfeitable right to the payments (e.g., the decedent's accrued salary), the amounts are generally taxable to the recipient as if the employee had lived and collected the payments. But when the employer makes voluntary payments, the gift issue arises. Generally, the IRS considers such payments to be compensation for prior services rendered by the deceased employee.⁸ However, some courts have held that payments to an employee's surviving spouse or other beneficiaries are gifts if the following are true:⁹

- The payments were made to the surviving spouse and children rather than to the employee's estate.
- The employer derived no benefit from the payments.
- The surviving spouse and children performed no services for the employer.
- The decedent had been fully compensated for services rendered.
- Payments were made pursuant to a board of directors' resolution that followed a general company policy of providing payments for families of deceased employees (but not exclusively for families of shareholder-employees).

When all of the above conditions are satisfied, the payment is presumed to have been made *as an act of affection or charity*. When one or more of these conditions is not satisfied, the surviving spouse and children may still be deemed the recipients of a gift if the payment is made in light of the survivors' financial needs.¹⁰

Income earned by an employee that was not received by the employee prior to his or her death is not an employee death benefit. These earnings are referred to as "income in respect of a decedent"¹¹ and are generally taxable income to the decedent's beneficiary. This is another rare instance (see Alimony in Chapter 4) where the beneficiary of the income, rather than the person who earned the income, is subject to tax.

⁸Rev.Rul. 62-102, 1962-2 C.B. 37.

⁹*Estate of Sydney J. Carter v. Comm.*, 72-1 USTC ¶9129, 29 AFTR 2d 332, 453 F.2d 61 (CA-2, 1972), and the cases cited there.

¹⁰*Simpson v. U.S.*, 58-2 USTC ¶9923, 2 AFTR 2d 6036, 261 F.2d 497 (CA-7, 1958), cert. denied 79 S.Ct. 724 (USSC, 1958).

¹¹§ 691.



TAX IN THE NEWS Frequent-Flyer Miles Will Not Be Taxed

IRS officials believe that when a taxpayer receives frequent-flyer miles in connection with business travel, the taxpayer has received income. This is clearly true if the taxpayer has deducted the cost of the airline ticket. Under the tax benefit rule, the frequent-flyer miles should be included in gross income as a recovery of a prior deduction. If the employer pays for the business travel but the employee is awarded the frequent-flyer miles, the employee has obviously received additional compensation.

Nevertheless, the IRS has announced (Announcement 2002-18) that it will not attempt to tax frequent-flyer miles. The major consideration in creating this nonstatutory exemption was the complexity that would result from attempting to tax the miles. Distinguishing the miles awarded for personal travel (nontaxable reduction in the cost of ticket) from the business miles would be difficult. Furthermore, the valuation issues would be horrendous.

5-3 LIFE INSURANCE PROCEEDS

5-3a General Rule

Life insurance proceeds paid to the beneficiary because of the death of the insured are exempt from income tax.¹²

Mark purchases an insurance policy on his life and names his wife, Linda, as the beneficiary. Mark pays \$45,000 in premiums. When he dies, Linda collects the insurance proceeds of \$200,000. The \$200,000 is exempt from Federal income tax.

EXAMPLE

2

Congress chose to exempt life insurance proceeds for the following reasons:

- For family members, life insurance proceeds serve much the same purpose as a nontaxable inheritance.
- In a business context (as well as in a family situation), life insurance proceeds replace an economic loss suffered by the beneficiary.

Gold Corporation purchases a life insurance policy to cover its key employee. If the proceeds were taxable, the corporation would require more insurance coverage to pay the tax as well as to cover the economic loss of the employee.

EXAMPLE

3

Thus, in general, Congress concluded that making life insurance proceeds exempt from income tax was a good policy.

5-3b Accelerated Death Benefits

Generally, if the owner of a life insurance policy cancels the policy and receives the cash surrender value, the taxpayer must recognize gain equal to the excess of the amount received over premiums paid on the policy (a loss is not deductible). The gain is recognized because the general exclusion provision for life insurance proceeds applies only to life insurance proceeds paid upon the death of the insured. If the taxpayer cancels the policy and receives the cash surrender value, the life insurance policy is treated as an investment by the insured.

In a limited circumstance, however, the insured is permitted to receive the benefits of the life insurance contract without having to include the gain in gross income. Under the **accelerated death benefits** provisions, exclusion treatment is available for insured taxpayers who are either terminally ill or chronically ill.¹³ A terminally ill taxpayer can collect the cash surrender value of the policy from the insurance company or assign the policy proceeds to a qualified third party. The resultant gain, if any, is excluded from

¹²§ 101(a).

¹³§ 101(g).

the insured's gross income. A *terminally ill* individual is a person whom a medical doctor certifies as having an illness that is reasonably expected to cause death within 24 months.

In the case of a chronically ill patient, no gain is recognized if the proceeds of the policy are used for the long-term care of the insured. A person is *chronically ill* if he or she is certified as being unable to perform without assistance certain activities of daily living. These exclusions for the terminally ill and the chronically ill are available only to the insured. Thus, a person who purchases a life insurance policy from the insured does not qualify.

Accelerated Death Benefits

EXAMPLE

4

Tom owned a term life insurance policy at the time he was diagnosed as having a terminal illness. After paying \$5,200 in premiums, he sold the policy to Amber Benefits, Inc., a company that is authorized by the state of Virginia to purchase such policies. Amber paid Tom \$50,000. When Tom died six months later, Amber collected the face amount of the policy, \$75,000. Tom is not required to include the \$44,800 gain ($\$50,000 - \$5,200$) on the sale of the policy in his gross income.

EXAMPLE

5

Assume that Amber in Example 4 paid additional premiums of \$4,000 during the six months it owned the policy. When Amber collects the life insurance proceeds of \$75,000, it must include the \$21,000 gain [$\$75,000$ proceeds $- (\$50,000$ cost $+ \$4,000$ additional premiums paid)] in gross income.

ETHICS & EQUITY Should the Terminally Ill Pay Social Security Taxes?

The rationale for excluding accelerated death benefits from the gross income of the terminally ill is that they often use the funds to pay medical expenses and other costs associated with dying and do not have the ability to pay tax on the gain from the accelerated receipt of the life insurance proceeds. Yet the wages of a terminally ill person who is employed (or profits of a self-employed person) are

subject to Social Security taxes. The Social Security taxes are intended to pay for retirement benefits, but a terminally ill person is unlikely to collect any Social Security benefits.

Several bills have been introduced in Congress to exempt the terminally ill from the Social Security tax. Evaluate the equity of the current tax treatment versus that in the proposed legislation.

5-3c Transfer for Valuable Consideration

A life insurance policy (other than one associated with accelerated death benefits) may be transferred after it is issued by the insurance company. If the policy is *transferred for valuable consideration*, the insurance proceeds are includible in the gross income of the transferee to the extent the proceeds received exceed the amount paid for the policy by the transferee plus any subsequent premiums paid.

EXAMPLE

6

Adam pays premiums of \$4,000 for an insurance policy in the face amount of \$10,000 upon the life of Beth and subsequently transfers the policy to Carol for \$6,000. Upon Beth's death, Carol receives the proceeds of \$10,000. The amount Carol can exclude from gross income is limited to \$6,000 plus any premiums she paid subsequent to the transfer.

The Code, however, provides four exceptions to the rule illustrated in the preceding example. These exceptions permit exclusion treatment for transfers to the following:

1. The insured under the policy.
2. A partner of the insured.

3. A partnership in which the insured is a partner.
4. A corporation in which the insured is an officer or a shareholder.
5. A transferee whose basis in the policy is determined by reference to the transferor's basis.

When Logan's daughter Emily was born, he purchased an insurance policy on her life. Twenty-four years later after Emily graduated from college and married, Logan sold her the policy for its fair value. When Emily dies, the transfer for consideration rules will not apply. Because the transfer was to the insured, the policy proceeds will be excluded from the recipient's gross income. The results would be the same if Logan gave (rather than sold) the policy to Emily.

EXAMPLE

7

The fifth exception applies to policies that were transferred pursuant to a tax-free exchange or were received by gift.¹⁴

Investment earnings arising from the reinvestment of life insurance proceeds are generally subject to income tax. Often the beneficiary will elect to collect the insurance proceeds in installments. The annuity rules (discussed in Chapter 4) are used to apportion the installment payment between the principal element (excludible) and the interest element (includible).¹⁵

5-4 SCHOLARSHIPS

5-4a General Information

Payments or benefits received by a student at an educational institution may be (1) compensation for services, (2) a gift, or (3) a scholarship. If the payments or benefits are received as compensation for services (past or present), the fact that the recipient is a student generally does not render the amounts received nontaxable.¹⁶ Thus, a university teaching or research assistant is generally considered an employee, and his or her stipend is taxable compensation for services rendered. On the other hand, athletic scholarships generally are nontaxable when the individual is not required to participate in the sport.¹⁷ In general, amounts received to be used for educational purposes (other than amounts received from family members) cannot be excluded as gifts because conditions attached to the receipt of the funds mean that the payments were not made out of "detached generosity."

The **scholarship** rules are intended to provide exclusion treatment for education-related benefits that cannot qualify as gifts but are not compensation for services. According to the Regulations, "a scholarship is an amount paid or allowed to, or for the benefit of, an individual to aid such individual in the pursuit of study or research."¹⁸ The recipient must be a candidate for a degree at an educational institution.¹⁹

Terry enters a contest sponsored by a local newspaper. Each contestant is required to submit an essay on local environmental issues. The prize is one year's tuition at State University. Terry wins the contest. The newspaper has a legal obligation to Terry (as contest winner). Thus, the benefits are not a gift. However, because the tuition payment aids Terry in pursuing her studies, the payment is a scholarship.

EXAMPLE

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¹⁴See the discussion of gifts in Chapter 13 and tax-free exchanges in Chapters 13, 18, and 21. In the case of a gift, the donor's basis becomes the donee's basis.

¹⁵Reg. §§ 1.72-7(c)(1) and 1.101-7T.

¹⁶Reg. § 1.117-2(a). See *C. P. Bhalla*, 35 T.C. 13 (1960), for a discussion of the distinction between a scholarship and compensation. See also *Bingler v. Johnson*, 69-1 USTC ¶9348, 23 AFTR 2d 1212, 89 S.Ct. 1439 (USSC,

1969). For potential exclusion treatment, see the subsequent discussion of qualified tuition reductions.

¹⁷Rev. Rul. 77-263, 1977-2 C.B. 47.

¹⁸§ Prop.Reg. § 117-6(c)(3)(i).

¹⁹§ 117(a).

As an exception to the compensation for services, nonprofit educational institutions can provide qualified tuition reduction plans for their employees and the employees can exclude the tuition from their gross income. The exclusion also applies to tuition reductions granted to the employee's spouse and the employee's dependent children.²⁰

A scholarship recipient may exclude from gross income the amount used for tuition and related expenses (fees, books, supplies, and equipment required for courses), provided the conditions of the grant do not require that the funds be used for other purposes.²¹

EXAMPLE

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Kelly receives a scholarship of \$9,500 from State University to be used to pursue a bachelor's degree. She spends \$4,000 on tuition, \$3,000 on books and supplies, and \$2,500 for room and board. Kelly may exclude \$7,000 (\$4,000 + \$3,000) from gross income. The \$2,500 spent for room and board is includible in Kelly's gross income.

5-4b Timing Issues

Frequently, the scholarship recipient is a cash basis taxpayer who receives the money in one tax year but pays the educational expenses in a subsequent year. The amount eligible for exclusion may not be known at the time the money is received. In that case, the transaction is held *open* until the educational expenses are paid.²²

EXAMPLE

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In August 2015, Sanjay received \$10,000 as a scholarship for the academic year 2015–2016. Sanjay's expenditures for tuition, books, and supplies were as follows:

August–December 2015	\$3,000
January–May 2016	<u>4,500</u>
	<u>\$7,500</u>

Sanjay's gross income for 2016 includes \$2,500 (\$10,000 – \$7,500) that is not excludible as a scholarship. None of the scholarship is included in his gross income in 2015.

5-4c Disguised Compensation

Some employers make scholarships available solely to the children of key employees. The tax objective of these plans is to provide a nontaxable fringe benefit to the executives by making the payment to the child in the form of an excludible scholarship. However, the IRS has ruled that the payments are generally includible in the gross income of the parent-employee.²³

The Big Picture**EXAMPLE**

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Return to the facts of *The Big Picture* on p. 5-1. Paul was paid \$400 a month by the university for teaching. This is reasonable compensation for his services. Although he received the assistantship because of his excellent academic record, the monthly pay of \$400 must be included in his gross income because it is compensation for his services. However, the \$6,000 graduate tuition reduction can be excluded from gross income.

²⁰§ 117(d).

²¹§ 117(b).

²²Prop.Reg. § 1.117–6(b)(2).

²³Rev.Rul. 75–448, 1975–2 C.B. 55; *Richard T. Armantrout*, 67 T.C. 996 (1977).

5-5 COMPENSATION FOR INJURIES AND SICKNESS

5-5a Damages

A person who suffers harm caused by another is often entitled to compensatory damages. The tax consequences of the receipt of damages depend on the type of harm the taxpayer has experienced. The taxpayer may seek recovery for (1) a loss of income, (2) expenses incurred, (3) property destroyed, or (4) personal injury.

Generally, reimbursement for a loss of income is taxed the same as the income replaced (see the exception under Personal Injury below). The recovery of an expense is not income unless the expense was deducted. Damages that are a recovery of the taxpayer's previously deducted expenses are generally taxable under the tax benefit rule, discussed later in this chapter.

A payment for damaged or destroyed property is treated as an amount received in a sale or exchange of the property. Thus, the taxpayer has a realized gain if the damages payments received exceed the property's basis. Damages for personal injuries receive special treatment under the Code.

Personal Injury

The legal theory of personal injury damages is that the amount received is intended "to make the plaintiff [the injured party] whole as before the injury."²⁴ It follows that if the damages payments received were subject to tax, the after-tax amount received would be less than the actual damages incurred and the injured party would not be "whole as before the injury." In terms of personal injury damages, a distinction is made between compensatory damages and punitive damages.



ETHICS & EQUITY Tax Treatment of Damages Not Related to Physical Personal Injury

An individual who prevails in a personal injury claim for something other than a physical injury or sickness must include the amount of the award or a settlement in gross income. In contrast, an award or a settlement for a physical personal injury or sickness can be excluded (except for

punitive damages) from gross income. Should damages awarded for a physical personal injury or sickness be treated more favorably than damages awarded for emotional distress or other nonphysical personal injuries such as age and sex discrimination?

Compensatory damages are intended to compensate the taxpayer for the damages incurred. Only those compensatory damages received on account of *physical personal injury or physical sickness* can be excluded from gross income.²⁵ Such exclusion treatment includes amounts received for loss of income associated with the physical personal injury or physical sickness. Compensatory damages awarded on account of emotional distress are not received on account of physical injury or physical sickness and thus cannot be excluded (except to the extent of any amount received for medical care) from gross income. Likewise, any amounts received for age discrimination or injury to one's reputation cannot be excluded.

Punitive damages are amounts the person who caused the harm must pay to the victim as punishment for outrageous conduct. Punitive damages are not intended to compensate the victim, but rather to punish the party who caused the harm. Thus, it follows that amounts received as punitive damages may actually place the victim in a better economic position than before the harm was experienced. Thus, punitive damages are included in gross income.

These rules are set forth in Concept Summary 5.1.

²⁴C. A. Hawkins, 6 B.T.A. 1023 (1928).

²⁵§ 104(a)(2).

Concept Summary 5.1

Taxation of Damages

Type of Claim	Taxation of Award or Settlement
Breach of contract (generally loss of income)	Taxable.
Property damages	Recovery of cost; gain to the extent of the excess over basis. A loss is deductible for business property and investment property to the extent of basis over the amount realized. A loss may be deductible for personal use property (see discussion of casualty losses in Chapter 7).
Personal injury	
Physical	All compensatory amounts are excluded unless previously deducted (e.g., medical expenses). Amounts received as punitive damages are included in gross income.
Nonphysical	Compensatory damages and punitive damages are included in gross income.

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 5-1. The damages Paul received were awarded as a result of a physical personal injury. Therefore, all of the compensatory damages can be excluded. Note that even the compensation for the loss of income of \$15,000 can be excluded. The punitive damages Paul received, however, must be included in his gross income.

Paul's mother did not suffer a personal physical injury or sickness. Therefore, the \$25,000 she received must be included in her gross income.

ETHICS & EQUITY Classifying the Amount of the Claim

Lee was injured in an automobile accident caused by a negligent driver of a commercial vehicle. Lee threatened to file a lawsuit against the company for \$100,000 damages for his physical injury and \$100,000

punitive damages. The company's insurer would not pay punitive damages. Therefore, the company advised Lee to revise his claim for \$150,000 physical damages and no punitive damages. Should Lee accept the offer?

5-5b Workers' Compensation

State workers' compensation laws require the employer to pay fixed amounts for specific job-related injuries. The state laws were enacted so that the employee will not have to go through the ordeal of a lawsuit (and possibly not collect damages because of some defense available to the employer) to recover the damages. Although the payments are intended, in part, to compensate for a loss of future income, Congress has specifically exempted workers' compensation benefits from inclusion in gross income.²⁶

5-5c Accident and Health Insurance Benefits

The income tax treatment of accident and health insurance benefits depends on whether the policy providing the benefits was purchased by the taxpayer or the taxpayer's employer. Benefits collected under an accident and health insurance policy *purchased by the taxpayer* are excludible even though the payments are a substitute for income.²⁷

²⁶§ 104(a)(1).

²⁷§ 104(a)(3).

Exempt Benefits

Bonnie purchases a medical and disability insurance policy. The insurance company pays Bonnie \$1,000 per week to replace wages she loses while in the hospital. Although the payments serve as a substitute for income, the amounts received are tax-exempt benefits collected under Bonnie's insurance policy.

EXAMPLE

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Joe's injury results in a partial paralysis of his left foot. He receives \$20,000 for the injury from his accident insurance company under a policy he had purchased. The \$20,000 accident insurance proceeds are tax-exempt.

EXAMPLE

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A different set of rules applies if the accident and health insurance protection was *purchased by the individual's employer*, as discussed in the following section.

5-6 EMPLOYER-SPONSORED ACCIDENT AND HEALTH PLANS

Congress encourages employers to provide employees, retired former employees, and their dependents with **accident and health benefits**, disability insurance, and long-term care plans. The *premiums* are deductible by the employer and excluded from the employee's income.²⁸ Although § 105(a) provides the general rule that the employee has includible income when he or she collects the insurance *benefits*, two exceptions are provided.

Section 105(b) generally excludes payments received for medical care of the employee, spouse, and dependents. However, if the payments are for expenses that do not meet the Code's definition of medical care,²⁹ the amount received must be included in gross income. In addition, the taxpayer must include in gross income any amounts received for medical expenses that were deducted by the taxpayer on a prior return.

In 2015, Tab's employer-sponsored health insurance plan pays \$4,000 for hair transplants that do not meet the Code's definition of medical care. Tab must include the \$4,000 in his gross income for 2015.

EXAMPLE

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Section 105(c) excludes payments for the permanent loss or the loss of the use of a member or function of the body or the permanent disfigurement of the employee, the spouse, or a dependent. Payments that are a substitute for salary (e.g., related to the period of time absent) are includible.

Jill loses an eye in an automobile accident unrelated to her work. As a result of the accident, Jill incurs \$2,000 of medical expenses, which she deducts on her return. She collects \$10,000 from an accident insurance policy carried by her employer. The benefits are paid according to a schedule of amounts that vary with the part of the body injured (e.g., \$10,000 for loss of an eye and \$20,000 for loss of a hand). Because the payment is for loss of a *member or function of the body*, the \$10,000 is excluded from gross income. Jill is absent from work for a week as a result of the accident. Her employer provides her with insurance for the loss of income due to illness or injury. Jill collects \$500, which is includible in gross income.

EXAMPLE

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5-6a Medical Reimbursement Plans

In lieu of providing the employee with insurance coverage for hospital and medical expenses, the employer may agree to reimburse the employee for these expenses. The amounts received through the insurance coverage (insured plan benefits) are excluded

²⁸§ 106, Reg. § 1.106-1, and Rev.Rul. 82-196, 1982-1 C.B. 106.

²⁹See the discussion of medical care in Chapter 10.



TAX IN THE NEWS Same-Sex Marriage and Employer-Provided Health Insurance

Now that same-sex marriages are recognized in some states, these marriages are recognized for Federal income tax purposes. As a result of the 2013 Supreme Court decision in *United States v. Windsor* [133 S.Ct. 2675 (USSC, 2013)], the IRS recognizes marriages validly entered into in a state or country whose laws authorize the marriage of two individuals of the same sex even if the married couple is domiciled in a state that does not recognize the validity of same-sex

marriages. As a result, when a same-sex spouse is provided coverage under a spouse's employee health insurance, the premiums may be excluded from the employee's gross income. This was not allowed prior to *Windsor*, resulting in the employee having taxable income from the benefit.

Source: Rev.Rul. 2013-17, 2013-38 I.R.B. 201.

from income under § 105 (as previously discussed). Unfortunately, in terms of cost considerations, the insurance companies that issue this type of policy usually require a broad coverage of employees. An alternative is to have a plan that is not funded with insurance (a self-insured arrangement). The benefits received under a self-insured plan can be excluded from the employee's income if the plan does not discriminate in favor of highly compensated employees.³⁰

There is also an alternative means of accomplishing a medical reimbursement plan. The employer can purchase a medical insurance plan with a high deductible (e.g., the employee is responsible for the first \$2,600 of the family's medical expenses) and then make contributions to the employee's **Health Savings Account (HSA)**.³¹ The employer can make contributions each month up to the maximum contribution of 100 percent of the deductible amount. The monthly deductible amount is limited to one-twelfth of \$3,350 under a high-deductible plan for self-only coverage. The monthly amount for an individual who has family coverage is limited to one-twelfth of \$6,650 under a high-deductible plan. Withdrawals from the HSA must be used to reimburse the employee for the medical expenses paid by the employee that are not covered under the high-deductible plan. The employee is not taxed on the employer's contributions to the HSA, the earnings on the funds in the account, or the withdrawals made for medical expenses.³²

5-6b Long-Term Care Insurance Benefits

Generally, **long-term care insurance**, which covers expenses such as the cost of care in a nursing home, is treated the same as accident and health insurance benefits. Thus, the employee does not recognize income when the employer pays the premiums. Also, the individual who purchases his or her own policy can exclude the benefits from gross income. However, statutory limitations (indexed for inflation) exist for the following amounts:

- Premiums paid by the employer.
- Benefits collected under the employer's plan.
- Benefits collected from the individual's policy.

The employer or insurance company generally provides the employee with information on the amount of his or her taxable benefits.

The maximum amount excluded must be reduced by any amount received from third parties (e.g., Medicare, Medicaid).³³

³⁰§ 105(h).

³¹§§ 106(d) and 223. See additional coverage in Chapter 10.

³²§§ 106(d), 223(b), and 223(d). The amounts for 2014 were \$3,300 and \$6,550.

³³§§ 7702B and § 213(d)(10). See IRS Publication 525 for the taxable and non-taxable amounts that the employer is required to report on the employee's W-2.

Hazel, who suffers from Alzheimer's disease, is a patient in a nursing home for the last 30 days of 2015. While in the nursing home, she incurs total costs of \$7,600. Medicare pays \$3,200 of the costs. Hazel receives \$7,000 from her long-term care insurance policy, which pays while she is in the facility.

The amount Hazel may exclude is calculated as follows:

Greater of:		
Daily statutory amount in 2015 ($\$330 \times 30$ days)	\$9,900	
Actual cost of the care	7,600	\$ 9,900
Less: Amount received from Medicare		(3,200)
Amount of exclusion		<u>\$ 6,700</u>

Therefore, Hazel must include \$300 ($\$7,000 - \$6,700$) of the long-term care benefits received in her gross income.

EXAMPLE

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The exclusion for long-term care insurance is not available if it is provided as part of a cafeteria plan or a flexible spending plan (explained later in the chapter).

5-7 MEALS AND LODGING

5-7a General Rules for the Exclusion

As discussed in Chapter 4, income can take any form, including meals and lodging. However, § 119 excludes from income the value of meals and lodging provided to the employee and the employee's spouse and dependents under the following conditions:³⁴

- The meals and/or lodging are *furnished* by the employer on the employer's *business premises* for the *convenience of the employer*.
- In the case of lodging, the *employee is required* to accept the lodging as a condition of employment.

The courts have interpreted both of these requirements strictly.

Furnished by the Employer

The following two questions have been raised with regard to the *furnished by the employer* requirement:

- Who is considered an *employee*?
- What is meant by *furnished*?

The IRS and some courts have reasoned that because a partner is not an employee, the exclusion does not apply to a partner. However, the Tax Court and the Fifth Circuit Court of Appeals have ruled in favor of the taxpayer on this issue.³⁵

The Supreme Court held that a cash meal allowance was ineligible for the exclusion because the employer did not actually furnish the meals.³⁶ Similarly, one court denied the exclusion where the employer paid for the food and supplied the cooking facilities but the employee prepared the meal.³⁷

³⁴§ 119(a). The meals and lodging are also excluded from FICA and FUTA tax. *Rowan Companies, Inc. v. U.S.*, 81-1 USTC ¶9479, 48 AFTR 2d 81-5115, 101 S.Ct. 2288 (USSC, 1981).

³⁵Rev.Rul. 80, 1953-1 C.B. 62; *Comm. v. Doak*, 56-2 USTC ¶9708, 49 AFTR 1491, 234 F.2d 704 (CA-4, 1956); but see *G. A. Papineau*, 16 T.C. 130 (1951); *Armstrong v. Phinney*, 68-1 USTC ¶9355, 21 AFTR 2d 1260, 394 F.2d 661 (CA-5, 1968).

³⁶*Comm. v. Kowalski*, 77-2 USTC ¶9748, 40 AFTR 2d 6128, 98 S.Ct. 315 (USSC, 1977).

³⁷*Tougher v. Comm.*, 71-1 USTC ¶9398, 27 AFTR 2d 1301, 441 F.2d 1148 (CA-9, 1971).

On the Employer's Business Premises

The *on the employer's business premises* requirement, applicable to both meals and lodging, has resulted in much litigation. The Regulations define business premises as simply "the place of employment of the employee."³⁸ Thus, the Sixth Circuit Court of Appeals held that a residence, owned by the employer and occupied by an employee, two blocks from the motel that the employee managed was not part of the business premises.³⁹ However, the Tax Court considered an employer-owned house across the street from the hotel that was managed by the taxpayer to be on the business premises of the employer.⁴⁰ Apparently, the closer the lodging is to the business operations, the more likely the convenience of the employer is served.

For the Convenience of the Employer

The *convenience of the employer* test is intended to focus on the employer's motivation for furnishing the meals and lodging rather than on the benefits received by the employee. If the employer furnishes the meals and lodging primarily to enable the employee to perform his or her duties properly, it does not matter that the employee considers these benefits to be a part of his or her compensation.

The Regulations give the following examples in which the tests for excluding meals are satisfied:⁴¹

- A restaurant requires its service staff to eat their meals on the premises during the busy lunch and breakfast hours.
- A bank furnishes meals on the premises for its tellers to limit the time the employees are away from their booths during the busy hours.
- A worker is employed at a construction site in a remote part of Alaska. The employer must furnish meals and lodging due to the inaccessibility of other facilities.

Required as a Condition of Employment

The *employee is required to accept* test applies only to lodging. If the employee's use of the housing would serve the convenience of the employer but the employee is not required to use the housing, the exclusion is not available.

EXAMPLE

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Khalid is the manager of a large apartment complex. The employer requires Khalid to live on the premises but does not charge him rent. The rental value of his apartment is \$9,600 a year. Although Khalid considers the rent-free housing a significant benefit, he is not required to include the value of the housing in his gross income.

5-7b Other Housing Exclusions

An employee of an educational institution may be able to exclude the value of campus housing provided by the employer. Generally, the employee does not recognize income if he or she pays annual rents equal to or greater than 5 percent of the appraised value of the facility. If the rent payments are less than 5 percent of the value of the facility, the deficiency must be included in gross income.⁴²

Ministers of the gospel and other religious leaders can exclude (1) the rental value of a home furnished as compensation; (2) a rental allowance paid to them as compensation, to the extent the allowance is used to rent, buy, or provide a home; or (3) the rental value of a home owned by the minister.⁴³ The housing or housing allowance must be provided as compensation for the conduct of religious worship, the administration

³⁸Reg. § 1.119-1(c)(1).

³⁹*Comm. v. Anderson*, 67-1 USTC ¶9136, 19 AFTR 2d 318, 371 F.2d 59 (CA-6, 1966).

⁴⁰*J. B. Lindeman*, 60 T.C. 609 (1973).

⁴¹Reg. § 1.119-1(f).

⁴²§ 119(d).

⁴³§ 107 and Reg. § 1.107-1.



TAX IN THE NEWS Two Trips to the Well

A minister of the gospel who receives a housing allowance may be living in a home being purchased. The funds received as a housing allowance and excluded from gross income may be used to pay on the home mortgage, and the minister may deduct the mortgage interest as

an itemized deduction. This was blessed by Congress when it enacted § 265(a)(6) permitting the minister to deduct his or her home mortgage interest even though the payments are financed from tax-exempt income.

and maintenance of religious organizations, or the performance of teaching and administrative duties at theological seminaries.

Military personnel are allowed housing exclusions under various circumstances. Authority for these exclusions generally is found in Federal laws that are not part of the Internal Revenue Code.⁴⁴

5-8 EMPLOYEE FRINGE BENEFITS

Benefits other than wages and salary that are provided to employees by the employer are often referred to as **fringe benefits**. Generally, Congress decided that the availability of these benefits serve social goals. Moreover, the income tax exclusion will provide an incentive for employees to bargain for these fringe benefits in lieu of cash, thus increasing the use of this form of compensation. For example, if the employee is in the 25 percent marginal tax bracket, \$1.00 of nontaxable fringe benefits is equivalent to \$1.33 ($\$1.00 / (1 - .25) = \1.33) in taxable compensation. From the employer's perspective then, it costs only \$1.00 to provide \$1.33 in value to that employee in the form of a tax-favored fringe benefit.

In Chapter 4 and earlier in this chapter, various fringe benefits were discussed (e.g., group term life insurance, accident and health insurance, and meals and lodging). Other employee benefits are discussed below.

5-8a Specific Benefits

Congress has dealt specifically with some other fringe benefits, which are summarized below.

- The employee does not have to include in gross income the value of child and dependent care services paid for by the employer and incurred to enable the employee to work. The exclusion cannot exceed \$5,000 per year (\$2,500 if married and filing separately). For a married couple, the annual exclusion cannot exceed the earned income of the spouse who has the lesser amount of earned income. For an unmarried taxpayer, the exclusion cannot exceed the taxpayer's earned income.⁴⁵
- The value of the use of a gymnasium or other athletic facilities by employees, their spouses, and their dependent children may be excluded from an employee's gross income. The facilities must be on the employer's premises, and substantially all of the use of the facilities must be by employees and their family members.⁴⁶
- Qualified employer-provided educational assistance (tuition, fees, books, and supplies) at the undergraduate and graduate level is excludible from gross income. The exclusion does not cover meals, lodging, and transportation costs. In addition, it does not cover educational payments for courses involving sports, games, or hobbies. The exclusion is subject to an annual employee statutory ceiling of \$5,250.⁴⁷

⁴⁴H. Rep. No. 99-841, 99th Cong., 2d Sess., p. 548 (1986). See § 134 and *Armed Forces Tax Guide* (IRS Publication 3).

⁴⁵§ 129. The exclusion applies to the same types of expenses that, if paid by the employee (and not reimbursed by the employer), would be

eligible for the credit for child and dependent care expense discussed in Chapter 12.

⁴⁶§ 132(j)(4).

⁴⁷§ 127.

- The employee can exclude from gross income up to \$13,400 of expenses incurred to adopt a child where the adoption expenses are paid or reimbursed by the employer under a qualified adoption assistance program.⁴⁸ The limit on the exclusion is the same even if the child has special needs (is not physically or mentally capable of caring for himself or herself). However, for a child with special needs, the \$13,400 exclusion from gross income applies even if the actual adoption expenses are less than that amount. For 2015, the exclusion is phased out as adjusted gross income increases from \$201,010 to \$241,010.

5-8b Cafeteria Plans

Generally, if an employee is offered a choice between cash and some other form of compensation, the employee is deemed to have constructively received the cash even when the noncash option is elected. Thus, the employee has gross income regardless of the option chosen.

An exception to this constructive receipt treatment is provided under the **cafeteria plan** rules. Under such a plan, the employee is permitted to choose between cash and nontaxable benefits (e.g., group term life insurance, health and accident protection, child care). If the employee chooses the otherwise nontaxable benefits, the cafeteria plan rules enable the benefits to remain nontaxable.⁴⁹ Cafeteria plans provide tremendous flexibility in tailoring the employee pay package to fit individual needs. Some employees (usually the younger group) prefer cash, while others (usually the older group) will opt for the fringe benefit program.

EXAMPLE

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Hawk Corporation offers its employees (on a nondiscriminatory basis) a choice of any one or all of the following benefits:

Benefit	Cost
Group term life insurance	\$ 200
Hospitalization insurance for family members	2,400
Child care payments	1,800
	<u>\$4,400</u>

If a benefit is not selected, the employee receives cash equal to the cost of the benefit. Kay, an employee, has a spouse who works for another employer that provides hospitalization insurance but no child care payments. Kay elects to receive the group term life insurance, the child care payments, and \$2,400 of cash. Only the \$2,400 must be included in Kay's gross income.

5-8c Flexible Spending Plans

Flexible spending plans (often referred to as flexible benefit plans) operate much like cafeteria plans. Under these plans, the employee accepts lower cash compensation (as much as \$2,550 in 2015) in return for the employer agreeing to pay certain costs that the employer can pay without the employee recognizing gross income. For example, assume that the employer's health insurance policy does not cover dental expenses. The employee could estimate his or her dental expenses for the upcoming year and agree to a salary reduction equal to the estimated dental expenses. The employer then pays or reimburses the employee for the actual dental expenses incurred, with a ceiling of the amount of the salary reduction. If the employee's actual dental expenses are less than the reduction in cash compensation, the employee cannot recover the difference. Hence, these plans are often referred to as *use or lose* plans. To avoid forfeiture of unpaid amounts, the IRS allows a payment until March 15 of the following year to

⁴⁸§ 137. A credit is also available under § 23, as discussed in Chapter 12.

⁴⁹§ 125.

count. As is the case for cafeteria plans, flexible spending plans cannot be used to pay long-term care insurance premiums.

5-8d General Classes of Excluded Benefits

An employer can confer numerous forms and types of economic benefits on employees. Under the all-inclusive concept of income, the benefits are taxable unless one of the provisions previously discussed specifically excludes the item from gross income. The amount of the income is the fair market value of the benefit.

Ryan is employed in New York as a ticket clerk for Trans National Airlines. He has a sick mother in Miami, Florida, but has no money for plane tickets. Trans National has daily flights from New York to Miami that often leave with empty seats. The cost of a round-trip ticket is \$400. If Trans National allows Ryan to fly without charge to Miami, under the general gross income rules, Ryan has income equal to the value of a ticket. Therefore, Ryan must include \$400 in gross income on a trip to Miami.

EXAMPLE

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Because Congress believed that taxing fringe benefits often yielded harsh results, § 132 was enacted to provide exclusion treatment. This provision established seven broad classes of nontaxable employee benefits:⁵⁰

- No-additional-cost services.
- Qualified employee discounts.
- Working condition fringes.
- *De minimis* fringes.
- Qualified transportation fringes.
- Qualified moving expense reimbursements.
- Qualified retirement planning services.

The value of the services that the employer provides its employees are nontaxable under certain circumstances.

No-Additional-Cost Services

Return to Example 20 above. This illustrates the reason for the **no-additional-cost service** type of fringe benefit. The services will be nontaxable if all of the following conditions are satisfied:

- The employee receives services, as opposed to property.
- The employer does not incur substantial additional cost, including forgone revenue, in providing the services to the employee.
- The services are offered to customers in the ordinary course of the business in which the employee works.⁵¹

In Example 20, although the airplane may burn slightly more fuel because Ryan is on board and he may receive the same snacks and meals as paying customers, the additional costs to the airline would not be substantial. Thus, the trip could qualify as a no-additional-cost service, and the value of Ryan's flight can be excluded from his gross income.

EXAMPLE

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The no-additional-cost exclusion extends to the employee's spouse and dependent children and to retired and disabled former employees.⁵² However, the exclusion is not allowed to highly compensated employees unless the benefit is available on a nondiscriminatory basis.

⁵⁰See, generally, § 132.

⁵¹Reg. § 1.132-2.

⁵²Reg. § 1.132-1(b).

Qualified Employee Discounts

When the employer sells goods or services (other than no-additional-cost benefits just discussed) to the employee for a price that is less than the price charged regular customers, the employee realizes income equal to the discount. However, the discount, referred to as a **qualified employee discount**, can be excluded from the gross income of the employee, subject to the following conditions and limitations:

- The exclusion is not available for real property (e.g., a house) or for personal property of the type commonly held for investment (e.g., common stocks).
- The property or services must be from the same line of business in which the employee works.
- In the case of *property*, the exclusion is limited to the *gross profit component* of the price to customers.
- In the case of *services*, the exclusion is limited to 20 percent of the customer price.

EXAMPLE

22

Silver Corporation, which operates a department store, sells a television set to a store employee for \$300. The regular customer price is \$500, and the gross profit rate is 25%. The corporation also sells the employee a service contract for \$120. The regular customer price for the contract is \$150. The employee must include \$75 in gross income.

Customer price for property	\$ 500
Less: Gross profit (25%)	<u>(125)</u>
	\$ 375
Employee price	<u>(300)</u>
Income	<u>\$ 75</u>
Customer price for service	\$ 150
Less: 20%	<u>(30)</u>
	\$ 120
Employee price	<u>(120)</u>
Income	<u>\$ -0-</u>

As in the case of no-additional-cost benefits, the exclusion applies to employees (including service partners), employees' spouses and dependent children, and retired and disabled former employees.

Working Condition Fringes

Generally, an employee is not required to include in gross income the cost of property or services provided by the employer if the employee could deduct the cost of those items if he or she had actually paid for them. These benefits are called **working condition fringes**.

EXAMPLE

23

Mitch is a CPA employed by an accounting firm. The employer pays Mitch's annual dues to professional organizations. Mitch is not required to include the payment of the dues in gross income because if he had paid the dues, he would have been allowed to deduct the amount as an employee business expense (as discussed in Chapter 9).⁵³

Unlike the other fringe benefits discussed previously, working condition fringes can be made available on a discriminatory basis and still qualify for the exclusion.

De Minimis Fringes

As the term suggests, **de minimis fringe** benefits are so small that accounting for them is impractical. The House Report contains the following examples of *de minimis* fringes:

⁵³In many cases, this exclusion merely avoids reporting income and an off-setting deduction.

- Occasional personal use of a company copying machine, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare for employees because of overtime work, and certain holiday gifts of property with a low fair market value are excluded.
- Subsidized eating facilities (e.g., an employees' cafeteria) operated by the employer are excluded if located on or near the employer's business premises, if revenue equals or exceeds direct operating costs, and if nondiscrimination requirements are met.

When taxpayers venture beyond the specific examples contained in the House Report and the Regulations, there is obviously much room for disagreement as to what is *de minimis*.

In Notice 2011-72, the IRS addressed the question of whether cell phones provided by the employer could be excluded from gross income as a working condition fringe benefit. Generally, the value of the cell phone can be excluded if it is provided for business reasons such as to enable the employee to be in contact with clients when the employee is away from the office. When the primary purpose test is satisfied, any personal use of the employer-provided cell phone will be excluded as a *de minimis* fringe benefit.

Qualified Transportation Fringes

The intent of the exclusion for **qualified transportation fringes** is to encourage the use of mass transit for commuting to and from work. Qualified transportation fringes encompass the following transportation benefits provided by the employer to the employee:

1. Transportation in a commuter highway vehicle between the employee's residence and the place of employment.
2. A transit pass.
3. Qualified parking.
4. Qualified bicycle commuting reimbursement.

Statutory dollar limits are placed on the amount of the exclusion. Categories (1) and (2) above are combined for purposes of applying the limit. In this case, the limit on the exclusion for 2015 is \$130 per month. Category (3) has a separate limit. For qualified parking, the limit on the exclusion for 2015 is \$250 per month. Both of these dollar limits are indexed annually for inflation.

A *commuter highway vehicle* is any highway vehicle with a seating capacity of at least six adults (excluding the driver). In addition, at least 80 percent of the vehicle's use must be for transporting employees between their residences and place of employment.

Qualified parking includes the following:

- Parking provided to an employee on or near the employer's business premises.
- Parking provided to an employee on or near a location from which the employee commutes to work via mass transit, in a commuter highway vehicle, or in a carpool.

The *qualified bicycle commuting reimbursement* enables an employee to exclude up to \$20 per month received from an employer as reimbursement for the cost of commuting by bicycle (i.e., bicycle purchase, improvement, repair, and storage).

Qualified transportation fringes may be provided directly by the employer or may be in the form of cash reimbursements.

Gray Corporation's offices are located in the center of a large city. The company pays for parking spaces to be used by the company officers. Steve, a vice president, receives \$300 of such benefits each month. The parking space rental qualifies as a qualified transportation fringe. Of the \$300 benefit received each month by Steve, \$250 is excludible from gross income. The balance of \$50 is included in his gross income. The same result would occur if Steve paid for the parking and was reimbursed by his employer.

EXAMPLE

24

Qualified Moving Expense Reimbursements

Qualified moving expenses that are reimbursed or paid by the employer are excludible from gross income. A qualified moving expense is an expense that would be deductible under § 217. See the discussion of moving expenses in Chapter 9.

Qualified Retirement Planning Services

Qualified retirement planning services include any retirement planning advice or information that an employer who maintains a qualified retirement plan provides to an employee or the employee's spouse. Congress decided to exclude the value of such services from gross income because they are a key part of retirement income planning. Such an exclusion should motivate more employers to provide retirement planning services to their employees.

Nondiscrimination Provisions

For no-additional-cost services, qualified employee discounts, and qualified retirement planning services that are discriminatory in favor of highly compensated employees, exclusion treatment is denied. However, for the discriminatory plans, the exclusion treatment for non-highly compensated employees remains.⁵⁴

EXAMPLE

25

Dove Company's officers are allowed to purchase goods from the company at a 25% discount. All other employees are allowed only a 15% discount. The company's gross profit margin on these goods is 30%. Because the officers receive more favorable discounts, the plan is discriminatory in favor of the officers. In regard to all other employees, the discount is "qualified" because it is available to all employees (other than the officers who receive a more favorable discount) and the discount is less than the company's gross profit.

Peggy, an officer in the company, purchased goods from the company for \$750 when the price charged to customers was \$1,000. Peggy must include \$250 in gross income because the plan is discriminatory.

Mason, an employee of the company who is not an officer, purchased goods for \$850 when the customer price was \$1,000. Mason is not required to recognize gross income because he received a qualified employee discount.

De minimis (except in the case of subsidized eating facilities) and working condition fringe benefits can be provided on a discriminatory basis. The *de minimis* benefits are not subject to tax because the accounting problems that would be created are out of proportion to the amount of additional tax that would result.

A review of employee fringe benefits is set forth in Concept Summary 5.2.

5-9 FOREIGN EARNED INCOME

The United States uses a global tax system as opposed to a territorial system. Under this global system, a U.S. citizen is generally subject to tax on his or her income regardless of its economic origin. Some other countries use a territorial system; that is, a person's income is taxed only in the country in which the income was earned. Under this global system, a U.S. citizen who earns income in another country could experience double taxation: the same income would be taxed in the United States and in the foreign country. Out of a sense of fairness and to encourage U.S. citizens to work abroad (so that exports might be increased), Congress has provided alternative forms of relief from taxes on foreign earned income. The taxpayer can elect *either* (1) to include the foreign income in his or her taxable income and then claim a credit for foreign taxes paid or (2) to exclude the foreign earnings from his or her U.S. gross income (the **foreign earned income exclusion**).⁵⁵ The foreign tax credit option is discussed in Chapter 12, but as is apparent from the following discussion, most taxpayers choose the exclusion.

⁵⁴ §§ 132(j)(1) and 132(m)(2).

⁵⁵ § 911(a). The exclusion for 2015 is limited to \$100,800. In 2014, the limit was \$99,200.

Concept Summary 5.2

Employee Fringe Benefits

Type of Benefit	Exclusion
Group term life insurance (§ 79)	Premiums on up to \$50,000 protection
Employee achievement awards (§ 74)	Up to \$1,600 in a year
Accident, health, and long-term care insurance and medical reimbursement (§§ 105 and 106)	Insurance premiums paid by the employer and benefits collected
High-deductible health insurance and contributions to employee's Health Savings Account (§§ 106 and 223)	Employer premiums on high-deductible medical insurance plus contributions to Health Savings Account (statutory limits, indexed for inflation).
Meals and lodging furnished for the convenience of the employer (§ 119)	Value of meals and lodging on the employer's premises
Child care provided by the employer or reimbursement for employee's cost (§ 129)	Services provided or reimbursement of expenses up to \$5,000 a year
Athletic facilities on the employer's premises (§ 132)	Value of services
Educational assistance for tuition, fees, books, and supplies (§ 127)	Limited to \$5,250 per year
No-additional-cost services [e.g., use of employer's facilities (§ 132)]	Value of the use
Employee discount on purchase of goods from employer at employer's cost (§ 132)	Employer's normal profit margin
Employee discount for purchases of employer's services (§ 132)	Maximum of 20% of employer's normal price
Working condition fringes [e.g., the mechanic's tools (§ 132)]	Employer's cost
<i>De minimis</i> items so small that the accounting effort is not warranted [e.g., use of employer telephone (§ 132)]	Value of the goods or services
Qualified transportation [e.g., transit passes and parking (§ 132)]	Statutory amounts, adjusted for inflation
Moving expense reimbursement (§ 132)	Reimbursement to the extent otherwise deductible by employee
Retirement planning services (§ 132)	Reasonable cost of services

Foreign earned income consists of the earnings from the individual's personal services rendered in a foreign country (other than as an employee of the U.S. government). To qualify for the exclusion, the taxpayer must be either of the following:

- A bona fide resident of the foreign country (or countries).
- Present in a foreign country (or countries) for at least 330 days during any 12 consecutive months.⁵⁶

Calculating the Exclusion

Sandra's trip to and from a foreign country in connection with her work were as follows:

Arrived in Foreign Country	Returned to United States
March 10, 2014	February 15, 2015

During the 12 consecutive months ending on March 10, 2015, Sandra was present in the foreign country for at least 330 days (365 days less 13 days in February and 10 days in March 2015). Therefore, all income earned in the foreign country through March 10, 2015, is eligible for the exclusion.

EXAMPLE

26

⁵⁶§ 911(d). For the definition of *resident*, see Reg. § 1.871-2(b). Under the Regulations, a taxpayer is not a resident if he or she is there for a definite period (e.g., until completion of a construction contract).

Calculating the Exclusion

EXAMPLE

27

Keith qualifies for the foreign earned income exclusion. He was present in France for all of 2015. Keith's salary for 2015 is \$120,000. Because all of the days in 2015 are qualifying days, Keith can exclude \$100,800 of his \$120,000 salary.

Assume instead that only 335 days were qualifying days. Then Keith's exclusion is limited to \$92,515, computed as follows:

$$\$100,800 \times \frac{335 \text{ days in foreign country}}{365 \text{ days in the year}} = \$92,515$$

EXAMPLE

28

In 2015, Carol, who is not married, had taxable income of \$30,000 after excluding \$100,800 of foreign earned income. Without the benefit of the exclusion, Carol's taxable income would have been \$130,800 (\$30,000 + \$100,800). The tax on the taxable income of \$30,000 is calculated using the marginal rate applicable to income between \$99,200 and \$129,200, which is 28%. Therefore, Carol's tax liability is \$8,400 (.28 × \$30,000).

As previously mentioned, the taxpayer may elect to include the foreign earned income in gross income and claim a credit (an offset against U.S. tax) for the foreign tax paid. The credit alternative may be advantageous if the individual's foreign earned income far exceeds the excludible amount so that the foreign taxes paid exceed the U.S. tax on the amount excluded. However, once an election is made, it applies to all subsequent years unless affirmatively revoked. A revocation is effective for the year of the change and the four subsequent years.

5-10 INTEREST ON CERTAIN STATE AND LOCAL GOVERNMENT OBLIGATIONS

At the time the Sixteenth Amendment was ratified by the states, there was some question as to whether the Federal government possessed the constitutional authority to tax interest on state and local government obligations. Taxing such interest was thought to violate the doctrine of intergovernmental immunity in that the tax would impair the state and local governments' ability to finance their operations.⁵⁷ Thus, interest on state and local government obligations was specifically exempted from Federal income taxation.⁵⁸ However, the Supreme Court has concluded that there is no constitutional prohibition against levying a nondiscriminatory Federal income tax on state and local government obligations.⁵⁹ Nevertheless, currently, the statutory exclusion still exists.

GLOBAL TAX ISSUES Benefits of the Earned Income Exclusion Are Questioned

The foreign earned income exclusion is intended to be a means to increase exports. But a recent GAO questioned whether the \$6 billion of lost revenue is money well spent. The report was inconclusive. It is clear that repealing the exclusion would make it more costly for U.S. companies to send their employees abroad, but there is

no evidence that the benefits to the U.S., in general, are worth the cost.

Source: Economic Benefits of Income Exclusion for U.S. Citizens Working Abroad Are Uncertain GAO-14-387: Published: May 20, 2014, available at www.gao.gov/products/GAO-14-387.

⁵⁷*Pollock v. Farmer's Loan & Trust Co.*, 3 AFTR 2602, 15 S.Ct. 912 (USSC, 1895).

⁵⁸§ 103(a).

⁵⁹*South Carolina v. Baker III*, 88-1 USTC ¶9284, 61 AFTR 2d 88-995, 108 S.Ct. 1355 (USSC, 1988).

Obviously, the exclusion of the interest reduces the cost of borrowing for state and local governments. A taxpayer in the 35 percent tax bracket requires only a 5.2 percent yield on a tax-exempt bond to obtain the same after-tax income as a taxable bond paying 8 percent interest [$5.2\% \div (1 - .35) = 8\%$].

The current exempt status applies solely to state and local government bonds. Thus, income received from the accrual of interest on a condemnation award or an overpayment of state income tax is fully taxable.⁶⁰ Nor does the exemption apply to gains on the sale of tax-exempt securities.

Megan purchases State of Virginia bonds for \$10,000 on July 1, 2014. The bonds pay \$400 interest each June 30 and December 31. On March 31, 2015, Megan sells the bonds for \$10,500 plus \$200 accrued interest. Megan must recognize a \$500 gain (\$10,500 – \$10,000), but the \$200 accrued interest is exempt from taxation.

EXAMPLE

29

Although the Internal Revenue Code excludes from Federal gross income the interest on state and local government bonds, the interest on U.S. government bonds is not excluded from the Federal tax base. Congress has decided, however, that if the Federal government is not to tax state and local bond interest, the state and local governments are prohibited from taxing interest on U.S. government bonds.⁶¹ While this parity between the Federal and state and local governments exists in regard to taxing each other's obligations, the states are free to tax one another's obligations. Thus, some states exempt the interest on the bonds they issue, but tax the interest on bonds issued by other states.⁶²

5-11 CORPORATE DISTRIBUTIONS TO SHAREHOLDERS

5-11a General Information

A corporate distribution is a payment to a shareholder with respect to his or her stock (see Chapter 4). Distributions are taxed as dividends to shareholders only to the extent the payments are made from *either* the corporation's *current earnings and profits* (similar to net income per books) or its *accumulated earnings and profits* (similar to retained earnings per books).⁶³ Distributions that exceed earnings and profits are treated as a nontaxable recovery of capital and reduce the shareholder's basis in the stock. Once the shareholder's basis is reduced to zero, any subsequent distributions are taxed as capital gains (see Chapters 13 and 19).⁶⁴

Some payments are frequently referred to as dividends but are not considered dividends for tax purposes:

- Dividends received on deposits with savings and loan associations, credit unions, and banks are actually interest (a contractual rate paid for the use of money).
- Patronage dividends paid by cooperatives (e.g., for farmers) are rebates made to the users and are considered reductions in the cost of items purchased from the association. The rebates are usually made after year-end (after the cooperative has determined whether it has met its expenses) and are apportioned among members on the basis of their purchases.
- Mutual insurance companies pay dividends on unmatured life insurance policies that are considered rebates of premiums.

⁶⁰*Kieselbach v. Comm.*, 43-1 USTC ¶9220, 30 AFTR 370, 63 S.Ct. 303 (USSC, 1943); *U.S. Trust Co. of New York v. Anderson*, 3 USTC ¶1125, 12 AFTR 836, 65 F.2d 575 (CA-2, 1933).

⁶¹31 U.S.C.A. § 742.

⁶²The practice of a state exempting interest on its bonds from tax but taxing the interest on bonds issued by other states has been upheld by the

Supreme Court. See *Department of Revenue of Kentucky v. Davis*, 128 S.Ct. 1801 (USSC, 2008).

⁶³§ 316(a). Refer to the discussion of the beneficial tax rates for qualified dividends in Chapter 4.

⁶⁴§ 301(c). See Chapter 19 for a detailed discussion of corporate distributions.

- Shareholders in a mutual investment fund are allowed to report as capital gains their proportionate share of the fund's gains realized and distributed. The capital gain and ordinary income portions are reported on the Form 1099 that the fund supplies its shareholders each year.

5-11b Stock Dividends

When a corporation issues a simple stock dividend (e.g., common stock issued to common shareholders), the shareholder has merely received additional shares that represent the same total investment. Thus, the shareholder does not realize income.⁶⁵ However, if the shareholder has the *option* of receiving either cash or stock in the corporation, the individual realizes gross income whether he or she receives stock or cash.⁶⁶ A taxpayer who elects to receive the stock could be deemed to be in constructive receipt of the cash he or she has rejected.⁶⁷ However, the amount of the income in this case is the value of the stock received, rather than the cash the shareholder has rejected. See Chapters 13 and 19 for a detailed discussion of stock dividends.

5-12 EDUCATIONAL SAVINGS BONDS

The cost of a college education has risen dramatically during the past 15 years. According to U.S. Department of Education estimates, the cost of attending a publicly supported university for four years now commonly exceeds \$60,000. For a private university, the cost often exceeds \$200,000. Consequently, Congress has attempted to assist low- to middle-income parents in saving for their children's college education.

One of the ways Congress assists such families is through an interest income exclusion on **educational savings bonds**.⁶⁸ The interest on Series EE U.S. government savings bonds may be excluded from gross income if the bond proceeds are used to pay qualified higher education expenses.

Qualified higher education expenses consist of tuition and fees paid to an eligible educational institution for the taxpayer, spouse, or dependent. If the redemption proceeds (both principal and interest) exceed the qualified higher education expenses, only a pro rata portion of the interest will qualify for exclusion treatment.

EXAMPLE

30

Tracy's redemption proceeds from qualified savings bonds during the taxable year are \$6,000 (principal of \$4,000 and interest of \$2,000). Tracy's qualified higher education expenses are \$5,000. Because the redemption proceeds exceed the qualified higher education expenses, only \$1,667 $[(\$5,000/\$6,000) \times \$2,000]$ of the interest is excludible.

The exclusion is limited by the application of the wherewithal to pay concept. That is, once the modified adjusted gross income exceeds a threshold amount, the phaseout of the exclusion begins. *Modified adjusted gross income (MAGI)* is adjusted gross income prior to the § 911 foreign earned income exclusion and the educational savings bond exclusion. The threshold amounts are adjusted for inflation each year. For 2015, the phaseout begins at \$77,200 (\$115,750 on a joint return).⁶⁹ The phaseout is completed when MAGI exceeds the threshold amount by more than \$15,000 (\$30,000 on a joint return). The otherwise excludible interest is reduced by the amount calculated as follows:

$$\frac{\text{MAGI} - \$77,200}{\$15,000} \times \text{Excludible interest before phaseout} = \text{Reduction in excludible interest}$$

On a joint return, \$115,750 is substituted for \$77,200 (in 2015), and \$30,000 is substituted for \$15,000.

⁶⁵*Eisner v. Macomber*, 1 USTC ¶32, 3 AFTR 3020, 40 S.Ct. 189 (USSC, 1920); § 305(a).

⁶⁸§ 135.

⁶⁶§ 305(b).

⁶⁹The indexed amounts for 2014 were \$76,000 and \$113,950.

⁶⁷Refer to the discussion of constructive receipt in Chapter 4.

Assume the same facts as in Example 30, except that Tracy's MAGI for 2015 is \$80,000. The phase-out results in Tracy's interest exclusion being reduced by \$311 $\{[(\$80,000 - \$77,200)/\$15,000] \times \$1,667\}$. Therefore, Tracy's exclusion is \$1,356 $(\$1,667 - \$311)$.

EXAMPLE**31**

5-13 QUALIFIED TUITION PROGRAMS (§ 529 PLANS)

Nearly all, if not all, states have created programs whereby parents can in effect prepay their child's college tuition. The prepayment serves as a hedge against future increases in tuition. Generally, if the child does not attend college, the parents are refunded their payments plus interest. Upon first impression, these prepaid tuition programs resemble the below-market loans discussed in Chapter 4. That is, assuming that the tuition increases, the parent receives a reduction in the child's tuition in exchange for the use of the funds. However, Congress has created an exclusion provision for these programs.⁷⁰

Under a **qualified tuition program (§ 529 plan)**, the amounts contributed must be used for qualified higher education expenses. These expenses include tuition, fees, books, supplies, room and board, and equipment required for enrollment or attendance at a college, a university, or certain vocational schools. The allowable expenses include computers and computer technology, including software that provides access to the Internet. Qualified higher education expenses also include the expenses for special needs services that are incurred in connection with the enrollment and attendance of special needs students.

The earnings of the contributed funds, including the discount on tuition charged to participants, are not included in Federal gross income provided the contributions and earnings are used for qualified higher education expenses. Some states also exclude these educational benefits from state gross income.

Agnes paid \$20,000 into a qualified tuition program to be used for her son's college tuition. When her son graduated from high school, the fund balance had increased to \$30,000 as a result of interest credited to the account. The interest was not included in Agnes's gross income. During the current year, \$7,500 of the balance in the fund was used to pay the son's tuition and fees. None of this amount is included in either Agnes's or the son's gross income.

EXAMPLE**32**

If the parent receives a refund (e.g., child does not attend college), the excess of the amount refunded over the amount contributed by the parent is included in the parent's gross income.

Qualified tuition programs have been expanded to apply to private educational institutions as well as public educational institutions.

5-14 QUALIFIED ABLE PROGRAMS (§ 529A PLANS)

In late 2014, a law change created a new type of program to assist individuals who became blind or disabled before age 26. The **qualified ABLE program** allows for § 529A plans, or ABLE (Achieving a Better Life Experience) plans, similar in concept to § 529 plans described earlier. The program must be established by a state. The ABLE account must be for the benefit of a designated beneficiary's disability expenses, and the beneficiary must have a disability certification from the government.

Contributions to the account must be in cash and may not exceed the annual gift tax exclusion for the year (\$14,000 for 2015). Contributions to the account are not deductible. The tax benefit of an ABLE account is that its earnings are not taxable. Distributions

⁷⁰§ 529.

from the account also are not taxable provided they do not exceed the qualified disability expenses of the designated beneficiary.

LQ.3

Determine the extent to which receipts can be excluded under the tax benefit rule.

5-15 TAX BENEFIT RULE

Generally, if a taxpayer obtains a deduction for an item in one year and in a later year recovers all or a portion of the prior deduction, the recovery is included in gross income in the year received.⁷¹

EXAMPLE

33

A taxpayer deducted as a loss a \$1,000 receivable from a customer when it appeared the amount would never be collected. The following year, the customer paid \$800 on the receivable. The taxpayer must report the \$800 as gross income in the year it is received.

However, the § 111 **tax benefit rule** provides that no income is recognized upon the recovery of a deduction, or the portion of a deduction, that did not yield a tax benefit in the year it was taken. If the taxpayer in Example 33 had no tax liability in the year of the deduction (e.g., itemized deductions and personal exemptions exceeded adjusted gross income), the recovery would be partially or totally excluded from gross income in the year of the recovery.⁷²

EXAMPLE

34

Ali filed his 2014 income tax return as a single individual. His AGI for 2014 was \$48,000. He had \$6,350 in itemized deductions, including \$1,200 in state income tax. His personal exemption was \$3,950. In 2015, he received a \$700 refund of the state income taxes that he paid in 2014. Because the standard deduction in 2014 was \$6,200, the \$1,200 of state income taxes Ali paid in 2014 yielded a tax benefit of only \$150 (\$6,350 itemized deductions – \$6,200 standard deduction) in 2014. Under the tax benefit rule, only \$150 of the state income tax refund is included in gross income in 2015.

LQ.4

Describe the circumstances under which income must be reported from the discharge of indebtedness.

5-16 INCOME FROM DISCHARGE OF INDEBTEDNESS

A transfer of appreciated property (fair market value is greater than adjusted basis) in satisfaction of a debt is an event that triggers the realization of income. The transaction is treated as a sale of the appreciated property followed by payment of the debt.⁷³ Foreclosure by a creditor is also treated as a sale or exchange of the property.⁷⁴

EXAMPLE

35

Juan owns land that serves as security for a \$50,000 mortgage held by State Bank. Juan does not have personal liability for the mortgage (it is non-recourse debt). When Juan's basis in the land is \$20,000 and the land's fair market value is \$50,000, the bank forecloses on the loan and takes title to the land. Juan must recognize a \$30,000 gain on the foreclosure, as though he sold the land for \$50,000.

In some cases, creditors will not exercise their right of foreclosure and will even forgive a portion of the debt to ensure the vitality of the debtor. In such cases, the debtor realizes income from discharge of indebtedness.

EXAMPLE

36

Kayla is personally liable on a mortgage on her office building, but she is unable to make the payments. Both Kayla and the mortgage holder are aware of the depressed market for real estate in the area. Foreclosure would only result in the creditor's obtaining unsalable property. The creditor agrees to forgive all amounts past due and to reduce the principal amount of the mortgage. Because Kayla was personally liable on the debt (it is recourse debt), she must recognize income equal to the amount of the forgiven debt, unless one of the exceptions discussed below applies.

⁷¹§ 111(a).

⁷²Itemized deductions are discussed in Chapter 10.

⁷³Reg. § 1.1001-2(a).

⁷⁴*Estate of Delman*, 73 T.C. 15 (1979).

The following discharge of indebtedness situations are subject to special treatment:⁷⁵

1. Creditors' gifts.
2. Discharges under Federal bankruptcy law.
3. Discharges that occur when the debtor is insolvent.
4. Discharge of the farm debt of a solvent taxpayer.
5. Discharge of **qualified real property business indebtedness**.
6. A seller's cancellation of the buyer's indebtedness.
7. A shareholder's cancellation of the corporation's indebtedness.
8. Forgiveness of certain loans to students.
9. Discharge of indebtedness on the taxpayer's principal residence that occurs between January 1, 2007, and January 1, 2015, and is the result of the financial condition of the debtor.

If the creditor reduces the debt as an act of *love, affection, or generosity*, the debtor has simply received a nontaxable gift (situation 1). Rarely will a gift be found to have occurred in a business context. A businessperson may settle a debt for less than the amount due, but as a matter of business expediency (e.g., high collection costs or disputes as to contract terms) rather than generosity.⁷⁶

In situations 2, 3, 4, 5, and 9, the Code allows the debtor to reduce his or her basis in the assets by the realized gain from the discharge.⁷⁷ Thus, the realized gain is merely deferred until the assets are sold (or depreciated). Similarly, in situation 6 (a price reduction), the debtor reduces the basis in the specific assets financed by the seller.⁷⁸

A shareholder's cancellation of the corporation's indebtedness to him or her (situation 7) usually is considered a tax-free contribution of capital to the corporation by the shareholder. Thus, the corporation's paid-in capital is increased, and its liabilities are decreased by the same amount.⁷⁹

Many states make loans to students on the condition that the loan will be forgiven if the student practices a profession in the state upon completing his or her studies. The amount of the loan that is forgiven (situation 8) is excluded from gross income.⁸⁰

5-17 TAX PLANNING

The present law excludes certain types of economic gains from taxation. Therefore, taxpayers may find tax planning techniques helpful in obtaining the maximum benefits from the exclusion of such gains. Following are some of the tax planning opportunities made available by the exclusions described in this chapter.

5-17a Life Insurance

Life insurance offers several favorable tax attributes. As discussed in Chapter 4, the annual increase in the cash surrender value of the policy is not taxable (because no income has been actually or constructively received). By borrowing on the policy's cash surrender value, the owner can actually receive the policy's increase in value in cash without recognizing income.

5-17b Employee Fringe Benefits

Generally, employees view accident and health insurance, as well as life insurance, as necessities. Employees can obtain group coverage at much lower rates than individuals would have to pay for the same protection. Premiums paid by the employer can be excluded from the employees' gross income. Because of the exclusion, employees will have a greater after-tax and after-insurance income if the employer pays a lower salary but also pays the insurance premiums.

LO.5

Identify tax planning strategies for obtaining the maximum benefit from allowable exclusions.

⁷⁵ §§ 108 and 1017.

⁷⁶ *Comm. v. Jacobson*, 49-1 USTC ¶9133, 37 AFTR 516, 69 S.Ct. 358 (USSC, 1949).

⁷⁷ §§ 108(a), (c), (e), and (g). Note that § 108(b) provides that other tax attributes (e.g., net operating loss) will be reduced by the realized gain from the

debt discharge prior to the basis adjustment unless the taxpayer elects to apply the basis adjustment first.

⁷⁸ § 108(e)(5).

⁷⁹ § 108(e)(6).

⁸⁰ § 108(f).

EXAMPLE

37

Pat receives a salary of \$30,000. The company has group insurance benefits, but Pat is required to pay his own premiums as follows:

Hospitalization and medical insurance	\$1,400
Term life insurance (\$30,000 coverage)	200
Disability insurance	400
	<u>\$2,000</u>

To simplify the analysis, assume that Pat's tax rate on income is 25%. After paying taxes of \$7,500 ($.25 \times \$30,000$) and \$2,000 for insurance, Pat has \$20,500 ($\$30,000 - \$7,500 - \$2,000$) for his other living needs.

If Pat's employer reduced Pat's salary by \$2,000 (to \$28,000) but paid his insurance premiums, Pat's tax liability would be only \$7,000 ($\$28,000 \times .25$). Thus, Pat would have \$21,000 ($\$28,000 - \$7,000$) to meet his other living needs. The change in the compensation plan would save Pat \$500 ($\$21,000 - \$20,500$), which is the marginal tax times the value of the insurance benefits ($.25 \times \$2,000 = \500).

Similarly, employees must often incur expenses for child care and parking. The employee can have more income for other uses if the employer pays these costs for the employee but reduces the employee's salary by the cost of the benefits.

The use of cafeteria plans has increased dramatically in recent years. These plans allow employees to tailor their benefits to meet their individual situations. Thus, where both spouses in a married couple are working, duplications of benefits can be avoided and other needed benefits can often be added. If less than all of the employee's allowance is spent, the employee can receive cash.

The meals and lodging exclusion enables employees to receive from their employer what they ordinarily must purchase with after-tax dollars. Although the requirements that the employee live and take his or her meals on the employer's premises limit the tax planning opportunities, the exclusion is an important factor in the employee's compensation in certain situations (e.g., hotels, motels, restaurants, farms, and ranches). The meals and lodging are clearly a benefit to the employee but are for the convenience of the employer and thus are excluded from income.

The employees' discount provision is especially important for manufacturers and wholesalers. Employees of manufacturers can avoid tax on the manufacturer's, wholesaler's, and retailer's markups. The wholesaler's employees can avoid tax on an amount equal to the wholesale and retail markups.

It should be recognized that the exclusion of benefits is generally available only to employees. Proprietors and partners must pay tax on the same benefits their employees receive tax-free. By incorporating and becoming an employee of the corporation, the former proprietor or partner can also receive these tax-exempt benefits. Thus, the availability of employee benefits is a consideration in the decision to incorporate.

5-17c Investment Income

Tax-exempt state and local government bonds are almost irresistible investments for high-income taxpayers, who may be subject to a 39.6 percent regular tax rate plus a 3.8 percent rate on their net investment income. To realize the maximum benefit from the exemption, the investor can purchase zero-coupon bonds. Like Series EE U.S. government savings bonds, these investments pay interest only at maturity. The advantage of the zero-coupon feature for a tax-exempt bond is that the investor can earn tax-exempt interest on the accumulated principal and interest. If the investor purchases a bond that pays the interest each year, the interest received may be such a small amount that an additional tax-exempt investment cannot be made. In addition, reinvesting the interest may entail transaction costs (brokers' fees). The zero-coupon feature avoids these problems.

Series EE U.S. government savings bonds can earn tax-exempt interest if the bond proceeds are used for qualified higher education expenses. Many taxpayers can foresee these expenditures being made for their children's educations. In deciding whether to invest in the bonds, however, the investor must take into account the income limitations for excluding the interest from gross income.

REFOCUS ON THE BIG PICTURE

EXCLUSIONS

You have looked into Paul's tax situation and have the following information for him:

- *Compensation.* The amount Paul was paid for his internship is compensation for services rendered and must be included in his gross income. This includes both his base pay and the \$1,500 bonus (Example 1).
- *Graduate assistantship.* The tuition waiver of \$6,000 is excluded from Paul's gross income. The related payments of \$400 per month are intended as a form of compensation. So Paul must include the \$400 per month in his gross income (Example 11).
- *Damages.* Damages awards that relate to personal physical injury or sickness can be excluded from gross income if the payments are for compensatory damages. So all of the compensatory damages of \$220,000 can be excluded from gross income. The punitive damages of \$160,000 must be included in Paul's gross income. Likewise, the compensatory damages of \$25,000 received by Paul's mother must be included in her gross income because emotional distress does not qualify as personal physical injury or sickness (Example 12).

**What If?**

From a tax planning perspective, can Paul do anything to reduce the amount of the punitive damages settlement that he must include in his gross income?

As things now stand (i.e., a completed settlement), Paul cannot reduce the \$160,000 punitive damages amount he must include in gross income. However, proper tax planning might have enabled Paul to reduce the amount includible in gross income. Note that both the amount of the damages and the labels attached to the damages are negotiated. If a larger portion of the settlement had been assigned to compensatory damages rather than punitive damages, Paul could have reduced the amount he must include in his gross income.

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Key Terms

Accelerated death benefits, 5-5
 Accident and health benefits, 5-11
 Cafeteria plan, 5-16
 Compensatory damages, 5-9
De minimis fringe, 5-18
 Death benefits, 5-4
 Educational savings bonds, 5-24
 Flexible spending plans, 5-16
 Foreign earned income exclusion, 5-20

Fringe benefits, 5-15
 Health Savings Account (HSA), 5-12
 Life insurance proceeds, 5-5
 Long-term care insurance, 5-12
 No-additional-cost service, 5-17
 Punitive damages, 5-9
 Qualified ABLE program, 5-25
 Qualified employee discount, 5-18

Qualified real property business indebtedness, 5-27
 Qualified transportation fringes, 5-19
 Qualified tuition program (§ 529 plan), 5-25
 Scholarship, 5-7
 Tax benefit rule, 5-26
 Working condition fringes, 5-18

Discussion Questions

- LO.2** Fred specified in his will that his nephew John should serve as executor of Fred's estate. John received \$10,000 for serving as executor. Can John exclude the \$10,000 from his gross income? Explain.
- LO.2** Leonard's home was damaged by a fire. He also had to be absent from work for several days to make his home habitable. Leonard's employer paid Leonard his regular salary, \$2,500, while he was absent from work. In Leonard's pay envelope was the following note from the employer: To help you in your time of need. Leonard's fellow employees also took up a collection and gave him \$900. Leonard spent over \$4,000 repairing the fire damage.

Based on the above information, how much is Leonard required to include in his gross income?
- LO.2** Dolly is a college student who works as a part-time server in a restaurant. Her usual tip is 20% of the price of the meal. A customer ordered a piece of pie and said that he would appreciate prompt service. Dolly abided with the customer's request. The customer's bill was \$8, but the customer left a \$100 bill on the table and did not ask for a receipt. Dolly gave the cashier \$8 and pocketed the \$100 bill. Dolly concludes that the customer thought that he had left a \$10 bill, although the customer did not return to correct the apparent mistake. The customer had commented about how much he appreciated Dolly's prompt service. Dolly thinks that a \$2 tip would be sufficient and that the other \$98 is like "found money." How much should Dolly include in her gross income?
- LO.2** Carey is a waiter at a restaurant that pays a small hourly amount plus tips. Customers are not required to tip the waiter. Carey is especially attentive and friendly, and her tips average 25% of the restaurant charges. Is Carey required to include any of her tips in gross income when the customer has no legal obligation to make the payment? Explain the basis for your conclusion.
- LO.2** Lime Finance Company requires its customers to purchase a credit life insurance policy associated with the loans it makes. Lime is the beneficiary of the policy to the extent of the remaining balance on the loan at the time of the customer's death. In 2014, Lime wrote off as uncollectible a \$5,000 account receivable from Wally, which included \$1,500 of accrued interest. When Wally died in 2015, the life insurance policy was still in force and Lime received \$3,500. Is the \$3,500 of life insurance proceeds received by Lime included in its gross income? Explain.
- LO.2** Billy fell off a bar stool and hurt his back. As a result, he was unable to work for three months. He sued the bar owner and collected \$100,000 for the physical injury and \$50,000 for the loss of income. Billy also collected \$15,000 from an income replacement insurance policy he purchased. Amber was away from work for three months following heart bypass surgery. Amber collected \$30,000 under an income replacement insurance policy purchased by her employer. Are the amounts received by Billy and Amber treated the same under the tax law? Explain.
- LO.2** Wes was a major league baseball pitcher who earned \$10 million for his 20 wins this year. Sam was also a major league baseball pitcher before a career-ending injury caused by a negligent driver. Sam sued the driver and collected \$6 million as compensation for lost estimated future income as a pitcher and \$4 million as punitive damages. Do the amounts that Wes and Sam receive have the same effect on their gross income? Explain.
- LO.2** Holly was injured while working in a factory and received \$12,000 as workers' compensation while she was unable to work because of the injury. Jill, who was self-employed, was also injured and unable to work. Jill collected \$12,000 on an insurance policy she had purchased to replace her loss of income while she was unable to work. How much are Holly and Jill each required to include in their gross income?

9. **LO.2, 5** Casey is in the 15% marginal tax bracket, and Jean is in the 35% marginal tax bracket. Their employer is experiencing financial difficulties and cannot continue to pay for the company's health insurance plan. The annual premiums are approximately \$8,000 per employee. The employer has proposed to either (1) require the employee to pay the premiums or (2) reduce each employee's pay by \$10,000 per year with the employer paying the premium. Which option is less objectionable to Casey, and which is less objectionable to Jean? **Decision Making**
10. **LO.2** What is the difference between a cafeteria plan and an employee flexible spending plan?
11. **LO.2** Ted works for Azure Motors, an automobile dealership. All employees can buy a car at the company's cost plus 2%. The company does not charge employees the \$300 dealer preparation fee that nonemployees must pay. Ted purchased an automobile for \$29,580 (\$29,000 + \$580). The company's cost was \$29,000. The price for a nonemployee would have been \$33,900 (\$33,600 + \$300 preparation fee). What is Ted's gross income from the purchase of the automobile?
12. **LO.2, 5** Wilbur has been offered a job at a salary that would put him in the 25% marginal tax bracket. In addition to his salary, he would receive health insurance coverage. Another potential employer does not offer health insurance but has agreed to match the first offer on an after-tax and insurance basis. The cost of health insurance comparable to that provided by the other potential employer is \$9,000 per year. How much more in salary must the second potential employer pay so that Wilbur's financial status will be the same under both offers?
13. **LO.2, 5** Eagle Life Insurance Company pays its employees \$.30 per mile for driving their personal automobiles to and from work. The company reimburses each employee who rides the bus \$100 a month for the cost of a pass. Tom collected \$100 for his automobile mileage, and Mason received \$100 as reimbursement for the cost of a bus pass.
- What are the effects of the above on Tom's and Mason's gross income?
 - Assume that Tom and Mason are in the 28% marginal tax bracket and the actual before-tax cost for Tom to drive to and from work is \$.30 per mile. What are Tom's and Mason's after-tax costs of commuting to and from work?
14. **LO.2** Several of Egret Company's employees have asked the company to create a hiking trail that employees could use during their lunch hours. The company owns vacant land that is being held for future expansion but would have to spend approximately \$50,000 if it were to make a trail. Nonemployees would be allowed to use the facility as part of the company's effort to build strong community support. What are the relevant tax issues for the employees? **Issue ID**
15. **LO.2** The Sage Company has the opportunity to purchase a building located next to its office. Sage would use the building as a day care center for the children of its employees and an exercise facility for the employees. Occasionally, portions of the building could be used for employees' family events such as reunions, birthday parties, and anniversaries. The company would like to know if the planned uses of the building would fit into a beneficially taxed employee compensation plan.
16. **LO.2, 5** Tammy, a resident of Virginia, is considering purchasing a North Carolina bond that yields 4.6% before tax. She is in the 35% Federal marginal tax bracket and the 5% state marginal tax bracket. She is aware that State of Virginia bonds of comparable risk are yielding 4.5%. However, the Virginia bonds are exempt from Virginia tax, but the North Carolina bond interest is taxable in Virginia. Which of the two options will provide the greater after-tax return to Tammy? Tammy can deduct any state taxes paid on her Federal income tax return. **Decision Making**

17. **LO.2** Andrea entered into a § 529 qualified tuition program for the benefit of her daughter, Joanna. Andrea contributed \$15,000 to the fund. The fund balance had accumulated to \$25,000 by the time Joanna was ready to enter college. However, Joanna received a scholarship that paid for her tuition, fees, books, supplies, and room and board. Therefore, Andrea withdrew the funds from the § 529 plan and bought Joanna a new car.
- What are the tax consequences to Andrea of withdrawing the funds?
 - Assume instead that Joanna's scholarship did not cover her room and board, which cost \$7,500 per academic year. During the current year, \$7,500 of the fund balance was used to pay for Joanna's room and board. The remaining amount was left in the § 529 plan to cover her room and board for future academic years. What are the tax consequences to Andrea and to Joanna of using the \$7,500 to pay for the room and board?
18. **LO.3** Dolly is a cash basis taxpayer. In 2015, she filed her 2014 South Carolina income tax return and received a \$2,200 refund. Dolly took the standard deduction on her 2014 Federal income tax return, but will itemize her deductions in 2015. Molly, a cash basis taxpayer, also filed her 2014 South Carolina income tax return in 2015 and received a \$600 refund. Molly had \$12,000 in itemized deductions on her 2014 Federal income tax return, but will take the standard deduction in 2015. How does the tax benefit rule apply to Dolly's and Molly's situations? Explain.
- Issue ID** 19. **LO.4** Ralph has experienced financial difficulties as a result of his struggling business. He has been behind on his mortgage payments for the last six months. The mortgage holder, who is a friend of Ralph's, has offered to accept \$80,000 in full payment of the \$100,000 owed on the mortgage and payable over the next 10 years. The interest rate of the mortgage is 7%, and the market rate is now 8%. What tax issues are raised by the creditor's offer?

Computational Exercises

20. **LO.2** Valentino is a patient in a nursing home for 45 days of 2015. While in the nursing home, he incurs total costs of \$13,500. Medicare pays \$8,000 of the costs. Valentino receives \$15,000 from his long-term care insurance policy, which pays while he is in the facility. Assume that the daily federal statutory amount for Valentino is \$330.
Of the \$15,000, what amount may Valentino exclude from his gross income?
21. **LO.2** Mio was transfer from New York to Germany. He lived and worked in Germany for 340 days in 2015. Mio's salary for 2015 is \$190,000. In your computation, round any division to four decimal places before converting to a percentage. For example, .473938 would be rounded to 47.39%.
What is Mio's foreign earned income exclusion?
22. **LO.2** Ellie purchases an insurance policy on her life and names her brother, Jason, as the beneficiary. Ellie pays \$32,000 in premiums for the policy during her life. When she dies, Jason collects the insurance proceeds of \$500,000.
As a result, how much gross income does Jason report?
23. **LO.2** Alfred owned a term life insurance policy at the time he was diagnosed with a terminal illness. After paying \$18,300 in premiums, he sold the policy to a company that is authorized by the state of South Carolina to purchase such policies. The company paid Alfred \$125,000. When Alfred died 18 months later, the company collected the face amount of the policy, \$150,000.
As a result of the sale of the policy, how much is Alfred required to include in his gross income?

24. **LO.2** Leland pays premiums of \$5,000 for an insurance policy in the face amount of \$25,000 upon the life of Caleb and subsequently transfers the policy to Tyler for \$7,500. Over the years, Tyler pays subsequent premiums of \$1,500 on the policy. Upon Caleb's death, Tyler receives the proceeds of \$25,000.
As a result, what amount is Tyler required to include in his gross income?
25. **LO.2** Jarrod receives a scholarship of \$18,500 from Riggers University to be used to pursue a bachelor's degree. He spends \$12,000 on tuition, \$1,500 on books and supplies, \$4,000 for room and board, and \$1,000 for personal expenses.
How much may Jarrod exclude from his gross income?
26. **LO.3** Myrna and Geoffrey filed a joint tax return in 2014. Their AGI was \$85,000, and itemized deductions were \$13,700, which included \$4,000 in state income tax. In 2015, they received a \$1,800 refund of the state income taxes they paid in 2014. The standard deduction for married filing jointly in 2014 was \$12,400. Under the tax benefit rule, what amount of the state income tax refund is included in gross income in 2015?

Problems

27. **LO.2** Ed, an employee of the Natural Color Company, suffered from a rare disease that was very expensive to treat. The local media ran several stories about Ed's problems, and the family received more than \$10,000 in gifts from individuals to help pay the medical bills. Ed's employer provided hospital and medical insurance for its employees, but the policy did not cover Ed's illness. When it became apparent that Ed could not pay all of his medical expenses, the hospital canceled the \$25,000 Ed owed at the time of his death. After Ed's death, his former employer paid Ed's widow \$12,000 in "her time of need." Ed's widow also collected \$50,000 on a group term life insurance policy paid for by Ed's employer. What are Ed's and his widow's gross income?
28. **LO.2** Determine the gross income of the beneficiaries in the following cases:
- Justin's employer was downsizing and offered employees an amount equal to one year's salary if the employee would voluntarily retire.
 - Trina contracted a disease and was unable to work for six months. Because of her dire circumstances, her employer paid her one-half of her regular salary while she was away from work.
 - Coral Corporation collected \$1 million on a key person life insurance policy when its chief executive died. The corporation had paid the premiums on the policy of \$77,000, which were not deductible by the corporation.
 - Juan collected \$40,000 on a life insurance policy when his wife, Leona, died in 2014. The insurance policy was provided by Leona's employer, and the premiums were excluded from Leona's gross income as group term life insurance. In 2015, Juan collected the \$3,500 accrued salary owed to Leona at the time of her death.
29. **LO.2, 5** Laura was recently diagnosed with cancer and has begun chemotherapy treatments. A cancer specialist has stated that Laura has less than one year to live. She has incurred a lot of medical bills and other general living expenses and is in need of cash. Therefore, she is considering selling stock that cost \$35,000 and has a fair market value of \$50,000. This amount would be sufficient to pay her medical bills. However, she has read about a company (the Vital Benefits Company) that would purchase her life insurance policy for \$50,000. She has paid \$30,000 in premiums on the policy.

Decision Making

- a. Considering only the tax effects, would selling the stock or selling the life insurance policy result in more beneficial tax treatment?
 - b. Assume that Laura is a dependent child and that her mother owns the stock and the life insurance policy, which is on the mother's life. Which of the alternative means of raising the cash would result in more beneficial tax treatment?
30. **LO.2** What is the taxpayer's gross income in each of the following situations?
- a. Darrin received a salary of \$50,000 in 2015 from his employer, Green Construction.
 - b. In July 2015, Green gave Darrin an all-expense-paid trip to Las Vegas (value of \$3,000) for exceeding his sales quota.
 - c. Megan received \$10,000 from her employer to help her pay medical expenses not covered by insurance.
 - d. Blake received \$15,000 from his deceased wife's employer "to help him in his time of greatest need."
 - e. Clint collected \$50,000 as the beneficiary of a group term life insurance policy when his wife died. The premiums on the policy were paid by his deceased wife's employer.
31. **LO.2** Donald was killed in an accident while he was on the job in 2015. Darlene, Donald's wife, received several payments as a result of Donald's death. What is Darlene's gross income from the items listed below?
- a. Donald's employer paid Darlene an amount equal to Donald's three months' salary (\$60,000), which is what the employer does for all widows and widowers of deceased employees.
 - b. Donald had \$20,000 in accrued salary that was paid to Darlene.
 - c. Donald's employer had provided Donald with group term life insurance of \$480,000 (twice his annual salary), which was payable to his widow in a lump sum. Premiums on this policy totaling \$12,500 had been included in Donald's gross income under § 79.
 - d. Donald had purchased a life insurance policy (premiums totaled \$250,000) that paid \$600,000 in the event of accidental death. The proceeds were payable to Darlene, who elected to receive installment payments as an annuity of \$30,000 each year for a 25-year period. She received her first installment this year.
32. **LO.2** Ray and Carin are partners in an accounting firm. The partners have entered into an arm's length agreement requiring Ray to purchase Carin's partnership interest from Carin's estate if she dies before Ray. The price is set at 120% of the book value of Carin's partnership interest at the time of her death. Ray purchased an insurance policy on Carin's life to fund this agreement. After Ray had paid \$45,000 in premiums, Carin was killed in an automobile accident and Ray collected \$800,000 of life insurance proceeds. Ray used the life insurance proceeds to purchase Carin's partnership interest.
- a. What amount should Ray include in his gross income from receiving the life insurance proceeds?
 - b. The insurance company paid Ray \$16,000 interest on the life insurance proceeds during the period Carin's estate was in administration. During this period, Ray had left the insurance proceeds with the insurance company. Is this interest taxable?
 - c. When Ray paid \$800,000 for Carin's partnership interest, priced as specified in the agreement, the fair market value of Carin's interest was \$1 million. How much should Ray include in his gross income from this bargain purchase?

33. **LO.2** Sally was an all-state soccer player during her junior and senior years in high school. She accepted an athletic scholarship from State University. The scholarship provided the following:

Tuition and fees	\$15,000
Housing and meals	6,000
Books and supplies	1,500
Transportation	1,200

- Determine the effect of the scholarship on Sally's gross income.
 - Sally's brother, Willy, was not a gifted athlete, but he received \$8,000 from their father's employer as a scholarship during the year. The employer grants the children of all executives a scholarship equal to one-half of annual tuition, fees, books, and supplies. Willy also received a \$6,000 scholarship (to be used for tuition) as the winner of an essay contest related to bioengineering, his intended field of study. Determine the effect of the scholarships on Willy's and his father's gross income.
34. **LO.2** Adrian was awarded an academic scholarship to State University for the 2015–2016 academic year. He received \$6,500 in August and \$7,200 in December 2015. Adrian had enough personal savings to pay all expenses as they came due. Adrian's expenditures for the relevant period were as follows:

Tuition, August 2015	\$3,700
Tuition, January 2016	3,750
Room and board	
August–December 2015	2,800
January–May 2016	2,500
Books and educational supplies	
August–December 2015	1,000
January–May 2016	1,200

Determine the effect on Adrian's gross income for 2015 and 2016.

35. **LO.2** Leigh sued an overzealous bill collector and received the following settlement:
- | | |
|--|----------|
| Damage to her automobile that the collector attempted to repossess | \$ 3,300 |
| Physical damage to her arm caused by the collector | 15,000 |
| Loss of income while her arm was healing | 6,000 |
| Punitive damages | 80,000 |
- What effect does the settlement have on Leigh's gross income?
 - Assume that Leigh also collected \$25,000 of damages for slander to her personal reputation caused by the bill collector misrepresenting the facts to Leigh's employer and other creditors. Is this \$25,000 included in Leigh's gross income? Explain.
36. **LO.2** Determine the effect on gross income in each of the following cases:
- Eloise received \$150,000 in settlement of a sex discrimination case against her former employer.
 - Nell received \$10,000 for damages to her personal reputation. She also received \$40,000 in punitive damages.
 - Orange Corporation, an accrual basis taxpayer, received \$50,000 from a lawsuit filed against its auditor who overcharged for services rendered in a previous year.
 - Beth received \$10,000 in compensatory damages and \$30,000 in punitive damages in a lawsuit she filed against a tanning parlor for severe burns she received from using its tanning equipment.
 - Joanne received compensatory damages of \$75,000 and punitive damages of \$300,000 from a cosmetic surgeon who botched her nose job.

37. **LO.2** Rex, age 55, is an officer of Blue Company, which provides him with the following nondiscriminatory fringe benefits in 2015:
- Hospitalization insurance premiums for Rex and his dependents. The cost of the coverage for Rex is \$2,900 per year, and the additional cost for his dependents is \$3,800 per year. The plan has a \$2,000 deductible, but his employer contributed \$1,500 to Rex's Health Savings Account (HSA). Rex withdrew only \$800 from the HSA, and the account earned \$50 of interest during the year.
 - Insurance premiums of \$840 for salary continuation payments. Under the plan, Rex will receive his regular salary in the event he is unable to work due to illness. Rex collected \$4,500 on the policy to replace lost wages while he was ill during the year.
 - Rex is a part-time student working on his bachelor's degree in engineering. His employer reimbursed his \$5,200 tuition under a plan available to all full-time employees.

Determine the amount Rex must include in gross income.

- Communications** 38. **LO.2** The UVW Union and HON Corporation are negotiating contract terms. Assume that the union members are in the 25% marginal tax bracket and that all benefits are provided on a nondiscriminatory basis. Write a letter to the UVW Union members explaining the tax consequences of the options discussed below. The union's address is 905 Spruce Street, Washington, DC 20227.
- The company would eliminate the \$250 deductible on medical insurance benefits. Most employees incur more than \$250 each year in medical expenses.
 - Employees would get an additional paid holiday with the same annual income (the same pay but less work).
 - An employee who did not need health insurance (because the employee's spouse works and receives family coverage) would be allowed to receive the cash value of the coverage.

- Decision Making** 39. **LO.2, 5** Mauve Corporation has a group hospitalization insurance plan that has a \$200 deductible amount for hospital visits and a \$15 deductible for doctor visits and prescriptions. The deductible portion paid by employees who have children has become substantial for some employees. The company is considering adopting a medical reimbursement plan or a flexible benefits plan to cover the deductible amounts. Either of these plans can be tailored to meet the needs of the employees. What are the cost considerations to the employer that should be considered in choosing between these plans?
40. **LO.2** Belinda spent the last 60 days of 2015 in a nursing home. The cost of the services provided to her was \$18,000 (\$300 per day). Medicare paid \$8,500 toward the cost of her stay. Belinda also received \$5,500 of benefits under a long-term care insurance policy she purchased. What is the effect on Belinda's gross income?
41. **LO.2** Tim is the vice president of western operations for Maroon Oil Company and is stationed in San Francisco. He is required to live in an employer-owned home, which is three blocks from his company office. The company-provided home is equipped with high-speed Internet access and several telephone lines. Tim receives telephone calls and e-mails that require immediate attention any time of day or night because the company's business is spread all over the world. A full-time administrative assistant resides in the house to assist Tim with the urgent business matters. Tim often uses the home for entertaining customers, suppliers, and employees. The fair market value of comparable housing is \$9,000 per month. Tim is also provided with free parking at his company's office. The value of the parking is \$350 per month. Calculate the amount associated with the company-provided housing and free parking that Tim must include in his gross income.

42. **LO.2** Does the taxpayer recognize gross income in the following situations?
- Ava is a filing clerk at a large insurance company. She is permitted to leave the premises for lunch, but she usually eats in the company's cafeteria because it is quick and she is on a tight schedule. On average, she pays \$2 for a lunch that would cost \$12 at a restaurant. However, if the prices in the cafeteria were not so low and the food was not so delicious, she would probably bring her lunch at a cost of \$3 per day.
 - Scott is an executive for an international corporation located in New York City. Often he works late, taking telephone calls from the company's European branch. Scott often stays in a company-owned condominium when he has a late-night work session. The condominium is across the street from the company office.
 - Ira recently moved to take a job. For the first month on the new job, Ira was searching for a home to purchase or rent. During this time, his employer permitted Ira to live in an apartment the company maintains for customers during the buying season. The month that Ira occupied the apartment was not during the buying season, and the apartment would not otherwise have been occupied.

43. **LO.2, 5** Bertha is considering taking an early retirement offered by her employer. She would receive \$3,000 per month, indexed for inflation. However, she would no longer be able to use the company's health facilities, and she would be required to pay her hospitalization insurance premiums of \$8,000 each year. Bertha and her husband will file a joint return and take the standard deduction. She currently receives a salary of \$55,000 a year. If she retires, she will spend approximately \$300 less each month for commuting and clothing. Bertha and her husband have other sources of income and are in and will remain in the 25% marginal tax bracket. Her income tax for the current year was \$8,875. She currently pays Social Security and Medicare taxes of 7.65% on her salary, but her retirement pay would not be subject to this tax. According to Bertha, she and her husband could live well if her after-tax retirement income was at least 50% of her current income. Provide Bertha with information she will need to make her decision.

Decision Making

44. **LO.2, 5** Finch Construction Company provides the carpenters it employs with all of the required tools. However, the company believes that this practice has led to some employees not taking care of the tools and to the mysterious disappearance of some tools. The company is considering requiring all of its employees to provide their own tools. Each employee's salary would be increased by \$1,500 to compensate for the additional cost. Write a letter to Finch's management explaining the tax consequences of this plan to the carpenters. Finch's address is 300 Harbor Drive, Vermillion, SD 57069.

Communications

45. **LO.2, 5** Bluebird, Inc., does not provide its employees with any tax-exempt fringe benefits. The company is considering adopting a hospital and medical benefits insurance plan that will cost approximately \$9,000 per employee. To adopt this plan, the company may have to reduce salaries and/or lower future salary increases. Bluebird is in the 35% (combined Federal and state rates) bracket. Bluebird is also responsible for matching the Social Security and Medicare taxes withheld on employees' salaries (at the full 7.65% rate). The hospital and medical benefits insurance plan will not be subject to the Social Security and Medicare taxes, and the company is not eligible for the small business credit for health insurance. The employees generally fall into two marginal tax rate groups:

Income Tax	Social Security and Medicare Tax	Total
.15	.0765	.2265
.35	.0145	.3645

The company has asked you to assist in its financial planning for the hospital and medical benefits insurance plan by computing the following:

- a. How much taxable compensation is the equivalent of \$9,000 of exempt compensation for each of the two classes of employees?
- b. What is the company's after-tax cost of the taxable compensation computed in part (a)?
- c. What is the company's after-tax cost of the exempt compensation?
- d. Briefly explain your conclusions from the preceding analysis.

Decision Making

46. **LO.2, 5** Rosa's employer has instituted a flexible benefits program. Rosa will use the plan to pay for her daughter's dental expenses and other medical expenses that are not covered by health insurance. Rosa is in the 28% marginal tax bracket and estimates that the medical and dental expenses not covered by health insurance will be within the range of \$4,000 to \$5,000. Her employer's plan permits her to set aside as much as \$5,000 in the flexible benefits account. Rosa does not itemize her deductions.
 - a. Rosa puts \$4,000 into her flexible benefits account, and her actual expenses are \$5,000. What is her cost of underestimating the expenses?
 - b. Rosa puts \$5,000 into her flexible benefits account, and her actual expenses are only \$4,000. What is her cost of overestimating her expenses?
 - c. What is Rosa's cost of underfunding as compared with the cost of overfunding the flexible benefits account?
 - d. Does your answer in part (c) suggest that Rosa should fund the account closer to the low end or to the high end of her estimates?
47. **LO.2** Sparrow Corporation would like you to review its employee fringe benefits program with regard to the tax consequences of the plan for the company's president (Polly), who is also the majority shareholder.
 - a. The company has a qualified retirement plan. The company pays the cost of employees attending a retirement planning seminar. The employee must be within 10 years of retirement, and the cost of the seminar is \$1,500 per attendee.
 - b. The company owns a parking garage that is used by customers, employees, and the general public. Only the general public is required to pay for parking. The charge to the general public for Polly's parking for the year would have been \$3,600 (a \$300 monthly rate).
 - c. All employees are allowed to use the company's fixed charge long-distance telephone services, as long as the privilege is not abused. Although no one has kept track of the actual calls, Polly's use of the telephone had a value (what she would have paid on her personal telephone) of approximately \$600.
 - d. The company owns a condominium at the beach, which it uses to entertain customers. Employees are allowed to use the facility without charge when the company has no scheduled events. Polly used the facility 10 days during the year. Her use had a rental value of \$1,000.
 - e. The company is in the household moving business. Employees are allowed to ship goods without charge whenever there is excess space on a truck. Polly purchased a dining room suite for her daughter. Company trucks delivered the furniture to the daughter. Normal freight charges would have been \$750.
 - f. The company has a storage facility for household goods. Officers are allowed a 20% discount on charges for storing their goods. All other employees are allowed a 10% discount. Polly's discounts for the year totaled \$900.
48. **LO.2** George is a U.S. citizen who is employed by Hawk Enterprises, a global company. Beginning on June 1, 2015, George began working in London. He worked there until January 31, 2016, when he transferred to Paris. He worked in Paris the remainder of 2016. His salary for the first five months of 2015 was \$100,000, and it was earned in the United States. His salary for the remainder of

2015 was \$175,000, and it was earned in London. George's 2016 salary from Hawk was \$300,000, with part being earned in London and part being earned in Paris. What is George's gross income in 2015 and 2016? (Assume that the 2016 indexed amount is the same as the 2015 indexed amount.)

49. **LO.2, 3** Determine Hazel's gross income from the following receipts for the year:

Gain on sale of Augusta County bonds	\$800
Interest on U.S. government savings bonds	400
Interest on state income tax refund	200
Interest on Augusta County bonds	700
Patronage dividend from Potato Growers Cooperative	350

The patronage dividend was received in March of the current year for amounts paid for her (nondeductible) garden and lawn supplies.

50. **LO.2** In January 2015, Ezra purchased 2,000 shares of Gold Utility Mutual Fund for \$20,000. In June, Ezra received an additional 100 shares as a dividend, in lieu of receiving \$1,000 in cash dividends. In December, the company declared a two-for-one stock split. Ezra received an additional 2,100 shares, but there was no option to receive cash. At the time of the stock dividend in December and at the end of the year, the fund shares were trading for \$5 per share. Also, at the end of the year, the fund offered to buy outstanding shares for \$4.50. Ezra did not sell any shares during the year.
- What is Ezra's gross income from the 100 shares received in June?
 - What is Ezra's gross income from the receipt of the 2,100 shares as a two-for-one stock split in December?
 - Should Ezra be required to recognize gross income in 2015 even though the fair market value of his investment at the end of the year was less than the fair market value at the beginning of the year? Explain.
51. **LO.2** Tonya, who lives in California, inherited a \$100,000 State of California bond in 2015. Her marginal Federal tax rate is 35%, and her marginal state tax rate is 5%. The California bond pays 3.3% interest, which is not subject to California income tax. She can purchase a corporate bond of comparable risk that will yield 5.2% or a U.S. government bond that pays 4.6% interest. Which investment will provide the greatest after-tax yield?
52. **LO.2** Lynn Swartz's husband died three years ago. Her parents have an income of over \$200,000 a year and want to ensure that funds will be available for the education of Lynn's 8-year-old son, Eric. Lynn is currently earning \$45,000 a year. Lynn's parents have suggested that they start a savings account for Eric. They have calculated that if they invest \$4,000 a year for the next 8 years, at the end of 10 years, sufficient funds will be available for Eric's college expenses. Lynn realizes that the tax treatment of the investments could significantly affect the amount of funds available for Eric's education. She asked you to write a letter to her advising about options available to her parents and to her for Eric's college education. Lynn's address is 100 Myrtle Cove, Fairfield, CT 06824.
53. **LO.2** Starting in 2004, Chuck and Luane have been purchasing Series EE bonds in their name to use for the higher education of their daughter Susie, who currently is age 18. During the year, they cash in \$12,000 of the bonds to use for freshman year tuition, fees, and room and board. Of this amount, \$5,000 represents interest. Of the \$12,000, \$8,000 is used for tuition and fees, and \$4,000 is used for room and board. Chuck and Luane's AGI, before the educational savings bond exclusion, is \$120,000.
- Determine the tax consequences for Chuck and Luane, who will file a joint return, and for Susie.

Decision Making

Decision Making
Communications

- b. Assume that Chuck and Luane purchased the bonds in Susie's name. Determine the tax consequences for Chuck and Luane and for Susie.
 - c. How would your answer to (a) change if Chuck and Luane filed separate returns?
54. **LO.2** Albert established a qualified tuition program for each of his twins, Kim and Jim. He started each fund with \$20,000 when the children were 5 years old. Albert made no further contributions to his children's plans. Thirteen years later, both children have graduated from high school. Kim's fund has accumulated to \$45,000, while Jim's has accumulated to \$42,000. Kim decides to attend a state university, which will cost \$60,000 for four years (tuition, fees, room and board, and books). Jim decides to go to work instead of going to college. During the current year, \$7,500 is used from Kim's plan to pay the cost of her first semester in college. Because Jim is not going to college now or in the future, Albert withdraws the \$42,000 plan balance and gives it to Jim to start his new life after high school.
- a. During the period since the plans were established, should Albert or the twins have been including the annual plan earnings in gross income? Explain.
 - b. What are the tax consequences to Kim and Albert of the \$7,500 being used for the first semester's higher education costs?
 - c. Because of her participation in the qualified tuition program, Kim received a 10% reduction in tuition charges; so less than \$7,500 was withdrawn from her account. Is either Albert or Kim required to include the value of this discount in gross income? Explain.
 - d. What are the tax consequences to Albert and Jim of Jim's qualified tuition program being closed?
55. **LO.3** How does the tax benefit rule apply in the following cases?
- a. In 2013, the Orange Furniture Store, an accrual method taxpayer, sold furniture on credit for \$1,000 to Sammy. The cost of the furniture was \$600. In 2014, Orange took a bad debt deduction for the \$1,000. In 2015, Sammy inherited some money and paid Orange the \$1,000 he owed. Orange was in the 35% marginal tax bracket in 2013, the 15% marginal tax bracket in 2014, and the 35% marginal tax bracket in 2015.
 - b. In 2014, Marvin, a cash basis taxpayer, took a \$2,000 itemized deduction for state income taxes paid. This increased his itemized deductions to a total that was \$800 more than the standard deduction. In 2015, Marvin received a \$1,600 refund when he filed his 2014 state income tax return. Marvin was in the 15% marginal tax bracket in 2014, but was in the 35% marginal tax bracket in 2015.
 - c. In 2014, Barb, a cash basis taxpayer, was in an accident and incurred \$8,000 in medical expenses, which she claimed as an itemized deduction for medical expenses. Because of the 10%-of-AGI reduction, the expense reduced her taxable income by only \$3,000. In 2015, Barb successfully sued the person who caused the physical injury and collected \$8,000 to reimburse her for the cost of her medical expenses. Barb was in the 15% marginal tax bracket in both 2014 and 2015.

Decision Making

56. **LO.4, 5** Fran, who is in the 35% tax bracket, recently collected \$100,000 on a life insurance policy she carried on her father. She currently owes \$120,000 on her personal residence and \$120,000 on business property. National Bank holds the mortgage on both pieces of property and has agreed to accept \$100,000 in complete satisfaction of either mortgage. The interest rate on the mortgages is 8%, and both mortgages are payable over 10 years. What would be the tax consequences of each of the following alternatives assuming that Fran currently deducts the mortgage interest on her tax return?
- a. Retire the mortgage on the residence.
 - b. Retire the mortgage on the business property.

Which alternative should Fran select?

57. **LO.4** Vic, who was experiencing financial difficulties, was able to adjust his debts as follows:
- Vic is an attorney. Vic owed his uncle \$25,000. The uncle told Vic that if he serves as the executor of the uncle's estate, Vic's debt will be canceled in the uncle's will.
 - Vic borrowed \$80,000 from First Bank. The debt was secured by land that Vic purchased for \$100,000. Vic was unable to pay, and the bank foreclosed when the liability was \$80,000, which was also the fair market value of the property.
 - The Land Company, which had sold land to Vic for \$80,000, reduced the mortgage on the land by \$12,000.

Determine the tax consequences to Vic.

Cumulative Problems



58. Alfred E. Old and Beulah A. Crane, each age 42, married on September 7, 2012. Alfred and Beulah will file a joint return for 2014. Alfred's Social Security number is 111-11-1111. Beulah's Social Security number is 123-45-6789, and she adopted "Old" as her married name. They live at 211 Brickstone Drive, Atlanta, GA 30304.

Tax Return Problem



Alfred was divorced from Sarah Old in March 2012. Under the divorce agreement, Alfred is to pay Sarah \$1,250 per month for the next 10 years or until Sarah's death, whichever occurs first. Alfred pays Sarah \$15,000 in 2014. In addition, in January 2014, Alfred pays Sarah \$50,000, which is designated as being for her share of the marital property. Also, Alfred is responsible for all prior years' income taxes. Sarah's Social Security number is 123-45-6788.

Alfred's salary for 2014 is \$150,000, and his employer, Cherry, Inc. (Federal I.D. No. 98-7654321), provides him with group term life insurance equal to twice his annual salary. His employer withheld \$24,900 for Federal income taxes and \$8,000 for state income taxes. The proper amounts were withheld for FICA taxes.

Beulah recently graduated from law school and is employed by Legal Aid Society, Inc. (Federal I.D. No. 11-1111111), as a public defender. She receives a salary of \$40,000 in 2014. Her employer withheld \$7,500 for Federal income taxes and \$2,400 for state income taxes. The proper amounts were withheld for FICA taxes.

Beulah has \$2,500 in qualified dividends on Yellow Corporation stock she inherited. Alfred and Beulah receive a \$1,900 refund on their 2013 state income taxes. They itemized deductions on their 2013 Federal income tax return (total of \$15,000). Alfred and Beulah pay \$4,500 interest and \$1,450 property taxes on their personal residence in 2014. Their charitable contributions total \$2,400 (all to their church). They paid sales taxes of \$1,400, for which they maintain the receipts. Both spouses had health insurance for all months of 2014 and do not want to contribute to the Presidential Election Campaign.

Compute the Olds' net tax payable (or refund due) for 2014. If you use tax forms for your solution, you will need Form 1040 and Schedules A and B. Suggested software: H&R BLOCK Tax Software.

59. Martin S. Albert (Social Security number 111-11-1111) is 39 years old and is married to Michele R. Albert (Social Security number 123-45-6789). The Alberts live at 512 Ferry Road, Newport News, VA 23601. They file a joint return and have two dependent children, Charlene, age 17, and Jordan, age 18. Charlene's Social Security number is 123-45-6788, and Jordan's Social Security number is 123-45-6787. In 2015, Martin and Michele had the following transactions:
- Martin received \$120,000 in salary from Red Steel Corporation, where he is a construction engineer. Withholding for Federal income tax was \$10,750. The amounts

Tax Computation Problem Decision Making Communications

withheld for FICA taxes were as follows: \$7,049 ($\$113,700 \times 6.2\%$) for Social Security and \$1,740 ($\$120,000 \times 1.45\%$) for Medicare. Martin worked in Mexico from January 1, 2014, until February 15, 2015. His \$120,000 salary for 2015 includes \$18,000 he earned for January and one-half of February 2015 while working in Mexico.

- b. Martin and Michele received \$800 in qualified dividends on Green, Inc. stock and \$400 interest on Montgomery County (Virginia) school bonds.
- c. Martin received \$2,300 interest from a Bahamian bank account.
- d. Michele received 50 shares of Applegate Corporation common stock as a stock dividend. The shares had a fair market value of \$2,500 at the time Michele received them, and she did not have the option of receiving cash.
- e. Martin and Michele received a \$1,200 refund on their 2014 Virginia income taxes. Their itemized deductions in 2014 totaled \$14,000.
- f. Martin paid \$6,600 alimony to his former wife, Rose T. Morgan (Social Security number 123-45-6786).
- g. Martin and Michele kept the receipts for their sales taxes paid of \$1,100.
- h. Martin and Michele's itemized deductions were as follows:
 - State income tax paid and withheld totaled \$5,100.
 - Real estate taxes on their principal residence were \$3,700.
 - Mortgage interest on their principal residence was \$2,500.
 - Cash contributions to the church totaled \$2,800.

Part 1—Tax Computation

Compute the Alberts's net tax payable (or refund due) for 2015.

Part 2—Tax Planning

The Alberts are considering buying another house. Their house mortgage payments would increase by \$500 (to \$1,500) per month, which includes a \$250 increase in interest and a \$100 increase in property tax. The Alberts would like to know how much the mortgage payments would increase net of any change in their income tax. Write a letter to the Alberts that contains your advice.

Research Problems



Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Murray reported to the Environmental Protection Agency that his employer was illegally dumping chemicals into a river. His charges were true, and Murray's employer was fined. In retaliation, Murray's employer fired him and made deliberate efforts to prevent Murray from obtaining other employment. Murray sued the employer, claiming that his reputation had been damaged. Murray won his lawsuit and received an award for "damages to his personal and professional reputation and for his mental suffering." Now he would like to know whether the award is taxable. He argues that he was awarded damages as a recovery of his human capital and that a recovery of capital is not income. Therefore, the Federal government does not have the power to tax the award.

Research Problem 2. Your client, John Butler, is an avid Houston Astros fan. Last March at the Astros' home opener, as a result of a random drawing of those in attendance at the game, John won 300 Shipley Do-Nut coupons. Each coupon entitled him to a cup of coffee and a free doughnut or a dozen doughnut holes.

John used some of the coupons (approximately 20), but he found that eating so many doughnuts directly conflicted with his goal of losing weight. The unused coupons expired on January 1, 2015. Thus, John was surprised when he received a Form 1099 in February 2015 that valued his prize at \$900. John would like to know whether the value of the doughnut coupons should be included in income and asks you to research his question. If you conclude that their value should be included in income, John also would like to know if he can reduce his gross income by including in income only the value of the coupons that he used. He has the unused coupons as documentation that neither he nor anyone else used them.

Research Problem 3. Aubrey Brown is a decorated veteran of the Vietnam War. As a result of his exposure to Agent Orange during the war, Aubrey developed lung cancer and is unable to work. He received \$12,000 of Social Security disability payments in the current year. He reasons that the payments should be excluded from his gross income because the payments are compensation for the physical injury he suffered as a result of his service in the armed forces. Is Aubrey correct? Explain.

Partial list of research aids:

Rev.Rul. 77-318, 1977-2 C.B. 45.

Reimels v. Comm., 2006-1 USTC ¶50,147, 97 AFTR 2d 2006-820, 436 F.3d 344 (CA-2, 2006).

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet
Activity

Research Problem 4. Employers often use the Internet as a means of attracting applications from potential employees. Locate an Internet site offering employment opportunities, ideally one provided by a well-known corporation. How does the employer promote its fringe benefit and cafeteria plan packages? Compare and contrast several such sites.

Research Problem 5. One income exclusion that some states allow that the federal government does not is for lottery winnings. Does your state have an exclusion for lottery winnings? If so, how does it work? Why do you think a state might allow winnings from its own state lottery to be excluded from state income taxes?

Roger CPA Review Questions

- In 20X12 Randall suffered bodily injury while at work. On his 20X12 tax return Randall deducted related medical expenses of \$10,000; and \$5,000 in 20X13. In 20X14 Randall won a worker's compensation claim and prevailed in an injury lawsuit, both in connection with the 20X12 injury. Randall received the following in 20X14 as settlement:

Punitive damages	\$150,000
Worker's compensation	50,000
Reimbursement for medical expenses	25,000
Compensation for emotional distress caused by the injury	15,000

What amount of the settlement should be excluded from Randall's 20X14 gross income?

- | | |
|-------------|--------------|
| a. \$75,000 | c. \$90,000 |
| b. \$60,000 | d. \$165,000 |

2. The following pertain to Joyce in 20X14:

Medical insurance premiums paid by employer	\$4,800
Teacher of the Year Award, in the form of gift cards redeemable at local businesses	500
Jewelry box, received from employer for 25 years of service (FMV)	100
20X14 holiday bonus awarded in December 20X14, to be paid in January 20X15	250

What total amount from the above may be excluded from Joyce's 20X14 gross income?

- a. \$5,650 c. \$5,150
 b. \$350 d. \$850
3. Pierce, a married individual, received the following in 20X14:

Worker's compensation award	\$25,000
W-2 income	20,000
Unemployment compensation	4,800
Damages awarded for emotional distress experienced as a result of workplace bodily injury	10,000

Considering only the above, what is Pierce's 20X14 gross income?

- a. \$49,800 c. \$30,000
 b. \$34,800 d. \$24,800
4. Norbert works in a beauty salon. He receives a 50% employee discount for salon services. In 20X14 he used his discount to buy for \$1,000 services with a fair market value of \$2,000. As a result of these bargain purchases, how much should Norbert include in 20X14 gross income?
- a. \$1,000 c. \$2,000
 b. \$600 d. \$0

5. Cole, a 48-year-old married individual, received the following in 20X14:

S Corporation stock dividends	\$5,000
Interest earned on federal Treasury bills	1,000
Interest earned on municipal bonds	2,500
Interest earned on state income tax refund	50
Interest earned on Series EE savings bonds, used to help pay for room and board for dependent in college	1,500
Common stock property dividend (FMV)	3,000

In addition, Cole spent \$500 on lottery scratch-off cards in 20X14. All of the cards were losers except for one, from which Cole won \$1,000.

Given these facts, what total amount from the above should be included in gross income on Cole's 20X14 tax return?

- a. \$4,550 c. \$11,050
 b. \$6,550 d. \$11,550
6. Manish is a student who began working part-time as a restaurant waiter in October of 20X14. He earned the following tips in 20X14, with each month's tips reported in a schedule submitted to the restaurant's management by the 10th of the following month:

October	\$400
November	215
December	150

In addition, Manish received a scholarship in 20X14 which provided \$5,000 for tuition, \$5,000 for room and board, \$1,000 for travel to study abroad, and \$1,000 for books.

What total amount from the above should be included in Manish's 20X14 gross income?

- a. \$5,765
- b. \$5,615
- c. \$6,615
- d. \$6,765



PART
3

DEDUCTIONS AND CREDITS

CHAPTER **6**

Deductions and Losses: In General

CHAPTER **7**

Deductions and Losses: Certain Business Expenses and Losses

CHAPTER **8**

Depreciation, Cost Recovery, Amortization, and Depletion

CHAPTER **9**

Deductions: Employee and Self-Employed-Related Expenses

CHAPTER **10**

Deductions and Losses: Certain Itemized Deductions

CHAPTER **11**

Investor Losses

CHAPTER **12**

Tax Credits and Payments

Part 3 presents the deduction component of the basic tax model. Deductions are classified as business versus nonbusiness, “for” AGI versus “from” AGI, employee versus employer, active versus passive, and reimbursed versus unreimbursed. The effect of each of these classifications is analyzed. The presentation includes not only the deductions that are permitted, but also limitations and disallowances associated with deductions. A separate chapter is included dealing with the special tax treatment accorded to losses resulting from investment activities. After deductions offset the income subject to tax in the basic tax model and the tax is computed, a wide variety of tax credits can be used to reduce the calculated tax liability. However, these credits are not always available and are subject to certain monetary limitations. Taxes (and penalties) imposed by the Affordable Care Act are also covered. Part 3 concludes with a discussion of the general procedures related to payment of the tax liability.

Deductions and Losses: In General

LEARNING OBJECTIVES: *After completing Chapter 6, you should be able to:*

- LO.1** Differentiate between deductions *for* and *from* adjusted gross income and describe the relevance of the differentiation.
- LO.2** Describe the cash and accrual methods of accounting with emphasis on the deduction aspects.
- LO.3** Apply the Internal Revenue Code deduction disallowance provisions associated with the following: public policy limitations, political activities, excessive executive compensation, investigation of business opportunities, hobby losses, vacation home rentals, payment of others' expenses, personal expenditures, capital expenditures, related-party transactions, and expenses related to tax-exempt income.
- LO.4** Identify tax planning opportunities for maximizing deductions and minimizing the disallowance of deductions.

CHAPTER OUTLINE

6-1 Classification of Deductible Expenses, 6-2

- 6-1a Classifying Deductions, 6-3
- 6-1b Authority for Deductions, 6-4
- 6-1c Deduction Criteria for § 162 and § 212, 6-5
- 6-1d Personal Expenses, 6-7
- 6-1e Business and Nonbusiness Losses, 6-7
- 6-1f Reporting Procedures, 6-7

6-2 Deductions and Losses—Timing of Expense Recognition, 6-8

- 6-2a Importance of Taxpayer's Method of Accounting, 6-8
- 6-2b Cash Method Requirements, 6-9
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THE BIG PICTURE

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CALCULATION OF DEDUCTIBLE EXPENSES

Dr. Cliff Payne determines that his deductible expenses associated with his dental practice are as follows:

Salaries including FICA (unpaid at year-end of \$5,000)	\$120,000
Building rent	24,000
Depreciation of dental equipment and office furnishings and equipment	52,000
Insurance (malpractice and of dental equipment and office furnishings and equipment)	22,000
Dental supplies	16,000
Office supplies	3,000
Investigation expenses	6,000
Contribution to the State Senate campaign fund of Tom Smith	1,000
Contribution to the State Senate campaign fund of Virginia White	1,000
Legal expenses associated with patient lawsuit (jury decision for defendant)	4,000
Fine imposed by city for improper disposal of medical waste	3,000
Dues paid to The Dental Society	10,000
Draw by Dr. Payne for living expenses (\$5,000 monthly)	60,000

Has Dr. Payne correctly calculated the business expenses for his dental practice?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	(x,xxx)
Gross income.....	<u>\$xx,xxx</u>
Less: Deductions for adjusted gross income.....	(x,xxx)
<small>FORM 1040 (p. 1)</small>	
12 Business income or (loss). Attach Schedule C or C-EZ	
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)
<small>FORM 1040 (p. 2)</small>	
40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	
Personal and dependency exemptions	(x,xxx)
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	(xxx)
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

The tax law has an all-inclusive definition of income; that is, income from whatever source derived is includible in gross income. Income cannot be excluded unless there is a specific statement to that effect in the Internal Revenue Code.

Similarly, deductions are disallowed unless a specific provision in the tax law permits them. The inclusive definition of income and the exclusive definition of deductions may not seem fair to taxpayers, but it is the structure of the tax law.

The courts have held that whether and to what extent deductions are allowed depends on legislative grace.¹ In other words, any exclusions from income and all deductions are gifts from Congress.

LO.1
Differentiate between deductions for and from adjusted gross income and describe the relevance of the differentiation.

6-1 CLASSIFICATION OF DEDUCTIBLE EXPENSES

It is important to classify deductible expenses as **deductions for adjusted gross income** (AGI) or **deductions from adjusted gross income**. Deductions *for* AGI can be claimed whether or not the taxpayer itemizes. Deductions *from* AGI result in a tax benefit only if they exceed the taxpayer's standard deduction. If itemized deductions (*from* AGI) are less than the standard deduction, they provide no tax benefit. As Example 1 illustrates, whether a deduction is classified as *for* AGI or *from* AGI can affect the benefit the taxpayer receives from the deduction.

¹*New Colonial Ice Co. v. Helvering*, 4 USTC ¶1292, 13 AFTR 1180, 54 S.Ct. 788 (USSC, 1934).

Steve is a self-employed CPA. Ralph is one of Steve's employees. During the year, Steve and Ralph incur the following expenses:

	Steve	Ralph
Dues to American Institute of CPAs and State Society of CPAs	\$ 400	\$ 300
Subscriptions to professional journals	500	200
Registration fees for tax conferences	800	800
	<u>\$1,700</u>	<u>\$1,300</u>

Steve does not reimburse any of his employees for dues, subscriptions, or educational programs.

Steve's expenses are classified as a deduction *for* AGI because they are considered business expenses since he is a sole proprietor. Therefore, he can deduct the \$1,700 on his Federal income tax return. Ralph's unreimbursed employee business expenses are classified as deductions *from* AGI. Ralph will be able to benefit from the \$1,300 of expenses on his Federal income tax return only if his itemized deductions exceed his standard deduction. If he takes the standard deduction instead, the \$1,300 of expenses will have no effect on the calculation of his taxable income. Even if Ralph does itemize deductions, he still may not benefit from the deduction because of the 2-percent-of-AGI phaseout rule for certain itemized deductions.

EXAMPLE

1

Concept Summary 6.3 later in the chapter shows the classification of deductions as deductions *for* AGI or as deductions *from* AGI.

It is important to understand that deductions *for* AGI may directly affect the *amount* of itemized deductions. The impact arises because many itemized deductions are limited to amounts in excess of specified percentages of AGI. Examples of such itemized deductions are medical expenses; personal casualty losses; and, as shown in Example 1, unreimbursed employee expenses.

Tina, age 36, earns a salary of \$80,000 and has no other income. She itemizes her deductions during 2015. Unreimbursed medical expenses for the year are \$12,000. Tina's medical expense deduction is \$4,000, as computed below. Alternatively, assume that Tina receives a \$10,000 bonus from her employer in 2015. Her AGI would then be \$90,000 (\$80,000 + \$10,000), and her medical expense is reduced by \$1,000 to \$3,000.

	No Bonus	Bonus
Qualified medical expenses	\$12,000	\$12,000
Reduction: AGI × 10%	<u>(8,000)</u>	<u>(9,000)</u>
Deductible medical expenses	<u>\$ 4,000</u>	<u>\$ 3,000</u>

When Tina's income increased by \$10,000, this reduced her medical expense deduction; so the total effect on taxable income is an increase of \$11,000.²

EXAMPLE

2

6-1a Classifying Deductions

It is important to understand that two key issues must be resolved for any potential deduction. First, it must be determined whether the item is deductible, as discussed in Section 6-1b. If the item is deductible, then the second issue is to determine if the deduction is classified as *for* AGI or *from* AGI. To understand how deductions of

²Example 4 in Chapter 3 illustrates this same point!

individual taxpayers are classified, it is necessary to examine the role of § 62. The purpose of § 62 is to classify various deductions as deductions *for* AGI. It does not provide the statutory authority for taking the deduction.

If a deduction is not listed in § 62, it is an itemized deduction, not a deduction *for* AGI. Exhibit 6.1 provides a partial list of the items classified as deductions *for* AGI by § 62.

6-1b Authority for Deductions

The specific authority for deductions is provided in many different Code sections. However, two of the most important are § 212 and § 162. To determine the proper authority for claiming a deduction, first determine what type of activity the expenditure relates to. All activities can be divided into one of the following mutually exclusive categories:

1. Investment/production of income (§ 212)
2. Trade or business (§ 162)
3. Personal (various sections)

For example, are legal expenses deductible? To make that determination, first determine whether the legal expense relates to an investment, trade or business, or to personal activity.

EXHIBIT 6.1

Common Deductions *for* Adjusted Gross Income

- Expenses attributable to a trade or business carried on by the taxpayer. A trade or business does not include the performance of services by the taxpayer as an employee (refer to Chapter 9).
- Expenses incurred by a taxpayer in connection with the performance of services as an employee if the expenses are reimbursed and other conditions are satisfied (refer to Chapter 9).
- Deductions that result from losses on the sale or exchange of property by the taxpayer (refer to Chapters 13 and 14).
- Deductions attributable to property held for the production of rents and royalties (discussed in this chapter).
- The deduction for payment of alimony (refer to Chapter 4).
- The deduction for part of the self-employment tax paid by a self-employed taxpayer (refer to Chapter 12).
- The deduction for the medical insurance premiums paid by a self-employed taxpayer for coverage of the taxpayer, a spouse, and any dependents (refer to Chapter 10).
- Certain contributions to pension, profit sharing, and annuity plans of self-employed individuals (refer to Chapter 9).
- The deduction for certain retirement savings allowed by § 219 (e.g., traditional IRAs) (refer to Chapter 9).
- The penalty imposed on premature withdrawal of funds from time savings accounts or deposits.
- The deduction for moving expenses (refer to Chapter 9).
- The deduction for interest paid on student loans (refer to Chapters 9 and 10).
- The deduction for qualified tuition and related expenses under § 222 if extended to 2015 by Congress (refer to Chapter 9).
- The deduction for up to \$250 for teacher supplies for elementary and secondary school teachers if extended to 2015 by Congress (refer to Chapter 9).

Section 212 Expenses

Section 212 allows deductions for ordinary and necessary expenses paid or incurred for the following:

- The production or collection of income.
- The management, conservation, or maintenance of property held for the production of income.
- Expenses paid in connection with the determination, collection, or refund of any tax.

Section 212 expenses may be *for* AGI or *from* AGI. Common examples of deductions *for* AGI are expenses related to rent and royalty income (reported on Schedule E) and professional fees paid to determine tax liability for a sole proprietor (reported on Schedule C), a farmer (Schedule F), or one that has rent or royalties (Schedule E). All other § 212 expenses are itemized deductions (deductions *from* AGI). For example, investment-related expenses (e.g., safe deposit box rentals) are deductible as itemized deductions attributable to the production of investment income.³

Section 162 Trade or Business Expenses

Section 162(a) permits a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. These include reasonable salaries paid for services, expenses for the use of business property, and part of self-employment taxes paid (see Chapter 12). Such expenses are deducted *for* AGI.

It is sometimes difficult to determine whether an expenditure is deductible as a trade or business expense. The term *trade or business* is not defined in the Code or Regulations, and the courts have not provided a satisfactory definition. It is usually necessary to ask one or more of the following questions to determine whether an item qualifies as a trade or business expense:

- Was the use of the particular item related to a business activity? For example, if funds are borrowed for use in a business, the interest is deductible as a business expense.
- Was the expenditure incurred with the intent to realize a profit or to produce income? For example, expenses in excess of the income from raising horses are not deductible if the activity is classified as a personal hobby rather than a trade or business.
- Were the taxpayer's operation and management activities extensive enough to indicate the carrying on of a trade or business?

Section 162 *excludes* the following items from classification as trade or business expenses:

- Charitable contributions or gifts.
- Illegal bribes and kickbacks and certain treble damage payments.
- Fines and penalties.

6-1c Deduction Criteria for § 162 and § 212

The terms **ordinary and necessary** are found in both § 162 and § 212. To be deductible, any trade or business expense must be “ordinary and necessary.” In addition, compensation for services must be “reasonable” in amount.

Many expenses that are necessary may not be ordinary. Neither “ordinary” nor “necessary” is defined in the Code or Regulations. The courts have held that an expense is *necessary* if a prudent businessperson would incur the same expense and the expense is expected to be appropriate and helpful in the taxpayer's business.⁴ But as Example 3 shows, no deduction will be allowed unless the expense is also ordinary.

³§ 62(a)(4) and Reg. § 1.212-1(g).

⁴*Welch v. Helvering*, 3 USTC ¶1164, 12 AFTR 1456, 54 S.Ct. 8 (USSC, 1933).

EXAMPLE

3

Pat purchased a business that had just been adjudged bankrupt. Because the business had a poor financial rating, Pat wanted to restore its financial reputation. Consequently, he paid off some of the debts owed by the former owners that had been cancelled by the bankruptcy court. Because Pat had no legal obligation to make these payments, the U.S. Supreme Court found he was trying to generate goodwill. Although the payments were necessary (i.e., appropriate and helpful), they were *not* ordinary and their deduction *was not* allowed.⁵

An expense is *ordinary* if it is normal, usual, or customary in the type of business conducted by the taxpayer and is not capital in nature.⁶ However, an expense need not be recurring to be deductible as ordinary. For example, a business may be in a situation that is a very rare occurrence and incur an expense. If other businesses in a similar situation are likely to incur a similar expense, then the expense can be ordinary, even though it is not recurring.

EXAMPLE

4

Albert engaged in a mail-order business. The post office judged that his advertisements were false and misleading. Under a fraud order, the post office stamped “fraudulent” on all letters addressed to Albert’s business and returned them to the senders. Albert spent \$30,000 on legal fees in an unsuccessful attempt to force the post office to stop. The legal fees (although not recurring) were ordinary business expenses because they were normal, usual, or customary in the circumstances.⁷

For § 212 deductions, the law requires that expenses bear a reasonable and proximate relationship to (1) the production or collection of income or to (2) the management, conservation, or maintenance of property held for the production of income.⁸

EXAMPLE

5

Debbye is a retired pilot who owns a small portfolio of investments, including 10 shares of Robin, Inc., a publicly traded company, worth \$1,000. She incurred \$350 in travel expenses to attend the annual shareholders’ meeting where she voted her 10 shares against the current management group. No deduction is permitted because a 10-share investment is insignificant in value in relation to the travel expenses incurred.⁹

The Code refers to **reasonableness** solely with respect to salaries and other compensation for services.¹⁰ But the courts have held that for any business expense to be ordinary and necessary, it must also be reasonable in amount.¹¹

What constitutes reasonableness is a question of fact. If an expense is unreasonable, the excess amount is not allowed as a deduction. The question of reasonableness generally arises with respect to closely held corporations where there is no separation of ownership and management.

Transactions between the shareholders and the closely held company may result in the disallowance of deductions for excessive salaries and rent expense paid by the corporation to the shareholders. The courts will view an unusually large salary in light of all relevant circumstances and may find that the salary is reasonable despite its size.¹² If excessive payments for salaries and rents are closely related to the percentage of stock owned by the recipients, the payments are generally treated as dividends.¹³ Because dividends are not deductible by the corporation, the disallowance results in an increase in the corporate taxable income. Deductions for reasonable salaries will not be disallowed *solely* because the corporation has paid insubstantial portions of its earnings as dividends to its shareholders.

⁵Welch v. Helvering, cited in footnote 4.

⁶Deputy v. DuPont, 40-1 USTC ¶9161, 23 AFTR 808, 60 S.Ct. 363 (USSC, 1940).

⁷Comm. v. Heininger, 44-1 USTC ¶9109, 31 AFTR 783, 64 S.Ct. 249 (USSC, 1943).

⁸Reg. § 1.212-1(d).

⁹J. Raymond Dyer, 36 T.C. 456 (1961).

¹⁰§ 162(a)(1).

¹¹Comm. v. Lincoln Electric Co., 49-2 USTC ¶9388, 38 AFTR 411, 176 F.2d 815 (CA-6, 1949).

¹²Kennedy, Jr. v. Comm., 82-1 USTC ¶9186, 49 AFTR 2d 82-628, 671 F.2d 167 (CA-6, 1982), rev’g 72 T.C. 793 (1979).

¹³Reg. § 1.162-8.

Sparrow Corporation, a closely held corporation, is owned equally by Lupe, Carlos, and Ramon. The company has been highly profitable for several years and has not paid dividends. Lupe, Carlos, and Ramon are key officers of the company, and each receives a salary of \$200,000. Salaries for similar positions in comparable companies average only \$100,000. Amounts paid the owners in excess of \$100,000 may be deemed unreasonable; if so, a total of \$300,000 in salary deductions by Sparrow is disallowed. The disallowed amounts are treated as dividends rather than salary income to Lupe, Carlos, and Ramon because the payments are proportional to stock ownership. Salaries are deductible by the corporation, but dividends are not. Note that the shareholders may benefit from this reclassification. Salaries would be taxed at ordinary income rates and are subject to payroll taxes. However, dividend income would be taxed at long-term capital rates if qualified.

EXAMPLE

6

6-1d Personal Expenses

Expenditures that are incurred in one's personal life are not deductible unless a specific Code section authorizes the deduction. These expenses, which generally are not related to the production of income, are usually deductions *from* AGI and, in some cases, must be less than (or greater than) a certain percentage of the AGI. Some of the more frequently encountered deductions in this category include the following:

- Contributions to qualified charitable organizations.
- Medical expenses.
- Certain state and local taxes.
- Personal casualty losses.
- Certain personal interest.
- Legal fees, but only if they relate to the determination of a tax liability.

Itemized deductions are discussed in detail in Chapter 10.

6-1e Business and Nonbusiness Losses

Section 165 provides for a deduction for losses not compensated for by insurance. As a general rule, deductible losses of individual taxpayers are limited to those incurred in a trade or business or in a transaction entered into for profit. Individuals also are allowed to deduct losses that are the result of a casualty. Casualty losses include, but are not limited to, those caused by fire, storm, shipwreck, and theft. See Chapter 7 for a further discussion of this topic. A personal casualty loss is an itemized deduction.

6-1f Reporting Procedures

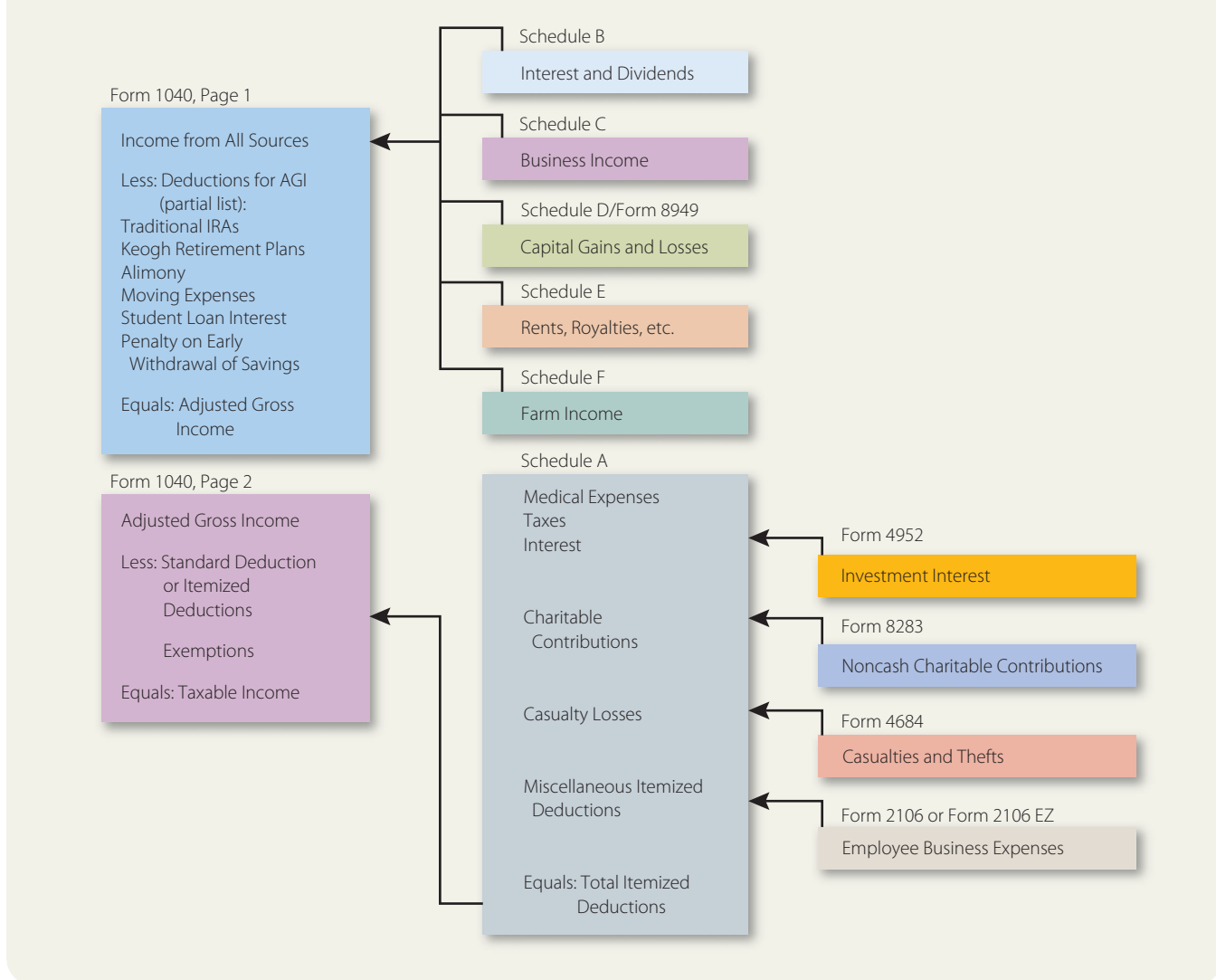
All deductions *for* AGI are ultimately reported on page 1 of Form 1040. Most of the deductions *for* AGI originate on supporting schedules. Examples include business expenses (Schedule C); rent, royalty, partnership, and fiduciary deductions (Schedule E); and farming expenses (Schedule F). Other deductions *for* AGI, such as traditional IRAs, Keogh retirement plans, and alimony, are entered directly on page 1 of Form 1040.

Adjusted gross income appears on the last line of page 1 and, again, on the first line of page 2. The total of all itemized deductions, which is carried over from Schedule A, is then subtracted *from* AGI. After that, personal and dependency exemptions are deducted to arrive at taxable income.

As indicated in Exhibit 6.2, some Schedule A deductions originate on other forms. Form 1040 incorporates the deductible amounts for many expenses that are computed on other schedules and forms. Also, see Concept Summary 6.3 later in the chapter for the classification of deductions as *for* AGI or *from* AGI.

EXHIBIT 6.2

Format of Form 1040



LO.2

Describe the cash and accrual methods of accounting with emphasis on the deduction aspects.

6-2 DEDUCTIONS AND LOSSES—TIMING OF EXPENSE RECOGNITION

6-2a Importance of Taxpayer's Method of Accounting

A taxpayer's **accounting method** is a major factor in determining taxable income. The method used determines when an item is includible in income and when an item is deductible on the tax return. Usually, the taxpayer's regular method of record keeping is used for income tax purposes.¹⁴ The taxing authorities do not require uniformity among all taxpayers. They do require that the method used clearly reflect income and that items be handled consistently.¹⁵ The most common methods of accounting are the cash method and the accrual method. If a taxpayer owns multiple businesses, it may be possible to use the cash method for some and the accrual method for others.

¹⁴§ 446(a).

¹⁵§§ 446(b) and (e); Reg. § 1.446-1(a)(2).

Throughout the portions of the Code dealing with deductions, the phrase *paid or incurred* is used. *Paid* refers to the cash basis taxpayer who gets a deduction only in the year of payment. *Incurred* concerns the accrual basis taxpayer who obtains the deduction in the year in which the liability for the expense becomes certain (refer to Chapter 4).

6-2b Cash Method Requirements

The expenses of cash basis taxpayers are deductible only when they are actually paid with cash or other property. Promising to pay or issuing a note does not satisfy the actually paid requirement.¹⁶ However, the payment can be made with borrowed funds. At the time taxpayers charge expenses on their credit cards, they are allowed to claim the deduction. They are deemed to have simultaneously borrowed money from the credit card issuer and constructively paid the expenses.¹⁷

Although the cash basis taxpayer must have actually or constructively paid the expense, payment does not ensure a current deduction. Cash basis and accrual basis taxpayers cannot take a current deduction for capital expenditures except through amortization, depletion, or depreciation over the life (actual or statutory) of the asset. The Regulations set forth the general rule that an expenditure that creates an asset having a useful life that extends substantially beyond the end of the tax year must be capitalized.¹⁸ Examples 7 and 8 illustrate how this rule applies to prepaid expenses.

John, a calendar year and cash basis taxpayer, rents property from Carl. On July 1, 2015, John pays \$24,000 rent for the 24 months ending June 30, 2017. The prepaid rent extends 18 months after the close of the tax year—substantially beyond the year of payment. Therefore, John must capitalize the prepaid rent and amortize the expense on a monthly basis. His deduction for 2015 is \$6,000.

EXAMPLE

7

The Tax Court and the IRS took the position that an asset that will expire or be consumed by the end of the tax year following the year of payment must be prorated. The Ninth Circuit Court of Appeals held that such expenditures are currently deductible, however, and the Supreme Court apparently concurs (the one-year rule for prepaid expenses).¹⁹

Assume the same facts as in Example 7, except that John is required to pay only 12 months' rent in 2015. He pays \$12,000 on July 1, 2015. The entire \$12,000 is deductible in 2015 as the benefit does not extend beyond the end of 2016.

EXAMPLE

8

The payment must be required, not a voluntary prepayment, to obtain the current deduction under the one-year rule.²⁰ The taxpayer must also demonstrate that allowing the current deduction will not result in a material distortion of income. Generally, the deduction will be allowed if the item is recurring or was made for a business purpose rather than to manipulate income.²¹

As Chapter 16 explains, not all taxpayers are allowed to use the cash method.²² For example, in most cases, the taxpayer is required to use the accrual method for sales and cost of goods sold if inventories are an income-producing factor of the business.

¹⁶*Page v. Rhode Island Trust Co., Exr.*, 37-1 USTC ¶9138, 19 AFTR 105, 88 F.2d 192 (CA-1, 1937).

¹⁷Rev.Rul. 78-39, 1978-1 C.B. 73. See also Rev.Rul. 80-335, 1980-2 C.B. 170, which applies to pay-by-phone arrangements.

¹⁸Reg. § 1.461-1(a).

¹⁹*Zaninovich v. Comm.*, 80-1 USTC ¶9342, 45 AFTR 2d 80-1442, 616 F.2d 429 (CA-9, 1980), *rev'g* 69 T.C. 605 (1978). Cited by the Supreme Court in

Hillsboro National Bank v. Comm., 83-1 USTC ¶9229, 51 AFTR 2d 83-874, 103 S.Ct. 1134 (USSC, 1983).

²⁰*Bonaire Development Co. v. Comm.*, 82-2 USTC ¶9428, 50 AFTR 2d 82-5167, 679 F.2d 159 (CA-9, 1982).

²¹*Keller v. Comm.*, 84-1 USTC ¶9194, 53 AFTR 2d 84-663, 725 F.2d 1173 (CA-8, 1984), *aff'g* 79 T.C. 7 (1982).

²²§ 448.

6-2c Accrual Method Requirements

The period in which an accrual basis taxpayer can deduct an expense is determined by applying the *all events test* and the *economic performance test*. That is, a deduction cannot be claimed until (1) all of the events have occurred to create the taxpayer's liability and (2) the amount of the liability can be determined with reasonable accuracy. Once these requirements are satisfied, the deduction is permitted only if economic performance has occurred. The economic performance test is met only when the service, property, or use of property giving rise to the liability is actually performed for, provided to, or used by the taxpayer.²³

EXAMPLE

9

Chris's entertainment business sponsored a jazz festival in a rented auditorium at a local college. His business is responsible for cleaning up after the festival, which took place on December 22, 2015, and reinstalling the auditorium seats. Because the college is closed over the Christmas holidays, the company hired by Chris to perform the work did not begin these activities until January 3, 2016. Chris's business cannot deduct its \$1,200 labor cost until 2016, when the services are performed.

An exception to the economic performance requirements allows certain *recurring items* to be deducted if all of the following conditions are met:

- The item is recurring in nature and is treated consistently by the taxpayer.
- Either the accrued item is not material or accruing it results in better matching of income and expenses.
- All of the events have occurred that determine the fact of the liability, and the amount of the liability can be determined with reasonable accuracy.
- Economic performance occurs within a reasonable period (but not later than 8½ months after the close of the taxable year).²⁴

Exceptions to Economic Performance Rules

EXAMPLE

10

Rick, an accrual basis, calendar year taxpayer, entered into a monthly maintenance contract during the year. He makes a monthly accrual at the end of every month for this service and pays the fee sometime between the first and fifteenth of the following month when services are performed. The amount involved is immaterial, and all of the other tests are met. The December 2015 accrual is deductible in 2015 even though the service is performed on January 12, 2016.

EXAMPLE

11

Rita, an accrual basis, calendar year taxpayer, shipped merchandise sold on December 30, 2015, via Greyhound Van Lines on January 3, 2016, and paid the freight charges at that time. Because Rita reported the sale of the merchandise in 2015, the shipping charge should also be deductible in 2015. This procedure results in a better matching of income and expenses.

Reserves for estimated expenses (frequently employed for financial accounting purposes) generally are not allowed for tax purposes because the economic performance test cannot be satisfied.

EXAMPLE

12

Blackbird Airlines is required by Federal law to test its engines after 3,000 flying hours. Aircraft cannot return to flight until the tests have been conducted. An unrelated aircraft maintenance company does all of the company's tests for \$1,500 per engine. For financial reporting purposes, the company accrues an expense based upon \$.50 per hour of flight and credits an allowance account. The actual amounts paid for maintenance are offset against the allowance account. For tax purposes, the economic performance test is not satisfied until the work has been done. Therefore, the reserve method cannot be used for tax purposes.

²³§ 461(h).

²⁴§ 461(h)(3)(A).

6-3 DISALLOWANCE POSSIBILITIES

The tax law provides for the disallowance of certain types of expenses. Without specific restrictions in the tax law, taxpayers might attempt to deduct items that, in reality, are personal expenditures. For example, specific tax rules are provided to determine whether an expenditure is for trade or business purposes or related to a personal hobby.

6-3a Public Policy Limitation

Certain disallowance provisions are a codification or extension of prior court decisions. For example, after the courts denied deductions for payments considered to be in violation of public policy, the tax law was changed to provide specific authority for the disallowance of these deductions.

Justification for Denying Deductions

The courts developed the principle that a payment in violation of public policy is not a necessary expense and is not deductible.²⁵ Although a bribe or fine may be helpful and may even contribute to the profitability of an activity, the courts held that to allow such expenses would be contrary to public policy. A deduction would, in effect, be indirectly subsidizing a taxpayer's wrongdoing.

Because tax law did not explain which actions violated public policy, the IRS and taxpayers had no clear guidance as to whether an expense was contrary to public policy. To solve these problems, Congress enacted legislation that attempts to better define the use of the public policy doctrine. Under the legislation, the following deductions are disallowed for certain specific types of expenditures that are considered contrary to public policy:

- Bribes and kickbacks, including those associated with Medicare or Medicaid. In the case of foreign bribes and kickbacks, only if the payments violate the U.S. Foreign Corrupt Practices Act of 1977.
- Fines and penalties paid to a government for violation of law.

The Big Picture

Refer to the facts of *The Big Picture* on p. 6-1. Dr. Payne had not instituted proper procedures for disposing of medical waste from his laboratory. During the current tax year, he was fined \$3,000 by the city. Dr. Payne believes the fine should be deducted as an ordinary business expense. However, because the fine was due to a violation of public policy, the \$3,000 is not deductible.

- Two-thirds of the treble damage payments made to claimants resulting from violation of the antitrust law.²⁶

To be disallowed, the bribe or kickback must be illegal under either Federal or state law and must also subject the payor to a criminal penalty or the loss of a license or privilege to engage in a trade or business. For a bribe or kickback that is illegal under state law, a deduction is denied if the state law is generally enforced.

During the year, Keith, an insurance salesperson, paid \$5,000 to Karen, a real estate broker. The payment represented 20% of the commissions Keith earned from customers referred by Karen. Under state law, the splitting of commissions by an insurance salesperson is an act of misconduct that could warrant a revocation of the salesperson's license. Keith's \$5,000 payments to Karen are not deductible if the state law is generally enforced.

LO.3

Apply the Internal Revenue Code deduction disallowance provisions associated with the following: public policy limitations, political activities, excessive executive compensation, investigation of business opportunities, hobby losses, vacation home rentals, payment of others' expenses, personal expenditures, capital expenditures, related-party transactions, and expenses related to tax-exempt income.

EXAMPLE

13

EXAMPLE

14

²⁵*Tank Truck Rentals, Inc. v. Comm.*, 58-1 USTC ¶9366, 1 AFTR 2d 1154, 78 S.Ct. 507 (USSC, 1958).

²⁶§§ 162(c), (f), and (g).



GLOBAL TAX ISSUES Overseas Gun Sales Result in Large Fines

The Foreign Corrupt Practices Act (FCPA) is intended to punish taxpayers who make illegal payments to foreign officials to obtain economic advantages. Not only are such payments (usually improperly recorded as business expenses) nondeductible for income tax purposes, but serious and consistent violations can lead to the imposition of fines. Severe consequences can result from violating the bribery provisions of the FCPA, as Smith & Wesson recently discovered.

Smith & Wesson is a Massachusetts-based firearms manufacturer that wanted to begin selling firearms in India, Pakistan, and other foreign countries. As a small player in

this international market, company officials decided to provide gifts to government officials in these countries to encourage them to do business with Smith & Wesson. This turned out to be a costly mistake. Smith & Wesson had profits of only \$100,000 from this scheme before it was uncovered, and in 2014, it agreed to pay the Securities and Exchange Commission fines of more than \$2 million. Of course, the fines are not deductible because they are a violation of public policy.

Source: www.sec.gov/News/PressRelease/Detail/PressRelease/1370542384677#.VDM-3RbuqKI.

Legal Expenses Incurred in Defense of Civil or Criminal Penalties

To deduct legal expenses, the taxpayer must be able to show that the origin and character of the claim are directly related to a trade or business; an income-producing activity; or the determination, collection, or refund of a tax. Personal legal expenses are not deductible. Thus, legal fees incurred in connection with a criminal defense are deductible only if the crime is associated with the taxpayer's trade or business or income-producing activity.²⁷

EXAMPLE

15

Debra, a financial officer of Blue Corporation, incurs legal expenses in connection with her defense in a criminal indictment for evasion of Blue's income taxes. Debra may deduct her legal expenses because she is deemed to be in the trade or business of being an executive. The legal action impairs her ability to conduct this business activity.²⁸

Deductible legal expenses associated with the following are deductible *for* AGI:

- Ordinary and necessary expenses incurred in connection with a trade or business.
- Ordinary and necessary expenses incurred in conjunction with rental or royalty property held for the production of income.

All other deductible legal expenses are deductible *from* AGI. For example, legal expenses generally are deductible *from* AGI if they are for fees for tax advice relative to the preparation of an individual's income tax return. Contrast this with the *for* AGI classification of legal fees for tax advice relative to the preparation of the portion of the tax return for a sole proprietor's trade or business (Schedule C) or an individual's rental or royalty income (Schedule E).

Expenses Relating to an Illegal Business

The usual expenses of operating an illegal business (e.g., a gambling operation) are deductible.²⁹ While allowing deductions for illegal activity may seem inappropriate, recall that the law taxes net income from a business operation, not gross revenue. However, § 162 disallows a deduction for fines, bribes to public officials, illegal kick-backs, and other illegal payments whether these payments are part of a legal or illegal business.

²⁷*Comm. v. Tellier*, 66-1 USTC ¶9319, 17 AFTR 2d 633, 86 S.Ct. 1118 (USSC, 1966).

²⁸Rev.Rul. 68-662, 1968-2 C.B. 69.

²⁹*Comm. v. Sullivan*, 58-1 USTC ¶9368, 1 AFTR 2d 1158, 78 S.Ct. 512 (USSC, 1958).

Sam owns and operates an illegal gambling establishment. In connection with this activity, he has the following expenses during the year:

Rent	\$ 60,000
Payoffs to the police	40,000
Depreciation on equipment	100,000
Wages	140,000
Interest	30,000
Criminal fines	50,000
Illegal kickbacks	<u>10,000</u>
Total	<u>\$430,000</u>

All of the usual expenses (rent, depreciation, wages, and interest) are deductible; payoffs, fines, and kickbacks are not deductible. Of the \$430,000 spent, \$330,000 is deductible and \$100,000 is not.

EXAMPLE

16

An exception applies to expenses incurred in illegal trafficking in drugs.³⁰ *Drug dealers* are not allowed a deduction for ordinary and necessary business expenses incurred in their business. In arriving at gross income from the business, however, dealers may reduce total sales by the cost of goods sold.³¹



ETHICS & EQUITY Medical Marijuana: Trade or Business Activity or Illegal Operation?

Cole England operates Herbal Medical Center in Sacramento, California, as a sole proprietorship. The distribution of marijuana for medical purposes is legal in California, as follows:

Medical patients and their designated primary caregivers may legally possess and cultivate (but not distribute or sell) marijuana under Health and Safety Code 11362.5 (Prop 215) if they have a physician's recommendation or approval.

This is Cole's first year of business operations. All of his patients have signed statements indicating that he

is their designated primary caregiver. He also has on file physician's recommendations for all marijuana that was provided to his patients. Tax information for this year is as follows:

Revenues	\$200,000
Cost of goods sold	120,000
Other expenses	50,000

Cole reported \$30,000 of net income on Schedule C this year for Herbal Medical Center. Is this position appropriate?

6-3b Political Contributions and Lobbying Activities

Generally, no business deduction is permitted for direct or indirect payments for political purposes.³² Historically, the government has been reluctant to accord favorable tax treatment to business expenditures for political purposes. Allowing deductions might encourage abuses and enable businesses to have undue influence on the political process.

The Big Picture

Refer to the facts of *The Big Picture* on p. 6-1. Dr. Payne had made political contributions to the State Senate campaigns of Tom Smith and Virginia White. Dr. Payne made these contributions to encourage these senators to support a new bill that is beneficial to the state's dental profession. Therefore, he assumed that these would be deductible business expenses. However, political contributions are not deductible, so he will receive no tax benefit from them.

EXAMPLE

17

³⁰§ 280E.

³²§ 276.

³¹Reg. § 1.61-3(a). Gross income is defined as sales minus cost of goods sold. Thus, while § 280E prohibits any deductions for drug dealers, it does not modify the normal definition of gross income.

Lobbying expenses incurred in attempting to influence state or Federal legislation or the actions of certain high-ranking public officials are not deductible.³³ The disallowance also applies to a pro rata portion of the membership dues of trade associations and other groups that are involved in lobbying activities.

The Big Picture

EXAMPLE

18

Refer to the facts of *The Big Picture* on p. 6-1. Dr. Payne had made contributions to The Dental Society, a trade association for dentists. The trade association estimates that 70% of its dues are allocated to lobbying activities. Thus, his deduction on Schedule C is limited to \$3,000 ($\$10,000 \times 30\%$).

There are three exceptions to the disallowance of lobbying expenses. First, an exception is provided for influencing local legislation (e.g., city and county governments). Second, the disallowance provision does not apply to activities devoted solely to monitoring legislation. Third, a *de minimis* exception is provided for annual in-house expenditures (lobbying expenses other than those paid to professional lobbyists or any portion of dues used by associations for lobbying) if such expenditures do not exceed \$2,000. If the in-house expenditures exceed \$2,000, none of the in-house expenditures can be deducted.

6-3c Excessive Executive Compensation

The deduction of executive compensation normally is subject to two limitations. As discussed earlier in this chapter, the compensation of shareholder-employees of closely held corporations is subject to the reasonableness requirement. The second limitation, the so-called millionaires' provision, applies to publicly held corporations (a corporation that has at least one class of stock registered under the Securities Exchange Act of 1934).³⁴

The millionaires' provision does not limit the amount of compensation that can be paid to an employee. Instead, it limits the amount the employer can deduct for the taxable compensation of a covered executive to \$1 million annually. Covered employees as defined by the SEC are the principal executive officer (PEO), the principal financial officer (PFO), and the three other most highly compensated executives.

This disallowance does not apply to commissions based on individual performance and performance-based compensation tied to overall company performance.

6-3d Investigation of a Business

Investigation expenses are expenses paid or incurred to determine the feasibility of entering a new business or expanding an existing business. They include such costs as travel, engineering and architectural surveys, marketing reports, and various legal and accounting services. How such expenses are treated for tax purposes depends on a number of variables, including the following:

- The current business, if any, of the taxpayer.
- The nature of the business being investigated.
- The extent to which the investigation has proceeded.
- Whether the acquisition actually takes place.

If the taxpayer is in a business that is the *same as or similar to* that being investigated, all investigation expenses are deductible in the year paid or incurred. The tax result is the same whether or not the taxpayer acquires the business being investigated.³⁵

³³§ 162(e).

³⁴§ 162(m).

³⁵§ 195. *York v. Comm.*, 58-2 USTC ¶9952, 2 AFTR 2d 6178, 261 F.2d 421 (CA-4, 1958).



TAX IN THE NEWS Do Deduction Limits Affect Executive Compensation?

Only \$1 million of compensation can be deducted for the CEO, CFO, and three other highest-compensated executives of publicly traded companies. However, as noted previously, this limitation does not apply to compensation that is performance-based. One interesting issue is whether this exception is broad enough to allow publicly traded companies to pay substantial compensation to executives and still receive a tax deduction. The answer is clearly yes.

For example, in 2012, the CEO of eBay received base salary of \$970,353, which is just under the \$1 million limitation. However, he received bonuses and stock incentives of over \$28.5 million, which qualify to be deducted under the performance-based exception. The CEO of Textron had salary of exactly \$1 million, and performance-based compensation

was over \$10 million. The biggest payday was for Robert Iger, CEO of Walt Disney, who had salary of \$2.5 million and performance-based compensation of almost \$34 million.

Of 170 S&P 500 CEO salaries that were analyzed by *USA TODAY*, only two had a base salary greater than \$2 million, and many had a base salary at or very close to \$1 million. This indicates that the \$1 million limit does have an influence on the base salary of CEOs. However, because of the performance-based exception, this tax law appears to have had very little impact on the escalation of executive salaries.

Source: Based on Matt Krantz and Barbara Hansen, "CEO Pay Rockets As Economy, Stocks Recover," *USA TODAY*, April 1, 2013, www.usatoday.com/story/money/business/2013/03/27/ceo-pay-executive-compensation-2012/2006203/

The Big Picture

Refer to the facts of *The Big Picture* on p. 6-1. Dr. Payne believes that his administrative and business skills can be used to turn around dental practices whose revenues have been declining. He investigates Teeth Restoration LLC, a local dental practice that is for sale. Expenses paid to consultants and accountants as part of this investigation totaled \$6,000. He determined that Teeth Restoration would not be a good investment, so he did not buy it. The \$6,000 spent to investigate this business is deductible as a business expense because Dr. Payne is already in the dental business. Investigating new business opportunities in one's current trade or business is an ordinary and necessary business expense.

EXAMPLE

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When the taxpayer is *not* in a business that is the same as or similar to the one being investigated, the tax result depends on whether the new business is acquired. If the business is not acquired, all investigation expenses generally are nondeductible.³⁶

Lynn, a retired merchant, incurs expenses in traveling from Rochester, New York, to California to investigate the feasibility of acquiring several auto care centers. If no acquisition takes place, none of the expenses are deductible.

EXAMPLE

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If the taxpayer is *not* in a business that is the same as or similar to the one being investigated and actually acquires the new business, the expenses must be capitalized as **startup expenditures**. Startup costs are not deductible under § 162 because they are incurred *before* a business begins rather than in the course of operating a trade or business. The first \$5,000 of the expenses is immediately deducted. Any excess of expenses is amortized over a period of 180 months (15 years). In arriving at the \$5,000 immediate deduction allowed, a dollar-for-dollar reduction must be made for those expenses in excess of \$50,000.³⁷ An election can be made by the taxpayer not to deduct or amortize any portion of the startup costs. In that case, this intangible asset will remain on the balance sheet until the business is sold.

³⁶Rev.Rul. 57-418, 1957-2 C.B. 143; *Morton Frank*, 20 T.C. 511 (1953); and *Dwight A. Ward*, 20 T.C. 332 (1953).

³⁷§ 195(b).

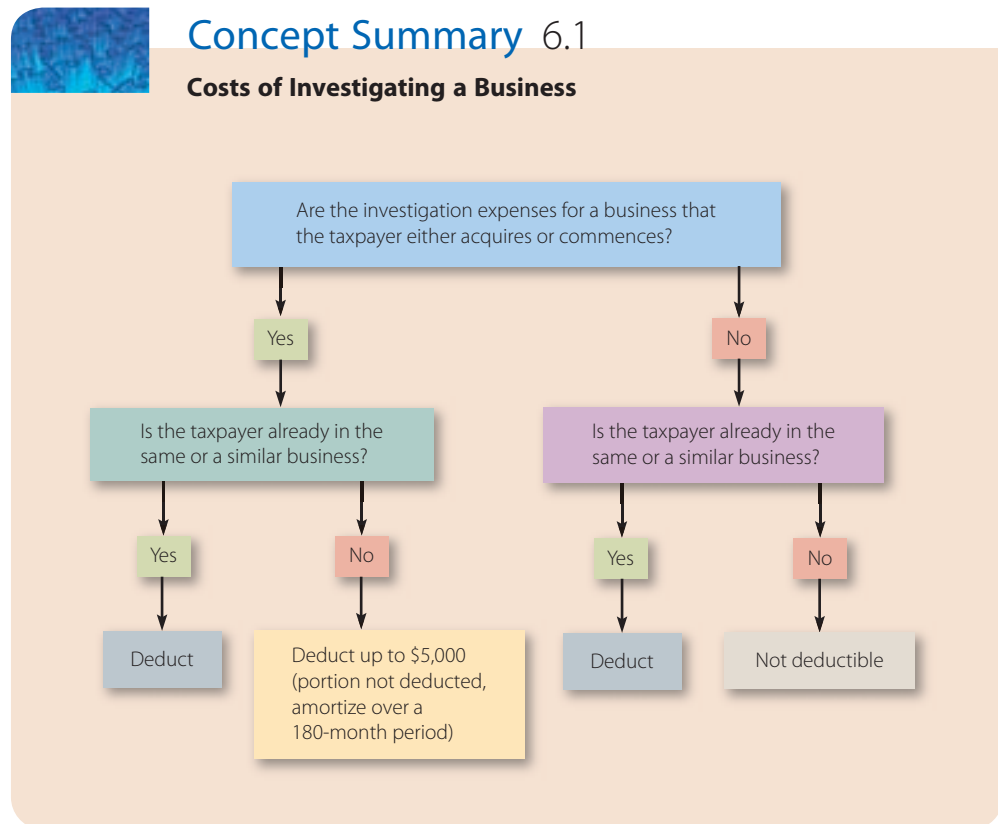
EXAMPLE

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Tina owns and operates 10 restaurants located in various cities throughout the Southeast. She travels to Atlanta to discuss the acquisition of an auto dealership. In addition, she incurs legal and accounting costs associated with the potential acquisition. After incurring total investigation costs of \$52,000, she acquires the auto dealership on October 1, 2015.

Tina may immediately deduct \$3,000 [$\$5,000 - (\$52,000 - \$50,000)$] and amortize the balance of \$49,000 ($\$52,000 - \$3,000$) over a period of 180 months. For calendar year 2015, therefore, Tina can deduct \$3,817 [$\$3,000 + (\$49,000 \times 3/180)$].

Concept Summary 6.1 sets forth the tax rules applicable to the costs involved in investigating a business.



6-3e Hobby Losses

Business or investment expenses are deductible only if the taxpayer can show that the activity was entered into for the purpose of making a profit. Certain activities can have attributes that make it difficult to determine if the primary motivation for the activity is to make a profit or is for personal pleasure. Examples include raising horses and operating a farm used as a weekend residence. While personal losses are not deductible, losses attributable to profit-seeking activities may be deducted and used to offset a taxpayer's other income. Activities that have both personal and profit-seeking motives are classified as hobbies, and the tax law limits the deductibility of **hobby losses**.

The income and deductions from a hobby are reported separately on the tax return. Whether deductions related to a hobby generate a tax benefit, the revenue for the hobby is always reported as other income on page 1 of Form 1040. The reporting of deductions is discussed below.



TAX IN THE NEWS IRS Doing Poorly in Policing Hobby Loss Deductions

The Treasury Inspector General for Tax Administration (TIGTA) has issued a report on the number of taxpayers who file Schedule C of Form 1040 showing losses over several consecutive years. Many of the returns examined reported substantial income from other sources, and the majority of the individuals involved had their tax returns prepared by tax practitioners. By claiming the Schedule C losses, approximately 1.2 million taxpayers were able to save \$2.8 billion in taxes for tax year 2005.

Because of the subjective nature of the hobby loss rules (i.e., whether a profit motive exists), these Schedule C losses

can be controlled only through thorough policing by the IRS. Unfortunately, the IRS has neither the time nor the resources to carry out the audit efforts required. The TIGTA report, therefore, suggests that § 183 be changed by legislation to establish a clear standard for determining whether an activity is a business or a hobby.

Source: "Significant Challenges Exist in Determining Whether Taxpayers with Schedule C Losses Are Engaged in Tax Abuse," *Treasury Inspector General for Tax Administration*, September 7, 2007 (Reference No. 2007-30-173).

General Rules

If an individual can show that an activity has been conducted with the intent to earn a profit, losses from the activity are fully deductible. The hobby loss rules apply only if the activity is not engaged in for profit. Hobby expenses are deductible only to the extent of hobby income.³⁸

The Regulations stipulate that the following nine factors should be considered in determining whether an activity is profit-seeking or is a hobby:³⁹

- Whether the activity is conducted in a businesslike manner.
- The expertise of the taxpayers or their advisers.
- The time and effort expended.
- The expectation that the assets of the activity will appreciate in value.
- The taxpayer's previous success in conducting similar activities.
- The history of income or losses from the activity.
- The relationship of profits earned to losses incurred.
- The financial status of the taxpayer (e.g., if the taxpayer does not have substantial amounts of other income, this may indicate that the activity is engaged in for profit).
- Elements of personal pleasure or recreation in the activity.

The presence or absence of a factor is not by itself determinative of whether the activity is profit-seeking or is a hobby. Rather, the decision is a subjective one that is based on an analysis of the facts and circumstances.

Presumptive Rule of § 183

The Code provides a rebuttable presumption that an activity is profit-seeking if the activity shows a profit in at least three of the previous five tax years.⁴⁰ If the activity involves horses, a profit in at least two of the previous seven tax years meets the presumptive rule. If these profitability tests are met, the activity is presumed to be a trade or business rather than a personal hobby. In this situation, the IRS bears the burden of proving that the activity is personal rather than trade- or business-related. On the other hand, if the three-year test (two for horses) is not met, then the activity is presumed to be a hobby and the taxpayer has the burden to prove that it is profit-seeking.

³⁸§ 183(b)(2).

³⁹Reg. §§ 1.183-2(b)(1) through (9).

⁴⁰§ 183(d).

EXAMPLE

22

Camille and Walter are married taxpayers who enjoy a busy lifestyle. Camille, who is an executive for a large corporation, is paid a salary of \$800,000. Walter is a collector of antiques. Several years ago he opened an antique shop in a local shopping center and spends most of his time buying and selling antiques. He occasionally earns a small profit from this activity but more frequently incurs substantial losses. If Walter's losses are business-related, they are fully deductible against Camille's salary income on a joint return. In resolving this issue, consider the following:

- Initially determine whether Walter's antique activity has met the three-out-of-five years profit test.
- If the presumption is not met, the activity may nevertheless qualify as a business if Walter can show that the intent is to engage in a profit-seeking activity. It is not necessary to show actual profits.
- Attempt to fit the operation within the nine criteria prescribed in the Regulations listed previously.

Determining the Amount of the Deduction

If an activity is deemed to be a hobby, the expenses are deductible only to the extent of the gross income from the hobby. These expenses must be deducted in the following order:

- Amounts deductible under other Code sections without regard to the nature of the activity, such as property taxes and home mortgage interest.
- Amounts deductible under other Code sections if the activity had been engaged in for profit, but only if those amounts do not affect adjusted basis. Examples include maintenance, utilities, and supplies.
- Amounts for depreciation, amortization, and depletion.⁴¹

The last two categories of deductions are deductible *from* AGI as itemized deductions to the extent they exceed 2 percent of AGI.⁴² If the taxpayer uses the standard deduction rather than itemizing, the hobby loss deductions generate no tax benefit. Even if this is the case, the revenue from a hobby still must be reported on page 1 of Form 1040.

EXAMPLE

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Jim, the vice president of an oil company, has AGI of \$80,000. He decides to pursue painting in his spare time. He uses a home studio comprising 10% of the home's square footage. During the current year, Jim incurs the following expenses:

Frames	\$ 1,800
Art supplies	900
Fees paid to models	4,000
Home studio expenses:	
Total home property taxes	2,000
Total home mortgage interest	10,000
Total home maintenance and utilities	4,600
Calculated depreciation on 10% of home	500

continued

⁴¹Reg. § 1.183-1(b)(1).

⁴²Reg. § 1.67-1T(a)(1)(iv) and Rev.Rul. 75-14, 1975-1 C.B. 90.

During the year, Jim sold paintings for a total of \$8,660. If the activity is held to be a hobby, Jim is allowed deductions as follows:

Gross income		\$ 8,660	
Deduct: Taxes and interest (10% of \$12,000)		<u>(1,200)</u>	
Remainder		\$ 7,460	
Deduct: Frames	\$1,800		
Art supplies	900		
Models' fees	4,000		
Maintenance and utilities (10%)	<u>460</u>	<u>(7,160)</u>	
Remainder		\$ 300	
Deduct: Depreciation (\$500, but limited to \$300)		<u>(300)</u>	
Net income		<u>\$ -0-</u>	

Jim includes the \$8,660 of income in AGI, making his AGI \$88,660. The taxes and interest are itemized deductions, deductible in full. The remaining \$7,460 of expenses are reduced by 2% of his AGI ($2\% \times \$88,660 = \$1,773$), so the net deduction is \$5,687. All of these deductions are reported as itemized deductions on Schedule A. Because the property taxes and home mortgage interest are deductible even without the hobby, the net effect is a \$2,973 (\$8,660 less \$5,687) increase in taxable income.

6-3f Rental of Vacation Homes

Restrictions on the deductions allowed for part-year rentals of personal **vacation homes** were written into the law to prevent taxpayers from deducting essentially personal expenses as rental losses. Many taxpayers who own vacation homes use the property for personal use during a portion of the year and rent the property at other times. For example, a summer cabin would be rented for 2 months per year, used for vacationing for 1 month, and left vacant the rest of the year. If the taxpayer could then deduct 11 months' depreciation, utilities, maintenance, etc., as rental expenses, resulting in a rental loss, the taxpayer would have converted into rental expenses personal expenses from the time the property was vacant. Section 280A eliminates this treatment by not allowing a loss for property that is not used primarily for rental purposes. Only a break-even situation is allowed; no losses can be deducted.

There are three possible tax treatments for residences used for both personal and rental purposes. The treatment depends upon the *relative time* the residence is used for personal purposes versus rental use. These rules are summarized in Concept Summary 6.2.

Primarily Personal Use

If the residence is *rented for fewer than 15 days* in a year, it is treated as a personal residence. The rent income is excluded from gross income, and mortgage interest and real estate taxes are allowed as itemized deductions, as with any personal residence.⁴³ No other expenses (e.g., depreciation, utilities, and maintenance) are deductible.

Catherine owns a vacation cottage on the lake. During the current year, she rented it for \$1,600 for two weeks, lived in it two months, and left it vacant the remainder of the year. The year's expenses amounted to \$6,000 mortgage interest expense, \$500 property taxes, \$1,500 utilities and maintenance, and \$2,400 depreciation. Because the property was not rented for at least 15 days, the income is excluded, the mortgage interest and property tax expenses are itemized deductions, and the remaining expenses are nondeductible personal expenses.

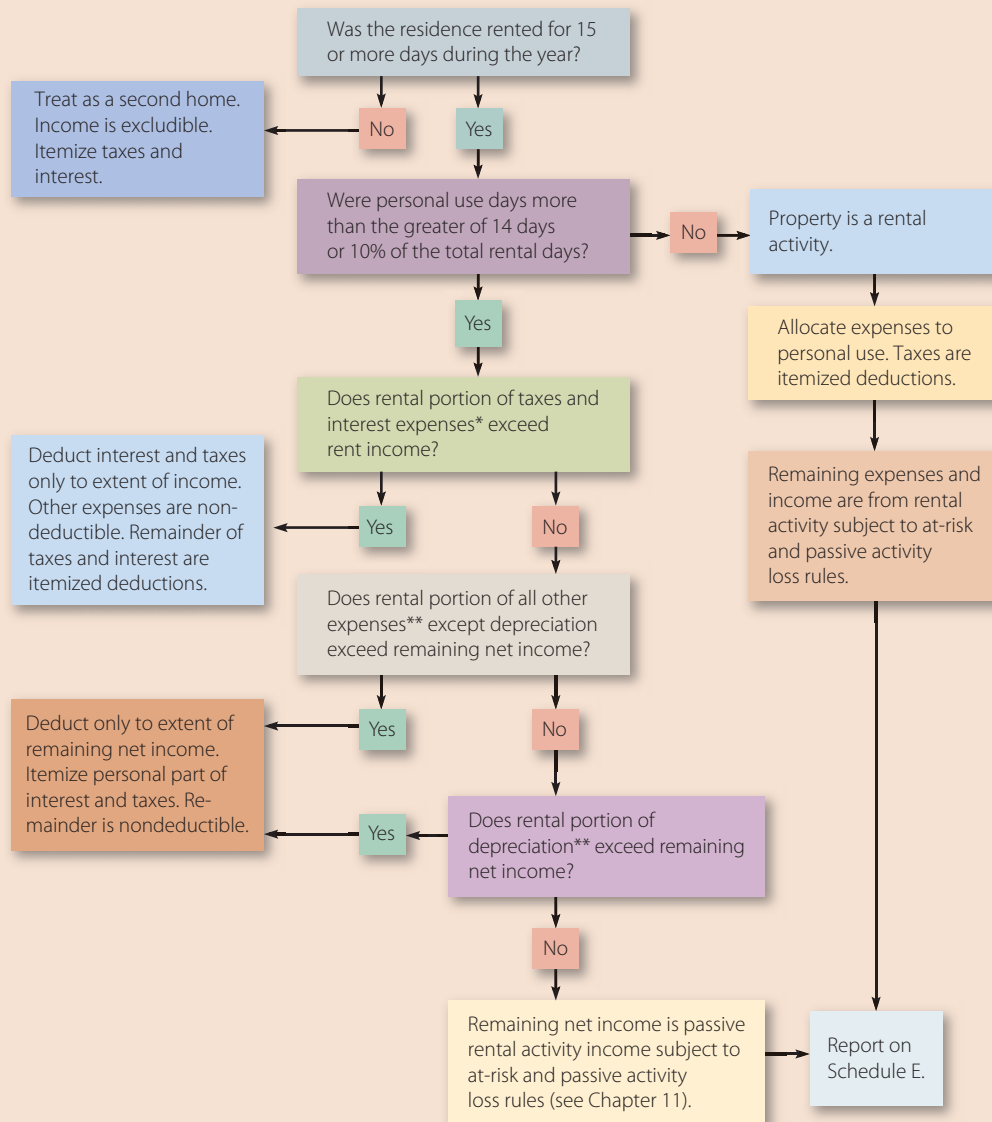
EXAMPLE

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⁴³§ 280A(g).

Concept Summary 6.2

Vacation/Rental Home



*Allocated on the basis of 365 (366 in a leap year) days (court) or total days of use (IRS).

**Allocated on the basis of total days of use.

Primarily Rental Use

If the residence is *rented* for 15 days or more in a year and is *not used* for personal purposes for more than the greater of (1) 14 days or (2) 10 percent of the total days rented, the residence is treated as rental property.⁴⁴ The expenses must be allocated between personal and rental days if there are any personal use days during the year. The real estate taxes allocated to the personal days are deductible as an itemized

⁴⁴§ 280A(d) and Prop.Reg. § 1.280A-3(c).

deduction. However, the mortgage interest allocated to the personal days cannot be deducted because the property is not a qualified residence. The deduction of the expenses allocated to rental days can exceed rent income and result in a rental loss. The loss may be deductible, subject to the at-risk and passive activity loss rules (discussed in Chapter 11).

Assume instead that Catherine in Example 24 used the cottage for 12 days and rented it for 48 days for \$4,800. The threshold for personal use is 14 days—the greater of (1) 14 days or (2) 4.8 days ($10\% \times 48$ rental days). Because she rented the cottage for 15 days or more but did not use it for more than 14 days, the cottage is treated as rental property. The expenses must be allocated between personal and rental days.

	Percentage of Use	
	Rental 80%	Personal 20%
Income	\$4,800	\$ -0-
Expenses		
Mortgage interest (\$6,000)	(\$4,800)	(\$1,200)
Property taxes (\$500)	(400)	(100)
Utilities and maintenance (\$1,500)	(1,200)	(300)
Depreciation (\$2,400)	(1,920)	(480)
Total expenses	(\$8,320)	(\$2,080)
Rental loss	(\$3,520)	\$ -0-

Catherine deducts the \$3,520 rental loss for AGI on Schedule E (assuming that she satisfies the at-risk and passive activity loss rules, discussed in Chapter 11). She also has an itemized deduction for property taxes of \$100 associated with the personal use. The mortgage interest of \$1,200 associated with the personal use is not deductible as an itemized deduction because the cottage is not a qualified residence (qualified residence interest) for this purpose (see Chapter 10). The portion of utilities and maintenance and depreciation attributable to personal use is not deductible.

EXAMPLE

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Personal/Rental Use

If the residence is rented for 15 days or more in a year *and* is used for personal purposes for more than the greater of (1) 14 days or (2) 10 percent of the total days rented, it is treated as a personal/rental use residence. The expenses must be allocated between personal days and rental days. Expenses are allowed only to the extent of rent income.⁴⁵

Assume instead that Catherine in Example 24 rented the property for 30 days and lived in it for 30 days. The threshold for personal use is 14 days—the greater of (1) 14 days or (2) 3 days ($10\% \times 30$ rental days). The residence is classified as personal/rental use property because she used it more than 14 days and rented it for 15 days or more. The expenses must be allocated between rental use and personal use, and the rental expenses are allowed only to the extent of rent income.

EXAMPLE

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⁴⁵A related issue is whether a taxpayer's primary residence is subject to the preceding rules if it is converted to rental property. If the vacation home rules apply, a taxpayer who converts a personal residence to rental property during the tax year, without any tax-avoidance motive, could have the allowable deductions limited to the rent income. To prevent this

from occurring, the personal use days will not cause the property to be treated as personal/rental if once the rental period begins, the property is rented for at least 12 consecutive months at a fair rental price (a qualified rental period).

If a residence is classified as personal/rental use property, the expenses that are deductible anyway (e.g., real estate taxes and mortgage interest) must be deducted first. If a positive net income results, expenses, other than depreciation, that are deductible for rental property (e.g., maintenance, utilities, and insurance) are allowed next. Finally, if any positive balance remains, depreciation is allowed. Any disallowed expenses allocable to rental use are carried forward and used in future years subject to the same limitations. Note that these ordering rules for deductions are the same as for hobby expenses.

Expenses must be allocated between personal and rental days before the limits are applied. The courts have held that real estate taxes and mortgage interest, which accrue ratably over the year, are allocated on the basis of 365 days.⁴⁶ The IRS, however, disagrees and allocates real estate taxes and mortgage interest on the basis of total days of use.⁴⁷ Other expenses (e.g., utilities, maintenance, depreciation) are allocated on the basis of total days used.

Personal/Rental: IRS vs. Courts

EXAMPLE

27

Jason rents his vacation home for 60 days and lives in the home for 30 days. The property is classified as personal/rental because it is rented for 15 days or more, and personal use (30 days) is greater than 14 [greater of 14 days or 6 days ($10\% \times 60$ rental days)]. Jason's gross rent income is \$10,000. For the entire year, the real estate taxes are \$2,190, his mortgage interest expense is \$10,220, utilities and maintenance expense equals \$2,400, and depreciation is \$9,000. Using the IRS approach, these amounts are deductible in this specific order:

Gross income	\$10,000
Deduct: Taxes and interest ($^{60}/_{90} \times \$12,410$)	<u>(8,273)</u>
Remainder to apply to rental operating expenses and depreciation	\$ 1,727
Deduct: Utilities and maintenance ($^{60}/_{90} \times \$2,400$)	<u>(1,600)</u>
Balance	\$ 127
Deduct: Depreciation ($^{60}/_{90} \times \$9,000 = \$6,000$ but limited to above balance)	<u>(127)</u>
Net rent income	<u>\$ -0-</u>

The nonrental use portion of real estate taxes and mortgage interest (\$4,137 in this case) is deductible if the taxpayer elects to itemize (see Chapter 10). The personal use portion of utilities, maintenance, and depreciation is not deductible in any case. Jason has a carryover of \$5,873 ($\$6,000 - \127) of the unused depreciation, which he may be able to deduct in future years. Also note that the basis of the property is only reduced by the \$127 depreciation allowed because of the above limitation. (See Chapter 13 for a discussion of the reduction in basis for depreciation allowed or allowable.)

EXAMPLE

28

Using the court's approach in allocating real estate taxes and mortgage interest, Jason, in Example 27, would have this result:

Gross income	\$10,000
Deduct: Taxes and interest ($^{60}/_{365} \times \$12,410$)	<u>(2,040)</u>
Remainder to apply to rental operating expenses and depreciation	\$ 7,960
Deduct: Utilities and maintenance ($^{60}/_{90} \times \$2,400$)	<u>(1,600)</u>
Balance	\$ 6,360
Deduct: Depreciation ($^{60}/_{90} \times \$9,000$ but limited to above balance.)	<u>(6,000)</u>
Net rent income	<u>\$ 360</u>

Jason can deduct \$10,370 (\$12,410 paid – \$2,040 deducted as expense in computing net rent income) of personal use mortgage interest and real estate taxes as itemized deductions.

⁴⁶*Bolton v. Comm.*, 82-2 USTC ¶9699, 51 AFTR 2d 83-305, 694 F.2d 556 (CA-9, 1982).

⁴⁷Prop.Reg. § 1.280A-3(d)(4).

Note the contrasting results in Examples 27 and 28. The IRS's approach (Example 27) results in no rental gain or loss and an itemized deduction for real estate taxes and mortgage interest of \$4,137. In Example 28, Jason has net rent income of \$360 and \$10,370 of itemized deductions. The court's approach decreases his taxable income by \$10,010 (\$10,370 itemized deductions less \$360 net rent income). The IRS's approach reduces his taxable income by only \$4,137.

6-3g Expenditures Incurred for Taxpayer's Benefit or Taxpayer's Obligation

To be deductible, an expense must be incurred for the taxpayer's benefit or arise from the taxpayer's obligation. An individual cannot claim a tax deduction for the payment of the expenses of another individual.

During the current year, Fred pays the property taxes on his son Jayden's home. Neither Fred nor Jayden can take a deduction for the amount paid for Jayden's property taxes. Fred is not entitled to a deduction because the property taxes are not his obligation. Jayden cannot claim a deduction because he did not pay the property taxes. The tax result would have been more favorable had Fred made a cash gift to Jayden and let him pay the property taxes. Then Jayden could have deducted the property taxes.

EXAMPLE

29

One exception to this disallowance rule is the payment of medical expenses for a dependent. Such expenses are deductible by the payor subject to the normal rules that limit the deductibility of medical expenses (see Chapters 3 and 10).⁴⁸

6-3h Disallowance of Personal Expenditures

Section 262 states that "except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." To justify a deduction, an individual must be able to identify a particular section of the Code that sanctions the deduction (e.g., charitable contributions and medical expenses). Sometimes the character of a particular expenditure is not easily determined. For example, the legal fee associated with a property settlement that results in one party retaining ownership of a family business is not deductible.

The IRS has clarified the issue of the deduction of legal fees incurred in connection with a divorce.⁴⁹ To be deductible, an expense must relate solely to tax advice in a divorce proceeding. For example, legal fees attributable to the determination of dependency exemptions of children are deductible if the fees are distinguishable from the general legal fees incurred in obtaining a divorce. Therefore, it is advisable to request an itemization of attorney's fees to substantiate a deduction for the tax-related amounts.



ETHICS & EQUITY Personal or Business Expenses?

For the last eight years, Jaynice and her family have lived in a large Victorian house in New England. In the current year, Jaynice and her husband decide to convert the home into a "bed-and-breakfast." The family (including the two children and the dog) moves into the basement, which accounts for 30 percent of the square footage of the house. The basement has two bedrooms, two baths, a den, and a small kitchen. The upper two floors of the house are used for the bed-and-breakfast, which is operated as a sole proprietorship.

Jaynice hires two employees to help her run the business. Total expenses for the first year of operation are as follows:

Mortgage interest	\$18,000
Real estate taxes	3,000
Salaries for two employees	40,000
Groceries for breakfast and snacks	7,000
Depreciation	10,000

For breakfast, all of the family members eat the same food that is prepared for the guests. They usually also share in the homemade cookies and cakes in the evening.

On Jaynice's Schedule C for the business, she deducts \$78,000 of expenses for the current tax year. Discuss whether these deductions are appropriate.

⁴⁸§ 213(a).

⁴⁹Rev.Rul. 72-545, 1972-2 C.B. 179.

EXAMPLE

30

Terry and Jack are divorced near the end of the current tax year. They had been married for 28 years and have two dependent children, Pauline (age 17) and Neal (age 18). As part of the divorce agreement, Jack paid all of the legal fees, which amounted to \$24,300. The invoice from the divorce lawyer listed the following charges:

Child custody agreement and determination of amount of monthly child support	\$ 3,000
Divorce decree proceedings	10,000
County court filing costs	1,800
Property settlement determination	6,000
Tax consequences of property settlement	2,000
Tax consequences of child custody and child support payments and tax filing status	1,500

Only the \$3,500 (\$2,000 + \$1,500) paid by Jack for the charges relating to tax advice is deductible.

6-3i Disallowance of Deductions for Capital Expenditures

The Code specifically disallows a deduction for “any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”⁵⁰ Incidental repairs and maintenance of the property are not capital expenditures and can be deducted as ordinary and necessary business expenses. Repairing a roof is a deductible expense, but replacing a roof is a capital expenditure subject to depreciation deductions over its recovery period. The tune-up of a delivery truck is an expense; a complete overhaul probably is a capital expenditure. Adding new gravel to a gravel parking lot is a repair, but paving the parking lot is a capital expenditure because this is doing more than restoring the asset to its original condition.

New Regulations took effect January 1, 2014, that apply for tax years beginning in 2014. All costs incurred in acquiring or producing a Unit of Property (UOP) are included in its cost, except for employee compensation and overhead costs. The taxpayer can elect to capitalize employee compensation and overhead costs (can elect separately or both). The cost includes all related expenditures incurred before the date the asset is placed in service, even if these expenditures would be repairs if incurred after the asset was placed in service. The cost of a UOP includes costs incurred to obtain a clean title and investigation costs.⁵¹ Material or supplies that cost \$200 or less can generally be deducted in the first tax year they are used or consumed.⁵²

A single UOP includes all components that are functionally interdependent. Thus, a building includes, for example, the walls, floors, ceilings, roof, windows, doors, electrical systems, plumbing, and heating and air systems. The major exception to this rule is that if a component is treated separately for depreciation purposes, it will not be grouped into another UOP.⁵³

Taxpayers can elect under the *de minimis* safe harbor election to expense outlays for lower-cost items. The election is irrevocable. This safe harbor applies if the taxpayer:

1. has written procedures in place at the beginning of the tax year that provide for the expensing of amounts below a specified dollar amount or that have a useful life of 12 months or less,
2. also expenses the items for its accounting/book records, and
3. ensures that items costing more than \$5,000 are capitalized [\$500 if the company does not have acceptable (generally meaning audited) financial statements].

⁵⁰§ 263(a)(1).

⁵¹Reg. § 1.263(a)-3(e)(1).

⁵²Reg. § 1.162-3(a)(1).

⁵³Reg. § 1.263(a)-3(e)(6).

The *de minimis* safe harbor election cannot be made for inventory, land, and certain types of spare parts.⁵⁴

Routine maintenance to keep UOPs operating efficiently is expensed, such as testing, cleaning, inspecting, and replacing parts. To be routine, the expectation is that the expenditure will be needed more than once during the asset's life. An expense cannot be treated as routine maintenance if it improves a UOP (treated as a betterment). A cost is treated as a betterment if it:

- enlarges or increases the capacity of a UOP, or
- materially increases the productivity, efficiency, or quality of the UOP.⁵⁵

Qualifying small taxpayers (those with \$10 million or less average annual gross receipts in the three preceding tax years) can deduct improvements made to an eligible building property (one with an unadjusted basis of \$1 million or less). The new safe harbor election applies only if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of \$10,000 or 2 percent of the building's unadjusted basis.⁵⁶

Capitalization versus Expense

When an expenditure is capitalized rather than expensed, the deduction is at best deferred and at worst lost forever. Although an immediate tax benefit for a large cash expenditure is lost, the cost may be deductible in increments over a longer period of time as the asset is depreciated, amortized, or depleted.

If the expenditure is for a tangible asset that has an ascertainable life, it is capitalized and may be deducted as depreciation (or cost recovery) over its depreciable life. Land is not subject to depreciation (or cost recovery) because it does not have an ascertainable life. [See Chapter 8 for a discussion of depreciation (cost recovery).]

Stan purchased a prime piece of land located in an apartment-zoned area. Stan paid \$500,000 for the property, which had an old but usable apartment building on it. He immediately had the building demolished at a cost of \$100,000. The \$500,000 purchase price and the \$100,000 demolition costs must be capitalized, and the basis of the land is \$600,000. Because land is a nondepreciable asset, no deduction is allowed.

EXAMPLE

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If the expenditure is for an intangible asset (e.g., copyright, patent, covenant not to compete, and goodwill), the capitalized expenditure can be amortized regardless of whether the intangible asset has an ascertainable life. Intangible assets, referred to as § 197 intangibles, are amortized over a 15-year statutory period using the straight-line method. See Chapter 8 for additional discussion of the amortization of intangibles.

6-3j Transactions between Related Parties

The Code places restrictions on the recognition of gains and losses from **related-party transactions**. Without these restrictions, relationships created by birth, marriage, and business would provide endless possibilities for engaging in financial transactions that produce tax savings with no real economic substance or change. For example, to create an artificial loss, a wife could sell investment property to her husband at a loss and deduct the loss on their joint return. Her husband could then hold the asset indefinitely, and the family would sustain no real economic loss. A complex set of laws has been designed to eliminate such possibilities.

accounting method to be used solely for amounts paid or incurred, and dispositions, in taxable years beginning after 2013. Since prior years are not affected, no adjustment to income is needed for the change. Further, if elected, these taxpayers will not be required to file Form 3115 (Application for Change in Accounting Method).

⁵⁴Reg. § 1.263(a)-1(f)(1).

⁵⁵Reg. § 1.263(a)-3(i)(1).

⁵⁶Reg. § 1.263(a)-3(h)(1). Rev.Proc. 2015-14 (2015-5 I.R.B. 450) has been modified to allow qualifying small taxpayers to elect to make these changes in accounting methods on a cut-off basis. This allows the new

Relationships and Constructive Ownership

Before reviewing the tax consequences of related party sales, it is important to know the individuals and business entities that are considered to be related parties. *Related parties* include the following:

- Brothers and sisters (whether whole, half, or adopted), spouse, ancestors (parents and grandparents), and lineal descendants (children and grandchildren) of the taxpayer.
- A corporation owned more than 50 percent (directly or indirectly) by the taxpayer.
- Two corporations that are members of a controlled group.
- A series of other complex relationships between trusts, corporations, and individual taxpayers.

Constructive ownership provisions are applied to determine whether the taxpayers are related. Under these provisions, stock owned by certain relatives or related entities is *deemed* to be owned by the taxpayer for purposes of applying the loss and expense deduction disallowance provisions. For example, a taxpayer is deemed to own not only his or her stock but also the stock owned by lineal descendants, ancestors, brothers and sisters or half-brothers and half-sisters, and spouse.

EXAMPLE

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The stock of Sparrow Corporation is owned 20% by Ted, 30% by Ted's father, 30% by Ted's mother, and 20% by Ted's sister. On July 1 of the current year, Ted loaned \$10,000 to Sparrow Corporation at 6% annual interest, principal and interest payable on demand. For tax purposes, Sparrow uses the accrual basis and Ted uses the cash basis. Both are on a calendar year. Through constructive ownership, Ted is deemed also to own the 80% held by his parents and sister. Thus, he directly and constructively owns 100% of Sparrow Corporation. If the corporation accrues the interest within the taxable year, no deduction can be taken until payment is made to Ted.

Losses

The Code provides for the disallowance of any "losses from sales or exchanges of property ... directly or indirectly" between related parties.⁵⁷ A right of offset is created equal to the disallowed loss. When the property is subsequently sold to a nonrelated party, any gain recognized is reduced by the right of offset. However, the right of offset cannot create or increase a loss. Any right of offset is permanently lost if it is not used by the related-party buyer to offset some or all of the recognized gain on a subsequent sale or exchange to an unrelated party.

Use of Right of Offset

EXAMPLE

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Freida sells common stock with a basis of \$10,000 to her son, Bill, for its fair market value of \$8,000. The \$2,000 realized loss is not recognized, which creates a \$2,000 right of offset. Bill sells the stock several years later for \$11,000. Freida's previously disallowed loss is used by Bill, and only \$1,000 of gain (\$11,000 selling price – \$8,000 basis – \$2,000 right of offset) is taxable to him upon the subsequent sale.

EXAMPLE

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Assume the same facts as in Example 33, except that Bill sells the stock for \$9,000. Bill's gain of \$1,000 (\$9,000 selling price – \$8,000 basis) is not recognized because of the right of offset of \$2,000 from Freida's sale. Note that the offset may result in only partial tax benefit upon the subsequent sale (as in this case). If Freida had sold the stock to an unrelated party rather than to Bill, she could have recognized a \$2,000 loss. However, as a family unit, Freida and Bill recognized only \$1,000 of loss.

⁵⁷§ 267(a)(1).

A loss can also be disallowed even if the asset is sold to an unrelated party. This occurs if a related party repurchases the asset on or near the same day and the two sales were prearranged.⁵⁸

Pete sells common stock with a basis of \$10,000 to an unrelated third party for its fair market value of \$8,000. Pete's son repurchased the same stock in the market on the same day for \$8,000. The \$2,000 loss is not allowed because the transaction is an indirect sale between related parties.

EXAMPLE

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6-3k Substantiation Requirements

The tax law is built on a voluntary compliance system. Taxpayers file their tax returns, report income and take deductions to which they are entitled, and pay their taxes through withholding or estimated tax payments during the year. The taxpayer has the burden of proof for substantiating expenses deducted on the returns and must retain adequate records. Upon audit, the IRS can disallow any undocumented or unsubstantiated deductions. These requirements have resulted in numerous conflicts between taxpayers and the IRS.

For example, *specific* and *more stringent* rules apply for deducting travel, entertainment, and gift expenses, which are discussed in Chapter 9. Certain mixed-use (both personal and business use) and listed property are also subject to the adequate records requirement (see Chapter 8).

Substantiation is also extremely important for establishing the basis of an asset (see Chapter 13). An asset's basis includes all costs incurred to place an asset in service, which includes transportation, sales tax, setup, testing, unpaid property taxes of the previous owner, and other purchase costs. Basis is used to determine gain or loss on a sale of the asset and to compute depreciation for depreciable assets. The taxpayer has the burden of substantiating all expenditures included in basis.

6-3l Expenses and Interest Relating to Tax-Exempt Income

Certain income, such as interest on municipal bonds, is tax-exempt.⁵⁹ The law also allows the taxpayer to deduct expenses incurred for the production of income.⁶⁰ However, the law does not permit a taxpayer to profit at the expense of the government by excluding interest income and deducting interest expense.⁶¹ The Code specifically disallows as a deduction the expenses of producing tax-exempt income. Interest on any indebtedness used to purchase or hold tax-exempt obligations also is disallowed.

Sandy, a taxpayer in the 35% bracket, purchased \$100,000 of 6% municipal bonds. At the same time, she used the bonds as collateral on a bank loan of \$100,000 at 8% interest. A positive cash flow would result from the tax benefit as follows:

Cash paid out on loan	(\$8,000)
Cash received from bonds	<u>6,000</u>
Net negative cash flow	<u><u>(\$2,000)</u></u>

Had the deduction of \$8,000 been allowed for interest expense, this would have resulted in a tax benefit of \$2,800 (35% of \$8,000). In that case, a positive cash flow of \$800 (\$6,000 + \$2,800 – \$8,000) would have resulted.

EXAMPLE

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⁵⁸*McWilliams v. Comm.*, 47-1 USTC ¶9289, 35 AFTR 1184, 67 S.Ct. 1477 (USSC, 1947).

⁵⁹§ 103.

⁶⁰§ 212.

⁶¹§ 265.

To eliminate the possibility illustrated in Example 36, the Code specifically disallows as a deduction the expenses of producing tax-exempt income. Interest on any indebtedness incurred or continued to purchase or carry tax-exempt obligations also is disallowed.

EXAMPLE**37**

In January of the current year, Alan borrowed \$100,000 at 8% interest. He used the loan proceeds to purchase 5,000 shares of stock in White Corporation. In July, he sold the stock for \$120,000 and reinvested the proceeds in City of Denver bonds, the income from which is tax-exempt. Assuming that the \$100,000 loan remained outstanding throughout the entire year, Alan cannot deduct the interest attributable to the period in which he held the bonds.

The classification of various expenses in terms of their deductibility and nondeductibility is reflected in Concept Summary 6.3.

LO.4

Identify tax planning opportunities for maximizing deductions and minimizing the disallowance of deductions.

6-4 TAX PLANNING**6-4a Time Value of Tax Deductions**

Cash basis taxpayers often have the ability to make early payments for their expenses at the end of the tax year. This may permit the payments to be deducted currently instead of in the following tax year. In view of the time value of money, a tax deduction this year may be worth more than the same deduction next year. Before employing this strategy, the taxpayer must consider what next year's expected income and tax rates will be and whether a cash-flow problem may develop from early payments. Thus, the time value of money as well as tax rate changes must be considered when an expense can be paid and deducted in either of two years.

EXAMPLE**38**

Jena pledged \$50,000 to her church's special building fund. She can make the contribution in December 2015 or January 2016. Jena is in the 35% tax bracket in 2015 and in the 28% bracket in 2016. She itemizes in both years. Assume that Jena's discount rate is 8%. If she takes the deduction in 2015, she saves \$4,536 (\$17,500 – \$12,964) due to the decrease in the tax rates and the time value of money.

	2015	2016
Contribution	\$50,000	\$50,000
Tax bracket	× .35	× .28
Tax savings	\$17,500	\$14,000
Discounted @ 8%	× 1.0	× .926
Present value of tax savings	\$17,500	\$12,964

6-4b Vacation Homes

As previously discussed in this chapter, homes that are used for both personal and rental use can fall into one of three categories, all of which have different tax consequences. Therefore, careful tax planning often ensures that the home is classified into the category that provides the optimal tax result. For example, if a taxpayer is planning to rent a home for 15 or more days, this will subject the net income from the rental activity to taxation. If the homeowner could rent the home for 14 days or less (possibly just one less day), then all of the rental income received would escape taxation. This strategy is particularly attractive to individuals who live in areas where major sporting or entertainment events are held if there is a lack of hotel accommodations in the area.



Concept Summary 6.3

Classification of Expenses

Expense Item	Deductible		Not Deductible	Applicable Code §
	For AGI	From AGI		
Investment expenses				
Rent and royalty	X			§ 62(a)(4)
All other investments		X ⁴		§ 212
Employee expenses				
Commuting expenses			X	§ 262
Travel and transportation ¹		X ^{4,5}		§ 162(a)(2)
Reimbursed expenses ¹	X			§ 62(a)(2)(A)
Moving expenses	X			§ 62(a)(15)
Entertainment ¹		X ^{4,5}		§ 162(a)
Teacher supplies (if extended to 2015 by Congress)	X ¹¹	X ⁴		§ 62(a)(2)(D)
All other employee expenses ¹		X ^{4,5}		§ 162(a)
Certain expenses of performing artists	X			§ 62(a)(2)(B)
Trade or business expenses	X			§§ 162 and 62(a)(1)
Casualty losses				
Business	X			§ 165(c)(1)
Personal		X ⁶		§ 165(c)(3)
Tax determination				
Collection or refund expenses	X ⁸	X		§§ 212 and 62(a)(1) or (4)
Bad debts	X			§§ 166 and 62(a)(1) or (3)
Medical expenses		X ⁷		§ 213
Charitable contributions		X		§ 170
Taxes				
Trade or business	X			§§ 162, 164, and 62(a)(1)
Personal taxes				
Real property		X		§ 164(a)(1)
Personal property		X		§ 164(a)(2)
State and local income or sales (sales tax if extended to 2015 by Congress)		X		§§ 164(a)(3) and (b)(5)
Investigation of a business ²	X			§§ 162 and 62(a)(1)
Interest				
Business	X			§§ 162, 163, and 62(a)(1)
Personal	X ⁹	X ³	X ¹⁰	§§ 163(a), (d), and (h)
Qualified tuition and related expenses (if extended to 2015 by Congress)	X			§§ 62(a)(18) and 222
All other personal expenses			X	§ 262

¹Deduction for AGI if reimbursed, an adequate accounting is made, and employee is required to repay excess reimbursements.

²Provided certain criteria are met.

³Subject to the excess investment interest and the qualified residence interest provisions.

⁴Subject (in the aggregate) to a 2%-of-AGI floor imposed by § 67.

⁵Only 50% of meals and entertainment are deductible.

⁶Subject to a \$100 floor per event and a 10%-of-AGI floor per tax year.

⁷Subject to a 7.5%- or 10%-of-AGI floor.

⁸Only the portion relating to business, rental, or royalty income or losses.

⁹Only the portion relating to student loans.

¹⁰Other personal interest is disallowed.

¹¹Subject to a statutory limit of \$250.

In addition, assume that a taxpayer intends to use a home for 150 rental days and 16 personal days. Because the personal days exceed 15 (the greater of 14 days or $10\% \times$ the number of rental days), the property will be classified as *rental/personal* and a rental loss will not be allowed. However, if the owner can reduce the personal use days by only one day to 15, then the property will be classified as *rental*, and a rental loss can be allowed (subject to the passive loss rules).

6-4c Hobby Losses

To demonstrate that an activity has been entered into for the purpose of making a profit, a taxpayer should treat the activity as a business. The business should engage in advertising, use business letterhead stationery, and maintain a business phone.

If a taxpayer's activity earns a profit in three out of five consecutive years, the presumption is that the activity is engaged in for profit. It may be possible for a cash basis taxpayer to meet these requirements by timing the payment of expenses or the receipt of revenues. The payment of certain expenses incurred before the end of the year might be made in the following year. The billing of year-end sales might be delayed so that collections are received in the following year.

Keep in mind that the three-out-of-five-years rule under § 183 is not absolute. All it does is shift the burden of proof. If a profit is not made in three out of five years, the losses may still be allowed if the taxpayer can show that they are due to the nature of the business. For example, success in artistic or literary endeavors can take a long time, so losses for several years in a row could occur even for a legitimate business. Also, depending on the state of the economy, full-time farmers and ranchers may have losses for several consecutive years.

Merely satisfying the three-out-of-five-years rule does not guarantee that a taxpayer is automatically home free. If the three years of profits are insignificant relative to the losses of other years or if the profits are not from the ordinary operation of the business, the taxpayer is vulnerable. The IRS may still be able to establish that the taxpayer is not engaged in an activity for profit.

EXAMPLE

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Ashley had the following gains and losses in an artistic endeavor:

2011	(\$50,000)
2012	(65,000)
2013	400
2014	200
2015	125

Under these circumstances, the IRS might try to overcome the presumption that this is a business because it has profits in three of the last five years. To do this, the IRS would focus on the nine factors from the Regulations discussed in Section 6-3e.

On the other hand, if Ashley could show conformity with the factors enumerated in the Regulations or could show evidence of business hardships (e.g., injury, death, or illness), the government might have difficulty overriding the presumption.⁶²

⁶²*Faulconer, Sr. v. Comm.*, 84-2 USTC ¶9955, 55 AFTR 2d 85-302, 748 F.2d 890 (CA-4, 1984), *rev'g* 45 TCM 1084, T.C.Memo. 1983-165.

REFOCUS ON THE BIG PICTURE

CALCULATION OF DEDUCTIBLE BUSINESS EXPENSES
AND TAX PLANNING

Of the expenses incurred by Dr. Payne, several comments need to be made. Being personal in nature, none of the \$5,000 monthly draw is deductible. Nor is the amount involved subject to the reasonableness test (see Example 6). Dr. Payne is a sole proprietor and not in an employment relationship. The fine paid for violating waste control rules comes under the public policy limitations (see Example 13) and is specifically made nondeductible by Code § 162(f). Along the same line are the political contributions (Example 17) made nondeductible by § 162(e). However, Dr. Payne's investigation of the practice of another dental firm (Example 19) appears reasonable and the expense incurred deductible. The dues paid to The Dental Society are not 100 percent deductible because 70 percent of the Society's efforts relate to lobbying activities. Although not specifically discussed in the text as to Dr. Payne, his legal fees incurred in connection with a lawsuit filed by a patient appear related to his practice (Example 15). As such, they are ordinary and necessary to his trade or business.

**What If?**

From a tax planning perspective, should Dr. Payne calculate his deductible business expenses using the accrual method of accounting or the cash method?

In Chapter 4, we concluded that Dr. Payne could minimize his Federal income tax liability if he used the cash method of accounting. If the cash method is used for reporting the gross income of a Schedule C business, the cash method must be used for reporting the deductible business expenses that will appear on Schedule C of Form 1040.

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Key Terms

Accounting method, 6-8
Deductions for adjusted gross income, 6-2
Deductions from adjusted gross income, 6-2

Hobby losses, 6-16
Ordinary and necessary, 6-5
Reasonableness, 6-6

Related-party transactions, 6-25
Startup expenditures, 6-15
Vacation homes, 6-19

Discussion Questions

- LO.1** "All income must be reported, and all deductions are allowed unless specifically disallowed in the Code." Discuss.
- LO.1** Michael earned \$20,000 at the K-M Resort Golf Club during the summer prior to his senior year in college. He wants to make a contribution to a traditional IRA, but the amount is dependent on whether it reduces his taxable income. If Michael is going to claim the standard deduction, will a contribution to a traditional IRA reduce his taxable income?

3. **LO.1** Classify each of the following expenditures as a deduction *for* AGI, a deduction *from* AGI, or not deductible:
 - a. Sam gives cash to his father as a birthday gift.
 - b. Sandra gives cash to her church.
 - c. Albert pays Dr. Dafashy for medical services rendered.
 - d. Mia pays alimony to Bill.
 - e. Rex, who is self-employed, contributes to his pension plan.
 - f. April pays expenses associated with her rental property.
4. **LO.1** Classify each of the following expenditures as a deduction *for* AGI, a deduction *from* AGI, or not deductible:
 - a. Amos contributes to his H.R. 10 plan (i.e., a retirement plan for a self-employed individual).
 - b. Keith pays child support to his former wife, Renee, for the support of their son, Chris.
 - c. Judy pays professional dues that are reimbursed by her employer.
 - d. Ted pays \$500 as the monthly mortgage payment on his personal residence. Of this amount, \$100 represents a payment on principal, and \$400 represents an interest payment.
 - e. Lynn pays a moving company for moving her household goods to Detroit, where she is starting a new job. She is not reimbursed by her employer.
 - f. Ralph pays property taxes on his personal residence.
5. **LO.1** Larry and Susan each invest \$10,000 in separate investment activities. They each incur deductible expenses of \$800 associated with their respective investments. Explain why Larry's expenses might be properly classified as deductions *from* AGI (itemized deductions) and Susan's expenses might be appropriately classified as deductions *for* AGI.
6. **LO.1** Nanette is a first-grade teacher. Potential deductions are charitable contributions of \$800, personal property taxes on her car of \$240, and various supplies purchased for use in her classroom of \$225 (none reimbursed by her school). How will these items affect Nanette's Federal income tax return for 2015?
7. **LO.1** In the determination of whether a business expense is deductible, the reasonableness requirement applies only to salaries. Evaluate this statement.
8. **LO.1** Dave uses the second floor of a building for his residence and the first floor for his business. The uninsured building is destroyed by fire. Are the tax consequences the same for each part of the building? Explain.
9. **LO.1** Mary Kate owns a building that she leases to an individual who operates a grocery store. Rent income is \$10,000, and rental expenses are \$6,000. On what Form 1040 schedule or schedules are the income and expenses reported?
10. **LO.2** What is the "actually paid" requirement for the deduction of an expense by a cash basis taxpayer? Does actual payment ensure a deduction? Explain.
11. **LO.2** Aubry, a cash basis and calendar year taxpayer, decides to reduce his taxable income for 2015 by buying \$65,000 worth of supplies for his business on December 27, 2015. The supplies will be used up in 2016.
 - a. Can Aubry deduct the expenditure for 2015?
 - b. Would your answer in part (a) change if Aubry bought the supplies because the seller was going out of business and offered a large discount on the price? Explain.

12. **LO.3** Clear, Inc., is a bottled water distributor. Clear's delivery trucks frequently are required to park in no-parking zones to make their deliveries. If the trucks are occasionally ticketed, can Clear deduct the fines that it pays? Explain.
13. **LO.3** Ted, an agent for an airline manufacturer, is negotiating a sale with a representative of the U.S. government and with a representative of a developing country. Ted's company has sufficient capacity to handle only one of the orders. Both orders will have the same contract price. Ted believes that if his employer authorizes a \$500,000 payment to the representative of the foreign country, he can guarantee the sale. He is not sure that he can obtain the same result with the U.S. government. Identify the relevant tax issues for Ted.
14. **LO.3** Stuart, an insurance salesperson, is arrested for allegedly robbing a convenience store. He hires an attorney who is successful in getting the charges dropped. Is the attorney's fee deductible? Explain.
15. **LO.3** Linda operates an illegal gambling operation. Which of the following expenses that she incurs can reduce taxable income?
- Bribes paid to city employees.
 - Salaries to employees.
 - Security cameras.
 - Kickbacks to police.
 - Rent on an office.
 - Depreciation on office furniture and equipment.
 - Tenant's casualty insurance.
 - Utilities.
16. **LO.3** Gordon anticipates that being positively perceived by the individual who is elected mayor will be beneficial for his business. Therefore, he contributes to the campaigns of both the Democratic and the Republican candidates. The Republican candidate is elected mayor. Can Gordon deduct any of the political contributions he made?
17. **LO.3** Melissa, the owner of a sole proprietorship, does not provide health insurance for her 20 employees. She plans to spend \$1,500 lobbying in opposition to legislation that would require her to provide such insurance. Discuss the tax advantages and disadvantages of paying the \$1,500 to a professional lobbyist rather than spending the \$1,500 on in-house lobbying expenditures.
18. **LO.3** What limits exist on the deductibility of executive compensation? Do the limits apply to all types of business entities? Are there any exceptions to the limitations? Explain.
19. **LO.3** Paul operates a restaurant in Cleveland. He travels to Columbus to investigate acquiring a business. He incurs expenses as follows: \$1,500 for travel, \$2,000 for legal advice, and \$3,500 for a market analysis. Based on the different tax consequences listed below, describe the circumstances that were involved in Paul's investigation of the business.
- Paul deducts the \$7,000 of expenses.
 - Paul cannot deduct any of the \$7,000 of expenses.
 - Paul deducts \$5,000 of the expenses and amortizes the \$2,000 balance over a period of 180 months.
20. **LO.3** Karen and Andy own a beach house. They have an agreement with a rental agent to rent it up to 200 days per year. For the past three years, the agent has been successful in renting it for 200 days. Karen and Andy use the beach house for one week during the summer and one week during Thanksgiving. Their

Issue ID

Issue ID

daughter, Sarah, a college student, has asked if she and some friends can use the beach house for the week of spring break. Advise Karen and Andy how they should respond, and identify any relevant tax issues.

21. **LO.3** Hank was transferred from Arizona to North Dakota on March 1 of the current year. He immediately put his home in Phoenix up for rent. The home was rented May 1 to November 30 and was vacant during the month of December. It was rented again on January 1 for six months. What expenses related to the home, if any, can Hank deduct on his return? Which deductions are *for* AGI, and which ones are *from* AGI?

Decision Making

22. **LO.3** Ray loses his job as a result of a corporate downsizing. Consequently, he falls behind on the mortgage payments on his personal residence. His friend Ted would like to make the delinquent mortgage payments for him.
- Could the payments be structured so that Ray can deduct the mortgage interest?
 - Could the payment arrangement deny both Ray and Ted a mortgage interest deduction?
 - Could the payments be structured so that Ted can deduct the mortgage interest?
23. **LO.3** Edna incurs various legal fees in obtaining a divorce. Which types of expenses associated with the divorce are deductible by Edna, and which are not?

Issue ID

24. **LO.3** Ella owns 60% of the stock of Peach, Inc. The stock has declined in value since she purchased it five years ago. She is going to sell 5% of the stock to a relative. Ella is also going to make a gift of 10% of the stock to another relative. Identify the relevant tax issues for Ella.
25. **LO.3** Jarret owns City of Charleston bonds with an adjusted basis of \$190,000. During the year, he receives interest payments of \$3,800. Jarret partially financed the purchase of the bonds by borrowing \$100,000 at 5% interest. Jarret's interest payments on the loan this year are \$4,900, and his principal payments are \$1,100.
- Should Jarret report any interest income this year? Explain.
 - Can Jarret deduct any interest expense this year? Explain.

Computational Exercises

26. **LO.2** Glenda, a calendar year and cash basis taxpayer, rents property from Janice. As part of the rental agreement, Glenda pays \$8,400 rent on April 1, 2015 for the 12 months ending March 31, 2016.
- How much is Glenda's deduction for rent expense in 2015?
 - Assume the same facts, except that the \$8,400 is for 24 months rent ending March 31, 2017. How much is Glenda's deduction for rent expense in 2015?
27. **LO.2** Falcon, Inc., paid salaries of \$500,000 to its employees during its first year of operations. At the end of the year, Falcon had unpaid salaries of \$45,000.
- Calculate the salary deduction if Falcon is a cash basis taxpayer.
 - Calculate the salary deduction if Falcon is an accrual basis taxpayer.
28. **LO.2** Maud, a calendar year taxpayer, is the owner of a sole proprietorship that uses the cash method. On February 1, 2015, she leases an office building to use in her business for \$120,000 for an 18-month period. To obtain this favorable lease rate, she pays the \$120,000 at the inception of the lease. How much rent expense may Maud deduct on her 2015 tax return?

29. **LO.3** Vella owns and operates an illegal gambling establishment. In connection with this activity, he has the following expenses during the year:

Rent	\$ 24,000
Bribes	40,000
Travel expenses	4,000
Utilities	18,000
Wages	230,000
Payroll taxes	13,800
Property insurance	1,600
Illegal kickbacks	22,000

What are Vella's total deductible expenses for tax purposes?

30. **LO.3** Printer Company pays a \$25,000 annual membership fee to a trade association for paper wholesalers. The trade association estimates that 60% of its dues are allocated to lobbying activities.
- What are Printer's total deductible expenses for tax purposes?
 - Assume the same facts as above except that the \$25,000 was incurred for in-house lobbying expenses. What are Printer's total deductible expenses for tax purposes?
31. **LO.3** Stanford owns and operates two dry cleaning businesses. He travels to Boston to discuss acquiring a restaurant. Later in the month, he travels to New York to discuss acquiring a bakery. Stanford does not acquire the restaurant but does purchase the bakery on November 1, 2015.

Stanford incurred the following expenses:

Total investigation costs related to the restaurant	\$28,000
Total investigation costs related to the bakery	51,000

What is the maximum amount Stanford can deduct in 2015 for investigation expenses?

32. **LO.3** Murphy has a brokerage account and buys on the margin, which resulted in an interest expense of \$20,000 during the year. Income generated through the brokerage account was as follows:

Municipal interest	\$ 50,000
Taxable dividends and interest	350,000

How much investment interest can Murphy deduct?

Problems

33. **LO.1** Amos is a self-employed tax attorney. He and Monica, his employee, attend a conference in Dallas sponsored by the American Institute of CPAs. The following expenses are incurred during the trip:

	Amos	Monica
Conference registration	\$ 900	\$900
Airfare	1,200	700
Taxi fares	100	-0-
Lodging in Dallas	750	300

- Amos pays for all of these expenses. Calculate the effect of these expenses on Amos's AGI.
- Would your answer to part (a) change if the American Bar Association had sponsored the conference? Explain.

Decision Making 34. **LO.1** Daniel, age 38, is single and has the following income and expenses in 2015.

Salary income	\$60,000
Net rent income	6,000
Dividend income	3,500
Payment of alimony	12,000
Mortgage interest on residence	4,900
Property tax on residence	1,200
Contribution to traditional IRA	5,000
Contribution to United Church	2,100
Loss on the sale of real estate (held for investment)	2,000
Medical expenses	3,250
State income tax	300
Federal income tax	7,000

- Calculate Daniel's AGI.
- Should Daniel itemize his deductions *from* AGI or take the standard deduction?

35. **LO.1** Janice, age 22, is a student who earns \$10,000 working part-time at the college ice cream shop in 2015. She has no other income. Her medical expenses for the year total \$3,000. During the year, she suffers a casualty loss of \$3,500 when her apartment catches on fire. Janice contributes \$1,000 to her church. On the advice of her parents, Janice is trying to decide whether to contribute \$1,000 to the traditional IRA her parents set up for her. What effect would the IRA contribution have on Janice's itemized deductions?

36. **LO.1** A list of the items that Peggy sold and the losses she incurred during the current tax year is as follows:

Yellow, Inc. stock	\$ 1,600
Peggy's personal use SUV	8,000
Peggy's personal residence	10,000
City of Newburyport bonds	900

She also had a theft loss of \$1,500 on her uninsured business use car. Calculate Peggy's deductible losses.

37. **LO.2** Duck, an accrual basis corporation, sponsored a rock concert on December 29, 2015. Gross receipts were \$300,000. The following expenses were incurred and paid as indicated:

Expense		Payment Date
Rental of coliseum	\$ 25,000	December 21, 2015
Cost of goods sold:		
Food	30,000	December 30, 2015
Souvenirs	60,000	December 30, 2015
Performers	100,000	January 5, 2016
Cleaning of coliseum	10,000	February 1, 2016

Because the coliseum was not scheduled to be used again until January 15, the company with which Duck had contracted did not perform the cleanup until January 8–10, 2016.

Calculate Duck's net income from the concert for tax purposes for 2015.

38. **LO.3** Doug incurred and paid the following expenses during the year:

- \$50 for a ticket for running a red light while he was commuting to work.
- \$100 for a ticket for parking in a handicapped parking space.
- \$200 to an attorney to represent him in traffic court as to the two tickets.

- \$500 to an attorney to draft an agreement with a tenant for a one-year lease on an apartment that Doug owns.
- \$1,000 to an attorney to negotiate a reduction in his child support payments.
- \$2,500 to an attorney to negotiate a reduction in his qualified alimony payments to a former spouse.

Calculate the amount of Doug's deductible expenses.

39. **LO.3** Trevor, a friend of yours from high school, works as a server at the ST Café. He asks you to help him prepare his Federal income tax return. When you inquire about why his bank deposits substantially exceed his tip income, he confides to you that he is a bookie on the side. Trevor then provides you with the following documented income and expenses for the year:

Tip income	\$16,000
Gambling income	52,000
Gambling expenses	
Payouts to winners	29,000
Employee compensation	8,000
Bribe to police officer who is aware of Trevor's bookie activity	7,500

- How will these items affect Trevor's AGI (ignore the impact of self-employment taxes)?
 - His taxable income (ignore the impact of self-employment taxes)?
40. **LO.3, 4** Amber, a publicly held corporation, currently pays its president an annual salary of \$900,000. In addition, it contributes \$20,000 annually to a defined contribution pension plan for him. As a means of increasing company profitability, the board of directors decides to increase the president's compensation. Two proposals are being considered. Under the first proposal, the salary and pension contribution for the president would be increased by 30%. Under the second proposal, Amber would implement a performance-based compensation program that is projected to provide about the same amount of additional compensation and pension contribution for the president.
- Evaluate the alternatives from the perspective of Amber.
 - Prepare a letter to Amber's board of directors that contains your recommendations. Address the letter to the board chairperson, Agnes Riddle, whose address is 100 James Tower, Cleveland, OH 44106.
41. **LO.3** Nancy, the owner of a very successful hotel chain in the Southeast, is exploring the possibility of expanding the chain into a city in the Northeast. She incurs \$35,000 of expenses associated with this investigation. Based on the regulatory environment for hotels in the city, she decides not to expand. During the year, she also investigates opening a restaurant that will be part of a national restaurant chain. Her expenses for this are \$53,000. The restaurant begins operations on September 1. Determine the amount that Nancy can deduct in the current year for investigating these two businesses.
42. **LO.3** Terry traveled to a neighboring state to investigate the purchase of two hardware stores. His expenses included travel, legal, accounting, and miscellaneous expenses. The total was \$52,000. He incurred the expenses in June and July 2015. Under the following circumstances, what can Terry deduct in 2015?
- Terry was in the hardware store business and did not acquire the two hardware stores.
 - Terry was in the hardware store business and acquired the two hardware stores and began operating them on October 1, 2015.

Decision Making Communications

- c. Terry did not acquire the two hardware stores and was not in the hardware store business.
- d. Terry acquired the two hardware stores but was not in the hardware store business when he acquired them. Operations began on October 1, 2015.

43. **LO.3** Harold conducts a business with the following results for the year:

Revenue	\$20,000
Depreciation on car	3,960
Operating expenses of car	3,100
Rent	6,000
Wages	8,200
Amortization of intangibles	680

Harold estimates that due to a depressed real estate market, the value of land owned by the business declined by \$5,200.

- a. Calculate the effect of Harold's business on his AGI.
- b. How would your answer in part (a) change if the activity was a hobby?

44. **LO.3** Alex, who is single, conducts an activity in 2015 that is appropriately classified as a hobby. The activity produces the following revenues and expenses:

Revenue	\$18,000
Property taxes	3,000
Materials and supplies	4,500
Utilities	2,000
Advertising	5,000
Insurance	750
Depreciation	4,000

Without regard to this activity, Alex's AGI is \$42,000. Determine the amount of income Alex must report, the amount of the expenses he is permitted to deduct, and his taxable income.

45. **LO.3** Samantha, an executive, has AGI of \$100,000 before considering income or loss from her miniature horse business. Her outside income comes from prizes for winning horse shows, stud fees, and sales of yearlings. Samantha's home is on 20 acres, half of which she uses for the horse activity (i.e., stables, paddocks, fences, tack houses, and other related improvements).

Samantha's office in her home is 10% of the square footage of the house. She uses the office exclusively for maintaining files and records on the horse activities. Her books show the following income and expenses for the current year:

Income from fees, prizes, and sales		\$22,000
Expenses		
Entry fees		1,000
Feed and veterinary bills		4,000
Supplies		900
Publications and dues		500
Travel to horse shows (no meals)		2,300
Salaries and wages of employees		8,000
Depreciation		
Horse equipment	\$3,000	
Horse farm improvements	7,000	
On 10% of personal residence	<u>1,000</u>	11,000
Total home mortgage interest		24,000
Total property taxes on home		2,200
Total property taxes on horse farm improvements		800

The mortgage interest is only on her home because the horse farm improvements are not mortgaged.

- a. What are Samantha's tax consequences if the miniature horse activity is a hobby?
- b. If it is a business?

46. **LO.3** Sarah owns a vacation cabin in the Tennessee mountains. Without considering the cabin, she has gross income of \$65,000. During the year, she rents the cabin for two weeks for \$2,500 and uses it herself for four weeks. The total expenses for the year are \$10,000 mortgage interest; \$1,500 property tax; \$2,000 utilities, insurance, and maintenance; and \$3,200 depreciation.
- a. What effect does the rental of the vacation cabin have on Sarah's AGI?
 - b. What expenses can Sarah deduct, and how are they classified (i.e., *for* or *from* AGI)?

47. **LO.3** Adelene, who lives in a winter resort area, rented her personal residence for 14 days while she was visiting Brussels. Rent income was \$5,000. Related expenses for the year were as follows:

Real property taxes	\$ 3,800
Mortgage interest	7,500
Utilities	3,700
Insurance	2,500
Repairs	2,100
Depreciation	15,000

Determine the effect on Adelene's AGI.

48. **LO.3** During the year (not a leap year), Anna rented her vacation home for 30 days, used it personally for 20 days, and left it vacant for 315 days. She had the following income and expenses:

Rent income	\$ 7,000
Expenses	
Real estate taxes	2,500
Interest on mortgage	9,000
Utilities	2,400
Repairs	1,000
Roof replacement (a capital expenditure)	12,000
Depreciation	7,500

- a. Compute Anna's net rent income or loss and the amounts she can itemize on her tax return, using the court's approach to allocating property taxes and interest.
 - b. How would your answer in part (a) differ using the IRS's method of allocating property taxes and interest?
49. **LO.3** How would your answer to Problem 48 differ if Anna had rented the house for 87 days and had used it personally for 13 days?
50. **LO.1, 3** Chee, single, age 40, had the following income and expenses during 2015:

Income	
Salary	\$43,000
Rental of vacation home (rented 60 days, used personally 60 days, vacant 245 days)	4,000
Municipal bond interest	2,000
Dividend from General Electric	400
Expenses	
Interest on home mortgage	8,400
Interest on vacation home	4,758
Interest on loan used to buy municipal bonds	3,100

Property tax on home	\$2,200
Property tax on vacation home	1,098
State income tax	3,300
State sales tax	900
Charitable contributions	1,100
Tax return preparation fee	300
Utilities and maintenance on vacation home	2,600
Depreciation on rental 50% of vacation home	3,500

Calculate Chee's taxable income for the year before personal exemptions. If Chee has any options, choose the method that maximizes his deductions.

- Decision Making** 51. **LO.1, 3, 4** Elisa and Clyde operate a retail sports memorabilia shop. For the current year, sales revenue is \$55,000 and expenses are as follows:

Cost of goods sold	\$21,000
Advertising	1,000
Utilities	2,000
Rent	4,500
Insurance	1,500
Wages to Boyd	8,000

Elisa and Clyde pay \$8,000 in wages to Boyd, a part-time employee. Because this amount is \$1,000 below the minimum wage, Boyd threatens to file a complaint with the appropriate Federal agency. Although Elisa and Clyde pay no attention to Boyd's threat, Chelsie (Elisa's mother) gives Boyd a check for \$1,000 for the disputed wages. Both Elisa and Clyde ridicule Chelsie for wasting money when they learn what she has done. The retail shop is the only source of income for Elisa and Clyde.

- Calculate Elisa and Clyde's AGI.
- Can Chelsie deduct the \$1,000 payment on her tax return? Explain.
- How could the tax position of the parties be improved?

- Decision Making Communications** 52. **LO.3, 4** Brittany Callihan sold stock (basis of \$184,000) to her son, Ridge, for \$160,000, the fair market value.

- What are the tax consequences to Brittany?
- What are the tax consequences to Ridge if he later sells the stock for \$190,000? For \$152,000? For \$174,000?
- Write a letter to Brittany in which you inform her of the tax consequences if she sells the stock to Ridge for \$160,000. Explain how a sales transaction could be structured that would produce better tax consequences for her. Brittany's address is 32 Country Lane, Lawrence, KS 66045.

53. **LO.3** The Robin Corporation is owned as follows:

Isabelle	26%
Peter, Isabelle's husband	19%
Sonya, Isabelle's mother	15%
Reggie, Isabelle's father	25%
Quinn, an unrelated party	15%

Robin is on the accrual basis, and Isabelle and Peter are on the cash basis. Isabelle and Peter each loaned the Robin Corporation \$40,000 out of their separate funds. On December 31, 2015, Robin accrued interest at 7% on both loans. The interest was paid on February 4, 2016. What is the tax treatment of this interest expense/income to Isabelle, Peter, and Robin?

54. **LO.3** For each of the following independent transactions, calculate the recognized gain or loss to the seller and the adjusted basis to the buyer.

- a. Bonnie sells Parchment, Inc. stock (adjusted basis \$17,000) to Phillip, her brother, for its fair market value of \$12,000.
 - b. Amos sells land (adjusted basis \$85,000) to his nephew, Boyd, for its fair market value of \$70,000.
 - c. Susan sells a tax-exempt bond (adjusted basis \$20,000) to her wholly owned corporation for its fair market value of \$19,000.
 - d. Ron sells a business truck (adjusted basis \$20,000) that he uses in his sole proprietorship to his cousin, Agnes, for its fair market value of \$18,500.
 - e. Martha sells her partnership interest (adjusted basis \$175,000) in Pearl Partnership to her adult daughter, Kim, for \$220,000.
55. **LO.1, 3, 4** During the current year, Robert pays the following amounts associated with his own residence: Decision Making

Property taxes	\$3,000
Mortgage interest	8,000
Repairs	1,200
Utilities	2,700
Replacement of roof	4,000

In addition, Robert paid \$1,500 of property taxes on the home that is owned and used by Anne, his daughter.

- a. Which of these expenses can Robert deduct?
- b. Can Anne deduct the \$1,500 of property taxes?
- c. Are the deductions *for* AGI or *from* AGI (itemized)?
- d. How could the tax consequences be improved?

Cumulative Problems



56. Roberta Santos, age 41, is single and lives at 120 Sanborne Avenue, Springfield, IL 60781. Her Social Security number is 123-45-6789. Roberta has been divorced from her former husband, Wayne, for three years. She has a son, Jason, who is 17, and a daughter, June, who is 18. Jason's Social Security number is 111-11-1111, and June's is 123-45-6788. Roberta does not want to contribute \$3 to the Presidential Election Campaign Fund.

Tax Return Problem



Roberta, an advertising executive, earned a salary of \$80,000 in 2014. Her employer withheld \$9,000 in Federal income tax and \$3,100 in state income tax.

Roberta has legal custody of Jason and June. The divorce decree provides that Roberta is to receive the dependency deductions for the children. Jason lives with his father during summer vacation. Wayne indicates that his expenses for Jason are \$10,500. Roberta can document that she spent \$6,500 for Jason's support during 2014. In prior years, Roberta gave a signed Form 8332 to Wayne regarding Jason. For 2014, she has decided not to do so. Roberta provides all of June's support.

Roberta's mother died on January 7, 2014. Roberta inherited assets worth \$625,000 from her mother. As the sole beneficiary of her mother's life insurance policy, Roberta received insurance proceeds of \$300,000. Her mother's cost basis for the life insurance policy was \$120,000. Roberta's favorite aunt gave her \$13,000 for her birthday in October.

On November 8, 2014, Roberta sells for \$22,000 Amber stock that she had purchased for \$24,000 from her first cousin, Walt, on December 5, 2009. Walt's cost basis for the stock was \$26,000, and the stock was worth \$23,000 on December 5,

2009. On December 1, 2014, Roberta sold Falcon stock for \$13,500. She had acquired the stock on July 2, 2011, for \$8,000.

An examination of Roberta's records reveals that she received the following:

- Interest income of \$2,500 from First Savings Bank.
- Groceries valued at \$750 from a local grocery store for being the 100,000th customer.
- Qualified dividend income of \$1,800 from Amber.
- Interest income of \$3,750 on City of Springfield school bonds.
- Alimony of \$16,000 from Wayne.
- Distribution of \$4,800 from ST Partnership. Her distributive share of the partnership passive taxable income was \$5,300. She had no prior passive losses.

From her checkbook records, she determines that she made the following payments during 2014:

- Charitable contributions of \$4,500 to First Presbyterian Church and \$1,500 to the American Red Cross (proper receipts obtained).
- Mortgage interest on her residence of \$7,800.
- Property taxes of \$3,200 on her residence and \$1,100 (ad valorem) on her car.
- Estimated Federal income taxes of \$3,800 and estimated state income taxes of \$1,000.
- Medical expenses of \$5,000 for her and \$800 for Jason. In December, her medical insurance policy reimbursed \$1,500 of her medical expenses.
- A \$1,000 ticket for parking in a handicapped space.
- Attorney's fees of \$500 associated with unsuccessfully contesting the parking ticket.
- Contribution of \$250 to the campaign of a candidate for governor.
- Because she did not maintain records of the sales tax she paid, she calculates the amount from the sales tax table to be \$994.

Calculate Roberta's net tax payable or refund due for 2014. Use the appropriate forms and schedules. Suggested software: H&R BLOCK Tax Software.

Tax Computation Problem
Decision Making
Communications

57. John and Mary Jane Diaz are married, filing jointly. Their address is 204 Shoe Lane, Blacksburg, VA 24061. John is age 35, and Mary Jane is age 30. They are expecting their first child in early 2016. John's salary in 2015 was \$105,000, from which \$20,800 of Federal income tax and \$4,700 of state income tax were withheld. Mary Jane made \$52,000 and had \$3,000 of Federal income tax and \$3,100 of state income tax withheld. The appropriate amounts of FICA tax and Medicare tax were withheld for John and for Mary Jane. John's Social Security number is 111-11-1111, and Mary Jane's Social Security number is 123-45-6789.

John and Mary Jane are both covered by their employer's medical insurance policies with four-fifths of the premiums being paid by the employers. The total premiums were \$10,000 for John and \$6,200 for Mary Jane. Mary Jane received medical benefits of \$7,300 under the plan. John was not ill during 2015. Mary Jane paid non-covered medical expenses of \$1,300.

John makes child support payments of \$15,000 for his son, Rod, who lives with June, John's former spouse, except for two months in the summer when he visits John and Mary Jane. At the time of the divorce, John worked for a Fortune 500 company and received a salary of \$225,000. As a result of corporate downsizing, he lost his job.

Mary Jane's father lived with them until his death in November. His only sources of income were salary of \$2,800, unemployment compensation benefits of \$3,500,

and Social Security benefits of \$4,100. Of this amount, he deposited \$6,000 in a savings account. The remainder of his support of \$9,500, which included funeral expenses of \$4,500, was provided by John and Mary Jane.

Other income received by the Diazes was as follows:

Interest on certificates of deposit	\$3,500
Share of S corporation taxable income (distributions from the S corporation to Mary Jane were \$1,100)	1,500
Award received by Mary Jane from employer for an outstanding suggestion for cutting costs	4,000

John has always wanted to operate his own business. In October 2015, he incurred expenses of \$15,000 in investigating the establishment of a retail computer franchise. With the birth of their child expected next year, however, he decides to forgo self-employment for at least a couple of years.

John and Mary Jane made charitable contributions of \$3,700 during the year and paid an additional \$1,800 in state income taxes in 2015 upon filing their 2014 state income tax return. Their deductible home mortgage interest was \$8,200, and their property taxes came to \$4,800. They paid sales taxes of \$2,000, for which they have receipts. They paid a ticket of \$150 that Mary Jane received for running a red light (detected by a red light camera).

Part 1—Tax Computation

Calculate John and Mary Jane's tax (or refund) due for 2015.

Part 2—Tax Planning

Assume that the Diazes come to you for advice in December 2015. John has learned that he will receive a \$30,000 bonus. He wants to know if he should take it in December 2015 or in January 2016. Mary Jane will quit work on December 31 to stay home with the baby. Their itemized deductions will decrease by \$3,100 because Mary Jane will not have state income taxes withheld. Mary Jane will not receive the employee award in 2016. She expects the medical benefits received to be \$9,000. The Diazes expect all of their other income items to remain the same in 2016. Write a letter to John and Mary Jane that contains your advice, and prepare a memo for the tax files.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Gray Chemical Company manufactured pesticides that were toxic. Over the course of several years, the toxic waste contaminated the air and water around the company's plant. Several employees suffered toxic poisoning, and the Environmental Protection Agency cited the company for violations. In court, the judge found Gray guilty and imposed fines of \$15 million. The company voluntarily set up a charitable fund for the purpose of bettering the environment and funded it with \$8 million. The company incurred legal expenses in setting up the foundation and defending itself in court. The court reduced the fine from \$15 million to \$7 million.

Communications

Gray Chemical Company deducted the \$8 million paid to the foundation and the legal expenses incurred. The IRS disallowed both deductions on the grounds that the payment was, in fact, a fine and in violation of public policy.

Gray's president, Ted Jones, has contacted you regarding the deductibility of the \$7 million fine, the \$8 million payment to the foundation, and the legal fees. Write a letter to Mr. Jones that contains your advice, and prepare a memo for the tax files. Gray's address is 200 Lincoln Center, Omaha, NE 68182.

Partial list of research aids:

§§ 162(a) and (f).

Reg. § 1.162-21(b).

Research Problem 2. Rex and Agnes Harrell purchased a beach house at Duck, North Carolina, in early 2014. Although they intended to use the beach house occasionally for recreational purposes, they also planned to rent it through the realty agency that had handled the purchase to help pay the mortgage payments, property taxes, and maintenance costs. Rex is a surgeon, and Agnes is a counselor.

The beach house was in need of substantial repairs. Rather than hiring a contractor, Rex and Agnes decided they would make the repairs themselves. During both high school and college, Rex had worked summers in construction. In addition, he had taken an advanced course in woodworking and related subjects from a local community college several years ago.

During 2014, according to a log maintained by the Harrells, they occupied the beach house 38 days and rented it 49 days. The log also indicated that on 24 of the 38 days they occupied the beach house, one or both of them were engaged in work on the beach house. Their two teenage children were with them on all of these days but did not help with the work being done. On their 2014 income tax return, Rex and Agnes, who filed a joint return, treated the beach house as a rental property and deducted a pro rata share of the property taxes, mortgage interest, utilities, maintenance and repairs, and depreciation in determining their net loss from the beach home. In the current year, after examining their return, an IRS agent has limited the deductions to the rent income. He contends that the 14-day personal use provision was exceeded and that many of the alleged repairs were capital expenditures. Advise the Harrells on how they should respond to the IRS.

Research Problem 3. Mona viewed herself as a creative individual who had chosen to go to law school for economic reasons. Mona's undergraduate majors were creative writing and American Indian studies.

Mona was very successful as an attorney and eventually was admitted to partnership in her law firm, having an expertise in negotiating settlements involving Indian water rights.

While practicing law, Mona continued her interest in the arts. She had directed plays in high school and maintained her involvement in the theater, even during law school. She belonged to local theater organizations while she practiced law. She took several courses in filmmaking and read extensively in the area. She even took several months off from her legal practice to enroll in NYU's filmmaking program. Her enrollment in the program provided her with hands-on experience and taught her about the technical aspects of filmmaking and allowed her to meet individuals who would later work with her on her documentary.

When she discovered that her husband had similar interests, she decided to create a documentary about Way to Sing America. After acquiring the rights to all of the archival footage of Way to Sing America, she hired a video production company to film interviews that she conducted with Way to Sing America alumni (over 400 hours of such interviews). She spent weekends and nights over a three-year period working on the documentary.

Once the documentary was completed, Mona began marketing it at film festivals. At some of these festivals, her documentary received awards. At the same time, she developed a business plan, hired a bookkeeper to manage the finances, and hired an accounting firm to provide tax advice.

During this three-year period, she reported the following losses:

2012	\$ 30,000
2013	400,000
2014	200,000

On her tax returns for the three-year period, she offset these amounts against her law firm income of approximately \$1 million in each year.

Upon audit by the IRS, the agent concluded that her filmmaking activity is a hobby and therefore the losses cannot be deducted except to the extent of the income generated.

Who is correct? Explain.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet Activity

Research Problem 4. Sarah was contemplating making a contribution to her traditional IRA in 2014. She determined she would contribute \$5,000 in December 2014, but forgot about making the contribution until she was preparing her 2014 tax return in February 2015. Use the website of any well-known IRA provider (e.g., Fidelity, Vanguard, T. Rowe Price) to determine if Sarah can make a 2014 contribution to her IRA after the tax year has ended.

Research Problem 5. The \$1 million maximum compensation deduction does not seem to have deterred large corporations from remunerating their executives at very high levels. What techniques are being used to work around the millionaires' provision? Are executives taking pay cuts, or are their salaries being deferred or changed in nature due to § 162(m)?

Roger CPA Review Questions

- Newton, a business owner, signed a ten-year lease beginning in July of 20X14, and immediately paid rent for the remainder of 20X14, all of 20X15, and all of 20X16. How much of the rent paid at the lease signing can be declared as a business expense on Schedule C of Newton's 20X14 tax return?
 - All of it
 - The July 20X14 – June 20X15 portion only
 - None of it
 - The 20X14 portion only
- The following facts pertain to Catch Ewe Later, a sole proprietorship owned by Shepherd:

20X09 net profit or (loss)	(\$ 3,000)
20X10 net profit or (loss)	10,000
20X11 net profit or (loss)	(1,000)
20X12 net profit or (loss)	(1,700)
20X13 net profit or (loss)	5,000

In 20X14 Shepherd gave out 50 livestock vests to prospective clients, at a cost of \$10 per vest. What amount of business expense can Shepherd include, as a result of the vests, on Shepherd's 20X14 Schedule C?

- \$500
- \$200
- \$0
- \$1,000

3. In 20X14 Adams, an individual, changed residences and converted her former residence into a passive rental activity. In 20X14 Adams lived in the former residence for 60 days, incurred \$7,000 in qualifying expenses preparing the property for rental, and rented it to a tenant for 90 days, receiving \$3,000 in rent. Before considering the rental activity, Adams's adjusted gross income for 20X14 is \$120,000. After considering the rental activity, what should Adams's 20X14 adjusted gross income be?
 - a. \$120,000
 - b. \$116,000
 - c. \$118,500
 - d. \$123,000
4. A sale between which of the following could trigger a gain or a loss for federal tax purposes?
 - a. Husband and wife
 - b. Cousin and cousin
 - c. Majority shareholder and corporation
 - d. Ancestor and descendent

Deductions and Losses: Certain Business Expenses and Losses

LEARNING OBJECTIVES: *After completing Chapter 7, you should be able to:*

- LO.1** Determine the amount, classification, and timing of the bad debt deduction.
- LO.2** State and illustrate the tax treatment of worthless securities, including § 1244 stock.
- LO.3** Distinguish between deductible and nondeductible losses of individuals.
- LO.4** Identify a casualty and determine the amount, classification, and timing of casualty and theft losses.
- LO.5** State and apply the alternative tax treatments for research and experimental expenditures.
- LO.6** Calculate the domestic production activities deduction.
- LO.7** Describe the tax impact of a net operating loss and review the effect of the carryback and carryover provisions on previous and subsequent years' taxable income.
- LO.8** Identify tax planning opportunities in deducting certain business expenses, business losses, and personal losses.

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- 7-1c Loans between Related Parties, 7-5

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THE BIG PICTURE

TETRA IMAGES/JUPITER IMAGES

LOSSES

Martha, a cash basis and calendar year taxpayer, is nearing the end of a year that she would like to forget. Several years ago, she loaned \$25,000 to her friend Jamil to enable him to start a business. Jamil had made scheduled payments of \$7,000 (\$1,000 of this was interest) when he unexpectedly died in January. At the time of his death, he was insolvent. Martha's attempts to collect on the debt were fruitless.

Last October, Martha invested \$50,000 in the stock of a pharmaceutical company that previously had been profitable. However, as a result of losing a patent infringement suit, the company declared bankruptcy in May of this year. Martha is notified by the bankruptcy trustee that she can expect to receive nothing from the company.

Martha has owned and operated a bookstore as a sole proprietorship for the past 10 years. The bookstore previously produced annual profits of about \$75,000. Due to the growth of online vendors and e-books, Martha's bookstore sustained a net loss of \$180,000 this year.

In September, a hurricane caused a large oak tree to blow over onto Martha's house. The cost of removing the tree and making repairs was \$32,000. Martha received a check for \$25,000 from her insurance company in final settlement of the claim. Her adjusted basis for the house was \$280,000.

In March, Martha purchased from a friend, for \$20,000, what she believed to be § 1244 stock. The stock's value began to decline significantly soon after its purchase. Several months after her purchase, Martha sold the stock for \$12,000.

Can you help relieve Martha's feeling of despair by making her aware of beneficial loss provisions in the tax law?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	(x,xxx)
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income.....	(x,xxx)

FORM 1040 (p. 1)

12 Business income or (loss). Attach Schedule C or C-EZ	
35 Domestic production activities deduction. Attach Form 8903	

Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)

FORM 1040 (p. 2)

40 Itemized deductions (from Schedule A) or your **standard deduction** (see left margin) . . .

Personal and dependency exemptions	(x,xxx)
Taxable income	\$xx,xxx
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	(xxx)
Tax due (<i>or refund</i>).....	\$ xxx

Working with the tax formula for individuals requires the proper classification of items that are deductible *for* adjusted gross income (AGI) and items that are deductions *from* AGI (itemized deductions). Business expenses and losses, discussed in this chapter, are reductions of gross income to arrive at the taxpayer's AGI. Expenses and losses incurred in connection with a transaction entered into for profit and attributable to rents and royalties are deducted *for* AGI. All other expenses and losses incurred in connection with a transaction entered into for profit are deducted *from* AGI. The determination of the taxpayer's activity (i.e., whether the taxpayer is engaged in a trade or business, an investment, or a personal activity) is crucial in this classification process.¹

Deductible losses on personal use property are deducted as an itemized deduction. Itemized deductions are deductions *from* AGI. While the general coverage of itemized deductions is in Chapter 10, casualty and theft losses on personal use property are discussed in this chapter.

In determining the amount and timing of the deduction for bad debts, proper classification is again important. A business bad debt is classified as a deduction *for* AGI, and a nonbusiness bad debt is classified as a short-term capital loss.

Other topics discussed in Chapter 7 are research and experimental expenditures, the domestic production activities deduction, and the net operating loss deduction.

LO.1

Determine the amount, classification, and timing of the bad debt deduction.

7-1 BAD DEBTS

If a taxpayer sells goods or provides services on credit and the account receivable subsequently becomes worthless, a **bad debt** deduction is permitted only if income arising from the creation of the account receivable was previously included in income.²

¹See, for example, *Groetzinger v. Comm.*, 85-2 USTC ¶9622, 56 AFTR 2d 85-5683, 771 F.2d 269 (CA-7, 1985), aff'd in 87-1 USTC ¶9191, 59 AFTR 2d 87-532, 107 S.Ct. 980 (USSC, 1987).

²Reg. § 1.166-1(e).

No deduction is allowed, for example, for a bad debt arising from the sale of a product or service when the taxpayer is on the cash basis because no income is reported until the cash has been collected. Permitting a bad debt deduction for a cash basis taxpayer would amount to a double deduction because the expenses of the product or service rendered are deducted when payments are made to suppliers and to employees or at the time of the sale.

Tracy, an individual, is a sole proprietor. She operates a business named Executive Accounting and Tax Services. Last year, Pat hired Tracy to help him with the accounting for his small business. Tracy also prepared the S corporation income tax return for the business and Pat's personal income tax return. Tracy billed Pat \$8,000 for the services she performed. Pat has never paid the bill, his business no longer exists, and his whereabouts are unknown.

If Tracy is an accrual basis taxpayer, she includes the \$8,000 in income when the services are performed. When she determines that Pat's account will not be collected, she deducts the \$8,000 as a bad debt expense.

If Tracy is a cash basis taxpayer, she does not include the \$8,000 in income until payment is received. When she determines that Pat's account will not be collected, she cannot deduct the \$8,000 as a bad debt expense because it was never recognized as income.

EXAMPLE

1

The Big Picture

Return to the facts of *The Big Picture* on p. 7-1. Because Martha is a cash basis taxpayer, she cannot take as a bad debt deduction any unpaid accrued interest on the loan to her friend because it was never recognized as income.

EXAMPLE

2

A bad debt can also result from the nonrepayment of a loan made by the taxpayer or from purchased debt instruments.

7-1a **Specific Charge-Off Method**

Taxpayers (other than certain financial institutions) may use only the **specific charge-off method** in accounting for bad debts. Certain financial institutions are allowed to use the **reserve method** for computing deductions for bad debts.

A taxpayer using the specific charge-off method may claim a deduction when a specific business debt becomes either partially or wholly worthless or when a specific non-business debt becomes wholly worthless.³ For the business debt, the taxpayer must satisfy the IRS that the debt is partially worthless and must demonstrate the amount of worthlessness.

If a business debt previously deducted as partially worthless becomes totally worthless in a future year, only the remainder not previously deducted can be deducted in the future year.

In the case of total worthlessness, a deduction is allowed for the entire amount in the year the debt becomes worthless. The amount of the deduction depends on the taxpayer's basis in the bad debt. If the debt arose from the sale of services or products and the face amount was previously included in income, that amount is deductible. If the taxpayer purchased the debt, the deduction is equal to the amount the taxpayer paid for the debt instrument.

One of the more difficult tasks is determining if and when a bad debt is worthless. The loss is deductible only in the year of partial or total worthlessness for business debts and only in the year of total worthlessness for nonbusiness debts. Legal proceedings need not be initiated against the debtor when the surrounding facts indicate that such action will not result in collection.

³§ 166(a).

EXAMPLE

3

In 2013, Ross loaned \$1,000 to Kay, who agreed to repay the loan in two years. In 2015, Kay disappeared after the note became delinquent. If a reasonable investigation by Ross indicates that he cannot find Kay or that a suit against Kay would not result in collection, Ross can deduct the \$1,000 in 2015.

Bankruptcy is generally an indication of at least partial worthlessness of a debt. Bankruptcy may create worthlessness before the settlement date. If this is the case, the deduction may be taken in the year of worthlessness.

EXAMPLE

4

In Example 3, assume that Kay filed for personal bankruptcy in 2014 and that the debt is a business debt. At that time, Ross learned that unsecured creditors (including Ross) were ultimately expected to receive 20 cents on the dollar. In 2015, settlement is made, and Ross receives only \$150. He should deduct \$800 (\$1,000 loan – \$200 expected settlement) in 2014 and \$50 in 2015 (\$200 balance – \$150 proceeds).

If a receivable has been written off as uncollectible during the current tax year and is subsequently collected during the current tax year, the write-off entry is reversed. If a receivable has been written off (deducted) as uncollectible, the collection of the receivable in a later tax year may result in income being recognized. Income will result if the deduction yielded a tax benefit in the year it was taken. See Examples 33 and 34 in Chapter 5.

See Concept Summary 7.1.

Concept Summary 7.1

The Tax Treatment of Bad Debts Using the Specific Charge-Off Method

	Business Bad Debts	Nonbusiness Bad Debts
Timing of deduction	A deduction is allowed when the debt becomes either partially or wholly worthless.	A deduction is allowed <i>only</i> when the debt becomes wholly worthless.
Character of deduction	The bad debt may be deducted as an ordinary loss.	The bad debt is classified as a short-term capital loss, subject to the \$3,000 capital loss limitation for individuals.
Recovery of amounts previously deducted	If the account recovered was written off during the current tax year, the write-off entry is reversed. If the account was written off in a previous tax year, income is created subject to the tax benefit rule.	If the account recovered was written off during the current tax year, the write-off entry is reversed. If the account was written off in a previous tax year, income is created subject to the tax benefit rule.

7-1b Business versus Nonbusiness Bad Debts

A **nonbusiness bad debt** is a debt unrelated to the taxpayer's trade or business either when it was created or when it became worthless. The nature of a debt depends upon whether the lender was engaged in the business of lending money or whether there is a proximate relationship between the creation of the debt and the lender's trade or business. The use to which the borrowed funds are put by the debtor is of no consequence. Loans to relatives or friends are the most common type of nonbusiness bad debt.

The Big Picture

EXAMPLE

5

Return to the facts of *The Big Picture* on p. 7-1. Martha loaned her friend Jamil \$25,000. Jamil used the money to start a business, which subsequently failed. When Jamil died after having made payments of \$7,000 on the loan, he was insolvent.

Even though the proceeds of the loan were used in a business, the loan is a nonbusiness bad debt because the business was Jamil's, not Martha's, and Martha is not in the business of lending money.

The distinction between a business bad debt and a nonbusiness bad debt is important. A **business bad debt** is deductible as an ordinary loss in the year incurred, whereas a nonbusiness bad debt is always treated as a short-term capital loss. Thus, regardless of the age of a nonbusiness bad debt, the deduction may be of limited benefit due to the limitations on capital loss deductibility in any one year. The maximum amount of a net short-term capital loss that an individual can deduct against ordinary income in any one year is \$3,000 (see Chapter 14 for a detailed discussion). Although no deduction is allowed when a nonbusiness bad debt is partially worthless, the taxpayer is entitled to deduct the net amount of the loss upon final settlement.

The following example is an illustration of business bad debts adapted from the Regulations.⁴

In 2014, Leif sold his business but retained a claim (note or account receivable) against Bob. The claim became worthless in 2015.

Leif's loss is treated as a business bad debt because the debt was created in the conduct of his former trade or business. Leif is accorded business bad debt treatment even though he was holding the note as an investor and was no longer in a trade or business when the claim became worthless.

EXAMPLE

6

The nonbusiness bad debt provisions are *not* applicable to corporations. It is assumed that any loans made by a corporation are related to its trade or business. Therefore, any bad debts of a corporation are business bad debts.

7-1c Loans between Related Parties

Loans between related parties (especially family members) raise the issue of whether the transaction was a *bona fide* loan or a gift. The Regulations state that a bona fide debt arises from a debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money. Thus, individual circumstances must be examined to determine whether advances between related parties are gifts or loans. Some considerations are these:

- Was a note properly executed?
- Was there a reasonable rate of interest?
- Was collateral provided?
- What collection efforts were made?
- What was the intent of the parties?

Lana loans \$2,000 to her widowed mother for an operation. Lana's mother owns no property and is not employed, and her only income consists of Social Security benefits. No note is issued for the loan, no provision for interest is made, and no repayment date is mentioned. In the current year, Lana's mother dies, leaving no estate.

Assuming that the loan is not repaid, Lana cannot take a deduction for a nonbusiness bad debt because the facts indicate that no debtor-creditor relationship existed.

EXAMPLE

7

See Concept Summary 7.2 for a review of the bad debt deduction rules.

7-2 WORTHLESS SECURITIES

A loss is allowed for securities that become *completely* worthless during the year (**worthless securities**).⁵ Such securities are shares of stock, bonds, notes, or other evidence of indebtedness issued by a corporation or government. The losses generated are treated as capital losses deemed to have occurred on the *last day* of the taxable year. By treating the loss as having occurred on the last day of the taxable year, a loss that

LO.2

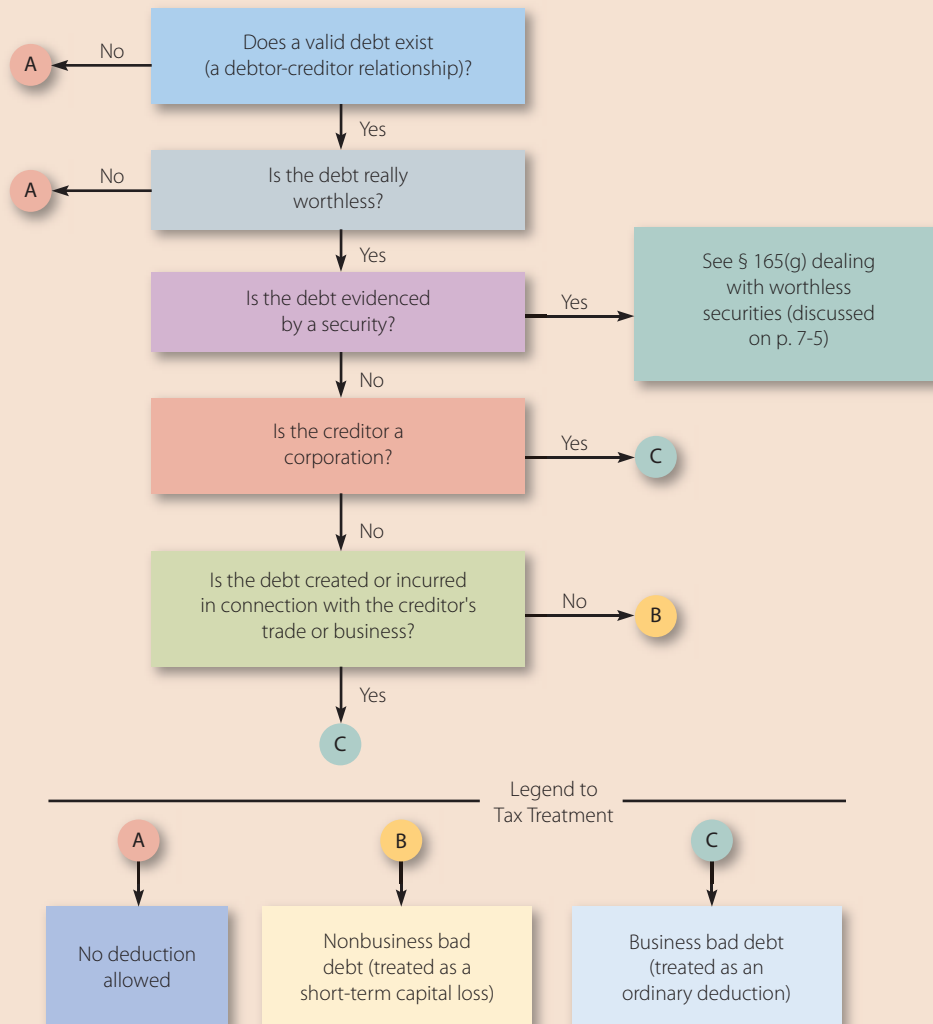
State and illustrate the tax treatment of worthless securities, including § 1244 stock.

⁴Reg. § 1.166-5(d).

⁵§ 165(g).

Concept Summary 7.2

Bad Debt Deductions



would otherwise have been classified as short-term (if the date of worthlessness was used) may be classified as a long-term capital loss. Capital losses may be of limited benefit due to the \$3,000 capital loss limitation.⁶

The Big Picture

EXAMPLE

8

Return to the facts of *The Big Picture* on p. 7-1. Martha owned stock in a pharmaceutical company that she acquired as an investment on October 1, 2014, at a cost of \$50,000. On May 31, 2015, the stock became worthless when the company declared bankruptcy.

Because the stock is deemed to have become worthless as of December 31, 2015, Martha has a capital loss from an asset held for 15 months (a long-term capital loss).

7-2a Small Business Stock (§ 1244)

The general rule is that shareholders receive capital gain or loss treatment upon the sale or exchange of stock. However, it is possible to receive an ordinary loss deduction if

⁶§ 1211(b).

the loss is sustained on **small business stock (§ 1244 stock)**. This loss could arise from a sale of the stock or from the stock becoming worthless. Only *individuals*⁷ who acquired the stock *from* the corporation are eligible to receive ordinary loss treatment under § 1244. The ordinary loss treatment is limited to \$50,000 (\$100,000 for married individuals filing jointly) per year. Losses on § 1244 stock in excess of the statutory limits receive capital loss treatment.

The corporation must meet certain requirements for the loss on § 1244 stock to be treated as an *ordinary*—rather than a capital—loss. The major requirement is that the total amount of money and other property received by the corporation for stock as a contribution to capital (or paid-in surplus) does not exceed \$1 million. The \$1 million test is made at the time the stock is issued. Section 1244 stock can be common or preferred stock. Section 1244 applies only to losses. If § 1244 stock is sold at a gain, the Section is not applicable and the gain is capital gain.

Iris, a single individual, was looking for an investment that would give some diversity to her stock portfolio. A friend suggested that she acquire some stock in Eagle Corporation, a new startup company. On July 1, 2013, Iris purchased 100 shares of Eagle Corporation for \$100,000. At the time Iris acquired her stock from Eagle Corporation, the corporation had \$700,000 of paid-in capital. As a result, the stock qualified as § 1244 stock. On June 20, 2015, Iris sold all of her Eagle stock for \$20,000.

Because the Eagle stock is § 1244 stock, Iris has a \$50,000 ordinary loss and a \$30,000 long-term capital loss.

EXAMPLE

9

The Big Picture

Return to the facts of *The Big Picture* on p. 7-1. On March 8, 2015, Martha purchases what she believes is § 1244 stock from her friend Janice for \$20,000. On November 2, 2015, she sells the stock in the marketplace for \$12,000.

Because Martha purchases the stock from Janice and not the corporation, the stock is not § 1244 stock to Martha. As a result, Martha has an \$8,000 short-term capital loss.

EXAMPLE

10

7-3 LOSSES OF INDIVIDUALS

An individual may deduct the following losses under § 165(c):

- Losses incurred in a trade or business.
- Losses incurred in a transaction entered into for profit.
- Losses caused by fire, storm, shipwreck, or other casualty or by theft.

Examples of losses in the first two categories include a loss on property used in a proprietorship, a loss on property held for rent, or a loss on stolen bearer bonds. An individual taxpayer suffering losses from damage to *nonbusiness* property can deduct only those losses attributable to fire, storm, shipwreck, or other casualty or theft. Although the meaning of the terms *fire*, *storm*, *shipwreck*, and *theft* is relatively free from dispute, the term *other casualty* needs further clarification. It means casualties analogous to fire, storm, or shipwreck. The term also includes accidental loss of property provided the loss qualifies under the same rules as any other casualty. These rules are that the loss must result from an event that is (1) identifiable; (2) damaging to property; and (3) sudden, unexpected, and unusual in nature.

A *sudden event* is an event that is swift and precipitous and not gradual or progressive. An *unexpected event* is an event that is ordinarily unanticipated and occurs without the intent of the individual who suffers the loss. An *unusual event* is an event that is extraordinary and nonrecurring and does not commonly occur during the activity in which the taxpayer was engaged when the destruction occurred.⁸ Examples include

LO3

Distinguish between deductible and nondeductible losses of individuals.

⁷The term *individuals* for this purpose does not include a trust or an estate (but could include a partnership or an LLC). ⁸Rev.Rul. 72-592, 1972-2 C.B. 101.

auto accidents, mine cave-ins, sonic booms, and vandalism. Weather that causes damage (e.g., drought) must be unusual and severe for the particular region. Damage must be to the taxpayer's property to qualify as a **casualty loss**.

A taxpayer can take a deduction for a casualty loss from an automobile accident only if the damage was not caused by the taxpayer's willful act or willful negligence.

EXAMPLE

11

Ted parks his car on a hill and fails to set the brake properly and to curb the wheels. As a result of Ted's negligence, the car rolls down the hill and is damaged. The repairs to Ted's car should qualify for casualty loss treatment because Ted's act of negligence does not appear to be willful.

LO.4

Identify a casualty and determine the amount, classification, and timing of casualty and theft losses.

7-3a Events That Are Not Casualties

Not all acts of nature are treated as casualty losses for income tax purposes. Because a casualty must be sudden, unexpected, and unusual, progressive deterioration (such as erosion due to wind or rain) is not a casualty because it does not meet the suddenness test.

Examples of nonsudden events that generally do not qualify as casualties include disease and insect damage. When the damage was caused by termites over a period of several years, some courts have disallowed a casualty loss deduction.⁹ On the other hand, some courts have held that termite damage over periods of up to 15 months after infestation constituted a sudden event and was, therefore, deductible as a casualty loss.¹⁰ Despite the existence of some judicial support for the deductibility of termite damage as a casualty loss, the current position of the IRS is that termite damage is not deductible.¹¹

Other examples of events that are not casualties are losses resulting from a decline in value rather than an actual loss of the property. No loss was allowed where the taxpayer's home declined in value as a result of a landslide that destroyed neighboring homes but did no actual damage to the taxpayer's home.¹² Similarly, a taxpayer was allowed a loss for the actual flood damage to his property but not for the decline in market value due to the property being flood-prone.¹³

7-3b Theft Losses

Theft includes, but is not necessarily limited to, larceny, embezzlement, and robbery.¹⁴ Theft does not include misplaced items.¹⁵

Theft losses are computed like other casualty losses (discussed in the following section), but the *timing* for recognition of the loss differs. A theft loss is deducted in the year of discovery, not the year of the theft (unless, of course, the discovery occurs in the same year as the theft). If in the year of the discovery a claim exists (e.g., against an insurance company) and there is a reasonable expectation of recovering the adjusted basis of the asset from the insurance company, no deduction is permitted.¹⁶ If in the year of settlement the recovery is less than the asset's adjusted basis, a partial deduction may be available. If the recovery is greater than the asset's adjusted basis, gain may be recognized.

EXAMPLE

12

Keith's new sailboat, which he uses for personal purposes, was stolen from the storage marina in December 2014. He discovered the loss on June 3, 2015, and filed a claim with his insurance company that was settled on January 30, 2016.

Assuming that there is a reasonable expectation of full recovery, no deduction is allowed in 2015. A partial deduction may be available in 2016 if the actual insurance proceeds are less than the lower of the fair market value or the adjusted basis of the asset. (Loss measurement rules are discussed later in this chapter.)

⁹*Fay v. Helvering*, 41-2 USTC ¶9494, 27 AFTR 432, 120 F.2d 253 (CA-2, 1941); *U.S. v. Rogers*, 41-1 USTC ¶9442, 27 AFTR 423, 120 F.2d 244 (CA-9, 1941).

¹⁰*Rosenberg v. Comm.*, 52-2 USTC ¶9377, 42 AFTR 303, 198 F.2d 46 (CA-8, 1952); *Shopmaker v. U.S.*, 54-1 USTC ¶9195, 45 AFTR 758, 119 F.Supp. 705 (D.Ct. Mo., 1953).

¹¹Rev.Rul. 63-232, 1963-2 C.B. 97.

¹²*H. Pulvers v. Comm.*, 69-1 USTC ¶9222, 23 AFTR 2d 69-678, 407 F.2d 838 (CA-9, 1969).

¹³*S. L. Solomon*, 39 TCM 1282, T.C.Memo. 1980-87.

¹⁴Reg. § 1.165-8(d).

¹⁵*Mary Francis Allen*, 16 T.C. 163 (1951).

¹⁶Reg. §§ 1.165-1(d)(2) and 1.165-8(a)(2).

7-3c When to Deduct Casualty Losses

General Rule

Generally, a casualty loss is deducted in the year the loss occurs. However, no casualty loss is permitted if a reimbursement claim with a *reasonable prospect of full recovery* exists.¹⁷ If the taxpayer has a partial claim, only part of the loss can be claimed in the year of the casualty, and the remainder is deducted in the year the claim is settled.

Brian's new sailboat was completely destroyed by fire in 2015. Its cost and fair market value were \$15,000. Brian's only claim against the insurance company was on a \$10,000 policy and was not settled by year-end. The following year, 2016, Brian settled with the insurance company for \$8,000.

Brian is entitled to a \$5,000 deduction in 2015 (\$15,000 less \$10,000) and a \$2,000 deduction in 2016. If Brian held the sailboat for personal use, the \$5,000 deduction in 2015 is reduced first by \$100 and then by 10% of his 2015 AGI. The \$2,000 deduction in 2016 is reduced by 10% of his 2016 AGI (see the following discussion on the \$100 and 10% floors).

EXAMPLE

13

If a taxpayer receives reimbursement for a casualty loss sustained and deducted in a previous year, an amended return is not filed for that year. Instead, the taxpayer must include the reimbursement in gross income on the return for the year in which it is received to the extent the previous deduction resulted in a tax benefit.

Fran had a deductible casualty loss of \$4,000 on her 2014 tax return. Fran's taxable income for 2014 was \$60,000. In June 2015, Fran is reimbursed \$2,750 for the prior year's casualty loss.

Fran includes the entire \$2,750 in gross income for 2015 because the deduction in 2014 produced a tax benefit.

EXAMPLE

14

Disaster Area Losses

An exception to the general rule for the time of deduction is allowed for **disaster area losses**, which are casualties sustained in an area designated as a disaster area by the President of the United States.¹⁸ In such cases, the taxpayer may *elect* to treat the loss as having occurred in the taxable year immediately *preceding* the taxable year in which the disaster actually occurred. The rationale for this exception is to provide immediate relief to disaster victims in the form of accelerated tax benefits.

If the due date, plus extensions, for the prior year's return has not passed, a taxpayer makes the election to claim the disaster area loss on the prior year's tax return. If the disaster occurs after the prior year's return has been filed, it is necessary to file either an amended return or a refund claim. In any case, the taxpayer must show clearly that such an election is being made.

Disaster loss treatment also applies in the case of a personal residence that has been rendered unsafe for use as a residence because of a disaster. This provision applies when, within 120 days after the President designates the area as a disaster area, the state or local government where the residence is located orders the taxpayer to demolish or relocate the residence.¹⁹

The Big Picture

Return to the facts of *The Big Picture* on p. 7-1. On September 28, 2015, Martha's personal residence was damaged when a hurricane caused an oak tree to fall onto the house. The amount of her uninsured loss was \$7,000. Because of the extent of the damage in the area, the President of the United States designated the area a disaster area. Because Martha's loss is a disaster area loss, she may elect to file an amended return for 2014 and take the loss in that year.

EXAMPLE

15

continued

¹⁷Reg. § 1.165-1(d)(2)(i).

¹⁸§ 165(h).

¹⁹§ 165(k).

If Martha elects this course of action, the amount of the loss will be reduced first by \$100 (the materiality amount in 2014) and then by 10% of her 2014 AGI.

If Martha forgoes the election, she may take the loss on her 2015 income tax return. The amount of the loss will be reduced first by \$100 (the materiality amount in 2015) and then by 10% of her 2015 AGI.

7-3d Measuring the Amount of Loss

Amount of Loss

The rules for determining the amount of a loss depend in part on whether business use, income-producing use, or personal use property was involved. Another factor that must be considered is whether the property was partially or completely destroyed.

If business property or property held for the production of income (e.g., rental property) is *completely destroyed*, the loss is equal to the adjusted basis of the property at the time of destruction.

EXAMPLE

16

Vicki's automobile, which was used only for business purposes, was destroyed by fire. Vicki had unintentionally allowed her insurance coverage to expire. The fair market value of the automobile was \$9,000 at the time of the fire, and its adjusted basis was \$10,000.

Vicki is allowed a loss deduction of \$10,000 (the basis of the automobile). The \$10,000 loss is a deduction *for* AGI.

A different measurement rule applies for *partial destruction* of business property and income-producing property and for *partial* or *complete destruction* of personal use property. In these situations, the loss is the *lesser* of the following:

- The adjusted basis of the property.
- The difference between the fair market value of the property before the event and the fair market value immediately after the event.

TAX IN THE NEWS The Tax Consequences of Lost Bitcoins

In Notice 2014–21 (2014–16 I.R.B. 938), the Internal Revenue Service provided initial guidance on transactions involving virtual currency (including bitcoins). Specifically, the IRS indicates that bitcoin is *not* currency; rather, it is property. As such, gain and losses on the disposition of bitcoins cannot be “exchange gain or loss.” This may come as a disappointment to taxpayers who lost money in bitcoin investments and may have hoped that the losses would be classified as exchange losses (and, as such, ordinary losses). Taxpayers who have disposed of appreciated investment positions in bitcoins may enjoy capital gains treatment. Taxpayers who hold bitcoin as inventory will be subject to ordinary gains and losses upon disposition.

But what happens if the hard drive on which bitcoins are stored crashes and the data are not recoverable? Is this a “sudden, unexpected, and unusual event” that could qualify for a casualty loss? One might argue that failure to back up the data on the hard drive might be deemed carelessness (and so none of the loss would be allowed). And, certainly,

no loss would be allowed until the taxpayer could confirm that there was no chance of recovery.

What if the taxpayer inadvertently deletes keys to bitcoins he or she previously mined? In general, you cannot take a loss for lost or misplaced property. In this case, no loss would be allowed due to carelessness on the part of the taxpayer. So the bottom line is this: Always back up your digital files.

What about losses in the 2013 collapse of Mt. Gox? Suppose a taxpayer lost \$20,000 worth of bitcoins in his or her Mt. Gox trading accounts (with a basis of \$12,000). Is this a loss due to theft? If the loss is a result of theft or embezzlement, the taxpayer would be entitled to claim a loss in the tax year that he or she discovers the loss. Further, at this point, it isn't clear whether any of the “lost” Mt. Gox bitcoins have been stolen or are even unrecoverable. If there is a “reasonable chance of recovery,” the taxpayer might not even be able to write off the Mt. Gox loss (and given that more than 25 percent of the “lost” bitcoins at Mt. Gox were subsequently located, there appears to be such a “reasonable chance of recovery”).

Kelly's uninsured automobile, which was used only for business purposes, was damaged in an accident. On the date of the accident, the fair market value of the automobile was \$12,000, and its adjusted basis was \$9,000. After the accident, the automobile was appraised at \$4,000.

Kelly's loss deduction is \$8,000 (the lesser of the adjusted basis or the decrease in fair market value). The \$8,000 loss is a deduction *for* AGI.

EXAMPLE

17

The deduction for the loss of property that is part business and part personal must be computed separately for the business portion and the personal portion.

Any insurance recovery reduces the loss for business, production of income, and personal use losses. In fact, a taxpayer may realize a gain if the insurance proceeds exceed the amount of the loss. Chapter 14 discusses the treatment of net gains and losses on business property and income-producing property.

A taxpayer is not permitted to deduct a casualty loss for damage to insured personal use property unless a *timely insurance claim* is filed with respect to the damage to the property. This rule applies to the extent that any insurance policy provides for full or partial reimbursement for the loss.²⁰

Generally, an appraisal before and after the casualty is needed to measure the amount of the loss. However, the *cost of repairs* to the damaged property is acceptable as a method of establishing the loss in value provided the following criteria are met:

- The repairs are necessary to restore the property to its condition immediately before the casualty.
- The amount spent for such repairs is not excessive.
- The repairs do not extend beyond the damage suffered.
- The value of the property after the repairs does not, as a result of the repairs, exceed the value of the property immediately before the casualty.²¹



ETHICS & EQUITY Is Policy Cancellation an Escape Hatch?

Noah's house is burglarized for the third time, and he knows that if he files a claim, the insurance company will cancel his homeowner's policy or impose a

prohibitive premium. Noah does not file a claim, yet he deducts the loss on his tax return. Is his loss allowed?

Reduction for \$100 and 10%-of-AGI Floors

The amount of the loss for personal use property must be further reduced by a \$100 *per event* floor and a 10%-of-AGI *aggregate* floor.²² The \$100 floor applies separately to each casualty and applies to the entire loss from each casualty (e.g., if a storm damages both a taxpayer's residence and automobile, only \$100 is subtracted from the total amount of the loss). The losses are then added together, and the total is reduced by 10 percent of the taxpayer's AGI. The resulting loss is the taxpayer's itemized deduction for casualty and theft losses.

Rocky, who had AGI of \$30,000, was involved in a motorcycle accident in 2015. His motorcycle, which was used only for personal use and had a fair market value of \$12,000 and an adjusted basis of \$9,000, was completely destroyed. He received \$5,000 from his insurance company.

Rocky's casualty loss deduction is \$900 [\$9,000 basis – \$5,000 insurance recovery – \$100 floor – \$3,000 (10% × \$30,000 AGI)]. The \$900 casualty loss is an itemized deduction (*from* AGI).

EXAMPLE

18

²⁰§ 165(h)(5)(E).

²¹Reg. § 1.165-7(a)(2)(ii).

²²§ 165(c)(3).

When a nonbusiness casualty loss is spread between two taxable years because of the *reasonable prospect of recovery* doctrine, the loss in the second year is not reduced by the \$100 floor. This result occurs because this floor is imposed per event and has already reduced the amount of the loss in the first year. However, the loss in the second year is still subject to the 10 percent floor based upon the taxpayer's second-year AGI (refer to Example 13). For taxpayers who suffer qualified disaster area losses, the 10%-of-AGI floor is determined by using the AGI of the year for which the deduction is claimed.²³

Multiple Losses

The rules for computing loss deductions where multiple losses have occurred are explained in Examples 19 and 20.

EXAMPLE

19

During the year, Tim had the following casualty losses:

Asset	Adjusted Basis	Fair Market Value of Asset		Insurance Recovery
		Before the Casualty	After the Casualty	
A	\$900	\$600	\$-0-	\$400
B	300	800	250	100

Assets A and B were used in Tim's business at the time of the casualty. The following losses are allowed:

- Asset A: \$500. The complete destruction of a business asset results in a deduction of the adjusted basis of the property (reduced by any insurance recovery), regardless of the asset's fair market value.
- Asset B: \$200. The partial destruction of a business (or personal use) asset results in a deduction equal to the lesser of the adjusted basis (\$300) or the decline in value (\$550), reduced by any insurance recovery (\$100).

Both the Asset A and Asset B losses are deductions *for* AGI. The \$100 floor and the 10%-of-AGI floor do not apply because the assets are business assets.

EXAMPLE

20

In 2015, Emily had AGI of \$20,000 and the following casualty losses:

Asset	Adjusted Basis	Fair Market Value of Asset		Insurance Recovery
		Before the Casualty	After the Casualty	
A	\$1,900	\$1,400	\$ -0-	\$200
B	2,500	4,000	1,000	-0-
C	800	400	100	250

Assets A, B, and C were held for personal use, and the losses to these three assets are from three different casualties. The loss for each asset is computed as follows:

- Asset A: \$1,100. The lesser of the adjusted basis of \$1,900 or the \$1,400 decline in value, reduced by the insurance recovery of \$200, minus the \$100 floor.
- Asset B: \$2,400. The lesser of the adjusted basis of \$2,500 or the \$3,000 decline in value, minus the \$100 floor.
- Asset C: \$0. The lesser of the adjusted basis of \$800 or the \$300 decline in value, reduced by the insurance recovery of \$250, minus the \$100 floor.

continued

²³§ 165(i).

Emily's itemized casualty loss deduction for the year is \$1,500:

Asset A loss	\$ 1,100
Asset B loss	2,400
Asset C loss	<u>-0-</u>
Total loss	\$ 3,500
Less: 10% of AGI (10% × \$20,000)	<u>(2,000)</u>
Itemized casualty loss deduction	<u>\$ 1,500</u>

7-3e Statutory Framework for Deducting Losses of Individuals

Casualty and theft losses incurred by an individual in connection with a trade or business are deductible *for* AGI.²⁴ These losses are not subject to the \$100 per event and the 10%-of-AGI limitations. Casualty and theft losses incurred by an employee in connection with a trade or business are deductible *for* AGI if the loss is reimbursed by the employer (with the net loss being deductible). If the loss is not reimbursed, the loss is deductible *from* AGI as a miscellaneous itemized deduction subject to the 2%-of-AGI floor. However, because these are business-related losses, they are not subject to the \$100 per event and the 10%-of-AGI limitations.

Casualty and theft losses incurred by an individual in a transaction entered into for profit are not subject to the \$100 per event and the 10%-of-AGI limitations. If these losses are attributable to rents or royalties, the deduction is *for* AGI.²⁵ However, if these losses are not connected with property held for the production of rents and royalties, they are deductions *from* AGI. More specifically, these losses are classified as other miscellaneous itemized deductions. An example of this type of loss would be the theft of a security. However, theft losses of investment property are not subject to the 2%-of-AGI floor on certain miscellaneous itemized deductions (explained in Chapters 9 and 10).

Casualty and theft losses attributable to personal use property are subject to the \$100 per event and the 10%-of-AGI limitations. These losses are itemized deductions, but they are not subject to the 2%-of-AGI floor.²⁶

7-3f Personal Casualty Gains and Losses

If a taxpayer has personal casualty and theft gains as well as losses, a special set of rules applies for determining the tax consequences. A **personal casualty gain** is the recognized gain from a casualty or theft of personal use property. A **personal casualty loss** for this purpose is a casualty or theft loss of personal use property after the application of the \$100 floor. A taxpayer who has both gains and losses for the taxable year must first net (offset) the personal casualty gains and personal casualty losses. If the gains exceed the losses, the gains and losses are treated as gains and losses from the sale of capital assets. The capital gains and losses are short-term or long-term, depending on the period the taxpayer held each of the assets. In the netting process, personal casualty and theft gains and losses are not netted with the gains and losses on business and income-producing property.

During the year, Cliff had the following personal casualty gains and losses (after deducting the \$100 floor):

Asset	Holding Period	Gain or (Loss)
A	Three months	(\$300)
B	Three years	(2,400)
C	Two years	3,200

continued

EXAMPLE

21

²⁴§ 62(a)(1).

²⁵§ 62(a)(4).

²⁶§ 67(b)(3).

Cliff computes the tax consequences as follows:

Personal casualty gain	\$ 3,200
Personal casualty loss (\$300 + \$2,400)	<u>(2,700)</u>
Net personal casualty gain	<u>\$ 500</u>

Cliff treats all of the gains and losses as capital gains and losses and has the following:

Short-term capital loss (Asset A)	\$ 300
Long-term capital loss (Asset B)	2,400
Long-term capital gain (Asset C)	3,200

If personal casualty losses exceed personal casualty gains, all gains and losses are treated as ordinary items. The gains—and the losses to the extent of gains—are treated as ordinary income and ordinary loss in computing AGI. Losses in excess of gains are deducted as itemized deductions to the extent the losses exceed 10 percent of AGI.²⁷

EXAMPLE

22

During the year, Hazel had AGI of \$20,000 and the following personal casualty gain and loss (after deducting the \$100 floor):

Asset	Holding Period	Gain or (Loss)
A	Three years	(\$2,700)
B	Four months	200

Hazel computes the tax consequences as follows:

Personal casualty loss	(\$2,700)
Personal casualty gain	<u>200</u>
Net personal casualty loss	<u>(\$2,500)</u>

Hazel treats the gain and the loss as ordinary items. The \$200 gain and \$200 of the loss are included in computing AGI. Hazel's itemized deduction for casualty losses is computed as follows:

Casualty loss in excess of gain (\$2,700 – \$200)	\$ 2,500
Less: 10% of AGI (10% × \$20,000)	<u>(2,000)</u>
Itemized deduction	<u>\$ 500</u>

See Concept Summary 7.3 for a review of the tax treatment of casualty gains and losses.

LO.5

State and apply the alternative tax treatments for research and experimental expenditures.

7-4 RESEARCH AND EXPERIMENTAL EXPENDITURES

Section 174 covers the treatment of research and experimental expenditures. The Regulations define **research and experimental expenditures** as follows:

all such costs incident to the development or improvement of a product (including an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property). The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions.²⁸

²⁷§ 165(h).

²⁸Reg. §§ 1.174-2(a)(1), (2), and (3).



Concept Summary 7.3

Casualty Gains and Losses

	Business Use or Income-Producing Property	Personal Use Property
Event creating the loss	Any event.	Casualty or theft.
Amount	The lesser of the decline in fair market value or the adjusted basis, but always the adjusted basis if the property is totally destroyed.	The lesser of the decline in fair market value or the adjusted basis.
Insurance	Insurance proceeds received reduce the amount of the loss.	Insurance proceeds received (or for which there is an unfiled claim) reduce the amount of the loss.
\$100 floor	Not applicable.	Applicable per event.
Gains and losses	Gains and losses are netted (see detailed discussion in Chapter 14).	Personal casualty and theft gains and losses are netted.
Gains exceeding losses		The gains and losses are treated as gains and losses from the sale of capital assets.
Losses exceeding gains		The gains—and the losses to the extent of gains—are treated as ordinary items in computing AGI. The losses in excess of gains, to the extent they exceed 10% of AGI, are itemized deductions.

Expenses in connection with the acquisition or improvement of land or depreciable property are not research and experimental expenditures. Rather, they increase the basis of the land or depreciable property. However, depreciation on a building used for research may be a research and experimental expense. Only the depreciation that is a research and experimental expense (not the cost of the asset) is subject to the three alternatives discussed below.

The law permits the following *three alternatives* for the handling of research and experimental expenditures:

- Expensed in the year paid or incurred.
- Deferred and amortized.
- Capitalized.

If the costs are capitalized, a deduction is not available until the research project is abandoned or is deemed worthless. Because many products resulting from research projects do not have a definite and limited useful life, a taxpayer should ordinarily opt to write off the expenditures immediately or to defer and amortize them. It is generally preferable to elect an immediate write-off of the research expenditures because of the time value of the tax deduction.

The law also provides a credit for increasing research expenses over what the expense amount was in a base year or years. Two different formulas are available for computing the credit.²⁹

7-4a Expense Method

A taxpayer can expense all of the research and experimental expenditures incurred in the current year and all subsequent years. The consent of the IRS is not required if the method is adopted for the first taxable year in which such expenditures were paid or incurred. Once this method is adopted, the taxpayer must continue to expense all qualifying expenditures unless a request for a change is made to, and approved by, the IRS.

²⁹§ 41. See Chapter 12 for a more detailed discussion. Congress is expected to extend this credit, which expired on December 31, 2014.

In certain instances, a taxpayer may incur research and experimental expenditures before actually engaging in any trade or business activity. In such instances, the Supreme Court has applied the liberal standard of deductibility crafted by Congress in § 174 and permitted a deduction in the year of incurrence.³⁰

7-4b Deferral and Amortization Method

Alternatively, research and experimental expenditures may be deferred and amortized if the taxpayer makes an election.³¹ Under the election, research and experimental expenditures are amortized ratably over a period of not less than 60 months. A deduction is allowed beginning with the month in which the taxpayer first realizes benefits from the experimental expenditure. The election is binding, and a change requires permission from the IRS.

EXAMPLE

23

Gold Corporation decides to develop a new line of adhesives. The project begins in 2015. Gold incurs the following expenses in 2015 and 2016 in connection with the project:

	2015	2016
Salaries	\$25,000	\$18,000
Materials	8,000	2,000
Depreciation on machinery	6,500	5,700

The benefits from the project will be realized starting in March 2017. If Gold Corporation elects a 60-month deferral and amortization period, there is no deduction prior to March 2017, the month benefits from the project begin to be realized. The deduction for 2017 is \$10,867, computed as follows:

Salaries (\$25,000 + \$18,000)	\$43,000
Materials (\$8,000 + \$2,000)	10,000
Depreciation (\$6,500 + \$5,700)	12,200
Total	<u>\$65,200</u>
$\$65,200 \times (10 \text{ months}/60 \text{ months}) =$	<u>\$10,867</u>

The option to treat research and experimental expenditures as deferred expense is usually employed when a company does not have sufficient income to offset the research and experimental expenses. Rather than create net operating loss carryovers that might not be utilized because of the 20-year limitation on such carryovers, the deferral and amortization method may be used.³² The deferral of research and experimental expenditures should also be considered if the taxpayer expects higher tax rates in the future.

LO.6

Calculate the domestic production activities deduction.

7-5 DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

A number of years ago, Congress enacted changes to a variety of tax provisions that our world trading partners regarded as allowing unfair advantage to U.S. exports. Among other changes, Congress created a deduction based on the income from manufacturing activities (designated as *production activities*).³³ The **domestic production activities deduction (DPAD)** is contained in § 199. Form 8903 is used to report the calculation of the domestic production activities deduction.

³⁰*Snow v. Comm.*, 74-1 USTC ¶9432, 33 AFTR 2d 74-1251, 94 S.Ct. 1876 (USSC, 1974).

³¹§ 174(b)(2).

³²Another option is to deduct these expenses for regular tax purposes, but elect in any year where helpful, to capitalize and amortize the expenses

over 10 years for both regular tax and alternative minimum tax purposes [§ 59(e)].

³³Section 101 of the *American Jobs Creation Act of 2004*, Public Law No. 108-357 (October 22, 2004).

7-5a **Operational Rules****Calculation of the Domestic Production Activities Deduction**

The DPAD is based on the following formula:³⁴

$$9\% \times \text{Lesser of} \begin{cases} \text{Qualified production activities income (QPAI)} \\ \text{Taxable (or modified adjusted gross) income} \\ \text{or alternative minimum taxable income} \end{cases}$$

Taxable income is determined without regard to the DPAD. In the case of an individual (a sole proprietorship or an owner of a flow-through entity), **modified adjusted gross income** is substituted for taxable income.³⁵

The taxable income limitation is determined after the application of any net operating loss (NOL) deduction for the tax year (NOLs are explained in detail later in the chapter). Thus, a company with an NOL carryforward for a tax year is ineligible for the DPAD if the carryforward eliminates current taxable income. Further, a taxpayer that has an NOL carryback may lose part or all of the DPAD benefit for that year. As taxable income is reduced by the NOL carryback, there is a corresponding reduction in the DPAD. If qualified production activities income (QPAI) cannot be used in a particular year due to the taxable income limitation (see the preceding formula), it is lost forever. (The calculation of QPAI is explained in the next section.)

DPAD: Calculation Using QPAI

Opal, Inc., manufactures and sells costume jewelry. It also sells costume jewelry purchased from other manufacturers. During 2015, Opal had a *profit* of \$200,000 (QPAI) from the sale of its own manufactured jewelry and a *loss* of \$50,000 from the sale of the purchased jewelry.

Based on this information, Opal's QPAI is \$200,000 and its taxable income is \$150,000 (\$200,000 – \$50,000). Opal's DPAD becomes \$13,500 [9% of the lesser of \$200,000 (QPAI) or \$150,000 (taxable income)].

EXAMPLE**24**

Assume the same facts as in Example 24, except that Opal also has an NOL carryover from 2014 of \$300,000.

As taxable income for 2015 is zero (\$200,000 – \$50,000 – \$300,000), there is no DPAD.

EXAMPLE**25**

Another important limitation is that the amount of the DPAD cannot exceed 50 percent of certain **W-2 wages** paid by the taxpayer during the tax year.³⁶ If no W-2 wages are paid, no DPAD will be allowed. So part of the rationale behind this limitation is to preserve U.S. manufacturing jobs and to discourage their outsourcing. An employer's W-2 wages include the sum of the aggregate amount of wages and elective deferrals required to be included on the W-2 wage statements for certain employees during the employer's taxable year. Elective deferrals include those amounts deferred under § 457 plans and Roth contributions. An employer previously included wages paid to all workers during a tax year and not just the wages of the employees engaged in qualified production activities. However, as a result of a recent statutory change, an employer is permitted to include only those W-2 wages paid to employees engaged in qualified production activities.

³⁴§ 199(a). For tax years beginning in 2005 or 2006, the 9% rate was 3%. For tax years beginning in 2007, 2008, and 2009, the 9% rate was 6%.

³⁶§ 199(b).

³⁵§ 199(d)(2). Generally, modified AGI is AGI prior to the effect of § 199.

DPAD: W-2 Limitation

EXAMPLE

26

In 2015, Red, Inc., a calendar year taxpayer, has QPAI of \$2 million and taxable income of \$2.1 million. Because Red outsources much of its work to independent contractors, its W-2 wage base, which for Red is related entirely to production activities, is \$80,000.

Although Red's DPAD normally would be \$180,000 [9% of the lesser of \$2 million (QPAI) or \$2.1 million (taxable income)], it is limited to \$40,000 [50% of \$80,000 (W-2 wages)].

EXAMPLE

27

Assume the same facts as in Example 26, except that Red also pays salaries of \$50,000 related to its *nonproduction* activities. Because these wages are not paid to employees engaged in production activities, the wage limitation on the DPAD remains at \$40,000 [50% of \$80,000 (\$80,000 + \$0)].

Calculation of Qualified Production Activities Income

Qualified production activities income (QPAI) is the excess of **domestic production gross receipts (DPGR)** over the sum of:

- The cost of goods sold allocated to such receipts.
- Other deductions, expenses, or losses directly allocated to such receipts.
- The ratable portion of deductions, expenses, and losses not directly allocable to such receipts or another class of income.³⁷

QPAI is determined on an item-by-item basis—not on a division-by-division or a transaction-by-transaction basis. Because all items must be netted in the calculation, the final QPAI amount can be either positive or negative. The effect of the netting rule is to preclude taxpayers from selecting only profitable product lines or profitable transactions when calculating QPAI.

EXAMPLE

28

A taxpayer manufactures pants and shirts with the following QPAI results: \$5 for one pair of pants and a negative \$2 for one shirt. Because the two items are netted, the QPAI amount that controls is \$3 (\$5 – \$2).

Five specific categories of DPGR qualify for the DPAD:³⁸

- The lease, license, sale, exchange, or other disposition of qualified production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) in the United States.
- Qualified films largely created in the United States.
- The production of electricity, natural gas, or potable water.
- Construction (but not self-construction) performed in the United States.
- Engineering and architectural services for domestic construction.

The sale of food and beverages prepared by a taxpayer at a retail establishment and the transmission or distribution of electricity, natural gas, or potable water are specifically excluded from the definition of DPGR.

7-5b Eligible Taxpayers

The deduction is available to a variety of taxpayers, including individuals, partnerships, S corporations, C corporations, cooperatives, estates, and trusts. For a pass-through entity (e.g., partnerships and S corporations), the deduction flows through to the individual owners. In the case of a sole proprietor, a deduction *for* AGI results and is claimed on Form 1040, line 35 on page 1. A Form 8903 must be attached to support the deduction.

³⁷§ 199(c).

³⁸§ 199(c)(4).

In practice, the DPAD calculation is challenging (and complicated by numerous rules and definitions contained in the Code and Regulations). For additional information on the DPAD, see Chapters 17, 21, and 22.

7-6 NET OPERATING LOSSES

The requirement that every taxpayer file an annual income tax return (whether on a calendar year or a fiscal year) may result in certain inequities for taxpayers who experience cyclical patterns of income or expense. Inequities result from the application of a progressive rate structure to taxable income determined on an annual basis. A **net operating loss (NOL)** in a particular tax year would produce no tax benefit if the Code did not provide for the carryback and carryforward of such losses to profitable years.

LO.7

Describe the tax impact of a net operating loss and review the effect of the carryback and carryover provisions on previous and subsequent years' taxable income.

Juanita has a business and realizes the following taxable income or loss over a five-year period: year 1, \$50,000; year 2, (\$30,000); year 3, \$100,000; year 4, (\$200,000); and year 5, \$380,000. She is married and files a joint return. Hubert also has a business and has a taxable income pattern of \$60,000 every year. He, too, is married and files a joint return. Note that both Juanita and Hubert have total taxable income of \$300,000 over the five-year period. Assume that there is no provision for carryback or carryover of NOLs. Juanita and Hubert would have the following five-year tax bills:

EXAMPLE

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Year	Juanita's Tax	Hubert's Tax
1	\$ 6,578	\$ 8,078
2	–0–	8,078
3	16,588	8,078
4	–0–	8,078
5	100,929	8,078
	<u>\$124,095</u>	<u>\$40,390</u>

Note: The computation of tax is made without regard to any NOL benefit. Rates applicable to 2015 (ignoring the additional 3.8% Medicare tax) are used to compute the tax.

Even though Juanita and Hubert realized the same total taxable income (\$300,000) over the five-year period, Juanita had to pay taxes of \$124,095, while Hubert paid taxes of only \$40,390.

To provide partial relief from this inequitable tax treatment, a deduction is allowed for NOLs.³⁹ This provision permits NOLs for any one year to be offset against taxable income of other years. The NOL provision is intended as a form of relief for business income and losses. Thus, only losses from the operation of a trade or business (or profession), casualty and theft losses, or losses from the confiscation of a business by a foreign government can create an NOL. In other words, a salaried individual with itemized deductions and personal exemptions in excess of gross income is not permitted to deduct the excess amounts as an NOL. On the other hand, a personal casualty loss is treated as a business loss and can therefore create (or increase) an NOL for an individual.

7-6a Carryback and Carryover Periods

General Rules

An NOL generally must be applied initially to the two taxable years preceding the year of the loss (unless an election is made not to carry the loss back at all). It is carried first to the second prior year and then to the immediately preceding tax year (or until used up). If the loss is not fully used in the carryback period, it must be carried forward to the first year after the loss year and then forward to the second, third, etc., year after the

³⁹§ 172.

loss year. The carryover (i.e., carryforward) period is 20 years. A loss sustained in 2015 is used in this order: 2013, 2014, 2016 through 2035.

A three-year carryback period is available for any portion of an individual's NOL resulting from a casualty or theft loss. The three-year carryback rule also applies to NOLs that are attributable to presidentially declared disasters that are incurred by a small business. A small business is a business whose average annual gross receipts for a three-year period are \$5 million or less.

A 5-year carryback period and a 20-year carryover period are allowed for a farming loss. A taxpayer may elect to waive the special five-year carryback period. If this election is made, the general two-year carryback period applies. A farming loss is the amount of the NOL for the taxable year if only income and deductions attributable to the farming business are taken into account. However, the amount of the farming loss cannot exceed the amount of the taxpayer's NOL for the taxable year. To determine the amount of the carryback and carryover, a farming loss for any taxable year is treated as a separate NOL for such year and applied after the remaining portion of the NOL for the year is taken into account.

EXAMPLE

30

For 2015, the taxpayer and spouse have an NOL of \$50,000. The \$50,000 NOL includes a \$40,000 loss that is attributable to a farming business.

Only the \$40,000 loss attributable to the farming business can be carried back five years. The loss not attributable to the farming business can be carried back only two years.

If the loss is being carried to a preceding year, an amended return is filed on Form 1040X or a quick refund claim is filed on Form 1045. In either case, a refund of taxes previously paid is requested. Form 1045 is an application for a tentative refund. The IRS normally will process Form 1045 and pay the refund within 90 days of the date it is filed. When the loss is carried forward, the current return shows an NOL deduction for the prior year's loss.

ETHICS & EQUITY Using NOLs in the Computation of Self-Employment Taxes

John has a net operating loss on his Federal income tax return for the year 2015. John has self-employment income and taxable income for the year 2013. John paid his tax liability for 2013 that included self-employment tax on his

self-employment income. John is considering carrying the NOL back to 2013 and reducing his income tax and self-employment tax. Evaluate John's plan.

Election to Forgo Carryback

A taxpayer can *irrevocably elect* not to carry back an NOL to any of the prior years. This election must be made by the due date (including extensions) for filing the taxpayer's return for the year in which the NOL occurred.⁴⁰ In that case, the loss is available as a carryover for 20 years. The election should be made if it is to the taxpayer's tax advantage. For example, a taxpayer might be in a low marginal tax bracket in the carryback years but expect to be in a high marginal tax bracket in future years. Therefore, it would be to the taxpayer's advantage to use the NOL to offset income in years when the tax rate is high rather than use it when the tax rate is relatively low.

⁴⁰§ 172(b)(3).

For 2015, taxpayer and spouse have an NOL of \$10,000. The NOL may be carried back and applied against taxable income first in 2013 and then in 2014. Any remaining NOL is carried forward to 2016 through 2035. If, however, the taxpayer and spouse elect to forgo the carryback period, the NOL initially is carried to 2016 and forward through 2035, until it's completely applied. The couple must maintain a record that notes when the NOL arose and how much is used in each year to ensure proper usage of the NOL carryover.

EXAMPLE

31

7-7 TAX PLANNING**7-7a Worthless Securities**

To be deductible, a security must be completely worthless. To obtain the deduction, the taxpayer must prove that the security was not worthless in a prior year and that the security was worthless in the year claimed. Because of the subjectivity associated with this burden of proof, the only safe practice is to claim a loss for the earliest year when it may be allowed and to renew the claim in subsequent years if there is any reasonable chance that it will be applicable to the income for those years.⁴¹ Fortunately, the statute of limitations for worthless securities is seven years.⁴²

LO.8

Identify tax planning opportunities in deducting certain business expenses, business losses, and personal losses.

7-7b Small Business Stock (§ 1244)

Because § 1244 limits the amount of loss classified as ordinary loss on a yearly basis, a taxpayer might maximize the benefits of § 1244 by selling the stock in more than one taxable year. The result could be that the losses in any one taxable year would not exceed the § 1244 limits on ordinary loss.

Mitch, a single individual, purchased small business stock in 2013 for \$150,000 (150 shares at \$1,000 per share). On December 20, 2015, the stock is worth \$60,000 (150 shares at \$400 per share). Mitch wants to sell the stock at this time. Mitch earns a salary of \$80,000 a year, has no other capital transactions, and does not expect any in the future.

EXAMPLE

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If Mitch sells all of the small business stock in 2015, his recognized loss will be \$90,000 (\$60,000 – \$150,000). The loss will be characterized as a \$50,000 ordinary loss and a \$40,000 long-term capital loss. In computing taxable income for 2015, Mitch could deduct the \$50,000 ordinary loss but could deduct only \$3,000 of the capital loss. The remainder of the capital loss could be carried over and used in future years subject to the \$3,000 limitation if Mitch has no capital gains.

If Mitch sells 82 shares in 2015, he will recognize an ordinary loss of \$49,200 [$82 \times (\$1,000 - \$400)$]. If Mitch then sells the remainder of the shares in 2016, he will recognize an ordinary loss of \$40,800 [$68 \times (\$1,000 - \$400)$]. Mitch could deduct the \$49,200 ordinary loss in computing 2015 taxable income and the \$40,800 ordinary loss in computing 2016 taxable income.

7-7c Casualty Losses

A special election is available for taxpayers who sustain casualty losses in an area designated by the President as a disaster area. This election affects only the *timing*, not the calculation, of the deduction. The deduction can be taken in the year before the year in which the loss occurred. Thus, for a loss occurring between January 1 and December 31, 2015, an individual can take the deduction on the 2014 return. The benefit, of course, is a faster refund (or reduction in tax). It will also be advantageous to carry the loss back if the taxpayer's tax rate in the carryback year is higher than the tax rate in the year of the loss.

To find out if an event qualifies as a disaster area loss, one can look in any of the major tax services, the Weekly Compilation of Presidential Documents, or the *Internal Revenue Bulletin*.

⁴¹*Young v. Comm.*, 41-2 USTC ¶9744, 28 AFTR 365, 123 F.2d 597 (CA-2, 1941).

⁴²§ 6511(d)(1).



TAX IN THE NEWS When Is a Security Worthless?

Usually, losses that have not been documented by the marketplace cannot be deducted (i.e., unrealized losses). An exception exists for securities that are completely worthless. But proving complete worthlessness can sometimes be difficult. Just because a company declares bankruptcy does not necessarily prove that its stock is completely worthless because in some cases the

stock can recover. Determining whether this can happen requires an analysis of the relevant facts and circumstances. Even though a stock may be selling for a fraction of a penny (i.e., it has some value), some tax advisers argue that if the stock's selling price would be less than the broker's commission for selling the stock, a deduction can be taken at that time.

7-7d Net Operating Losses

In certain instances, it may be advisable for a taxpayer to elect not to carry back an NOL. For an individual, the benefits from the loss carryback could be scaled down or lost due to the economic adjustments that must be made to taxable income for the year to which the loss is carried. For example, a taxpayer should attempt to minimize the number of taxable years to which an NOL is carried. The more years to which the NOL is applied, the more benefits are lost from adjustments for items such as personal and dependency exemptions.

The election not to carry back the loss might also be advantageous if there is a disparity in marginal tax rates applicable to different tax years.

EXAMPLE

33

Abby sustained an NOL of \$10,000 in year 3. Her marginal tax bracket in year 1 was 15%. In year 4, however, she expects her bracket to be 35% due to a large profit she will make on a business deal.

If Abby carries her loss back, her refund will be \$1,500 ($15\% \times \$10,000$). If she elects not to carry it back to year 1 but chooses, instead, to carry it forward, her savings will be \$3,500 ($35\% \times \$10,000$). Even considering the time value of an immediate tax refund, Abby appears to be better off using the carryover approach.

REFOCUS ON THE BIG PICTURE

LOSSES



Martha can receive tax benefits associated with her unfortunate occurrences during the current tax year. Some of the losses, however, will provide a greater tax benefit than others as a result of different tax provisions governing the amount and the classification of the losses.

Bad Debt

Based on the facts provided, it appears that Martha's loan to her friend was a bona fide debt. Otherwise, nothing would be deductible. The amount of the deduction is the unpaid principal balance of \$19,000 ($\$25,000 - \$6,000$). Unfortunately, because the bad debt is a nonbusiness bad debt, it is classified as a short-term capital loss (see Example 5).

Investment Losses

The \$50,000 loss is deductible. However, it appears that the loss should be classified as a long-term capital loss rather than as a short-term capital loss. Although the actual holding period was not greater than one year (October through May), the disposal

continued

date for the stock (qualifies as a worthless security) is deemed to be the last day of the tax year (October of last year through end of December of the current year). The loss does not appear to qualify for ordinary loss treatment under § 1244 (see Example 8). The stock she purchased from her friend results in an \$8,000 short-term capital loss (and does not qualify under § 1244; see Example 10).

Loss from Bookstore

The \$180,000 loss from the bookstore is reported on Schedule C of Form 1040. It is an ordinary loss, and it qualifies for NOL treatment. Therefore, Martha can carry any net loss back and offset it against taxable income of the past two years (starting with the earliest carryback year). Any amount not offset by carrying the loss back to the two previous taxable years can be carried forward for the next 20 years. Any carryback will produce a claim for a tax refund.

Casualty Loss

The loss on the damage to Martha's personal residence is classified as a personal casualty loss. Using the cost of repairs method, the amount of the casualty loss is \$7,000 (\$32,000 – \$25,000). However, this amount must be reduced by the statutory materiality amounts of \$100 and 10 percent of AGI.

If the President classified the area in which Martha's house is located as a disaster area, Martha has the option of deducting the casualty loss on the prior year's tax return (see Example 15).

Key Terms

Bad debt, 7-2	Modified adjusted gross income, 7-17	Research and experimental expenditures, 7-14
Business bad debt, 7-5	Net operating loss (NOL), 7-19	Reserve method, 7-3
Casualty loss, 7-8	Nonbusiness bad debt, 7-4	Small business stock (§ 1244 stock), 7-7
Disaster area losses, 7-9	Personal casualty gain, 7-13	Specific charge-off method, 7-3
Domestic production activities deduction (DPAD), 7-16	Personal casualty loss, 7-13	Theft losses, 7-8
Domestic production gross receipts (DPGR), 7-18	Qualified production activities income (QPAI), 7-18	W-2 wages, 7-17
		Worthless securities, 7-5

Discussion Questions

- LO.1** Explain how an account receivable can give rise to a bad debt deduction.
- LO.1** Ron, a cash basis taxpayer, sells his business accounts receivable of \$100,000 to Mike for \$70,000 (70% of the actual accounts receivable). Discuss the amount and classification of Ron's bad debt deduction.
- LO.1** Discuss when a bad debt deduction can be taken for a nonbusiness debt.
- LO.1** Discuss the treatment of a business bad debt when the business also has long-term capital gains.
- LO.1** Many years ago, Jack purchased 400 shares of Canary stock. During the current year, the stock became worthless. It was determined that the company "went under" because several corporate officers embezzled a large amount of company funds. Identify the relevant tax issues for Jack.

Issue ID

6. **LO.2** Sean is in the business of buying and selling stocks and bonds. He has a bond of Green Corporation for which he paid \$200,000. The bond is currently worth only \$50,000. Discuss whether Sean can take a \$150,000 loss for a business bad debt or for a worthless security.
7. **LO.2** Discuss the tax treatment of the sale of § 1244 stock at a gain.
8. **LO.3, 4** Jim discovers that his residence has extensive termite damage. Discuss whether he may take a deduction for the damage to his residence.
9. **LO.3, 4** The value of Mary's personal residence has declined significantly because of a recent forest fire in the area where she lives. Mary's house suffered no actual damage during the fire, but because much of the surrounding area was destroyed, the value of all of the homes in the area declined substantially. Discuss whether Mary can take a casualty loss for the decline in value of her residence caused by the fire.
10. **LO.4** Discuss at what point in time a theft loss generally is recognized.
11. **LO.4** Discuss the circumstances under which the cost of repairs to the damaged property can be used to measure the amount of a casualty loss.
12. **LO.4** Hazel sustained a loss on the theft of a painting. She had paid \$20,000 for the painting, but it was worth \$40,000 at the time of the theft. Evaluate the tax consequences of treating the painting as investment property or as personal use property.
- Issue ID** 13. **LO.4** Kelly decided to invest in Lime, Inc. common stock after reviewing Lime's public disclosures, including recent financial statements and a number of press releases issued by Lime. On August 7, 2013, Kelly purchased 60,000 shares of Lime for \$210,000. In May 2014, Lime entered into a joint venture with Cherry, Inc. In November 2014, the joint venture failed, and Lime's stock began to decline in value. In December 2014, Cherry filed a lawsuit against Lime for theft of corporate opportunity and breach of fiduciary responsibility. In February 2015, Lime filed a countersuit against Cherry for fraud and misappropriation of funds. At the end of December 2015, Kelly's stock in Lime was worth \$15,000. Identify the relevant tax issues for Kelly.
- Issue ID** 14. **LO.3, 4** In 2012, John opened an investment account with Randy Hansen, who held himself out to the public as an investment adviser and securities broker. John contributed \$200,000 to the account in 2012. John provided Randy with a power of attorney to use the \$200,000 to purchase and sell securities on John's behalf. John instructed Randy to reinvest any gains and income earned. In 2012, 2013, and 2014, John received statements of the amount of income earned by his account and included these amounts in his gross income for these years. In 2015, it was discovered that Randy's purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a Ponzi scheme. In reality, John's account balance was zero, the money having been used by Randy in his scheme. Identify the relevant tax issues for John.
15. **LO.5** Discuss under what circumstances a company would elect to amortize research and experimental expenditures rather than use the expense method.
- Issue ID** 16. **LO.6** Amos began a business, Silver, Inc., on July 1, 2012. The business extracts and processes silver ore. During 2015, Amos becomes aware of the domestic production activities deduction (DPAD) and would like to take advantage of this deduction. Identify the relevant tax issues for Silver, Inc.
17. **LO.6** The DPAD is unlike other deductions and is designed to provide a tax benefit in a somewhat unique manner. Explain this statement.
18. **LO.7** Discuss whether deductions *for* AGI can be treated as nonbusiness deductions in computing an individual's NOL.

Computational Exercises

19. **LO.1** During the past tax year, Jane identified \$50,000 as a nonbusiness bad debt. In that tax year, Jane had \$100,000 of taxable income, of which \$5,000 consisted of short-term capital gains. During the current tax year, Jane collected \$10,000 of the amount she had previously identified as a bad debt. Determine Jane's tax treatment of the \$10,000 received in the current tax year.
20. **LO.1** Bob owns a collection agency. He purchases uncollected accounts receivable from other businesses at 60% of their face value and then attempts to collect these accounts. During the current year, Bob collected \$60,000 on an account with a face value of \$80,000. Determine the amount of Bob's bad debt deduction.
21. **LO.2** On May 9, 2013, Calvin acquired 250 shares of stock in Aero Corporation, a new startup company, for \$68,750. Calvin acquired the stock directly from Aero, and it is classified as § 1244 stock (at the time Calvin acquired his stock, the corporation had \$900,000 of paid-in capital). On January 15, 2015, Calvin sold all of his Aero stock for \$7,000. Assuming that Calvin is single, determine his tax consequences as a result of this sale.
22. **LO.4** Mary's diamond ring was stolen in 2014. She originally paid \$8,000 for the ring, but it was worth considerably more at the time of the theft. Mary filed an insurance claim for the stolen ring, but the claim was denied. Because the insurance claim was denied, Mary took a casualty loss for the stolen ring on her 2014 tax return. In 2014, Mary had AGI of \$40,000. In 2015, the insurance company had a "change of heart" and sent Mary a check for \$5,000 for the stolen ring. Determine the proper tax treatment of the \$5,000 Mary received from the insurance company in 2015.
23. **LO.4** Determine the treatment of a loss on rental property under the following facts:

Basis	\$650,000
FMV before the loss	800,000
FMV after the loss	200,000

24. **LO.4** Belinda was involved in a boating accident in 2015. Her speedboat, which was used only for personal use and had a fair market value of \$28,000 and an adjusted basis of \$14,000, was completely destroyed. She received \$10,000 from her insurance company. Her AGI for 2015 is \$37,000. What is Belinda's casualty loss deduction (after any limitations)?
25. **LO.4** During the year, Tucker had the following personal casualty gains and losses (after deducting the \$100 floor):

Asset	Holding Period	Gain or (Loss)
Asset 1	18 months	(\$1,200)
Asset 2	2 months	750
Asset 3	3 years	1,500

What are the tax consequences of these items to Tucker?

26. **LO.5** Sandstorm Corporation decides to develop a new line of paints. The project begins in 2015. Sandstorm incurs the following expenses in 2015 in connection with the project:

Salaries	\$85,000
Materials	30,000
Depreciation on equipment	12,500

The benefits from the project will be realized starting in July 2016. If Sandstorm Corporation chooses to defer and amortize its research and experimental expenditures over a period of 60 months, what are its related deductions in 2015 and 2016?

27. **LO.6** In 2015, Loftis, Inc., a calendar year taxpayer, has QPAI of \$4.5 million and taxable income of \$3.1 million. Because Loftis outsources much of its work to independent contractors, its W-2 wage base, which for Loftis is related entirely to production activities, is \$214,000. What is Loftis, Inc.'s DPAD for 2015?

Problems

- Communications** 28. **LO.1** Several years ago, John Johnson, who is in the lending business, loaned Sara \$30,000 to purchase an automobile to be used for personal purposes. In August of the current year, Sara filed for bankruptcy, and John was notified that he could not expect to receive more than \$4,000. As of the end of the current year, John has received \$1,000. John has contacted you about the possibility of taking a bad debt deduction for the current year.

Write a letter to John that contains your advice as to whether he can claim a bad debt deduction for the current year. Also prepare a memo for the tax files. John's address is 100 Tyler Lane, Erie, PA 16563.

29. **LO.1** Monty loaned his friend Ned \$20,000 three years ago. Ned signed a note and made payments on the loan. Last year, when the remaining balance was \$11,000, Ned filed for bankruptcy and notified Monty that he would be unable to pay the balance on the loan. Monty treated the \$11,000 as a nonbusiness bad debt. Last year, Monty had capital gains of \$4,000 and taxable income of \$20,000. During the current year, Ned paid Monty \$10,000 in satisfaction of the debt. Determine Monty's tax treatment for the \$10,000 received in the current year.
30. **LO.1** Sally is in the business of purchasing accounts receivable. Last year, Sally purchased an account receivable with a face value of \$80,000 for \$60,000. During the current year, Sally settled the account, receiving \$65,000. Determine the maximum amount of the bad debt deduction for Sally for the current year.
31. **LO.1, 2** Mable and Jack file a joint return. For the current year, they had the following items:

Salaries	\$120,000
Loss on sale of § 1244 stock acquired two years ago	105,000
Gain on sale of § 1244 stock acquired six months ago	20,000
Nonbusiness bad debt	19,000

Determine their AGI for the current year.

- Decision Making** 32. **LO.2, 8** Mary, a single taxpayer, purchased 10,000 shares of § 1244 stock several years ago at a cost of \$20 per share. In November of the current year, Mary received an offer to sell the stock for \$12 per share. She has the option of either selling all of the stock now or selling half of the stock now and half of the stock in January of next year. Mary will receive a salary of \$80,000 for the current year and \$90,000 next year. Mary will have long-term capital gains of \$8,000 for the current year and \$10,000 next year. If Mary's goal is to minimize her AGI for the two years, determine whether she should sell all of her stock this year or half of her stock this year and half next year.

33. **LO.4** During 2015, someone broke into Jacob's personal residence and took the following items:

Asset	Adjusted Basis	FMV before	FMV after	Insurance Recovery
Business computer	\$12,000	\$10,000	–0–	\$ 7,000
Bearer bonds	30,000	25,000	–0–	–0–
Silverware	7,000	20,000	–0–	18,000
Cash	8,000	8,000	–0–	–0–

Jacob is an employee and used the computer 100% of the time in his employment. Although his homeowner's insurance policy paid Jacob \$7,000 for the stolen computer, Jacob's employer did not reimburse Jacob for any of the remainder of his loss. Jacob's AGI for the year, before considering any of the above items, is \$50,000. Determine the total deduction for the stolen items on Jacob's 2015 tax return.

34. **LO.3, 4, 8** Olaf lives in the state of Minnesota. A tornado hit the area and damaged his home and automobile. Applicable information is as follows:

Decision Making

Item	Adjusted Basis	FMV before	FMV after	Insurance Proceeds
Home	\$350,000	\$500,000	\$100,000	\$280,000
Auto	60,000	40,000	10,000	20,000

Because of the extensive damage caused by the tornado, the President designated the area a disaster area.

Olaf and his wife, Anna, always file a joint return. Their 2014 tax return shows AGI of \$180,000 and taxable income of \$140,000. In 2015, their return shows AGI of \$300,000 and taxable income (exclusive of the casualty loss deduction) of \$215,000.

Determine the amount of Olaf and Anna's loss and the year in which they should take the loss.

35. **LO.3, 4** Heather owns a two-story building. The building is used 40% for business use and 60% for personal use. During 2015, a fire caused major damage to the building and its contents. Heather purchased the building for \$800,000 and has taken depreciation of \$100,000 on the business portion. At the time of the fire, the building had a fair market value of \$900,000. Immediately after the fire, the fair market value was \$200,000. The insurance recovery on the building was \$600,000. The contents of the building were insured for any loss at fair market value. The business assets had an adjusted basis of \$220,000 and a fair market value of \$175,000. These assets were totally destroyed. The personal use assets had an adjusted basis of \$50,000 and a fair market value of \$65,000. These assets were also totally destroyed. If Heather's AGI is \$100,000 before considering the effects of the fire, determine her itemized deduction as a result of the fire. Also determine Heather's AGI.

36. **LO.3, 4** On July 24 of the current year, Sam Smith was involved in an accident with his business use automobile. Sam had purchased the car for \$30,000. The automobile had a fair market value of \$20,000 before the accident and \$8,000 immediately after the accident. Sam has taken \$20,000 of depreciation on the car. The car is insured for the fair market value of any loss. Because of Sam's history, he is afraid that if he submits a claim, his policy will be canceled. Therefore, he is considering not filing a claim. Sam believes that the tax loss deduction will help mitigate the loss of the insurance reimbursement. Sam's current marginal tax rate is 35%.

Decision Making
Communications

Write a letter to Sam that contains your advice with respect to the tax and cash-flow consequences of filing versus not filing a claim for the insurance reimbursement for the damage to his car. Also prepare a memo for the tax files. Sam's address is 450 Colonel's Way, Warrensburg, MO 64093.

37. **LO.5** Blue Corporation, a manufacturing company, decided to develop a new line of merchandise. The project began in 2015. Blue had the following expenses in connection with the project:

	2015	2016
Salaries	\$500,000	\$600,000
Materials	90,000	70,000
Insurance	8,000	11,000
Utilities	6,000	8,000
Cost of inspection of materials for quality control	7,000	6,000
Promotion expenses	11,000	18,000
Advertising	-0-	20,000
Equipment depreciation	15,000	14,000
Cost of market survey	8,000	-0-

The new product will be introduced for sale beginning in July 2017. Determine the amount of the deduction for research and experimental expenditures for 2015, 2016, and 2017 if:

- Blue Corporation elects to expense the research and experimental expenditures.
 - Blue Corporation elects to amortize the research and experimental expenditures over 60 months.
38. **LO.6** Sarah Ham, operating as a sole proprietor, manufactures printers in the United States. For 2015, the proprietorship has QPAI of \$400,000. Sarah's modified AGI was \$350,000. The W-2 wages paid by the proprietorship to employees engaged in the qualified domestic production activity were \$60,000. Calculate Sarah's DPAD for 2015.
39. **LO.6** Barbara, a calendar year taxpayer, owns and operates a company that manufactures toys. For 2015, she has modified AGI of \$500,000 and QPAI of \$550,000. Ignoring the W-2 wage limitation, calculate Barbara's DPAD.
40. **LO.6** Red Corporation manufactures hand tools in the United States. For the current year, the QPAI derived from the manufacture of hand tools was \$1 million. Red's taxable income for the current year was \$2.0 million. Last year, Red had an NOL of \$800,000, which Red elected to carry forward. Calculate Red's DPAD for the current year.
41. **LO.6** Green Corporation manufactures skirts and blouses in the United States. The DPGR derived from the manufacture of one skirt is \$12, and the DPGR from one blouse is \$10. The cost of goods sold is \$5 for one skirt and \$6 for one blouse. Other allocated costs are \$1 for one skirt and \$5 for one blouse. What amount of QPAI is available to Green for calculating the DPAD?
- Decision Making** 42. **LO.6** In 2015, Rose, Inc., has QPAI of \$4 million and taxable income of \$3 million. Rose pays independent contractors \$500,000. Rose's W-2 wages are \$600,000, but only \$400,000 of the wages are paid to employees engaged in qualified domestic production activities.
- Calculate the DPAD for Rose, Inc., for 2015.
 - What suggestions could you make to enable Rose to increase its DPAD?
43. **LO.1, 3** Nell, single and age 38, had the following income and expense items in 2015:

Nonbusiness bad debt	\$ 6,000
Business bad debt	2,000
Nonbusiness long-term capital gain	4,000
Nonbusiness short-term capital loss	3,000
Salary	50,000
Interest income	3,000

Determine Nell's AGI for 2015.

44. **LO.1, 4** Assume that in addition to the information in Problem 43, Nell had the following items in 2015:

Personal casualty gain on an asset held for four months	\$10,000
Personal casualty loss on an asset held for two years	1,000

Determine Nell's AGI for 2015.

Cumulative Problems



45. Jane Smith, age 40, is single and has no dependents. She is employed as a legal secretary by Legal Services, Inc. She owns and operates Typing Services located near the campus of Florida Atlantic University at 1986 Campus Drive. Jane is a material participant in the business. She is a cash basis taxpayer. Jane lives at 2020 Oakcrest Road, Boca Raton, FL 33431. Jane's Social Security number is 123-45-6789. Jane indicates that she wants to designate \$3 to the Presidential Election Campaign Fund. Jane had health insurance for all months of 2014. During 2014, Jane had the following income and expense items:

- \$100,000 salary from Legal Services, Inc.
- \$20,000 gross receipts from her typing services business.
- \$700 interest income from Acme National Bank.
- \$1,000 Christmas bonus from Legal Services, Inc.
- \$60,000 life insurance proceeds on the death of her sister.
- \$5,000 check given to her by her wealthy aunt.
- \$100 won in a bingo game.
- Expenses connected with the typing service:

Office rent	\$7,000
Supplies	4,400
Utilities and telephone	4,680
Wages to part-time typists	5,000
Payroll taxes	500
Equipment rentals	3,000

- \$9,500 interest expense on a home mortgage (paid to San Jose Savings and Loan).
- \$15,000 fair market value of silverware stolen from her home by a burglar on October 12, 2014. Jane had paid \$14,000 for the silverware on July 1, 2005. She was reimbursed \$1,500 by her insurance company.
- Jane had loaned \$2,100 to a friend, Joan Jensen, on June 3, 2011. Joan declared bankruptcy on August 14, 2014, and was unable to repay the loan. Assume that the loan is a bona fide debt.
- Legal Services, Inc., withheld Federal income tax of \$16,000 and the appropriate amount of FICA tax from her wages.
- Alimony of \$10,000 received from her former husband, Ted Smith.
- Interest income of \$800 on City of Boca Raton bonds.
- Jane made estimated Federal tax payments of \$1,000.
- Sales taxes from the sales tax table of \$946.
- Property taxes on her residence of \$1,100.
- Charitable contributions of \$2,500.

Tax Return Problem
Decision Making
Communications



- s. In November 2014, Jane was involved in an automobile accident. At the time of the accident, Jane's automobile had an FMV of \$45,000. After the accident, the automobile's FMV was \$38,000. Jane's basis in the car was \$52,000. Jane's car was covered by insurance, but because the policy had a \$5,000 deduction clause, Jane decided not to file a claim for the damage.

Part 1—Tax Computation

Compute Jane Smith's 2014 Federal income tax payable (or refund due). If you use tax forms for your computations, you will need Forms 1040 and 4684 and Schedules A, C, and D. Suggested software: H&R BLOCK Tax Software.

Part 2—Tax Planning

In 2015, Jane plans to continue her job with Legal Services, Inc. Therefore, items a, d, and l will recur in 2015. Jane plans to continue her typing services business (refer to item b) and expects gross receipts of \$26,000. She projects that all business expenses (refer to item h) will increase by 10%, except for office rent, which, under the terms of her lease, will remain the same as in 2014. Items e, f, g, j, k, and s will not recur in 2015. Items c, i, m, n, p, q, and r will be approximately the same as in 2014.

Jane would like you to compute the minimum amount of estimated tax she will have to pay for 2015 so that she will not have to pay any additional tax upon filing her 2015 Federal income tax return. Write a letter to Jane that contains your advice, and prepare a memo for the tax files.

Tax Computation Problem

46. Mason Phillips, age 45, and his wife, Ruth, live at 230 Wood Lane, Salt Lake City, UT 84101. Mason's Social Security number is 111-11-1111. Ruth's Social Security number is 123-45-6789. Mason and Ruth are cash basis taxpayers and had the following items for 2015:

- Salary of \$140,000.
- Bad debt of \$30,000 from uncollected rent.
- Collection of unpaid rent from a prior year of \$6,000.
- Sale of § 1244 stock resulting in a loss of \$105,000. The stock was acquired eight months ago.
- Rental income of \$60,000.
- Rental expenses of \$33,000.
- Casualty loss on rental property of \$10,000.
- Personal casualty loss (from one event) of \$20,000.
- Theft loss of \$5,000 on a computer used 100% associated with their jobs.
- Theft loss of \$8,000 on a painting held for investment.
- Other itemized deductions of \$18,000.
- Federal income tax withheld of \$3,000.

Compute Mason and Ruth's 2015 Federal income tax payable (or refund due).

Research Problems

THOMSON REUTERS

CHECKPOINT[®]

Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint[®] Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. During 2015, John was the chief executive officer and a shareholder of Maze, Inc. He owned 60% of the outstanding stock of Maze. In 2012, John and Maze, as co-borrowers, obtained a \$100,000 loan from United National Bank. This loan was secured by John's personal residence. Although Maze was listed as a co-borrower, John repaid the loan in full in 2015. On Maze's Form 1120 tax returns,

no loans from shareholders were reported. Discuss whether John is entitled to a bad debt deduction for the amount of the payment on the loan.

Partial list of research aids:

U.S. v. Geneser, 405 U.S. 93 (1972).

Dale H. Sundby, T.C.Memo. 2003–204.

Arrigoni v. Comm., 73 T.C. 792 (1980).

Estate of Herbert M. Rapoport, T.C.Memo. 1982–584.

Clifford L. Brody and Barbara J. DeClerk, T.C. Summary Opinion, 2004–149.

Research Problem 2. Mary Marble took out a homeowner’s insurance policy on her residence. One of the policy provisions listed the insured’s duties with respect to a loss. This provision required the policyholder to give notice and required an inventory of damaged personal property within 60 days of the insurance company’s request and to supply proof of loss.

In November of the current year, Mary’s home was damaged by a fire. Shortly after the fire, Mary reported the loss to the insurance company. In December, the insurance company generated a claim report sheet with a claim number and sent Mary a proof of loss form. Mary failed to provide the insurance company with the proof of loss form within the required 60-day period; hence, the insurance company denied Mary’s claim for damages. Discuss whether Mary is entitled to a casualty loss deduction for the damage to her home caused by the fire.

Research Problem 3. Esther owns a large home on the East Coast. Her home is surrounded by large, mature oak trees that significantly increase the value of her home. In August 2014, a hurricane damaged many of the trees surrounding her home. In September 2014, Esther engaged a local arborist to evaluate and treat the trees, but five of the largest trees were seriously weakened by the storm. These trees died from disease in 2015. Esther has ascertained that the amount of the casualty loss from the death of the five trees is \$25,000; however, she is uncertain in which year to deduct this loss. Discuss whether the casualty loss should be deducted in the calculation of Esther’s 2014 or 2015 taxable income.

Partial list of research aids:

Reg. § 1.165–1.

Oregon Mesabi Corporation, 39 B.T.A. 1033 (1939).

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. Find a newspaper article that discusses tax planning for casualty losses when a disaster area designation is made. Does the article convey the pertinent tax rules correctly? Then list all of the locations identified by the President as Federal disaster areas in the last two years.

Research Problem 5. Many states that have corporate income taxes “piggyback” onto the Federal corporate income tax calculation. In other words, these states’ corporate income tax calculations incorporate many of the Federal calculations and deductions to make both compliance and verification of tax liability easier. However, some state legislatures were concerned that the domestic production activities deduction, if allowed for state tax purposes, would result in significant revenue losses. Determine whether states with corporate income taxes allow or disallow the domestic production activities deduction in the calculation of the state’s corporate income tax liability. Be sure to state the sources for your answer.



Internet Activity

Communications

Roger CPA Review Questions

1. Glenn and Mary's house was damaged by a hurricane in 20X4. The fair value of their home before the hurricane was \$150,000. After the hurricane, the fair value of their home was \$125,000. They received \$10,000 from their homeowner's insurance policy. What is their casualty loss deduction for 20X4, if their adjusted gross income was \$40,000?
 - a. \$10,900
 - b. \$11,000
 - c. \$14,900
 - d. \$15,000
2. Hank's home is burglarized on December 22, 20X14. Personal property with a fair market value of \$40,000 and an adjusted basis to Hank of \$25,000 is stolen. Hank paid an independent appraiser \$700 on December 29 to determine the fair market value of the property at the time of the break-in. Hank's homeowner's insurance policy leads him to believe he is entitled to receive \$15,000 in reimbursement for the event, but no settlement has been made with the insurance company by year-end. Hank's AGI in 20X14 is \$30,000. How much may Hank deduct from AGI as a result of these facts on his 20X14 tax return? Assume Hank itemizes and assume there has still been no settlement with the insurance company at the time of filing.
 - a. \$7,000
 - b. \$21,900
 - c. \$6,900
 - d. \$22,000
3. On the night of October 14, 20X14, a hurricane caused serious damage to Paige's personal vehicle and to the roof of her personal residence, a townhome. Just prior to the hurricane, Paige had a \$200,000 basis in her home and a \$12,000 basis in her vehicle, which had a fair market value just prior to the hurricane of \$10,000. The damage to the roof is appraised at \$7,000 and the fair market value of the vehicle immediately after the hurricane is appraised at \$5,000. Paige is uninsured and has a 20X14 AGI of \$40,000. What amount of casualty loss deduction may Paige claim on her 20X14 tax return as a result of the hurricane?
 - a. \$9,800
 - b. \$7,900
 - c. \$9,900
 - d. \$7,800
4. Regarding the tax treatment of a business's research and experimental (R&E) expenditures, which of the following statements is true?
 - a. A common reason for electing tax deferral for such expenses is the expectation of lower tax rates in the future
 - b. Expenses associated with the acquisition of land upon which a purpose-built R&E facility is constructed are considered R&E expenditures for tax purposes
 - c. Companies generally prefer to expense R&E costs immediately, but may elect instead to defer and amortize such costs over a minimum of 60 months
 - d. Companies may elect to immediately expense R&E costs incurred in the first applicable taxable year and all future years through an appropriate filing with the IRS
5. Identify the correct statement below regarding the Domestic Production Activities Deduction (DPAD).
 - a. Qualified Production Activities Income (QPAI) is calculated by applying a percentage to net income from an IRS rate table based on specific criteria
 - b. The DPAD cannot exceed attributable W-2 wages paid
 - c. A sole proprietorship cannot claim the DPAD, but a partnership or an S corporation with more than one shareholder can
 - d. Taxable income for the purposes of calculating or amending the DPAD includes any net operating loss (NOL) deduction, such as an NOL carryforward or NOL carryback

Depreciation, Cost Recovery, Amortization, and Depletion

LEARNING OBJECTIVES: *After completing Chapter 8, you should be able to:*

- LO.1** State the rationale for the cost consumption concept and identify the relevant time periods for depreciation, ACRS, and MACRS.
- LO.2** Determine the amount of cost recovery under MACRS.
- LO.3** Recognize when and how to make the § 179 expensing election, calculate the amount of the deduction, and apply the effect of the election in making the MACRS calculation.
- LO.4** Identify listed property and apply the deduction limitations on listed property and on luxury automobiles.
- LO.5** Determine when and how to use the alternative depreciation system (ADS).
- LO.6** Report cost recovery deductions appropriately.
- LO.7** Identify intangible assets that are eligible for amortization and calculate the amount of the deduction.
- LO.8** Determine the amount of depletion expense, including being able to apply the alternative tax treatments for intangible drilling and development costs.
- LO.9** Identify tax planning opportunities for cost recovery, amortization, and depletion.

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THE BIG PICTURE

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CALCULATING COST RECOVERY DEDUCTIONS

Dr. Cliff Payne purchased and placed in service in his dental practice the following new fixed assets during the current year.

Office furniture and fixtures	\$ 70,000
Computers and peripheral equipment	67,085
Dental equipment	475,000

Using his financial reporting system, he concludes that the depreciation expense on Schedule C of Form 1040 is \$91,298.

Office furniture and fixtures ($\$70,000 \times 14.29\%$)	\$10,003
Computers and peripheral equipment ($\$67,085 \times 20\%$)	13,417
Dental equipment ($\$475,000 \times 14.29\%$)	<u>67,878</u>
	<u>\$91,298</u>

In addition, this year Dr. Payne purchased another personal residence for \$300,000 and converted his original residence to rental property. He also purchased a condo in the prior year for \$170,000 near his office that he is going to rent to a third party.

Has Dr. Payne correctly calculated the depreciation expense for his dental practice? Will he be able to deduct any depreciation expense for his rental properties?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	(x,xxx)
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income	(x,xxx)
<small>FORM 1040 (p. 1)</small>	
12 Business income or (loss). Attach Schedule C or C-EZ . . . . .	.
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions <i>or</i> the standard deduction.....	(x,xxx)
Personal and dependency exemptions	(x,xxx)
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	(xxx)
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

The Internal Revenue Code allows a depreciation, cost recovery, amortization, or depletion deduction based on an asset’s cost. These deductions are applications of the recovery of capital doctrine (discussed in Chapter 4). Cost recovery deductions are based on the premise that the asset acquired (or improvement made) benefits more than one accounting period. Otherwise, the expenditure is deducted in the year incurred.¹

Congress completely overhauled the **depreciation** rules in 1981 by creating the **accelerated cost recovery system (ACRS)**, which shortened depreciable lives and allowed accelerated depreciation methods. In 1986, Congress made substantial modifications to ACRS, which resulted in the **modified accelerated cost recovery system (MACRS)**. Tax professionals use the terms *depreciation* and **cost recovery** interchangeably. Concept Summary 8.1 provides an overview of the various depreciation systems and the time frames involved.

Concept Summary 8.1

Depreciation and Cost Recovery: Relevant Time Periods

System	Date Property Is Placed in Service
Pre-1981 depreciation	Before January 1, 1981, and <i>certain</i> property placed in service after December 31, 1980.
Accelerated cost recovery system (ACRS)	After December 31, 1980, and before January 1, 1987.
Modified accelerated cost recovery system (MACRS)	After December 31, 1986.

¹See Chapter 6 and the discussion of capitalization versus expense.

The statutory changes that have taken place since 1980 have widened the gap that exists between the accounting and tax versions of depreciation. The tax rules that existed prior to 1981 were much more compatible with generally accepted accounting principles.

This chapter focuses on the MACRS rules because they cover more recent property acquisitions (i.e., after 1986).² The ACRS rules and the pre-1981 rules are covered in Appendix G of this text. The chapter concludes with a discussion of the amortization of intangible property and startup expenditures and the depletion of natural resources.

Taxpayers may “write off” (deduct) the cost of certain assets that are used in a trade or business or held for the production of income. A write-off may take the form of depreciation (or cost recovery), depletion, or amortization. Tangible assets, other than natural resources, are *depreciated*. Natural resources, such as oil, gas, coal, and timber, are *depleted*. Intangible assets, such as copyrights and patents, are *amortized*. Generally, no write-off is allowed for an asset that does not have a determinable useful life.

8-1 DEPRECIATION AND COST RECOVERY

8-1a Nature of Property

Property includes both realty (real property) and personalty (personal property). Realty generally includes land and buildings permanently affixed to the land. Personalty is defined as any asset that is not realty.³ Do not confuse personalty (or personal property) with *personal use* property. Personal use property is any property (realty or personalty) that is held for personal use rather than for use in a trade or business or an income-producing activity. Cost recovery deductions are not allowed for personal use assets.

In summary, both realty and personalty can be either business use/income-producing property or personal use property. Examples include:

- A residence (realty that is personal use),
- An office building (realty that is business use),
- A dump truck (personalty that is business use), and
- Common wearing apparel (personalty that is personal use).

It is imperative that this distinction between the *classification* of an asset (realty or personalty) and the *use* to which the asset is put (business or personal) be understood.

Assets used in a trade or business or for the production of income are eligible for cost recovery if they are subject to wear and tear, decay or decline from natural causes, or obsolescence (e.g., an automobile that the taxpayer rents to third parties). Assets that do not decline in value on a predictable basis or that do not have a determinable useful life (e.g., land, stock, and antiques) are not eligible for cost recovery.

8-1b Placed in Service Requirement

The key date for the commencement of depreciation is the date an asset is placed in service. This date, and not the purchase date of an asset, is relevant. This distinction is particularly important for an asset that is purchased near the end of the tax year, but not placed in service until after the beginning of the following tax year.

8-1c Cost Recovery Allowed or Allowable

The basis of cost recovery property is reduced by the cost recovery allowed (and by not less than the allowable amount). The *allowed* cost recovery is the cost recovery actually deducted, whereas the *allowable* cost recovery is the amount that could have been taken under the applicable cost recovery method. If the taxpayer does not claim any

LO.1

State the rationale for the cost consumption concept and identify the relevant time periods for depreciation, ACRS, and MACRS.

²§ 168. The terms *depreciation* and *cost recovery* are used interchangeably in the text and in § 168.

³Refer to Chapter 1 (pp. 6–8) for further discussion.

cost recovery on property during a particular year, the basis of the property still is reduced by the amount of cost recovery that should have been deducted (the allowable cost recovery).

EXAMPLE

1

On March 15, year 1, Jack purchased a copier, to use in his business, for \$10,000. The copier is 5-year property, and Jack elected to use the straight-line method of cost recovery. Jack made the election because the business was a new undertaking and he reasoned that in the first few years of the business, a large cost recovery deduction was not needed.

Because the business was doing poorly, Jack did not even claim any cost recovery deductions in years 3 and 4. In years 5 and 6, Jack deducted the proper amount of cost recovery. Therefore, the allowed cost recovery (cost recovery actually deducted) and the allowable cost recovery are computed as follows.

	Cost Recovery Allowed	Cost Recovery Allowable
Year 1	\$1,000	\$1,000
Year 2	2,000	2,000
Year 3	–0–	2,000
Year 4	–0–	2,000
Year 5	2,000	2,000
Year 6	1,000	1,000

If Jack sold the copier for \$800 in year 7, he would recognize an \$800 gain (\$800 amount realized – \$0 adjusted basis); the adjusted basis of the copier is zero (\$10,000 cost – \$10,000 total allowable cost recovery in years 1 through 6).

8-1d Cost Recovery Basis for Personal Use Assets Converted to Business or Income-Producing Use

If personal use assets are converted to business or income-producing use, the basis for cost recovery and for loss is the *lower* of the adjusted basis or the fair market value at the time the property was converted. As a result of this lower-of-basis rule, losses that occurred while the property was personal use property are not recognized for tax purposes through the cost recovery of the property.

The Big Picture

EXAMPLE

2

Return to the facts of *The Big Picture* on p. 8-1. Five years ago, Dr. Payne purchased a personal residence for \$250,000. In the current year, with the housing market down, Dr. Payne found a larger home that he acquired for his personal residence. Because of the downturn in the housing market, however, he was not able to sell his original residence and recover his purchase price of \$250,000. The residence was appraised at \$180,000.

Instead of continuing to try to sell the original residence, Dr. Payne converted it to rental property. The basis for cost recovery of the rental property is \$180,000 because the fair market value is less than the adjusted basis. The \$70,000 decline in value is deemed to be personal (because it occurred while the property was held for personal use by Dr. Payne) and therefore nondeductible.

LO.2

Determine the amount of cost recovery under MACRS.

8-2 MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS): GENERAL RULES

Under the modified accelerated cost recovery system (MACRS), the cost of an asset is recovered over a predetermined period that generally is shorter than the useful life of the asset or the period that the asset is used to produce income. The MACRS rules were designed to encourage investment, improve productivity, and simplify the pertinent law and its administration.

MACRS provides separate cost recovery tables for realty and personalty. Cost recovery allowances for real property, other than land, are based on recovery lives specified in the law. The IRS provides tables that specify cost recovery allowances for personalty and for realty. Excerpts from those tables are provided in Section 8-7d of this chapter.

8-2a **Personalty: Recovery Periods and Methods**

Classification of Property

MACRS provides that the cost recovery basis of eligible personalty (and certain realty) is recovered over 3, 5, 7, 10, 15, or 20 years. Property is classified by recovery period under MACRS as follows. See Exhibit 8.1 for examples of assets in each class.⁴

3-year 200% class.....	ADR midpoints of 4 years and less. ⁵ Excludes automobiles and light trucks. Includes racehorses more than 2 years old and other horses more than 12 years old.
5-year 200% class.....	ADR midpoints of more than 4 years and less than 10 years, adding automobiles, light trucks, qualified technological equipment, renewable energy and biomass properties that are small power production facilities, research and experimentation property, semiconductor manufacturing equipment, and computer-based central office switching equipment.
7-year 200% class.....	ADR midpoints of 10 years and more and less than 16 years, adding property with no ADR midpoint not classified elsewhere. Includes railroad track and office furniture, fixtures, and equipment.
10-year 200% class.....	ADR midpoints of 16 years and more and less than 20 years, adding single-purpose agricultural or horticultural structures, any tree or vine bearing fruits or nuts.
15-year 150% class.....	ADR midpoints of 20 years and more and less than 25 years, including sewage treatment plants and telephone distribution plants and comparable equipment used for the two-way exchange of voice and data communications.
20-year 150% class.....	ADR midpoints of 25 years and more, other than real property with an ADR midpoint of 27.5 years and more and including sewer pipes.

Accelerated depreciation is allowed for these six MACRS classes of property. Two hundred percent declining-balance is used for the 3-, 5-, 7-, and 10-year classes, with a switchover to straight-line depreciation when the latter computation yields a larger amount. One hundred and fifty percent declining-balance is allowed for the 15- and 20-year classes, with an appropriate straight-line switchover.⁶ The appropriate computation methods and conventions are built into the tables, so it is not necessary to calculate the appropriate percentages.

To determine the amount of the cost recovery allowances, simply identify the asset by class and go to the appropriate table for the percentage. The MACRS percentages for personalty appear in Exhibit 8.4 (see Section 8-7d). Concept Summary 8.2 provides an overview of the various conventions that apply under the MACRS statutory percentage method.

⁴§ 168(e).

⁶§ 168(b).

⁵Rev.Proc. 87-56, 1987-2 C.B. 674 is the source for the ADR midpoint lives.

EXHIBIT 8.1

Cost Recovery Periods: MACRS Personality

Class of Property	Examples
3-year	Tractor units for use over the road. Any horse that is not a racehorse and is more than 12 years old at the time it is placed in service. Any racehorse that is more than 2 years old at the time it is placed in service. Breeding hogs. Special tools used in the manufacturing of motor vehicles such as dies, fixtures, molds, and patterns.
5-year	Automobiles and taxis. Light and heavy general-purpose trucks. Buses. Trailers and trailer-mounted containers. Typewriters, calculators, and copiers. Computers and peripheral equipment. Breeding and dairy cattle. Rental appliances, furniture, and carpets.
7-year	Office furniture, fixtures, and equipment. Breeding and work horses. Agricultural machinery and equipment. Railroad track.
10-year	Vessels, barges, tugs, and similar water transportation equipment. Assets used for petroleum refining or for the manufacture of grain and grain mill products, sugar and sugar products, or vegetable oils and vegetable oil products. Single-purpose agricultural or horticultural structures.
15-year	Land improvements. Assets used for industrial steam and electric generation and/or distribution systems. Assets used in the manufacture of cement. Assets used in pipeline transportation. Electric utility nuclear production plant. Municipal wastewater treatment plant.
20-year	Farm buildings except single-purpose agricultural and horticultural structures. Gas utility distribution facilities. Water utilities. Municipal sewer.



Concept Summary 8.2

Statutory Percentage Method under MACRS

	Personal Property	Real Property*
Convention	Half-year or mid-quarter	Mid-month
Cost recovery deduction in the year of disposition	Half-year for year of disposition or half-quarter for quarter of disposition	Half-month for month of disposition

*Straight-line method must be used.



FINANCIAL DISCLOSURE INSIGHTS Tax and Book Depreciation

A common book-tax difference relates to the depreciation amounts that are reported for GAAP and Federal income tax purposes. Typically, tax depreciation deductions are accelerated; that is, they are claimed in earlier reporting periods than is the case for financial accounting purposes.

Almost every tax law change since 1980 has included depreciation provisions that accelerate the related deductions relative to the expenses allowed under GAAP. Accelerated

cost recovery deductions represent a means by which the taxing jurisdiction infuses the business with cash flow created by the reduction in the year's tax liabilities.

For instance, recently, about one-quarter of General Electric's deferred tax liabilities related to depreciation differences. For Toyota's and Ford's depreciation differences, that amount was about one-third. And for the trucking firm Ryder Systems, depreciation differences accounted for all but 1 percent of the deferred tax liabilities.

Taxpayers may *elect* the straight-line method to compute cost recovery allowances for each of these classes of property. Certain property is not eligible for accelerated cost recovery and must be depreciated under an alternative depreciation system (ADS). Both the straight-line election and ADS are discussed later in the chapter.

MACRS views property as placed in service in the middle of the asset's first year (the **half-year convention**).⁷ Thus, for example, the statutory recovery period for property with a life of three years begins in the middle of the year an asset is placed in service and ends three years later. In practical terms, this means that taxpayers must wait an extra year to recover the full cost of depreciable assets. That is, the actual write-offs are claimed over 4, 6, 8, 11, 16, and 21 years. MACRS also allows for a half-year of cost recovery in the year of disposition or retirement.

Half-Year Convention

Kareem acquires a 5-year class asset on April 10, 2015, for \$30,000. Kareem's cost recovery deduction for 2015 is computed as follows.

MACRS cost recovery [$\$30,000 \times .20$ (Exhibit 8.4)]	<u>\$6,000</u>
--	----------------

EXAMPLE

3

Assume the same facts as in Example 3. Kareem disposes of the asset on March 5, 2017. Kareem's cost recovery deduction for 2017 is \$2,880 [$\$30,000 \times \frac{1}{2} \times .192$ (Exhibit 8.4)].

EXAMPLE

4

Mid-Quarter Convention

The half-year convention arises from the simplifying presumption that assets generally are acquired at an even pace throughout the tax year. However, Congress was concerned that taxpayers might defeat that presumption by placing large amounts of property in service during the last quarter of the taxable year (and, by doing so, receive a half-year's depreciation on those large, fourth-quarter acquisitions).

To inhibit this behavior, Congress added the **mid-quarter convention** that applies if more than 40 percent of the value of property other than eligible real estate (discussed in a later section) is placed in service during the last quarter of the year.⁸ Under this convention, property acquisitions are grouped by the quarter they were acquired for cost recovery purposes. Acquisitions during the first quarter are allowed 10.5 months (three and one-half quarters) of cost recovery; the second quarter,

⁷§ 168(d)(4)(A).

⁸§ 168(d)(3).

7.5 months (two and one-half quarters); the third quarter, 4.5 months (one and one-half quarters); and the fourth quarter, 1.5 months (one-half quarter). The percentages are shown in Exhibit 8.5.

EXAMPLE**5**

Silver Corporation acquires the following new 5-year class property in 2015.

Property Acquisition Dates	Cost
February 15	\$ 200,000
July 10	400,000
December 5	600,000
Total	<u>\$1,200,000</u>

Under the statutory percentage method, Silver's cost recovery allowances for the first two years are computed below. Because more than 40% ($\$600,000/\$1,200,000 = 50\%$) of the acquisitions are in the last quarter, the mid-quarter convention applies.

2015		
	Mid-Quarter Convention Depreciation (Exhibit 8.5)	Total Depreciation
February 15	$\$200,000 \times .35$	\$ 70,000
July 10	$\$400,000 \times .15$	60,000
December 5	$\$600,000 \times .05$	30,000
		<u>\$160,000</u>
2016		
	Mid-Quarter Convention Depreciation (Exhibit 8.5)	Total Depreciation
February 15	$\$200,000 \times .26$	\$ 52,000
July 10	$\$400,000 \times .34$	136,000
December 5	$\$600,000 \times .38$	228,000
		<u>\$416,000</u>

Without the mid-quarter convention, Silver's 2015 MACRS deduction would have been \$240,000 [$\$1,200,000 \times .20$ (Exhibit 8.4)]. The mid-quarter convention slows down the taxpayer's available cost recovery deductions.

When property to which the mid-quarter convention applies is disposed of, the property is treated as though it were disposed of at the midpoint of the quarter. Hence, in the quarter of disposition, cost recovery is allowed for one-half of the quarter.

EXAMPLE**6**

Assume the same facts as in Example 5, except that Silver Corporation sells the \$400,000 asset on November 30, 2016. The cost recovery allowance for 2016 is computed as follows (Exhibit 8.5).

February 15	$\$200,000 \times .26$	\$ 52,000
July 10	$\$400,000 \times .34 \times (3.5/4)$	119,000
December 5	$\$600,000 \times .38$	228,000
Total		<u>\$399,000</u>



TAX IN THE NEWS Cost Segregation

Cost segregation identifies certain assets within a commercial property that can qualify for shorter depreciation schedules than the building itself. The identified assets are classified as 5-, 7-, or 15-year property, rather than 39-year property, as part of the building. This allows for greater accelerated

depreciation, which reduces taxable income and hence the tax liability.

For instance, a telecommunications system might be segregated from the building in which it is installed. This allows the system to be depreciated over 5 or 7 years, instead of 39 years.

The Big Picture

Return to the facts of *The Big Picture* on p. 8-1. If the placed-in-service date for the office furniture and fixtures and computers and peripheral equipment is September 29 and the placed-in-service date for the dental equipment is October 3, Dr. Payne’s total cost recovery is computed as follows.

Office furniture and fixtures:	
MACRS cost recovery $\$70,000 \times .1071$ (Exhibit 8.5)	\$ 7,497
Computers and peripheral equipment:	
MACRS cost recovery $\$67,085 \times .15$ (Exhibit 8.5)	10,063
Dental equipment:	
MACRS cost recovery $\$475,000 \times .0357$ (Exhibit 8.5)	<u>16,958</u>
Total cost recovery	<u>\$ 34,518</u>

Note the implications of the mid-quarter convention. If the dental equipment had been placed in service before October 1 (the beginning of the fourth quarter), the total cost recovery deduction would have been \$91,298 (p. 8-1).

EXAMPLE

7

8-2b Realty: Recovery Periods and Methods

Under MACRS, the cost recovery period for residential rental real estate is 27.5 years, and the straight-line method is used for computing the cost recovery allowance.

Residential rental real estate includes property where 80 percent or more of the gross rental revenues are from nontransient dwelling units (e.g., an apartment building). Hotels, motels, and similar establishments are not residential rental property. Low-income housing is classified as residential rental real estate. Nonresidential real estate uses a recovery period of 39 years; it also is depreciated using the straight-line method.⁹

Some items of real property are not treated as real estate for purposes of MACRS. For example, single-purpose agricultural structures are in the 10-year MACRS class. Land improvements are in the 15-year MACRS class.

All eligible real estate is depreciated using the **mid-month convention**.¹⁰ Regardless of when the property is placed in service, it is deemed to have been placed in service at the middle of the month. This allows for one-half month’s cost recovery for the month the property is placed in service. If the property is disposed of before the end of the recovery period, one-half month’s cost recovery is permitted for the month of disposition regardless of the specific date of disposition.

Cost recovery is computed by multiplying the applicable rate (Exhibit 8.9) by the cost recovery basis.

Real Estate Cost Recovery

Alec acquired a building on April 1, 1998, for \$800,000. If the building is classified as residential rental real estate, the cost recovery deduction for 2015 is \$29,088 ($.03636 \times \$800,000$).

If the building is sold on October 7, 2015, the cost recovery deduction for 2015 is \$23,028 [$.03636 \times (9.5/12) \times \$800,000$]. (See Exhibit 8.9 for percentage.)

EXAMPLE

8

⁹ §§ 168(b), (c), and (e). A 31.5-year life is used for such property placed in service before May 13, 1993.

¹⁰ § 168(d)(1).

Real Estate Cost Recovery

EXAMPLE

9

Jane acquired a building on March 2, 1993, for \$1 million. If the building is classified as nonresidential real estate, the cost recovery deduction for 2015 is \$31,740 $(.03174 \times \$1,000,000)$.

If the building is sold on January 5, 2015, the cost recovery deduction for 2015 is \$1,323 $[(.03174 \times (.5/12) \times \$1,000,000)]$. (See Exhibit 8.9 for percentage.)

EXAMPLE

10

Mark acquired a building on November 19, 2015, for \$1.2 million. If the building is classified as nonresidential real estate, the cost recovery deduction for 2015 is \$3,852 $[(.00321 \times \$1,200,000)$ (Exhibit 8.9)]. The cost recovery deduction for 2016 is \$30,768 $[(.02564 \times \$1,200,000)$ (Exhibit 8.9)].

If the building is sold on May 21, 2016, the cost recovery deduction for 2016 is \$11,538 $[(.02564 \times (4.5/12) \times \$1,200,000)$ (Exhibit 8.9)].

8-2c **Straight-Line Election**

Although MACRS requires straight-line depreciation for all eligible real estate, the taxpayer may *elect* to use the straight-line method for depreciable personal property.¹¹ The property is depreciated using the class life (recovery period) of the asset with a half-year convention or a mid-quarter convention, whichever applies. The election is available on a class-by-class and year-by-year basis (see Concept Summary 8.3). The percentages for the straight-line election with a half-year convention appear in Exhibit 8.6.

Concept Summary 8.3

Straight-Line Election under MACRS

	Personal Property	Real Property*
Convention	Half-year or mid-quarter	Mid-month
Cost recovery deduction in the year of disposition	Half-year for year of disposition or half-quarter for quarter of disposition	Half-month for month of disposition
Elective or mandatory	Elective	Mandatory
Breadth of election	Class by class	

*Straight-line method must be used.

The Big Picture

EXAMPLE

11

Return to the facts of *The Big Picture* on p. 8-1. If Dr. Payne elects the straight-line method of cost recovery, his total cost recovery is computed as follows.

Office furniture and fixtures $(\$70,000 \times .0714)$ (Exhibit 8.6)	\$ 4,998
Computers and peripheral equipment $(\$67,085 \times .10)$ (Exhibit 8.6)	6,709
Dental equipment $(\$475,000 \times .0714)$ (Exhibit 8.6)	<u>33,915</u>
Total cost recovery	<u>\$45,622</u>

If Dr. Payne does not elect the straight-line cost recovery method, his cost recovery deduction is \$91,298 (as detailed on p. 8-1).

¹¹§ 168(b)(5).

The Big Picture

Assume the same facts as in Example 11, except that Dr. Payne sells the computers and peripheral equipment on November 21, 2016. His cost recovery deduction for 2016 is \$6,709 ($\$67,085 \times .20 \times 1/2$) (Exhibit 8.6).

EXAMPLE

12

8-3 MODIFIED ACCELERATED COST RECOVERY SYSTEM (MACRS): SPECIAL RULES

8-3a Additional First-Year Depreciation

As noted in Chapter 1, Congress uses the tax system to stimulate the economy—especially in challenging economic times. Such is the case with **additional first-year depreciation** (also referred to as bonus depreciation). Under this provision, taxpayers can take an additional 50 percent cost recovery in the year qualified property is placed in service.¹²

The term *qualified property* includes most *new* depreciable assets other than buildings. The term *new* means the original or first use of the property. Property that is used but “new to the taxpayer” does not qualify.

The additional first-year depreciation is taken in the year in which the qualifying property is placed in service; it may be claimed in addition to the otherwise available depreciation deduction. After the additional first-year depreciation is calculated, the standard MACRS cost recovery allowance is calculated by multiplying the cost recovery basis (original cost recovery basis less additional first-year depreciation) by the percentage that reflects the applicable cost recovery method and convention. A taxpayer may elect *not* to take additional first-year depreciation.

Examples 13, 14, and 15 reflect the tax treatment for 2015, assuming that Congress extends this provision.

Bonus Depreciation

Morgan acquires, for \$50,000, and places in service a 5-year class asset on March 20, 2015. Morgan’s total 2015 cost recovery deduction is:

50% additional first-year depreciation ($\$50,000 \times .50$)	\$25,000
MACRS cost recovery [$(\$50,000 - \$25,000) \times .20$ (Exhibit 8.4)]	<u>5,000</u>
Total cost recovery	<u><u>\$30,000</u></u>

EXAMPLE

13

Assume the same facts as in Example 13. Morgan disposes of the asset on October 22, 2016. Morgan’s 2016 cost recovery deduction for the asset is \$4,000 [$\$25,000$ basis for MACRS recovery $\times 1/2$ year convention $\times .32$ (Exhibit 8.4)].

EXAMPLE

14

The Big Picture

Return to the facts of *The Big Picture* on p. 8-1, and assume that the tax year is 2015. If Dr. Payne takes additional first-year depreciation, his total cost recovery is computed as follows.

EXAMPLE

15

continued

¹²§ 168(k). The 50% additional first-year depreciation is allowed for qualified property placed in service after 2011 and before 2015. Congress is

expected to extend this provision. Different rules applied between 2008 and 2011.

Office furniture and fixtures	
Additional first-year depreciation ($\$70,000 \times .50$)	\$ 35,000
MACRS cost recovery $[(\$70,000 - \$35,000) \times .1429$ (Exhibit 8.4)]	5,002
Computers and peripheral equipment	
Additional first-year depreciation ($\$67,085 \times .50$)	33,543
MACRS cost recovery $[(\$67,085 - \$33,543) \times .20$ (Exhibit 8.4)]	6,708
Dental equipment	
Additional first-year depreciation ($\$475,000 \times .50$)	237,500
MACRS cost recovery $[(\$475,000 - \$237,500) \times .1429$ (Exhibit 8.4)]	33,939
Total cost recovery	<u>\$351,692</u>

If Dr. Payne does not elect additional first-year depreciation, his cost recovery deduction is \$91,298 (as detailed on p. 8-1).

LO3

Recognize when and how to make the § 179 expensing election, calculate the amount of the deduction, and apply the effect of the election in making the MACRS calculation.

8-3b Election to Expense Assets (§ 179)

Section 179 (Election to Expense Certain Depreciable Business Assets) permits the taxpayer to elect to write off up to \$500,000 of the acquisition cost of *tangible personal property* used in a trade or business. Amounts that are expensed under § 179 may not be capitalized and depreciated.

The § 179 expensing election is an annual election that applies to the acquisition cost of property placed in service that year. The immediate expense election generally is not available for real property or for property used for the production of income.¹³

Any elected § 179 expense is taken *before* additional first-year depreciation is computed. The base for calculating the remaining standard MACRS deduction is net of the § 179 expense and any additional first-year depreciation.

EXAMPLE

16

Kelly acquires equipment (5-year class asset) on February 1, 2015, at a cost of \$525,000 and elects to expense \$500,000 under § 179. Kelly takes the statutory percentage cost recovery for 2015 (see Exhibit 8.4). As a result, the total deduction for the year is calculated as follows.

§ 179 expense	\$500,000
50% additional first-year depreciation $[(\$525,000 - \$500,000) \times 50\%]$	12,500
Standard MACRS calculation $[(\$525,000 - \$500,000 - \$12,500) \times .20]$	2,500
	<u>\$515,000</u>

Annual Limitations

Two additional limitations apply to the amount deductible under § 179. First, the ceiling amount on the deduction is reduced dollar for dollar when § 179 property placed in service during the taxable year exceeds a maximum amount (\$2 million). Second, the § 179 deduction cannot exceed the taxpayer's trade or business taxable income, computed without regard to the § 179 amount.

Any § 179 amount in excess of taxable income is carried forward to future taxable years and added to other amounts eligible for expensing. The § 179 amount eligible for expensing in a carryforward year is limited to the *lesser* of (1) the statutory dollar amount (\$500,000) reduced by the cost of § 179 property placed in service in excess of \$2 million in the carryforward year or (2) business taxable income in the carryforward year.

¹³The § 179 amount allowed is per taxpayer, per year. On a joint return, the statutory amount applies to the couple. If the taxpayers are married and file separate returns, each spouse is eligible for 50% of the statutory amount.

The annual expense and phaseout amounts (\$500,000 and \$2 million, respectively) apply to 2014 and prior years. However, Congress is expected

to extend these amounts to 2015 and the text, examples, and problems assume this will occur. If this does not occur, the annual expense and phaseout amounts will be \$25,000 and \$200,000, respectively.

Jill owns a computer service and operates it as a sole proprietorship. In 2015, taxable income is \$138,000 before considering any § 179 deduction. If Jill spends \$2.3 million on new equipment, her § 179 expense deduction for the year is computed as follows.

EXAMPLE

17

§ 179 deduction before adjustment	\$ 500,000
Less: Dollar limitation reduction (\$2,300,000 – \$2,000,000)	(300,000)
Remaining § 179 deduction	<u>\$ 200,000</u>
Business income limitation	<u>\$ 138,000</u>
§ 179 deduction allowed	<u>\$ 138,000</u>
§ 179 deduction carryforward (\$200,000 – \$138,000)	<u>\$ 62,000</u>

Effect on Basis

The basis of the property for cost recovery purposes is reduced by the § 179 amount after accounting for the current-year amount of property placed in service in excess of \$2 million. This adjusted amount does not reflect any business income limitation.

Conversion to Personal Use

Conversion of the expensed property to personal use at any time results in recapture income (see Chapter 14). A property is converted to personal use if it is not used predominantly in a trade or business.¹⁴



ETHICS & EQUITY Section 179 Limitation

Joe Moran worked in the construction business throughout most of his career. In June of the current year, he sold his interest in Ajax Enterprises LLC for a profit of \$300,000. Shortly thereafter, Joe started his own business, which involves the redevelopment of distressed residential real estate.

In connection with his new business venture, Joe purchased a dump truck at a cost of \$70,000. The new business struggled and showed a net operating loss for the year. Joe is considering expensing the \$70,000 cost of the truck under §179 on this year's tax return. Evaluate Joe's plan.

8-3c Business and Personal Use of Automobiles and Other Listed Property

Limits exist on MACRS deductions for automobiles and other listed property that are used for both personal and business purposes.¹⁵ If the listed property is *predominantly used* for business, the taxpayer can use the MACRS tables to recover the cost. In cases where the property is *not predominantly used* for business, the cost is recovered using the *straight-line method*.

Listed property includes:

- Any passenger automobile.
- Any other property used as a means of transportation.
- Any property of a type generally used for purposes of entertainment, recreation, or amusement.
- Any computer or peripheral equipment, with the exception of equipment used exclusively at a regular business establishment, including a qualifying home office.
- Any other property specified in the Regulations.

LO.4

Identify listed property and apply the deduction limitations on listed property and on luxury automobiles.

¹⁴See Reg. § 1.179-1(e) and related examples.

¹⁵§ 280F.

Automobiles and Other Listed Property Used Predominantly in Business

For listed property to be considered as *predominantly used in business*, its *business usage* must exceed 50 percent.¹⁶ The use of listed property for production of income does not qualify as business use for purposes of the more-than-50% test. However, both production of income and business use percentages are used to compute the cost recovery deduction.

EXAMPLE

18

On September 1, 2015, Emma places in service listed 5-year recovery property. The property cost \$10,000. She elects not to take any available additional first-year depreciation.

If Emma uses the property 40% for business and 25% for the production of income, the property is not considered as predominantly used for business. The cost is recovered using straight-line cost recovery. Emma's cost recovery allowance for the year is \$650 ($\$10,000 \times .10 \times 65\%$).

If, however, Emma uses the property 60% for business and 25% for the production of income, the property is considered as used predominantly for business. Therefore, she may use the statutory percentage method. Emma's cost recovery allowance for the year is \$1,700 ($\$10,000 \times .20 \times 85\%$).

In determining the percentage of business usage for listed property, a mileage-based percentage is used for automobiles. For other listed property, one employs the most appropriate unit of time (e.g., hours) for which the property actually is used (rather than its availability for use).¹⁷

Limits on Cost Recovery for Automobiles

The law places special limitations on cost recovery deductions for passenger automobiles. These statutory dollar limits were imposed on passenger automobiles because of the belief that the tax system was being used to underwrite automobiles whose cost and luxury far exceeded what was needed for the taxpayer's business use.

A *passenger automobile* is any four-wheeled vehicle manufactured for use on public streets, roads, and highways with an unloaded gross vehicle weight (GVW) rating of 6,000 pounds or less.¹⁸ This definition specifically excludes vehicles used directly in the business of transporting people or property for compensation, such as taxicabs, ambulances, hearses, and trucks and vans as prescribed by the Regulations.

The following "luxury auto" depreciation limits apply.¹⁹

Date Placed in Service	First Year	Second Year	Third Year	Fourth and Later Years
2014*	\$3,160	\$5,100	\$3,050	\$1,875
2012–2013	\$3,160	\$5,100	\$3,050	\$1,875
2010–2011	\$3,060	\$4,900	\$2,950	\$1,775
2009	\$2,960	\$4,800	\$2,850	\$1,775

*Because the 2015 indexed amounts are not yet available, the 2014 amounts are used in the Examples and end-of-chapter problem materials.

For an automobile placed in service prior to 2009, the limitation for subsequent years' cost recovery is based on the limits for the year the automobile was placed in service.²⁰

In the event a passenger automobile used predominantly for business qualifies for additional first-year depreciation (i.e., new property), the first-year recovery limitation is increased by \$8,000. Therefore, for acquisitions made in 2014, the initial-year cost recovery limitation increases from \$3,160 to \$11,160 ($\$3,160 + \$8,000$).

There are also separate cost recovery limitations for trucks and vans and for electric automobiles. Because these limitations are applied in the same manner as those imposed on passenger automobiles, these additional limitations are not discussed further in this chapter.

¹⁶§ 280F(b)(3).

¹⁷Reg. § 1.280F-6T(e).

¹⁸§ 280F(d)(5).

¹⁹§ 280F(a)(1); Rev.Proc. 2014-21 (2014-11 I.R.B.641).

²⁰Cost recovery limitations for years prior to 2009 are found in IRS Publication 463.

The luxury auto limits are imposed before any percentage reduction for personal use. In addition, the limitation in the first year includes any amount the taxpayer elects to expense under § 179.²¹ If the passenger automobile is used partly for personal use, the personal use percentage is ignored for the purpose of determining the unrecovered cost available for deduction in later years.

On July 1, 2015, Dan places in service a new automobile that cost \$40,000. He does not elect § 179 expensing, and he elects not to take any available additional first-year depreciation. The car is used 80% for business and 20% for personal use in each tax year. Dan chooses the MACRS 200% declining-balance method of cost recovery (the auto is a 5-year asset).

The depreciation computation for 2015 through 2020 is summarized in the table below. The cost recovery allowed is the lesser of the MACRS amount or the recovery limitation.

Year	MACRS Amount	Recovery Limitation	Depreciation Allowed
2015	\$6,400 ($\$40,000 \times .2000 \times 80\%$)	\$2,528 ($\$3,160 \times 80\%$)	\$2,528
2016	\$10,240 ($\$40,000 \times .3200 \times 80\%$)	\$4,080 ($\$5,100 \times 80\%$)	\$4,080
2017	\$6,144 ($\$40,000 \times .1920 \times 80\%$)	\$2,440 ($\$3,050 \times 80\%$)	\$2,440
2018	\$3,686 ($\$40,000 \times .1152 \times 80\%$)	\$1,500 ($\$1,875 \times 80\%$)	\$1,500
2019	\$3,686 ($\$40,000 \times .1152 \times 80\%$)	\$1,500 ($\$1,875 \times 80\%$)	\$1,500
2020	\$1,843 ($\$40,000 \times .0576 \times 80\%$)	\$1,500 ($\$1,875 \times 80\%$)	\$1,500

If Dan continues to use the car after 2020, his cost recovery is limited to the lesser of the recoverable basis or the recovery limitation (i.e., $\$1,875 \times$ business use percentage). For this purpose, the recoverable basis is computed as if the full recovery limitation was allowed even if it was not. Thus, the recoverable basis as of January 1, 2020, is \$23,065 ($\$40,000 - \$3,160 - \$5,100 - \$3,050 - \$1,875 - \$1,875 - \$1,875$).

If Dan takes additional first-year depreciation, the calculated amount of additional first-year depreciation is \$16,000 ($\$40,000 \times 50\% \times 80\%$). However, the deduction would be limited to \$8,928 [$(\$8,000 + \$3,160) \times 80\%$].

The cost recovery limitations are maximum amounts. If the regular MACRS calculation produces a lesser amount of cost recovery, the lesser amount is used.

On April 2, 2015, Gail places in service a used automobile that cost \$10,000. The car is always used 70% for business and 30% for personal use. The cost recovery allowance for 2015 is \$1,400 ($\$10,000 \times .20$ MACRS table factor $\times 70\%$), and not \$2,212 ($\$3,160$ passenger auto maximum $\times 70\%$).

The luxury auto limitations apply *only* to passenger automobiles and not to other listed property.

Special Limitation

A \$25,000 limit applies for the § 179 deduction when the luxury auto limits do not apply. The limit is in effect for sport utility vehicles (SUVs) with an unloaded GVW rating of more than 6,000 pounds and not more than 14,000 pounds.²²

EXAMPLE

19

EXAMPLE

20

²¹§ 280F(d)(1).

²²§ 179(b)(6).

EXAMPLE

21

During 2015, Jay acquires and places in service a new SUV that cost \$70,000 and has a GVW of 8,000 pounds. Jay uses the vehicle 100% of the time for business use. The total deduction for 2015 with respect to the SUV is computed as follows.

§ 179 expense	\$25,000
50% additional first-year depreciation $[(\$70,000 - \$25,000) \times 50\%]$	22,500
Standard MACRS calculation $[(\$70,000 - \$25,000 - \$22,500) \times .20 \text{ (Exhibit 8.4)}]$	4,500
	<u>\$52,000</u>

Automobiles and Other Listed Property Not Used Predominantly in Business

For automobiles and other listed property not used predominantly in business in the year of acquisition (i.e., 50 percent or less), the straight-line method under the alternative depreciation system (see Section 8-3e) is required.²³ Under this system, the straight-line recovery period for automobiles is five years. However, the cost recovery allowance for any passenger automobile cannot exceed the luxury auto amount.

Auto Not Predominantly Used in Business

EXAMPLE

22

On July 27, 2015, Fred places in service an automobile that cost \$20,000. The auto is used 40% for business and 60% for personal use. The cost recovery allowance for 2015 is \$800 $[\$20,000 \times .10 \text{ (Exhibit 8.8)} \times 40\%]$.

EXAMPLE

23

Assume the same facts as in Example 22, except that the automobile cost \$50,000. The cost recovery allowance for 2015 is \$1,264 $[\$50,000 \times .10 \text{ (Exhibit 8.8)} = \$5,000 \text{ (limited to } \$3,160) \times 40\%]$.

The straight-line method is used even if, at some later date, the business usage of the property increases to more than 50 percent. In that case, the amount of cost recovery reflects the increase in business usage.

EXAMPLE

24

Assume the same facts as in Example 22, except that in 2016, Fred uses the automobile 70% for business and 30% for personal use. Fred's cost recovery allowance for 2016 is \$2,800 $[\$20,000 \times .20 \text{ (Exhibit 8.8)} \times 70\%]$, which is less than 70% of the second-year limit.

Change from Predominantly Business Use

If the business use percentage of listed property falls to 50 percent or less after the year the property is placed in service, the property is subject to *cost recovery recapture*. The amount required to be recaptured and included in the taxpayer's return as ordinary income is the excess cost recovery.

Excess cost recovery is the excess of the cost recovery deduction taken in prior years using the statutory percentage method over the amount that would have been allowed if the straight-line method had been used since the property was placed in service.²⁴

EXAMPLE

25

Seth purchased a new car on January 22, 2015, at a cost of \$20,000. Business usage was 80% in 2015, 70% in 2016, 40% in 2017, and 60% in 2018. Seth elects not to take any available additional first-year depreciation. Seth's excess cost recovery to be recaptured as ordinary income in 2017 is:

continued

²³§ 280F(b)(1).

²⁴§ 280F(b)(2).

2015	
MACRS [(\$20,000 × .20 × 80%) (limited to \$3,160 × 80%)]	\$ 2,528
Straight-line [(\$20,000 × .10 × 80%) (limited to \$3,160 × 80%)]	(1,600)
Excess	<u>\$ 928</u>
2016	
MACRS [(\$20,000 × .32 × 70%) (limited to \$5,100 × 70%)]	\$ 3,570
Straight-line [(\$20,000 × .20 × 70%) (limited to \$5,100 × 70%)]	(2,800)
Excess	<u>\$ 770</u>
2017	
2015 excess	\$ 928
2016 excess	770
Ordinary income recapture	<u>\$ 1,698</u>

After the business usage of the listed property drops below the more-than-50% level, the straight-line method is used for the remaining life of the property.

Assume the same facts as in Example 25. Seth's cost recovery deduction for 2017 and 2018 is:

2017:	\$1,220 [(\$20,000 × .20 × 40%) limited to \$3,050 × 40%]
2018:	\$1,125 [(\$20,000 × .20 × 60%) limited to \$1,875 × 60%]

EXAMPLE**26**

Concept Summary 8.4 illustrates the cost recovery rules for various types of listed property.

Leased Automobiles

A taxpayer who leases a passenger automobile reports an *inclusion amount* in gross income. The inclusion amount is computed from an IRS table for each taxable year for which the taxpayer leases the automobile. The purpose of this provision is to prevent taxpayers from circumventing the luxury auto and other limitations by leasing, instead of purchasing, an automobile.

The inclusion amount is based on the fair market value of the automobile; it is prorated for the number of days the auto is used during the taxable year. The prorated dollar amount then is multiplied by the business and income-producing usage percentage.²⁵ The taxpayer deducts the lease payments, multiplied by the business and income-producing usage percentage. In effect, the taxpayer's annual deduction for the lease payment is reduced by the inclusion amount.

On April 1, 2015, Jim leases and places in service a passenger automobile worth \$52,400. The lease is to be for a period of five years. During the taxable years 2015 and 2016, Jim uses the automobile 70% for business and 30% for personal use.

Assuming that the inclusion amounts from the IRS table for 2015 and 2016 are \$32 and \$70, respectively, Jim includes in gross income:

2015:	$\$32 \times (275/365) \times 70\% = \17
2016:	$\$70 \times (366/366) \times 70\% = \49

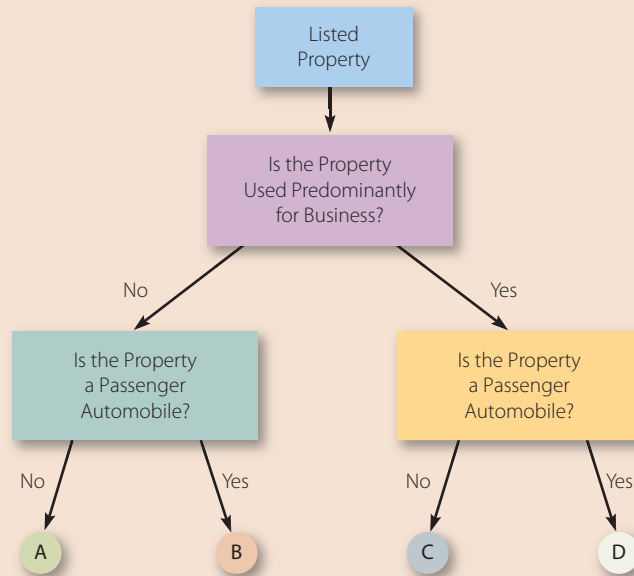
In each year, Jim still can deduct 70% of the lease payments made, related to his business use of the auto.

EXAMPLE**27**

²⁵Reg. § 1.280F-7(a).

Concept Summary 8.4

Listed Property Cost Recovery



Legend to Tax Treatment

- A Straight-line cost recovery reduced by the personal use percentage.
- B Straight-line cost recovery subject to the recovery limitations that apply (based on the year placed in service) and reduced by the personal use percentage.
- C Statutory percentage cost recovery reduced by the personal use percentage.
- D Statutory percentage cost recovery subject to the recovery limitations that apply (based on the year placed in service) and reduced by the personal use percentage.

Substantiation Requirements

Listed property is subject to the substantiation requirements of § 274. This means that the taxpayer must prove for any business usage the amount of expense or use, the time and place of use, the business purpose for the use, and the business relationship to the taxpayer of persons using the property.

Substantiation requires adequate records or sufficient evidence corroborating the taxpayer's statement. However, these substantiation requirements do not apply to vehicles that, by reason of their nature, are not likely to be used more than a *de minimis* amount for personal purposes.²⁶

8-3d Farm Property

A farming business is defined as the trade or business of farming, which includes operating a nursery or sod farm and the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees. When tangible personal property is used in a farming business, the cost of the asset generally is recovered under MACRS using the 150 percent declining-balance method. However, the MACRS straight-line method is required for any tree or vine bearing fruits or nuts.

²⁶ §§ 274(d) and (i).

EXHIBIT 8.2

Cost Recovery Periods for Farming Assets

Assets	Recovery Period in Years	
	MACRS	ADS
Agricultural structures (single purpose)	10	15
Cattle (dairy or breeding)	5	7
Farm buildings	20	25
Farm machinery and equipment	7	10
Fences (agricultural)	7	10
Horticultural structures (single purpose)	10	15
Trees or vines bearing fruit or nuts	10	20
Truck (heavy-duty, unloaded weight 13,000 pounds or more)	5	6
Truck (actual weight less than 13,000 pounds)	5	5

In general, the cost of real property used in the farming business is recovered over the usual recovery periods (27.5 years and 39 years) using the straight-line method. Exhibit 8.2 shows examples of cost recovery periods for some typical farming assets.

Special rules are used if the uniform capitalization rules apply to the farming business. Under the uniform capitalization rules, the costs of property produced or acquired for resale must be capitalized.

Alternatively, the farmer can elect to apply the alternative depreciation system (ADS) straight-line method (discussed in Section 8-3e). Section 179 expensing can be used even when the ADS is in effect.

Farm Property

James purchased new farm equipment on July 10, 2015, for \$80,000. If James does not elect to expense any of the cost under § 179, his cost recovery deduction for 2015 is \$8,568 $[(.1071 \times \$80,000)]$ (Exhibit 8.7).

EXAMPLE

28

Assume the same facts as in Example 28, except that James has made an election not to have the uniform capitalization rules apply. His 2015 cost recovery deduction is \$4,000 $[(.05 \times \$80,000)]$ (Exhibit 8.8).

EXAMPLE

29

8-3e **Alternative Depreciation System (ADS)**

The **alternative depreciation system (ADS)** must be used:²⁷

- To calculate the portion of depreciation treated as an alternative minimum tax (AMT) adjustment for purposes of the corporate and individual AMT (see Chapter 15).²⁸
- To compute depreciation allowances for property for which any of the following is true.
 - Used predominantly outside the United States.

LO.5

Determine when and how to use the alternative depreciation system (ADS).

²⁷§ 168(g).

²⁸This AMT adjustment applies for real and personal property placed in service before 1999. However, it also applies for personal property placed in

service after 1998 if the taxpayer uses the 200% declining-balance method for regular income tax purposes. See Chapter 15.

- Leased or otherwise used by a tax-exempt entity.
- Financed with the proceeds of tax-exempt bonds.
- Imported from foreign countries that maintain discriminatory trade practices or otherwise engage in discriminatory acts.
- To compute depreciation allowances for earnings and profits purposes (see Chapter 19).

In general, ADS depreciation is computed using straight-line recovery. However, for purposes of the AMT, depreciation of personal property is computed using the 150 percent declining-balance method with an appropriate switch to the straight-line method.

The taxpayer must use the half-year or the mid-quarter convention, whichever is applicable, for all property other than eligible real estate. The mid-month convention is used for eligible real estate. The applicable ADS rates are found in Exhibits 8.7, 8.8, and 8.10.

The recovery periods under ADS are determined as follows.²⁹

- The ADR midpoint life for property that does not fall into any of the following listed categories.
- Five years for qualified technological equipment, automobiles, and light-duty trucks.
- Twelve years for personal property with no class life.
- Forty years for all residential rental property and all nonresidential real property.

Taxpayers may *elect* to use the 150 percent declining-balance method to compute the regular income tax rather than the 200 percent declining-balance method that is available for personal property. Hence, when the election is made, there is no difference between the cost recovery for computing the regular income tax and the AMT.³⁰

EXAMPLE

30

On March 1, 2015, Abby purchases computer-based telephone central office switching equipment for \$80,000. Abby elects not to take any available additional first-year depreciation. If Abby uses statutory percentage cost recovery (assuming no § 179 election), her deduction for 2015 is \$16,000 [$\$80,000 \times .20$ (Exhibit 8.4, 5-year class property)].

If Abby elects to use ADS 150% declining-balance cost recovery for the regular income tax (assuming no § 179 election), the cost recovery allowance for 2015 is \$12,000 [$\$80,000 \times .15$ (Exhibit 8.7, 5-year class property)].

In lieu of depreciation under the regular MACRS method, taxpayers may *elect* straight-line under ADS for property that qualifies for the regular MACRS method. One reason for making this election is to avoid a difference between deductible depreciation and earnings and profits depreciation, thereby reducing the number of cost recovery computations that must be made.³¹

EXAMPLE

31

Polly acquires an apartment building on March 17, 2015, for \$700,000. She takes the maximum cost recovery allowance for determining taxable income. For 2015, Polly deducts \$20,153 [$\$700,000 \times .02879$ (Exhibit 8.9)]. However, Polly's cost recovery for computing her earnings and profits is only \$13,853 [$\$700,000 \times .01979$ (Exhibit 8.10)].

²⁹The class life for certain properties described in § 168(e)(3) is specially determined under § 168(g)(3)(B).

³⁰For personal property placed in service before 1999, taxpayers making the election use the ADS recovery periods in computing cost recovery for the regular income tax. The ADS recovery periods generally are longer than the regular recovery periods under MACRS.

³¹This straight-line election is made on a year-by-year basis. For property other than real estate, the election is made by MACRS class and applies to all assets in that MACRS class. So, for example, the election could be made for 7-year MACRS property and not for 5-year MACRS property placed in service during the same year. For real estate, the election is made on a property-by-property basis.

8-4 REPORTING PROCEDURES

Sole proprietors engaged in a business file a Schedule C, Profit or Loss from Business, to accompany Form 1040. The 2015 Schedule C was not available at our press date, so a 2014 Schedule C is illustrated.

The top part of page 1 requests certain key information about the taxpayer (e.g., name, address, Social Security number, principal business activity, and accounting method used). Part I provides for the reporting of items of income. If the business requires the use of inventories and the computation of cost of goods sold (see Chapter 16 for when this is necessary), Part III must be completed and the cost of goods sold amount transferred to line 4 of Part I.

Part II allows for the reporting of deductions. Some of the deductions discussed in this chapter and their location on the form are depletion (line 12) and depreciation (line 13). Other expenses (line 27) include those items not already covered (see lines 8–26). An example is research and experimental expenditures.

If depreciation is claimed, it should be supported by completing Form 4562. The 2015 Form 4562 was not available at our press date, so a 2014 Form 4562 is illustrated. The amount listed on line 22 of Form 4562 is transferred to line 13 of Part II of Schedule C.

LO.6

Report cost recovery deductions appropriately.

Thomas Andrews, Social Security number 111-11-1111, was employed as an accountant until May 2014, when he opened his own practice. His address is 279 Mountain View, Ogden, UT 84201. Andrews keeps his books on the cash basis and reported the following revenue and business expenses in 2014.

- a. Revenue from accounting practice, \$192,000.
- b. Insurance, \$5,000.
- c. Office supplies, \$4,000.
- d. Office rent, \$16,000.
- e. Copier lease payments, \$3,000.
- f. Licenses, \$2,000.
- g. New furniture and fixtures were acquired on May 10, for \$142,000. Thomas elects § 179 expensing and uses the statutory percentage cost recovery method.

Andrews reports the above information on Schedule C and Form 4562 as illustrated on the following pages.

EXAMPLE

32

8-5 AMORTIZATION

Taxpayers can claim an **amortization** deduction on intangible assets called “amortizable § 197 intangibles.” The amount of the deduction is determined by amortizing the adjusted basis of such intangibles ratably over a 15-year period beginning in the month in which the intangible is acquired.³²

An *amortizable § 197 intangible* is any § 197 intangible acquired after August 10, 1993, and held in connection with the conduct of a trade or business or for the production of income. Section 197 intangibles include goodwill and going-concern value, franchises, trademarks, and trade names. Covenants not to compete, copyrights, and patents also are included if they are acquired in connection with the acquisition of a business. Generally, self-created intangibles are not § 197 intangibles.

The 15-year amortization period applies regardless of the actual useful life of an amortizable § 197 intangible. No other depreciation or amortization deduction is permitted with respect to any amortizable § 197 intangible except those permitted under the 15-year amortization rules.

LO.7

Identify intangible assets that are eligible for amortization and calculate the amount of the deduction.

³²§ 197(a).

Form **4562**

Depreciation and Amortization
(Including Information on Listed Property)

OMB No. 1545-0172

2014

Department of the Treasury
Internal Revenue Service (99)

▶ **Attach to your tax return.**
▶ **Information about Form 4562 and its separate instructions is at www.irs.gov/form4562.**

Attachment
Sequence No. **179**

Name(s) shown on return <i>Thomas Andrews</i>	Business or activity to which this form relates <i>Accounting services</i>	Identifying number <i>111-11-1111</i>
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Part I Election To Expense Certain Property Under Section 179
Note: If you have any listed property, complete Part V before you complete Part I.

1 Maximum amount (see instructions)	1	
2 Total cost of section 179 property placed in service (see instructions)	2	142,000
3 Threshold cost of section 179 property before reduction in limitation (see instructions)	3	
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	-0-
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	142,000
6 (a) Description of property <i>Furniture and Fixtures</i>	(b) Cost (business use only) <i>142,000</i>	(c) Elected cost <i>142,000</i>
7 Listed property. Enter the amount from line 29	7	
8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	142,000
9 Tentative deduction. Enter the smaller of line 5 or line 8	9	142,000
10 Carryover of disallowed deduction from line 13 of your 2013 Form 4562	10	-0-
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	142,000
12 Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	142,000
13 Carryover of disallowed deduction to 2015. Add lines 9 and 10, less line 12	13	

Note: Do not use Part II or Part III below for listed property. Instead, use Part V.

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

14 Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15 Property subject to section 168(f)(1) election	15	
16 Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

17 MACRS deductions for assets placed in service in tax years beginning before 2014	17	
18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here <input type="checkbox"/>		

Section B—Assets Placed in Service During 2014 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	

Section C—Assets Placed in Service During 2014 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21 Listed property. Enter amount from line 28	21	
22 Total. Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	142,000
23 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 12906N

Form **4562** (2014)

**SCHEDULE C
(Form 1040)**

**Profit or Loss From Business
(Sole Proprietorship)**

OMB No. 1545-0074

2014

Attachment
Sequence No. **09**

Department of the Treasury
Internal Revenue Service (99)

► **Information about Schedule C and its separate instructions is at www.irs.gov/schedulec.**
► **Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.**

Name of proprietor
Thomas Andrews

A Principal business or profession, including product or service (see instructions)

C Business name. If no separate business name, leave blank.
Andrews Accounting Services

E Business address (including suite or room no.) ► *279 Mountain View*
City, town or post office, state, and ZIP code *Ogden, UT 84201*

F Accounting method: (1) Cash (2) Accrual (3) Other (specify) ►

G Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on losses Yes No

H If you started or acquired this business during 2014, check here

I Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) Yes No

J If "Yes," did you or will you file required Forms 1099? Yes No

Social security number (SSN)
111-11-1111

B Enter code from instructions

D Employer ID number (EIN), (see instr.)

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked	<input type="checkbox"/>	1	<i>192,000</i>
2	Returns and allowances		2	
3	Subtract line 2 from line 1		3	<i>192,000</i>
4	Cost of goods sold (from line 42)		4	
5	Gross profit. Subtract line 4 from line 3		5	<i>192,000</i>
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)		6	
7	Gross income. Add lines 5 and 6		7	<i>192,000</i>

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense (see instructions)	18	<i>4,000</i>
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	<i>3,000</i>
12	Depletion	12		b	Other business property	20b	<i>16,000</i>
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	<i>142,000</i>	21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14	<i>5,000</i>	22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	<i>2,000</i>
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17		25	Utilities	25	
28	Total expenses before expenses for business use of home. Add lines 8 through 27a			26	Wages (less employment credits)	26	
29	Tentative profit or (loss). Subtract line 28 from line 7			27a	Other expenses (from line 48)	27a	
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30			27b	Reserved for future use	27b	
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.			28		28	<i>172,000</i>
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.			29		29	<i>20,000</i>
				30		30	
				31		31	<i>20,000</i>

32a All investment is at risk.
32b Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2014

EXAMPLE

33

On June 1, 2015, Neil purchased and began operating the Falcon Café. Of the purchase price, \$90,000 is allocated to goodwill. The 2015 § 197 amortization deduction is \$3,500 $[(\$90,000/15) \times (7/12)]$.

Startup expenditures are partially amortizable by using a § 195 election.³³ A taxpayer must make this election no later than the due date of the return for the taxable year in which the trade or business begins.³⁴ If no election is made, the startup expenditures are capitalized.³⁵

The amortization election for startup expenditures allows the taxpayer to deduct the lesser of (1) the amount of startup expenditures with respect to the trade or business or (2) \$5,000, reduced, but not below zero, by the amount by which the startup expenditures exceed \$50,000. Any startup expenditures not deducted are amortized ratably over a 180-month period, beginning in the month in which the trade or business begins.³⁶

Startup Expenditures

EXAMPLE

34

Green Corporation begins business on August 1, 2015. The corporation incurs startup expenditures of \$47,000. If Green elects amortization under § 195, the total startup expenditures that Green may deduct in 2015 is computed as follows.

Deductible amount	\$5,000
Amortizable amount $\{[(\$47,000 - \$5,000)/180] \times 5 \text{ months}\}$	<u>1,167</u>
Total deduction	<u>\$6,167</u>

EXAMPLE

35

Assume the same facts as in Example 34, except that the startup expenditures total \$53,000. The 2015 deduction is computed as follows.

Deductible amount $[\$5,000 - (\$53,000 - \$50,000)]$	\$2,000
Amortizable amount $\{[(\$53,000 - \$2,000)/180] \times 5 \text{ months}\}$	<u>1,417</u>
Total deduction	<u>\$3,417</u>

Amortizable startup expenditures generally must satisfy two requirements.³⁷ First, the expenditures must be paid or incurred in connection with:

- The creation of an active trade or business,
- The investigation of the creation or acquisition of an active trade or business, or
- Any activity engaged in for profit in anticipation of such activity becoming an active trade or business.

Second, the expenditures must be the kinds of costs that would be currently deductible if connected with an existing trade or business in the same field as that entered into by the taxpayer (see Investigation of a Business, Chapter 6).

The startup costs of creating a new active trade or business could include advertising; salaries and wages; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and salaries and fees for executives, consultants, and professional services. Costs that relate to either created or acquired businesses could include expenses incurred for the analysis or survey of potential markets, products, labor supply,

³³§ 195(b).

³⁴§ 195(d).

³⁵§ 195(a).

³⁶§§ 195(b)(1)(A) and (B).

³⁷§§ 195(c)(1)(A) and (B).

transportation facilities, and the like. Startup expenditures do not include allowable deductions for interest, taxes, and research and experimental costs.³⁸

Amortization deductions also can be claimed for organizational expenses (see Chapter 17) and research and experimental expenditures (see Chapter 5).

8-6 DEPLETION

Natural resources (e.g., oil, gas, coal, gravel, and timber) are subject to **depletion**, which can be seen as a form of depreciation applicable to natural resources. Land generally cannot be depleted.

The owner of an interest in the natural resource is entitled to deduct depletion. An owner is one who has an economic interest in the property.³⁹ An economic interest requires the acquisition of an interest in the resource in place and the receipt of income from the extraction or severance of that resource. Like depreciation, depletion is a trade or business deduction *for* adjusted gross income.

Although all natural resources are subject to depletion, oil and gas wells are used as an example in the following paragraphs to illustrate the related costs and issues.

In developing an oil or gas well, the producer typically makes four types of expenditures.

- Natural resource costs.
- Intangible drilling and development costs.
- Tangible asset costs.
- Operating costs.

Natural resources are physically limited, and the costs to acquire them (e.g., oil under the ground) are, therefore, recovered through depletion. Costs incurred in making the property ready for drilling, such as the cost of labor in clearing the property, erecting derricks, and drilling the hole, are **intangible drilling and development costs (IDCs)**. These costs generally have no salvage value and are a lost cost if the well is dry.

Costs for tangible assets such as tools, pipes, and engines are capitalized and recovered through depreciation (cost recovery). Costs incurred after the well is producing are operating costs. These costs include expenditures for such items as labor, fuel, and supplies. Operating costs are deductible as trade or business expenses. Depletable costs and intangible drilling and development costs receive different treatment.

8-6a Intangible Drilling and Development Costs (IDCs)

Intangible drilling and development costs can be handled in one of two ways at the option of the taxpayer. They can be *either* charged off as an expense in the year in which they are incurred *or* capitalized and written off through depletion. The taxpayer makes the election in the first year such expenditures are incurred, either by taking a deduction on the return or by adding them to the depletable basis.

Once made, the election is binding on both the taxpayer and the IRS for all such expenditures in the future. If the taxpayer fails to elect to expense IDCs on the original timely filed return for the first year in which such expenditures are incurred, an irrevocable election to capitalize them has been made.

As a general rule, it is more advantageous to expense IDCs. The obvious benefit of an immediate write-off (as opposed to a deferred write-off through depletion) is not the only advantage. Because a taxpayer can use percentage depletion, which is calculated without reference to basis (see Example 37), the IDCs may be completely lost as a deduction if they are capitalized.

LO.8

Determine the amount of depletion expense, including being able to apply the alternative tax treatments for intangible drilling and development costs.

³⁸§ 195(c).

³⁹Reg. § 1.611-1(b).



TAX IN THE NEWS Depletion of Air Space

Landfill operators are allowed a depletion allowance, which is a deduction in computing Federal taxable income. The depletion deduction is the value of the air space

that is being filled up. The value of the air space is the product of some of the goodwill costs; some of the land costs; and all of the engineering, siting, and construction costs.

8-6b Depletion Methods

There are two methods of calculating depletion. *Cost depletion* can be used on any wasting asset (and is the only method allowed for timber). *Percentage depletion* is subject to a number of limitations, particularly for oil and gas deposits. Depletion should be calculated both ways, and the method that results in the larger deduction should be used. The choice between cost depletion and percentage depletion is an annual decision; the taxpayer can use cost depletion in one year and percentage depletion in the following year.

Cost Depletion

Cost depletion is determined by using the adjusted basis of the asset.⁴⁰ The basis is divided by the estimated recoverable units of the asset (e.g., barrels and tons) to arrive at the depletion per unit. This amount then is multiplied by the number of units sold (*not* the units produced) during the year to arrive at the cost depletion allowed. Cost depletion, therefore, resembles the units-of-production method of calculating depreciation.

EXAMPLE

36

On January 1, 2015, Pablo purchases the rights to a mineral interest for \$1 million. At that time, the remaining recoverable units in the mineral interest are estimated to be 200,000. The depletion per unit is \$5 (\$1,000,000 adjusted basis ÷ 200,000 estimated recoverable units).

If 60,000 units are mined and 25,000 are sold this year, the cost depletion is \$125,000 (\$5 depletion per unit × 25,000 units sold).

If the taxpayer later discovers that the original estimate was incorrect, the depletion per unit for future calculations is redetermined, using the revised estimate.⁴¹

EXAMPLE

37

Assume the same facts as in Example 36. In 2016, Pablo realizes that an incorrect estimate was made as to the capacity of the mine. The remaining recoverable units now are determined to be 400,000. Based on this new information, the revised depletion per unit is \$2.1875 (\$875,000 adjusted basis ÷ 400,000 estimated recoverable units). The \$875,000 adjusted basis is the original cost (\$1,000,000) reduced by the depletion claimed in 2015 (\$125,000).

If 30,000 units are sold in 2016, the depletion for the year is \$65,625 (\$2.1875 depletion per unit × 30,000 units sold).

Percentage Depletion

Percentage depletion (also referred to as statutory depletion) uses a specified percentage provided by the Code. The percentage varies according to the type of mineral interest involved. A sample of these percentages is shown in Exhibit 8.3. The rate is applied to the gross income from the property, but in no event may percentage depletion exceed 50 percent of the taxable income from the property before the allowance for depletion.⁴²

⁴⁰§ 612.

⁴¹§ 611(a).

⁴²§ 613(a). Special rules apply for certain oil and gas wells (e.g., the 50% ceiling is replaced with a 100% ceiling, and the percentage depletion may not

exceed 65% of the taxpayer's taxable income from all sources before the allowance for depletion). § 613A.

EXHIBIT 8.3

Sample of Percentage Depletion Rates

22% Depletion

Cobalt	Sulfur
Lead	Tin
Nickel	Uranium
Platinum	Zinc

15% Depletion

Copper	Oil and gas
Gold	Oil shale
Iron	Silver

14% Depletion

Borax	Magnesium carbonates
Calcium carbonates	Marble
Granite	Potash
Limestone	Slate

10% Depletion

Coal	Perlite
Lignite	Sodium chloride

5% Depletion

Gravel	Pumice
Peat	Sand

CarrollCo reports gross income of \$100,000 and other property-related expenses of \$60,000 and uses a depletion rate of 22%. CarrollCo's depletion allowance is determined as follows.

Gross income	\$100,000
Less: Other expenses	<u>(60,000)</u>
Taxable income before depletion	\$ 40,000
Depletion allowance [the lesser of \$22,000 (22% × \$100,000) or \$20,000 (50% × \$40,000)]	<u>(20,000)</u>
Taxable income after depletion	<u>\$ 20,000</u>

The adjusted basis of CarrollCo's property is reduced by \$20,000, the depletion deduction allowed. If the other expenses had been only \$55,000, the full \$22,000 could have been deducted, and the adjusted basis would have been reduced by \$22,000.

EXAMPLE

38

Note that percentage depletion is based on a percentage of the gross income from the property and makes no reference to cost. All other deductions detailed in this chapter are a function of the adjusted basis (cost) of the property. Thus, when percentage depletion is used, it is possible to claim aggregate depletion deductions that exceed the original cost of the property. If percentage depletion is used, however, the adjusted basis of the property (for computing cost depletion in a future tax year) is reduced by any depletion deducted, until the basis reaches zero. See Example 43.

Effect of Intangible Drilling Costs on Depletion

The treatment of IDCs has an effect on the depletion deduction in two ways. If the costs are capitalized, the basis for cost depletion is increased. As a consequence, the cost depletion deductions can be increased. If IDCs are expensed, they reduce the taxable

income from the property. This reduction may trigger the provision that limits depletion to 50 percent (100 percent for certain oil and gas wells) of taxable income before depletion is deducted.

EXAMPLE

39

Iris purchased the rights to an oil interest for \$1 million. The recoverable barrels were estimated to be 200,000. During the year, 50,000 barrels were sold for \$2 million. Other business expenses amounted to \$800,000, and IDCs totaled \$650,000. If the IDCs are capitalized, the depletion per unit is \$8.25 $[(\$1,000,000 + \$650,000) \div 200,000 \text{ barrels}]$, and the following taxable income results.

Gross income	\$2,000,000
Less: Expenses	<u>(800,000)</u>
Taxable income before depletion	\$1,200,000
Cost depletion $(\$8.25 \times 50,000) = \$412,500$	
Percentage depletion $(15\% \times \$2,000,000) = \$300,000$	
Greater of cost or percentage depletion	<u>(412,500)</u>
Taxable income	<u>\$ 787,500</u>

If the IDCs are expensed, taxable income is calculated as follows.

Gross income	\$ 2,000,000
Less: Expenses, including IDCs	<u>(1,450,000)</u>
Taxable income before depletion	\$ 550,000
Cost depletion $[(\$1,000,000 \div 200,000 \text{ barrels}) \times 50,000 \text{ barrels}] = \$250,000$	
Percentage depletion $(15\% \times \$2,000,000 = \$300,000, \text{ limited to } 100\% \text{ of } \$550,000 \text{ taxable income before depletion}) = \$300,000$	
Greater of cost or percentage depletion	<u>(300,000)</u>
Taxable income	<u>\$ 250,000</u>

LO.9

Identify tax planning opportunities for cost recovery, amortization, and depletion.

8-7 TAX PLANNING**8-7a Cost Recovery**

Cost recovery schedules should be reviewed annually for possible retirements, abandonments, and obsolescence.

EXAMPLE

40

An examination of the cost recovery schedule of Eagle Company reveals:

- Asset A was abandoned when it was discovered that the cost of repairs would be in excess of the cost of replacement. Asset A had an adjusted basis of \$3,000.
- Asset J became obsolete this year, at which point its adjusted basis was \$8,000.

Assets A and J should be written off, resulting in deductions of \$11,000.

Because of the deductions for cost recovery, interest, and ad valorem property taxes, investments in real estate can be highly attractive. In examining the economics of such investments, one should take into account any tax savings that result.

The Big Picture**EXAMPLE**

41

Return to the facts of *The Big Picture* on p. 8-1. In early January 2014, Dr. Payne purchased residential rental property for \$170,000 (of which \$20,000 was allocated to the land and \$150,000 to the building). He made a down payment of \$25,000 and assumed the seller's mortgage for the balance. Under the mortgage agreement, monthly payments of \$1,000 are required and are applied toward interest, taxes, insurance, and principal.

Because the property was already occupied, Dr. Payne continued to receive rent income of \$1,200 per month from the tenant. He actively participates in this activity and so comes under the special rule for a rental real estate activity with respect to the limitation on passive activity losses (refer to Chapter 11). He is in the 28% tax bracket.

continued

For 2015, Dr. Payne's expenses were determined to include:

Interest	\$10,000
Taxes	800
Insurance	1,000
Repairs and maintenance	2,200
Depreciation ($\$150,000 \times .03636$)	<u>5,454</u>
Total expenses	<u>\$19,454</u>

The deductible loss from the rental property is:

Rent income ($\$1,200 \times 12$ months)	\$ 14,400
Less total expenses (see above)	<u>(19,454)</u>
Net loss	<u>(\$ 5,054)</u>

But what is Dr. Payne's net cash position for the year when the tax benefit of the loss is taken into account?

Intake—		
Rent income	\$14,400	
Tax savings [28% (income tax bracket) \times \$5,054 (loss from the property)]	<u>1,415</u>	\$ 15,815
Outlay—		
Mortgage payments ($\$1,000 \times 12$ months)	\$12,000	
Repairs and maintenance	<u>2,200</u>	<u>(14,200)</u>
Net cash benefit		<u>\$ 1,615</u>

Should Dr. Payne cease to be an active participant in the rental activity, the passive activity loss rules would apply and he could lose the current period benefit of the loss.

Another consideration when making decisions with respect to cost recovery is whether fast or slow cost recovery will be more beneficial for the taxpayer. If the taxpayer's goal is to recover the cost of fixed assets as quickly as possible, the following strategies should be used.

- When constructing a facility, keep in mind any resulting property tax implications. Refer to the discussion in Chapter 1 on pp. 1-6 and 1-7.
- When electing § 179 expensing, choose assets with longer lives.
- Choose accelerated cost recovery methods where available.

If a taxpayer has a new business with little income or a business with a net operating loss carryover, the taxpayer's goal may be to slow down cost recovery. In such a situation, the taxpayer should:

- Elect not to take additional first-year depreciation, if available.
- Choose the straight-line cost recovery method.
- Make no election under § 179.
- Defer placing assets in service in the current tax year or postpone capital outlays until future tax years.

Section 179 and the Mid-Quarter Convention

The mid-quarter convention generally results in smaller depreciation deductions in the asset's acquisition year. However, the basis of property used to determine whether the mid-quarter convention applies is derived *after* any § 179 immediate expense election.⁴³ As a result, a taxpayer may be able to avoid the mid-quarter convention by designating § 179 treatment for assets placed in service during the last quarter of the taxable year.

⁴³Reg. § 1.168(d)-1(b)(4).

EXAMPLE

42

Dimond Manufacturing places the following assets in service during 2015. All are 5-year class assets, and they are the only assets that Dimond placed in service during the year.

Asset 1 (April 3, 2015)	\$ 438,000
Asset 2 (July 17, 2015)	232,000
Asset 3 (October 22, 2015)	<u>580,000</u>
Total	<u>\$1,250,000</u>

As Dimond has placed more than 40% of the assets in service during the last quarter of the taxable year, the mid-quarter convention applies ($\$580,000/\$1,250,000 = 46.4\%$). As a result, Dimond's MACRS deduction for the year is computed as follows (see Exhibit 8.5).

Asset 1	$\$438,000 \times .25$	\$109,500
Asset 2	$\$232,000 \times .15$	34,800
Asset 3	$\$580,000 \times .05$	<u>29,000</u>
Total		<u>\$173,300</u>

However, if Dimond elects to expense \$500,000 of the October 22 acquisition under § 179, the mid-quarter convention would not apply.

Asset 1 (April 3, 2015)	\$438,000
Asset 2 (July 17, 2015)	232,000
Asset 3 (October 22, 2015; $\$580,000 - \$500,000$)	<u>80,000</u>
Total	<u>\$750,000</u>

Now, Dimond has placed only 10.7% ($\$80,000/\$750,000$) of the assets in service during the last quarter of the taxable year. As a result, the mid-quarter convention does not apply, and Dimond's MACRS deduction for the year (including the § 179 expense election) is:

MACRS depreciation ($\$750,000 \times .20$; Exhibit 8.4)	\$150,000
Section 179 expense (Asset 3)	<u>500,000</u>
Total	<u>\$650,000</u>

As a result of its effective use of § 179, Dimond has increased its 2015 MACRS deduction and simplified its reporting and record keeping related to these assets.

8-7b Amortization

When a business is purchased, goodwill and covenants not to compete are both subject to a statutory amortization period of 15 years. Therefore, the purchaser does not derive any tax benefits when part of the purchase price is assigned to a covenant rather than to goodwill.

Thus, from the purchaser's perspective, bargaining for a covenant should be based on legal rather than tax reasons. Note, however, that from the seller's perspective, goodwill is a capital asset, and the covenant is an ordinary income asset.

Because the amortization period for both goodwill and a covenant is 15 years, the purchaser may want to attempt to minimize these amounts if the purchase price can be assigned to assets with shorter lives (e.g., inventory, receivables, and personalty). Conversely, the purchaser may want to attempt to maximize these amounts if part of the purchase price will otherwise be assigned to assets with longer recovery periods (e.g., realty) or to assets not eligible for cost recovery (e.g., land).

8-7c Depletion

As long as the basis of a depletable asset remains above zero, cost depletion or percentage depletion, whichever method produces the larger deduction, will be used. When the basis of the asset is exhausted, percentage depletion still can be taken.

Melissa reports the following related to her sulfur mine.

Remaining depletable basis	\$ 11,000
Gross income (10,000 units)	100,000
Expenses (other than depletion)	30,000

Because cost depletion is limited to the remaining depletable basis of \$11,000, Melissa would choose percentage depletion of \$22,000 (a 22% depletion rate is used for sulfur). Her basis in the mine then becomes zero. In future years, however, she can continue to take percentage depletion; percentage depletion is computed without reference to the remaining basis.

EXAMPLE
43

The election to expense intangible drilling and development costs is a one-time election. Once the election is made to either expense or capitalize the IDCs, it is binding on all future expenditures. The permanent nature of the election makes it extremely important for the taxpayer to determine which treatment will provide the greater tax advantage. (Refer to Example 39 for an illustration of the effect of using the two alternatives for a given set of facts.)

8-7d Cost Recovery Tables

Summary of Tables

Exhibit 8.4	Modified ACRS statutory percentage table for personalty. Applicable depreciation methods: 200 or 150 percent declining-balance switching to straight-line. Applicable recovery periods: 3, 5, 7, 10, 15, 20 years. Applicable convention: half-year.
Exhibit 8.5	Modified ACRS statutory percentage table for personalty. Applicable depreciation method: 200 percent declining-balance switching to straight-line. Applicable recovery periods: 3, 5, 7 years. Applicable convention: mid-quarter.
Exhibit 8.6	Modified ACRS optional straight-line table for personalty. Applicable depreciation method: straight-line. Applicable recovery periods: 3, 5, 7, 10, 15, 20 years. Applicable convention: half-year.
Exhibit 8.7	Alternative minimum tax declining-balance table for personalty. Applicable depreciation method: 150 percent declining-balance switching to straight-line. Applicable recovery periods: 3, 5, 7, 9.5, 10, 12 years. Applicable convention: half-year.
Exhibit 8.8	Alternative depreciation system straight-line table for personalty. Applicable depreciation method: straight-line. Applicable recovery periods: 5, 10, 12 years. Applicable convention: half-year.
Exhibit 8.9	Modified ACRS straight-line table for realty. Applicable depreciation method: straight-line. Applicable recovery periods: 27.5, 31.5, 39 years. Applicable convention: mid-month.
Exhibit 8.10	Alternative depreciation system straight-line table for realty. Applicable depreciation method: straight-line. Applicable recovery period: 40 years. Applicable convention: mid-month.

EXHIBIT 8.4

MACRS Accelerated Depreciation for Personal Property
Assuming Half-Year Convention

For Property Placed in Service after December 31, 1986

Recovery Year	3-Year (200% DB)	5-Year (200% DB)	7-Year (200% DB)	10-Year (200% DB)	15-Year (150% DB)	20-Year (150% DB)
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81*	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52*	12.49	11.52	7.70	6.177
5		11.52	8.93*	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55*	5.90*	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462*
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

*Switchover to straight-line depreciation.

EXHIBIT 8.5

MACRS Accelerated Depreciation for Personal Property
Assuming Mid-Quarter Convention

For Property Placed in Service after December 31, 1986 (Partial Table*)

Recovery Year	First Quarter	3-Year		
		Second Quarter	Third Quarter	Fourth Quarter
1	58.33	41.67	25.00	8.33
2	27.78	38.89	50.00	61.11
Recovery Year	First Quarter	5-Year		
		Second Quarter	Third Quarter	Fourth Quarter
1	35.00	25.00	15.00	5.00
2	26.00	30.00	34.00	38.00
Recovery Year	First Quarter	7-Year		
		Second Quarter	Third Quarter	Fourth Quarter
1	25.00	17.85	10.71	3.57
2	21.43	23.47	25.51	27.55

*The figures in this table are taken from the official tables that appear in Rev.Proc. 87-57, 1987-2 C.B. 687. Because of their length, the complete tables are not presented.

EXHIBIT 8.6

MACRS Straight-Line Depreciation for Personal Property Assuming Half-Year Convention*

For Property Placed in Service after December 31, 1986

MACRS Class	% First Recovery Year	Other Recovery Years		Last Recovery Year	
		Years	%	Year	%
3-year	16.67	2-3	33.33	4	16.67
5-year	10.00	2-5	20.00	6	10.00
7-year	7.14	2-7	14.29	8	7.14
10-year	5.00	2-10	10.00	11	5.00
15-year	3.33	2-15	6.67	16	3.33
20-year	2.50	2-20	5.00	21	2.50

*The official table contains a separate row for each year. For ease of presentation, certain years are grouped in this table. In some instances, this will produce a difference of .01 for the last digit when compared with the official table.

EXHIBIT 8.7

Alternative Minimum Tax: 150% Declining-Balance Assuming Half-Year Convention

For Property Placed in Service after December 31, 1986 (Partial Table*)

Recovery Year	3-Year 150%	5-Year 150%	7-Year 150%	9.5-Year 150%	10-Year 150%	12-Year 150%
1	25.00	15.00	10.71	7.89	7.50	6.25
2	37.50	25.50	19.13	14.54	13.88	11.72
3	25.00**	17.85	15.03	12.25	11.79	10.25
4	12.50	16.66**	12.25**	10.31	10.02	8.97
5		16.66	12.25	9.17**	8.74**	7.85
6		8.33	12.25	9.17	8.74	7.33**
7			12.25	9.17	8.74	7.33
8			6.13	9.17	8.74	7.33
9				9.17	8.74	7.33
10				9.16	8.74	7.33
11					4.37	7.32
12						7.33
13						3.66

*The figures in this table are taken from the official table that appears in Rev.Proc. 87-57, 1987-2 C.B. 687. Because of its length, the complete table is not presented.

**Switchover to straight-line depreciation.

EXHIBIT 8.8

ADS Straight-Line for Personal Property Assuming Half-Year Convention

For Property Placed in Service after December 31, 1986 (Partial Table)*

Recovery Year	5-Year Class	10-Year Class	12-Year Class
1	10.00	5.00	4.17
2	20.00	10.00	8.33
3	20.00	10.00	8.33
4	20.00	10.00	8.33
5	20.00	10.00	8.33
6	10.00	10.00	8.33
7		10.00	8.34
8		10.00	8.33
9		10.00	8.34
10		10.00	8.33
11		5.00	8.34
12			8.33
13			4.17

*The figures in this table are taken from the official table that appears in Rev.Proc. 87-57, 1987-2 C.B. 687. Because of its length, the complete table is not presented. The tables for the mid-quarter convention also appear in Rev.Proc. 87-57.

EXHIBIT 8.9

MACRS Straight-Line Depreciation for Real Property Assuming Mid-Month Convention*

For Property Placed in Service after December 31, 1986: 27.5-Year Residential Real Property

Recovery Year(s)	The Applicable Percentage Is (Use the Column for the Month in the First Year the Property Is Placed in Service):											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.455	0.152
2-18	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
19-27	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637	3.637
28	1.970	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29	0.000	0.000	0.000	0.000	0.000	0.000	0.152	0.455	0.758	1.061	1.364	1.667

For Property Placed in Service after December 31, 1986, and before May 13, 1993: 31.5-Year Nonresidential Real Property

Recovery Year(s)	The Applicable Percentage Is (Use the Column for the Month in the First Year the Property Is Placed in Service):											
	1	2	3	4	5	6	7	8	9	10	11	12
1	3.042	2.778	2.513	2.249	1.984	1.720	1.455	1.190	0.926	0.661	0.397	0.132
2-19	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175	3.175
20-31	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174	3.174
32	1.720	1.984	2.249	2.513	2.778	3.042	3.175	3.175	3.175	3.175	3.175	3.175
33	0.000	0.000	0.000	0.000	0.000	0.000	0.132	0.397	0.661	0.926	1.190	1.455

For Property Placed in Service after May 12, 1993: 39-Year Nonresidential Real Property

Recovery Year(s)	The Applicable Percentage Is (Use the Column for the Month in the First Year the Property Is Placed in Service):											
	1	2	3	4	5	6	7	8	9	10	11	12
1	2.461	2.247	2.033	1.819	1.605	1.391	1.177	0.963	0.749	0.535	0.321	0.107
2-39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

*The official tables contain a separate row for each year. For ease of presentation, certain years are grouped in these tables. In some instances, this will produce a difference of .001 for the last digit when compared with the official tables.

EXHIBIT 8.10

ADS Straight-Line for Real Property Assuming Mid-Month Convention

For Property Placed in Service after December 31, 1986

Recovery Year	Month Placed in Service											
	1	2	3	4	5	6	7	8	9	10	11	12
1	2.396	2.188	1.979	1.771	1.563	1.354	1.146	0.938	0.729	0.521	0.313	0.104
2-40	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500	2.500
41	0.104	0.312	0.521	0.729	0.937	1.146	1.354	1.562	1.771	1.979	2.187	2.396

REFOCUS ON THE BIG PICTURE

CALCULATING COST RECOVERY DEDUCTIONS

Regardless of whether the accrual method or the cash method of accounting is used, MACRS must be used in calculating the depreciation expense for fixed assets for tax purposes. Evidently, Dr. Payne's financial reporting system uses MACRS, because \$91,298 is the correct amount of depreciation expense. The computers and peripheral equipment are 5-year property. The office furniture and fixtures and the dental equipment are 7-year property.

Based on the IRS cost recovery tables, the following percentages are used in calculating depreciation expense for the first year of each asset's life.

5-year property	20.00%
7-year property	14.29%

Dr. Payne can deduct depreciation on the house he converted from personal use to rental use and on the rental house he purchased.

What If?

From a tax planning perspective, what can Dr. Payne do to increase the depreciation deductions associated with the purchase of these fixed assets and thereby reduce the amount of the business net income reported on Schedule C of Form 1040 for his dental practice?

In addition to the standard MACRS deduction using the percentages for 2015, § 179 provides for the limited expensing of fixed assets. This provision applies to personalty, but does not apply to realty (e.g., buildings). The maximum amount that can be deducted under this limited expensing provision is subject to several overall limits. First, the total amount deducted cannot exceed \$500,000 (assuming that Congress extends this 2014 amount to 2015). Second, the \$500,000 amount is reduced dollar for dollar for § 179 asset purchases placed in service during the tax year once such purchases exceed \$2 million. Finally, the § 179 deduction for a tax year cannot exceed the taxable income from the trade or business.

If Dr. Payne elects § 179 treatment for some of the fixed asset purchases of his dental practice, he can reduce the Schedule C net income of his dental practice beyond the \$91,298 of depreciation expense computed using MACRS to a maximum of \$500,000 § 179 expense in 2015.

The remaining amount of the \$612,085 purchases of § 179 assets not deducted in the current year are eligible for additional first-year depreciation and MACRS cost recovery.

For future reference associated with similar fixed asset purchases for his business, the sequence of calculating the deduction is as follows.

- § 179 limited expensing.
- Additional first-year depreciation, if available.
- Standard MACRS cost recovery.



Key Terms

Accelerated cost recovery system (ACRS), 8-2
 Additional first-year depreciation, 8-11
 Alternative depreciation system (ADS), 8-19
 Amortization, 8-21
 Cost depletion, 8-26
 Cost recovery, 8-2

Depletion, 8-25
 Depreciation, 8-2
 Half-year convention, 8-7
 Intangible drilling and development costs (IDCs), 8-25
 Listed property, 8-13
 Mid-month convention, 8-9

Mid-quarter convention, 8-7
 Modified accelerated cost recovery system (MACRS), 8-2
 Percentage depletion, 8-26
 Residential rental real estate, 8-9
 Section 179 expensing, 8-12
 Startup expenditures, 8-24

Discussion Questions

1. **LO.1** Discuss whether property that is classified as personal use is subject to cost recovery.
2. **LO.1** Discuss the difference between personal property and personal use property.
3. **LO.1** Discuss whether land improvements are eligible for cost recovery.
- Issue ID 4. **LO.2** At the beginning of the current year, Henry purchased a ski resort for \$10 million. Henry does not own the land on which the resort is located. The Federal government owns the land, and Henry has the right to operate the resort on the land pursuant to Special Use Permits, which are terminable at will by the Federal government, and Term Special Use Permits, which allow the land to be used for a fixed number of years.

In preparing the income tax return for the current year, Henry properly allocated \$2 million of the purchase price to the costs of constructing mountain roads, slopes, and trails. Since the acquisition, Henry has spent an additional \$1 million on maintaining the mountain roads, slopes, and trails. Identify the relevant tax issues for Henry.
5. **LO.2** Identify the three factors reflected in the MACRS tables when the amount of cost recovery is determined.
6. **LO.2** Discuss the computation of cost recovery in the year an asset is placed in service when the mid-quarter convention is being used.
7. **LO.2** Discuss the computation of cost recovery in the year of sale of an asset when the mid-quarter convention is being used.
8. **LO.2** Robert purchased and placed in service \$100,000 of 7-year class assets on August 10 of the current year. He also purchased and placed in service \$500,000 of 5-year class assets on November 15 of the current year. He does not claim any available additional first-year depreciation. If Robert elects to use the MACRS straight-line method of cost recovery on the 7-year class assets, discuss the calculation of cost recovery for the 5-year class assets.
- Issue ID 9. **LO.2** Jim owns a very large ranch. A large part of his business is the production and raising of breeding cattle. Jim understands that he is entitled to use MACRS cost recovery on breeding cattle. Identify the relevant tax issues for Jim with respect to taking cost recovery on his self-produced breeding cattle.
10. **LO.3** Discuss when § 179 expense must be recaptured.
11. **LO.3** Explain how the § 179 limited expensing deduction affects the computation of MACRS cost recovery.

12. **LO.3** Discuss the treatment of a § 179 expensing carryforward.
13. **LO.3** Discuss the definition of *taxable income* as it is used in limiting the § 179 expensing amount.
14. **LO.2, 3** A professional consulting business sells professional tools and equipment and provides associated services, such as repair and maintenance, to its customer base. The company's employees include technicians, who are required to provide and maintain their own tools and equipment for performing the repairs and maintenance work. The company will reimburse a technician for amounts spent to purchase tools and equipment eligible for a § 179 deduction up to a set amount each year. Any costs for tools and equipment that exceed the set amount will not be reimbursed. **Issue ID**
- John is a technician for the company. During the current year, he purchased equipment that qualifies for the § 179 deduction. John paid \$50,000 for the equipment and was reimbursed the set amount of \$40,000. Identify the relevant tax issues for John with respect to § 179 and the computation of his taxable income.
15. **LO.4** Discuss how the limits on cost recovery apply to listed property.
16. **LO.4** Discuss the tax consequences if the business use percentage of listed property falls to 50% or lower after the year the property is placed in service.
17. **LO.7** Explain the amortization period of a § 197 intangible if the actual useful life is less than 15 years.
18. **LO.7** Harold and Bart own 75% of the stock of Orange Motors. The other 25% of the stock is owned by Jeb. Orange Motors entered into an agreement with Harold and Bart to acquire all of their Orange stock. **Issue ID**
- In addition, Harold and Bart signed a noncompete agreement with Orange Motors. Under the terms of the noncompete agreement, Orange will pay Harold and Bart \$15,000 each per year for four years. Identify the relevant tax issues for Orange Motors.
19. **LO.7** In May 2015, George began searching for a trade or business to acquire. In anticipation of finding a suitable acquisition, George hired an investment banker to evaluate three potential businesses. He also hired a law firm to begin drafting regulatory approval documents for a target company. Eventually, George decided to purchase all of the assets of Brash Corporation. Brash and George entered into an acquisition agreement on December 1, 2015. Identify the relevant tax issues for George. **Issue ID**
20. **LO.8** Discuss how the cost of mineral rights enters into the calculation of cost depletion.

Computational Exercises

21. **LO.2** Euclid acquires a 7-year class asset on May 9, 2015, for \$80,000. Euclid does not elect immediate expensing under § 179. She does not claim any available additional first-year depreciation. Calculate Euclid's cost recovery deduction for 2015 and 2016.
22. **LO.2** Hamlet acquires a 7-year class asset on November 23, 2015, for \$100,000. Hamlet does not elect immediate expensing under § 179. He does not claim any available additional first-year depreciation. Calculate Hamlet's cost recovery deductions for 2015 and 2016.
23. **LO.2** Lopez acquired a building on June 1, 2010, for \$1 million. Calculate Lopez's cost recovery deduction for 2015 if the building is:
- Classified as residential rental real estate.
 - Classified as nonresidential real estate.

24. **LO.2** Andre acquired a computer on March 3, 2015, for \$2,800. He elects the straight-line method for cost recovery. Andre does not elect immediate expensing under § 179. He does not claim any available additional first-year depreciation. Calculate Andre's cost recovery deduction for the computer in 2015 and 2016.
25. **LO.2** Diana acquires, for \$65,000, and places in service a 5-year class asset on December 19, 2015. It is the only asset that Diana acquires during 2015. Diana does not elect immediate expensing under § 179. She elects additional first-year depreciation. Calculate Diana's total cost recovery deduction for 2015.
26. **LO.3** McKenzie purchased qualifying equipment for his business that cost \$212,000 in 2015. The taxable income of the business for the year is \$5,600 before consideration of any § 179 deduction. Calculate McKenzie's § 179 expense deduction for 2015 and any carryover to 2016.
27. **LO.4** On April 5, 2015, Kinsey places in service a new automobile that cost \$36,000. He does not elect § 179 expensing, and he elects not to take any available additional first-year depreciation. The car is used 70% for business and 30% for personal use in each tax year.
Kinsey chooses the MACRS 200% declining-balance method of cost recovery (the auto is a 5-year asset). Assume the following luxury automobile limitations: year 1: \$3,160; year 2: \$5,100. Compute the total depreciation allowed for 2015 and 2016.
28. **LO.7** On September 30, 2015, Priscilla purchased a business. Of the purchase price, \$60,000 is allocated to a patent and \$375,000 is allocated to goodwill. Calculate Priscilla's 2015 § 197 amortization deduction.
29. **LO.8** On March 25, 2015, Parscale Company purchases the rights to a mineral interest for \$8 million. At that time, the remaining recoverable units in the mineral interest are estimated to be 500,000 tons. If 80,000 tons are mined and 75,000 tons are sold this year, calculate Parscale's cost depletion for 2015.
30. **LO.8** Jebali Company reports gross income of \$340,000 and other property-related expenses of \$229,000 and uses a depletion rate of 14%. Calculate Jebali's depletion allowance for the current year.

Problems

31. **LO.1, 2** On November 4, 2013, Blue Company acquired an asset (27.5-year residential real property) for \$200,000 for use in its business. In 2013 and 2014, respectively, Blue took \$642 and \$5,128 of cost recovery. These amounts were incorrect; Blue applied the wrong percentages (i.e., those for 39-year rather than 27.5-year assets). Blue should have taken \$910 and \$7,272 cost recovery in 2013 and 2014, respectively.
On January 1, 2015, the asset was sold for \$180,000. Calculate the gain or loss on the sale of the asset for that year.
32. **LO.1, 2** José purchased a house for \$300,000 in 2012. He used the house as his personal residence. In March 2015, when the fair market value of the house was \$400,000, he converted the house to rental property. What is José's cost recovery for 2015?
33. **LO.2** Orange Corporation acquired new office furniture on August 15, 2015, for \$130,000. Orange does not elect immediate expensing under § 179. Orange claims any available additional first-year depreciation. Determine Orange's cost recovery for 2015.
34. **LO.2** Weston acquires a new office machine (7-year class asset) on November 2, 2014, for \$75,000. This is the only asset Weston acquired during the year. He

does not elect immediate expensing under § 179. He claims the maximum additional first-year depreciation deduction. On September 15, 2015, Weston sells the machine.

- a. Determine Weston's cost recovery for 2014.
 - b. Determine Weston's cost recovery for 2015.
35. **LO.2** Juan acquires a new 5-year class asset on March 14, 2015, for \$200,000. This is the only asset Juan acquired during the year. He does not elect immediate expensing under § 179. He does not claim any available additional first-year depreciation. On July 15, 2016, Juan sells the asset.
- a. Determine Juan's cost recovery for 2015.
 - b. Determine Juan's cost recovery for 2016.
36. **LO.2** Debra acquired the following new assets during 2015.

Date	Asset	Cost
April 11	Furniture	\$40,000
July 28	Trucks	40,000
November 3	Computers	70,000

Determine Debra's cost recovery deductions for the current year. Debra does not elect immediate expensing under § 179. She does not claim any available additional first-year depreciation.

37. **LO.2** On August 2, 2015, Wendy purchased a new office building for \$3.8 million. On October 1, 2015, she began to rent out office space in the building. On July 15, 2019, Wendy sold the office building.
- a. Determine Wendy's cost recovery deduction for 2015.
 - b. Determine Wendy's cost recovery deduction for 2019.
38. **LO.2** On April 3, 2015, Terry purchased and placed in service a building that cost \$2 million. An appraisal determined that 25% of the total cost was attributed to the value of the land. The bottom floor of the building is leased to a retail business for \$32,000. The other floors of the building are rental apartments with an annual rent of \$160,000. Determine Terry's cost recovery deduction for 2015.
39. **LO.2** On May 5, 2015, Christy purchased and placed in service a hotel. The hotel cost \$10.8 million. Calculate Christy's cost recovery deductions for 2015 and for 2025.
40. **LO.2** Janice acquired an apartment building on June 4, 2015, for \$1.6 million. The value of the land is \$300,000. Janice sold the apartment building on November 29, 2021.
- a. Determine Janice's cost recovery deduction for 2015.
 - b. Determine Janice's cost recovery deduction for 2021.
41. **LO.2** On April 20, 2015, Ralph purchased used equipment to be used in his farming business. The cost of the equipment is \$150,000. Ralph does not elect immediate expensing under § 179, nor does he elect not to have the uniform capitalization rules apply. Compute Ralph's cost recovery deduction for 2015.
42. **LO.2** During March 2015, Sam constructed new agricultural fences on his farm. The cost of the fencing was \$80,000. Sam does not elect immediate expensing under § 179, and he does not claim any available additional first-year depreciation. However, an election not to have the uniform capitalization rules apply is in effect. Compute Sam's cost recovery deduction for 2015. Sam wants to maximize his cost recovery deductions.

- Decision Making** 43. **LO.2, 3, 9** Lori, who is single, purchased 5-year class property for \$200,000 and 7-year class property for \$400,000 on May 20, 2015. Lori expects the taxable income derived from her business (without regard to the amount expensed under § 179) to be about \$800,000. Lori wants to elect immediate § 179 expensing, but she doesn't know which asset she should expense under § 179. She does not claim any available additional first-year depreciation.
- Determine Lori's total deduction if the § 179 expense is first taken with respect to the 5-year class asset.
 - Determine Lori's total deduction if the § 179 expense is first taken with respect to the 7-year class asset.
 - What is your advice to Lori?
44. **LO.2, 3** Olga is the proprietor of a small business. In 2015, the business's income, before consideration of any cost recovery or § 179 deduction, is \$250,000. Olga spends \$600,000 on new 7-year class assets and elects to take the § 179 deduction on them. She does not claim any available additional first-year depreciation. Olga's cost recovery deduction for 2015, except for the cost recovery with respect to the new 7-year assets, is \$95,000. Determine Olga's total cost recovery for 2015 with respect to the 7-year class assets and the amount of any § 179 carryforward.
45. **LO.2, 3, 9** On June 5, 2014, Dan purchased and placed in service a 7-year class asset costing \$550,000. Determine the maximum deductions that Dan can claim with respect to this asset in 2014 and 2015.
- Communications** 46. **LO.3, 4** Jabari Johnson is considering acquiring an automobile at the beginning of 2015 that he will use 100% of the time as a taxi. The purchase price of the automobile is \$35,000. Johnson has heard of cost recovery limits on automobiles and wants to know how much of the \$35,000 he can deduct in the first year. Write a letter to Jabari in which you present your calculations. Also prepare a memo for the tax files, summarizing your analysis. Johnson's address is 100 Morningside, Clinton, MS 39058.
47. **LO.2, 4** On October 15, 2015, Jon purchased and placed in service a used car. The purchase price was \$25,000. This was the only business use asset Jon acquired in 2015. He used the car 80% of the time for business and 20% for personal use. Jon used the MACRS statutory percentage method. Calculate the total deduction Jon may take for 2015 with respect to the car.
48. **LO.4** On June 5, 2014, Leo purchased and placed in service a new car that cost \$20,000. The business use percentage for the car is always 100%. Leo claims any available additional first-year depreciation. Compute Leo's cost recovery deductions for 2014 and 2015.
49. **LO.2, 3, 4** On March 15, 2015, Helen purchased and placed in service a new Escalade. The purchase price was \$62,000, and the vehicle had a rating of 6,500 GVW. The vehicle was used 100% for business. Calculate the maximum total depreciation deduction that Helen may take with respect to the vehicle in 2015.
50. **LO.2, 4** On May 28, 2015, Mary purchased and placed in service a new \$20,000 car. The car was used 60% for business, 20% for production of income, and 20% for personal use in 2015. In 2016, the usage changed to 40% for business, 30% for production of income, and 30% for personal use. Mary did not elect immediate expensing under § 179. She did not claim any available additional first-year depreciation. Compute Mary's cost recovery deduction and any cost recovery recapture in 2016.
- Decision Making** 51. **LO.2, 4, 9** Sally purchased a new computer (5-year property) on June 1, 2015, for \$4,000. Sally could use the computer 100% of the time in her business,

or she could allow her family to use the computer as well. Sally estimates that if her family uses the computer, the business use will be 45% and the personal use will be 55%.

Determine the tax cost to Sally, in the year of acquisition, of allowing her family to use the computer. Assume that Sally would not elect § 179 limited expensing and that her marginal tax rate is 28%. She does not claim any available additional first-year depreciation.

52. **LO.2, 4, 9** Dennis Harding is considering acquiring a new automobile that he will use 100% for business. The purchase price of the automobile would be \$48,500. If Dennis leased the car for five years, the lease payments would be \$375 per month. Dennis will acquire the car on January 1, 2015. The inclusion dollar amounts from the IRS table for the next five years are \$28, \$62, \$93, \$111, and \$127.

Dennis wants to know the effect on his adjusted gross income of purchasing versus leasing the car for the next five years. He does not claim any available additional first-year depreciation. Write a letter to Dennis, and present your calculations. Also prepare a memo for the tax files. His address is 150 Avenue I, Memphis, TN 38112.

53. **LO.2, 5** In 2015, Muhammad purchased a new computer for \$16,000. The computer is used 100% for business. Muhammad did not make a § 179 election with respect to the computer. He does not claim any available additional first-year depreciation. If Muhammad uses the MACRS statutory percentage method, determine his cost recovery deduction for 2015 for computing taxable income and for computing his alternative minimum tax.

54. **LO.2, 5, 9** Jamie purchased \$100,000 of new office furniture for her business in June of the current year. Jamie understands that if she elects to use ADS to compute her regular income tax, there will be no difference between the cost recovery for computing the regular income tax and the AMT. Jamie wants to know the *regular* income tax cost, after three years, of using ADS rather than MACRS. Assume that Jamie does not elect § 179 limited expensing and that her marginal tax rate is 28%. She does not claim any available additional first-year depreciation.

55. **LO.2, 7, 9** Mike Saxon is negotiating the purchase of a business. The final purchase price has been agreed upon, but the allocation of the purchase price to the assets is still being discussed. Appraisals on a warehouse range from \$1.2 million to \$1.5 million. If a value of \$1.2 million is used for the warehouse, the remainder of the purchase price, \$800,000, will be allocated to goodwill. If \$1.5 million is allocated to the warehouse, goodwill will be \$500,000.

Mike wants to know what effect each alternative will have on cost recovery and amortization during the first year. Under the agreement, Mike will take over the business on January 1 of next year. Write a letter to Mike in which you present your calculations and recommendation. Also prepare a memo for the tax files. Mike's address is 200 Rolling Hills Drive, Shavertown, PA 18708.

56. **LO.7** Oleander Corporation, a calendar year entity, begins business on March 1, 2015. The corporation incurs startup expenditures of \$64,000. If Oleander elects § 195 treatment, determine the total amount of startup expenditures that it may deduct in 2015.

57. **LO.7** Martha was considering starting a new business. During her preliminary investigations related to the new venture, she incurred the following expenditures.

Salaries	\$22,000
Travel	18,000
Interest on short-term note	4,000
Professional fees	13,000

Martha begins the business on July 1 of the current year. If Martha elects § 195 treatment, determine her startup expenditure deduction for the current year.

Decision Making
Communications

Decision Making

Decision Making
Communications

58. **LO.8** Wes acquired a mineral interest during the year for \$10 million. A geological survey estimated that 250,000 tons of the mineral remained in the deposit. During the year, 80,000 tons were mined, and 45,000 tons were sold for \$12 million. Other related expenses amounted to \$5 million. Assuming that the mineral depletion rate is 22%, calculate Wes's lowest taxable income, after any depletion deductions.

- Decision Making** 59. **LO.8, 9** Chris purchased an oil interest for \$2 million. Recoverable barrels were estimated to be 500,000. During the year, 120,000 barrels were sold for \$3.84 million, other business expenses (including cost recovery) were \$1.24 million, and IDCs were \$1 million. Calculate Chris's taxable income under the expensing and capitalization methods of accounting for IDCs.

Cumulative Problems

Tax Return Problem



60. Janice Morgan, age 24, is single and has no dependents. She is a freelance writer. In January 2014, Janice opened her own office located at 2751 Waldham Road, Pleasant Hill, NM 88135. She called her business Writers Anonymous. Janice is a cash basis taxpayer. She lives at 132 Stone Avenue, Pleasant Hill, NM 88135. Her Social Security number is 123-45-6789. Janice's parents continue to provide health insurance for her under their policy. Janice wants to contribute to the Presidential Election Campaign Fund.

During 2014, Janice reported the following income and expense items connected with her business.

Income from sale of articles	\$85,000
Rent	16,500
Utilities	7,900
Supplies	1,800
Insurance	5,000
Travel (including meals of \$1,200)	3,500

Janice purchased and placed in service the following fixed assets for her business. Janice wants to elect immediate expensing under § 179.

- Furniture and fixtures (new) costing \$21,000 on January 10.
- Computer equipment (new) costing \$12,400 on July 28.

Janice's itemized deductions include:

State income tax	\$3,000
Home mortgage interest paid to First Bank	6,000
Property taxes on home	1,500
Charitable contributions	1,200

Janice did not keep a record of the sales tax she paid. The pertinent amount from the sales tax table is \$437.

Janice reports interest income of \$4,000 on certificates of deposit at Second Bank. Janice makes estimated tax payments of \$3,000 for 2014.

Compute Janice Morgan's 2014 Federal income tax payable (or refund due). If you use tax forms for your computations, you will need Forms 1040 and 4562 and Schedules A, B, and C. Suggested software: H&R BLOCK Tax Software.

Tax Computation Problem Decision Making Communications

61. John Smith, age 31, is single and has no dependents. At the beginning of 2015, John started his own excavation business and named it Earth Movers. John lives at 1045 Center Street, Lindon, UT, and his business is located at 381 State Street, Lindon, UT. The ZIP Code for both addresses is 84042. John's Social Security number is 111-11-1111, and the business identification number is 11-111111. John is a cash basis taxpayer.

During 2015, John reports the following items in connection with his business.

Fee income for services rendered	\$912,000
Building rental expense	36,000
Office furniture and equipment rental expense	9,000
Office supplies	2,500
Utilities	4,000
Salary for secretary	34,000
Salary for equipment operators	42,000
Payroll taxes	7,000
Fuel and oil for the equipment	21,000
Purchase of three new front-end loaders on January 15, 2015, for \$550,000.	550,000
Purchase of a new dump truck on January 18, 2015	80,000

During 2015, John recorded the following additional items.

Interest income from First National Bank	\$10,000
Dividends from ExxonMobil	9,500
Quarterly estimated tax payments	11,500

John makes the election under § 179 on the three front-end loaders purchased in January. John claims any available additional first-year depreciation. Assume that bonus depreciation and the 2014 § 179 expense and limitation amounts apply in 2015.

On October 8, 2015, John inherited IBM stock from his Aunt Mildred. John had been her favorite nephew. According to the data provided by the executor of Aunt Mildred's estate, the stock was valued for estate tax purposes at \$110,000. John is considering selling the IBM stock for \$125,000 on December 29, 2015, and using \$75,000 of the proceeds to purchase an Acura ZDX. He would use the car 100% for business. John wants to know what effect these transactions would have on his 2015 adjusted gross income.

Write a letter to John in which you present your calculations, and prepare a memo for the tax files. Ignore any Federal self-employment tax implications.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Your client, Dave's Sport Shop, sells sports equipment and clothing in three retail outlets in New York City. Earlier this year, the CFO decided that keeping track of inventory using a combination of QuickBooks and Excel was not an efficient way to manage the stores' inventories. So Dave's purchased an inventory management system for \$9,000 that allowed the entity to keep track of inventory, as well as automate ordering and purchasing, without replacing QuickBooks for its accounting function.

Communications

The CFO would like to know whether the cost of the inventory management program can be expensed in the year of purchase. Write a letter to the CFO, Cassandra Martin, that addresses the tax treatment of purchased software. Cassandra's mailing address is 867 Broadway, New York, NY 10003.

Research Problem 2. In 2011, Jed James began planting a vineyard. The costs of the land preparation, labor, rootstock, and planting were capitalized. The land preparation costs do not include any nondepreciable land costs. In 2015, when the plants became viable,

Jed placed the vineyard in service. Jed wants to know whether he can claim a deduction under § 179 on his 2015 income tax return for the 2011 costs for planting the vineyard.

Research Problem 3. Juan owns a business that acquires exotic automobiles that are high-tech, state-of-the-art vehicles with unique design features or equipment. The exotic automobiles are not licensed or set up to be used on the road. Rather, the cars are used exclusively for car shows or related promotional photography. With respect to the exotic automobiles, Juan would like to know whether he can take a cost recovery deduction on his Federal income tax return.

Partial list of research aids:

Bruce Selig, 70 TCM 1125, T.C.Memo. 1995-519.

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. Locate a financial calculator program that assesses the wisdom of buying versus leasing a new car. Install the program on your computer, and become familiar with it. Use the program to work through Problem 52 in this chapter.

Communications

Research Problem 5. Changes to depreciation systems often are discussed by policy-makers and observers of the tax system. Outline the terms and policy objectives of one of the changes currently proposed by the Treasury, a member of Congress, or a tax policy think tank.

Roger CPA Review Questions

- Quanti Co., a calendar-year taxpayer, purchased small tools for \$5,000 on December 21, 20X14, representing the company's **only** purchase of tangible personal property that took place during 20X14. On its 20X14 tax return, how many months of MACRS depreciation may Quanti Co. claim on the tools?
 - One-and-a-half months
 - One month
 - Six months
 - None
- Which of the following is **correct** about depreciation under federal tax law?
 - The recovery period is longer than the useful life of the asset.
 - There are different recovery periods for new and used property.
 - Salvage values are ignored.
 - I and II only
 - II only
 - III only
 - I, II, and III
- Joe purchased a van on February 1, 20X4 for use in his business, Crew Airport Transport. The van was purchased for \$30,000, has an estimated useful life of 10 years, and a salvage value of \$2,000. No other assets were put into service that year. What is Joe's MACRS depreciation for the van in 20X4?
 - \$2,567
 - \$6,000
 - \$10,500
 - \$10,267
- Dolly purchased and placed into service qualifying depreciable property in 20X4 at a total cost of \$2,250,000. Dolly has elected to take the Section 179 deduction. What is Dolly's Section 179 deduction for 20X4?
 - \$0
 - \$250,000
 - \$500,000
 - \$1,750,000

5. Christa purchased and placed into service five-year assets at a total cost of \$2,250,000. If Christa elects both the Section 179 deduction and additional first-year bonus depreciation, but does not elect the straight-line method, what is Christa's depreciation expense for tax purposes for the year, assuming a half-year convention?
- a. \$250,000
 - b. \$500,000
 - c. \$1,250,000
 - d. \$1,450,000

Deductions: Employee and Self-Employed-Related Expenses

LEARNING OBJECTIVES: After completing Chapter 9, you should be able to:

- | | |
|--|---|
| <p>LO.1 Distinguish between employee and self-employed status.</p> <p>LO.2 Recognize deductible transportation expenses.</p> <p>LO.3 Describe how travel expenses are treated.</p> <p>LO.4 Determine the moving expense deduction.</p> <p>LO.5 Differentiate between deductible and nondeductible education expenses.</p> <p>LO.6 Explain how entertainment and meal expenses are treated.</p> | <p>LO.7 Identify other employee expenses.</p> <p>LO.8 Compare various deductions for contributions to retirement accounts.</p> <p>LO.9 Demonstrate the difference between accountable and nonaccountable employee plans.</p> <p>LO.10 Apply the limitations on miscellaneous itemized deductions.</p> <p>LO.11 List and evaluate tax planning ideas related to employee business expenses.</p> |
|--|---|

CHAPTER OUTLINE

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- 9-2 Employee Expenses—In General, 9-4**
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 - 9-3a Qualified Expenditures, 9-5
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THE BIG PICTURE

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THE FIRST JOB

After an extensive search, Morgan, a recent college graduate with a major in finance, has accepted a job with Kite Corporation. The job is in sales and will require travel and some entertainment (i.e., business lunches). She will be based in a major metropolitan area in another state. Kite has no available space in the locale, so Morgan will have to maintain her own work facility. In addition to her salary, Morgan will receive a travel allowance. However, Kite has made it clear that the allowance *will not* cover all of her travel expenses.

Morgan is delighted with the new job because it will enable her to maintain a flexible work schedule. Furthermore, working out of her own apartment avoids a time-consuming and costly commute.

What are some of the income tax problems presented by this situation?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3–3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income.....	<u>(x,xxx)</u>

FORM 1040 (p. 1)

12	Business income or (loss). Attach Schedule C or C-EZ			
23	Educator expenses	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
26	Moving expenses. Attach Form 3903	26		
32	IRA deduction	32		
34	Tuition and fees. Attach Form 8917	34		

Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	<u>(x,xxx)</u>

FORM 1040 (p. 2)

40	Itemized deductions (from Schedule A) or your standard deduction (see left margin) . . .
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Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

Considering the large number of taxpayers affected, the tax treatment of job-related expenses is unusually complex. To resolve this matter in a systematic fashion, a number of key questions must be asked:

- Is the taxpayer an *employee* or *self-employed*?
- If an employee, what expenses *qualify* as deductions?
- How are the expenses that qualify *classified* for tax purposes?
- To the extent the expenses are classified as deductions *from* AGI, are they subject to any *limitation*?

Once these questions have been posed and answered, the chapter considers various planning procedures available to maximize the deductibility of employee and self-employed expenses.

LO.1
Distinguish between employee and self-employed status.

9-1 EMPLOYEE VERSUS SELF-EMPLOYED

When one person performs services for another, the person performing the service is either an employee or self-employed (an **independent contractor**). Failure to recognize one’s work status correctly can have serious consequences. Tax deficiencies as well as interest and penalties may result.

Unlike employees, self-employed persons do not have to be included in various fringe benefit programs (e.g., group term life insurance and retirement plans). Because

they are not covered by FICA and FUTA (see Chapter 1), these payroll costs are avoided. The IRS is very much aware of the tendency of businesses to wrongly classify workers as self-employed rather than as employees.

In terms of tax consequences, employment status makes a great deal of difference to the persons who perform the services. Expenses of self-employed taxpayers, to the extent allowable, are classified as deductions *for* AGI and are reported on Schedule C (Profit or Loss From Business) of Form 1040.¹ With the exception of reimbursement under an accountable plan (see later in the chapter), expenses of employees are deductions *from* AGI. They are reported on Form 2106 (Employee Business Expenses) and Schedule A (Itemized Deductions) of Form 1040.²

Most persons classified as employees are common law employees. The common law employee classification originated in judicial case law and is summarized in various IRS pronouncements.³ Revenue Ruling 87-41, for example, lists 20 factors that can be used in determining whether a worker is a common law employee or an independent contractor (and, thus, self-employed).⁴

A common law employee-employer relationship exists when the employer has the right to specify the end result and the ways and means by which that result is to be attained.⁵ An employee is subject to the will and control of the employer with respect not only to what shall be done but also to how it shall be done. If the individual is subject to the direction or control of another only to the extent of the end result but not as to the means of accomplishment, an employee-employer relationship does not exist.

Certain factors indicate a common law employee-employer relationship. These include the performance of the following by the employer:

- Furnishing of tools or equipment and a place to work.
- Providing support services, including the hiring of assistants to help do the work.
- Making training available to provide needed job skills.
- Allowing participation in various workplace fringe benefits (e.g., accident and health plans, group life insurance, and retirement plans).
- Paying for services based on time rather than the task performed.

For their part, independent contractors are more likely than employees to have unreimbursed business expenses, a significant investment in tools and work facilities, and less permanency in their business relationships. Independent contractors, moreover, anticipate a profit from their work, make their services available to the relevant marketplace, and are paid a flat fee on a per-job basis.

In resolving employment status, each case must be tested on its own merits. Keep in mind, however, that the right to control the means and methods of accomplishment is the definitive test that leads to a common law employee result. Compare Examples 1 and 2.

Self-Employed *versus* Employed

Arnold is a lawyer whose major client accounts for 60% of his billings. He does the routine legal work and income tax returns at the client's request. He is paid a monthly retainer in addition to amounts charged for extra work. Arnold is a self-employed individual. Even though most of his income comes from one client, he still has the right to determine how the end result of his work is attained.

EXAMPLE

1

¹In simple situations, a Schedule C-EZ can be substituted. Also, a Schedule SE (Self-Employment Tax) must be filed.

²In simple situations, a Form 2106-EZ (Unreimbursed Employee Business Expenses) can be substituted.

³See, for example, *Employer's Supplemental Tax Guide* (IRS Publication 15-A).

⁴1987-1 C.B. 296.

⁵Reg. § 31.3401(c)-(1)(b).

Self-Employed *versus* Employed

EXAMPLE

2

Ellen is a lawyer hired by Arnold to assist him in the performance of services for the client mentioned in Example 1. Ellen is under Arnold's supervision; he reviews her work and pays her an hourly fee. Ellen is an employee of Arnold.

When one taxpayer holds multiple jobs, it is possible to have dual status as both an employee and an independent contractor (i.e., self-employed).

EXAMPLE

3

Dr. Davis, DDS, is a full-time employee at the Robin University Health Center. In the evenings and on weekends, he shares a practice with another dentist who works the Monday through Friday daytime shifts. Dr. Davis is both employed and self-employed.

Certain workers who *are not* common law employees are treated as employees for employment tax purposes. Known as **statutory employees**, this group includes certain drivers (e.g., nondairy beverage distributors and laundry and dry cleaning pickup service), life insurance sales agents, home workers, and other salespersons. These employees are allowed to claim their business-related expenses as deductions *for* AGI by using Schedule C. The wages or commissions paid to statutory employees are not subject to Federal income tax withholding but are subject to Social Security tax.⁶

To avoid the confusion that might otherwise result in their classification, the tax law categorically treats certain categories of workers as independent contractors. Included in this group are licensed real estate agents and direct sellers. Such persons are treated as self-employed for all Federal purposes, including income and employment taxes.⁷

If a taxpayer wants clarification as to whether employee or independent contractor status exists, a ruling from the IRS can be obtained by filing Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding). An adverse ruling is appealable to the U.S. Tax Court.⁸

9-2 EMPLOYEE EXPENSES—IN GENERAL

Once the employment relationship is established, employee expenses fall into one of the following categories:

- Transportation.
- Travel.
- Moving.
- Education.
- Entertainment.
- Other.

These expenses are discussed below in the order presented.

Keep in mind, however, that these expenses are not necessarily limited to employees. A deduction for business transportation, for example, is equally available to taxpayers who are self-employed.

⁶§ 3121(d)(3). See Circular E, *Employer's Tax Guide* (IRS Publication 15), for further discussion of statutory employees.

⁸§ 7436.

⁷§ 3508. See *Employer's Supplemental Tax Guide* (IRS Publication 15-A).

9-3 TRANSPORTATION EXPENSES

9-3a Qualified Expenditures

An employee may deduct unreimbursed employment-related transportation expenses as an itemized deduction *from* AGI. **Transportation expenses** include only the cost of transporting the employee from one place to another in the course of employment when the employee is *not* away from home *in travel status*. Such costs include taxi fares, automobile expenses, tolls, and parking.

Commuting Expenses

Commuting between home and one's place of employment is a personal, nondeductible expense. The fact that one employee drives 30 miles to work and another employee walks six blocks is of no significance.

Geraldo is employed by Sparrow Corporation. He drives 22 miles each way to work. The 44 miles he drives each workday are nondeductible commuting expenses.

LO.2

Recognize deductible transportation expenses.

EXAMPLE

4

The rule that disallows a deduction for commuting expenses has several exceptions. An employee who uses an automobile to transport heavy tools to work and who otherwise would not drive to work is allowed a deduction, but only for the additional costs incurred to transport the work implements. Additional costs are those exceeding the cost of commuting by the same mode of transportation without the tools. For example, the rental of a trailer for transporting tools is deductible, but the expenses of operating the automobile generally are not deductible. The Supreme Court has held that a deduction is permitted only when the taxpayer can show that the automobile would not have been used without the necessity to transport tools or equipment.⁹

Another exception is provided for an employee who has a second job. The expenses of getting from one job to another are deductible. If the employee goes home between jobs, the deduction is based on the distance between jobs.

In the current year, Cynthia holds two jobs, a full-time job with Blue Corporation and a part-time job with Wren Corporation. Cynthia customarily leaves home at 7:30 A.M. and drives 30 miles to the Blue Corporation plant, where she works until 5:00 P.M. After dinner at a nearby café, Cynthia drives 20 miles to Wren Corporation and works from 7:00 to 11:00 P.M. The distance from the second job to Cynthia's home is 40 miles. Her deduction is based on 20 miles (the distance between jobs).

EXAMPLE

5

If the taxpayer is required to incur a transportation expense to travel between workstations, that expense is deductible.

Norman is the local manager for a national chain of fast-food outlets. Each workday, he drives from his home to his office to handle administrative matters. Most of his day, however, is then spent making the rounds of the retail outlets, after which he drives home. The costs incurred in driving to his office and driving home from the last outlet are nondeductible commuting expenses. The other transportation costs are deductible.

EXAMPLE

6

Likewise, the commuting costs from home to a temporary workstation and from the temporary workstation to home are deductible.

⁹*Fausner v. Comm.*, 73-2 USTC ¶9515, 32 AFTR 2d 73-5202, 93 S.Ct. 2820 (USSC, 1973).

EXAMPLE

7

Vivian works for a firm in downtown Denver and commutes to work. She occasionally works in a customer's office. On one such occasion, Vivian drove directly to the customer's office, a round-trip distance from her home of 40 miles. She did not go into her office, which is a 52-mile round-trip. Her mileage for going to and from the temporary workstation is deductible.

Also deductible is the reasonable travel cost between the general working area and a temporary workstation outside that area.

EXAMPLE

8

Sam, a building inspector in Minneapolis, regularly inspects buildings for building code violations for his employer, a general contractor. During one busy season, the St. Paul inspector became ill, and Sam was required to inspect several buildings in St. Paul. The expenses for transportation for the trips to St. Paul are deductible.

What constitutes the general working area depends on the facts and circumstances of each situation. Furthermore, if an employee customarily works on several temporary assignments in a localized area, that localized area becomes the regular place of employment. Transportation from home to these locations becomes a personal, non-deductible commuting expense.

If a taxpayer has an office in the home that qualifies as a principal place of business, the transportation between home and various work locations is not a commuting expense.

The Big Picture

EXAMPLE

9

Return to the facts of *The Big Picture* on p. 9-1. Because Morgan will have an office in her home, the apartment will be her principal place of business. Thus, any transportation from her home to business sites is *not* a commuting expense.¹⁰

9-3b Computation of Automobile Expenses

A taxpayer has two choices in determining automobile expenses: the automatic mileage method and the actual cost method. If a mixed-use automobile is involved, only the expenses attributable to the business use are deductible. The percentage of business use is usually arrived at by comparing the business mileage with total mileage—both business and personal.

Automatic Mileage Method

Also called the standard mileage method, the **automatic mileage method** is convenient in that it simplifies record keeping. The rate allowed per mile takes into account average operating expenses (such as gas and oil, repairs, and depreciation). Consequently, the taxpayer only has to multiply the automatic mileage rate by the miles driven to compute the deduction for business transportation.

For 2015, the deduction is based on 57.5 cents per mile for business miles.¹¹ This represents a one and one-half cent increase from the rate of 56 cents applicable to 2014. Although the mileage rate usually remains constant for an entire year, such is not always the case. In the past and due to the extreme variation in the cost of fuel, the IRS has made mid-year changes in the rate. The possibility of such a change makes it important that the taxpayer be able to identify when the mileage took place.

The automatic mileage rate for deductible education expenses is the same as for business; 23 cents per mile is allowed for moving (discussed later in this chapter) and medical purposes, and the rate for the charitable contribution deduction is 14 cents a

¹⁰Walter K. Strobmalter, 113 T.C. 106 (1999).

¹¹Notice 2014-79, 2014-53 I.R.B. 1001 and Rev. Proc. 2010-51, 2010-51 I.R.B. 883.

mile (as to medical and charitable deductions, see Chapter 10). Parking fees and tolls are allowed in addition to expenses computed using the automatic mileage method.

Generally, a taxpayer may elect either method for any particular year. However, the following restrictions apply:

- The vehicle must be owned or leased by the taxpayer.
- The vehicle is not used for hire (e.g., taxicab).
- If five or more vehicles are in use (for business purposes) at the *same* time (not alternately), a taxpayer may not use the automatic mileage method.
- A basis adjustment is required if the taxpayer changes from the automatic mileage method to the actual operating cost method. Depreciation is considered allowed for the business miles in accordance with the following schedule for the most recent five years:

Year	Rate per Mile
2015	24 cents
2014	22 cents
2013	23 cents
2012	23 cents
2011	22 cents

Tim purchased his automobile in 2012 for \$36,000. It is used 90% for business purposes. Tim drove the automobile for 10,000 business miles in 2014; 8,500 business miles in 2013; and 6,000 business miles in 2012. At the beginning of 2015, the basis of the business portion is \$26,865.

EXAMPLE

10

Depreciable basis (\$36,000 × 90%)	\$32,400
Less depreciation:	
2014 (10,000 miles × 22 cents)	(2,200)
2013 (8,500 miles × 23 cents)	(1,955)
2012 (6,000 miles × 23 cents)	<u>(1,380)</u>
Adjusted business basis 1/1/2015	<u><u>\$26,865</u></u>

- Use of the automatic mileage method in the first year the auto is placed in service is considered an election to exclude the auto from the MACRS method of depreciation (discussed in Chapter 8).
- A taxpayer may not switch to the automatic mileage method if the MACRS statutory percentage method or the election to expense under § 179 has been used.

Actual Cost Method

Under this method, the actual cost of operating the automobile is used to compute the deduction. Actual costs include the following expenses:

- Gas and oil, lubrication.
- Depreciation (or lease payments).
- Insurance.
- Dues to auto clubs.
- Repairs.
- Tires and other parts.
- Licenses and registration fees.
- Parking and tolls.

As noted in Chapter 8, the allowance for depreciation (or lease payments) is subject to limitations when mixed-use vehicles are involved. Interest on car loans is not deductible if the taxpayer is an employee, but it can qualify as a business expense if the taxpayer is self-employed. Sales taxes paid on the purchase of a car are added to the cost of the car and recovered by means of the depreciation deduction. In mixed-use situations, the portion of the sales tax attributable to personal use may, in some cases, be claimed as a deduction *from* AGI (see Chapter 10 and the choice required between state and local income and sales taxes).

Except for parking and tolls, none of the expenses noted previously can be separately claimed under the automatic mileage method. A deduction for parking tickets and other traffic violations is not allowed under either method due to the public policy limitation (see Chapter 6).

The Big Picture

EXAMPLE

11

Return to the facts of *The Big Picture* on p. 9-1. During Morgan's senior year in college, her parents gave her one of the family cars—a 2009 Chevrolet Impala. Morgan has no idea as to the car's original cost or the odometer reading at the time the car was registered in her name. She has, however, kept track of the miles driven for business since she accepted her new job. Morgan should use the automatic mileage method in claiming business use of the car.

LO.3

Describe how travel expenses are treated.

9-4 TRAVEL EXPENSES

9-4a Definition of Travel Expenses

An itemized deduction is allowed for unreimbursed travel expenses related to a taxpayer's employment. **Travel expenses** are more broadly defined in the Code than are transportation expenses. Travel expenses include transportation expenses and meals and lodging while away from home in the pursuit of a trade or business. Meals cannot be lavish or extravagant under the circumstances. Transportation expenses (as previously discussed) are deductible even though the taxpayer is not away from home. A deduction for travel expenses is available only if the taxpayer is away from his or her tax home. Travel expenses also include reasonable laundry and incidental expenses.

9-4b Away-from-Home Requirement

The crucial test for the deductibility of travel expenses is whether the employee is away from home overnight. "Overnight" need not be a 24-hour period, but it must be a period substantially longer than an ordinary day's work and must require rest, sleep, or a relief-from-work period.¹² A one-day business trip is not travel status, and meals and lodging for such a trip are not deductible.

Temporary Assignments

The employee must be away from home for a temporary period. If the taxpayer-employee is reassigned to a new post for an indefinite period of time, that new post becomes his or her tax home. *Temporary* indicates that the assignment's termination is expected within a reasonably short period of time. The position of the IRS is that the tax home is the business location, post, or station of the taxpayer. Thus, travel expenses are not deductible if a taxpayer is reassigned for an indefinite period and does not move his or her place of residence to the new location.

¹²*U.S. v. Correll*, 68-1 USTC ¶9101, 20 AFTR 2d 5845, 88 S.Ct. 445 (USSC, 1967); Rev.Rul. 75-168, 1975-1 C.B. 58.

Temporary Becomes Permanent

Malcolm's employer opened a branch office in San Diego. Malcolm was assigned to the new office for three months to train a new manager and to assist in setting up the new office. He tried commuting from his home in Los Angeles for a week and decided that he could not continue driving several hours a day. He rented an apartment in San Diego, where he lived during the week. He spent weekends with his wife and children at their home in Los Angeles. Malcolm's rent, meals, laundry, incidentals, and automobile expenses in San Diego are deductible. To the extent that Malcolm's transportation expense related to his weekend trips home exceeds what his cost of meals and lodging would have been, the excess is personal and nondeductible.

EXAMPLE

12

Assume that Malcolm in Example 12 was transferred to the new location to become the new manager permanently. His wife and children continued to live in Los Angeles until the end of the school year. Malcolm is no longer "away from home" because the assignment is not temporary. His travel expenses are not deductible.

EXAMPLE

13

To curtail controversy in this area, the Code specifies that a taxpayer "*shall not* be treated as *temporarily* away from home during any period of employment if such period exceeds 1 year."¹³

Determining the Tax Home

Under ordinary circumstances, determining the location of a taxpayer's tax home does not present a problem. The tax home is the area in which the taxpayer derives his or her source of income.

It is possible for a taxpayer never to be away from his or her tax home. In other words, the tax home follows the taxpayer. Thus, all meals and lodging remain personal and are not deductible.

Jim is single and works full-time as a long-haul truck driver. He lists his mother's home as his address and stays there during holidays. However, he contributes nothing toward its maintenance. Because Jim has no regular place of duty or place where he regularly lives, his tax home is where he works (i.e., on the road). As an itinerant (transient), he is never away from home, and all of his meals and lodging while on the road are personal and not deductible.

EXAMPLE

14

The result reached in Example 14 is justified on the grounds that there is no duplication of living expenses in the case of itinerant taxpayers.¹⁴

When a taxpayer has more than one place of business or work, the main one is considered to be the tax home. This is determined by considering the time spent, the level of activity involved, and the income earned at each job.

Art, a physical therapist, lives with his family in Lancaster, Pennsylvania. For seven months each year, he is employed by the New Orleans Saints football team at a salary of \$150,000. During this period, he rents an apartment in New Orleans. In the off-season, he works for the Lancaster YMCA at a salary of \$15,000. Art's tax home is clearly New Orleans and not Lancaster. Consequently, his living expenses while in New Orleans (i.e., food and lodging) are not deductible.

EXAMPLE

15

9-4C Restrictions on Travel Expenses

The possibility always exists that taxpayers will attempt to treat vacation or pleasure travel as deductible business travel. To prevent such practices, the law contains restrictions on certain travel expenses.

¹³§ 162(a).

¹⁴Rev.Rul. 73-539, 1973-2 C.B. 37 and *James O. Henderson*, 70 TCM 1407, T.C.Memo. 1995-559, *aff'd* by 98-1 USTC ¶50,375, 81 AFTR 2d 98-1748, 143 F.3d 497 (CA-9, 1998).

Conventions

For travel expenses to be deductible, a convention must be directly related to the taxpayer's trade or business.¹⁵ Compare Examples 16 and 17.

Type of Convention

EXAMPLE

16

Dr. Hill, a pathologist who works for a hospital in Ohio, travels to Las Vegas to attend a two-day session on recent developments in estate planning. No deduction is allowed for Dr. Hill's travel expenses.

EXAMPLE

17

Assume the same facts as in Example 16, except that the convention deals entirely with recent developments in pathology. Now a travel deduction is allowed.

If the proceedings of the convention are videotaped, the taxpayer must attend convention sessions to view the videotaped materials along with other participants. However, a deduction will be allowed for costs (other than travel, meals, and entertainment) of renting or using videotaped materials related to business.

EXAMPLE

18

A CPA is unable to attend a convention at which current developments in taxation are discussed. She pays \$300 for videotapes of the lectures and views them at home later. The \$300 is an itemized deduction if the CPA is an employee. If she is self-employed, the \$300 is a deduction *for* AGI.

The Code places stringent restrictions on the deductibility of travel expenses of the taxpayer's spouse or dependent.¹⁶ Generally, the accompaniment by the spouse or dependent must serve a bona fide business purpose, and the expenses must be otherwise deductible.

EXAMPLE

19

Assume the same facts as in Example 17 with the additional fact that Dr. Hill is accompanied by Mrs. Hill. Mrs. Hill is not employed, but possesses secretarial skills and takes notes during the proceedings. No deduction is allowed for Mrs. Hill's travel expenses. If, however, Mrs. Hill is a nurse trained in pathology and is employed by Dr. Hill as his assistant, her travel expenses become deductible.

Education

Travel as a form of education is not deductible.¹⁷ If, however, the education qualifies as a deduction, the travel involved is allowed. Compare Examples 20 and 21.

Education Travel

EXAMPLE

20

Greta, a German teacher, travels to Germany to maintain general familiarity with the language and culture. No travel expense deduction is allowed.

EXAMPLE

21

Jean-Claude, a scholar of French literature, travels to Paris to do specific library research that cannot be done elsewhere and to take courses that are offered only at the Sorbonne. The travel costs are deductible assuming that the other requirements for deducting education expenses (discussed later in the chapter) are met.

9-4d Combined Business and Pleasure Travel

To be deductible, travel expenses need not be incurred in the performance of specific job functions.

¹⁵§ 274(h)(1).

¹⁶§ 274(m)(3).

¹⁷§ 274(m)(2).

Domestic Travel for Business and Pleasure

In order to limit the possibility of a taxpayer claiming a tax deduction for what is essentially a personal vacation, several provisions have been enacted to govern deductions associated with combined business and pleasure trips. If the business/pleasure trip is from one point in the United States to another point in the United States, the transportation expenses are deductible only if the trip is *primarily for business*.¹⁸ Meals, lodging, and other expenses are allocated between business and personal days. If the trip is primarily for pleasure, no transportation expenses qualify as a deduction. Compare Examples 22 and 23.

Meeting the Primary Business Purpose Test

In the current year, Hana travels from Seattle to New York primarily for business. She spends five days conducting business and three days sightseeing and attending shows. Her plane and taxi fare amounts to \$1,160. Her meals amount to \$200 per day, and lodging and incidental expenses are \$350 per day. She can deduct the transportation charges of \$1,160, because the trip is primarily for business (five days of business versus three days of sightseeing). Meals are limited to five days and are subject to the 50% cutback (discussed later in the chapter), for a total of \$500 [5 days × (\$200 × 50%)], and other expenses are limited to \$1,750 (5 days × \$350). If Hana is an employee, the unreimbursed travel expenses are miscellaneous itemized deductions.

EXAMPLE

22

Assume that Hana goes to New York for a two-week vacation. While there, she spends several hours renewing acquaintances with people in her company's New York office. Her transportation expenses are not deductible.

EXAMPLE

23

Foreign Travel for Business and Pleasure

When the trip is *outside the United States*, special rules apply. Transportation expenses must be allocated between business and personal unless (1) the taxpayer is away from home for seven days or less or (2) less than 25 percent of the time was for personal purposes. No allocation is required if the taxpayer has no substantial control over arrangements for the trip or the desire for a vacation is not a major factor in taking the trip. If the trip is primarily for pleasure, no transportation charges are deductible. Days devoted to travel are considered business days. Weekends, legal holidays, and intervening days are considered business days, provided that both the preceding and succeeding days were business days.¹⁹ Compare Examples 24 and 25.

The Amount of Nonbusiness Time Permitted

In the current year, Robert takes a trip from New York to Japan primarily for business purposes. He is away from home from June 10 through June 19. He spends three days vacationing and seven days (including two travel days) conducting business. His airfare is \$4,000, his meals amount to \$200 per day, and lodging and incidental expenses are \$300 per day. Because Robert is away from home for more than seven days and more than 25% of his time is devoted to personal purposes, only 70% (7 days business/10 days total) of the transportation is deductible. His deductions are as follows:

EXAMPLE

24

Transportation (70% × \$4,000)		\$2,800
Lodging (\$300 × 7)		2,100
Meals (\$200 × 7)	\$1,400	
Less: 50% cutback (discussed later)	<u>(700)</u>	<u>700</u>
Total		<u><u>\$5,600</u></u>

¹⁸Reg. § 1.162-2(b)(1).

¹⁹§ 274(c) and Reg. § 1.274-4. For purposes of the seven-days-or-less exception, the departure travel day is not counted.

The Amount of Nonbusiness Time Permitted

EXAMPLE

25

Assume the same facts as in Example 24. Robert is gone the same period of time, but spends only two days (rather than three) vacationing. Now no allocation of transportation is required. Because the pleasure portion of the trip is less than 25% of the total, all of the airfare qualifies for the travel deduction.

LO.4

Determine the moving expense deduction.

9-5 MOVING EXPENSES

Moving expenses are deductible for moves in connection with the commencement of work at a new principal workplace.²⁰ Both employees and self-employed individuals can deduct these expenses. To be eligible for a moving expense deduction, a taxpayer must meet two basic tests: distance and time.

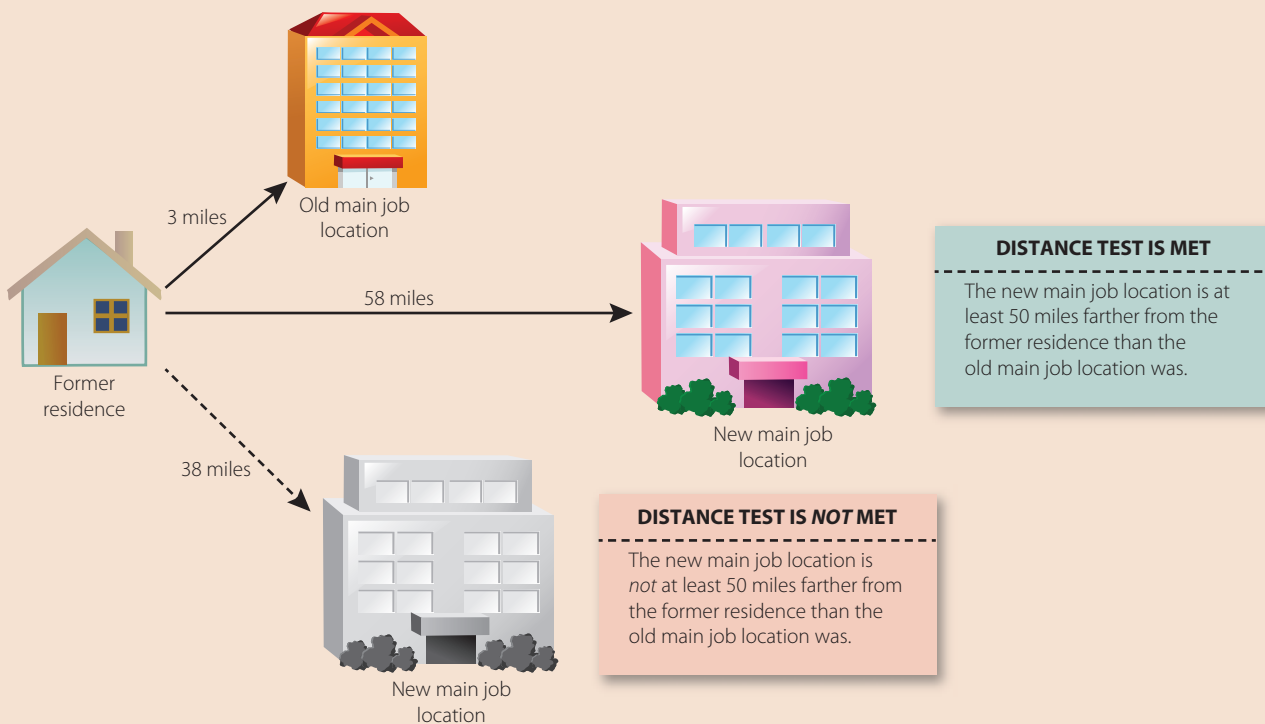
9-5a Distance Test

To meet the distance test, the taxpayer's new job location must be at least 50 miles farther from the taxpayer's old residence than the old residence was from the former place of employment. In this regard, the location of the new residence is not relevant. This eliminates a moving deduction for taxpayers who purchase a new home in the same general area without changing their place of employment. Those who accept a new job in the same general area as the old job location are also eliminated.

Concept Summary 9.1 illustrates what does and does not satisfy the distance test.

Concept Summary 9.1

Meeting and Not Meeting the Distance Test



²⁰§ 217(a).

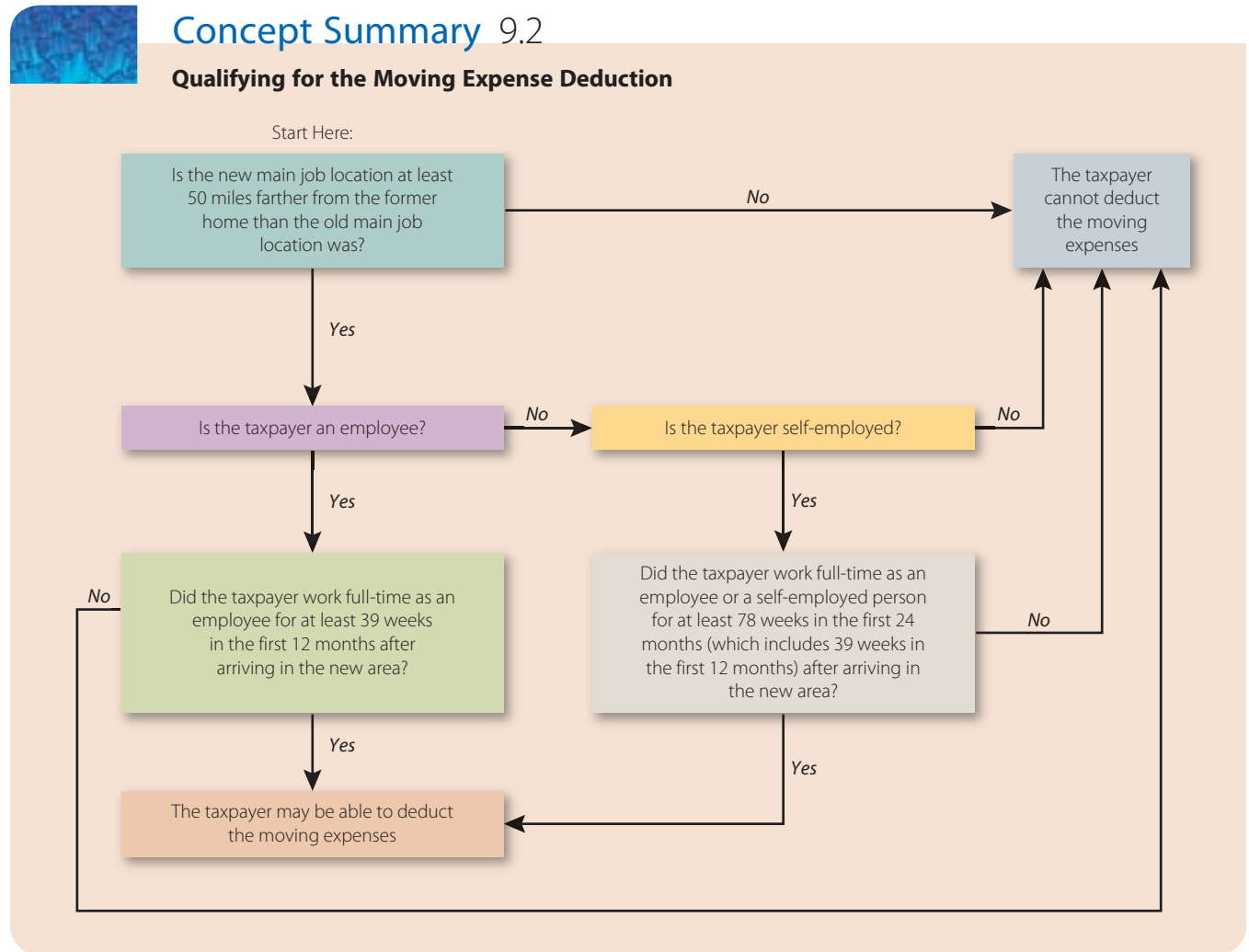
If an individual is not employed before the move, the new job must be at least 50 miles from the former residence.

9-5b **Time Test**

To meet the time test, an employee must be employed on a full-time basis at the new location for 39 weeks in the 12-month period following the move. If the taxpayer is a self-employed individual, he or she must work in the new location for 78 weeks during the next two years. The first 39 weeks must be in the first 12 months. The time test is disregarded if the taxpayer dies, becomes disabled, or is discharged (other than for willful misconduct) or transferred by the employer.

A taxpayer might not be able to meet the 39-week test by the due date of the tax return for the year of the move. For this reason, two alternatives are allowed. The taxpayer can take the deduction in the year the expenses are incurred, even though the 39-week test has not been met. If the taxpayer later fails to meet the test, either (1) the income of the following year is increased by an amount equal to the deduction previously claimed for moving expenses or (2) an amended return is filed for the year of the move. The second alternative is to wait until the test is met and then file an amended tax return for the year of the move.

These rules are summarized in Concept Summary 9.2. Members of the armed forces are subject to special rules.²¹



²¹See IRS Publication 521 (*Moving Expenses*), pp. 14–15.

9-5c Treatment of Moving Expenses

What Is Included

“Qualified” moving expenses include *reasonable* expenses of:

- Moving household goods and personal effects.
- Traveling from the former residence to the new place of residence.

For this purpose, *traveling* includes lodging, but not meals, for the taxpayer and members of the household.²² The taxpayer can elect to use actual auto expenses (no depreciation is allowed) or the automatic mileage method. In this case, moving expense mileage is limited in 2015 to 23 cents per mile for each car. The automatic mileage rate for 2014 was 23.5 cents. These expenses are also limited by the reasonableness standard. For example, if one moves from Texas to Florida via Maine and takes six weeks to do so, the transportation and lodging must be allocated between personal and moving expenses.

EXAMPLE

26

Jill is transferred by her employer from the Atlanta office to the San Francisco office. In this connection, she spends the following amounts:

Cost of moving furniture	\$4,800
Transportation	700
Meals	450
Lodging	600

Jill's total qualified moving expense is \$6,100 (\$4,800 + \$700 + \$600).

The moving expense deduction is allowed regardless of whether the employee is transferred by the existing employer or is employed by a new employer. It is allowed if the employee moves to a new area and obtains employment or switches from self-employed status to employee status (and vice versa). The moving expense deduction is also allowed if an individual is unemployed before obtaining employment in a new area.

What Is Not Included

In addition to meals while en route, the moving expense deduction does *not* include the following costs:

- New car tags and driver's licenses.
- Loss on the sale of a residence or penalty for breaking a lease.
- Forfeiture of security deposits and loss from disposing of club memberships.
- Pre-move house-hunting expenses.
- Temporary living expenses.

Also not deductible are the costs of moving servants and others who are not members of the household.

How Treated

Qualified moving expenses that are paid (or reimbursed) by the employer are not reported as part of the gross income of the employee.²³ Moving expenses that are paid (or reimbursed) by the employer and are not qualified moving expenses are included in the employee's gross income and are not deductible.

²²§ 217(b).

²³§§ 132(a)(6) and (g).



GLOBAL TAX ISSUES Expatriates and the Moving Expense Deduction

Expatriates, U.S. persons who accept work assignments overseas, enjoy several favorable tax advantages regarding foreign moves. First, the cost of storing household goods qualifies as a moving expense. This could lead to a major tax saving because expatriates do not ship most of their household effects to the foreign location. Furthermore, the cost of storage, particularly in a climate-controlled facility, is not insignificant.

The second advantage expatriates could enjoy is an exemption from the time test. Those who return to the United States to retire are absolved from the 39-week or 78-week work requirement. Thus, the return home expenses are treated as qualified moving expenses.

Source: Internal Revenue Code § 217(i).

The employer is responsible for allocating the reimbursement between the qualified and nonqualified moving expenses. Reimbursed qualified moving expenses are separately stated on the Form W-2 given to the employee for the year involved. Qualified moving expenses that are not reimbursed and those of self-employed taxpayers are deductions *for* AGI.²⁴

The Big Picture

Return to the facts of *The Big Picture* on p. 9-1. Even though this is her first job, Morgan will be entitled to a moving expense deduction. This presumes that she is not reimbursed by Kite Corporation for these expenses. She should not forget that the mileage on her auto also is allowed. Her deduction is *for* AGI and can be claimed even if she chooses the standard deduction option.

EXAMPLE

27

Form 3903 is used to report the details of the moving expense deduction if the employee is not reimbursed or a self-employed person is involved.

9-6 EDUCATION EXPENSES

9-6a General Requirements

An employee can deduct expenses incurred for education (**education expenses**) as ordinary and necessary business expenses provided the expenses are incurred for either of two reasons:

- To meet the express requirements of the employer or the requirements imposed by law to retain his or her employment status.
- To maintain or improve existing skills required in the present job.

Education expenses are *not* deductible if the education is for either of the following purposes (except as discussed under A Limited Deduction Approach, which follows):

- To meet the minimum educational standards for qualification in the taxpayer's existing job.
- To qualify the taxpayer for a new trade or business.²⁵

Fees incurred for professional qualification exams (the bar exam, for example) and fees for review courses (such as a CPA review course) are not deductible.²⁶ If the education incidentally results in a promotion or raise, the deduction still can be taken as

LO.5

Differentiate between deductible and nondeductible education expenses.

²⁴§ 62(a)(15).

²⁵Reg. §§ 1.162-5(b)(2) and (3).

²⁶Reg. § 1.212-1(f) and Rev.Rul. 69-292, 1969-1 C.B. 84.

long as the education maintained and improved existing skills and did not qualify a person for a new trade or business. A change in duties is not always fatal to the deduction if the new duties involve the same general work. For example, the IRS has ruled that a practicing dentist's education expenses incurred to become an orthodontist are deductible.²⁷

9-6b Requirements Imposed by Law or by the Employer for Retention of Employment

Taxpayers are permitted to deduct education expenses if additional courses are required by the employer or are imposed by law. Many states require a minimum of a bachelor's degree and a specified number of additional courses to retain a teaching job. In addition, some public school systems have imposed a master's degree requirement and require teachers to make satisfactory progress toward a master's degree to keep their positions. If the required education is the minimum degree required for the job, no deduction is allowed.

A taxpayer classified as a staff accountant who went back to school to obtain a bachelor's degree in accounting was not allowed to deduct the expenses. Although some courses tended to maintain and improve his existing skills in his entry-level position, the degree was the minimum requirement for his job.²⁸

Expenses incurred for education required by law for various professions will also qualify for deduction.

EXAMPLE

28

To satisfy the State Board of Public Accountancy rules for maintaining her CPA license, Nancy takes an auditing course sponsored by a local college. The cost of the education is deductible.

9-6c Maintaining or Improving Existing Skills

The "maintaining or improving existing skills" requirement in the Code has been difficult for both taxpayers and the courts to interpret. For example, a business executive may be permitted to deduct the costs of obtaining an MBA on the grounds that the advanced management education is undertaken to maintain and improve existing management skills. The executive is eligible to deduct the costs of specialized, nondegree management courses that are taken for continuing education or to maintain or improve existing skills. Expenses incurred by the executive to obtain a law degree are not deductible, however, because the education constitutes training for a new trade or business. The Regulations specifically deny a self-employed accountant a deduction for expenses relating to law school.²⁹

The conditions required for the regular education expense deduction are summarized in Concept Summary 9.3.

9-6d Classification of Specific Items

Education expenses include books and supplies, tuition, and transportation (e.g., from the office to night school) and travel (e.g., meals and lodging while away from home at summer school).

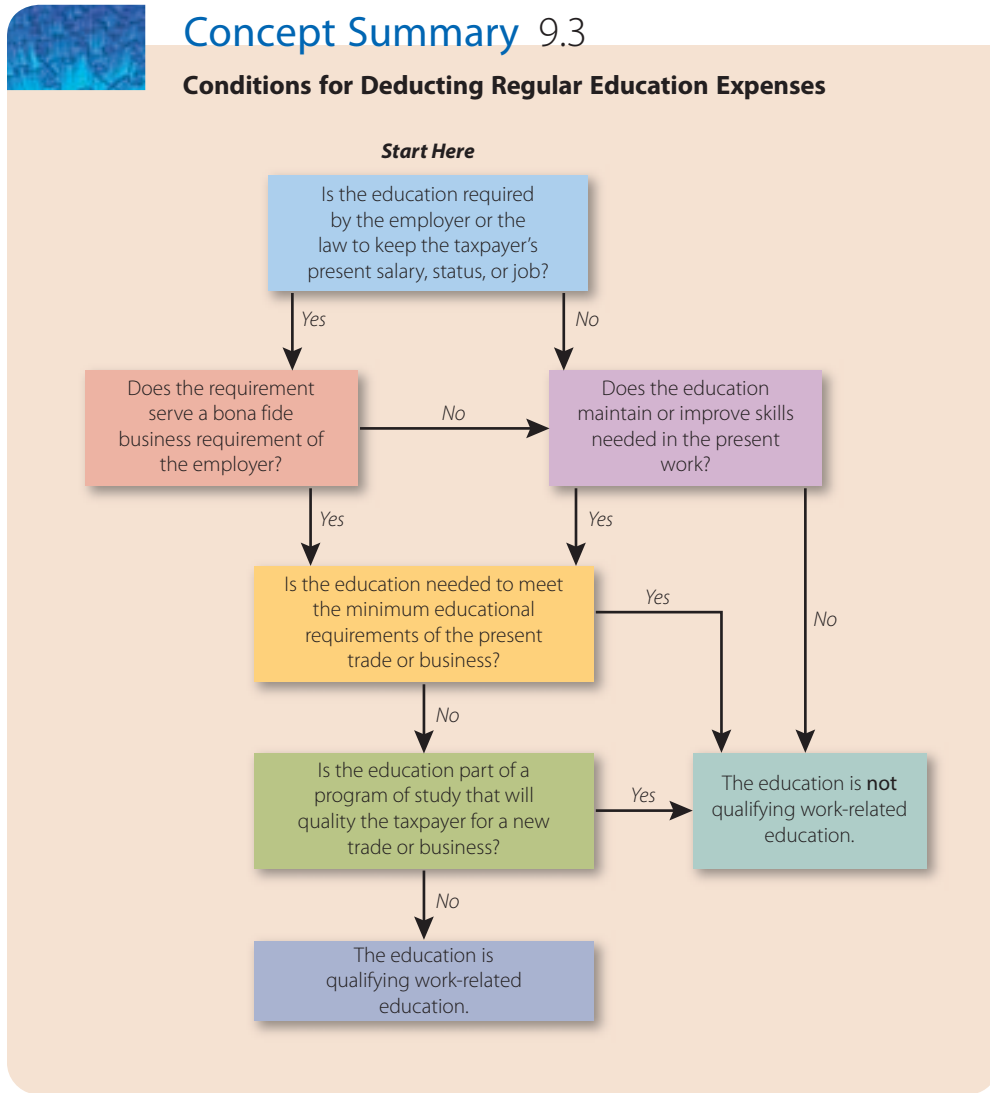
²⁷Rev.Rul. 74-78, 1974-1 C.B. 44.

²⁸Reg. § 1.162-5(b)(2)(iii) Example (2); *Collin J. Davidson*, 43 TCM 743, T.C.Memo. 1982-119. But see the subsequent discussion of § 222 (i.e., the deduction for higher education qualified tuition and related expenses).

²⁹Reg. § 1.162-5(b)(3)(ii) Example (1).

Concept Summary 9.3

Conditions for Deducting Regular Education Expenses



Bill, who holds a bachelor of education degree, is a secondary education teacher in the Charleston school system. The school board recently raised its minimum education requirement for new teachers from four years of college training to five. A grandfather clause allows teachers with only four years of college to continue to qualify if they show satisfactory progress toward a graduate degree. Bill enrolls at the University of South Carolina and takes two graduate courses. His unreimbursed expenses for this purpose are as follows:

Books and tuition	\$3,600
Lodging while in travel status (June–August)	2,150
Meals while in travel status	1,100
Laundry while in travel status	220
Transportation	900

Bill has an itemized deduction as follows:

Books and tuition	\$3,600
Lodging	2,150
Meals less 50% cutback (discussed later)	550
Laundry	220
Transportation	900
	<u>900</u>
	<u>\$7,420</u>

EXAMPLE

29



TAX IN THE NEWS Is an MBA Degree Deductible?

Education that maintains or improves existing skills is deductible, but education that qualifies a taxpayer for a new field is not. But how do these basic rules apply to a conventional (i.e., nonspecialized) MBA degree? Does being a manager or a consultant require an MBA degree? Generally, the answer has always been that it does not. In this regard, therefore, the education does not create a new skill; so its cost should be deductible.

Several recent holdings, however, have found that an MBA degree can lead to qualifying for a new trade or business. But these holdings involved situations where the education resulted in a job change and satisfied different

minimum requirements set by the employer. In one case, for example, the taxpayer moved from the position of investment analyst to become an investment banker, and the latter position required an MBA degree. Under these circumstances, the cost of the education was held to be nondeductible.

But barring a change to a job where the degree is required, the cost of an MBA degree should be deductible as merely improving existing managerial skills.

Source: Daniel R. Allemeier, Jr., 90 TCM 197, T.C.Memo. 2005-207.

9-6e A Limited Deduction Approach

One of the major shortcomings of the education deduction, previously discussed, is that it is unavailable for taxpayers obtaining a basic skill (i.e., to meet the minimum standards required for the taxpayer's current job). This shortcoming has been partly resolved with the **deduction for qualified tuition and related expenses**.

A deduction *for* AGI is allowed for qualified tuition and related expenses involving higher education (i.e., postsecondary). The deduction is the lesser of the qualifying amount spent or the maximum amount allowed by § 222. The maximum deductions allowed are shown in Exhibit 9.1. Note that the limitations are based on the taxpayer's MAGI and filing status.³⁰ Although a phaseout is provided for, note its

EXHIBIT 9.1

Limitations for Qualified Tuition Deduction

Filing Status	MAGI Limit	Maximum Deduction Allowed
Single	\$ 65,000	\$4,000
Married	130,000	
Single	65,001 to 80,000*	2,000
Married	130,001 to 160,000*	2,000

*No deduction at all is available if MAGI exceeds this amount.

³⁰MAGI is modified adjusted gross income as defined in § 222(b)(2)(C). Examples of some of these modifications include the adding back to regular AGI

of the foreign earned income exclusion and the domestic production activities deduction. See IRS Publication 970 (*Tax Benefits for Education*).

short and drastic effect. Only two steps are involved (\$65,000/\$80,000 for single and \$130,000/\$160,000 for married), and the benefit of § 222 *disappears completely* after the second step. Thus, a married couple with MAGI of \$160,000 would lose the entire deduction if they earned an additional \$1. The § 222 limitations are not indexed for inflation.³¹

Various aspects of the higher education tuition deduction are summarized below.

- *Qualified tuition and related expenses* include whatever is required for enrollment at the institution. Usually, student activity fees, books, and room and board are not included.³²
- The expense need not be employment related, although it can be.
- The deduction is available for a taxpayer's spouse or anyone who can be claimed as a dependent and is an eligible student.
- The deduction is not available for married persons who file separate returns.
- To avoid a "double benefit," the deduction must be coordinated with other education provisions (e.g., American Opportunity and lifetime learning credits). Along this same line, no deduction is allowed for a taxpayer who qualifies as another's dependent.³³
- The deduction *for* AGI classification avoids the 2%-of-AGI floor on miscellaneous itemized deductions. As noted later in the chapter, this is the fate suffered by other education-related employee expenses.

The deduction for qualified tuition and related expenses can be determined by completing Form 8917 (Tuition and Fees Deduction). The form should be attached to Form 1040 (or Form 1040-A).

The Big Picture

Return to the facts of *The Big Picture* on p. 9-1. After starting her new job, Morgan enrolls in the night program of a local law school and begins attending classes. Although Morgan does not plan to practice law, she thinks that a law degree will advance her career. Except for the tuition she pays (see the discussion of § 222), none of her expenses relating to the education will be deductible.³⁴

EXAMPLE

30

9-6f Other Provisions Dealing with Education

Although this chapter deals with employment-related expenses, mention should be made of various other tax provisions that deal with education. Because the encouragement of education is a desirable social goal, Congress continues to enact laws that provide tax incentives. The incentives come in the form of income exclusions, deductions (both *for* AGI and *from* AGI), and various credits.

Concept Summary 9.4 reviews the tax consequences of the various provisions dealing with education and indicates where they are discussed in the text.

³¹Section 222 expired on December 31, 2014, but is expected to be extended.

³²Section 222(d) refers to § 25A(f), which deals with the American Opportunity and lifetime learning credits (see Chapter 12). Student activity fees and

prescribed course-related books may be allowed if they are a condition for enrollment.

³³§ 222(c).

³⁴*Steven Galligan*, 83 TCM 1859, T.C.Memo. 2002-150.

Concept Summary 9.4

Tax Consequences of Provisions Dealing with Education

Provision	Tax Effect	Income Phaseout ^a	Reference	
			Code	Text
Educational savings bonds	<i>Exclusion</i> for interest on U.S. Series EE bonds used for qualified higher education	Yes	§ 135	Ch. 5, p. 5-24
Qualified tuition program	No deduction; <i>exclusion</i> for distributions	No	§ 529	Ch. 5, p. 5-25
Educational assistance plans	<i>Exclusion</i> of up to \$5,250 for employer-provided assistance	No ^b	§ 127	Ch. 5, p. 5-15
Scholarships	<i>Exclusion</i> allowed for education costs (excluding room and board)	No	§ 117	Ch. 5, p. 5-7
Qualified tuition reduction plan	<i>Exclusion</i> as to tuition waivers for employees (and dependents) of nonprofit educational institutions	No	§ 117(d)	Ch. 5, p. 5-8
Coverdell Education Savings Account (CESA)	No deduction (\$2,000 maximum annual contribution); <i>exclusion</i> for distributions	Yes ^c	§ 530	—
Premature distributions from IRAs	If used for qualified higher education, income recognized but penalty waived	—	§ 72(t)	Ch. 9, p. 9-32
Qualified tuition and related expenses	<i>Deduction</i> for AGI; up to \$4,000	Yes	§ 222	Ch. 9, p. 9-18
Educator expenses	<i>Deduction</i> for AGI; up to \$250	No	§ 62(a)(2)(D)	Ch. 9, p. 9-27
Interest on student loans	<i>Deduction</i> for AGI; up to \$2,500 per year	Yes	§ 221	Ch. 10, p. 10-14
Job-related education expenses	<i>Deduction</i> from AGI for an <i>employee</i> and subject to 2%-of-AGI floor; <i>deduction</i> for AGI for <i>self-employed</i>	No	§ 162	Ch. 9, p. 9-15
American Opportunity credit	Formerly the HOPE credit; extended to 4 years of postsecondary education; up to \$2,500 per year	Yes	§ 25A(i)	Ch. 12, p. 12-20
Lifetime learning credit	20% of qualifying expenses (not to exceed \$10,000 per year)	Yes	§ 25A(c)	Ch. 12, p. 12-20

^aThe phaseout of benefits occurs when income reaches a certain level. The phaseout amounts vary widely, depend on filing status (i.e., single or married filing jointly), and are based on MAGI (modified AGI).

^bThe availability of the benefit cannot be discriminatory (i.e., cannot favor higher-income taxpayers).

^cIn 2015, the phaseout begins once AGI reaches \$190,000 (married taxpayers) or \$95,000 (unmarried taxpayers).

LO.6

Explain how entertainment and meal expenses are treated.

9-7 ENTERTAINMENT AND MEAL EXPENSES

Many taxpayers attempt to deduct personal entertainment expenses as business expenses. For this reason, the tax law restricts the deductibility of entertainment expenses. The Code contains strict record-keeping requirements and provides restrictive tests for the deduction of certain types of **entertainment expenses**.

9-7a Cutback Adjustment

During the administration of Jimmy Carter, considerable controversy arose regarding the “three martini” business lunch. By virtue of allowing a tax deduction, should the tax law be subsidizing a practice that contained a significant element of personal pleasure? One possible remedy for the situation was to disallow any deduction for business entertainment, but this option was regarded as being too harsh. Instead the *cutback* rule was instituted. Rather than disallowing *all* of the deduction, only a certain percentage, would be allowed and the rest of the expenditure would be cut back. Currently, only 50 percent of meal and entertainment expenses are allowed as a deduction.³⁵ The limitation applies in

³⁵§ 274(n).

the context of both employment and self-employment status. Although the 50 percent cutback can apply to either the employer or the employee, it will not apply twice. The cutback applies to the one who really pays (economically) for the meals or entertainment.

Jane, an employee of Pato Corporation, entertains one of her clients. If Pato Corporation does not reimburse Jane, she is subject to the cutback adjustment. If, however, Pato Corporation reimburses Jane (or pays for the entertainment directly), Pato suffers the cutback.

EXAMPLE

31

In certain situations, however, a full 50 percent cutback seems unfair. If, for example, the hours of service are regulated (by the U.S. Department of Transportation) and away-from-home meals are frequent and necessary, the “three martini” business lunch type of abuse is unlikely. Consequently, the cutback rule is mitigated for the following types of employees:

- Certain air transportation employees, such as flight crews, dispatchers, mechanics, and control tower operators.
- Interstate truck and bus drivers.
- Certain railroad employees, such as train crews and dispatchers.
- Certain merchant mariners.

In these situations, 80 percent of the cost of meals is allowed as a deduction.

What Is Covered

Transportation expenses are not affected by the cutback rule—only meals and entertainment. The cutback also applies to taxes and tips relating to meals and entertainment. Cover charges, parking fees at an entertainment location, and room rental fees for a meal or cocktail party are also subject to the 50 percent rule.

Joe pays a \$40 cab fare to meet his client for dinner. The meal costs \$150, and Joe leaves a \$30 tip. His deduction is \$130 $[(\$150 + \$30) \times 50\% + \$40 \text{ cab fare}]$.

EXAMPLE

32

What Is Not Covered

The cutback rule has a number of exceptions. One exception covers the case where the full value of the meals or entertainment is included in the compensation of the employee (or independent contractor).

Myrtle wins an all-expense-paid trip to Europe for selling the most insurance for her company during the year. Her employer treats this trip as additional compensation to Myrtle. The cutback adjustment does not apply to the employer.

EXAMPLE

33

Another exception applies to meals and entertainment in a subsidized eating facility or where the *de minimis* fringe benefit rule is met (see Chapter 5).

Exemption from Cutback Rule

General Hospital has an employee cafeteria on the premises for its doctors, nurses, and other employees. The cafeteria operates at cost. The cutback rule does not apply to General Hospital.

EXAMPLE

34

Canary Corporation gives a ham, a fruitcake, and a bottle of wine to each employee at year-end. Because the *de minimis* fringe benefit exclusion applies to business gifts of packaged foods and beverages, their *full cost* is deductible by Canary.

EXAMPLE

35



TAX IN THE NEWS Tax Status of a Gourmet Cafeteria

Although the cost of operating the company cafeteria is deductible by the employer (and is not subject to the cutback rule), what are the tax consequences to the employee? A meal will be classified as a nontaxable fringe benefit if it is noncompensatory in nature and furnished for the convenience of the employer. If the employer-provided meals become too elaborate, however, the IRS will treat

them as a taxable perk that should be included in income. Apparently this is the approach that is being taken in the case of certain high-tech companies located in California (e.g., Google, Facebook, and Twitter).

Source: Adapted from Mark Maremont, "Silicon Valley Cafeterias Whet Appetite of IRS," *Wall Street Journal*, September 2, 2014, p. B1.

A similar exception applies to employer-paid recreational activities for employees (e.g., the annual Christmas party or spring picnic).³⁶

9-7b Classification of Expenses

Entertainment expenses are categorized as follows: those *directly related* to business and those *associated with* business.³⁷ Directly related expenses are related to an actual business meeting or discussion. These expenses are distinguished from entertainment expenses that are incurred to promote goodwill, such as maintaining existing customer relations. To obtain a deduction for directly related entertainment, it is not necessary to show that actual benefit resulted from the expenditure as long as there was a reasonable expectation of benefit. To qualify as directly related, the expense should be incurred in a clear business setting. If there is little possibility of engaging in the active conduct of a trade or business due to the nature of the social facility, it is difficult to qualify the expenditure as directly related to business.

Expenses associated with, rather than directly related to, business entertainment must serve a specific business purpose, such as obtaining new business or continuing existing business. These expenditures qualify only if the expenses directly precede or follow a bona fide business discussion. Entertainment occurring on the same day as the business discussion meets the test.

9-7c Restrictions upon Deductibility

Business Meals

Any business meal is deductible only if all of the following are true:³⁸

- The meal is directly related to or associated with the active conduct of a trade or business.
- The expense is not lavish or extravagant under the circumstances.
- The taxpayer (or an employee) is present at the meal.

A business meal with a business associate or customer is not deductible unless business is discussed before, during, or after the meal. This requirement is not intended to disallow the deduction for a meal consumed while away from home on business.

EXAMPLE

36

Lacy travels to San Francisco for a business convention. She pays for dinner with three colleagues and is not reimbursed by her employer. They do not discuss business. She can deduct 50% of the cost of her meal. However, she cannot deduct the cost of her colleagues' meals.

The taxpayer or an employee must be present at the business meal for the meal to be deductible. An independent contractor who renders significant services to the taxpayer is treated as an employee.

³⁶§ 274(e)(4).

³⁷§ 274(a)(1)(A).

³⁸§ 274(k).

Lance, a party to a contract negotiation, buys dinner for other parties to the negotiation but does not attend the dinner. No deduction is allowed.

EXAMPLE**37****ETHICS & EQUITY Your Turn or Mine?**

Natalie (a CPA), Mathew (an attorney), Jacob (a banker), and Avery (an insurance agent) all live and work in the same community. They have been friends since college. Every Friday, they have lunch together and make it a point to discuss some business matters. They take turns paying for the group's

lunches, and each deducts the amount he or she paid for the lunch as an entertainment expense. Presuming that one of the four is audited, do you anticipate any difficulty with the IRS? Explain.

Club Dues

The Code provides: "No deduction shall be allowed ... for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose."³⁹ Although this prohibition seems quite broad, the IRS does allow a deduction for dues to clubs whose primary purpose is public service and community volunteerism (e.g., Kiwanis, Lions, and Rotary).

Even though dues are not deductible, actual entertainment at a club may qualify.

During the current year, Vincent spent \$1,400 on business lunches at the Lakeside Country Club. The annual membership fee was \$6,000, and Vincent used the facility 60% of the time for business. Presuming that the lunches meet the business meal test, Vincent may claim \$700 ($50\% \times \$1,400$) as a deduction. None of the club dues are deductible.

EXAMPLE**38****Ticket Purchases for Entertainment**

A deduction for the cost of a ticket for an entertainment activity is limited to the face value of the ticket.⁴⁰ This limitation is applied before the 50 percent rule. The face value of a ticket includes any tax. Under this rule, the excess payment to a scalper for a ticket is not deductible. Similarly, the fee to a ticket agency for the purchase of a ticket is not deductible.

Expenditures for the rental or use of a luxury skybox at a sports arena in excess of the face value of regular tickets are disallowed as deductions. If a luxury skybox is used for entertainment that is directly related to or associated with business, the deduction is limited to the face value of nonluxury box seats. All seats in the luxury skybox are counted, even when some seats are unoccupied.

The taxpayer may also deduct stated charges for food and beverages under the general rules for business entertainment. The deduction for skybox seats, food, and beverages is limited to 50 percent of cost.

In the current year, Jay Company pays \$12,000 to rent a 10-seat skybox at City Stadium for three football games. Nonluxury box seats at each event range from \$55 to \$120 a seat. In September, a Jay representative and eight clients use the skybox for the first game. The entertainment follows a bona fide business discussion, and Jay spends \$490 for food and beverages during the game. The deduction for the first sports event is as follows:

Food and beverages	\$ 490
Deduction for seats ($\$120 \times 10$ seats)	<u>1,200</u>
Total entertainment expense	\$1,690
50% limitation	<u>$\times .50$</u>
Deduction	<u><u>\$ 845</u></u>

EXAMPLE**39**

³⁹§ 274(a)(3).

⁴⁰§ 274(l).

Business Gifts

Although not subject to a cutback adjustment, business gifts are deductible only to the extent of \$25 per donee per year.⁴¹ An exception is made for gifts costing \$4 or less (e.g., pens with the employee's or company's name on them) or promotional materials. Such items are not treated as business gifts subject to the \$25 limitation. In addition, incidental costs such as engraving of jewelry and nominal charges for gift-wrapping, mailing, and delivery are not included in the cost of the gift in applying the limitation. Gifts to superiors and employers are not deductible.

The \$25 limitation on business gifts cannot be circumvented by having the donor's spouse join in the gift or by making multiple gifts that include the customer's family.

Records must be maintained to substantiate business gifts.

LO.7

Identify other employee expenses.

9-8 OTHER EMPLOYEE EXPENSES

9-8a Office in the Home

Employees and self-employed individuals are not allowed a deduction for **office in the home expenses** unless a portion of the residence is used *exclusively* on a *regular basis* as either of the following:

- The principal place of business for any trade or business of the taxpayer.
- A place of business used by clients, patients, or customers.

Employees must meet an additional test: The use must be for the *convenience of the employer* rather than merely being “appropriate and helpful.”⁴²

The precise meaning of “principal place of business” has been the subject of considerable controversy.⁴³ Congress ultimately resolved the issue by amending the Code.⁴⁴ The term *principal place of business* now includes a place of business that satisfies the following requirements:

- The office is used by the taxpayer to conduct administrative or management activities of a trade or business.
- There is no other fixed location of the trade or business where the taxpayer conducts these activities.

EXAMPLE

40

Dr. Smith is a self-employed anesthesiologist. During the year, he spends 30 to 35 hours per week administering anesthesia and postoperative care to patients in three hospitals, none of which provides him with an office. He also spends two or three hours per day in a room in his home that he uses exclusively as an office. He does not meet patients there, but he performs a variety of tasks related to his medical practice (e.g., contacting surgeons, bookkeeping, and reading medical journals). A deduction will be allowed because Dr. Smith uses the office in the home to conduct administrative or management activities of his trade or business and there is no other fixed location where these activities can be carried out.

The exclusive use requirement means that part of the home must be used solely for business purposes. An exception allows mixed use (both business and personal) of the home if a licensed day-care business is involved.

Exclusive Use Requirement

EXAMPLE

41

Troy is self-employed and maintains an office in his home for business purposes. The office is also used by his wife to pay the family bills and by his children to do homework assignments. Troy does not satisfy the exclusive use requirement, and no office in the home deduction is allowed.

⁴¹§ 274(b)(1).

⁴²§ 280A(c)(1).

⁴³See the restrictive interpretation arrived at in *Comm. v. Soliman*, 93-1 USTC ¶50,014, 71 AFTR 2d 93-463, 113 S.Ct. 701 (USSC, 1993).

⁴⁴§ 280A(c)(1) as modified by the Tax Reform Act of 1997.

Exclusive Use Requirement

Muriel operates a licensed day-care center in her home. The children use the living room as a play area during the day, and Muriel and her family use it for personal purposes in the evening and on weekends. The mixed use of the living room does not disqualify Muriel from an office in the home deduction.

EXAMPLE

42

The office in the home deduction can be determined in either of two ways: the regular (actual expense) method or the simplified (safe harbor) method.

Regular Method

In arriving at the office in the home deduction, relevant expenses are categorized as direct or indirect. Direct expenses benefit only the business part of the home (e.g., the office is repainted) and are deducted in full. Indirect expenses are for maintaining and operating the home. Because they benefit both business and personal use, an allocation between the two is necessary. The allocation is made based on the floor space involved—divide the business area by the total home area to arrive at the business percentage.

The allowable home office expenses cannot exceed the gross income from the business less all other business expenses attributable to the activity. Furthermore, the home office expenses that are allowed as itemized deductions anyway (e.g., mortgage interest and real estate taxes) must be deducted first. All home office expenses of an employee are miscellaneous itemized deductions, except those (such as interest and taxes) that qualify as other personal itemized deductions. Home office expenses of a self-employed individual are trade or business expenses and are deductible *for* AGI.

Any disallowed home office expenses are *carried forward* and used in future years subject to the same limitations.

Rick is a certified public accountant employed by a regional CPA firm as a tax manager. He operates a separate business in which he refinishes furniture in his home. For this business, he uses two rooms in the basement of his home exclusively and regularly. The floor space of the two rooms is 240 square feet, which constitutes 10% of the total floor space of his 2,400-square-foot residence. Gross income from the business totals \$8,000. Expenses of the business (other than home office expenses) are \$6,500. Rick incurs the following home office expenses:

EXAMPLE

43

Real property taxes on residence	\$4,000
Interest expense on residence	7,500
Operating expenses of residence (including homeowners insurance)	2,000
Depreciation on residence (based on 10% business use)	350

Rick's deductions are determined as follows:

Business income	\$ 8,000
Less: Other business expenses	<u>(6,500)</u>
Net income from the business (before the office in the home deduction)	\$ 1,500
Less: Allocable taxes ($\$4,000 \times 10\%$)	\$400
Allocable interest ($\$7,500 \times 10\%$)	<u>750</u>
	(1,150)
	\$ 350
Allocable operating expenses of the residence ($\$2,000 \times 10\%$)	<u>(200)</u>
	\$ 150
Allocable depreciation ($\$350$, limited to remaining income)	<u>(150)</u>
	<u>\$ -0-</u>

Rick has a carryover of \$200 (the unused excess depreciation). Because he is self-employed, the allocable taxes and interest (\$1,150), the other deductible office expenses (\$200 + \$150), and \$6,500 of other business expenses are deductible *for* AGI.

As noted in Example 43, the office in the home deduction includes an allocable portion of the depreciation on the personal residence. To arrive at this depreciation, taxpayers use the MACRS percentage for 39-year nonresidential real property. Except for the first and last years (i.e., 1 and 40), the applicable percentage is 2.564 percent—see Exhibit 8.9 in Chapter 8. Office furnishings are handled separately and are either expensed under § 179 or depreciated in accordance with the rules discussed in Chapter 8—see Exhibit 8.1 and Exhibit 8.4.

An office in the home deduction is also available to those who rent (rather than own) their home. If the taxpayer does not own the property, the applicable percentage of business use is applied to the rent being paid.

The office in the home deduction as computed under the regular method can be claimed using Form 8829 (Expenses for Business Use of Your Home).

Simplified Method

Because of the complexity involved in using the regular method and, in particular, the difficulty in working with Form 8829, the IRS has established an optional simplified method for the office in the home deduction.⁴⁵ Presuming the taxpayer has met the requirements for the deduction (e.g., business purpose, exclusive use requirements), the amount allowed is \$5 per square foot of space devoted to the office. However, as no more than 300 square feet can be counted, the maximum deduction is limited to \$1,500. The various rules governing the use of the simplified method are summarized below.

- No depreciation on the residence can be claimed.
- Actual expenses of maintaining and operating the home (e.g., qualified residence interest, property taxes, homeowners insurance, utilities) are ignored. Some of these expenses (e.g., qualified residence interest, property taxes) might otherwise be claimed elsewhere on the return. Further, these expenses can be claimed in full without any reduction due to a home office deduction being claimed.
- No unused deduction (e.g., in excess of the net income from the business) can be carried over to a future year. Nor can an unused deduction from a prior year be carried to a simplified method year.

Taxpayers who claim an office in the home deduction are allowed an annual choice between the regular method and the simplified method. Although the choice of the simplified method once made is binding for that year, it is not binding on future years. Care should be taken in making the choice because the simplified method may yield a smaller deduction.

EXAMPLE

44

Assume the same facts as in Example 43 except that Rick does not choose the regular method for determining the office in the home deduction. He chooses the simplified method with the following results:

Net income from the business (before the office in the home deduction)	\$1,500
Simplified office in the home deduction (\$5 × 240 square feet)	<u>1,200</u>
Net income from the business	<u>\$ 300</u>

In comparing the results of Examples 43 and 44, note that the use of the simplified method left Rick with \$500 less in deductions (counting the \$200 unused carryover). However, Rick can now restore the nonallocated property taxes (\$400) and interest (\$750) to his itemized deductions on Schedule A.

9-8b Miscellaneous Employee Expenses

Miscellaneous employee expenses include those costs that are job-related and are not otherwise covered elsewhere. As the focus here is on their deductibility, this discussion

⁴⁵Rev.Proc. 2013-13, 2013-6 I.R.B. 478.

presumes that such expenses have not been reimbursed by the employer under an accountable plan arrangement (discussed later in the chapter).

Expenses related to maintaining job status make up a significant category of miscellaneous expenses. They include such costs as union dues, membership dues to professional organizations, subscriptions to trade publications and professional journals, and various license fees paid to government agencies and other regulatory bodies.

Special Clothing

To be deductible, special clothing must be both specifically required as a condition of employment and not adaptable for regular wear. For example, a police officer's uniform must be worn when "on duty" but is not suitable for "off-duty" activities. Its cost, therefore, is deductible. When special clothing qualifies for deductibility, so does the cost of its maintenance (i.e., alterations, laundry, and dry cleaning).

The cost of clothing possessing *safety* features to prevent workplace injuries will qualify. This includes such items as safety glasses, shoes (e.g., "steel-toed"), special gloves, lab coats, and hard hats. The tolerance of the IRS in the area of safety clothing is partially attributable to its lack of suitability for personal use.

Job Hunting

The expenses incurred in seeking employment can be deductible under certain conditions. The search must involve the same trade or business as the taxpayer's current position. No deduction is allowed for the cost of obtaining the first job. Nor does a change in jobs have to result. Costs that qualify include job counseling, compilation and distribution of biographical data (such as work history), and unreimbursed travel for job interviews.

The Big Picture

Return to the facts of *The Big Picture* on p. 9-1. Recall that Morgan conducted an extensive job search before obtaining her position with Kite Corporation. Because this is her first job, the expenses she incurred in the search are not deductible.

EXAMPLE

45

Educator Expenses

Many teachers purchase school supplies for classroom use and are not reimbursed by their employer. These out-of-pocket expenses can be deducted only if the teacher itemizes his or her deductions *from* AGI, and even then they are subject to the 2%-of-AGI floor (discussed later in this chapter). Thus, these restrictions can reduce or eliminate any tax benefit available to the teacher. *Modest* relief is provided for such out-of-pocket expenses by allowing elementary and secondary school teachers to claim up to \$250 for school supplies as a deduction *for* AGI.⁴⁶ Eligible educators must work at least 900 hours during a school year as a teacher, an instructor, a counselor, a principal, or an aide at either public or private elementary and secondary schools. Covered costs include unreimbursed expenses for books, supplies, computer and other equipment, and supplementary materials used in the classroom.

Hortense is a full-time teacher at Hoover Elementary. During the year, she spends \$1,200 for school supplies for her fourth-grade class. Under an accountable plan (discussed later in the chapter), Hoover reimburses her for \$400 of these supplies. As to the \$800 balance, Hortense may claim \$250 as a deduction *for* AGI and \$550 as a miscellaneous itemized deduction (subject to the 2%-of-AGI floor).

EXAMPLE

46

⁴⁶§ 62(a)(2)(D). This provision expired on December 31, 2014, but is expected to be extended.

LO.8

Compare various deductions for contributions to retirement accounts.

9-9 CONTRIBUTIONS TO RETIREMENT ACCOUNTS

Pension considerations are an essential feature of any compensation arrangement. As noted in Chapter 1, providing retirement security for employees can be justified on both economic and social grounds. Because the public sector (i.e., Social Security) will not provide sufficient retirement security for recipients, the private sector must fill the need. Congress has given the private sector the necessary incentive by enacting various measures that provide significant tax advantages for retirement plans. Although amounts that may be deferred under these plans are limited, the tax advantages are substantive and include (1) the deductibility of contributions (individuals are not taxed on these contributions until they are distributed), (2) income earned on the contributions is not subject to tax until distributed (thus growing at a tax-free rate of return), and (3) employer contributions to and benefits payable under qualified plans generally are not subject to FICA and FUTA taxes.

Although a wide variety of retirement plans exist, we will focus on some typical qualified retirement plans: (1) § 401(k) plans (a defined contribution plan⁴⁷ typically offered to employees); (2) Individual Retirement Accounts (available to any person who has earned income); and (3) plans available to self-employed individuals, including Keogh plans (also known as H.R. 10 plans), Solo § 401(k) plans, Saving Incentive Match for Employees (SIMPLE) plans, and Simplified Employee Pension (SEP) plans.

9-9a § 401(k) Plans

In General

A **§ 401(k) plan** allows participants to elect either to receive up to \$18,000 in 2015⁴⁸ in cash (taxed currently) or to have a contribution made on their behalf to a profit sharing or stock bonus plan. The plan may also be in the form of a salary-reduction agreement under which a contribution will be made only if the participant elects to reduce his or her compensation or to forgo an increase in compensation.

Any employee-elected plan contributions are pretax amounts that are excluded from gross income in the year of the deferral and are 100 percent vested. Like employer plan contributions, employee contributions are tax-deferred until distributed, as are earnings on those contributions.

EXAMPLE

47

Sam participates in a § 401(k) plan of his employer. The plan permits the participants to choose between a full salary or a reduced salary where the reduction becomes a before-tax contribution to a retirement plan. Sam elects to contribute 10% of his annual compensation of \$40,000 to the plan. Income taxes are paid on only \$36,000. No income taxes are paid on the \$4,000—or on any earnings—until it is distributed from the plan to Sam. The main benefit of a § 401(k) plan is that Sam can shift a portion of his income to a later taxable year.

The maximum annual elective contribution to a § 401(k) plan is reduced dollar-for-dollar by other salary-reduction contributions to tax-sheltered annuities, simplified employee pension plans, and § 401(k) plans. Elective contributions in excess of the maximum limitation are taxable in the year of deferral. These amounts may be refunded from the plan tax-free before April 15 of the following year. Excess amounts not timely distributed will be double-taxed because they will be taxable in the year of distribution, even though they were included in income in the year of deferral. Annual elective contributions are also limited by complicated nondiscrimination requirements designed to encourage participation by non-highly compensated employees and by the general defined contribution plan limitations.

A person who has attained age 50 by the end of 2015 can make catch-up contributions of \$6,000.⁴⁹

⁴⁷There are two types of qualified pension plans: defined benefit plans and defined contribution plans. A defined benefit plan includes a formula that defines the *benefits* employees are to receive. A defined contribution plan defines the amount of the *contribution* to the plan. The majority of employer pension plans today are defined contribution plans.

⁴⁸§§ 402(g)(1) and (4). The amount was \$16,500 for 2009, 2010, and 2011, \$17,000 for 2012, and \$17,500 for 2013 and 2014.

⁴⁹A \$5,000 catch-up contribution amount is indexed in \$500 increments in 2007 and thereafter. The catch-up contribution amount is \$5,000 from 2006 through 2008 and \$5,500 from 2009 through 2014.

9-10 INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

9-10a General Rules

Employees not covered by another qualified plan can establish their own tax-deductible **Individual Retirement Accounts (IRAs)**. For 2015, the contribution ceiling is the smaller of \$5,500 (or \$11,000 for spousal IRAs) or 100 percent of compensation.⁵⁰ The contribution ceiling applies to all types of IRAs (traditional deductible, traditional nondeductible, and Roth).

An individual who attains the age of 50 by the end of the tax year can make additional catch-up IRA contributions of \$1,000 for years after 2005 (\$500 for the period 2002 through 2005).

If the taxpayer is an *active participant* in a qualified plan, the traditional IRA deduction limitation is phased out *proportionately* between certain AGI ranges, as shown in Exhibit 9.2.⁵¹ If AGI is above the phaseout range, no IRA deduction is allowed.

AGI is calculated taking into account any § 469 passive losses and § 86 taxable Social Security benefits and ignoring any § 911 foreign income exclusion, § 135 savings bonds interest exclusion, and the IRA deduction. There is a \$200 floor on the IRA deduction limitation for individuals whose AGI is not above the phaseout range.

IRA Deduction Calculation

Dan, who is single, has compensation income of \$67,000 in 2015. He is an active participant in his employer's qualified retirement plan. Dan contributes \$5,500 to a traditional IRA. The deductible amount is reduced from \$5,500 by \$3,300 because of the phaseout mechanism:

$$\frac{\$6,000}{\$10,000} \times \$5,500 = \$3,300 \text{ reduction}$$

Therefore, of the \$5,500 contribution, Dan can deduct only \$2,200 (\$5,500 – \$3,300).

EXAMPLE

48

Ben, an unmarried individual, is an active participant in his employer's qualified retirement plan in 2014. With AGI of \$70,800, he would normally have an IRA deduction limit of \$110 { $\$5,500 - [(\$70,800 - \$61,000)/\$10,000 \times \$5,500]$ }. However, because of the special floor provision, Ben is allowed a \$200 IRA deduction.

EXAMPLE

49

An individual is not considered an active participant in a qualified plan merely because the individual's spouse is an active participant in such a plan for any part of a plan year. Thus, even when filing jointly, the nonparticipating individual may take a full \$5,500 deduction regardless of the participation status of his or her spouse, unless the couple has AGI above \$183,000. If their AGI is above \$183,000, the phaseout of the deduction begins at \$183,000 and ends at \$193,000 (phaseout over the \$10,000 range) rather than beginning and ending at the phaseout amounts in Exhibit 9.2.⁵²

EXHIBIT 9.2

Phaseout of IRA Deduction of an Active Participant in 2015

AGI Filing Status	Phaseout Begins*	Phaseout Ends
Single and head of household	\$61,000	\$ 71,000
Married, filing joint return	98,000	118,000
Married, filing separate return	–0–	10,000

* These amounts are indexed annually for inflation.

⁵⁰ §§ 219(b)(1) and (c)(2). After 2008, the limit is adjusted annually for inflation in \$500 increments. For 2008 through 2012, the contribution ceiling is the smaller of \$5,000 (or \$10,000 for spousal IRAs) or 100 percent of compensation; the contribution ceiling increased to \$5,500 beginning in 2013.

⁵¹ § 219(g).

⁵² § 219(g)(7). However, a special rule in § 219(g)(4) allows a married person filing a separate return to avoid the phaseout rules even though the spouse is an active participant. The individual must live apart from the spouse at all times during the taxable year and must not be an active participant in another qualified plan.

EXAMPLE

50

Nell is covered by a qualified employer retirement plan at work. Her husband, Nick, is not an active participant in a qualified plan. If Nell and Nick's combined AGI is \$135,000, Nell cannot make a deductible IRA contribution because she exceeds the income threshold for an active participant in Exhibit 9.2.

However, because Nick is not an active participant and their combined AGI does not exceed \$183,000, he can make a deductible contribution of \$5,500 to an IRA.

To the extent that an individual is ineligible to make a deductible contribution to an IRA, *nondeductible contributions* can be made to separate accounts.⁵³ The nondeductible contributions are subject to the same dollar limits as deductible contributions (\$5,500 of earned income, \$11,000 for a spousal IRA). Income in the account accumulates tax-free until distributed. Only the account earnings are taxed upon distribution because the account basis equals the contributions made by the taxpayer. A taxpayer may elect to treat deductible IRA contributions as nondeductible. If an individual has no taxable income for the year after taking into account other deductions, the election will be beneficial. The election is made on the individual's tax return for the taxable year to which the designation relates.

A taxpayer may be entitled to a nonrefundable credit for contributions to a traditional IRA or elective deferrals for a § 401(k) plan (see Chapter 12). Distributions to a traditional IRA holder must begin no later than April 1 of the calendar year *following* the year in which the IRA holder reaches 70½.⁵⁴

Roth IRAs

Introduced by Congress to encourage individual savings, a **Roth IRA** is a *nondeductible* alternative to the traditional deductible IRA. Earnings inside a Roth IRA are not taxable, and all qualified distributions from a Roth IRA are tax-free.⁵⁵ The maximum allowable annual contribution to a Roth IRA for 2015 is the smaller of \$5,500 (\$11,000 for spousal IRAs) or 100 percent of the individual's compensation for the year. Contributions to a Roth IRA must be made by the due date (excluding extensions) of the taxpayer's tax return. Roth IRAs are not subject to the minimum distribution rules that apply to traditional IRAs. Contributions to a Roth IRA (unlike a traditional IRA) may continue beyond age 70½ so long as the person generates compensation income and is not barred by the AGI limits.

A taxpayer can make tax-free withdrawals from a Roth IRA after an initial five-year holding period if any of the following requirements is satisfied:

- The distribution is made on or after the date on which the participant attains age 59½.
- The distribution is made to a beneficiary (or the participant's estate) on or after the participant's death.
- The participant becomes disabled.
- The distribution is used to pay for qualified first-time homebuyer's expenses (statutory ceiling of \$10,000).

EXAMPLE

51

Edith establishes a Roth IRA at age 42 and contributes \$5,000 per year for 20 years. The account is now worth \$149,400, consisting of \$100,000 of nondeductible contributions and \$49,400 in accumulated earnings that have not been taxed.

Edith may withdraw the \$149,400 tax-free from the Roth IRA because she is over age 59½ and has met the five-year holding period requirement.

⁵³§ 408(o).

⁵⁴§ 401(a)(9).

⁵⁵§ 408A.

If the taxpayer receives a distribution from a Roth IRA and does not satisfy the aforementioned requirements, the distribution may be taxable. If the distribution represents a return of capital, it is not taxable. Conversely, if the distribution represents a payout of earnings, it is taxable. Under the ordering rules for Roth IRA distributions, distributions are treated as first made from contributions (return of capital).

Assume the same facts as in the previous example, except that Edith is only age 50 and receives a distribution of \$55,000.

Because her adjusted basis for the Roth IRA is \$100,000 (contributions made), the distribution is tax-free and her adjusted basis is reduced to \$45,000 (\$100,000 – \$55,000).

EXAMPLE**52**

Roth IRAs are subject to income limits. In 2015, the maximum annual contribution of \$5,500 is phased out beginning at AGI of \$116,000 for single taxpayers and \$183,000 for married couples who file a joint return. The phaseout range is \$10,000 for married filing jointly and \$15,000 for single taxpayers. For a married taxpayer filing separately, the phaseout begins with AGI of \$0 and is phased out over a \$10,000 range.⁵⁶

Bev, who is single, would like to contribute \$5,500 to her Roth IRA. However, her AGI is \$126,000, so her contribution is limited to \$1,833 (\$5,500 – \$3,667) calculated as follows:

$$\frac{\$10,000}{\$15,000} \times \$5,500 = \$3,667 \text{ reduction}$$

EXAMPLE**53**

Spousal IRA

For a married couple, each spouse may establish an IRA individually and deduct contributions of up to \$5,500 if the combined compensation of both spouses is at least equal to the total contributed amount. Thus, if only one spouse is employed or if both are employed but one has compensation of less than \$5,500, each of them may contribute a maximum of \$5,500 if their combined compensation is at least \$11,000.

For the spousal IRA provision to apply, a joint return must be filed.⁵⁷ The spousal IRA deduction is also proportionately reduced for active participants whose AGI exceeds the above target ranges.

Spousal IRAs

Tony, who is married, is eligible to establish an IRA. He received \$30,000 in compensation in 2015, and his spouse does not work outside the home. Tony can contribute up to \$11,000 to two IRAs, to be divided in any manner between the two spouses, except that no more than \$5,500 can be allocated to either spouse.

EXAMPLE**54**

Assume the same facts as in the previous example, except that Tony's wife has compensation income of \$2,200. Without the spousal IRA provision, Tony could contribute \$5,500 to his IRA, and his spouse could contribute only \$2,200 to her IRA. With the spousal IRA provision, they both can contribute \$5,500 to their IRAs.

EXAMPLE**55**

Alimony is considered to be earned income for purposes of IRA contributions. Thus, a person whose only income is alimony can contribute to an IRA.

Timing of Contributions

Contributions (both deductible and nondeductible) can be made to an IRA anytime before the due date of the individual's tax return.⁵⁸ For example, an individual can

⁵⁶The income limits for Roth IRA contributions are indexed for tax years after 2006.

⁵⁷§ 219(c).

⁵⁸§ 219(f)(3).

establish and contribute to an IRA through April 15, 2016 (the return due date), and deduct this amount on his or her tax return for 2015. IRA contributions that are made during a tax return extension period do not satisfy the requirement of being made by the return due date.⁵⁹

Taxation of Benefits

A participant has a zero basis in the *deductible* contributions of a traditional IRA because the contributions were deducted.⁶⁰ Therefore, all withdrawals from a deductible IRA are taxed as ordinary income in the year of receipt. They are not eligible for the 10-year averaging allowed for certain lump-sum distributions.

A participant has a basis equal to the contributions made for a *nondeductible* traditional IRA. Therefore, only the earnings component of withdrawals is included in gross income. Such amounts are taxed as ordinary income in the year of receipt and are not eligible for the 10-year averaging allowed for certain lump-sum distributions.

In addition to being included in gross income, payments from IRAs made to a participant before age 59½ are subject to a nondeductible 10 percent penalty tax on such actual, or constructive, payments.⁶¹ However, an individual may make penalty-free withdrawals to pay for medical expenses in excess of 10 percent (7.5 percent if at least age 65) of AGI, to pay for qualified higher education expenses, and to pay for qualified first-time homebuyer expenses (up to \$10,000). Note that a qualified first-time homebuyer is defined as an individual (and spouse) who has not owned a principal residence in the two-year period preceding the date of acquisition of a principal residence. Further, an individual who has received unemployment compensation for at least 12 consecutive weeks may use IRA withdrawals to pay for health insurance for himself or herself, the spouse, and dependents without incurring the 10 percent penalty tax.⁶²

Rollovers: General Provisions

An IRA may be the recipient of a rollover from another qualified plan, including another IRA. Such a distribution from a qualified plan is not included in gross income if it is transferred within 60 days of receipt to an IRA or another qualified plan. For a series of distributions that constitute a lump-sum distribution, the 60-day period does not begin until the last distribution. Amounts received from IRAs may be rolled over tax-free only once in a 12-month period.

EXAMPLE

56

Ruth Sanchez withdraws \$15,000 from a traditional IRA on May 2, 2015 (closing the account). She deposits these funds into a different traditional IRA on June 5, 2015.

This is a qualified rollover and will not result in any gross income for Ruth during 2015.

Starting in 2015, taxpayers are only allowed one traditional IRA rollover per 12-month period regardless of how many IRAs they have.⁶³ A rollover is different from a direct transfer of funds from a qualified plan to an IRA or another qualified plan by a trustee or an issuer. A direct transfer is not subject to the one-year waiting period and the withholding rules.⁶⁴ As a result, a person can still make unlimited direct trustee-to-trustee rollovers.

Rollovers and Conversions: Roth IRAs

A Roth IRA may be rolled over tax-free into another Roth IRA.⁶⁵ A traditional IRA may be rolled over or converted to a Roth IRA. A conversion occurs when the taxpayer notifies the IRA trustee that the IRA is now a Roth IRA.

⁵⁹§ 404(h)(1)(B).

⁶⁰§ 408(d)(1).

⁶¹§ 72(t). There are limited exceptions to the penalty on early distributions.

⁶²§§ 72(t)(2)(B), (D), (E), and (F). For purposes of the unemployment provision, a self-employed individual who otherwise would have been eligible for unemployment compensation will qualify.

⁶³*Bobrow v. Commissioner*, 107 TCM 110, T.C. Memo. 2014-21; IRS Announcement 2014-15 (2014-16 IRB 973); IRS Announcement 2014-32 (2014-48 IRB 907).

⁶⁴Reg. § 35.3405-1.

⁶⁵§ 408A(c)(3)(B).

Unlike a traditional IRA, which requires withdrawals at age 70½, there are no required withdrawals from a Roth IRA. Thus, money can be accumulated over the taxpayer's lifetime and then passed to heirs without tax penalties.⁶⁶

When a traditional IRA is rolled over or converted to a Roth IRA, the tax consequences depend on whether the traditional IRA was deductible or nondeductible. If deductible, the basis for the IRA is zero. Thus, the entire amount of the rollover or conversion is included in gross income. If nondeductible, the basis for the IRA is equal to the sum of the contributions. Thus, only the IRA earnings included in the rollover or conversion are included in gross income. The 10 percent penalty tax will not apply in either case.⁶⁷

9-11 RETIREMENT PLANS FOR SELF-EMPLOYED INDIVIDUALS

A wide variety of retirement plans are available to self-employed individuals. In addition to Individual Retirement Accounts (discussed previously), self-employed individuals can establish a Keogh plan (also known as an H.R. 10 plan), a Solo § 401(k) plan, a Saving Incentive Match for Employees (SIMPLE) plan, or a Simplified Employee Pension plan (SEP).

9-11a Keogh (H.R. 10) Plans

Keogh plans are the self-employed equivalent of corporate pension plans. As Keogh plans are qualified retirement plans, these plans must be administered by an independent trustee. When an individual decides to make all investment decisions, a self-directed retirement plan is established. However, the individual may prefer to invest the funds with a financial institution such as a broker, a bank, or a savings and loan institution. A variety of funding vehicles can be used for Keogh investments, such as mutual funds, annuities, real estate shares, certificates of deposit, debt instruments, commodities, securities, and personal properties. Investment in most collectibles is not allowed in a self-directed plan.

Contribution Limitations

A self-employed individual may annually contribute the smaller of \$53,000 in 2015 (\$52,000 in 2014) or 100 percent of earned income to a *defined contribution* Keogh plan.⁶⁸ However, if the defined contribution plan is a profit sharing plan or stock bonus plan, a 25 percent deduction limit applies. Under a *defined benefit* Keogh plan, the annual benefit payable to an employee is limited to the smaller of \$210,000 in 2015 (the same amount in 2014) or 100 percent of the employee's average compensation for the three highest years of employment.⁶⁹ An employee includes a self-employed person.

Earned income refers to net earnings from self-employment as defined in § 1402(a).⁷⁰ Net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by that individual, less appropriate deductions, plus the distributive share of income or loss from a partnership.⁷¹ Earned income is reduced by contributions to a Keogh plan on the individual's behalf and by 50 percent of any self-employment tax.⁷² A defined *benefit* Keogh plan requires an actuary to calculate the amount to contribute each year. Thus, the annual actuarial fees and the required IRS reports can be expensive.

⁶⁶ Additional details on traditional and Roth IRAs can be found in IRS Publication 590, *Individual Retirement Accounts (IRAs)*.

⁶⁷ § 408A(d)(3)(A)(ii). When a traditional IRA is converted, the increase in gross income (and modified AGI) may result in the taxpayer being subject to the additional Medicare tax and the net investment income tax (see Chapter 12).

⁶⁸ § 415(c)(1).

⁶⁹ § 415(b)(1). This amount is indexed annually.

⁷⁰ § 401(c)(2).

⁷¹ § 1402(a).

⁷² §§ 401(c)(2)(A)(v) and 164(f).

EXAMPLE

57

Pat, a sole proprietor, has earned income of \$150,000 in 2015 (after the deduction for one-half of self-employment tax). The maximum contribution Pat may make to a defined contribution Keogh plan is \$53,000, the lesser of \$150,000 or \$53,000.

Although a Keogh plan must be established before the end of the year in question, contributions may be made up to the normal filing date for that year. Self-employed individuals who hire employees may want to choose a different retirement plan for a simple reason—the plan must provide retirement benefits to all employees on a nondiscriminatory basis (i.e., the sole proprietor's employees must also be covered by the Keogh plan). This could be a substantial cost to the owner. Obviously, a sole proprietor with no employees is an ideal candidate for a Keogh plan.

9-11b Solo § 401(k) Plans

A Solo § 401(k) plan is designed for self-employed individuals and combines a regular § 401(k) plan with a profit sharing plan. As previously discussed, the maximum annual elective contribution to a § 401(k) plan is \$18,000 in 2015 (\$17,500 in 2014)—with an additional catch-up adjustment of \$6,000 allowed to a self-employed individual who reaches age 50 by the end of the tax year (\$5,500 in 2014). Under the profit sharing plan rules, the proprietor can contribute an additional 20 percent of net earnings from self-employment (computed in the same way as for a Keogh plan). The maximum deduction allowed is \$53,000 in 2015 (\$52,000 in 2014) or 100 percent of net earnings from self-employment.⁷³ Because the amount of compensation deferred as part of a § 401(k) plan does not count toward the 20 percent limit, the proprietor can defer the maximum amount of compensation under the § 401(k) plan and still contribute an additional 20 percent of self-employment income.⁷⁴

EXAMPLE

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Dan is 35 years old and is a sole proprietor. His net earnings from self-employment in 2015 are \$100,000. Dan sets up a Solo § 401(k) plan for his retirement. Under current tax law, Dan's plan account can accept a profit sharing contribution of \$20,000 (20% of \$100,000) plus a § 401(k) elective deferral contribution of \$18,000.

As a result, Dan can make total plan contributions of \$38,000 (\$20,000 plus \$18,000, which is less than the maximum allowed of \$53,000).

9-11c Saving Incentive Match Plan for Employees (SIMPLE Plans)

Employers with 100 or fewer employees who do not maintain another qualified retirement plan may establish a *savings incentive match plan for employees* (SIMPLE plan).⁷⁵ The plan can be in the form of a § 401(k) plan or an IRA. A SIMPLE § 401(k) plan is not subject to the nondiscrimination rules that are normally applicable to § 401(k) plans.

All employees who received at least \$5,000 in compensation from the employer during any two preceding years and who reasonably expect to receive at least \$5,000 in compensation during the current year must be eligible to participate in the plan. The decision to participate is up to the employee. A self-employed individual also may participate in the plan.

The contributions made by the employee (a salary-reduction approach) must be expressed as a percentage of compensation rather than as a fixed dollar amount. The SIMPLE plan must not permit the SIMPLE elective employee contribution for the year to exceed \$12,500 in 2015 (\$12,000 in 2014).⁷⁶ The SIMPLE elective deferral limit is

⁷³ §§ 415(c) and (d).

⁷⁴ Prop.Reg. § 1.401(k)-1(a)(6)(ii).

⁷⁵ § 408(p).

⁷⁶ For 2004, the limit was \$9,000. The \$10,000 amount for 2005 is indexed for inflation in \$500 increments in 2006 and thereafter. For 2006, the amount

remained at \$10,000. For 2007 and 2008, it increased to \$10,500. For 2009, it increased to \$11,500 and remained at this amount in 2010, 2011, and 2012. § 408(p)(2)(E)(i).

increased under the catch-up provision for employees age 50 and over. The catch-up amount is \$3,000 in 2015 (\$2,500 in 2014) and is indexed for inflation in \$500 increments.

Generally, the employer must either match elective employee contributions up to 3 percent of the employee's compensation or provide nonmatching contributions of 2 percent of compensation for each eligible employee. Thus, the maximum amount that may be contributed to the plan for an employee under age 50 for 2015 is \$20,450 [\$12,500 employee contributions + \$7,950 (\$265,000 compensation ceiling × 3%) employer match].

No other contributions may be made to the plan other than the employee elective contribution and the required employer matching contribution (or nonmatching contribution under the 2 percent rule). All contributions are fully vested.

9-11d **Simplified Employee Pension Plans (SEPs)**

Simplified Employee Pensions—referred to as SEPs or SEP-IRAs—are generic retirement plans that allow the proprietor to deduct up to 20 percent of self-employment income.⁷⁷ As with Keogh and Solo § 401(k) plans, the maximum deduction allowed is \$53,000 in 2015 (\$52,000 in 2014). SEPs are much simpler to establish and administer than Keogh profit sharing and pension plans, and costs are minimal. The IRS provides a standardized plan that can be adopted (Form 5305-SEP), and no annual reporting to the IRS is required. Overall, SEPs are as easy to administer as deductible IRAs, but have a larger contribution limit.

9-12 **CLASSIFICATION OF EMPLOYEE EXPENSES**

The classification of employee expenses depends on whether they are reimbursed by the employer under an accountable plan. If so, then they are not reported by the employee at all. In effect, therefore, this result is equivalent to treating the expenses as deductions *for* AGI. If the expenses are reimbursed under a nonaccountable plan or are not reimbursed at all, then they are classified as deductions *from* AGI and can be claimed only if the employee-taxpayer itemizes. An exception is made for moving expenses and the employment-related expenses of a qualified performing artist.⁷⁸ Here, deduction *for* AGI classification is allowed.

For classification purposes, therefore, the difference between accountable and non-accountable plans is significant.

9-12a **Accountable Plans**

An **accountable plan** requires the employee to satisfy these two requirements:

- Adequately account for (substantiate) the expenses. An employee renders an *adequate accounting* by submitting a record, with receipts and other substantiation, to the employer.⁷⁹
- Return any excess reimbursement or allowance. An “excess reimbursement or allowance” is any amount the employee does not adequately account for as an ordinary and necessary business expense.

Substantiation

The law provides that no deduction is allowed for any travel, entertainment, business gift, or listed property (automobiles and computers) expenditure unless properly substantiated by adequate records. The records should contain the following information:⁸⁰

- The amount of the expense.
- The time and place of travel or entertainment (or date of gift).

⁷⁷§ 408.

⁷⁸As defined in § 62(b).

⁷⁹Reg. § 1.162-17(b)(4).

⁸⁰§ 274(d).

LO.9

Demonstrate the difference between accountable and nonaccountable employee plans.

- The business purpose of the expense.
- The business relationship of the taxpayer to the person entertained (or receiving the gift).

This means that the taxpayer must maintain an account book or diary in which the above information is recorded at the time of the expenditure. Documentary evidence, such as itemized receipts, is required to support any expenditure for lodging while traveling away from home and for any other expenditure of \$75 or more. If a taxpayer fails to keep adequate records, each expense must be established by a written or oral statement of the exact details of the expense and by other corroborating evidence.⁸¹

Inadequate Substantiation

EXAMPLE

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Bertha has travel expenses substantiated only by canceled checks. The checks establish the date, place, and amount of the expenditure. Because neither the business relationship nor the business purpose is established, the deduction is disallowed.⁸²

EXAMPLE

60

Dwight has travel and entertainment expenses substantiated by a diary showing the time, place, and amount of the expenditure. His oral testimony provides the business relationship and business purpose. However, because he has no receipts, any expenditures of \$75 or more are disallowed.⁸³

Deemed Substantiation

In lieu of reimbursing actual expenses for travel away from home, many employers reduce their paperwork by adopting a policy of reimbursing employees with a *per diem* allowance, a flat dollar amount per day of business travel. Of the substantiation requirements listed previously, the *amount* of the expense is proved, or *deemed substantiated*, by using such a per diem allowance or reimbursement procedure. The amount of expenses that is deemed substantiated is equal to the lesser of the per diem allowance or the amount of the Federal per diem rate.

The regular Federal per diem rate is the highest amount the Federal government will pay to its employees for lodging, meals, and incidental expenses⁸⁴ while in travel status away from home in a particular area. The rates are different for different locations.⁸⁵

The use of the standard Federal per diem rates for meals and incidental expenses constitutes an adequate accounting. Employees and self-employed persons can use these standard allowances instead of deducting the actual cost of daily meals and incidental expenses, even if not reimbursed. There is no standard lodging allowance, however.

Only the amount of the expense is considered substantiated under the deemed substantiated method. The other substantiation requirements must be provided: place, date, business purpose of the expense, and the business relationship of the parties involved.

9-12b Nonaccountable Plans

A **nonaccountable plan** is a plan in which an adequate accounting or return of excess amounts, or both, is not required. All reimbursements of expenses are reported in full as wages on the employee's Form W-2. Any allowable expenses are deductible in the same manner as unreimbursed expenses.

⁸¹Reg. § 1.274-5T(c)(3).

⁸²William T. Whitaker, 56 TCM 47, T.C.Memo. 1988-418.

⁸³W. David Tyler, 43 TCM 927, T.C.Memo. 1982-160.

⁸⁴Incidental expenses include tips and fees to porters, bellhops, hotel maids, etc. For travel away from home, the term does *not* include expenses for laundry and dry cleaning of clothing, lodging taxes, and telephone calls.

⁸⁵*Per Diem Rates* (IRS Publication 1542) contains the list and amounts for the year. This publication is available only on the Internet at www.irs.gov. Links to per diem rates can also be found at www.gsa.gov.

Unreimbursed Employee Expenses

Unreimbursed employee expenses are treated in a straightforward manner. Meals and entertainment expenses are subject to the 50 percent limit. Total unreimbursed employee business expenses are usually reported as miscellaneous itemized deductions subject to the 2%-of-AGI floor (see next page). If the employee could have received, but did not seek, reimbursement for whatever reason, none of the employment-related expenses are deductible.

Failure to Comply with Accountable Plan Requirements

An employer may have an accountable plan and require employees to return excess reimbursements or allowances, but an employee may fail to follow the rules of the plan. In that case, the expenses and reimbursements are subject to nonaccountable plan treatment.

9-12c Reporting Procedures

The reporting requirements range from no reporting at all (accountable plans when all requirements are met) to the use of some or all of the following forms: Form W-2 (Wage and Tax Statement), Form 2106 (Employee Business Expenses) or Form 2106-EZ (Unreimbursed Employee Business Expenses), and Schedule A (Itemized Deductions) for non-accountable plans and unreimbursed employee expenses. Expenses reimbursed under a nonaccountable plan, and unreimbursed expenses are deductible *from* AGI on Schedule A, subject to the 2%-of-AGI floor.

When a reimbursement under an accountable plan is paid in separate amounts relating to designated expenses such as meals or entertainment, no problem arises. The reimbursements and expenses are reported as such on the appropriate forms. If the reimbursement is made in a single amount, an allocation must be made to determine the appropriate portion of the reimbursement that applies to meals and entertainment and to other employee expenses.

Sophia, who is employed by Garnet Company, had AGI of \$60,000 during the year. She incurred employment-related expenses as follows: \$4,000 (transportation), \$3,000 (lodging), \$2,000 (meals), and \$1,000 (entertainment). Under an accountable plan, Sophia received partial reimbursement from Garnet of \$6,000. Because Sophia was not fully reimbursed, she must make an allocation to determine the portion attributable to the expenses subject to the cutback adjustment.

$$\frac{\$2,000 \text{ (meals)} + \$1,000 \text{ (entertainment)}}{\$10,000 \text{ (total expenses)}} = 30\%$$

Thus, 30% of the reimbursement, or \$1,800, relates to meals and entertainment, while the balance of \$4,200 applies to transportation and lodging. Further computations follow to account for the reimbursement (treated, in effect, as a deduction *for* AGI), apply the cutback adjustment, and deduct the 2% floor.

	No Cutback Adjustment	Cutback Adjustment
Transportation and lodging (\$4,000 + \$3,000)	\$ 7,000	
Meals and entertainment (\$2,000 + \$1,000)		\$ 3,000
Less reimbursement		
(70% × \$6,000)	(4,200)	
(30% × \$6,000)		(1,800)
	\$ 2,800	\$ 1,200
Cutback adjustment (50% × \$1,200)		(600)
Unreimbursed portion	<u>\$ 2,800</u>	<u>\$ 600</u>

The unreimbursed portion of \$3,400 (\$2,800 + \$600) is reported on Schedule A and is reduced by 2% of AGI. Thus, \$3,400 – \$1,200 [2% × \$60,000 (AGI)] yields a deduction *from* AGI of \$2,200. Sophia does not have to report any of the \$6,000 reimbursement.

EXAMPLE

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LO.10

Apply the limitations on miscellaneous itemized deductions.

9-13 LIMITATIONS ON ITEMIZED DEDUCTIONS

Many itemized deductions, such as medical expenses and charitable contributions, are subject to limitations expressed as a percentage of AGI. These limitations may be expressed as floors or ceilings and are discussed in Chapter 10.

9-13a Miscellaneous Itemized Deductions Subject to the 2 Percent Floor

Certain miscellaneous itemized deductions, including most *unreimbursed employee business expenses*, are aggregated and then reduced by 2 percent of AGI.⁸⁶ Expenses subject to the 2 percent floor include the following:

- All § 212 expenses, except expenses of producing rent and royalty income (refer to Chapter 6).
- All unreimbursed employee expenses (after the 50 percent reduction, if applicable), except moving expenses.
- Professional dues and subscriptions.
- Union dues and work uniforms.
- Employment-related education expenses (except § 222 qualified tuition and related expenses).
- Malpractice insurance premiums.
- Expenses of job hunting (including employment agency fees and résumé-writing expenses).
- Home office expenses of an employee or outside salesperson.
- Legal, accounting, and tax return preparation fees.
- Hobby expenses (up to hobby income).
- Investment expenses, including investment counsel fees, subscriptions, and safe deposit box rental.
- Custodial fees relating to income-producing property or a traditional IRA or a Keogh plan.
- Any fees paid to collect interest or dividends.
- Appraisal fees establishing a casualty loss or charitable contribution.

9-13b Miscellaneous Itemized Deductions Not Subject to the 2 Percent Floor

Certain miscellaneous itemized deductions, including the following, are not subject to the 2 percent floor:

- Impairment-related work expenses of handicapped individuals.
- Gambling losses to the extent of gambling winnings.
- Certain terminated annuity payments.

EXAMPLE

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Ted, who has AGI of \$40,000, has the following miscellaneous itemized deductions:

Gambling losses (to extent of gains)	\$2,200
Tax return preparation fees	500
Unreimbursed employee transportation	600
Professional dues and subscriptions	360
Safe deposit box rental	90

continued

⁸⁶§ 67.

Ted's itemized deductions are as follows:

Deduction not subject to 2% floor (gambling losses)		\$2,200
Deductions subject to 2% floor (\$500 + \$600 + \$360 + \$90)	\$1,550	
Less 2% of AGI	<u>(800)</u>	<u>750</u>
Total miscellaneous itemized deductions		<u>\$2,950</u>

If instead Ted's AGI is \$80,000, the floor is \$1,600 (2% of \$80,000); in this case, he can only deduct the \$2,200 because his expenses subject to the 2% floor do not exceed \$1,600.

9-14 TAX PLANNING

9-14a Employment Status

When considering the merits of employee or independent contractor status, much depends on which party is involved. If it is the worker, being self-employed carries the obvious advantage of a deduction *for* AGI category of job-related expenses and the avoidance of the 2 percent limitation applicable to any unreimbursed excess.

However, a self-employed individual may have other costs, such as local gross receipts taxes, license fees, franchise fees, personal property taxes, and occupation taxes. In addition, the record-keeping and filing requirements can be quite burdensome.

One of the most expensive considerations is the Social Security tax versus the self-employment tax. For an employee in 2015, for example, the Social Security tax applies at a rate of 6.2 percent on a base amount of wages of \$118,500 (\$117,000 in 2014), and the Medicare tax applies at a rate of 1.45 percent with no limit on the base amount. Further, a .9 percent additional Medicare tax applies to certain high earners. For self-employed persons, the rate, but not the base amount, for each tax doubles. Even though a deduction *for* AGI is allowed for part of the self-employment tax paid, an employee and a self-employed individual are not in the same tax position on equal amounts of earnings. For the applicability of these taxes to employees, see Chapter 1.

9-14b Misclassification Danger

Recently, the Patient Protection and Affordable Care Act, commonly called the Affordable Care Act (ACA), has imposed certain compliance burdens (both financial and reporting) on employers with reference to providing health care coverage for their employees. The rules are complex and vary according to the size of the employer (large or small) and the status of the employee (full- or part-time).⁸⁷ Because the ACA does not apply to independent contractors and part-time employees, the misclassification of workers by some employers is to be expected. To discourage such misclassification, penalties will be levied on those employers who wrongfully categorize workers as independent contractors.

There are many other reasons to favor classifying workers as independent contractors rather than as employees. Besides avoiding payroll taxes and income tax withholdings, the employer circumvents a myriad of state and local laws. Examples include vacation pay obligations, unemployment tax and workers' compensation requirements, and overtime and minimum wage restrictions. Because complying with these rules is costly and burdensome, many employers are motivated to misclassify their workers as independent contractors.

In the event of misclassification, two remedies are available—one legislative and one administrative. The legislative option, known as Section 530 relief, completely absolves

LO.11

List and evaluate tax planning ideas related to employee business expenses.

⁸⁷Large employers are those with 50 or more full-time employees. Part-time employees work 30 hours or less per week.



TAX IN THE NEWS The i's Were Dotted But the t's Weren't Crossed

In two recent cases, the taxpayers sincerely believed that their workers were independent contractors and applied for Section 530 relief (see text discussion) against their reclassification as employees. The relief was denied because they did not file Form 1099-MISC for any of

the workers and, therefore, did not meet one of the three requirements.

Source: *John Keller* (103 TCM 1298, T.C.Memo. 2012-62); *Atlantic Coast Masonry, Inc.* (104 TCM 189, T.C.Memo. 2012-233).

the employer of the employment taxes that should have been paid.⁸⁸ To obtain Section 530 relief, *all* three of the following requirements must be met:

- The employer has a reasonable basis for *not* treating the workers as employees. Reasonable basis means reliance on any of the following:
 - A judicial precedent, published ruling, or technical advice.
 - A past IRS audit that resulted in no employment tax assessment.
 - A longstanding practice of independent contractor status in the same industry.
- The employer has consistently treated the workers as independent contractors.
- The employer has filed Form 1099-MISC (Miscellaneous Income) for each worker (when such filing was required).

As noted in “Tax in the News” (see above), a common hurdle to securing Section 530 relief is the failure to file the required Forms 1099-MISC.

The administrative remedy for employers who are misclassifying workers is the recently promulgated Voluntary Classification Settlement Program (VCSP).⁸⁹ A type of amnesty arrangement, the VCSP allows the applicant to be absolved from all employment taxes that should have been paid plus any interest and penalties that would be due. To be accepted, Form 8952 [Application for Voluntary Classification Settlement Program (VCSP)] must be filed and certain conditions met.⁹⁰ A major condition is the payment of about 1 percent of the wages paid to reclassified workers in the past year.

9-14c Improving the Tax Position of Employees

For an employee with job-related expenses who receives reimbursement from the employer, the ideal tax position results from the following arrangement:

- Render an adequate accounting to the employer.
- Be fully reimbursed.
- Return any excess reimbursement.

If these conditions exist, the employee will avoid any cutback adjustment (for meals and entertainment) and will completely eliminate the 2 percent floor on employee expenses. As all of the employee expenses are shifted to the employer, the employee may even be able to claim the standard deduction rather than itemize.

Even if the reimbursement of expenses is partial (not full), some planning is possible. Consider what happens in Example 61 if Garnet’s reimbursement states that it specifically covers the \$2,000 meals and \$1,000 entertainment expenditures. Sophia now has no cutback adjustment, and her deduction is increased.

These considerations should be taken into account when an employee enters into an employment agreement. In some cases, it may even be worthwhile to accept a lower base salary in order to obtain a favorable expense reimbursement arrangement.

⁸⁸This safe harbor for withholding purposes originated in Section 530 of the Revenue Act of 1978. See *IRS Headliner*, vol. 152 (March 27, 2006).

⁸⁹Announcement 2011-64, 2011-4 I.R.B. 503.

⁹⁰The conditions to be met are set forth in the instructions for Form 8952. Many of these conditions are the same as those required for Section 530 relief.

9-14d **Transportation and Travel Expenses**

Adequate detailed records of all transportation and travel expenses should be kept. Because the automatic (standard) mileage allowance often is modest in amount, a new, expensive automobile used primarily for business may generate a higher expense based on actual cost. In using the actual cost method, include the business portion of depreciation, repairs and maintenance, automobile club dues, insurance, gasoline and oil, and other related costs. The cost of gasoline, when coupled with the poor mileage performance of some vehicles, can be a significant factor. If the taxpayer is located in a metropolitan area, automobile insurance is more expensive. For the self-employed taxpayer, the business portion of finance charges (i.e., interest on car loans) can be included under the actual cost method.

Once a method is chosen, a later change may be possible. Conversion from the automatic mileage method to the actual cost method is allowed if a basis adjustment is made for depreciation deemed taken (see Example 10). Conversion from the actual cost method to the automatic mileage method is possible only if the taxpayer has not used the MACRS statutory percentage method or claimed § 179 limited expensing.

If an automobile has mixed use (i.e., both personal and business), the business use portion should be realistic under the circumstances. For example, a 95 percent business use allocation for a one-car family living in the suburbs does not make sense (i.e., does the 5 percent allocated to personal use suffice to cover, for example, trips to the grocery store and mall, soccer practice, and dance lessons?) More likely, the large business use percentage claimed will be an invitation for an IRS audit.

If a taxpayer wants to sightsee or vacation on a business trip, it would be beneficial to schedule business on both a Friday and a Monday to turn the weekend into business days for allocation purposes. It is especially crucial to schedule appropriate business days when foreign travel is involved.

9-14e **Moving Expenses**

Persons who retire and move to a new location incur personal nondeductible moving expenses. If the retired person accepts a full-time job in the new location, the moving expenses are deductible.

At the time of his retirement from the national office of a major accounting firm, Gordon had an annual salary of \$420,000. He moves from New York City to Seattle to retire. To qualify for the moving expense deduction, Gordon accepts a full-time teaching position at a Seattle junior college at an annual salary of \$15,000. If Gordon satisfies the 39-week test, his moving expenses are deductible. The disparity between the two salaries (previous and current) is of no consequence.

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9-14f **Education Expenses**

Education expenses are treated as nondeductible personal items unless the individual is employed or is engaged in a trade or business. A temporary leave of absence for further education is one way to reasonably ensure that the taxpayer is still qualified, even if a full-time student. An individual was permitted to deduct education expenses even though he resigned from his job, returned to school full-time for two years, and accepted another job in the same field upon graduation. The court held that the student had merely suspended active participation in his field.⁹¹

If the time away from the field is too long, educational expense deductions will be disallowed. For example, a teacher who left the field for four years to raise her child and curtailed her employment searches and writing activities was denied a deduction. She was not actively engaged in the trade or business of being an educator.⁹²

To secure the deduction, an individual should arrange his or her work situation to preserve employee or business status.

⁹¹*Stephen G. Sherman*, 36 TCM 1191, T.C.Memo. 1977-301.

⁹²*Brian C. Mulberin*, 42 TCM 834, T.C.Memo. 1981-454; *George A. Baist*, 56 TCM 778, T.C.Memo. 1988-554.

The deduction for qualified tuition and related expenses provides some relief from the current restrictions on the deduction of education expenses by employees. First, the education expense does not have to be work-related. Second, it is a deduction *for* (not *from*) AGI. Unfortunately, the deduction possesses severe shortcomings: not only is the annual amount allowed quite modest, but it may be unavailable to certain taxpayers. It is not available, for example, to those who exceed an AGI ceiling or to someone who can be claimed as a dependent of another.

Before selecting the § 222 deduction approach, however, consider the possible availability of the American Opportunity credit (formerly the HOPE credit) or the lifetime learning credit under § 25A.⁹³ As credits provide a dollar-for-dollar reduction of tax liability, these provisions could yield a greater tax benefit than deductions *for* AGI. But these credits may not be available to higher-income taxpayers.

9-14g Entertainment and Meal Expenses

Proper documentation of expenditures is essential because of the strict record-keeping requirements and the restrictive tests that must be met. For example, documentation that consists solely of credit card receipts and canceled checks may be inadequate to substantiate the business purpose and business relationship.⁹⁴ Taxpayers should maintain detailed records of amounts, time, place, business purpose, and business relationships. A credit card receipt details the place, date, and amount of the expense. A notation made on the receipt of the names of the person(s) attending, the business relationship, and the topic of discussion should constitute proper documentation.

Associated with or goodwill entertainment is not deductible unless a business discussion is conducted immediately before or after the entertainment. Furthermore, a business purpose must exist for the entertainment. Taxpayers should arrange for a business discussion before or after such entertainment. They must provide documentation of the business purpose, such as obtaining new business from a prospective customer.

Unreimbursed meals and entertainment are subject to the 50 percent cutback rule in addition to the 2 percent floor. Consequently, the procedure of negotiating a salary reduction, as discussed in a prior section, is even more valuable to the taxpayer.

9-14h Office in the Home

The availability of the simplified method under Rev.Proc. 2013–13 presents another decision that a taxpayer will have to make each year. In arriving at which method to use for computing the office in the home deduction, here are some factors to consider:

- The simplified method requires fewer calculations and less record keeping.
- Because no depreciation is allowed, the simplified method will avoid recapture on the disposition of the residence.
- Even though the simplified method frees up certain home-related expenses (e.g., qualified residence interest, property taxes, homeowners insurance, utilities), are these expenses otherwise deductible? Some are (property taxes), and some are not (homeowners insurance). But even the expenses that are deductible (property taxes) may be subject to various limitations placed on itemized deductions (see Chapter 10).
- The simplified method, being limited to a maximum of \$1,500, does not offer a very generous result. In most cases, the regular method will yield a larger deduction.
- Unlike the regular method, under the simplified method, a taxpayer is not allowed to carry over unused deductions.
- Once a taxpayer has made a choice for a year, the election is irrevocable and cannot be changed.

⁹³These credits are briefly mentioned on p. 19 in this chapter and are discussed at greater length in Chapter 12.

⁹⁴*Kenneth W. Guenther*, 54 TCM 382, T.C.Memo. 1987–440.

Tyler, a calendar year taxpayer, prepared and filed his own tax return for 2014. Being in a hurry, he chose and used the simplified method of computing his deduction for an office in the home. In March 2016, Tyler seeks tax advice and learns how much he could have saved by using the regular method. Tyler cannot file an amended return for 2014, but he can switch to the regular method for 2015.

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REFOCUS ON THE BIG PICTURE

THE FIRST JOB

The first issue that might arise as a result of Morgan's new job is the dependency exemption possibility. If Morgan was living at home and accepted the job late in the year, she could qualify as a dependent of her parents. If so, they might also be able to claim the qualified tuition deduction (or the lifetime learning credit). If, however, her employment began early in the year, she could not be a qualifying child (due to the self-supporting limitation) or a qualifying relative (due to the gross income limitation)—see Chapter 3.

Although Morgan's "extensive search" for employment indicates that she may have incurred job hunting expenses, such expenses are not deductible in a *first job* setting (see Example 45). Her qualified moving expenses, however, are not so restricted. Moving expenses are deductions *for* AGI (see Example 27).

Morgan is justified in claiming an office in the home deduction. She can use either the regular (actual expense) method or the simplified (safe harbor) method. Under the regular method, the deduction would include a portion of the rent and utilities paid and related maintenance costs (e.g., janitorial service). The safe harbor method would allow Morgan \$5 per square foot for business space, but not more than 300 square feet, or \$1,500. Under either method, she would also be allowed depreciation (or expensing) of office equipment and furnishings (e.g., computer, copier, desk, file cabinet). She must be careful, however, not to violate the "exclusive use" restriction (see Examples 41, 43, and 44) regardless of which method she uses.

As she is required to travel as part of her job, Morgan will use her car for business. Thus, she will need to make a choice between the automatic mileage method and the actual cost method (see Example 11). Because her tax home is in her apartment, she will have no nondeductible commuting expenses (see Example 9).

If she renders an adequate accounting (and has to return any excess) to Kite Corporation, then her allowance need not be reported on her Federal tax return. Nonreimbursed amounts, however, will have to be allocated between meals and entertainment (subject to the 50 percent cutback adjustment) and other employment-related expenses. The balance is an itemized deduction subject to the 2%-of-AGI floor.

If she does not render an adequate accounting, the full allowance is included in her gross income. All of the meals and entertainment expenses are subject to the 50 percent cutback adjustment, and the total of all employment-related expenses is an itemized deduction subject to the 2%-of-AGI floor.

If Morgan started the job with Kite Corporation late in the year, it is unlikely that she will be in a position to itemize her deductions *from* AGI. Instead, she will claim the standard deduction.

Morgan must maintain adequate substantiation regarding all of these employment-related transactions. Detailed records are particularly important in arriving at the office in the home deduction (if the regular method is used) and the business use of an automobile (under the actual cost method). If Morgan does not render an accounting to Kite, records are crucial in supporting the travel and entertainment expenses.



Key Terms

Accountable plan, 9-35

Automatic mileage method, 9-6

Deduction for qualified tuition and related expenses, 9-18

Education expenses, 9-15

Entertainment expenses, 9-20

Independent contractor, 9-2

Individual Retirement Accounts (IRAs), 9-29

Keogh plans, 9-33

Moving expenses, 9-12

Nonaccountable plan, 9-36

Office in the home expenses, 9-24

Roth IRA, 9-30

Section 401(k) plan, 9-28

Statutory employees, 9-4

Transportation expenses, 9-5

Travel expenses, 9-8

Discussion Questions

- Issue ID** 1. **LO.1, 9** Sophia and Jacob are married and file a joint return. The return for 2014 included a Form 2106 for each of them. The return for 2015, however, included a Form 2106 and a Schedule C. In terms of employment status, what could have changed?
2. **LO.1** Mason performs services for Isabella. In determining whether Mason is an employee or an independent contractor, comment on the relevance of each of the factors listed below.
- Mason performs services only for Isabella and does not work for anyone else.
 - Mason sets his own work schedule.
 - Mason reports his job-related expenses on a Schedule C.
 - Mason obtained his job skills from Isabella's training program.
 - Mason performs the services at Isabella's business location.
 - Mason is paid based on time worked rather than on task performed.
- Issue ID** 3. **LO.2** Milton is a resident of Mobile (AL) and is employed by Scaup Corporation. Because Scaup closed its Mobile office, Milton no longer has any nondeductible commuting expenses although he continues to work for Scaup. Explain why.
- Issue ID** 4. **LO.2** In 2013, Emma purchased an automobile, which she uses for both business and personal purposes. Although Emma does not keep records as to operating expenses (e.g., gas, oil, and repairs), she can prove the percentage of business use and the miles driven each year. In March 2015, Emma seeks your advice as to what income tax benefit, if any, she can derive from the use of her automobile. What would you suggest?
- Issue ID** 5. **LO.3** Dr. Werner is a full-time professor of accounting at Pelican University. During the year, he teaches continuing education programs for CPA groups in several cities. He also serves as an expert witness in numerous lawsuits involving accounting fraud. Comment on the possible tax treatment of Dr. Werner's job-related expenses.
6. **LO.4** To qualify for the moving expense deduction, a taxpayer must satisfy a time test.
- What is the time test?
 - When might the taxpayer be excused from satisfying the time test?
 - What reporting procedure should be followed when the taxpayer has to file a return *after* the moving expenses have been incurred but *before* the time test requirement is met?
7. **LO.4** Emma, who lives and works in Wisconsin, is planning to retire and move to Costa Rica. She has heard that when you retire and move to a foreign country,

all moving expenses are deductible. Does Emma have a correct grasp of the rules involved? Explain.

8. **LO.5, 10** Jamie has an undergraduate degree in finance and is employed full-time by a bank. She is taking courses at a local university leading to an MBA degree.
 - a. Is the cost of this education deductible to her?
 - b. If so, what limitations are imposed on the deduction?
9. **LO.5, 10** In connection with § 222 (deduction for qualified tuition and related expenses), comment on the relevance of the following:
 - a. The standard deduction is claimed.
 - b. Enrollment at a college does not require the payment of a student activity fee.
 - c. Miscellaneous itemized deductions are less than 2% of AGI.
 - d. The taxpayer is married and files a separate return.
 - e. A father pays the tuition on behalf of a daughter who does not qualify as his dependent.
 - f. The taxpayer is single and has MAGI of \$80,001.
 - g. The lifetime learning credit is claimed.
 - h. The taxpayer, a CPA, pays for tuition and course materials to attend law school.
10. **LO.6** In each of the following situations, indicate whether there is a cutback adjustment.
 - a. Each year, the employer awards its top salesperson an all-expense-paid trip to Jamaica.
 - b. The employer has a cafeteria for its employees where meals are furnished at cost.
 - c. The employer sponsors an annual Labor Day picnic for its employees.
 - d. Every Christmas, the employer gives each employee a fruitcake.
 - e. The taxpayer, an airline pilot, pays for meals and lodging during a layover between flights.
 - f. The taxpayer pays a cover charge to take key clients to a nightclub.
 - g. The taxpayer gives business gifts to her clients at Christmas.
 - h. The taxpayer purchases tickets to take clients to an athletic event.
11. **LO.7** In connection with the office in the home deduction, comment on the following:
 - a. The exclusive use requirement.
 - b. The distinction between *direct* and *indirect* expenses.
 - c. The effect of the taxpayer's work status (i.e., employed or self-employed) on the deduction.
 - d. The ownership status of the residence (i.e., owned or rented).
 - e. The tax treatment of office furnishings (e.g., desk, chairs, and file cabinets).
 - f. The treatment of expenses that exceed the gross income from the business.
12. **LO.7** Review the advantages and disadvantages of the simplified method for determining the office in the home deduction.
13. **LO.4, 7** Trent, a resident of Florida, attends Rice University. After graduation, he moves to Dallas, where he begins a job search. Shortly thereafter, he accepts a position with a local TV station as a reporter. Trent's college degree is in accounting. Presuming no reimbursement, what employment-related expenses might Trent be eligible to deduct?

Issue ID

14. **LO.8** Regarding the tax implications of various retirement plans, comment on the following:
 - a. The difference between Keogh (H.R. 10) and traditional deductible IRA plans.
 - b. The difference between traditional IRA and Roth IRA plans.
15. **LO.8** Joey, who is single, is not covered by another qualified plan and earns \$118,000 at his job in 2015. How much can he contribute to a traditional IRA or to a Roth IRA in 2015?
16. **LO.9** What tax return reporting procedures must be followed by an employee under the following circumstances?
 - a. Expenses and reimbursements are equal under an accountable plan.
 - b. Reimbursements at the appropriate Federal per diem rate exceed expenses, and an adequate accounting is made to the employer.
 - c. Expenses exceed reimbursements under a nonaccountable plan.

Computational Exercises

17. **LO.2** Michael holds a full-time job with Brown Company and a part-time job with Tan Corporation. During a workday, he drives 20 miles to Brown, returns home, has a meal, and then drives 15 miles to Tan. Tan is located 12 miles from Brown. What is Michael's deductible mileage?
18. **LO.2** Lara uses the standard mileage method for determining auto expenses. During 2015, she used her car as follows: 9,000 miles for business, 2,000 miles for personal use, 2,500 miles for a move to a new job, 1,000 miles for charitable purposes, and 500 miles for medical visits. Presuming that all the mileage expenses are allowable (i.e., not subject to percentage limitations), what is Lara's deduction for:
 - a. Business?
 - b. Moving?
 - c. Charitable?
 - d. Medical?
19. **LO.3** Fred travels from Denver to Miami primarily on business. He spends five days conducting business and two days sightseeing. His expenses are \$400 (airfare), \$150 per day (meals), and \$300 per night (lodging). What are Fred's deductible expenses?
20. **LO.3** Brenda travels from Chicago to Barcelona (Spain) on business. She is gone ten days (including two days of travel) during which time she spends five days conducting business and three days sightseeing. Her expenses are \$1,500 (airfare), \$200 per day (meals), and \$400 per night (lodging). Because Brenda stayed with relatives while sightseeing, only five nights of lodging were business-related. What is Brenda's deduction for:
 - a. Airfare?
 - b. Meals?
 - c. Lodging?
21. **LO.4** After accepting his first job upon graduating from college, Christian has the following moving expenses:

Rental of moving van	\$450
Meals	200
Lodging	250

Presuming no reimbursement, what is Christian's moving expense deduction?

22. **LO.5** Samantha was recently employed by an accounting firm. During the year, she spends \$2,500 for a CPA exam review course and begins working on a law degree in night school. Her law school expenses were \$4,200 for tuition and \$450 for books. Assuming no reimbursement, how much can Samantha deduct for the:
- CPA exam review course?
 - Law school expenses?
23. **LO.6** Robert entertains four key clients and their spouses at a nightclub. Expenses were \$200 (limo charge), \$120 (cover charge), \$700 (drinks and dinner), and \$140 (tips to servers). If Robert is self-employed, how much can he deduct for this event?
24. **LO.6** The CEO of Crimson, Inc., entertains seven clients at a skybox in Memorial Stadium for an athletic event. The box costs \$2,000 per event and seats 10 people. (The cost of a regular seat at Memorial ranges from \$55 to \$100.) Refreshments served during the event cost \$700. How much of these costs may Crimson deduct?
25. **LO.6** Andrew sends Godiva chocolates to 10 of his key clients at Christmas. The chocolates cost \$50 a box not including \$4 for gift wrapping and shipping. How much can Andrew deduct?
26. **LO.7** Cindy maintains an office in her home that comprises 8% (200 square feet) of total floor space. Gross income for her business is \$42,000, and her residence expenses are as follows:

Real property taxes	\$2,400
Interest on mortgage	4,000
Operating expenses	2,200
Depreciation (based on 8% business use)	450

What is Cindy's office in the home deduction based on:

- The regular method?
 - The simplified method?
27. **LO.4,7** Mason, a licensed pharmacist, has always lived and worked in Boston. When he retires from a national drugstore chain, he conducts an extensive job search for any kind of employment in Florida. He finally moves to Tampa where he is able to obtain a position as a night manager of a motel. In connection with the relocation, he incurs job search expenses of \$7,000 and qualified moving expenses of \$12,000. How much can Mason deduct?
28. **LO.10** Ava has AGI of \$58,000 and the following miscellaneous itemized deductions:

Home office expenses	\$1,200
Union dues and work uniforms	350
Unreimbursed employee expenses	415
Gambling losses to the extent of gambling winnings	890

What is Ava's total itemized deduction (after any percentage limit)?

Problems

29. **LO.2,3** During the year, Olivia holds two jobs. After an eight-hour day at the first job, she works three hours at the second job. On Fridays of each week, she returns home for dinner before going to the second job. On the other days (Monday

through Thursday), she goes directly from the first job to the second job, stopping along the way for a meal. The mileage involved is as follows:

Home to first job	15
First job to second job	18
Home to second job	20

- a. Assuming that Olivia works 48 weeks during the year, how much of her mileage is deductible?
 - b. Can Olivia deduct the dinners she purchased? Why or why not?
30. **LO.2, 5** William is employed by an accounting firm and uses his automobile in connection with his work. During the month of October 2015, he works at the office for 3 days and participates in the audit of a key client for 19 days. In the audit situation, William goes directly from his home to the client's office. On all other days, he drives to his employer's office. On four Saturdays in October, he drives from his home to a local university where he attends classes in a part-time MBA program. Relevant mileage is as follows:

Home to office	12
Office to audit client	13
Home to audit client	14
Home to university	10

Using the automatic mileage method, what is William's deduction for the month?

31. **LO.2** Ella is the regional sales manager for a fast-food chain. She starts her work day by driving from home to the regional office, works there for several hours, and then visits the three sales outlets in her region. Relevant mileage is as follows:

Home to regional office	10
Regional office to sales outlet 1	13
Sales outlet 1 to sales outlet 2	11
Sales outlet 2 to sales outlet 3	9
Sales outlet 3 to home	15

If Ella uses the automatic mileage method and works 240 days in 2015, what is her deduction for the year?

32. **LO.2** Jackson uses his automobile 90% for business and during 2015 drove a total of 14,000 miles. Information regarding his car expenses is listed below.

Business parking	\$ 140
Auto insurance	1,300
Auto club dues (includes towing service)	180
Toll road charges (business-related)	200
Oil changes and engine tune-ups	210
Repairs	160
Depreciation allowable	2,850
Fines for traffic violations (incurred during business use)	320
Gasoline purchases	2,800

What is Jackson's deduction in 2015 for the use of his car if he uses:

- a. The actual cost method?
 - b. The automatic mileage method?
33. **LO.2** On July 1, 2011, Rex purchases a new automobile for \$40,000. He uses the car 80% for business and drives the car as follows: 8,000 miles in 2011, 19,000 miles in 2012, 20,000 miles in 2013, and 15,000 miles in 2014. Determine Rex's basis in the auto as of January 1, 2015, under the following assumptions.

- a. Rex uses the automatic mileage method.
- b. Rex uses the actual cost method. [Assume that no § 179 expensing is claimed and that 200% declining-balance cost recovery with the half-year convention is used—see Chapter 8. The recovery limitation for an auto placed in service in 2011 is as follows: \$3,060 (first year), \$4,900 (second year), \$2,950 (third year), and \$1,775 (fourth year).]
34. **LO.3** Kristen, the regional manager for a national hardware chain, is based in Atlanta. During March and April of this year, she has to replace temporarily the district manager in Jackson, Mississippi. During this period, Kristen flies to Jackson on Sunday night, spends the week at the district office, and returns home to Atlanta on Friday afternoon. The cost of returning home is \$550, while the cost of spending the weekend in Jackson would have been \$490.
- a. Presuming no reimbursement by her employer, how much, if any, of these weekend expenses may Kristen deduct?
- b. Would your answer in (a) change if the amounts involved are reversed (i.e., the trip home cost \$490; staying in Jackson would have been \$550)? Explain.
35. **LO.3, 6** In June of this year, Dr. and Mrs. Bret Spencer traveled to Denver to attend a three-day conference sponsored by the American Society of Implant Dentistry. Bret, a practicing oral surgeon, participated in scheduled technical sessions dealing with the latest developments in surgical procedures. On two days, Mrs. Spencer attended group meetings where various aspects of family tax planning were discussed. On the other day, she went sightseeing. Mrs. Spencer does not work for her husband, but she does their tax returns and handles the family investments. Expenses incurred in connection with the conference are summarized below.

Airfare (two tickets)	\$2,000
Lodging (single and double occupancy are the same rate—\$250 each day)	750
Meals (\$200 × 3 days)*	600
Conference registration fee (includes \$120 for Family Tax Planning sessions)	620
Car rental	300

*Split equally between Dr. and Mrs. Spencer.

How much, if any, of these expenses can the Spencers deduct?

36. **LO.1, 3, 6** Kim works for a clothing manufacturer as a dress designer. She travels to New York City to attend five days of fashion shows and then spends three days sight seeing. Her expenses are as follows:
- | | |
|------------------------|---------|
| Airfare | \$1,500 |
| Lodging (8 nights) | 1,920 |
| Meals (8 days) | 1,440 |
| Airport transportation | 120 |
- [Assume that lodging/meals are the same amount for the business and personal portion of the trip (e.g., \$180 per day for meals).]
- a. Presuming no reimbursement, how much can Kim deduct as to the trip?
- b. Would the tax treatment of Kim's deduction differ if she was an independent contractor (rather than an employee)? Explain.
37. **LO.3** On Thursday, Justin flies from Baltimore (his home office) to Cadiz (Spain). He conducts business on Friday and Tuesday; vacations on Saturday, Sunday, and Monday (a legal holiday in Spain); and returns to Baltimore on Thursday. Justin was scheduled to return home on Wednesday, but all flights were canceled due to

bad weather. Therefore, he spent Wednesday watching floor shows at a local casino.

- For tax purposes, what portion of Justin's trip is regarded as being for business?
- Suppose Monday was not a legal holiday. Would this change your answer in (a)? Explain.
- Under either (a) or (b), how much of Justin's airfare qualifies as a deductible business expense?

Decision Making 38. **LO.3** Monica travels from her office in Boston to Lisbon, Portugal, on business. Her absence of 13 days was spent as follows:

Thursday	Depart for and arrive at Lisbon
Friday	Business transacted
Saturday and Sunday	Vacationing
Monday through Friday	Business transacted
Saturday and Sunday	Vacationing
Monday	Business transacted
Tuesday	Depart Lisbon and return to office in Boston

- For tax purposes, how many days has Monica spent on business?
 - What difference does it make?
 - Could Monica have spent more time than she did vacationing on the trip without loss of existing tax benefits? Explain.
39. **LO.4** Caden, a financial planner, decides to quit his job with an investment bank in Charleston, South Carolina, and establish a private practice in Santa Fe, New Mexico. In connection with the move in 2015, he incurs the following expenses:

Moving van charge	\$4,500
Lodging during move	540
Meals during move	410
Loss on sale of residence in Charleston	9,000
Mileage for personal autos	3,500 miles

How much of these expenses, if any, can Caden deduct?

40. **LO.4,7** Upon losing his job as a plant manager in Quincy, Massachusetts, Anthony incurs \$6,200 in job search expenses. Having no success in finding new employment in the same type of work, Anthony moves to Clearwater, Florida in 2015 and begins a charter boat business. His expenses in connection with the move are summarized below.

Penalty for breaking lease on Quincy rented residence	\$2,800
Forfeiture of membership in Quincy Country Club	2,200
Packing and moving van charges	7,100
Lodging during move (3 nights)	380
Meals during move	360
Mileage (for two automobiles)	2,400 miles

How much of these expenses may Anthony deduct?

41. **LO.4** After being downsized by his former employer, in November 2014, Wayne moves from Minnesota to Alabama to accept a new job. When filing his Federal income tax return for 2014, Wayne deducts the \$14,000 in moving expenses he incurred (none of which were reimbursed by either his former or new employer). On June 6, 2015, Wayne's employment terminates. What are the tax consequences if the termination occurred because:
- Wayne was killed by a drunk driver?
 - Wayne was downsized by the new employer?

- c. Wayne was fired by the new employer because he assaulted a client?
- d. Wayne quit because he inherited a large amount of money and decided he did not want to work anymore?
42. **LO.5** Elijah is employed as a full-time high school teacher. The school district where he works recently instituted a policy requiring all of its teachers to start working on a master's degree. Pursuant to this new rule, Elijah spent most of the summer of 2015 taking graduate courses at an out-of-town university. His expenses are as follows:

Tuition	\$6,600
Books and course materials	1,500
Lodging	1,700
Meals	2,200
Laundry and dry cleaning	200
Campus parking	300

In addition, Elijah drove his personal automobile 2,200 miles in connection with the education. He uses the automatic mileage method.

- a. How much, if any, of these expenses might qualify as deductions *for* AGI?
- b. How much, if any, of these expenses might qualify as deductions *from* AGI?
43. **LO.5** In each of the following independent situations, determine how much, if any, qualifies as a deduction *for* AGI under § 222 (qualified tuition and related expenses):
- a. Lily is single and is employed as an architect. During 2015, she spends \$4,100 in tuition to attend law school at night. Her MAGI is \$64,000.
- b. Liam is single and is employed as a pharmacist. During 2015, he spends \$2,400 (\$2,100 for tuition and \$300 for books) to take a course in herbal supplements at a local university. His MAGI is \$81,000.
- c. Hailey is married and is employed as a bookkeeper. She spends \$5,200 for tuition and \$900 for books and supplies pursuing a bachelor's degree in accounting. Her MAGI is \$40,000 on the separate return she files.
- d. John spends \$6,500 of his savings on tuition to attend Carmine State College. John is claimed as a dependent by his parents.
- e. How much, if any, of the above amounts *not allowed under* § 222 might otherwise qualify as a deduction *from* AGI?
44. **LO.6, 9** Eric is a licensed commercial pilot who works for Snipe Charter Jet Service. Typically, Eric, who lives near the airport, flies a charter out of Tupelo, Mississippi, to either Las Vegas or Reno, spends several nights there, and then returns home with the same group. Snipe provides Eric with a travel allowance of \$1,800 per month but requires no accountability. For the current calendar year, Eric had the following job-related expenses:

Meals	\$ 7,000
Lodging	10,000
Transportation (taxi, limos)	500
Uniforms	1,300
Dry cleaning of uniforms	400
Annual physical exam	1,500

The uniforms are required to be worn on the job. The Federal Aviation Administration requires the annual physical exam for the maintenance of a commercial pilot's license. How may Eric treat these expenses for Federal income tax purposes?

45. **LO.6** Stork Associates paid \$60,000 for a 20-seat skybox at Veterans Stadium for eight professional football games. Regular seats to these games range from \$80 to

\$250 each. At one game, an employee of Stork entertained 18 clients. Stork furnished food and beverages for the event at a cost of \$1,300. The game was preceded by a bona fide business discussion, and all expenses are adequately substantiated.

- How much may Stork deduct for this event?
- What if there was no bona fide business discussion either before or after the event?

46. **LO.6** During the current year, Paul, the vice president of a bank, made gifts in the following amounts:

To Sarah (Paul's personal assistant) at Christmas	\$36
To Darryl (a key client)—\$3 was for gift wrapping	53
To Darryl's wife (a homemaker) on her birthday	20
To Veronica (Paul's boss) at Christmas	30

In addition, on professional assistants' day, Paul takes Sarah to lunch at a cost of \$82. Presuming that Paul has adequate substantiation and is not reimbursed, how much can he deduct?

47. **LO.7** Melanie is employed full-time as an accountant for a national hardware chain. She recently started a private consulting practice, which provides tax advice and financial planning to the general public. For this purpose, she maintains an office in her home. Expenses relating to her home for 2015 are as follows:

Real property taxes	\$3,600
Interest on home mortgage	3,800
Operating expenses of home	900

Melanie's residence cost \$350,000 (excluding land) and has living space of 2,000 square feet, of which 20% (400 square feet) is devoted to business. The office was placed in service in February 2014, and under the regular method, Melanie had an unused office in the home deduction of \$800 for 2014. Presuming sufficient net income from her consulting practice, what is Melanie's office in the home deduction under the:

- Regular method.
- Simplified method.

48. **LO.7** Christine is a full-time teacher of the fourth grade at Vireo Academy. During the current year, she spends \$1,400 for classroom supplies. On the submission of adequate substantiation, Vireo reimburses her for \$500 of these expenses—the maximum reimbursement allowed for supplies under school policy. [The reimbursement is not shown as income (Box 1) of Form W-2 given to Christine by Vireo.] What are the income tax consequences of the \$1,400 if Christine:

- Itemizes her deductions *from* AGI?
- Chooses the standard deduction?

Decision Making

49. **LO.8** Amber's employer, Lavender, Inc., has a § 401(k) plan that permits salary deferral elections by its employees. Amber's salary is \$99,000, and her marginal tax rate is 33%.

- What is the maximum amount Amber can elect for salary deferral treatment for 2015?
- If Amber elects salary deferral treatment for the amount in (a), how much can she save in taxes?
- What amount would you recommend that Amber elect for salary deferral treatment for 2015?

50. **LO.8** Shyam is a participant in a SIMPLE § 401(k) plan. He elects to contribute 4% of his \$40,000 compensation to the account, while his employer contributes 3%. What amount will not vest immediately, if any?

51. **LO.8** Harvey is a self-employed accountant with earned income from the business of \$120,000 (after the deduction for one-half of his self-employment tax). He has a profit sharing plan (e.g., defined contribution Keogh plan). What is the maximum amount Harvey can contribute to his retirement plan in 2015?
52. **LO.8** Answer the following independent questions with respect to traditional IRA contributions for 2015:
- Juan, age 41, earns a salary of \$28,000 and is not an active participant in any other qualified plan. His wife, Agnes, has no earned income. What is the maximum total deductible contribution to their IRAs? Juan wants to contribute as much as possible to his own IRA.
 - Abby, age 29, has earned income of \$25,000, and her husband, Sam, has earned income of \$2,600. They are not active participants in any other qualified plan. What is the maximum contribution to their IRAs?
 - Leo's employer makes a contribution of \$3,500 to Leo's simplified employee pension plan. If Leo is single, has earned income of \$32,000, and has AGI of \$29,000, what amount, if any, can he contribute to an IRA?
53. **LO.8** Jimmy establishes a Roth IRA at age 47 and contributes a total of \$89,600 over 18 years. The account is now worth \$112,000. How much of these funds may Jimmy withdraw tax-free?
54. **LO.8** Carri and Dane, ages 34 and 32, respectively, have been married for 11 years, and both are active participants in employer qualified retirement plans. Their total AGI in 2015 is \$186,000, and they earn salaries of \$87,000 and \$95,000, respectively. What amount may Carri and Dane:
- Contribute to regular IRAs?
 - Deduct for their contributions in (a)?
 - Contribute to Roth IRAs?
 - Deduct for their contributions in (c)?
55. **LO.3, 6, 9** Charles has AGI of \$94,000 during the year and the following expenses related to his employment:

Lodging while in travel status	\$5,000
Meals during travel	4,000
Business transportation	6,000
Entertainment of clients	3,800
Professional dues and subscriptions	800

Charles is reimbursed \$14,000 under his employer's accountable plan. What are his deductions *for* and *from* AGI?

56. **LO.3, 6, 9** During the year, Brenda has the following expenses related to her employment:

Airfare	\$8,500
Meals	4,000
Lodging	4,900
Transportation while in travel status (taxi and limos)	940
Entertainment of clients	8,000

Although Brenda renders an adequate accounting to her employer, she is reimbursed for only \$12,000 of the above expenses. What are Brenda's tax consequences based on the following assumptions?

- The \$12,000 reimbursement does not designate which expenses are covered.
- The reimbursement specifically covers *only* the meals and entertainment expenses.

Decision Making

- c. The reimbursement covers any of the expenses *other than* meals and entertainment.
- d. If Brenda has a choice of reimbursement procedures [parts (a), (b), or (c) above], which should she select? Why?

57. **LO.6, 9, 10** Audry, age 38 and single, earns a salary of \$59,000. She has interest income of \$1,600 and has a \$2,000 long-term capital loss from the sale of a stock investment. Audry incurs the following employment-related expenses during the year:

Transportation	\$5,500
Meals	2,800
Lodging	4,200
Entertainment of clients	2,200
Professional dues and subscriptions	300

Under an accountable plan, Audry receives reimbursements of \$4,500 from her employer. Calculate her AGI and itemized employee business expenses.

- Decision Making** 58. **LO.3, 6, 9, 10, 11** Ava recently graduated from college and is interviewing for a position in marketing. Gull Corporation has offered her a job as a sales representative that will require extensive travel and entertainment but provide valuable experience. Under the offer, she has two options: a salary of \$53,000 and she absorbs all expenses; a salary of \$39,000 and Gull reimburses for all expenses. Gull assures Ava that the \$14,000 difference in the two options will be adequate to cover the expenses incurred. What issues should have an impact on Ava's choice?

59. **LO.5, 7, 10** B. J. and Carolyn Grace are full-time employees. B. J. is an elementary school teacher, and Carolyn is a registered nurse at a hospital. During the year, they incur the following employment-related expenses:

School supplies for use in the classroom	\$1,400
Emergency room uniforms	800
Union dues (teachers association)	200
Job hunting expenses (Carolyn obtained another nursing position but decided not to change jobs)	1,300
Continuing education correspondence courses (required to maintain nursing license)	380
Professional dues and subscriptions	1,100

None of these expenses are reimbursed by the employers.

For the year, the Graces file a joint return reflecting salary income of \$90,000. They also have gambling income of \$6,000 and gambling losses of \$7,000 (fully substantiated). They pay \$400 to have their tax return prepared. They have other itemized deductions (i.e., interest on home mortgage, property taxes on personal residence, state income taxes, and charitable contributions) of \$14,500. Determine the total amount of itemized deductions allowed to the Graces.

60. **LO.1, 2, 4, 5, 7, 10** Complete the following table by classifying each of the independent expenditures (assume that no reimbursement takes place).

Expense Item	Deductible for AGI	Deductible from AGI	Not Deductible
a. Moving expense of an employee	_____	_____	_____
b. Tax return preparation fee incurred by an employed plumber	_____	_____	_____
c. Safety glasses purchased by an employed pipefitter	_____	_____	_____

Expense Item	Deductible for AGI	Deductible from AGI	Not Deductible
d. Dues to auto club (e.g., AAA) for taxpayer who uses the automatic mileage method	_____	_____	_____
e. Nursing refresher course for taxpayer who retired from nursing five years ago	_____	_____	_____
f. Gambling loss <i>not</i> in excess of gambling gain by a self-employed architect	_____	_____	_____
g. Contribution to Roth IRA by a self-employed attorney	_____	_____	_____
h. Business travel expenses by a statutory employee	_____	_____	_____
i. Job hunting expense by an elementary school teacher seeking a position as an elementary school principal	_____	_____	_____
j. Cost of bar exam review course taken by a recent law school graduate	_____	_____	_____

Cumulative Problems



61. David R. and Ella M. Cole (ages 39 and 38, respectively) are husband and wife who live at 1820 Elk Avenue, Denver, CO 80202. David is a regional sales manager for Wren Industries, a national wholesaler of plumbing and heating supplies, and Ella is a part-time dental hygienist for a chain of dental clinics.

Tax Return Problem

- David is classified by Wren as a statutory employee with compensation for 2014 (based on commissions) of \$95,000. He is expected to maintain his own office and pay for all business expenses from this amount. Wren does not require him to render any accounting as to the use of these funds. It does not withhold Federal and state income taxes but does withhold and account for the payroll taxes incurred (e.g., Social Security and Medicare). The Coles are adequately covered by Wren's noncontributory medical plan but have chosen not to participate in its § 401(k) retirement plan.

David's employment-related expenses for 2014 are summarized below:

Airfare	\$8,800
Lodging	5,000
Meals (during travel status)	4,800
Entertainment	3,600
Ground transportation (e.g., limos, rental cars, and taxis)	800
Business gifts	900
Office supplies (includes postage, overnight delivery, and copying)	1,500

The entertainment involved business meals for purchasing agents, store owners, and building contractors. The business gifts consisted of \$50 gift certificates to a national restaurant. These were sent by David during the Christmas holidays to 18 of his major customers.

In addition, David drove his 2012 Ford Expedition 11,000 miles for business and 3,000 for personal use during 2014. He purchased the Expedition on August 15, 2011, and has always used the automatic (standard) mileage method for tax purposes. Parking and tolls relating to business use total \$340 in 2014.

- When the Coles purchased their present residence in April 2011, they devoted 450 of the 3,000 square feet of living space to an office for David. The property



cost \$440,000 (\$40,000 of which is attributable to the land) and has since appreciated in value. Expenses relating to the residence in 2014 (except for mortgage interest and property taxes; see below) are as follows:

Insurance	\$2,600
Repairs and maintenance	900
Utilities	4,700
Painting office area; area rugs and plants (in the office)	1,800

In terms of depreciation, the Coles use the MACRS percentage tables applicable to 39-year nonresidential real property. As to depreciable property (e.g., office furniture), David tries to avoid capitalization and uses whatever method provides the fastest write-off for tax purposes.

- Ella works part-time as a substitute for whichever hygienist is ill or on vacation or when one of the clinics is particularly busy (e.g., prior to the beginning of the school year). Besides her transportation, she must provide and maintain her own uniforms. Her expenses for 2014 appear below.

Uniforms	\$690
State and city occupational licenses	380
Professional journals and membership dues in the American Dental Hygiene Association	340
Correspondence study course (taken online) dealing with teeth whitening procedures	420

Ella's salary for the year is \$42,000, and her Form W-2 for the year shows income tax withholdings of \$4,000 (Federal) and \$1,000 (state) and the proper amount of Social Security and Medicare taxes. Because Ella is a part-time employee, she is not included in her employer's medical or retirement plans.

- Besides the items already mentioned, the Coles had the following receipts during 2014.

Interest income—		
State of Colorado general purpose bonds	\$2,500	
IBM bonds	800	
Wells Fargo Bank CD	<u>1,200</u>	\$ 4,500
Federal income tax refund for year 2013		510
Life insurance proceeds paid by Eagle Assurance Corporation		200,000
Inheritance of savings account from Sarah Cole		50,000
Sales proceeds from two ATVs		9,000

For several years, the Coles's household has included David's divorced mother, Sarah, who has been claimed as their dependent. In late November 2014, Sarah unexpectedly died of coronary arrest in her sleep. Unknown to Ella and David, Sarah had a life insurance policy and a savings account (with David as the designated beneficiary of each). In 2013, the Coles purchased two ATVs for \$14,000. After several near mishaps, they decided that the sport was too dangerous. In 2014, they sold the ATVs to their neighbor.

- Additional expenditures for 2014 include:

Funeral expenses for Sarah		\$ 4,500
Taxes—		
Real property taxes on personal residence	\$6,400	
Colorado state income tax due (paid in April 2014 for tax year 2013)	<u>310</u>	6,710
Mortgage interest on personal residence		6,600
Paid church pledge		2,400
Contributions to traditional IRAs for Ella and David (\$5,500 + \$5,500)		11,000

In 2014, the Coles made quarterly estimated tax payments of \$1,400 (Federal) and \$500 (state) for a total of \$5,600 (Federal) and \$2,000 (state).

Part 1—Tax Computation

Using the appropriate forms and schedules, compute the Coles's Federal income tax for 2014. Disregard the alternative minimum tax (AMT) and various education credits as these items are not discussed until later in the text (Chapters 12 and 15). Relevant Social Security numbers are:

David Cole	123-45-6788
Ella Cole	123-45-6787
Sarah Cole	123-45-6799

The Coles do not want to contribute to the Presidential Election Campaign Fund. Also, they want any overpayment of tax refunded to them and *not* applied toward next year's tax liability. Suggested software: H&R BLOCK Tax Software.

Part 2—Follow-Up Advice

Ella has always wanted to pursue a career in nursing. To this end, she has earned a substantial number of college credits on a part-time basis. With Sarah no longer requiring home care, Ella believes that she can now complete her degree by attending college on a full-time basis.

David would like to know how Ella's plans will affect their income tax position. Specifically, he wants to know:

- How much Federal income tax they will save if Ella quits her job.
- Any tax benefits that might be available from the cost of the education.

Write a letter to David addressing these concerns. Note: In making your projections, assume that David's salary and expenses remain the same. Also disregard any consideration of the various educational tax credits as these are not discussed until Chapter 12.

62. Addison Parker, single and age 32, lives at 3218 Columbia Drive, Spokane, WA 99210. She is employed as regional sales manager by VITA Corporation, a manufacturer and distributor of vitamins and food supplements. Addison is paid an annual salary of \$83,000 and a separate travel allowance of \$24,000. As to the travel allowance, VITA does not require any accounting on the part of Addison.

Tax Computation Problem

- Addison participates in VITA's contributory health and § 401(k) plans. During 2015, she paid \$3,500 for her share of the medical insurance and contributed \$11,000 to the § 401(k) retirement plan.
- Addison uses her automobile 70% for business and 30% for personal. The automobile, a Toyota Avalon, was purchased new on June 30, 2013, for \$37,000 (no trade-in was involved). Depreciation has been claimed under MACRS 200% declining balance method, and no § 179 election was made in the year of purchase. (For depreciation information, see the IRS Instructions for Form 4562, Part V). During 2015, Addison drove 15,000 miles and incurred and paid the following expenses relating to the automobile:

Gasoline	\$3,100
Insurance	2,900
Auto club dues	240
Interest on car loan	1,100
Repairs and maintenance	1,200
Parking (during business use)	600
Traffic fines (during business use)	500

- Because VITA does not have an office in Spokane, the company expects Addison to maintain one in her home. Out of 1,500 square feet of living space in her apartment, Addison has set aside 300 square feet as an office. Expenses for 2015 relating to the office are listed below.

Rent	\$18,000
Utilities	4,000
Insurance (renter's casualty and theft coverage)	1,600
Carpet replacement (office area only)	1,200

- Addison's employment-related expenses (except for the trip to Korea) for 2015 are summarized below.

Airfare	\$4,100
Lodging	3,200
Meals	2,800
Entertainment (business lunches)	2,400
Transportation (taxis and airport limos)	300
Business gifts	540
Continuing education	400
Professional journals	140

Most of Addison's business trips involve visits to retail outlets in her region. Store managers and their key employees, as well as some suppliers, were the parties entertained. The business gifts were boxes of candy costing \$30 (\$25 each plus \$5 for wrapping and shipping) sent to 18 store managers at Christmas. The continuing education was a noncredit course dealing with improving management skills that Addison took online.

- In July 2015, Addison traveled to Korea to investigate a new process that is being developed to convert fish parts to a solid consumable tablet form. She spent one week checking out the process and then took a one-week vacation tour of the country. The round-trip airfare was \$3,600, while her expenses relating to business were \$2,100 for lodging (\$300 each night), \$1,470 for meals, and \$350 for transportation. Upon returning to the United States, Addison sent her findings about the process to her employer. VITA was so pleased with her report that it gave her an employee achievement award of \$10,000. The award was sent to Addison in January 2016.
- Addison provides more than 50% of the support of her parents (Gordon and Anita Parker), who live in Seattle. In addition to modest Social Security benefits, her parents receive a small amount of interest on municipal bonds and nontaxable retirement income.
- Besides the items already mentioned, Addison had the following receipts in 2015:

Interest income—		
City of Tacoma general purpose bonds	\$ 350	
Olympia State Bank	<u>400</u>	\$ 750
Proceeds from property sales—		
City lot	\$13,000	
Sailboat	<u>18,000</u>	31,000
Cash found at airport		5,000

Regarding the city lot (located in Vancouver), Addison purchased the property in 2000 for \$16,000 and held it as an investment. Unfortunately, the neighborhood where the lot was located deteriorated, and property values declined. In 2015, Addison decided to cut her losses and sold the property for \$13,000. The sailboat was used for pleasure and was purchased in 2011 for \$16,500. Addison sold the boat because she purchased a new and larger model (see below). While at the Spokane airport, Addison found an unmarked envelope containing \$5,000 in

\$50 bills. As no mention of any lost funds was noted in the media, Addison kept the money.

- Addison's expenditures for 2015 (not previously noted) are summarized below.

Medical (not covered by insurance)	\$7,000
State and local general sales tax	3,300
Church pledge (2014 and 2015)	5,600
Fee paid for preparation of 2014 income tax return	500
Contribution to mayor's reelection campaign fund	200
Premiums on life insurance policy	2,100
Contribution to a Coverdell Education Savings account (on behalf of a favorite nephew)	2,000

Most of the medical expenses Addison paid were for her mother's dental implants. Addison keeps careful records regarding sales taxes. In 2015, the sales tax total was unusually high due to the purchase of a new sailboat. In 2015, Addison decided to pay her church pledge for both 2014 and 2015. The insurance premium was on a policy covering her father's life. (Addison is the designated beneficiary under the policy.)

Relevant Social Security numbers are 123-45-6785 (Addison), 123-45-6783 (Gordon), and 123-45-6784 (Anita). Addison's employer withheld \$5,600 for Federal income tax purposes, and she applied her \$800 overpayment for 2014 toward the 2015 tax liability.

Compute Addison's Federal income tax payable (or refund) for 2015. In making the calculation, use the Tax Rate Schedule and disregard the application of the alternative minimum tax (AMT), which is not discussed until Chapter 15.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Aaron, a resident of Minnesota, has been a driver for Green Delivery Service for the past six years. For this purpose, he leases a truck from Green, and his compensation is based on a percentage of the income resulting from his pickup and delivery services. Green allows its drivers to choose their 10-hour shifts and does not exercise any control on how these services are carried out (e.g., the route to be taken or the order in which parcels are delivered or picked up). Under Green's operating agreement with its drivers, Green can terminate the arrangement after 30 days' notice. In practice, however, Green allows its truckers to quit immediately without giving advance notice. The agreement also labels the drivers as independent contractors. Green maintains no health or retirement plans for its drivers, and each year it reports their income by issuing Forms 1099-MISC (and not Forms W-2). Green requires its drivers to maintain a commercial driver's license and be in good standing with the state highway law enforcement division.

Citing the employment tax Regulations in §§ 31.3121(d)-1(c)(2) and 31.3306(i)-1(b), an IRS agent contends that Aaron is an independent contractor and, therefore, is subject to the self-employment tax. Based on *Peno Trucking, Inc.* (93 TCM 1027, T.C.Memo. 2007-66), Aaron disagrees and contends that he is an employee (i.e., not self-employed). Who is correct? Why?

Research Problem 2. Your client, a large construction firm organized as a C corporation, allows certain employees (including the president of the corporation) to use its company-owned airplane for nonbusiness flights. The employees include the value

of those flights in their income. Your client is uncertain about how to treat the expenses related to these nonbusiness flights. In certain situations the expenses of operating the plane are more than the income imputed to the employees and in certain circumstances the expenses are less. In doing some of their own research, your client found *Sutherland Lumber-Southwest, Inc.* [114 T.C. 197 (2000)], which suggests that as long as the employee imputes income, the full amount of the related expenses can be deducted. [The decision in the case was affirmed on appeal, *Sutherland Lumber-Southwest, Inc. v. Comm.* (2001–2 USTC ¶50,503, 88 AFTR 2d 2001–5026, 255 F.3d 495 (CA–8, 2001)).] Should your client follow the approach in *Sutherland*?

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 3. What are the guidelines regarding the deductibility of luxury water travel (e.g., cruise ship) for business purposes? Refer to Chapter 1 of IRS Publication 463.

Roger CPA Review Questions

1. The following facts pertain to Lewis Productions, a sole proprietorship owned by Lewis, in the current year:

Total cost of holiday gifts given to top 10 clients (each gift identical)	\$ 550
Receivable for prior-year purchase from Egan, who declared bankruptcy in the current year	2,500
Lodging costs incurred by Lewis while traveling to client sites	3,000
Meal costs incurred by Lewis only while traveling to and from client sites	1,500
Meal costs incurred by Lewis while entertaining business clients and engaging in some business-related discussion	3,000

Considering only the above facts, what is the total amount of business expenses that Lewis can declare on Schedule C of the current year's tax return?

- | | |
|------------|------------|
| a. \$8,000 | c. \$6,250 |
| b. \$5,500 | d. \$8,750 |
2. Pinnacle Productions, Inc. holds a luxury skybox season ticket at a local sporting arena. Pinnacle uses the skybox to entertain clients while holding business meetings. The cost of Pinnacle's luxury skybox season ticket is \$25,000; the cost of the most expensive non-luxury season ticket is \$15,000. How much of the luxury skybox season ticket cost may Pinnacle deduct from its corporate taxable income?
- | | |
|-------------|-------------|
| a. \$7,500 | c. \$10,000 |
| b. \$20,000 | d. \$15,000 |
3. Betty, a salesperson, is an employee with \$52,000 AGI who maintains a home office for the convenience of her employer, Smart Systems. The office takes up 5% of Betty's home and is used exclusively for her job. Smart Systems reimburses all of Betty's direct costs of maintaining the home office. Betty also has the following expenses associated with her home:

Expense	Amount
Real property taxes on residence	\$3,500
Interest expense on residence	5,000
Operating expenses on residence	1,800
Depreciation on residence (based on 5% home office use)	150

Considering these facts, how much may Betty deduct *from* AGI on her tax return, assuming she elects to itemize deductions?

- a. \$0
b. \$665
- c. \$9,410
d. \$10,450
4. In 20X13 Archer, a single individual, moved from Minneapolis to Phoenix to start a new job with InnoTech, which began 1 February 20X13. Archer worked for InnoTech until 15 November 20X13, when Archer accepted a job offer from InnoTech's Phoenix rival MegaTech. The following 20X13 facts apply to Archer:

Income	\$75,000
Expenses incurred during	
Minneapolis – Phoenix move	
1,000 Moving truck rental	
1,000 Packing and unloading costs paid to moving company	
1,500 Loss on sale of Minneapolis home	
750 Lodging	
250 Meals	
100 Storage costs in Phoenix prior to move-in to new home	

Considering only the above facts, what is Archer's 20X13 adjusted gross income?

- a. \$70,475
b. \$70,650
- c. \$72,150
d. \$75,000
5. On 15 February of the current year Young received a \$10,000 lump-sum payment from a qualified profit-sharing plan, the full amount of which Young rolled over into an IRA 46 days later. How much of this lump-sum payment may Young exclude from current year gross income?
- a. \$0
b. \$10,000
- c. Depends on contribution limit
d. \$8,000
6. Claire is a self-employed individual who owns and runs Claire's Creations, LLC. In 20X14 she had \$225,000 in net self-employment earnings, including a deduction for 50% of self-employment tax, prior to any Keogh deduction. Claire has a defined contribution, stock bonus Keogh plan. What is the highest deductible Keogh contribution Claire can make for the 20X14 tax year? Assume no excess contribution carryover from prior years.
- a. \$56,250
b. \$225,000
- c. \$52,000
d. \$45,000

Deductions and Losses: Certain Itemized Deductions

LEARNING OBJECTIVES: *After completing Chapter 10, you should be able to:*

- | | |
|---|---|
| <p>LO.1 Distinguish between deductible and nondeductible personal expenses.</p> <p>LO.2 Define medical expenses and compute the medical expense deduction.</p> <p>LO.3 Contrast deductible taxes with nondeductible fees, licenses, and other charges.</p> <p>LO.4 Explain the Federal income tax treatment of state and local income taxes and sales taxes.</p> <p>LO.5 Distinguish between deductible and nondeductible interest and apply the appropriate limitations to deductible interest.</p> | <p>LO.6 Recognize charitable contributions and identify their related measurement problems and percentage limitations.</p> <p>LO.7 List the business and personal expenditures that are deductible either as miscellaneous itemized deductions or as other itemized deductions.</p> <p>LO.8 Recognize the limitation on certain itemized deductions applicable to high-income taxpayers.</p> <p>LO.9 Identify tax planning strategies that can maximize the benefit of itemized deductions.</p> |
|---|---|

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THE BIG PICTURE

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IMPACT OF ITEMIZED DEDUCTIONS ON MAJOR PURCHASES

John and Susan Williamson, a young professional couple, have been renting an apartment in Atlanta, Georgia, since they were married. Their income has grown as they've become more established in their careers, and they now believe that the time has come to purchase their own home. In addition, their desire to buy a home now may be coming at a good time, because John's mother, Martha, needs to move in with them due to her declining health and their current apartment is too small to accommodate her. John and Susan's current monthly rent is \$2,000, but they are willing to spend \$2,500 per month on an after-tax basis if necessary for their first home.

After months of house hunting, they have found the perfect home, but they fear it may be too expensive. If they acquire a standard mortgage to finance the purchase of the home, the total cash outlay during the first year of ownership will be \$43,000 (\$2,000 principal payments, \$37,000 interest payments, and \$4,000 real estate taxes). Alternatively, if they use their retirement and taxable investments to secure the home financing, they can qualify for a lower interest rate and thereby reduce the interest charge from \$37,000 to \$35,000. They expect their Federal AGI to be \$200,000, and their taxable income to range between \$160,000 and \$185,000 for the year. John and Susan have not itemized their deductions in prior years because the amount of their qualifying personal expenditures has fallen just short of the standard deduction amount. Assume that the Williamsons' marginal income tax rate under Georgia law is 6 percent.

Can John and Susan Williamson afford to pursue their dream of home ownership?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income	<u>(x,xxx)</u>
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)

FORM 1040 (p. 2)

40 Itemized deductions (from Schedule A) or your **standard deduction** (see left margin) . . .

Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>)	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>).....	<u>(xxx)</u>
Tax due (<i>or refund</i>)	<u>\$ xxx</u>

LO.1
Distinguish between deductible and nondeductible personal expenses.

As a general rule, a deduction for personal expenditures is disallowed by § 262 of the Code. However, Congress has chosen to allow certain personal expenditures to be deducted as itemized deductions. Personal expenditures that are deductible as itemized deductions include medical expenses, certain taxes, mortgage interest, investment interest, and charitable contributions. These expenditures and other personal expenditures that are allowed as itemized deductions are covered in this chapter. Although certain exceptions exist (e.g., alimony and traditional IRA contributions are deductible *for* AGI), personal expenditures not specifically allowed as itemized deductions by the tax law are nondeductible.

Allowable itemized deductions are deductible *from* AGI in arriving at taxable income if the taxpayer elects to itemize. The election to itemize is appropriate when total itemized deductions exceed the standard deduction based on the taxpayer's filing status.¹

The Big Picture

EXAMPLE

1

Return to the facts of *The Big Picture* on p. 10-1. John and Susan Williamson will discover that with the purchase of a home, they will be able to itemize their deductions for the first time instead of claiming the standard deduction. Assuming that the home mortgage interest expense and real estate taxes meet the requirements discussed in this chapter, they will be deducted *from* AGI because their total would exceed the amount of the standard deduction for a married couple filing a joint return. Further, other qualifying expenditures, such as state income taxes and charitable contributions, likewise will be deductible as itemized deductions, providing an explicit tax benefit to the Williamsons.

¹See §§ 63(c) and (d), respectively, for the definitions of the terms *standard deduction* and *itemized deductions*.



TAX IN THE NEWS The Debate Continues Over the Future of Itemized Deductions

In an era of huge government deficits and debt ceiling debates, many have concluded that the Federal government needs to learn to live within its means. In simplest of terms, to bring the government's spending in line with its revenues, more revenues must be raised, expenditures must be decreased, or some combination of the two must occur. During these debates, some continue to argue that "tax reform" should occur simultaneously with the search for increased tax revenues, and such reform should lead to certain tax deductions being either repealed or scaled back. They observe that if the tax code were simplified by no longer allowing certain popular itemized deductions, billions of dollars of additional tax revenue would be collected because taxable income would be higher.

Currently, popular tax deductions "cost" the government billions by virtue of the fact that they reduce taxable income. These deductions are often referred to as "tax expenditures." Recently, the Joint Committee on Taxation estimated the cost during 2015 of allowing the following itemized deductions for individuals:

Deduction	Cost in Billions of Dollars
Mortgage interest on owner-occupied housing	\$75.0
Charitable contributions	45.1
State and local income, sales, and personal property taxes	54.9
Property tax on real property	30.4

Arguably, by repealing these deductions, government revenues would increase by significant amounts. While repealing all of these deductions may not be feasible for political, economic, or other reasons, be aware that certain politicians or policy wonks will push to reform, limit, or scale back these deductions to all or certain taxpayers in the future.

Source: The Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017," (JCS-1-13), February 1, 2013, Table 1.

10-1 MEDICAL EXPENSES

Medical expenses paid for the care of the taxpayer, spouse, and dependents are allowed as an itemized deduction to the extent the expenses are not reimbursed. The **medical expense** deduction is limited to the amount by which such expenses *exceed* a threshold percentage of the taxpayer's AGI. Under current law, the threshold percentage is 10 percent for most taxpayers. For taxpayers age 65 and older, however, the threshold is 7.5 percent of AGI until 2017, when it increases to 10 percent.²

LO.2

Define medical expenses and compute the medical expense deduction.

The Big Picture

Return to the facts of *The Big Picture* on p. 10-1. Because the Williamsons' AGI for the year is \$200,000, they must itemize their deductions and have more than \$20,000 ($\$200,000 \times 10\%$) in unreimbursed medical expenses to receive a tax benefit from those expenses.

EXAMPLE

2

10-1a Medical Expenses Defined

The term *medical care* includes expenditures incurred for the "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."³ A *partial* list of deductible and nondeductible medical items appears in Exhibit 10.1.

A medical expense does not have to relate to a particular ailment to be deductible. Because the definition of medical care is broad enough to cover preventive measures, the cost of periodic physical and dental exams qualifies even for a taxpayer in good health.

²Prior to 2013, the percentage threshold for regular income tax purposes was 7.5 percent of AGI for all taxpayers.

³§ 213(d)(1)(A).

EXHIBIT 10.1

Examples of Deductible and Nondeductible Medical Expenses Paid by Taxpayer

Deductible	Nondeductible
Medical (including dental, mental, and hospital) care	Funeral, burial, or cremation expenses
Prescription drugs and insulin	Nonprescription drugs (except insulin)
Special equipment	Bottled water
Wheelchairs	Toiletries, cosmetics
Crutches	Diaper service, maternity clothes
Artificial limbs	Programs for the <i>general</i> improvement of health
Eyeglasses (including contact lenses)	Weight reduction
Hearing aids	Health spas
Transportation for medical care	Social activities (e.g., dancing and swimming lessons)
Medical and hospital insurance premiums	Unnecessary cosmetic surgery
Long-term care insurance premiums (subject to limitations)	
Cost of alcohol and drug rehabilitation	
Certain costs to stop smoking	
Weight reduction programs related to obesity	

Amounts paid for unnecessary *cosmetic surgery* are not deductible medical expenses. However, if cosmetic surgery is deemed necessary, it is deductible as a medical expense. Cosmetic surgery is necessary when it improves the effects of (1) a deformity arising from a congenital abnormality, (2) a personal injury, or (3) a disfiguring disease.

EXAMPLE

3

Art, a calendar year taxpayer, paid \$21,000 to a plastic surgeon for a face-lift. Art, age 75, merely wanted to improve his appearance. The \$21,000 does not qualify as a medical expense because the surgery was unnecessary.

In contrast, Marge's face is disfigured as a result of a serious automobile accident. The cost of restorative cosmetic surgery is deductible as a medical expense.

TAX IN THE NEWS Medical Expense Deductions Are Now Harder to Come By

For taxpayers under age 65, being in a position to claim a medical expense deduction is more challenging than ever because of a recent increase in the AGI threshold that limits a medical expense's deductibility. Currently, the threshold is 10 percent of AGI for most taxpayers, an increase from 7.5 percent under prior law. For example, if a taxpayer's AGI is \$100,000, only those medical expenses in excess of \$10,000 are deductible ($\$100,000 \times 10\%$ —an increase of \$2,500 from the prior threshold).

This means that to protect a medical expense deduction, taxpayers must have a better grasp on what qualifies as a

medical expense and do a better job of documenting these costs. IRS Publication 502, *Medical and Dental Expenses*, includes a long list of qualifying expenses as well as expenses that do not qualify.

For example, the travel costs to see a doctor or dentist count, as well as fees paid to a chiropractor or psychologist for medical care. Contact lenses, pregnancy test kits, and even doctor-prescribed weight loss programs may qualify. However, the law is not liberal enough to allow for the deductibility of health club dues or for the purchase of substances that are illegal under Federal law, such as medical marijuana.

The cost of care in a *nursing home or home for the aged*, including meals and lodging, can be included in deductible medical expenses if the primary reason for being in the home is to get medical care. If the primary reason for being there is personal, any costs for medical or nursing care can be included in deductible medical expenses, but the cost of meals and lodging must be excluded.⁴

Norman has a chronic heart ailment. In October, his family decides to place Norman in a nursing home equipped to provide medical and nursing care. Total nursing home expenses amount to \$35,000 during the year. Of this amount, \$20,000 is directly attributable to medical and nursing care. Because Norman is in need of significant medical and nursing care and is placed in the facility primarily for this purpose, all \$35,000 of the nursing home costs are deductible (subject to the AGI floor, explained earlier).

EXAMPLE

4

Tuition expenses of a dependent at a special school may be deductible as a medical expense. The cost of medical care can include the expenses of a special school for a mentally or physically handicapped individual. The deduction is allowed if a principal reason for sending the individual to the school is the school's special resources for alleviating the infirmities. In this case, the cost of meals and lodging, in addition to the tuition, is a proper medical expense deduction.⁵

Jason's daughter Sophia attended public school through the seventh grade. Because Sophia was a poor student, she was examined by a psychiatrist who diagnosed a problem that created a learning disability. Upon the recommendation of the psychiatrist, Sophia is enrolled in a private school so that she can receive individual attention. The school has no special program for students with learning disabilities and does not provide special medical treatment. The expense related to Sophia's attendance is not deductible as a medical expense. The cost of any psychiatric care, however, qualifies as a medical expense.

EXAMPLE

5

Example 5 shows that the recommendation of a physician does not automatically make the expenditure deductible.

10-1b Capital Expenditures for Medical Purposes

When capital expenditures are incurred for medical purposes, they must be deemed medically necessary by a physician, the facility must be used primarily by the patient alone, and the expense must be reasonable. Examples of such expenditures include dust elimination systems,⁶ elevators,⁷ and vans specially designed for wheelchair-bound taxpayers. Other examples of expenditures that may qualify are swimming pools if the taxpayer does not have access to a neighborhood pool and air conditioners if they do not become permanent improvements (e.g., window units).⁸

Both a capital expenditure for a permanent improvement and expenditures made for the operation or maintenance of the improvement may qualify as medical expenses. The allowable cost of such qualified medical expenditures is deductible in the year incurred. Although depreciation is required for most other capital expenditures, it is not required for those qualifying for medical purposes.

A permanent capital improvement that ordinarily would not have a medical purpose qualifies as a medical expense if it is directly related to prescribed medical care and is deductible to the extent that the expenditure *exceeds* the increase in value of the related property. Appraisal costs related to capital improvements are also deductible, but not as medical expenses. These costs are classified as expenses incurred in the determination of the taxpayer's tax liability.⁹

⁴Reg. § 1.213-1(e)(1)(v).

⁵*Donald R. Pfeifer*, 37 TCM 816, T.C.Memo. 1978-189. Also see Rev.Rul. 78-340, 1978-2 C.B. 124.

⁶Ltr.Rul. 7948029.

⁷*Riach v. Frank*, 62-1 USTC ¶9419, 9 AFTR 2d 1263, 302 F.2d 374 (CA-9, 1962).

⁸Reg. § 1.213-1(e)(1)(iii).

⁹§ 212(3).

EXAMPLE

6

Fred is afflicted with heart disease. His physician advises him to install an elevator in his residence so that he will not be required to climb the stairs. The cost of installing the elevator is \$10,000, and the increase in the value of the residence is determined to be only \$4,000.

Therefore, \$6,000 (\$10,000 – \$4,000) is treated as a medical expense. Additional utility costs to operate the elevator and maintenance costs are also medical expenses as long as the medical reason for the capital expenditure continues to exist.

The full cost of certain home-related capital expenditures incurred to enable a *physically handicapped* individual to live independently and productively qualifies as a medical expense. Qualifying costs include expenditures for constructing entrance and exit ramps to the residence, widening hallways and doorways to accommodate wheelchairs, installing support bars and railings in bathrooms and other rooms, and adjusting electrical outlets and fixtures.¹⁰ These expenditures are subject to the AGI percentage limitation only, and the increase in the home's value is deemed to be zero.

10-1c Medical Expenses Incurred for Spouse and Dependents

In computing the medical expense deduction, a taxpayer may include medical expenses for a spouse and for a person who was a dependent at the time the expenses were paid or incurred. Of the requirements that normally apply in determining dependency status,¹¹ neither the gross income nor the joint return test applies in determining dependency status for medical expense deduction purposes.

EXAMPLE

7

William (age 22) is married and a full-time student at a university. During the year, William incurred medical expenses that were paid by Karen (William's mother). She provided more than half of William's support for the year. Even if William files a joint return with his wife, Karen may claim the medical expenses she paid for him. Karen would combine William's expenses with her own before applying the AGI floor.

For *divorced persons* with children, a special rule applies to the noncustodial parent. The noncustodial parent may claim any medical expenses he or she pays even though the custodial parent claims the children as dependents.

EXAMPLE

8

Irv and Joan were divorced last year, and Joan was awarded custody of their child, Keith. During the current year, Irv pays \$2,500 of Keith's medical bills. Together, Irv and Joan provide more than half of Keith's support. Even though Joan claims Keith as a dependent, Irv can combine the \$2,500 of medical expenses that he pays for Keith with his own when calculating his medical expense deduction.

10-1d Transportation, Meal, and Lodging Expenses for Medical Treatment

Payments for transportation to and from a point of treatment for medical care are deductible as medical expenses (subject to the AGI floor). These costs include bus, taxi, train, or plane fare; charges for ambulance service; and out-of-pocket expenses for the use of an automobile. A mileage allowance of 23 cents per mile for 2015 may be used instead of actual out-of-pocket automobile expenses.¹² Whether the taxpayer chooses to claim out-of-pocket automobile expenses or the 23 cents per mile automatic mileage option, related parking fees and tolls can also be deducted. Also

¹⁰For a complete list of the items that qualify, see Rev.Rul. 87-106, 1987-2 C.B. 67.

¹¹Refer to Chapter 3 for discussion of these requirements.

¹²This amount is adjusted periodically. The allowance was 23.5 cents per mile for 2014.

included are transportation expenditures for someone such as a parent or nurse who must accompany the patient. The cost of meals while en route to obtain medical care is not deductible.

A deduction is allowed for lodging while away from home for medical care if the following requirements are met:¹³

- The lodging is primarily for and essential to medical care.
- Medical care is provided by a doctor in a licensed hospital or a similar medical facility (e.g., a clinic).
- The lodging is not lavish or extravagant under the circumstances.
- There is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The deduction for lodging expenses included as medical expenses cannot exceed \$50 *per* night for *each* person. The deduction is allowed not only for the patient but also for anyone who must travel with the patient.

The Big Picture

Return to the facts of *The Big Picture* on p. 10-1. John's mother, Martha, eventually moves in with the Williamsons because of her disabilities, and she becomes their dependent. John is advised by his family physician that Martha needs specialized treatment for her heart condition. Consequently, John and Martha fly to Cleveland, Ohio, where Martha receives the therapy at a heart clinic on an outpatient basis. Expenses in connection with the trip are as follows:

Round-trip airfare (\$250 each)	\$500
Lodging in Cleveland for two nights (\$120 each per night)	480

Assuming that the Williamsons itemize their deductions, the medical expense deduction for transportation is \$500 and the medical expense deduction for lodging is \$200 (\$50 per night per person). Because Martha is disabled, it is assumed that John's accompanying her is justified.

EXAMPLE

9

No deduction is allowed for the cost of meals unless they are part of the medical care and are furnished at a medical facility. When allowable, such meals are not subject to the 50 percent limit applicable to business meals (see Chapter 9).

10-1e Amounts Paid for Medical Insurance Premiums

Medical insurance premiums are included with other medical expenses subject to the AGI floor. Premiums paid by the taxpayer under a group plan or an individual plan are included as medical expenses. If an employer pays all or part of the taxpayer's medical insurance premiums, the amount paid by the employer is not included in gross income by the employee. Likewise, the premium is not included in the employee's medical expenses. However, the medical insurance premiums paid by the employer are deductible as business expenses on the employer's tax return (see Chapter 6).

If a taxpayer is *self-employed*, insurance premiums paid for medical coverage are deductible as a *business expense* (*for* AGI).¹⁴ The deduction *for* AGI is allowed for premiums paid on behalf of the taxpayer, the taxpayer's spouse, and dependents of the taxpayer. The deduction is not allowed to any taxpayer who is eligible to participate in a subsidized health plan maintained by any employer of the taxpayer or of the taxpayer's spouse.

¹³§ 213(d)(2).

¹⁴§ 162(l).

The Big Picture

EXAMPLE

10

Return to the facts of *The Big Picture* on p. 10-1. John Williamson is the sole practitioner in his unincorporated accounting firm. During the year, he paid health insurance premiums of \$8,000 for his own coverage and \$7,000 for coverage for his wife, Susan. John can deduct \$15,000 as a business deduction (for AGI) in computing their taxable income.

Taxpayers may also include premiums paid on qualified long-term care insurance contracts in medical expenses, subject to limitations based on the age of the insured. For 2015, the per-person limits range from \$380 for taxpayers age 40 and under to \$4,750 for taxpayers over age 70. See IRS Publication 502 for details relating to requirements for deducting costs associated with qualified long-term care insurance contracts.¹⁵

10-1f Year of Deduction

Regardless of a taxpayer's method of accounting, medical expenses are deductible only in the year *paid*. In effect, this places all individual taxpayers on a cash basis as far as the medical expense deduction is concerned. One exception, however, is allowed for deceased taxpayers. If the medical expenses are paid within one year from the day following the day of death, they can be treated as being paid at the time they were *incurred*. Thus, such expenses may be reported on the final income tax return of the decedent or on earlier returns if incurred before the year of death.

No current deduction is allowed for payment for medical care to be rendered in the future unless the taxpayer is under an obligation to make the payment. Whether an obligation to make the payment exists depends upon the policy of the physician or the institution furnishing the medical care.

EXAMPLE

11

Upon the recommendation of his regular dentist, in December 2015, Gary consults Dr. Smith, a prosthodontist, who specializes in crown and bridge work. Dr. Smith tells Gary that he can do the restorative work for \$12,000 and that he requires all new patients to prepay 40% of the total cost of the procedure. Accordingly, Gary pays \$4,800 in December 2015. The balance of \$7,200 is paid when the work is completed in January 2016.

Under these circumstances, the qualifying medical expense deductions are \$4,800 for 2015 and \$7,200 in 2016. The result would be the same even if Gary prepaid the full \$12,000 in 2015.

10-1g Reimbursements

If medical expenses are reimbursed in the same year as paid, no problem arises. The reimbursement merely reduces the amount that would otherwise qualify for the medical expense deduction. But what happens if the reimbursement occurs in a later year than the expenditure? In computing casualty losses, any reasonable prospect of recovery must be considered (refer to Chapter 7). For medical expenses, however, any expected reimbursement is disregarded in measuring the amount of the deduction. Instead, the reimbursement is accounted for separately in the year in which it occurs.

Under the *tax benefit rule*, a taxpayer who receives an insurance reimbursement for medical expenses deducted in a previous year must include the reimbursement in income up to the amount of the deductions that decreased taxable income in the earlier year. A taxpayer who did not itemize deductions in the year the expenses were paid did not receive a tax benefit and is *not* required to include a reimbursement in gross income.

¹⁵The amounts for 2014 were \$370 for taxpayers age 40 and under and \$4,660 for taxpayers over age 70.

Daniel (age 50) had AGI of \$45,000 for 2015. He was injured in a car accident and paid \$4,300 for hospital expenses and \$700 for doctor bills. Daniel also incurred medical expenses of \$600 for his dependent child. In 2016, Daniel was reimbursed \$650 by his insurance company for the medical expenses attributable to the car accident. His deduction for medical expenses in 2015 is computed as follows:

Hospitalization	\$ 4,300
Bills for doctor's services	700
Medical expenses for dependent	600
Total	<u>\$ 5,600</u>
Less: 10% of \$45,000	(4,500)
Medical expense deduction (assuming that Daniel itemizes his deductions)	<u><u>\$ 1,100</u></u>

Assume that Daniel would have elected to itemize his deductions even if he had no medical expenses in 2015. If the reimbursement for medical care had occurred in 2015, the medical expense deduction would have been only \$450 [\$5,600 (total medical expenses) – \$650 (reimbursement) – \$4,500 (floor)] and Daniel would have paid more income tax.

Because the reimbursement was made in a subsequent year, Daniel will include \$650 in gross income for 2016. If Daniel had not itemized in 2015, he would *not* have included the \$650 reimbursement in 2016 gross income because he would have received no tax benefit for the medical expenses in 2015.

EXAMPLE

12

10-1h Health Savings Accounts

Qualifying individuals may make deductible contributions to a **Health Savings Account (HSA)**. An HSA is a qualified trust or custodial account administered by a qualified HSA trustee, which can be a bank, an insurance company, or another IRS-approved trustee.¹⁶ A taxpayer can use an HSA in conjunction with a high-deductible medical insurance policy to help reduce the overall cost of medical coverage. Converting from a low-deductible to a high-deductible plan can generally save an individual a considerable amount in premiums. The high-deductible policy provides coverage for extraordinary medical expenses (in excess of the deductible), and expenses not covered by the policy can be paid with funds withdrawn tax-free from the HSA.

Sanchez, who is married and has three dependent children, carries a high-deductible medical insurance policy with a deductible of \$4,400. He establishes an HSA and contributes the maximum allowable amount to the HSA in 2015. During 2015, the Sanchez family incurs medical expenses of \$7,000. The high-deductible policy covers \$2,600 of the expenses (\$7,000 expenses – \$4,400 deductible). Sanchez may withdraw \$4,400 from the HSA to pay the medical expenses not covered by the high-deductible policy.

EXAMPLE

13

High-Deductible Plans

High-deductible policies are less expensive than low-deductible policies, so taxpayers with low medical costs can benefit from the lower premiums and use funds from the HSA to pay costs not covered by the high-deductible policy. A plan must meet two requirements to qualify as a high-deductible plan.¹⁷

1. The annual deductible in 2015 is not less than \$1,300 for self-only coverage (\$2,600 for family coverage).
2. The annual limit in 2015 on total out-of-pocket costs (excluding premiums) under the plan does not exceed \$6,450 for self-only coverage (\$12,900 for family coverage).

¹⁶§ 223.

¹⁷§ 223(c)(2).



TAX IN THE NEWS Health Savings Accounts Offer Additional Retirement Savings Opportunities

Many Americans understand that for a financially secure retirement to be possible, a career-long savings and investment habit must be developed. While this may be easier said than done, most people know that IRAs and § 401(k)s are qualified retirement savings vehicles that provide important tax advantages, which can help in the construction of that retirement nest egg. Now an additional option is being discussed, where a Health Savings Account (HSA) is touted as an additional retirement savings vehicle for those who can afford it.

The idea is to make annual tax-deductible contributions to the HSA at the highest amount permissible {\$8,650 in 2015 for married couples who are each at least age 55

[\$6,650 + (\$1,000 × 2)]] and then allow all or part of the account to grow on a tax-deferred basis. As intended by Congress, the account balance can be tapped to pay for medical costs, and such distributions used to pay for medical expenses not covered by the taxpayer's high-deductible policy will be free of income tax. Any remaining amount withdrawn from the HSA once the taxpayer reaches age 65 will be taxed in the same fashion as traditional IRA and § 401(k) distributions, even if the distribution is used for nonmedical purposes.

Source: Peter S. Green, "Health Savings Accounts Can Double as Shadow IRAs," *Wall Street Journal*, June 2, 2014.

Tax Treatment of HSA Contributions and Distributions

To establish an HSA, a taxpayer contributes funds to a tax-exempt trust.¹⁸ As illustrated in the preceding example, funds can be withdrawn from an HSA to pay medical expenses that are not covered by the high-deductible policy. The following general tax rules apply to HSAs:

1. Contributions made by the taxpayer to an HSA are deductible from gross income to arrive at AGI (deduction *for* AGI). Thus, the taxpayer does not need to itemize to take the deduction.
2. Earnings on HSAs are not subject to taxation unless distributed, in which case taxability depends on the way the funds are used.¹⁹
 - Distributions from HSAs are excluded from gross income if they are used to pay for medical expenses not covered by the high-deductible policy.
 - Distributions that are not used to pay for medical expenses are included in gross income and are subject to an additional 20 percent penalty if made before age 65, death, or disability. Such distributions made by reason of death or disability and distributions made after the HSA beneficiary becomes eligible for Medicare are taxed but not penalized.

HSAs have at least two other attractive features. First, an HSA is portable. Taxpayers who switch jobs can take their HSAs with them. Second, anyone under age 65 who has a high-deductible plan and is not covered by another policy that is not a high-deductible plan can establish an HSA.

Deductible Amount

The annual deduction for contributions to an HSA is limited to the sum of the monthly limitations. The monthly limitation is calculated for each month the individual is an eligible individual. The monthly deduction is not allowed after the individual becomes eligible for Medicare coverage.

The amount of the monthly limitation for an individual who has self-only coverage in 2015 is one-twelfth of \$3,350, while the monthly limitation for an individual who has family coverage in 2015 is one-twelfth of \$6,650. These amounts are subject to annual

¹⁸§ 223(d).

¹⁹§ 223(f).

cost-of-living adjustments.²⁰ An eligible taxpayer who has attained age 55 by the end of the tax year may make an additional annual contribution in 2015 of up to \$1,000. This additional amount is referred to as a *catch-up* contribution.

Determining the Maximum HSA Contribution Deduction

Liu (age 45), who is married and self-employed, carries a high-deductible medical insurance policy with family coverage and an annual deductible of \$4,000. In addition, he has established an HSA. Liu's maximum annual deductible contribution to the HSA in 2015 is \$6,650.

EXAMPLE

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During 2015, Adam, who is self-employed, made 12 monthly payments of \$1,200 for an HSA contract that provides medical insurance coverage with a \$3,600 deductible. The plan covers Adam, his wife, and two children. Of the \$1,200 monthly fee, \$675 was for the high-deductible policy and \$525 was deposited into an HSA. The deductible monthly contribution to the HSA is calculated as follows:

EXAMPLE

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Maximum annual deduction for family coverage	<u>\$ 6,650</u>
Monthly limitation (1/12 of \$6,650)	<u>\$554.17</u>

Because Adam is *self-employed*, he can deduct \$8,100 of the amount paid for the high-deductible policy (\$675 per month \times 12 months) as a deduction *for* AGI (refer to Example 10 and related discussion). In addition, he can deduct the \$6,300 (\$525 \times 12) paid to the HSA as a deduction *for* AGI. Note that the \$6,300 HSA deduction does not exceed the \$6,650 ceiling.

10-2 TAXES

A deduction is allowed for certain state and local taxes paid or accrued by a taxpayer.²¹ The deduction was created to relieve the burden of multiple taxes upon the same source of revenue.

10-2a Deductibility as a Tax

A distinction must be made between a tax and a fee, because fees are not deductible unless incurred as an ordinary and necessary business expense or as an expense in the production of income. The IRS has defined a tax as follows:

A tax is an enforced contribution exacted pursuant to legislative authority in the exercise of taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes, and not as payment for some special privilege granted or service rendered. Taxes are, therefore, distinguished from various other contributions and charges imposed for particular purposes under particular powers or functions of the government. In view of such distinctions, the question whether a particular contribution or charge is to be regarded as a tax depends upon its real nature.²²

Accordingly, fees for dog licenses, automobile inspections, automobile titles and registration, hunting and fishing licenses, bridge and highway tolls, driver's licenses, parking meter deposits, and postage are not deductible if personal in nature. Deductible and nondeductible taxes are summarized in Exhibit 10.2.

LO3

Contrast deductible taxes with nondeductible fees, licenses, and other charges.

²⁰§ 223(b)(2). The annual limits were \$3,300 and \$6,550 in 2014.

²²Rev.Rul. 57-345, 1957-2 C.B. 132, and Rev.Rul. 70-622, 1970-2 C.B. 41.

²¹Most deductible taxes are listed in § 164, while nondeductible items are included in § 275.

EXHIBIT 10.2

Deductible and Nondeductible Taxes

Deductible	Nondeductible
State, local, and foreign real property taxes	Federal income taxes
State and local personal property taxes	FICA taxes imposed on employees
State and local income taxes or sales/use taxes*	Employer FICA taxes paid on domestic household workers
Foreign income taxes	Estate, inheritance, and gift taxes
	Federal, state, and local excise taxes (e.g., gasoline, tobacco, and spirits)
	Foreign income taxes if the taxpayer chooses the foreign tax credit option
	Taxes on real property to the extent such taxes are to be apportioned and treated as imposed on another taxpayer

* The sales/use tax alternative is available through 2014. Many tax professionals expect Congress will extend this provision.

10-2b Property Taxes

State, local, and foreign taxes on real property are generally deductible only by the person upon whom the tax is imposed. Deductible personal property taxes must be *ad valorem* (assessed in relation to the value of the property). Therefore, a motor vehicle tax based on weight, model, year, and horsepower is not an *ad valorem* tax. However, a tax based on value and other criteria may qualify in part.

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 10-1. Assuming that the Williamsons proceed with the purchase of a home, the real estate taxes they pay will be deductible from AGI because they qualify to itemize their deductions. However, if they also pay a personal property tax on their automobile, the payment may be only partially deductible.

For example, assume that in their state, the government imposes a motor vehicle registration tax on 2% of the value of the vehicle plus 40 cents per hundredweight. The Williamsons own a car having a value of \$20,000 and weighing 3,000 pounds. They pay an annual registration tax of \$412. Of this amount, \$400 (2% × \$20,000 of value) is deductible as a personal property tax. The remaining \$12, based on the weight of the car, is not deductible.

Assessments for Local Benefits

As a general rule, real property taxes do not include taxes assessed for local benefits because such assessments tend to increase the value of the property (e.g., special assessments for streets, sidewalks, curbing, and other similar improvements). A taxpayer was denied a deduction for the cost of a new sidewalk (relative to a personal residence), even though the construction was required by the city and the sidewalk may have provided an incidental benefit to the public welfare.²³ Such assessments are added to the basis of the taxpayer's property.

Apportionment of Real Property Taxes between Seller and Purchaser

Real estate taxes for the entire year are apportioned between the buyer and seller on the basis of the number of days the property was held by each during the real property

²³Erie H. Rose, 31 TCM 142, T.C.Memo. 1972-39; Reg. § 1.164-4(a).

tax year. This apportionment is required whether the tax is paid by the buyer or the seller or is prorated according to the purchase agreement. The apportionment determines who is entitled to deduct the real estate taxes in the year of sale. The required apportionment prevents the shifting of the deduction for real estate taxes from the buyer to the seller, or vice versa. In making the apportionment, the assessment date and the lien date are disregarded.²⁴

A county's real property tax year runs from January 1 to December 31. Abigail, the owner on January 1 of real property located in the county, sells the real property to Bob on June 30 (assume that this year is not a leap year). Bob owns the real property from June 30 through December 31. The tax for the real property tax year, January 1 through December 31, is \$3,650.

The portion of the real property tax treated as imposed upon Abigail, the seller, is \$1,800 $[(180/365) \times \$3,650]$, January 1 through June 29, and \$1,850 $[(185/365) \times \$3,650]$, June 30 through December 31] of the tax is treated as imposed upon Bob, the purchaser.

EXAMPLE

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If the actual real estate taxes are not prorated between the buyer and seller as part of the purchase agreement, adjustments are required. The adjustments are necessary to determine the amount realized by the seller and the basis of the property to the buyer. If the buyer pays the entire amount of the tax, he or she has, in effect, paid the seller's portion of the real estate tax and has therefore paid more for the property than the actual purchase price. Thus, the amount of real estate tax that is apportioned to the seller (for Federal income tax purposes) and paid by the buyer is added to the buyer's basis. The seller must increase the amount realized on the sale by the same amount.

Seth sells real estate on October 3 for \$400,000. The buyer, Wilma, pays the real estate taxes of \$3,650 for the calendar year, which is the real estate property tax year. Assuming that this is not a leap year, \$2,750 (for 275 days) of the real estate taxes is apportioned to and is deductible by the seller, Seth, and \$900 (for 90 days) of the taxes is deductible by Wilma. The buyer has, in effect, paid Seth's real estate taxes of \$2,750 and has therefore paid \$402,750 for the property. Wilma's basis is increased to \$402,750, and the amount realized by Seth from the sale is increased to \$402,750.

EXAMPLE

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The opposite result occurs if the seller (rather than the buyer) pays the real estate taxes. In this case, the seller reduces the amount realized from the sale by the amount that has been apportioned to the buyer. The buyer is required to reduce his or her basis by a corresponding amount.

10-2c State and Local Income Taxes and Sales Taxes

The position of the IRS is that state and local income taxes imposed upon an individual are deductible only as itemized deductions, even if the taxpayer's sole source of income is from a business, rents, or royalties.

Cash basis taxpayers are entitled to deduct state income taxes withheld by the employer in the year the taxes are withheld. In addition, estimated state income tax payments are deductible in the year the payment is made by cash basis taxpayers even if the payments relate to a prior or subsequent year.²⁵ If the taxpayer overpays state income taxes because of excessive withholdings or estimated tax payments, the refund received is included in gross income of the following year to the extent the deduction reduced taxable income in the prior year.

LO.4

Explain the Federal income tax treatment of state and local income taxes and sales taxes.

²⁴For most years, the apportionment is based on a 365-day year. However, in a leap year (i.e., a year that is evenly divisible by 4, such as 2016), the taxes are prorated over 366 days. In making the apportionment, the date of sale counts as a day the property is owned by the buyer.

²⁵Rev. Rul. 71-190, 1971-1 C.B. 70. See also Rev. Rul. 82-208, 1982-2 C.B. 58, where a deduction is not allowed when the taxpayer cannot, in good faith, reasonably determine that there is additional state income tax liability.

EXAMPLE

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Leona, a cash basis, unmarried taxpayer, had \$800 of state income tax withheld during 2015. Also in 2015, Leona paid \$100 that was due when she filed her 2014 state income tax return and made estimated payments of \$300 towards her 2015 state income tax liability. When Leona files her 2015 Federal income tax return in April 2016, she elects to itemize deductions, which amount to \$7,500, including the \$1,200 of state income tax payments and withholdings, all of which reduce her taxable income.

As a result of overpaying her 2015 state income tax, Leona receives a refund of \$200 early in 2016. She will include this amount in her 2016 gross income in computing her Federal income tax. It does not matter whether Leona received a check from the state for \$200 or applied the \$200 toward her 2016 state income tax.

Itemized Deduction for Sales Taxes Paid

Individuals can elect to deduct either their state and local income taxes *or* their sales/use taxes paid as an itemized deduction on Schedule A of Form 1040. The annual election can reflect actual sales/use tax payments *or* an amount from an IRS table (see Appendix A). The amount from the table may be increased by sales tax paid on the purchase of motor vehicles, boats, and other specified items. Most likely, the sales tax deduction will be elected by those living in states with no individual income tax. At present, this deduction alternative is available only through 2014. However, many tax professionals expect that Congress will extend this provision.

LO.5

Distinguish between deductible and nondeductible interest and apply the appropriate limitations to deductible interest.

10-3 INTEREST

A deduction for interest has been allowed since the income tax law was enacted in 1913. Despite its long history of congressional acceptance, the interest deduction has been one of the most controversial areas in the tax law. The controversy centered around the propriety of allowing the deduction of interest charges for the purchase of consumer goods and services and interest on borrowings used to acquire investments (investment interest). Currently, personal (consumer) interest is not deductible. This includes credit card interest; interest on car loans; and other types of interest. However, interest on qualified student loans, qualified residence (home mortgage) interest, and investment interest continue to be deductible, subject to the limits discussed on the following pages.

10-3a Allowed and Disallowed Items

The Supreme Court has defined *interest* as compensation for the use or forbearance of money.²⁶ The general rule permits a deduction for interest paid or accrued within the taxable year on indebtedness.

Interest on Qualified Student Loans

Taxpayers who pay interest on a qualified student loan may be able to deduct the interest as a deduction *for* AGI. The deduction is allowable only to the extent that the proceeds of the loan are used to pay qualified education expenses. Such payments must be made to qualified educational institutions.²⁷

The maximum annual deduction for qualified student loan interest is \$2,500. However, in 2015, the deduction is phased out for taxpayers with modified AGI (MAGI) between \$65,000 and \$80,000 (\$130,000 and \$160,000 on joint returns). The deduction is not allowed for taxpayers who are claimed as dependents or for married taxpayers filing separately.²⁸

The numerator in the phaseout computation is equal to MAGI minus the floor of the phaseout range (i.e., \$65,000 or \$130,000, depending on filing status). The denominator

²⁶*Old Colony Railroad Co. v. Comm.*, 3 USTC ¶880, 10 AFTR 786, 52 S.Ct. 211 (USSC, 1932).

²⁷See IRS Publication 970, *Tax Benefits for Education*, for details.

²⁸§ 221. See § 221(b)(2)(C) for the definition of MAGI. For 2014, the MAGI threshold amounts also were \$65,000 and \$80,000 (\$130,000 and \$160,000 on joint returns).

is equal to the amount of the phaseout range (e.g., \$160,000 – \$130,000 = \$30,000 for married taxpayers filing jointly).

In 2015, Curt and Rita, who are married and file a joint return, paid \$3,000 of interest on a qualified student loan. Their MAGI was \$137,500. Their maximum potential deduction for qualified student loan interest is \$2,500, but it must be reduced by \$625 as a result of the phaseout rules.

$$\begin{aligned} & \$2,500 \text{ interest} \times (\$137,500 \text{ MAGI} - \$130,000 \text{ phaseout floor}) / \\ & \quad \$30,000 \text{ phaseout range} = \$625 \text{ reduction} \end{aligned}$$

Curt and Rita are allowed a student loan interest deduction of \$1,875 (\$2,500 maximum deduction – \$625 reduction = \$1,875 deduction for AGI).

EXAMPLE

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Qualified Residence Interest

Qualified residence interest is interest paid or accrued during the taxable year on indebtedness (subject to limitations) *secured* by any property that is a qualified residence of the taxpayer. Qualified residence interest falls into two categories: (1) interest on acquisition indebtedness and (2) interest on home equity loans. Before discussing each of these categories, however, the term *qualified residence* must be defined.

A *qualified residence* includes the taxpayer's principal residence and one other residence of the taxpayer or spouse. The *principal residence* is one that meets the requirement for nonrecognition of gain upon sale under § 121 (see Chapter 13). The *one other residence*, or second residence, refers to one that is used as a residence if not rented or, if rented, meets the requirements for a personal residence under the rental of vacation home rules (refer to Chapter 6). A taxpayer who has more than one second residence can make the selection each year as to which one is the qualified second residence. A residence includes, in addition to a house in the ordinary sense, cooperative apartments, condominiums, and mobile homes and boats that have living quarters (sleeping accommodations and toilet and cooking facilities).

Although in most cases interest paid on a home mortgage is fully deductible, there are limitations.²⁹ Interest paid or accrued during the tax year on aggregate **acquisition indebtedness** of \$1 million or less (\$500,000 for married persons filing separate returns) is deductible as qualified residence interest. *Acquisition indebtedness* refers to amounts incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer.

The Big Picture

Return to the facts of *The Big Picture* on p. 10-1. Because John and Susan Williamson will need to borrow at least a portion of the purchase price of a new home, a standard mortgage likely will qualify as acquisition indebtedness because the borrowed funds are used to acquire a principal residence. However, the interest on the acquisition indebtedness will be fully deductible only if the amount of the mortgage is \$1 million or less (assuming that John and Susan file a joint return) and the mortgage is secured by the home, which is the typical case.

Recall that the Williamsons are also considering what appears to be a less expensive route of using their retirement and taxable investments to secure the debt. If they choose this alternative, the interest will not be deductible as qualified residence interest because the loan would not be acquisition indebtedness (i.e., the loan would not be secured by the home).

EXAMPLE

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Qualified residence interest also includes interest on **home equity loans**. These loans utilize the personal residence of the taxpayer as security, typically in the form of a second mortgage. Because the funds from home equity loans can be used for personal purposes (e.g., auto purchases and medical expenses), what would otherwise have been nondeductible personal interest becomes deductible qualified residence interest.

²⁹§ 163(h)(3).

However, interest is deductible only on the portion of a home equity loan that does not exceed the *lesser of*:

- The fair market value of the residence, reduced by the acquisition indebtedness, *or*
- \$100,000 (\$50,000 for married persons filing separate returns).

EXAMPLE

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Larry owns a personal residence with a fair market value of \$450,000 and an outstanding first mortgage of \$420,000. Therefore, his equity in his home is \$30,000 (\$450,000 – \$420,000). Larry issues a second mortgage on the residence and in return borrows \$15,000 to purchase a new family automobile. All interest on the \$435,000 of first and second mortgage debt is treated as qualified residence interest.

Under current law, mortgage insurance premiums paid by the taxpayer on a qualified residence may be deducted (treated as qualified residence interest). However, the deduction begins to phase out for taxpayers with AGI in excess of \$100,000 (\$50,000 for married taxpayers filing separately). The deduction is fully phased out when AGI exceeds \$109,000 (\$54,500 for married taxpayers filing separately).³⁰

Interest Paid for Services

Mortgage loan companies commonly charge a fee, often called a loan origination fee, for finding, placing, or processing a mortgage loan. Loan origination fees are typically nondeductible amounts included in the basis of the acquired property. Other fees, sometimes called **points** and expressed as a percentage of the loan amount, are paid to reduce the interest rate charged over the term of the loan. Essentially, the payment of points is a prepayment of interest and is considered compensation to a lender solely for the use or forbearance of money. To be deductible, points must be in the nature of interest and cannot be a form of service charge or payment for specific services.³¹

Points must be capitalized and are amortized and deductible ratably over the life of the loan. A special exception, however, permits the purchaser of a principal residence to deduct qualifying points in the year of payment.³² The exception also covers points paid to obtain funds for home improvements.

Points paid to *refinance* an existing home mortgage cannot be immediately deducted, but must be capitalized and amortized as an interest deduction over the life of the new loan.³³

EXAMPLE

23

Sandra purchased her residence many years ago, obtaining a 30-year mortgage at an annual interest rate of 8%. In the current year, Sandra refinances the mortgage to reduce the interest rate to 4%. To obtain the refinancing, she has to pay points of \$2,600. The \$2,600, which is considered prepayment of interest, must be capitalized and amortized over the life of the mortgage.

Points paid by the seller for a buyer are, in effect, treated as an adjustment to the price of the residence, and the buyer is treated as having used cash to pay the points that were paid by the seller. A buyer may deduct seller-paid points in the tax year in which they are paid if several conditions are met.³⁴

Prepayment Penalty

When a mortgage or loan is paid off in full in a lump sum before its term (early), the lending institution may require an additional payment of a certain percentage applied to the unpaid amount at the time of prepayment. This is known as a prepayment penalty and is considered to be interest (e.g., personal, qualified residence, or investment) in the year paid. The general rules for deductibility of interest also apply to prepayment penalties.

³⁰ §§ 163(h)(3)(E)(i) and (ii). This provision expired at the end of 2014. However, many tax professionals expect that Congress will extend this provision.

³¹ Rev. Rul. 69-188, 1969-1 C.B. 54.

³² § 461(g)(2).

³³ Rev. Rul. 87-22, 1987-1 C.B. 146.

³⁴ Refer to Revenue Procedure 94-27 for a complete list of these conditions and additional aspects of this arrangement. Rev. Proc. 94-27, 1994-1 C.B. 613.

Interest Paid to Related Parties

Nothing prevents the deduction of interest paid to a related party as long as the payment actually took place and the interest meets the requirements for deductibility. Recall from Chapter 6 that a special rule for related taxpayers applies when the debtor uses the accrual basis and the related creditor is on the cash basis. If this rule is applicable, interest that has been accrued but not paid at the end of the debtor's tax year is not deductible until payment is made and the income is reportable by the cash basis recipient.

Investment Interest

Taxpayers frequently borrow funds they use to acquire investment assets. Congress, however, has limited the deductibility of interest on funds borrowed for the purpose of purchasing or continuing to hold investment property. Under this limitation, the deduction for investment interest expense may not exceed the net investment income for the year. A complete discussion of investment interest occurs in Chapter 11 in the context of the limitations taxpayers face when dealing with assets held for investment purposes.

Tax-Exempt Securities

The tax law provides that no deduction is allowed for interest on debt incurred to purchase or carry tax-exempt securities.³⁵ A major problem for the courts has been to determine what is meant by the words *to purchase or carry*. Refer to Chapter 6 for a detailed discussion of these issues.

10-3b Restrictions on Deductibility and Timing Considerations

Even if the interest expense qualifies as a type that is deductible (e.g., qualified residence interest), a current deduction still may not be available unless certain additional conditions described below are met.

Taxpayer's Obligation

Allowed interest is deductible if the related debt represents a bona fide obligation for which the taxpayer is liable.³⁶ Thus, for interest to be deductible, both the debtor and the creditor must intend for the loan to be repaid. Intent of the parties can be especially crucial between related parties such as a shareholder and a closely held corporation. In addition, an individual may not deduct interest paid on behalf of another taxpayer. For example, a shareholder may not deduct interest paid by the corporation on his or her behalf.³⁷ Likewise, a husband may not deduct interest paid on his wife's property if he files a separate return, except in the case of qualified residence interest. If both husband and wife consent in writing, either the husband or the wife may deduct the allowed interest on the principal residence and one other residence.

Time of Deduction

Generally, interest must be paid to secure a deduction unless the taxpayer uses the accrual method of accounting. Under the accrual method, interest is deductible ratably over the life of the loan.

On November 1, 2015, Ramon borrows \$1,000 to purchase appliances for a rental house. The loan is payable in 90 days at 12% interest. On the due date in late January 2016, Ramon pays the \$1,000 note and interest amounting to \$30. Ramon can deduct the accrued portion ($\frac{2}{3} \times \$30 = \20) of the interest in 2015 only if he is an accrual basis taxpayer. Otherwise, the entire amount of interest (\$30) is deductible in 2016.

EXAMPLE

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³⁵§ 265(a)(2).

³⁶*Arcade Realty Co.*, 35 T.C. 256 (1960).

³⁷*Continental Trust Co.*, 7 B.T.A. 539 (1927).

Prepaid Interest

Accrual method reporting is imposed on cash basis taxpayers for interest prepayments that extend beyond the end of the taxable year.³⁸ Such payments must be allocated to the tax years to which the interest payments relate. These provisions are intended to prevent cash basis taxpayers from *manufacturing* tax deductions before the end of the year by prepaying interest.

10-3c Classification of Interest Expense

Whether interest is deductible *for* AGI or as an itemized deduction (*from* AGI) depends on whether the indebtedness has a business, investment, or personal purpose. If the indebtedness is incurred in relation to a business (other than performing services as an employee) or for the production of rent or royalty income, the interest is deductible *for* AGI. If the indebtedness is incurred for personal use, such as qualified residence interest, any deduction allowed is taken *from* AGI and is reported on Schedule A of Form 1040 if the taxpayer elects to itemize. Note, however, that interest on a student loan is a deduction *for* AGI. If the taxpayer is an employee who incurs debt in relation to his or her employment, the interest is considered to be personal, or consumer, interest and is not deductible. Business expenses appear on Schedule C of Form 1040, and expenses related to rents or royalties are reported on Schedule E.

See Concept Summary 10.1 for a summary of the interest deduction rules.

Concept Summary 10.1

Deductibility of Personal, Student Loan, Mortgage, and Investment Interest

Type	Deductible	Comments
Personal (consumer) interest	No	Includes any interest that is not qualified residence interest, qualified student loan interest, investment interest, or business interest. Examples include interest on car loans and credit card debt.
Qualified student loan interest	Yes	Deduction <i>for</i> AGI; subject to limitations.
Qualified residence interest on acquisition indebtedness	Yes	Deductible as an itemized deduction; limited to indebtedness of \$1 million.
Qualified residence interest on home equity indebtedness	Yes	Deductible as an itemized deduction; limited to indebtedness equal to lesser of \$100,000 or FMV of residence minus acquisition indebtedness.
Investment interest (<i>not</i> related to rental or royalty property)	Yes	Itemized deduction; limited to net investment income for the year; disallowed interest can be carried over to future years. See Chapter 11 for a complete discussion of investment interest.
Investment interest (related to rental or royalty property)	Yes	Deduction <i>for</i> AGI; limited to net investment income for the year; disallowed interest can be carried over to future years. See Chapter 11 for a complete discussion of investment interest.

LO.6

Recognize charitable contributions and identify their related measurement problems and percentage limitations.

10-4 CHARITABLE CONTRIBUTIONS

Section 170 allows individuals and corporations to deduct contributions made to qualified *domestic* organizations. Contributions to qualified charitable organizations serve certain social welfare needs and thus relieve the government of the cost of providing these needed services to the community.

³⁸§ 461(g)(1).

The **charitable contribution** provisions are among the most complex in the tax law. To determine the amount deductible as a charitable contribution, several important questions must be answered:

- What constitutes a charitable contribution?
- Was the contribution made to a qualified organization?
- When is the contribution deductible?
- What record-keeping and reporting requirements apply to charitable contributions?
- How is the value of donated property determined?
- What special rules apply to contributions of property that has increased in value?
- What percentage limitations apply to the charitable contribution deduction?
- What rules apply to amounts in excess of percentage limitations (carryovers)?

These questions are addressed in the sections that follow.

10-4a **Criteria for a Gift**

A *charitable contribution* is defined as a gift made to a qualified organization.³⁹ The major elements needed to qualify a contribution as a gift are a donative intent, the absence of consideration, and acceptance by the donee. Consequently, the taxpayer has the burden of establishing that the transfer was made from motives of *disinterested generosity* as established by the courts.⁴⁰ This test is quite subjective and has led to problems of interpretation (refer to the discussion of gifts in Chapter 5).

Benefit Received Rule

When a donor derives a tangible benefit from a contribution, he or she cannot deduct the value of the benefit.

Ralph purchases a ticket at \$100 for a special performance of the local symphony (a qualified charity). If the price of a ticket to a symphony concert is normally \$35, Ralph is allowed only \$65 as a charitable contribution. Even if Ralph does not attend the concert, the deduction is limited to \$65.

If, however, Ralph does *not* accept the ticket from the symphony (or returns it prior to the event), he can deduct the full \$100.

EXAMPLE

25

An exception to this benefit rule provides for the deduction of an automatic percentage of the amount paid for the right to purchase athletic tickets from colleges and universities.⁴¹ Under this exception, 80 percent of the amount paid to or for the benefit of the institution qualifies as a charitable contribution deduction.

Janet donates \$1,000 to State University's athletic department. The payment guarantees that she will have preferred seating on the 50-yard line at football games. Subsequently, Janet buys four \$50 game tickets. Under the exception to the benefit rule, she is allowed an \$800 (80% of \$1,000) charitable contribution deduction for the taxable year.

If, however, Janet's \$1,000 donation includes four \$50 tickets, that portion [\$200 ($\50×4)] and the remaining portion of \$800 ($\$1,000 - \200) are treated as separate amounts. Thus, Janet is allowed a charitable contribution deduction of \$640 (80% of \$800).

EXAMPLE

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Contribution of Services

No deduction is allowed for a contribution of one's services to a qualified charitable organization. However, unreimbursed expenses related to the services rendered may

³⁹§ 170(c).

⁴¹§ 170(d).

⁴⁰*Comm. v. Duberstein*, 60-2 USTC ¶9515, 5 AFTR 2d 1626, 80 S.Ct. 1190 (USSC, 1960).

be deductible. For example, the cost of a uniform (without general utility) that is required to be worn while performing services may be deductible, as are certain out-of-pocket transportation costs incurred for the benefit of the charity. In lieu of these out-of-pocket costs for an automobile, a standard mileage rate of 14 cents per mile is allowed.⁴² Deductions are permitted for transportation, reasonable expenses for lodging, and the cost of meals while away from home that are incurred in performing the donated services. The travel expenses are not deductible if the travel involves a significant element of personal pleasure, recreation, or vacation.⁴³

EXAMPLE
27

Grace, a delegate representing her church in Miami, Florida, travels to a two-day national meeting in Denver, Colorado, in February. After the meeting, Grace spends two weeks at a nearby ski resort. Under these circumstances, none of the transportation, meals, or lodging is deductible because the travel involved a significant element of personal pleasure, recreation, or vacation.

Nondeductible Items

In addition to the benefit received rule and the restrictions placed on contributions of services, the following items may *not* be deducted as charitable contributions:

- Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups.
- Cost of raffle, bingo, or lottery tickets.
- Cost of tuition.
- Value of blood given to a blood bank.
- Donations to homeowners associations.
- Gifts to individuals.
- Rental value of property used by a qualified charity.

10-4b Qualified Organizations

To be deductible, a contribution must be made to one of the following organizations:⁴⁴

- A state or possession of the United States or any subdivisions thereof.
- A corporation, trust, community chest, fund, or foundation that is situated in the United States and is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals.
- A veterans' organization.
- A fraternal organization operating under the lodge system.
- A cemetery company.

The IRS publishes a list of organizations that have applied for and received tax-exempt status under § 501 of the Code.⁴⁵ This publication is updated frequently and may be helpful in determining whether a gift has been made to a qualifying charitable organization.

Because gifts made to needy individuals are not deductible, a deduction will not be permitted if a gift is received by a donee in an individual capacity rather than as a representative of a qualifying organization.

⁴²§ 170(i).

⁴³§ 170(j).

⁴⁴§ 170(c).

⁴⁵Although this *Cumulative List of Organizations*, IRS Publication 78, may be helpful, qualified organizations are not required to be listed. Not all organizations that qualify are listed in this publication. The list is also available at www.irs.gov.



ETHICS & EQUITY An Indirect Route to a Contribution Deduction

In July, a plane crashed into a residential community in Middleboro, destroying and damaging many homes. Chloe's church, a qualified charitable organization, initiated a fund-raising drive to help the Middleboro citizens whose homes had been affected. Chloe donated \$50,000 to First Middleboro Church and suggested to the pastor that \$25,000 of her contribution should be given to her sister,

Rebecca, whose home had suffered extensive damage. The pastor appointed a committee to award funds to needy citizens. The committee solicited applications from the community and awarded Rebecca \$15,000. Discuss whether Chloe is justified in deducting \$50,000 as a charitable contribution.

10-4c Time of Deduction

A charitable contribution generally is deducted in the year the payment is made. This rule applies to both cash and accrual basis individuals. A contribution is ordinarily deemed to have been made on the delivery of the property to the donee. For example, if a gift of securities (properly endorsed) is made to a qualified charitable organization, the gift is considered complete on the day of delivery or mailing. However, if the donor delivers the certificate to his or her bank or broker or to the issuing corporation, the gift is considered complete on the date the stock is transferred on the books of the corporation.

A contribution made by check is considered delivered on the date of mailing. Thus, a check mailed on December 31, 2015, is deductible on the taxpayer's 2015 tax return. If the contribution is charged on a credit card, the date the charge is made determines the year of deduction.

10-4d Record-Keeping and Valuation Requirements

Recall that income tax deductions allowed by law are a matter of legislative grace, but a taxpayer still bears the burden of showing that he or she is entitled to claim the deduction. Not surprisingly, the IRS provides specific documentation requirements that must be met if a charitable contribution deduction is to be protected.

Record-Keeping Requirements

No deduction is allowed for a charitable contribution made to a qualified organization unless the taxpayer gathers (and, in some cases, supplies to the IRS) the appropriate documentation and substantiation. The specific type of documentation required depends on the amount of the contribution and whether the contribution is made in cash or noncash property.⁴⁶ In addition, special rules may apply to gifts of certain types of property (e.g., used automobiles) where Congress has noted taxpayer abuse in the past. Further, for certain gifts of noncash property, Form 8283 (Noncash Charitable Contributions) must be attached to the taxpayer's return.

The required substantiation must be obtained before the earlier of (1) the due date (including extensions) of the return for the year the contribution is claimed or (2) the date the return is filed. Failure to comply with the reporting rules may result in disallowance of the charitable contribution deduction. In addition, significant overvaluation exposes the taxpayer to stringent penalties.

Common documentation and substantiation requirements are summarized in Concept Summary 10.2.

Valuation Requirements

Property donated to a charity is generally valued at fair market value at the time the gift is made. The Code and Regulations give very little guidance on the measurement of the

⁴⁶The specific documentation thresholds and requirements are provided in § 170(f).

Concept Summary 10.2

Documentation and Substantiation Requirements for Charitable Contributions

Cash gifts	<ul style="list-style-type: none"> • A deduction is allowed only if the taxpayer has a proper receipt (e.g., bank record such as a canceled check or written statement from the charity) showing the name of the charitable organization and the date and amount of the contribution. • A written statement from the charity is required if a payment is for more than \$75 and is partly a contribution and partly for goods or services. The statement must provide an estimate of the value of the goods and services received by the donor.
Noncash gifts (e.g., household items)	<ul style="list-style-type: none"> • A receipt from the charity must be kept for any gift of property other than money. Clothes or other household items are deductible if they are in "good used condition or better" at the time of the gift. • If the items are not in good used condition or better and their value is \$500 or more, a deduction is allowed if a "qualified appraisal" is included with the return.
Used automobiles	<ul style="list-style-type: none"> • The deduction is generally limited to the amount the charity receives on the sale of the car. The taxpayer should obtain a statement from the charity documenting the sales price of the automobile.
Cash or noncash gifts of \$250 or more	<ul style="list-style-type: none"> • Written acknowledgment from the charity (or certain payroll records in the case of gifts made by payroll deductions) is required to deduct a single cash or property contribution of \$250 or more. The acknowledgment must include the amount of money and a description of any other property contributed, whether the charity provided any goods or services in return for the contribution, and a description and estimated value of the goods or services provided.
Noncash gifts of more than \$500	<ul style="list-style-type: none"> • Additional substantiation (e.g., how the property was acquired and its basis) is required on the tax return if donated noncash property is valued at more than \$500. Qualified appraisals may be required if noncash contributions exceed \$5,000 in value.
Antiques, paintings, jewelry, and other "tangible personal property"	<ul style="list-style-type: none"> • The deduction is equal to the property's appreciated FMV only if the charity puts the property to "a use related to its tax-exempt purpose." Otherwise, the deduction is limited to the property's cost. The taxpayer should obtain a statement from the charity documenting the property's use.

fair market value except to say, "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."

Generally, charitable organizations do not attest to the fair market value of the donated property. Nevertheless, as noted in Concept Summary 10.2, the taxpayer must maintain reliable written evidence of the donation.

TAX IN THE NEWS Complying with Documentation Requirements Is Critical, Even for IRS Agents

The income tax law is clear that a taxpayer bears the burden to show that he or she is entitled to claim a deduction for a gift made to a qualified charity. Some may argue that the documentation and substantiation rules written by the IRS are overly strict. Nonetheless, if a taxpayer wants to take a deduction for charitable gifts, the best recommendation would be to follow the rules carefully and be able to provide credible support if requested by the IRS.

One taxpayer, a 28-year employee of the IRS, was denied charitable deductions in two recent years because she was unable to provide convincing evidence that she had made cash gifts of over \$20,000 to a New York church (*Margaret*

Payne, T.C. Summary Opinion 2013-64). The evidence *Payne* provided to support the deduction, a statement on church letterhead, was characterized as a "cut and paste job" that was apparently signed by one of *Payne's* children. The Tax Court ultimately denied the deduction stating that the "record was full of inconsistencies, contradicting testimony, fabricated documents, and simple untruths."

So if any lessons can be gleaned from this experience, they may be that tax rules apply equally to IRS agents and regular citizens alike, and if a cash gift is made to one's favorite charity, whether it be for \$20,000 or \$20, legitimate and convincing documentation must be gathered to support it.



GLOBAL TAX ISSUES Choose the Charity Wisely

Aiko, a U.S. citizen of Japanese descent, was distressed by the damage caused by a major earthquake in Japan. She donated \$100,000 to the Earthquake Victims' Relief Fund, a Japanese charitable organization that was set up to help victims of the earthquake. Kaito, also a U.S. citizen of Japanese descent, donated \$100,000 to help with

the relief effort. However, Kaito's contribution went to his church, which sent the proceeds of a fund drive to the Earthquake Victims' Relief Fund in Japan. Aiko's contribution is not deductible, but Kaito's is. Why? Contributions to charitable organizations are not deductible unless the organization is a U.S. charity.

10-4e Limitations on Charitable Contribution Deduction

The potential charitable contribution deduction is the total of all donations, both money and property, that qualify for the deduction. After this determination is made, the actual amount of the charitable contribution deduction that is allowed for individuals for the tax year is limited as follows:

- If the qualifying contributions for the year total 20 percent or less of AGI, they are fully deductible.
- If the qualifying contributions are more than 20 percent of AGI, the deductible amount may be limited to 20 percent, 30 percent, or 50 percent of AGI, depending on the type of property given and the type of organization to which the donation is made.
- In any case, the maximum charitable contribution deduction may not exceed 50 percent of AGI for the tax year.

To understand the complex rules for computing the amount of a charitable contribution deduction, it is necessary to understand the distinction between capital gain property and ordinary income property. In addition, it is necessary to understand when the 50 percent, 30 percent, and 20 percent limitations apply. If a taxpayer's contributions for the year exceed the applicable percentage limitations, the excess contributions may be carried forward and deducted during a five-year carryover period. These topics are discussed in the sections that follow.

Ordinary Income Property

Ordinary income property is any property that, if sold, will result in the recognition of ordinary income. The term includes inventory for sale in the taxpayer's trade or business, a work of art created by the donor, and a manuscript prepared by the donor. It also includes, *for purposes of the charitable contribution calculation*, a capital asset held by the donor for less than the required holding period for long-term capital gain treatment (long-term is a period longer than one year). To the extent that disposition of property results in the recognition of ordinary income due to the recapture of depreciation, it is ordinary income property.⁴⁷

If ordinary income property is contributed, the deduction is equal to the fair market value of the property less the amount of ordinary income that would have been reported if the property were sold. In most instances, the deduction is limited to the adjusted basis of the property to the donor.

⁴⁷For a more complete discussion of the difference between ordinary income and capital gain property, see Chapter 14.

EXAMPLE

28

Tim donates stock in White Corporation to a university on May 1, 2015. Tim had purchased the stock for \$2,500 on March 3, 2015, and the stock had a value of \$3,600 when he made the donation. Because he had not held the property long enough to meet the long-term capital gain requirement, Tim would have recognized a short-term capital gain of \$1,100 if he had sold the property.

Because short-term capital gain property is treated as ordinary income property for charitable contribution purposes, Tim's charitable contribution deduction is limited to the property's basis of \$2,500 (\$3,600 – \$1,100).

Assume, instead, that the stock had a fair market value of \$2,300 (rather than \$3,600) when Tim donated it to the university. Because the fair market value now is less than the basis, the charitable contribution deduction is \$2,300.

Capital Gain Property

Capital gain property is any property that would have resulted in the recognition of long-term capital gain or § 1231 gain if the property had been sold by the donor.⁴⁸ As a general rule, the deduction for a contribution of capital gain property is equal to the fair market value of the property.

Two common exceptions disallow the deductibility of the appreciation on capital gain property. One exception concerns certain private foundations. Private foundations are organizations that traditionally do not receive their funding from the general public (e.g., the Bill and Melinda Gates Foundation). Generally, foundations fall into two categories: operating and nonoperating. A private *operating* foundation spends substantially all of its income in the active conduct of the charitable undertaking for which it was established. Other private foundations are *nonoperating* foundations. Often, only the private foundation knows its status (operating or nonoperating) for sure, and the status can change from year to year.

If capital gain property is contributed to a private *nonoperating* foundation, the taxpayer must reduce the contribution by the long-term capital gain that would have been recognized if the property had been sold at its fair market value. The effect of this provision is to limit the deduction to the property's adjusted basis.⁴⁹

EXAMPLE

29

Walter purchased land for \$8,000 on January 1, 2002, and has held it as an investment since then. This year, when the land is worth \$20,000, he donates it to a private *nonoperating* foundation. Walter's charitable contribution is \$8,000 (\$20,000 – \$12,000), the land's basis.

If, instead, Walter had donated the land to either a public charity or a private *operating* foundation, his charitable contribution would have been \$20,000, the fair market value of the land.

A second exception applying to capital gain property relates to *tangible personalty*. Tangible personalty is all property that is not realty (land and buildings) and does not include intangible property such as stock or securities. If tangible personalty is contributed to a public charity such as a museum, church, or university, the charitable deduction may have to be reduced. The amount of the reduction is the long-term capital gain that would have been recognized if the property had been sold for its fair market value. In general, the reduction is required if the property is put to an *unrelated use*. The term *unrelated use* means a use that is unrelated to the exempt purpose or function of the charitable organization. For example, artwork donated to the American Red Cross is unlikely to be put to a related use. Instead, the Red Cross would likely sell the art to generate funds that would then be used to support its mission of providing assistance to individuals who have been struck by disasters.

This reduction generally will not apply if the property is, in fact, not put to an unrelated use or if, at the time of the contribution, it was reasonable to anticipate that the property would not be put to an unrelated use by the donee.⁵⁰

⁴⁸See General Scheme of Taxation in Chapter 14 for a discussion of holding periods.

⁵⁰§ 170(e)(1)(B)(i) and Reg. § 1.170A-4(b)(3)(ii)(b).

⁴⁹§ 170(e)(1)(B)(ii).

Emma contributes a Picasso painting, for which she paid \$20,000, to a local museum. She had owned the painting for four years. It had a value of \$30,000 at the time of the donation. The museum displays the painting for five years and subsequently sells it for \$50,000. The charitable contribution is \$30,000. It is not reduced by the unrealized appreciation because the painting is not put to an unrelated use even though it is later sold by the museum.

EXAMPLE**30****Fifty Percent Ceiling**

Contributions made to public charities may not exceed 50 percent of an individual's AGI for the year. The 50 percent ceiling on contributions applies to public charities such as churches; schools; hospitals; and Federal, state, or local governmental units. The 50 percent ceiling also applies to contributions to private operating foundations and certain private nonoperating foundations.

In the remaining discussion of charitable contributions, public charities and private foundations (both operating and nonoperating) that qualify for the 50 percent ceiling will be referred to as *50 percent organizations*.

Thirty Percent Ceiling

A 30 percent ceiling applies to contributions of cash and ordinary income property to private nonoperating foundations that are not 50 percent organizations. The 30 percent ceiling also applies to contributions of appreciated capital gain property to 50 percent organizations.⁵¹

In the event the contributions for any one tax year involve both 50 percent and 30 percent property, the allowable deduction comes first from the 50 percent property.

During the year, Lisa makes the following donations to her church: cash of \$2,000 and unimproved land worth \$30,000. Lisa had purchased the land four years ago for \$22,000 and held it as an investment. Therefore, it is capital gain property. Lisa's AGI for the year is \$60,000. Disregarding percentage limitations, Lisa's potential deduction is \$32,000 [\$2,000 (cash) + \$30,000 (fair market value of land)].

In applying the percentage limitations, however, the *current* deduction for the land is limited to \$18,000 [30% (limitation applicable to capital gain property) × \$60,000 (AGI)]. Thus, the total current deduction is \$20,000 (\$2,000 cash + \$18,000 land). Note that the total deduction does not exceed \$30,000, which is 50% of Lisa's AGI.

EXAMPLE**31****Twenty Percent Ceiling**

A 20 percent ceiling applies to contributions of appreciated capital gain property to private nonoperating foundations that are not 50 percent organizations.

Concept Summary 10.3 summarizes limitations on the deductibility of charitable gifts.

Contribution Carryovers

Contributions that exceed the percentage limitations for the current year can be carried over for five years. In the carryover process, such contributions do not lose their identity for limitation purposes. Thus, if the contribution originally involved 30 percent property, the carryover will continue to be classified as 30 percent property in the carryover year.

Assume the same facts as in Example 31. Because only \$18,000 of the \$30,000 value of the land is deducted in the current year, the balance of \$12,000 may be carried over to the following year. But the carryover will still be treated as capital gain property and is subject to the 30%-of-AGI limitation.

EXAMPLE**32**

⁵¹Under a special election, a taxpayer may choose to permanently forgo a deduction of the appreciation on capital gain property. Referred to as the

reduced deduction election, this enables the taxpayer to move from the 30% limitation to the 50% limitation. See § 170(b)(1)(C)(iii).

Concept Summary 10.3

Determining the Deduction for Contributions of Appreciated Property by Individuals

If the Type of Property Contributed Is:	And the Property Is Contributed to:	The Contribution Is Measured by:	But the Deduction Is Limited to:
1. Capital gain property (see Example 31)	A 50% organization	Fair market value of the property	30% of AGI
2. Ordinary income property (see Example 28)	A 50% organization	The basis of the property*	50% of AGI
3. Capital gain property (and the property is tangible personal property put to an unrelated use by the donee; see Example 30)	A 50% organization	The basis of the property*	50% of AGI
4. Capital gain property (see Example 29)	A private nonoperating foundation that is not a 50% organization	The basis of the property*	The lesser of: 1. 20% of AGI 2. 50% of AGI minus other contributions to 50% organizations

*If the fair market value of the property is less than the adjusted basis (i.e., the property has declined in value instead of appreciating), the fair market value is used.

In applying the percentage limitations, current charitable contributions must be claimed first before any carryovers can be considered. If carryovers involve more than one year, they are utilized in a first-in, first-out order.

LO.7

List the business and personal expenditures that are deductible either as miscellaneous itemized deductions or as other itemized deductions.

10-5 MISCELLANEOUS ITEMIZED DEDUCTIONS

In general, no deduction is allowed for personal, living, or family expenses.⁵² However, a taxpayer may incur a number of expenditures related to employment. If an employee or outside salesperson incurs unreimbursed business expenses or expenses that are reimbursed under a nonaccountable plan, including travel and transportation, the expenses are deductible as **miscellaneous itemized deductions**.⁵³ Certain other expenses also fall into the special category of miscellaneous itemized deductions. Some are deductible only if, in total, they exceed 2 percent of the taxpayer's AGI. These miscellaneous itemized deductions include (but are not limited to) the following:

- Professional dues to membership organizations.
- Cost of uniforms or other clothing that cannot be used for normal wear.
- Fees incurred for the preparation of one's tax return or fees incurred for tax litigation before the IRS or the courts.
- Job-hunting costs.
- Fee paid for a safe deposit box used to store papers and documents relating to taxable income-producing investments.
- Investment expenses that are deductible under § 212 as discussed in Chapter 6.

⁵²§ 262.

⁵³Actors and performing artists who meet certain requirements are not subject to this rule. See § 62(a)(2)(B).

- Appraisal fees to determine the amount of a casualty loss or the fair market value of donated property.
- Hobby losses up to the amount of hobby income (refer to Chapter 6).
- Unreimbursed employee expenses (refer to Chapter 9).

Certain employee business expenses that are reimbursed are not itemized deductions, but are deducted *for* AGI. Employee business expenses are discussed in depth in Chapter 9.

10-6 OTHER MISCELLANEOUS DEDUCTIONS

Certain expenses and losses do not fall into any category of itemized deductions already discussed but are nonetheless deductible. The following expenses and losses are deductible on line 28 of Schedule A as Other Miscellaneous Deductions. These are not subject to the 2%-of-AGI floor.

- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of a handicapped person.
- Federal estate tax on income in respect of a decedent.
- Deduction for repayment of amounts under a claim of right (but only if more than \$3,000; discussed in Chapter 16).
- The unrecovered investment in an annuity contract when the annuity ceases by reason of death, discussed in Chapter 4.

10-7 COMPREHENSIVE EXAMPLE OF SCHEDULE A

Harry and Jean Brown (ages 42 and 43, respectively), married filing jointly, had the following transactions for 2014:

Medicines that required a prescription	\$ 430
Doctor and dentist bills paid and not reimbursed	3,120
Medical insurance premium payments	1,200
Contact lenses	170
Transportation for medical purposes on March 1, 2014 (226 miles × 23.5 cents/mile + \$10.00 parking)	63
State income tax withheld (This amount exceeds the sales tax from the sales tax table)	3,900
Real estate taxes	1,580
Interest paid on qualified residence mortgage	2,340
Qualifying charitable contributions paid by check	860
Transportation in performing charitable services (800 miles × 14 cents/mile + \$7.00 parking and tolls)	119
Unreimbursed employee expenses (from Form 2106)	870
Tax return preparation	150
Safe deposit box (used for keeping investment documents and tax records)	170

The Browns' AGI is \$40,000. Their completed 2014 Schedule A (on the following page) reports itemized deductions totaling \$10,172. A 2014 example (and related illustration using a 2014 Schedule A) is used because the 2015 form was not available at the date of this printing.

**SCHEDULE A
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Information about Schedule A and its separate instructions is at www.irs.gov/schedulea.
▶ Attach to Form 1040.

OMB No. 1545-0074

2014

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

Harry and Jean Brown

Your social security number

111 11 1111

Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.			
	1 Medical and dental expenses (see instructions)	1	<i>4,983</i>	
	2 Enter amount from Form 1040, line 38 2 <i>40,000</i>			
	3 Multiply line 2 by 10% (.10). But if either you or your spouse was born before January 2, 1950, multiply line 2 by 7.5% (.075) instead	3	<i>4,000</i>	
	4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4 <i>983</i>
Taxes You Paid	5 State and local (check only one box): a <input checked="" type="checkbox"/> Income taxes, or b <input type="checkbox"/> General sales taxes	5	<i>3,900</i>	
	6 Real estate taxes (see instructions)	6	<i>1,580</i>	
	7 Personal property taxes	7		
	8 Other taxes. List type and amount ▶	8		
	9 Add lines 5 through 8	9		<i>5,480</i>
Interest You Paid	10 Home mortgage interest and points reported to you on Form 1098	10	<i>2,340</i>	
	11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶	11		
	12 Points not reported to you on Form 1098. See instructions for special rules	12		
	13 Mortgage insurance premiums (see instructions)	13		
	14 Investment interest. Attach Form 4952 if required. (See instructions.)	14		
	15 Add lines 10 through 14	15		<i>2,340</i>
Gifts to Charity	16 Gifts by cash or check. If you made any gift of \$250 or more, see instructions	16	<i>860</i>	
	17 Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500	17	<i>119</i>	
	18 Carryover from prior year	18		
	19 Add lines 16 through 18	19		<i>979</i>
20 Casualty or theft loss(es). Attach Form 4684. (See instructions.)	20			
Job Expenses and Certain Miscellaneous Deductions	21 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶	21	<i>870</i>	
	22 Tax preparation fees	22	<i>150</i>	
	23 Other expenses—investment, safe deposit box, etc. List type and amount ▶ <i>Safe deposit box</i>	23	<i>170</i>	
	24 Add lines 21 through 23	24	<i>1,190</i>	
	25 Enter amount from Form 1040, line 38 25 <i>40,000</i>			
	26 Multiply line 25 by 2% (.02)	26	<i>800</i>	
	27 Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-	27		<i>390</i>
28 Other—from list in instructions. List type and amount ▶	28			
Total Itemized Deductions	29 Is Form 1040, line 38, over \$152,525? <input checked="" type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40. <input type="checkbox"/> Yes. Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.	29		<i>10,172</i>
	30 If you elect to itemize deductions even though they are less than your standard deduction, check here <input type="checkbox"/>			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 17145C

Schedule A (Form 1040) 2014



TAX IN THE NEWS The First Family and Itemized Deduction Phaseouts

In 2014, President Barack H. and Michelle L. Obama itemized deductions on their 2013 tax return. Because of their income level, their itemized deductions were reduced by \$5,433 as shown in the column to the right.

Because the marginal rate of 33 percent applied to the Obamas' taxable income in 2013, the phaseout of itemized deductions cost them \$1,793 in additional Federal income tax (\$5,433 reduction \times 33% marginal tax rate). Over the years, phaseouts such as this have been a popular way to raise tax revenues without increasing tax rates.

Itemized Deductions	
Taxes	\$ 51,568
Interest	42,383
Charitable contributions	59,251
Total itemized deductions	\$153,202
Reduction due to phaseout [(\$481,098 AGI – \$300,000) \times 3%]	<u>(5,433)</u>
Itemized deductions allowed	<u>\$147,769</u>

10-8 OVERALL LIMITATION ON CERTAIN ITEMIZED DEDUCTIONS

Similar in effect to the exemption phaseout described in Chapter 3, high-income taxpayers also are subject to a limitation on the tax benefits from certain itemized deductions. In 2015, the phaseout of itemized deductions (also referred to as a *cutback adjustment*) applies to married taxpayers filing jointly whose AGI exceeds \$309,900 (\$258,250 for single filers).⁵⁴ Phaseouts of this type are sometimes referred to as “stealth taxes.” The “Tax in the News” above reports the effect of the limitation on President and Mrs. Obama’s 2013 income tax return, which required them to pay \$1,793 more in Federal income taxes than they would have paid had their itemized deductions been fully deductible.

The limitation applies to the following frequently encountered itemized deductions:

- Taxes.
- Home mortgage interest, including points.
- Charitable contributions.
- Unreimbursed employee expenses subject to the 2%-of-AGI floor.
- All other expenses subject to the 2%-of-AGI floor.

The following are *not* subject to the limitation on itemized deductions:

- Medical expenses.
- Investment interest expense.
- Nonbusiness casualty and theft losses.
- Gambling losses.

Taxpayers subject to the limitation must reduce itemized deductions by the *lesser* of:

- 3 percent of the amount by which AGI exceeds \$309,900 (\$258,250 if single).
- 80 percent of itemized deductions that are affected by the limit.

The overall limitation is applied after applying all other limitations to those itemized deductions that are affected by the overall limitation. For example, other limitations apply to charitable contributions, certain meals and entertainment expenses, and certain miscellaneous itemized deductions.

LO.8

Recognize the limitation on certain itemized deductions applicable to high-income taxpayers.

⁵⁴§ 68. The AGI thresholds are \$284,050 for heads of household and \$154,950 for married taxpayers filing separately. In 2014, the phaseouts applied to married taxpayers filing jointly whose AGI exceeded \$305,050

(\$254,200 for single taxpayers, \$279,650 for heads of household, and \$152,525 for married taxpayers filing separately).

EXAMPLE

33

Gavin, who is single and age 45, had AGI of \$275,000 for 2015. He incurred the following expenses and losses during the year:

Medical expenses before 10%-of-AGI limitation	\$29,500
State and local income taxes	3,200
Real estate taxes	2,800
Home mortgage interest	7,200
Charitable contributions	2,000
Casualty loss before 10% limitation (after \$100 floor)	29,000
Unreimbursed employee expenses (subject to 2%-of-AGI limitation)	5,800
Gambling losses (Gavin had \$3,000 of gambling income)	7,000

Gavin's itemized deductions *before* the overall limitation are computed as follows:

Medical expenses [$\$29,500 - (10\% \times \$275,000)$]	\$ 2,000
State and local income taxes	3,200
Real estate taxes	2,800
Home mortgage interest	7,200
Charitable contributions	2,000
Casualty loss [$\$29,000 - (10\% \times \$275,000)$]	1,500
Unreimbursed employee expenses [$\$5,800 - (2\% \times \$275,000)$]	300
Gambling losses (\$7,000 loss limited to \$3,000 of gambling income)	<u>3,000</u>
Total itemized deductions before overall limitation	<u><u>\$22,000</u></u>

Gavin's itemized deductions subject to the overall limitation are as follows:

State and local income taxes	\$ 3,200
Real estate taxes	2,800
Home mortgage interest	7,200
Charitable contributions	2,000
Unreimbursed employee expenses	<u>300</u>
Total	<u><u>\$15,500</u></u>

Gavin must reduce the amount by the smaller of the following:

• $3\% \times (\$275,000 \text{ AGI} - \$258,250)$	\$ 503
• 80% of itemized deductions subject to limitation ($\$15,500 \times .80$)	12,400

Therefore, the amount of the reduction is \$503, and Gavin has \$21,497 of deductible itemized deductions, computed as follows:

Deductible itemized deductions subject to overall limitation ($\$15,500 - \503)	\$14,997
Itemized deductions not subject to overall limitation:	
Medical expenses	2,000
Casualty loss	1,500
Gambling losses	<u>3,000</u>
Deductible itemized deductions	<u><u>\$21,497</u></u>

LO.9

Identify tax planning strategies that can maximize the benefit of itemized deductions.

10-9 TAX PLANNING

10-9a Effective Utilization of Itemized Deductions

Because an individual may use the standard deduction in one year and itemize deductions in another year, it is frequently possible to obtain maximum benefit by shifting itemized deductions from one year to another. For example, if a taxpayer's itemized deductions and the standard deduction are approximately the same for each year of a two-year period, the taxpayer should use the standard deduction in one year and shift

itemized deductions (to the extent permitted by law) to the other year. The individual could, for example, prepay a church pledge for a particular year to shift the deduction to the current year or avoid paying end-of-the-year medical expenses to shift the deduction to the following year.

10-9b Utilization of Medical Deductions

When a taxpayer anticipates that medical expenses will approximate the percentage floor, much might be done to generate a deductible excess. Any of the following procedures can help build a deduction by the end of the year:

- Incur the obligation for needed dental work or have needed work carried out.⁵⁵
- Have elective remedial surgery that may have been postponed from prior years.
- Incur the obligation for capital improvements to the taxpayer's personal residence recommended by a physician (e.g., an air filtration system to alleviate a respiratory disorder).

As an aid to taxpayers who may experience temporary cash-flow problems at the end of the year, the use of credit cards is deemed to be payment for purposes of timing the deductibility of charitable and medical expenses.

On December 13, 2015, Marge (a calendar year taxpayer) purchases two pairs of prescription contact lenses and one pair of prescribed orthopedic shoes for a total of \$450. These purchases are separately charged to Marge's credit card. On January 6, 2016, Marge receives her statement containing these charges and makes payment shortly thereafter. The purchases are deductible as medical expenses in the year charged (2015) and not in the year the account is settled (2016).

EXAMPLE

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Recognizing which expenditures qualify for the medical deduction also may be crucial to exceeding the percentage limitations.

Ethan employs Lana (an unrelated party) to care for his incapacitated and dependent mother. Lana is not a trained nurse but spends approximately one-half of the time performing nursing duties (e.g., administering injections and providing physical therapy) and the rest of the time doing household chores. An allocable portion of Lana's wages that Ethan pays (including the employer's portion of FICA taxes) qualifies as a medical expense.

EXAMPLE

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10-9c Timing the Payment of Deductible Taxes

It is sometimes possible to defer or accelerate the payment of certain deductible taxes, such as state income tax, real property tax, and personal property tax. For instance, the final installment of estimated state income tax is generally due after the end of a given tax year. Accelerating the payment of the final installment could result in larger itemized deductions for the current year.

Jenny, who is single, expects to have itemized deductions of \$6,000 in 2015 and \$4,000 in 2016. She plans to pay \$900 as the final installment on her 2015 estimated state income tax, which is due on January 15, 2016. The standard deduction for 2015 is \$6,300 for single taxpayers. If Jenny does not pay the final installment until 2016, she will not itemize in either 2015 or 2016.

However, if she pays the final installment in December 2015, her itemized deductions will be \$6,900 (\$6,000 + \$900) in 2015 and she will benefit from itemizing.

EXAMPLE

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⁵⁵Prepayment of medical expenses does not generate a current deduction unless the taxpayer is under an obligation to make the payment.

10-9d **Protecting the Interest Deduction**

Although the deductibility of prepaid interest by a cash basis taxpayer has been severely restricted, a notable exception allows a deduction for points paid by the buyer to obtain financing for the purchase or improvement of a principal residence in the year of payment. However, such points must actually be paid by the taxpayer obtaining the loan and must represent a charge for the use of money. It has been held that points paid from the mortgage proceeds do not satisfy the payment requirement.⁵⁶ Also, the portion of the points attributable to service charges does not represent deductible interest.⁵⁷ Taxpayers financing home purchases or improvements usually should direct their planning toward avoiding these two hurdles to immediate deductibility.

In rare instances, a taxpayer may find it desirable to forgo the immediate expensing of points in the year paid. Instead, it could prove beneficial to capitalize the points and write them off as interest expense over the life of the mortgage.

EXAMPLE

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Alexander purchases a home on December 15, 2015, for \$380,000 with \$120,000 cash and a 15-year mortgage of \$260,000 financed by the Greater Metropolis National Bank. Alexander pays two points in addition to interest allocated to the period from December 15 until December 31, 2015, at an annual rate of 4%.

If Alexander does not have enough itemized deductions to exceed the standard deduction for 2015, he should elect to capitalize the points and amortize them over 15 years. In this instance, Alexander would deduct \$346.67 for 2016, as part of his qualified residence interest expense [\$5,200 (two points) divided by 15 years], if he elects to itemize that year.

Because personal (consumer) interest is not deductible, taxpayers should consider making use of home equity loans. Recall that these loans utilize the personal residence of the taxpayer as security. The funds from these loans can be used for personal purposes (e.g., auto purchases and vacations). By making use of home equity loans, therefore, what would have been nondeductible personal interest becomes deductible qualified residence interest.

10-9e **Ensuring the Charitable Contribution Deduction**

For a charitable contribution deduction to be available, the recipient must be a qualified charitable organization. Sometimes the mechanics of how the contribution is carried out can determine whether a deduction results.

EXAMPLE

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Fumiko wants to donate \$5,000 to her church's mission in Kobe, Japan. In this regard, she considers three alternatives:

1. Send the money directly to the mission.
2. Give the money to her church in Charlotte with the understanding that it is to be passed on to the mission.
3. Give the money directly to the missionary in charge of the mission who is currently in the United States on a fund-raising trip.

If Fumiko wants to obtain a deduction for the contribution, she should choose alternative 2. A direct donation to the mission (alternative 1) is not deductible because the mission is a foreign charity. A direct gift to the missionary (alternative 3) does not comply because an individual cannot be a qualified charity for income tax purposes.⁵⁸

⁵⁶*Alan A. Rubnitz*, 67 T.C. 621 (1977). Seller-paid points may also be deductible by the buyer under the provisions of Rev.Proc. 94-27, cited in footnote 34.

⁵⁷*Donald L. Wilkerson*, 70 T.C. 240 (1978).

⁵⁸*Thomas E. Leslie*, 36 TCM 495, T.C.Memo. 1977-111.

When making noncash donations, the type of property chosen can have decided implications in determining the amount, if any, of the deduction.

Sam wants to give \$60,000 in value to his church in some form other than cash. In this connection, he considers four alternatives:

1. Stock held for two years as an investment with a basis of \$100,000 and a fair market value of \$60,000.
2. Stock held for five years as an investment with a basis of \$10,000 and a fair market value of \$60,000.
3. The rent-free use for a year of a building that normally leases for \$5,000 a month.
4. A valuable stamp collection held as an investment and owned for 10 years with a basis of \$10,000 and a fair market value of \$60,000. The church plans to sell the collection if and when it is donated.

Alternative 1 is ill-advised as the subject of the gift. Even though Sam would obtain a deduction of \$60,000, he would forgo the potential loss of \$40,000 that would be recognized if the property were sold.⁵⁹

Alternative 2 makes good sense because the deduction still is \$60,000 and none of the \$50,000 of appreciation that has occurred must be recognized as income.

Alternative 3 yields no deduction at all and is not a wise choice.

Alternative 4 involves tangible personalty that the recipient does not plan to use. As a result, the amount of the deduction is limited to \$10,000, the stamp collection's basis.⁶⁰

EXAMPLE

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For property transfers (particularly real estate), the ceiling limitations on the amount of the deduction allowed in any one year (50 percent, 30 percent, or 20 percent of AGI, as the case may be) could be a factor to take into account. With proper planning, donations can be controlled to stay within the limitations and therefore avoid the need for a carryover of unused charitable contributions.

Andrew wants to donate a tract of unimproved land held as an investment to Eastern University (a qualified charitable organization). The land has been held for six years and has a current fair market value of \$300,000 and a basis to Andrew of \$50,000. Andrew's AGI for the current year is estimated to be \$200,000, and he expects much the same for the next few years. In the current year, he deeds (transfers) an undivided one-fifth interest in the real estate to the university.

EXAMPLE

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What has Andrew in Example 40 accomplished for income tax purposes? In the current year, he will be allowed a charitable contribution deduction of \$60,000 ($1/5 \times \$300,000$), which will be within the applicable limitation of AGI ($30\% \times \$200,000$). Presuming no other charitable contributions for the year, Andrew has avoided the possibility of a carryover. In future years, Andrew can arrange donations of undivided interests in the real estate to stay within the bounds of the percentage limitations. The only difficulty with this approach is the need to revalue the real estate each year before the donation, because the amount of the deduction is based on the fair market value of the interest contributed at the time of the donation.

⁵⁹*LaVar M. Withers*, 69 T.C. 900 (1978).

⁶⁰No reduction of appreciation is necessary in alternative 2 because stock is intangible property and not tangible personalty.

REFOCUS ON THE BIG PICTURE

ITEMIZED DEDUCTIONS CAN REDUCE THE AFTER-TAX COST OF MAJOR PURCHASES



Because the Federal tax law provides that qualified residence interest and real estate taxes are deductible by individual taxpayers, the after-tax cost of a home purchase will be reduced by the tax savings associated with these itemized tax deductions (see Example 1). Given the Williamsons' projected taxable income, they are in the 28 percent Federal tax bracket and the 6 percent state tax bracket (i.e., aggregate marginal tax bracket of 34 percent). As a result, the after-tax cost of financing the purchase of the home will be:

Nondeductible principal payments	\$ 2,000
Deductible qualified residence interest and real estate taxes [(\$37,000 + \$4,000) × (1 – .34)]	<u>27,060</u>
Total	<u>\$29,060</u>
After-tax monthly cost (\$29,060 ÷ 12)	<u>\$ 2,422</u>

Because the Williamsons will be able to itemize their deductions if they purchase a new home and will be able to deduct most of their monthly house payment, the home purchase will be affordable (see Examples 16 and 21).

What If?

What if the Williamsons use the less expensive route to finance the purchase of their home by using their retirement and taxable portfolio as security for the loan? What may at first appear to be a cost-effective approach ends up being more costly when considering the impact of the tax law. With this approach, the interest expense is not deductible because it is not qualified residence interest (see Example 21); further, it is not deductible as investment interest (see Chapter 11). Therefore, the after-tax cost of financing the home using this approach makes the home unaffordable.

Nondeductible principal and interest payments	\$37,000
Deductible real estate taxes [\$4,000 × (1 – .34)]	<u>2,640</u>
Total	<u>\$39,640</u>
After-tax monthly cost (\$39,640 ÷ 12)	<u>\$ 3,303</u>

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Key Terms

Acquisition indebtedness, 10-15

Capital gain property, 10-24

Charitable contribution, 10-19

Health Savings Account (HSA), 10-9

Home equity loans, 10-15

Medical expense, 10-3

Miscellaneous itemized deductions, 10-26

Ordinary income property, 10-23

Points, 10-16

Qualified residence interest, 10-15

Discussion Questions

1. **LO.1, 2** Dan, a self-employed individual taxpayer, prepared his own income tax return for the past year and has asked you to check it for accuracy. Your review indicates that Dan failed to claim certain business entertainment expenses.
 - a. Will the correction of this omission affect the amount of medical expenses Dan can deduct? Explain.
 - b. Would it matter if Dan were employed rather than self-employed? Explain.
2. **LO.2** Joe was in an accident and required cosmetic surgery for injuries to his nose. He also had the doctor do additional surgery to reshape his chin, which had not been injured. Will the cosmetic surgery to Joe's nose qualify as a medical expense? Will the cosmetic surgery to Joe's chin qualify as a medical expense? Explain.
3. **LO.2, 9** Jerry and Ernie are comparing their tax situations. Both are paying all of the nursing home expenses of their parents. Jerry can include the expenses in computing his medical expense deduction, but Ernie cannot. What explanation can you offer for the difference?
4. **LO.2** Cheryl incurred \$8,700 of medical expenses in November 2015. On December 5, the clinic where she was treated mailed her the insurance claim form it had prepared for her with a suggestion that she sign and return the form immediately to receive her reimbursement from the insurance company by December 31. What tax issues should Cheryl consider in deciding whether to sign and return the form in December 2015 or January 2016?
5. **LO.2** David, a sole proprietor of a bookstore, pays a \$7,500 premium for medical insurance for him and his family. Joan, an employee of a small firm that doesn't provide her with medical insurance, pays medical insurance premiums of \$8,000 for herself. How does the tax treatment differ for David and Joan?
6. **LO.2** Jayden, a calendar year taxpayer, paid \$16,000 in medical expenses and sustained a \$20,000 casualty loss in 2015. He expects \$12,000 of the medical expenses and \$14,000 of the casualty loss to be reimbursed by insurance companies in 2016. Before considering any limitations on these deductions, how much can Jayden include in determining his itemized deductions for 2015?
7. **LO.2** Jacob, a self-employed taxpayer, is married and has two children. He has asked you to explain the tax and nontax advantages of creating a Health Savings Account (HSA) for him and his family.
8. **LO.5, 9** Diane owns a principal residence in Georgia, a townhouse in San Francisco, and a yacht in Cape Cod. All of the properties have mortgages on which Diane pays interest. What are the limitations on Diane's mortgage interest deduction? What strategy should Diane consider to maximize her mortgage interest deduction?
9. **LO.5, 9** Mason Gregg's car was destroyed by a flood. Unfortunately, his insurance had lapsed two days before he incurred the loss. Mason uses his car for both business and personal use. Mason, who is self-employed, does not have adequate savings to replace the car and must borrow money to purchase a new car. He is considering taking out a home equity loan, at a 5% interest rate, to obtain funds for the purchase. Margaret, his wife, would prefer not to do so because they paid off their mortgage recently and she does not want to incur any obligations related to their home. She would prefer to sell some of their stock in Bluebird, Inc., to raise funds to purchase the new car. Mason does not want to sell the stock because it has declined in value since they purchased it and he is convinced that its price will increase in the next two years. Mason has suggested that they obtain conventional financing for the purchase from their bank, which charges 7% interest on

Issue ID

Decision Making

Issue ID

car loans. Identify the tax issues related to each of the three alternatives Mason and Margaret are considering.

10. **LO.5** Commercial Bank has initiated an advertising campaign that encourages customers to take out home equity loans to pay for purchases of automobiles. Are there any tax advantages related to this type of borrowing? Explain.
 11. **LO.5** Thomas purchased a personal residence from Rachel. To sell the residence, Rachel agreed to pay \$5,500 in points related to Thomas's mortgage. Discuss the deductibility of the points.
 12. **LO.6** The city of Lawrence was hit by a tornado in April 2015, leaving many families in need of food, clothing, shelter, and other necessities. Betty contributed \$500 to a family whose home was completely destroyed by the tornado. Jack contributed \$700 to the family's church, which gave the money to the family. Discuss the deductibility of these contributions.
 13. **LO.6** Mike purchased four \$100 tickets to a fund-raising dinner and dance sponsored by the public library, a qualified charitable organization. In its advertising for the event, the library indicated that the cost of the tickets would be deductible for Federal income tax purposes. Comment on the library's assertion.
- Issue ID** 14. **LO.6, 9** William, a high school teacher, earns about \$50,000 each year. In December 2015, he won \$1 million in the state lottery. William plans to donate \$100,000 to his church. He has asked you, his tax adviser, whether he should donate the \$100,000 in 2015 or 2016. Identify the tax issues related to William's decision.

Computational Exercises

15. **LO.2** Barbara incurred the following expenses during the year: \$840 dues at a health club she joined at the suggestion of her physician to improve her general physical condition, \$240 for multiple vitamins and antioxidant vitamins, \$500 for a smoking cessation program, \$240 for nonprescription nicotine gum, \$600 for insulin, and \$7,200 for funeral expenses for her mother who passed away in June. Before considering the AGI limitation, what amount may Barbara include in computing her medical expense deduction?
16. **LO.3** Tabitha sells real estate on March 2 for \$260,000. The buyer, Ramona, pays the real estate taxes of \$5,200 for the calendar year, which is the real estate property tax year. Assume that this is not a leap year.
 - a. Determine the real estate taxes apportioned to and deductible by the seller, Tabitha, and the amount of taxes deductible by Ramona.
 - b. Calculate Ramona's basis in the property and the amount realized by Tabitha from the sale.
17. **LO.4** Pierre, a cash basis, unmarried taxpayer, had \$1,400 of state income tax withheld during 2015. Also in 2015, Pierre paid \$455 that was due when he filed his 2014 state income tax return and made estimated payments of \$975 towards his 2015 state income tax liability. When Pierre files his 2015 Federal income tax return in April 2016, he elects to itemize deductions, which amount to \$10,650, including the state income tax payments and withholdings, all of which reduce his taxable income.
 - a. What is Pierre's 2015 state income tax deduction?
 - b. As a result of overpaying his 2015 state income tax, Pierre receives a refund of \$630 early in 2016. The standard deduction for single taxpayers for 2015 was \$6,300. How much of the \$630 will Pierre include in his 2016 gross income?

18. **LO.4** Derek, a cash basis, unmarried taxpayer, had \$610 of state income tax withheld during 2015. Also in 2015, Derek paid \$50 that was due when he filed his 2014 state income tax return and made estimated payments of \$100 towards his 2015 state income tax liability. When Derek files his 2015 Federal income tax return in April 2016, he elects to take the standard deduction, which reduced his taxable income. As a result of overpaying his 2015 state income tax, Derek receives a refund of \$435 early in 2016. How much of the \$435 will Derek include in his 2016 gross income?
19. **LO.5** Miller owns a personal residence with a fair market value of \$195,000 and an outstanding first mortgage of \$157,500. Miller gets a second mortgage on the residence and in return borrows \$10,000 to purchase new jet skis. How much of the first and second mortgage debt is treated as qualified residence indebtedness?
20. **LO.6** Donna donates stock in Chipper Corporation to the American Red Cross on September 10, 2015. She purchased the stock for \$18,100 on December 28, 2014, and it had a fair market value of \$27,000 when she made the donation.
- What is Donna's charitable contribution deduction?
 - Assume instead that the stock had a fair market value of \$15,000 (rather than \$27,000) when it was donated to the American Red Cross. What is Donna's charitable contribution deduction?
21. **LO.7** Issac has AGI of \$73,400 and incurred the following expenses. How much of the business and personal expenditures are deductible (after any limitation) either as miscellaneous itemized deductions or as other itemized deductions?

Cost of uniforms	\$ 535
Tax return preparation fees	600
Fee paid for a safe deposit box used to store papers and documents relating to taxable income-producing investments	65
Job-hunting costs	1,100

22. **LO.8** Pedro, who is a single taxpayer, had AGI of \$328,000 for 2015. He incurred the following expenses during the year:

Medical expenses before 10%-of-AGI limitation	\$12,000
State and local income taxes	8,900
Real estate taxes	1,600
Home mortgage interest	16,000
Charitable contributions	2,200
Deductible investment interest expense	1,700

Compute the amount of Pedro's itemized deductions after any applicable reductions.

23. **LO.9** The Wilmoths plan to purchase a house but want to determine the after-tax cost of financing its purchase. Given their projected taxable income, the Wilmoths are in the 28% Federal income tax bracket and the 8% state income tax bracket (i.e., an aggregate marginal tax bracket of 36%). The total cash outlay during the first year of ownership will be \$23,400 (\$1,200 principal payments, \$22,200 qualified residence interest payments). Determine the initial year after-tax cost of financing the purchase of the home.

Problems

- Communications** 24. **LO.2** Emma Doyle, age 55, is employed as a corporate attorney. For calendar year 2015, she had AGI of \$100,000 and paid the following medical expenses:

Medical insurance premiums	\$3,700
Doctor and dentist bills for Bob and April (Emma's parents)	6,800
Doctor and dentist bills for Emma	5,200
Prescription medicines for Emma	400
Nonprescription insulin for Emma	350

Bob and April would qualify as Emma's dependents except that they file a joint return. Emma's medical insurance policy does not cover them. Emma filed a claim for reimbursement of \$2,800 of her own expenses with her insurance company in December 2015 and received the reimbursement in January 2016. What is Emma's maximum allowable medical expense deduction for 2015? Prepare a memo for your firm's tax files in which you document your conclusions.

25. **LO.2** Reba, who is single and age 45, does a lot of business entertaining at home. Lawrence, Reba's 84-year-old dependent grandfather, lived with Reba until this year, when he moved to Lakeside Nursing Home because he needs medical and nursing care. During the year, Reba made the following payments on behalf of Lawrence:

Room at Lakeside	\$11,000
Meals for Lawrence at Lakeside	2,200
Doctor and nurse fees at Lakeside	1,700
Cable TV service for Lawrence's room at Lakeside	380
Total	<u>\$15,280</u>

Lakeside has medical staff in residence. Disregarding the 10%-of-AGI floor, how much, if any, of these expenses qualifies for a medical expense deduction by Reba?

26. **LO.2** Paul, age 62, suffers from emphysema and severe allergies and, upon the recommendation of his physician, has a dust elimination system installed in his personal residence. In connection with the system, Paul incurs and pays the following amounts during 2015:

Doctor and hospital bills	\$ 2,500
Dust elimination system	10,000
Increase in utility bills due to the system	450
Cost of certified appraisal	300

In addition, Paul pays \$750 for prescribed medicines.

The system has an estimated useful life of 20 years. The appraisal was to determine the value of Paul's residence with and without the system. The appraisal states that his residence was worth \$350,000 before the system was installed and \$356,000 after the installation. Paul's AGI for the year was \$50,000. How much of the medical expenses qualify for the medical expense deduction in 2015?

27. **LO.2** For calendar year 2015, Jean was a self-employed consultant with no employees. She had \$80,000 of net profit from consulting and paid \$7,000 in medical insurance premiums on a policy covering 2015. How much of these premiums may Jean deduct as a deduction *for* AGI? How much may she deduct as an itemized deduction (subject to the AGI floor)?

28. **LO.2** During 2015, Susan, age 49, incurred and paid the following expenses for Beth (her daughter), Ed (her father), and herself:

Surgery for Beth	\$4,500
Red River Academy charges for Beth:	
Tuition	5,100
Room, board, and other expenses	4,800
Psychiatric treatment	5,100
Doctor bills for Ed	2,200
Prescription drugs for Susan, Beth, and Ed	780
Insulin for Ed	540
Nonprescription drugs for Susan, Beth, and Ed	570
Charges at Heartland Nursing Home for Ed:	
Medical care	5,000
Lodging	2,700
Meals	2,650

Beth qualifies as Susan's dependent, and Ed would also qualify except that he receives \$7,400 of taxable retirement benefits from his former employer. Beth's psychiatrist recommended Red River Academy because of its small classes and specialized psychiatric treatment program that is needed to treat Beth's illness. Ed, who is a paraplegic and diabetic, entered Heartland in October. Heartland offers the type of care that he requires.

Upon the recommendation of a physician, Susan has an air filtration system installed in her personal residence. She suffers from severe allergies. In connection with this equipment, Susan incurs and pays the following amounts during the year:

Filtration system and cost of installation	\$6,500
Increase in utility bills due to the system	700
Cost of certified appraisal	360

The system has an estimated useful life of 10 years. The appraisal was to determine the value of Susan's residence with and without the system. The appraisal states that the system increased the value of Susan's residence by \$2,200. Ignoring the 10%-of-AGI floor, what is the total of Susan's expenses that qualifies for the medical expense deduction?

29. **LO.2** In May, Rebecca's daughter, Isabella, sustained a serious injury that made it impossible for her to continue living alone. Isabella, who is a novelist, moved back into Rebecca's home after the accident. Isabella has begun writing a novel based on her recent experiences. To accommodate Isabella, Rebecca incurred significant remodeling expenses (widening hallways, building a separate bedroom and bathroom, and making kitchen appliances accessible to Isabella). In addition, Rebecca had an indoor swimming pool constructed so that Isabella could do rehabilitation exercises prescribed by her physician.

Issue ID

In September, Isabella underwent major reconstructive surgery in Denver. The surgery was performed by Dr. Rama Patel, who specializes in treating injuries of the type sustained by Isabella. Rebecca drove Isabella from Champaign, Illinois, to Denver, a total of 1,100 miles, in Isabella's specially equipped van. They left Champaign on Tuesday morning and arrived in Denver on Thursday afternoon. Rebecca incurred expenses for gasoline, highway tolls, meals, and lodging while traveling to Denver. Rebecca stayed in a motel near the clinic for eight days while Isabella was hospitalized. Identify the relevant tax issues based on this information, and prepare a list of questions you would need to ask Rebecca and Isabella to advise them as to the resolution of any issues you have identified.

30. **LO.2** In 2015, Roger pays a \$3,000 premium for high-deductible medical insurance for him and his family. In addition, he contributed \$2,600 to a Health Savings Account.
- How much may Roger deduct if he is self-employed? Is the deduction *for* AGI or *from* AGI?
 - How much may Roger deduct if he is an employee? Is the deduction *for* AGI or *from* AGI?
31. **LO.3** Alicia sold her personal residence to Rick on June 30 for \$300,000. Before the sale, Alicia paid the real estate tax of \$4,380 for the calendar year. For income tax purposes, the deduction is apportioned as follows: \$2,160 to Alicia and \$2,220 to Rick. What is Rick's basis in the residence?
32. **LO.4** Norma, who uses the cash method of accounting, lives in a state that imposes an income tax. In April 2015, she files her state income tax return for 2014 and pays an additional \$1,000 in state income taxes. During 2015, her withholdings for state income tax purposes amount to \$7,400, and she pays estimated state income tax of \$700. In April 2016, she files her state income tax return for 2015, claiming a refund of \$1,800. Norma receives the refund in August 2016.
- Assuming that Norma itemized deductions in 2015, how much may she claim as a deduction for state income taxes on her Federal return for calendar year 2015 (filed April 2016)?
 - Assuming that Norma itemized deductions in 2015, how will the refund of \$1,800 that she received in 2016 be treated for Federal income tax purposes?
 - Assume that Norma itemized deductions in 2015 and that she elects to have the \$1,800 refund applied toward her 2016 state income tax liability. How will the \$1,800 be treated for Federal income tax purposes?
 - Assuming that Norma did not itemize deductions in 2015, how will the refund of \$1,800 received in 2016 be treated for Federal income tax purposes?
33. **LO.5** In 2006, Liam, who is single, purchased a personal residence for \$340,000 and took out a mortgage of \$200,000 on the property. In May of the current year, when the residence had a fair market value of \$440,000 and Liam owed \$140,000 on the mortgage, he took out a home equity loan for \$220,000. He used the funds to purchase a recreational vehicle, which he uses 100% for personal use. What is the maximum amount on which Liam can deduct home equity interest?
34. **LO.5** Malcolm owns 60% and Buddy owns 40% of Magpie Corporation. On July 1, 2015, each lends the corporation \$30,000 at an annual interest rate of 10%. Malcolm and Buddy are not related. Both shareholders are on the cash method of accounting, and Magpie Corporation is on the accrual method. All parties use the calendar year for tax purposes. On June 30, 2016, Magpie repays the loans of \$60,000 together with the specified interest of \$6,000.
- How much of the interest can Magpie Corporation deduct in 2015? In 2016?
 - When is the interest included in Malcolm and Buddy's gross income?
35. **LO.6** Nadia donates \$4,000 to Eastern University's athletic department. The payment guarantees that Nadia will have preferred seating near the 50-yard line.
- Assume that Nadia subsequently buys four \$100 game tickets. How much can she deduct as a charitable contribution to the university's athletic department?
 - Assume that Nadia's \$4,000 donation includes four \$100 tickets. How much can she deduct as a charitable contribution to the university's athletic department?
36. **LO.6** Liz had AGI of \$130,000 in 2015. She donated Bluebird Corporation stock with a basis of \$10,000 to a qualified charitable organization on July 5, 2015.

- a. What is the amount of Liz’s deduction assuming that she purchased the stock on December 3, 2014, and the stock had a fair market value of \$17,000 when she made the donation?
 - b. Assume the same facts as in (a), except that Liz purchased the stock on July 1, 2012.
 - c. Assume the same facts as in (a), except that the stock had a fair market value of \$7,500 (rather than \$17,000) when Liz donated it to the charity.
37. **LO.6** During the year, Ricardo made the following contributions to a qualified public charity:

Cash	\$220,000
Stock in Seagull, Inc. (a publicly traded corporation)	280,000

Ricardo acquired the stock in Seagull, Inc., as an investment five years ago at a cost of \$120,000. Ricardo’s AGI is \$840,000.

- a. What is Ricardo’s charitable contribution deduction?
 - b. How are excess amounts, if any, treated?
38. **LO.6** Ramon had AGI of \$180,000 in 2015. He is considering making a charitable contribution this year to the American Heart Association, a qualified charitable organization. Determine the current allowable charitable contribution deduction in each of the following independent situations, and indicate the treatment for any amount that is not deductible currently.
- a. A cash gift of \$95,000.
 - b. A gift of OakCo stock worth \$95,000 on the contribution date. Ramon had acquired the stock as an investment two years ago at a cost of \$84,000.
 - c. A gift of a painting worth \$95,000 that Ramon purchased three years ago for \$60,000. The charity has indicated that it would sell the painting to generate cash to fund medical research.
39. **LO.6** On December 27, 2015, Roberta purchased four tickets to a charity ball sponsored by the city of San Diego for the benefit of underprivileged children. Each ticket cost \$200 and had a fair market value of \$35. On the same day as the purchase, Roberta gave the tickets to the minister of her church for personal use by his family. At the time of the gift of the tickets, Roberta pledged \$4,000 to the building fund of her church. The pledge was satisfied by a check dated December 31, 2015, but not mailed until January 3, 2016.
- a. Presuming that Roberta is a cash basis and calendar year taxpayer, how much can she deduct as a charitable contribution for 2015?
 - b. Would the amount of the deduction be any different if Roberta was an accrual basis taxpayer? Explain.
40. **LO.6, 9** In December of each year, Eleanor Young contributes 10% of her gross income to the United Way (a 50% organization). Eleanor, who is in the 28% marginal tax bracket, is considering the following alternatives for satisfying the contribution.

Decision Making

Decision Making
Communications

	Fair Market Value
(1) Cash donation	\$23,000
(2) Unimproved land held for six years (\$3,000 basis)	23,000
(3) Blue Corporation stock held for eight months (\$3,000 basis)	23,000
(4) Gold Corporation stock held for two years (\$28,000 basis)	23,000

Eleanor has asked you to help her decide which of the potential contributions listed above will be most advantageous taxwise. Evaluate the four alternatives, and write a letter to Eleanor to communicate your advice to her. Her address is 2622 Bayshore Drive, Berkeley, CA 94709.

**Decision Making
Communications**

41. **LO.2, 3, 4, 5, 7, 9** Bart and Elizabeth Forrest, both age 47, are married and have no dependents. They have asked you to advise them whether they should file jointly or separately in 2015. They present you with the following information:

	Bart	Elizabeth	Joint
Salary	\$38,000		
Business net income		\$110,000	
Interest income	400	1,200	\$2,200
Deductions for AGI	2,400	14,000	
Medical expenses	10,427	3,358	
State income tax	800	1,800	
Real estate tax			3,800
Mortgage interest			4,200
Unreimbursed employee expenses	1,200		

If they file separately, Bart and Elizabeth will split the real estate tax and mortgage interest deductions equally. Write Bart and Elizabeth a letter in which you make and explain a recommendation on filing status for 2015. Bart and Elizabeth reside at 2003 Highland Drive, Durham, NC 27707.

42. **LO.2, 3, 4, 5, 6, 7, 8** Evan, age 61, is single and has AGI of \$277,300 in 2015. His potential itemized deductions before any limitations for the year total \$52,300 and consist of the following:

Medical expenses (before the 10%-of-AGI limitation)	\$28,000
Interest on home mortgage	8,700
State income taxes	9,500
Real estate taxes	3,600
Charitable contributions	2,500

After all necessary adjustments are made, what is the amount of itemized deductions Evan may claim?

43. **LO.2, 3, 4, 5, 6, 7, 8** Linda, age 37, who files as a single taxpayer, had AGI of \$280,000 for 2015. She incurred the following expenses and losses during the year:

Medical expenses (before the 10%-of-AGI limitation)	\$33,000
State and local income taxes	4,500
State sales tax	1,300
Real estate taxes	4,000
Home mortgage interest	5,000
Automobile loan interest	750
Credit card interest	1,000
Charitable contributions	7,000
Casualty loss (before 10% limitation but after \$100 floor)	34,000
Unreimbursed employee expenses subject to the 2%-of-AGI limitation	7,600

Calculate Linda's allowable itemized deductions for the year.

44. **LO.2, 3, 4, 5, 6, 7, 8** For calendar year 2015, Stuart and Pamela Gibson file a joint return reflecting AGI of \$350,000. Their itemized deductions are as follows:

Casualty loss after \$100 floor (not covered by insurance)	\$48,600
Home mortgage interest	19,000
Credit card interest	800
Property taxes on home	16,300
Charitable contributions	28,700
State income tax	18,000
Tax return preparation fees	1,200

Calculate the amount of itemized deductions the Gibsons may claim for the year.

Cumulative Problems



45. Alice J. and Bruce M. Byrd are married taxpayers who file a joint return. Their Social Security numbers are 123-45-6789 and 111-11-1111, respectively. Alice's birthday is September 21, 1967, and Bruce's is June 27, 1966. They live at 473 Revere Avenue, Lowell, MA 01850. Alice is the office manager for Lowell Dental Clinic, 433 Broad Street, Lowell, MA 01850 (employer identification number 98-7654321). Bruce is the manager of a Super Burgers fast-food outlet owned and operated by Plymouth Corporation, 1247 Central Avenue, Hauppauge, NY 11788 (employer identification number 11-1111111).

Tax Return Problem
Decision Making



The following information is shown on their Wage and Tax Statements (Form W-2) for 2014.

Line	Description	Alice	Bruce
1	Wages, tips, other compensation	\$58,000	\$62,100
2	Federal income tax withheld	4,500	6,300
3	Social Security wages	58,000	62,100
4	Social Security tax withheld	3,596	3,850
5	Medicare wages and tips	58,000	62,100
6	Medicare tax withheld	841	900
15	State	Massachusetts	Massachusetts
16	State wages, tips, etc.	58,000	62,100
17	State income tax withheld	2,950	3,100

The Byrds provide over half of the support of their two children, Cynthia (born January 25, 1990, Social Security number 123-45-6788) and John (born February 7, 1994, Social Security number 123-45-6786). Both children are full-time students and live with the Byrds except when they are away at college. Cynthia earned \$4,200 from a summer internship in 2014, and John earned \$3,800 from a part-time job.

During 2014, the Byrds provided 60% of the total support of Bruce's widower father, Sam Byrd (born March 6, 1938, Social Security number 123-45-6787). Sam lived alone and covered the rest of his support with his Social Security benefits. Sam died in November, and Bruce, the beneficiary of a policy on Sam's life, received life insurance proceeds of \$800,000 on December 28.

The Byrds had the following expenses relating to their personal residence during 2014:

Property taxes	\$5,000
Qualified interest on home mortgage	8,700
Repairs to roof	5,750
Utilities	4,100
Fire and theft insurance	1,900

The Byrds had the following medical expenses for 2014:

Medical insurance premiums	\$4,500
Doctor bill for Sam incurred in 2013 and not paid until 2014	7,600
Operation for Sam	8,500
Prescription medicines for Sam	900
Hospital expenses for Sam	3,500
Reimbursement from insurance company, received in 2014	3,600

The medical expenses for Sam represent most of the 60% that Bruce contributed toward his father's support.

Other relevant information follows:

- When they filed their 2013 state return in 2014, the Byrds paid additional state income tax of \$900.
- During 2014, Alice and Bruce attended a dinner dance sponsored by the Lowell Police Disability Association (a qualified charitable organization). The Byrds paid \$300 for the tickets. The cost of comparable entertainment would normally be \$50.
- The Byrds contributed \$5,000 to Lowell Presbyterian Church and gave used clothing (cost of \$1,200 and fair market value of \$350) to the Salvation Army. All donations are supported by receipts, and the clothing is in very good condition.
- In 2014, the Byrds received interest income of \$2,750, which was reported on a Form 1099-INT from Second National Bank.
- Alice's employer requires that all employees wear uniforms to work. During 2014, Alice spent \$850 on new uniforms and \$566 on laundry charges.
- Bruce paid \$400 for an annual subscription to the *Journal of Franchise Management* and \$741 for annual membership dues to his professional association.
- Neither Alice's nor Bruce's employer reimburses for employee expenses.
- The Byrds do not keep the receipts for the sales taxes they paid and had no major purchases subject to sales tax.
- All members of the Byrd family had health insurance coverage for all of 2014.
- Alice and Bruce paid no estimated Federal income tax. Neither Alice nor Bruce wants to designate \$3 to the Presidential Election Campaign Fund.

Part 1—Tax Computation

Compute net tax payable or refund due for Alice and Bruce Byrd for 2014. If they have overpaid, they want the amount to be refunded to them. If you use tax forms for your computations, you will need Forms 1040 and 2106 and Schedules A and B. Suggested software: H&R BLOCK At Home.

Part 2—Tax Planning

Alice and Bruce are planning some significant changes for 2015. They have provided you with the following information and asked you to project their taxable income and tax liability for 2015.

The Byrds will invest the \$800,000 of life insurance proceeds in short-term certificates of deposit (CDs) and use the interest for living expenses during 2015. They expect to earn total interest of \$32,000 on the CDs.

Bruce has been promoted to regional manager, and his salary for 2015 will be \$88,000. He estimates that state income tax withheld will increase by \$4,000 and the Social Security tax withheld will be \$5,456.

Alice, who has been diagnosed with a serious illness, will take a leave of absence from work during 2015. The estimated cost for her medical treatment is \$15,400, of which \$6,400 will be reimbursed by their insurance company in 2015. Their medical insurance premiums will increase to \$9,769. Property taxes on their residence are expected to increase to \$5,100. The Byrds' home mortgage interest expense and charitable contributions are expected to be unchanged from 2014.

John will graduate from college in December 2014 and will take a job in New York City in January 2015. His starting salary will be \$46,000.

Assume that all of the information reported in 2014 will be the same in 2015 unless other information has been presented above.

46. Paul and Donna Decker are married taxpayers, ages 44 and 42, respectively, who file a joint return for 2015. The Deckers live at 1121 College Avenue, Carmel, IN 46032. Paul is an assistant manager at Carmel Motor Inn, and Donna is a teacher at Carmel Elementary School. They present you with W-2 forms that reflect the following information:

Tax Computation Problem

	Paul	Donna
Salary	\$68,000	\$56,000
Federal tax withheld	6,770	6,630
State income tax withheld	900	800
FICA (Social Security and Medicare) withheld	5,202	4,284
Social Security numbers	111-11-1111	123-45-6789

Donna is the custodial parent of two children from a previous marriage who reside with the Deckers through the school year. The children, Larry and Jane Parker, reside with their father, Bob, during the summer. Relevant information for the children follows:

	Larry	Jane
Age	17	18
Social Security numbers	123-45-6788	123-45-6787
Months spent with Deckers	9	9

Under the divorce decree, Bob pays child support of \$150 per month per child during the nine months the children live with the Deckers. Bob says that he spends \$200 per month per child during the three summer months they reside with him. Donna and Paul can document that they provide \$2,000 support per child per year. The divorce decree is silent as to which parent can claim the exemptions for the children.

In August, Paul and Donna added a suite to their home to provide more comfortable accommodations for Hannah Snyder (123-45-6786), Donna's mother, who had moved in with them in February 2014 after the death of Donna's father. Not wanting to borrow money for this addition, Paul sold 300 shares of Acme Corporation stock for \$50 per share on May 3, 2015, and used the proceeds of \$15,000 to cover construction costs. The Deckers had purchased the stock on April 29, 2010, for \$25 per share. They received dividends of \$750 on the jointly owned stock a month before the sale.

Hannah, who is 66 years old, received \$7,500 in Social Security benefits during the year, of which she gave the Deckers \$2,000 to use toward household expenses and deposited the remainder in her personal savings account. The Deckers determine that they have spent \$2,500 of their own money for food, clothing, medical expenses, and other items for Hannah. They do not know what the rental value of Hannah's suite would be, but they estimate it would be at least \$300 per month.

Interest paid during the year included the following:

Home mortgage interest (paid to Carmel Federal Savings & Loan)	\$7,890
Interest on an automobile loan (paid to Carmel National Bank)	1,660
Interest on Citibank Visa card	620

In July, Paul hit a submerged rock while boating. Fortunately, he was uninjured after being thrown from the boat and landing in deep water. However, the boat, which was uninsured, was destroyed. Paul had paid \$25,000 for the boat in June 2014, and its value was appraised at \$18,000 on the date of the accident.

The Deckers paid doctor and hospital bills of \$10,700 and were reimbursed \$2,000 by their insurance company. They spent \$640 for prescription drugs and medicines and \$5,904 for premiums on their health insurance policy. They have filed additional claims of \$1,200 with their insurance company and have been told they will receive payment for that amount in January 2016. Included in the amounts paid for doctor and hospital bills were payments of \$380 for Hannah and \$850 for the children. All members of the Decker family had health insurance coverage for all of 2015.

Additional information of potential tax consequence follows:

Real estate taxes paid	\$3,850
Sales taxes paid (per table)	1,379
Contributions to church	1,950
Appraised value of books donated to public library	740
Paul's unreimbursed employee expenses to attend hotel management convention:	
Airfare	340
Hotel	170
Meals	95
Registration fee	340
Refund of state income tax for 2014 (the Deckers itemized on their 2014 Federal tax return)	1,520

Compute net tax payable or refund due for the Deckers for 2015. Ignore the child tax credit in your computations. If the Deckers have overpaid, the amount is to be credited toward their taxes for 2016.

Research Problems

THOMSON REUTERS

CHECKPOINT
Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Jane suffers from a degenerative spinal disorder. Her physician said that swimming could help prevent the onset of permanent paralysis and recommended the installation of a swimming pool at her residence for her use. Jane's residence had a market value of approximately \$500,000 before the swimming pool was installed. The swimming pool was built, and an appraiser estimated that the value of Jane's home increased by \$98,000 because of the addition.

The pool cost \$194,000, and Jane claimed a medical expense deduction of \$96,000 (\$194,000 – \$98,000) on her tax return. Upon audit of the return, the IRS determined that an adequate pool should have cost \$70,000 and would increase the value of her home by only \$31,000. Thus, the IRS claims that Jane is entitled to a deduction of only \$39,000 (\$70,000 – \$31,000).

- Is there any ceiling limitation on the amount deductible as a medical expense? Explain.
- Can capital expenditures be deductible as medical expenses? Explain.
- What is the significance of a "minimum adequate facility"? Should aesthetic or architectural qualities be considered in the determination? Why or why not?

Research Problem 2. Ken and Mary Jane Blough, your neighbors, have asked you for advice after receiving correspondence in the mail from the IRS. You learn that the IRS is asking for documentation in support of the itemized deductions the Bloughs claimed on a recent tax return. The Bloughs tell you that their income in the year of question was \$75,000. Because their record-keeping habits are poor, they felt justified in claiming itemized deductions equal to the amounts that represent the average claimed by other taxpayers in their income bracket. These averages are calculated and reported by the IRS annually based on actual returns filed in an earlier year. Accordingly, they claimed medical expenses of \$7,102, taxes of \$6,050, interest of \$10,659, and charitable contributions of \$2,693. What advice do you give the Bloughs?

Partial list of research aids:

Cheryl L. de Werff, T.C. Summary Opinion, 2011–29.

Research Problem 3. Marcia, a shareholder in a corporation with stores in five states, donated stock with a basis of \$10,000 to a qualified charitable organization in 2014. Although the stock of the corporation was not traded on a public stock exchange, many shares had been sold over the past several years. Based on the average selling price for the stock in 2014, Marcia deducted \$95,000 on her 2014 tax return. Marcia received a notice from the IRS that the \$95,000 deduction had been reduced to \$10,000 because she had not obtained a qualified appraisal or attached a summary of her appraisal to her tax return. Marcia has asked you to advise her on this matter. Write a letter containing your conclusions to Ms. Marcia Meyer, 1311 Santos Court, San Bruno, CA 94066.

Partial list of research aids:

Reg. § 1.170A–13(c)(2).

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. The cutback adjustment that limits the amount of itemized deductions for some taxpayers is otherwise known as the Pease limitation. This limitation is named after former Congressman Donald Pease and was first in effect for tax years after December 31, 1990. The purpose of this limitation is to raise additional tax revenue by limiting some popular and common itemized deductions incurred by high-income taxpayers. One such deduction is the charitable contribution deduction. Search Google or a business press database to see what tax law analysts speculated the consequences would be of limiting charitable contribution deductions. Also determine whether such speculation has materialized.

Research Problem 5. Use the IRS's website to determine if taxpayers who are not U.S. residents can claim itemized deductions when calculating their taxable income.

Communications



Internet Activity

Roger CPA Review Questions

- Kellye, a teacher, volunteers for eight hours per week at a school for high-risk children, a qualified charitable organization. Kellye's normal rate for teaching is \$30 per hour. Kellye's out-of-pocket costs in 20X4 were \$250 for supplies, and she spent \$20 each week in transportation getting to-and-from the school. Kellye had no cash contributions to charity in 20X4. If Kellye volunteered every week in 20X4, what is her charitable contributions deduction?
 - \$0
 - \$250
 - \$1,290
 - \$13,770

2. Aaron, age 55, has an adjusted gross income in 20X4 of \$30,000. His expenses are as follows:

Non-prescription medicine	\$ 100
Prescription medicine	500
Doctor visits	500
Weekly meal preparation for a diet plan	2,000
Removal of a benign facial mole	400
Contact lenses	500
Eyeglasses	200
Dental services	300

What is Aaron's itemized deduction for medical expenses?

- a. \$0
b. \$1,500
c. \$2,000
d. \$4,500
3. Which of the following deductions for taxes paid may be taken in the same year?
- Real estate taxes, state income taxes, state sales taxes.
 - Real estate taxes, property taxes, state income taxes.
 - Property taxes, state income taxes, state sales taxes.
 - Real estate taxes, property taxes, state income taxes, state sales taxes.
4. Zunilda is 77-year-old individual with an AGI of \$25,000 in 2014. She began living in a nursing home in 2014 upon the recommendation of her primary care physician in order to receive medical care for a specific condition. She had the following unreimbursed expenses in 2014:

Expense	Amount
Nursing home health care costs	\$5,000
Nursing home meal and lodging costs	8,000
Prescription drugs	1,500

As a result of these unreimbursed expenses, how much may Zunilda deduct from AGI on her 2014 tax return? Assume Zunilda elects to itemize deductions.

- a. \$12,000
b. \$4,000
c. \$12,625
d. \$4,625

Investor Losses

LEARNING OBJECTIVES: *After completing Chapter 11, you should be able to:*

- | | |
|--|---|
| <p>LO.1 Explain the tax shelter problem and the reasons for at-risk and passive loss limitations.</p> <p>LO.2 Explain the at-risk limitation.</p> <p>LO.3 Describe how the passive loss rules limit deductions for losses and identify the taxpayers subject to these restrictions.</p> <p>LO.4 Explore the elements required for an activity to be treated as passive and review the rules for identifying an activity.</p> <p>LO.5 Identify the tests for material participation.</p> <p>LO.6 Describe the nature of rental activities under the passive loss rules.</p> | <p>LO.7 Determine the relationship between the at-risk and passive loss limitations.</p> <p>LO.8 Recognize the special treatment available to real estate activities.</p> <p>LO.9 Determine the proper tax treatment upon the disposition of a passive activity.</p> <p>LO.10 Identify restrictions placed on the deductibility of other investor losses and deductions, including those that apply to investment interest.</p> <p>LO.11 Suggest tax planning strategies to minimize the effect of the passive loss and investment interest limitations and recognize the general impact of the surtax on net investment income.</p> |
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CHAPTER OUTLINE

- | | |
|--|---|
| <p>11-1 The Tax Shelter Problem, 11-2</p> <p>11-2 At-Risk Limits, 11-4</p> <p>11-3 Passive Loss Limits, 11-5</p> <p>11-3a Classification and Impact of Passive Income and Losses, 11-5</p> <p>11-3b Taxpayers Subject to the Passive Loss Rules, 11-10</p> <p>11-3c Working with the Definition of Passive Activities, 11-11</p> <p>11-3d Interaction of the At-Risk and Passive Loss Limits, 11-16</p> <p>11-3e Special Passive Activity Rules for Real Estate Activities, 11-18</p> <p>11-3f Dispositions of Passive Interests, 11-21</p> | <p>11-4 Investment Interest Limitation, 11-23</p> <p>11-4a Limitation Imposed, 11-23</p> <p>11-4b Computation of Allowable Deduction, 11-24</p> <p>11-5 Other Investment Losses, 11-24</p> <p>11-6 Tax Planning, 11-25</p> <p>11-6a Utilizing Passive Losses, 11-25</p> <p>11-6b Planning with Investment Interest Limitation, 11-27</p> <p>11-6c Effect of Medicare Contribution Surtax on Net Investment Income, 11-27</p> |
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THE BIG PICTURE

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INVESTOR LOSS LIMITATIONS AFFECT THE VIABILITY OF CERTAIN INVESTMENT OPPORTUNITIES

Trudy and Jim Reswick are considering ways to enhance their financial security. In fact, they are willing to borrow a substantial sum so that they can make an appropriate investment.

Currently, Trudy and Jim's sole source of income is their salaries, totaling \$100,000, from their full-time jobs. Their most significant asset is their personal residence (fair market value of \$500,000 with a mortgage of \$350,000). The Reswicks' broker suggests that they borrow \$100,000 at 8 percent and use the proceeds to make *one* of the following investments:

- A high-growth, low-yield portfolio of marketable securities. The portfolio's value is expected to grow 10 percent each year.
- An interest in a limited partnership that owns and operates orange groves in Florida. The limited partnership interest is expected to generate tax losses of \$25,000 in each of the next five years, after which profits are expected. The broker predicts that after taking into account the tax benefit from the losses, the Reswicks would average an annual 10 percent return over a 10-year period.
- An interest in a local limited partnership that owns and rents apartments to college students. This limited partnership interest also would generate losses of \$25,000 per year for five years, after which profits would follow. These expected profits and losses would produce an average annual total return of 10 percent over a 10-year period.

Trudy and Jim want to choose the alternative that produces the best after-tax return over a 10-year planning horizon. They are aware, however, that tax restrictions may limit the advantages of some of these investment options. In this connection, evaluate each option.

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>)	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income.....	<u>(x,xxx)</u>

FORM 1040 (p. 1)

- 12** Business income or (loss). Attach Schedule C or C-EZ
- 13** Capital gain or (loss). Attach Schedule D if required. If not required, check here ►
- 14** Other gains or (losses). Attach Form 4797
- 17** Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E

Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)

FORM 1040 (p. 2)

- 40** **Itemized deductions** (from Schedule A) or your **standard deduction** (see left margin) . . .

Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>
Tax due (<i>or refund</i>)	<u>\$ xxx</u>

As discussed in Chapter 6, a tax deduction for an expense or a loss is not allowed unless specifically provided for by Congress. For example, losses can be recognized and deducted in the case of certain unprofitable investments only because the Code so provides. Such losses can arise from the operation of an activity or upon its ultimate disposition. For most individual taxpayers, deductible investor losses come within the scope of § 165(c)(2) relating to transactions entered into for profit.¹ But what happens if the investment is mostly motivated by the tax loss it generates and the profit objective is not controlling? Or what if the investment generates expenses that offset ordinary income and it later is expected to produce appreciation taxed at capital gain rates? This chapter addresses these tax minimization procedures and the Code provisions enacted to restrict their use.

LO.1
Explain the tax shelter problem and the reasons for at-risk and passive loss limitations.

11-1 THE TAX SHELTER PROBLEM

Before Congress enacted legislation to reduce their effectiveness, **tax shelters** provided a popular way to avoid or defer taxes, as they could generate deductions and other benefits to offset income from other sources. Because of the tax avoidance potential of many tax shelters, they were attractive to wealthy taxpayers in high-income tax brackets. Many tax shelters merely provided an opportunity for “investors” to buy deductions and credits in ventures that were not expected to generate a profit, even in the long run.

¹If the losses are incurred in connection with a trade or business, § 165(c)(1) applies.

Although it may seem odd that a taxpayer would intentionally invest in an activity that was designed to produce losses, there is a logical explanation. The typical tax shelter operated as a partnership and relied heavily on nonrecourse financing.² Accelerated depreciation and interest expense deductions generated large losses in the early years of the activity. At the very least, the tax shelter deductions deferred the recognition of any net income from the venture until the activity was sold. In the best of situations, the investor could realize additional tax savings by offsetting other income (e.g., salary, interest, dividends) with deductions flowing from the tax shelter. Ultimately, the sale of the investment would result in capital gain. The following example illustrates what was possible *before* Congress enacted legislation to curb tax shelter abuses.

Bob, who earned a salary of \$400,000 as a business executive and dividend income of \$15,000, invested \$20,000 for a 10% interest in a cattle-breeding tax shelter. Through the use of \$800,000 of nonrecourse financing and available cash of \$200,000, the partnership acquired a herd of an exotic breed of cattle costing \$1 million. Depreciation, interest, and other deductions related to the activity resulted in a loss of \$400,000, of which Bob's share was \$40,000. Bob was allowed to deduct the \$40,000 loss even though he had invested and stood to lose only \$20,000 if the investment became worthless. The net effect of the \$40,000 deduction from the partnership was that a portion of Bob's salary and dividend income was "sheltered," and as a result, he was required to calculate his tax liability on only \$375,000 of income [\$415,000 (salary and dividends) – \$40,000 (deduction)] rather than \$415,000. If this deduction were available under current law and if Bob was in a combined Federal and state income tax bracket of 40%, this deduction would generate a tax savings of \$16,000 ($\$40,000 \times 40\%$) in the first year alone!

EXAMPLE

1

A review of Example 1 shows that the taxpayer took a *two-for-one* write-off (\$40,000 deduction, \$20,000 amount invested). In the heyday of these types of tax shelters, promoters often promised tax deductions for the investor well in excess of the amount invested.

The first major provision aimed at tax shelters was the **at-risk limitation**. Its objective is to limit a taxpayer's deductions to the amount "at risk," which is the amount the taxpayer stands to lose if the investment becomes worthless. Thus, in Example 1, the at-risk rule limits Bob's loss to \$20,000—the amount at risk.

The second major attack on tax shelters came with the passage of the **passive loss** rules. The passive loss rules require the taxpayer to segregate all income and losses into three categories: active, portfolio, and passive. (These categories are defined in Section 11-3.) In general, the passive loss limits disallow the deduction of passive losses against active or portfolio income even when the taxpayer is at risk to the extent of the loss. In general, passive losses can only offset passive income.

Thus, in Example 1, the passive loss rules disallow a current deduction for any of the loss. The loss from the tax shelter is a passive loss because Bob does not materially participate in the activity. Therefore, the \$20,000 loss that is allowed under the at-risk rules is disallowed under the passive loss rules because Bob does not report any passive income for the year—he reports only active and portfolio income. Consequently, Bob's current-year income must reflect his nonpassive income of \$415,000. As explained later in the chapter, the disallowed \$20,000 passive loss is suspended and may be deducted in a future year under certain conditions.

The nature of the at-risk limits and the passive activity loss rules and their impact on investors are discussed in the pages that follow. An interesting consequence of these

²Nonrecourse debt is an obligation for which the borrower is not personally liable. An example of nonrecourse debt is a liability on real estate acquired by a partnership without the partnership or any of the partners assuming

any liability for the mortgage. The acquired property generally is pledged as collateral for the loan.

rules is that now investors evaluating potential investments must consider mainly the economics of the venture instead of the tax benefits or tax avoidance possibilities that an investment may generate.

LO.2

Explain the at-risk limitation.

11-2 AT-RISK LIMITS

The at-risk provisions limit the deductibility of losses from business and income-producing activities. These provisions, which apply to individuals and closely held corporations, are designed to prevent taxpayers from deducting losses in excess of their actual economic investment in an activity. In the case of an S corporation or a partnership, the at-risk limits apply at the owner level. Under the at-risk rules, a taxpayer's deductible loss from an activity for any taxable year is limited to the amount the taxpayer has at risk at the end of the taxable year (the amount the taxpayer could actually lose in the activity).

While the amount at risk generally vacillates over time, the initial amount considered at risk consists of the following:³

- The amount of cash and the adjusted basis of property contributed to the activity by the taxpayer.
- Amounts borrowed for use in the activity for which the taxpayer is personally liable or has pledged as security property not used in the activity.

This amount generally is increased each year by the taxpayer's share of income and is decreased by the taxpayer's share of deductible losses and withdrawals from the activity. In addition, because general partners are jointly and severally liable for recourse debts of the partnership, their at-risk amounts are increased when the partnership increases its debt and are decreased when the partnership reduces its debt. However, a taxpayer generally is not considered at risk with respect to borrowed amounts if either of the following is true:

- The taxpayer is not personally liable for repayment of the debt (e.g., nonrecourse debt).
- The lender has an interest (other than as a creditor) in the activity.

An important exception provides that in the case of an activity involving the holding of real property, a taxpayer is considered at risk for his or her share of any *qualified nonrecourse financing* that is secured by real property used in the activity.⁴

Subject to the passive activity rules discussed later in the chapter, a taxpayer may deduct a loss as long as the at-risk amount is positive. However, once the at-risk amount is exhausted, any remaining loss cannot be deducted until a later year. Any losses disallowed for any given taxable year by the at-risk rules may be deducted in the first succeeding year in which the rules do not prevent the deduction—that is, when there is, and to the extent of, a positive at-risk amount.

The Big Picture

EXAMPLE

2

Return to the facts of *The Big Picture* on p. 11-1. In addition to the three investment options presented to the Reswicks, in 2015, they invest \$40,000 in an oil partnership that incurs a first-year net loss, of which \$60,000 is their share. Assume that the Reswicks' interest in the partnership is subject to the at-risk limits but is not subject to the passive loss limits. Because the Reswicks have only \$40,000 of capital at risk, they cannot deduct more than \$40,000 against their other income and must reduce their at-risk amount to zero (\$40,000 at-risk amount – \$40,000 loss deducted). The nondeductible loss of \$20,000 (\$60,000 loss generated – \$40,000 loss allowed) can be carried over to 2016.

³§ 465(b)(1).

⁴Section 465(b)(6) defines qualified nonrecourse financing.

The Big Picture

In 2016, the Reswicks in the preceding example have taxable income of \$15,000 from the oil partnership and invest an additional \$10,000 in the venture. Their at-risk amount is now \$25,000 (\$0 beginning balance + \$15,000 taxable income + \$10,000 additional investment). This enables them to deduct the carryover loss and requires them to reduce their at-risk amount to \$5,000 (\$25,000 at-risk amount – \$20,000 carryover loss allowed).

EXAMPLE

3

Complicating the at-risk rule is the fact that previously allowed losses must be recaptured to the extent the at-risk amount is reduced below zero.⁵ That is, previous losses that were allowed must be offset by the recognition of enough income to bring the at-risk amount up to zero. This rule applies in situations such as those when the amount at risk is reduced below zero by distributions to the taxpayer or when the status of indebtedness changes from recourse to nonrecourse.

Calculation of at-risk amount is reviewed in Concept Summary 11.1.



Concept Summary 11.1

Calculation of At-Risk Amount

Increases to a taxpayer's at-risk amount:

- Cash and the adjusted basis of property contributed to the activity.
- Amounts borrowed for use in the activity for which the taxpayer is personally liable or has pledged as security property not used in the activity.
- Taxpayer's share of amounts borrowed for use in the activity that are qualified nonrecourse financing.
- Taxpayer's share of the activity's income.

Decreases to a taxpayer's at-risk amount:

- Withdrawals from the activity.
- Taxpayer's share of the activity's deductible loss.
- Taxpayer's share of any reductions of debt for which recourse against the taxpayer exists or any reductions of qualified nonrecourse debt.

11-3 PASSIVE LOSS LIMITS

This section identifies and explains a number of key issues that are pertinent when applying the passive loss limits.

- The limits apply only to passive losses incurred by certain types of taxpayers.
- Losses are limited under these rules only if they are generated by a passive activity.
- Special rules exist for interests in real estate activities.
- Benefits may arise when a disposition of a passive activity occurs.

LO.3

Describe how the passive loss rules limit deductions for losses and identify the taxpayers subject to these restrictions.

11-3a Classification and Impact of Passive Income and Losses

The passive loss rules operate by requiring taxpayers to classify their income and losses into various categories. Then the rules limit the extent to which losses in the passive category can be used to offset income in the other categories.

⁵§ 465(e).



TAX IN THE NEWS “Passive” under the Tax Law May Not Be “Passive” in the Real World

As the real estate market continues to strengthen from the economic depths of several years ago, more Americans are interested in buying and managing rental property as a sideline. Many such investors quickly learn that holding rental property invariably is more involved than simply collecting rent every month.

Managing rental property can be a time-consuming business venture. Screening potential renters, routinely maintaining and upgrading the property, managing the books and accounting records, and responding to calls from the

renters at any hour of the day or night concerning property issues are but a few of the tasks that rental property owners face regularly.

Then at the end of the year when the tax preparer mentions to the taxpayer that the rental property is a passive activity, the taxpayer is mystified by the disconnect between reality and the terminology of the tax law. But the more significant sting may arise from the application of the passive loss restrictions that apply under the tax law.

Classification

The passive loss rules require income and losses to be classified into one of three categories: active, portfolio, or passive. **Active income** includes the following:

- Wages, salary, commissions, bonuses, and other payments for services rendered by the taxpayer.
- Profit from a trade or business in which the taxpayer is a material participant.
- Gain on the sale or other disposition of assets used in an active trade or business.
- Income from intangible property if the taxpayer’s personal efforts significantly contributed to the creation of the property.

Portfolio income includes the following:

- Interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business.
- Gain or loss from the disposition of property that produces portfolio income or is held for investment purposes.

Section 469 provides that passive income or loss arises from activities that are treated as passive, which include:

- Any trade or business or income-producing activity in which the taxpayer does not materially participate.
- Subject to certain exceptions, all rental activities, whether the taxpayer materially participates or not.

Although the Code defines rental activities as passive activities, several exceptions allow losses from certain real estate rental activities to offset nonpassive (active or portfolio) income. These exceptions are discussed under Special Passive Activity Rules for Real Estate Activities later in the chapter.

General Impact

Losses or expenses generated by passive activities can be deducted only to the extent of income from all of the taxpayer’s passive activities. Any excess may not be used to offset income from active sources or portfolio income. Instead, any unused passive losses are suspended and carried forward to future years to offset passive income generated in those years. Otherwise, suspended losses may be used only when a taxpayer disposes of his or her entire interest in an activity. In that event, all current and suspended losses related to the activity may offset active and portfolio income.

The Big Picture

Return to the facts of *The Big Picture* on p. 11-1. In addition to their salaries of \$100,000 from full-time jobs, assume that the Reswicks receive \$12,000 in dividends and interest from various portfolio investments. Further, assume that they decide to invest \$100,000 in the orange grove limited partnership, which produces a \$25,000 loss for the Reswicks this year. Because their at-risk basis in the partnership is \$100,000, the current \$25,000 loss is not limited by the at-risk rules. However, because the loss is a passive loss, it is not deductible against their other income. The loss is suspended and carried over to the future. If the Reswicks have passive income from this investment or from other passive investments in the future, they can offset the suspended loss against that passive income. If they do not have passive income to offset this suspended loss in the future, they will be allowed to offset the loss against other types of income when they eventually dispose of their investment in the passive activity.

EXAMPLE

4

Impact of Suspended Losses

When a taxpayer disposes of his or her entire interest in a passive activity, the actual economic gain or loss from the investment, including any suspended losses, can finally be determined. As a result, under the passive loss rules, upon a fully taxable disposition, any overall loss realized from the taxpayer's activity is recognized and can be offset against any income.

A fully taxable disposition generally involves a sale of the property to a third party at arm's length and thus, presumably, for a price equal to the property's fair market value. As presented in the following example, a gain recognized upon the transfer of an interest in a passive activity generally is treated as passive and is first offset by the suspended losses from that activity.

Rex sells an apartment building, a passive activity, with an adjusted basis of \$100,000 for \$180,000. In addition, he has suspended losses of \$60,000 associated with the building. His total gain, \$80,000, and his taxable gain, \$20,000, are calculated as follows:

Net sales price	\$ 180,000
Less: Adjusted basis	<u>(100,000)</u>
Total gain	\$ 80,000
Less: Suspended losses	<u>(60,000)</u>
Taxable gain (passive)	<u>\$ 20,000</u>

EXAMPLE

5

If current and suspended losses of the passive activity exceed the gain realized or if the sale results in a realized loss, the amount of

- any loss from the activity for the tax year (including losses suspended in the activity disposed of)

in excess of

- net income or gain for the tax year from all passive activities (without regard to the activity disposed of)

is treated as a loss that is not from a passive activity. In computing the loss from the activity for the year of disposition, any gain or loss recognized is included.

Dean sells an apartment building, a passive activity, with an adjusted basis of \$100,000 for \$150,000. In addition, he has current and suspended losses of \$60,000 associated with the building and has no other passive activities. His total gain of \$50,000 and his deductible loss of \$10,000 are calculated as follows:

EXAMPLE

6

continued

Net sales price	\$ 150,000
Less: Adjusted basis	(100,000)
Total gain	<u>\$ 50,000</u>
Less: Suspended losses	(60,000)
Deductible loss (not passive)	<u><u>(\$ 10,000)</u></u>

The \$10,000 deductible loss is offset against Dean's active and portfolio income. Even if the building is sold for a loss (i.e., the adjusted basis exceeds the sales price), the total loss, including the suspended losses, is deductible as a nonpassive loss.

Carryovers of Suspended Losses

The preceding examples assumed that the taxpayer had an interest in only one passive activity; as a result, the suspended loss was related exclusively to the activity that was disposed of. However, taxpayers often own interests in more than one activity, in which case any suspended losses must be allocated among those passive activities. The allocation to an activity is made by multiplying the disallowed passive activity loss from all activities using the following fraction:

$$\frac{\text{Loss from one passive activity}}{\text{Sum of losses for taxable year from all passive activities having losses}}$$

EXAMPLE

7

Diego has investments in three passive activities with the following income and losses for 2014:

Activity A	(\$30,000)
Activity B	(20,000)
Activity C	<u>25,000</u>
Net passive loss	<u><u>(\$25,000)</u></u>
Net passive loss allocated to:	
Activity A ($\$25,000 \times \$30,000/\$50,000$)	(\$15,000)
Activity B ($\$25,000 \times \$20,000/\$50,000$)	<u>(10,000)</u>
Total suspended losses	<u><u>(\$25,000)</u></u>

Suspended losses are carried over indefinitely and are offset in the future first against any passive income from the activities to which they relate and then against passive income from other passive activities.⁶

EXAMPLE

8

Assume that the facts are the same as in Example 7 and that Activity A produces \$10,000 of income in 2015. Of the suspended loss of \$15,000 from 2014 for Activity A, \$10,000 is offset against the income from this activity. If Diego sells Activity A in early 2016, the remaining \$5,000 suspended loss is used to determine his taxable gain or loss.

Passive Credits

Credits (such as the low-income housing credit and rehabilitation credit—discussed in Chapter 12) that arise from passive activities are limited in much the same way as passive losses. Passive credits can be utilized only against regular tax attributable to passive income,⁷ which is calculated by comparing the tax on all income (including passive income) with the tax on income excluding passive income.

⁶§ 469(b).

⁷§ 469(d)(2).

Sam owes \$50,000 of tax, disregarding net passive income, and \$80,000 of tax, considering both net passive and other taxable income (disregarding the credits in both cases). The amount of tax attributable to the passive income is \$30,000.

EXAMPLE

9

In the preceding example, Sam can claim a maximum of \$30,000 of passive activity credits; the excess credits are carried over. These passive activity credits can be used only against the *regular* tax attributable to passive income. If a taxpayer has a net loss from passive activities during a given year, no credits can be used.

Carryovers of Passive Credits

Tax credits attributable to passive activities can be carried forward indefinitely much like suspended passive losses. Unlike passive losses, however, passive credits are lost forever when the activity is disposed of in a taxable transaction where loss is recognized. Credits are allowed on dispositions only when there is sufficient tax on passive income to absorb them.

Use of Passive Credits upon Disposition of an Activity

Alicia sells a passive activity for a gain of \$10,000. The activity had suspended losses of \$40,000 and suspended credits of \$15,000. The \$10,000 gain is offset by \$10,000 of the suspended losses, and the remaining \$30,000 of suspended losses is deductible against Alicia's active and portfolio income. The suspended credits are lost forever because the sale of the activity did not generate any tax.

EXAMPLE

10

If Alicia in Example 10 had realized a \$100,000 gain on the sale of the passive activity, the suspended credits could have been used to the extent of the regular tax attributable to the net passive income.

Gain on sale	\$100,000
Less: Suspended losses	<u>(40,000)</u>
Taxable gain	<u>\$ 60,000</u>

EXAMPLE

11

If the tax attributable to the taxable gain of \$60,000 is \$15,000 or more, the entire \$15,000 of suspended credits can be used. If the tax attributable to the gain is less than \$15,000, the excess of the suspended credits over the tax attributable to the gain is lost forever.

When a taxpayer has sufficient regular tax liability from passive activities to trigger the use of suspended credits, the credits lose their character as passive credits. They are reclassified as regular tax credits and made subject to the same limits as other credits (discussed in Chapter 12).

Passive Activity Changes to Active

If a formerly passive activity becomes an active one, suspended losses are allowed to the extent of income from the now active business.⁸ If any of the suspended loss remains, it continues to be treated as a loss from a passive activity. The excess suspended loss can be deducted from passive income or carried over to the next tax year and deducted to the extent of income from the now active business in the succeeding year(s). The activity must continue to be the same activity.

⁸§ 469(f).

EXAMPLE

12

Rebecca has owned an interest in a passive activity for several years, which has produced losses of \$80,000 during that period. Because she did not have passive income from other sources, she could not deduct any of the activity's passive losses. In the current year, she becomes a material participant in the activity and her share of the business profits total \$25,000. As a result, she may use \$25,000 of the suspended passive loss to offset the current business profits. Rebecca's remaining suspended passive loss from the activity is \$55,000 (\$80,000 – \$25,000), which is carried over to future years.

11-3b Taxpayers Subject to the Passive Loss Rules

The passive loss rules apply to individuals, estates, trusts, personal service corporations, and closely held C corporations.⁹ Passive income or loss from investments in S corporations or partnerships (see Chapters 21 and 22) flows through to the owners, and the passive loss rules are applied at the owner level.

Personal Service Corporations

Application of the passive loss limitations to personal service corporations is intended to prevent taxpayers from sheltering personal service income by creating personal service corporations and acquiring passive activities at the corporate level.

EXAMPLE

13

Two tax accountants who earn an aggregate of \$200,000 a year in their individual practices agree to work together in a newly formed personal service corporation. Shortly after its formation, the corporation invests in a passive activity that produces a \$200,000 loss during the year. Because the passive loss rules apply to personal service corporations, the corporation may not deduct the \$200,000 passive loss against the \$200,000 of active income.

Determination of whether a corporation is a **personal service corporation** is based on rather broad definitions. A personal service corporation is a regular (or C) corporation that meets *both* of the following conditions:

- The principal activity is the performance of personal services.
- Such services are substantially performed by employee-owners.

Generally, personal service corporations include those in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.¹⁰ A corporation is treated as a personal service corporation if more than 10 percent of the stock (by value) is held by employee-owners.¹¹ An employee is treated as an employee-owner if he or she owns stock on *any day* during the taxable year.¹² For these purposes, shareholder status and employee status do not have to occur on the same day.

Closely Held C Corporations

Application of the passive loss rules to closely held (nonpersonal service) C corporations is also intended to prevent individuals from incorporating to avoid the passive loss limitations. A corporation is classified as a **closely held corporation** if at any time during the taxable year more than 50 percent of the value of its outstanding stock is owned, directly or indirectly, by or for five or fewer individuals. Closely held C corporations (other than personal service corporations) may use passive losses to offset *active* income but not portfolio income.

⁹§ 469(a).

¹⁰§ 448(d)(2)(A).

¹¹§ 469(j)(2).

¹²§ 269A(b)(2).

Silver Corporation, a closely held (nonpersonal service) C corporation, has \$500,000 of passive losses from a rental activity, \$400,000 of active income, and \$100,000 of portfolio income. The corporation may offset \$400,000 of the \$500,000 passive loss against the \$400,000 of active business income but may not offset the remainder against the \$100,000 of portfolio income. Thus, \$100,000 of the passive loss is suspended (\$500,000 passive loss – \$400,000 offset against active income).

EXAMPLE

14

Application of the passive loss limitations to closely held C corporations prevents taxpayers from transferring their portfolio investments to such corporations to offset passive losses against portfolio income.

11-3c Working with the Definition of Passive Activities

As noted earlier, the following types of activities are treated as passive:

- Any trade or business or income-producing activity in which the taxpayer does not materially participate.
- Subject to certain exceptions pertaining to real estate (discussed later), all rental activities.

To understand the meaning of the term *passive activity* and the impact of the rules, one must address the following issues, each of which is the subject of statutory or administrative guidance:

- What constitutes an activity?
- What is meant by material participation?
- When is an activity a rental activity?

Even though guidance is available to help the taxpayer deal with these issues, their resolution is anything but simple.

Identification of an Activity

Identifying what constitutes an activity is a necessary first step in applying the passive loss limitations. Taxpayers who are involved in complex business operations need to determine whether a given segment of their overall business operations constitutes a separate activity or is to be treated as part of a single activity. Proper treatment is necessary to determine whether income or loss from an activity is active or passive.

Treatment as a Component of an Activity or as a Separate Activity

Ben owns a business with two separate departments. Department A generates net income of \$120,000, and Department B generates a net loss of \$95,000. Ben participates 700 hours in the operations of Department A and 100 hours in Department B. If Ben is allowed to treat the departments as components of a single activity, he can offset the \$95,000 loss from Department B against the \$120,000 of income from Department A.

EXAMPLE

15

Assume the same facts as in the previous example. If Ben is required to treat each department as a separate activity, the tax result is not as favorable. Because he is a material participant in Department A (having devoted 700 hours to it), the \$120,000 profit is active income. Assuming Ben is not considered a material participant in Department B (100 hours), the \$95,000 loss is a passive loss. Therefore, Ben cannot offset the \$95,000 passive loss from Department B against the \$120,000 of active income from Department A. (A complete discussion of the material participation rules follows.)

EXAMPLE

16

Recall that on the disposition of a passive activity, a taxpayer is allowed to offset suspended losses from the activity against other types of income. Therefore, as illustrated in the next example, identifying what constitutes an activity is of crucial importance for this purpose too.

LO.4

Explore the elements required for an activity to be treated as passive and review the rules for identifying an activity.



TAX IN THE NEWS If You Can't Trust Your Tax Preparer, Who Can You Trust?

Many taxpayers choose to remain ignorant of the tax law because they assume that by paying a “professional” to complete their returns, they have shifted all responsibility to someone else. But they do so at their own risk. Failure to have at least a general understanding of the tax rules that apply to one’s return can be a big mistake and can lead to various tax penalties.

One such taxpayer invested in several partnerships that engaged in horse activities in California. Being fully employed in New York, he did not participate in the partnerships’ activities and had no knowledge of their business operations. When he received the tax information from the partnerships about his investments, he simply turned over the statements to his tax preparer, who included the infor-

mation on the return filed. Essentially, the tax return reflected the taxpayer’s losses from the horse activities even though they are disallowed under the passive loss rules.

When the IRS discovered the error, the taxpayer pleaded ignorance and blamed the tax preparer. The taxpayer claimed that he had been “duped by a charlatan” and pleaded for mercy. The Tax Court showed no compassion and held that he owed additional taxes, interest, and penalties (*Ralph P. Cunningham*, 98 TCM 143, T.C.Memo. 2009–194). Perhaps the result would have been different if the taxpayer had had a better understanding of the tax law in general and the passive activity rules in particular. Reliance on a tax preparer is not an excuse for blindly signing a tax return without understanding its content.

EXAMPLE

17

Linda owns a business with two departments. Department A has a net loss of \$125,000 in the current year, and Department B has a \$70,000 net loss. She disposes of Department B at the end of the year. Assuming Linda is allowed to treat the two departments as separate passive activities, she can offset the passive loss from Department B against other types of income in the following order: gain from disposition of the passive activity, other passive income, and nonpassive income. This treatment leaves her with a suspended loss of \$125,000 from Department A. If Departments A and B are treated as components of the same activity, however, upon the disposal of Department B, its \$70,000 net loss would be suspended along with the other \$125,000 of suspended loss of the activity.

The rules used to delineate what constitutes an activity for purposes of the passive loss limitations are provided in the Regulations.¹³ These guidelines state that, in general, a taxpayer can treat one or more trade or business activities or rental activities as a single activity if those activities form an *appropriate economic unit* for measuring gain or loss. To determine what ventures form an appropriate economic unit, all of the relevant facts and circumstances must be considered. Taxpayers may use any reasonable method in applying the facts and circumstances. The following example, adapted from the Regulations, illustrates the application of the general rules for grouping activities.¹⁴

EXAMPLE

18

George owns a men’s clothing store and an Internet café in Chicago. He also owns a men’s clothing store and an Internet café in Milwaukee. Reasonable methods of applying the facts and circumstances test may result in any of the following groupings:

- All four activities may be grouped into a single activity because of common ownership and control.
- The clothing stores may be grouped into an activity, and the Internet cafés may be grouped into a separate activity.
- The Chicago activities may be grouped into an activity, and the Milwaukee activities may be grouped into a separate activity.
- Each of the four activities may be treated as a separate activity.

¹³Reg. § 1.469–4.

¹⁴Reg. § 1.469–4(c)(3).

Regrouping of Activities Taxpayers should carefully consider all tax factors when deciding how to group their activities. Once activities have been grouped, they cannot be regrouped unless the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances. The Regulations also grant the IRS the right to regroup activities when both of the following conditions exist:¹⁵

- The taxpayer's grouping fails to reflect one or more appropriate economic units.
- One of the primary purposes of the taxpayer's grouping is to avoid the passive loss limitations.

Special Grouping Rules for Rental Activities Two rules deal specifically with the grouping of rental activities. These provisions are designed to prevent taxpayers from grouping rental activities, which are generally passive, with other businesses in a way that would result in a tax advantage.

First, a rental activity may be grouped with a trade or business activity only if one activity is insubstantial in relation to the other. That is, the rental activity must be insubstantial in relation to the trade or business activity, or the trade or business activity must be insubstantial in relation to the rental activity. The Regulations provide no clear guidelines as to the meaning of "insubstantial."¹⁶

Schemers, a firm of CPAs, owns a building in downtown Washington, D.C., in which it conducts its public accounting practice. The firm also rents space on the street level of the building to several retail establishments, which generally is considered a passive activity. Of the total revenue generated by the firm, 95% is associated with the public accounting practice and 5% is related to the rental operation. It is likely that the rental activity would be considered insubstantial relative to the accounting practice and the two ventures could be grouped as one nonrental activity. This grouping could be advantageous to the firm, particularly if the rental operation generates a loss! Alternatively, treating the rental operation as a *separate* activity may be advantageous if this operation produces (passive) income. The passive income could then be used to absorb otherwise nondeductible passive losses.

EXAMPLE

19

Second, taxpayers generally may not treat an activity involving the rental of real property and an activity involving the rental of personal property as a single activity.

Material Participation

As indicated previously, if an individual taxpayer materially participates in a nonrental trade or business activity, any loss from that activity is treated as an active loss that can offset active or portfolio income. (Participation is defined later in the chapter.) If a taxpayer does not materially participate, however, the loss is treated as a passive loss, which can only offset passive income. Therefore, controlling whether a particular activity is treated as active or passive is an important part of the tax strategy of a taxpayer who owns an interest in one or more businesses. Consider the following examples.

LO.5

Identify the tests for material participation.

Implications of Material Participation Status

Dewayne, a corporate executive, earns a salary of \$600,000 per year. In addition, he owns a separate business in which he participates. The business produces a loss of \$100,000 during the year. If Dewayne materially participates in the business, the \$100,000 loss is an active loss that may offset his active income from his corporate employer. If he does not materially participate, the loss is passive and is suspended. Dewayne may use the suspended loss in the future only when he has passive income or disposes of the activity.

EXAMPLE

20

¹⁵Reg. § 1.469-4(f).

¹⁶Reg. § 1.469-4(d).

Implications of Material Participation Status

EXAMPLE

21

Kay, an attorney, earns \$350,000 a year in her law practice. In addition, she owns interests in two activities, A and B, in which she participates. Activity A, in which she does *not* materially participate, produces a loss of \$50,000. Kay has not yet met the material participation standard, described below, for Activity B, which produces income of \$80,000. However, she can meet the material participation standard if she spends an additional 50 hours in Activity B during the year. Should Kay attempt to meet the material participation standard for Activity B? If she continues working in Activity B and becomes a material participant, the \$80,000 of income from the activity is *active*, and the \$50,000 passive loss from Activity A must be suspended. A more favorable tax strategy is for Kay *not to meet* the material participation standard for Activity B, thus making the income from that activity passive. This enables her to offset the \$50,000 passive loss from Activity A against most of the passive income from Activity B.

It is possible to devise numerous scenarios in which the taxpayer could control the tax outcome by increasing or decreasing his or her participation in different activities. Examples 20 and 21 demonstrate some of the possibilities. The conclusion reached in most analyses of this type is that taxpayers will benefit by having profitable activities classified as passive so that any passive losses can be used to offset that passive income. If the activity produces a loss, however, the taxpayer will benefit if it is classified as active so that the loss is not subject to the passive loss limitations.

As discussed previously, a nonrental trade or business in which a taxpayer owns an interest must be treated as a passive activity unless the taxpayer materially participates. As the Staff of the Joint Committee on Taxation explained, a material participant is one who has “a significant nontax economic profit motive” for taking on activities and selects them for their economic value. In contrast, a passive investor mainly seeks a return from a capital investment (including a possible reduction in taxes) as a supplement to an ongoing source of livelihood.¹⁷ Even if the concept or the implication of being a material participant is clear, the precise meaning of the term **material participation** can be vague. As enacted, § 469 requires a taxpayer to participate on a *regular, continuous, and substantial* basis to be a material participant. In many situations, however, it is difficult or impossible to gain any assurance that this nebulous standard is met.

In response to this dilemma, Temporary Regulations¹⁸ provide seven tests that are intended to help taxpayers cope with these issues. Material participation is achieved by meeting any *one* of the tests. These tests are listed in Concept Summary 11.2 and can be divided into the following three categories:

- Tests based on current participation.
- Tests based on prior participation.
- Test based on facts and circumstances.

Participation Defined Participation generally includes any work done by an individual in an activity that he or she owns. Participation does not include work if it is of a type not customarily done by owners *and* if one of its principal purposes is to avoid the disallowance of passive losses or credits. Also, work done in an individual’s capacity as an investor (e.g., reviewing financial reports in a nonmanagerial capacity) is not counted in applying the material participation tests. However, participation by an owner’s spouse counts as participation by the owner.¹⁹

¹⁷General Explanation of the Tax Reform Act of 1986 (“Blue Book”), prepared by The Staff of the Joint Committee on Taxation, May 4, 1987, H.R. 3838, 99th Cong., p. 212.

¹⁸Temp.Reg. § 1.469–5T(a). The Temporary Regulations are also Proposed Regulations. Temporary Regulations have the same effect as final Regulations. Refer to Chapter 2 for a discussion of the different categories of Regulations.

¹⁹§ 469(h)(5) and Temp.Reg. § 1.469–5T(f)(3).

Concept Summary 11.2

Tests to Determine Material Participation

Tests Based on Current Participation

1. The individual participates in the activity for more than 500 hours during the year.
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in the activity of all individuals (including nonowner employees) for the year.
3. The individual participates in the activity for more than 100 hours during the year, and this participation is not less than that participation of any other individual (including nonowner employees) for the year.
4. The activity is a **significant participation activity** (where the person's participation exceeds 100 hours during the year), and the aggregate of all significant participation activities during the year is more than 500 hours.

Tests Based on Prior Participation

5. The individual materially participated in the activity for any 5 taxable years during the 10 taxable years that immediately precede the current taxable year.
6. The activity is a personal service activity, and the individual materially participated in the activity for any 3 preceding taxable years.

Test Based on Facts and Circumstances

7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.

Tom, who is a partner in a CPA firm, owns a computer store that operated at a loss during the year. To offset this loss against the income from his CPA practice, Tom would like to avoid having the computer business classified as a passive activity. During the year, he worked 480 hours in the business in management and selling activities and 30 hours doing janitorial chores. In addition, Tom's wife participated 40 hours as a salesperson. It is likely that Tom's 480 hours of participation in management and selling activities will count as participation in work customarily done by owners, but the 30 hours spent doing janitorial chores will not. However, the 40 hours of participation by his wife will count. Assuming none of the participation's principal purposes is to avoid the disallowance of passive losses or credits, Tom will qualify as a material participant under the more-than-500-hour rule ($480 + 40 = 520$).

EXAMPLE

22

Limited Partners A *limited* partner is a partner whose liability to third-party creditors of the partnership is limited to the amount the partner has invested in the partnership. Such a partnership must have at least one *general* partner, who is fully liable in an individual capacity for the debts of the partnership to third parties. Generally, a *limited partner* is not considered a material participant unless he or she qualifies under Test 1, 5, or 6 as shown in Concept Summary 11.2. However, a *general partner* may qualify as a material participant by meeting any of the seven tests. If a general partner also owns a limited interest in the same limited partnership, all interests are treated as a general interest.²⁰

Rental Activities Defined

Subject to certain exceptions, all rental activities are to be treated as passive activities.²¹ A **rental activity** is defined as any activity where payments are received principally for the use of tangible (real or personal) property.²² Importantly, an activity that is classified as a rental activity is subject to the passive activity loss rules even if the taxpayer involved is a material participant.

LO.6

Describe the nature of rental activities under the passive loss rules.

²⁰§ 469(h)(2) and Temp.Reg. § 1.469-5T(e)(3)(ii). Under Prop. Reg. § 1.469-5, however, material participation status for owners of LLCs and LLPs is dependent on the taxpayer's general involvement in the business.

²¹§ 469(c)(2).

²²§ 469(j)(8).



TAX IN THE NEWS The Passive Loss Rules Are a Trap for the Novice Landlord

Most sophisticated investors are well aware of the passive loss rules. Such investors are not surprised when the rules apply and have learned how to minimize their negative effect.

The real damage caused by the passive loss rules often falls on taxpayers who have never heard of them and hold passive activities “on the side” only as secondary ventures. Suppose, for example, that Taylor just inherited her aunt’s

furnished residence. Rather than sell the house in a depressed market, she is attracted by the regular cash flow provided by rent income. Although Taylor knows to expect a tax benefit from the paper loss that may result from rental property, does she know about the passive loss limitations? Unlike the professional, most novice landlords are surprised by these rules on an after-the-fact basis.

EXAMPLE

23

Sarah owns a fleet of automobiles that are held for rent, and she spends an average of 60 hours a week in the activity. Assuming that her automobile business is classified as a rental activity, it is automatically subject to the passive activity rules even though Sarah spends more than 500 hours a year in its operation.

Temporary Regulations, however, provide exceptions for certain situations where activities involving rentals of real and personal property are *not* to be *treated* as rental activities.²³ Consider the following example.

EXAMPLE

24

Dan owns a bicycle rental business at a nearby resort. Because the average period of customer use is seven days or less, Dan’s business is not treated as a rental activity.

This exception is based on the presumption that a person who rents property for seven days or less is generally required to provide significant services to the customer. Providing such services supports a conclusion that the person is engaged in a service business rather than a rental business.

The fact that Dan’s business in the previous example is not treated as a rental activity does not necessarily mean that it is classified as a nonpassive activity. Instead, the business is treated as a trade or business activity subject to the material participation standards listed in Concept Summary 11.2. If Dan is a material participant, the business is treated as active. If he is not a material participant, it is treated as a passive activity. For additional discussion of the rental exceptions, see IRS Publication 925 (*Passive Activity and At-Risk Rules*).

LO.7

Determine the relationship between the at-risk and passive loss limitations.

11-3d Interaction of the At-Risk and Passive Loss Limits

The determination of whether a loss is suspended under the passive loss rules is made *after* application of the at-risk rules, as well as other provisions relating to the measurement of taxable income. A loss that is not allowed for the year because the taxpayer is not at risk with respect to it is suspended under the at-risk provision, not under the passive loss rules. Further, a taxpayer’s at-risk basis is reduced by the losses (but not below zero) even if the deductions are not currently usable because of the passive loss rules. The following examples illustrate these points.

²³Temp.Reg. § 1.469-1T(e)(3).

At-Risk and Passive Loss Interactions

Jack's adjusted basis in a passive activity is \$10,000 at the beginning of 2014. His loss from the activity in 2014 is \$4,000. Because Jack has no passive activity income, the \$4,000 cannot be deducted. At year-end, Jack has an adjusted basis and an at-risk amount of \$6,000 in the activity and a suspended passive loss of \$4,000.

EXAMPLE

25

Jack in Example 25 has a loss of \$9,000 in the activity in 2015. Because the \$9,000 exceeds his at-risk amount (\$6,000) by \$3,000, that \$3,000 loss is disallowed by the at-risk rules. If Jack has no passive activity income, the remaining \$6,000 is suspended under the passive activity rules. At year-end, he has:

EXAMPLE

26

- A \$3,000 loss suspended under the at-risk rules.
- \$10,000 of suspended passive losses (\$4,000 from 2014 and \$6,000 from 2015).
- An adjusted basis and an at-risk amount in the activity of zero.

Jack in Example 26 realizes \$1,000 of passive income from the activity in 2016. Because the \$1,000 increases his at-risk amount, \$1,000 of the \$3,000 unused loss from 2015 is reclassified as a passive loss. If he has no other passive income, the \$1,000 income is offset by \$1,000 of suspended passive losses. At the end of 2016, Jack has:

EXAMPLE

27

- No taxable passive income.
- \$2,000 (\$3,000 – \$1,000) of suspended losses under the at-risk rules.
- \$10,000 of (reclassified) suspended passive losses (\$10,000 + \$1,000 of reclassified suspended at-risk losses – \$1,000 of passive losses offset against passive income).
- An adjusted basis and an at-risk amount in the activity of zero.

In 2017, Jack has no gain or loss from the activity in Example 27. He contributes \$5,000 more to the passive activity. Because the \$5,000 increases his at-risk amount, the \$2,000 of losses suspended under the at-risk rules is reclassified as passive. Jack gets no passive loss deduction in 2017. At year-end, he has:

EXAMPLE

28

- No suspended losses under the at-risk rules.
- \$12,000 of suspended passive losses (\$10,000 + \$2,000 of reclassified suspended at-risk losses).
- An adjusted basis and an at-risk amount of \$3,000 (\$5,000 additional investment – \$2,000 of reclassified losses).

The Big Picture

Return to the facts of *The Big Picture* on p. 11-1. If the Reswicks invest in the orange grove limited partnership, the at-risk rules will not limit the deductibility of the \$25,000 losses until after year 4. Ample at-risk basis will exist until the close of that year (i.e., the at-risk basis is reduced from \$100,000 by \$25,000 over each of the first four years of the investment). However, the passive loss rules prohibit deductions for the losses in the first four years of the investment (assuming that the Reswicks do not have passive income from other sources). Therefore, based on the facts provided, none of the suspended losses would be deductible until year 6, when the orange grove is expected to begin producing profits.

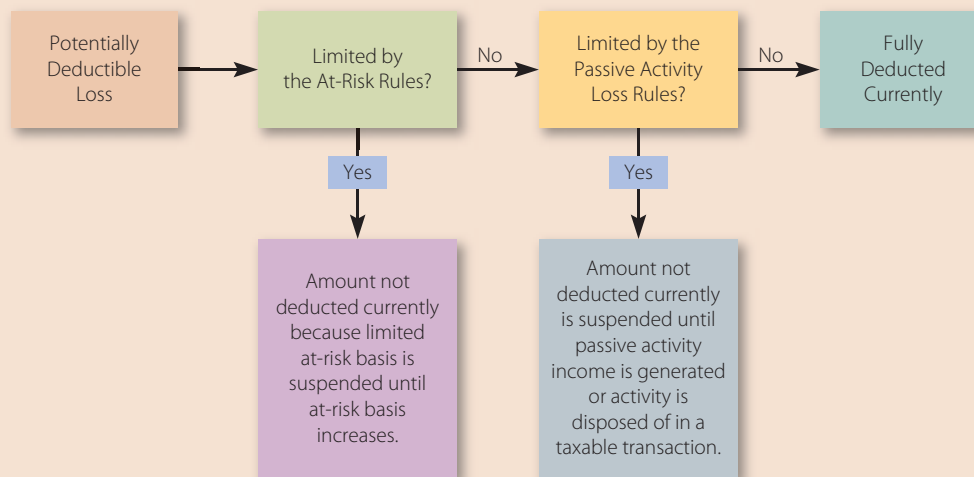
EXAMPLE

29

See Concept Summary 11.3 where the interactions of the at-risk and passive activity limits are set out.

Concept Summary 11.3

Treatment of Losses Subject to the At-Risk and Passive Activity Loss Limitations



LO.8

Recognize the special treatment available to real estate activities.

11-3e Special Passive Activity Rules for Real Estate Activities

The passive loss limits contain two exceptions related to real estate activities. These exceptions allow all or part of real estate rental losses to offset active or portfolio income even though the activity otherwise is defined as a passive activity.

Material Participation in a Real Property Rental Trade or Business

The first exception relates to a special rule for material participation in a real estate rental trade or business. Losses from real estate rental activities are *not* treated as passive losses for certain real estate professionals.²⁴ To qualify for nonpassive treatment, a taxpayer must satisfy both of the following requirements:

- More than half of the personal services that the taxpayer performs in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates.
- The taxpayer performs more than 750 hours of services in these real property trades or businesses as a material participant.

Taxpayers who do not satisfy the above requirements must continue to treat losses from real estate rental activities as passive losses.

EXAMPLE

30

During the current year, Della performs personal service activities as follows: 900 hours as a personal financial planner, 550 hours in a real estate development business, and 600 hours in a real estate rental activity. Any loss Della incurs in either real estate activity will not be subject to the passive loss rules. Being a nonrental business, the development business is deemed active under the more-than-500-hour rule. The real estate rental activity is active because more than 50% of her personal services are devoted to real property trades or businesses (i.e., the development and rental businesses) and her material participation in those real estate activities exceeds 750 hours. Thus, any losses from either real estate activity can offset active and portfolio sources of income.

²⁴ § 469(c)(7).



TAX IN THE NEWS Full-Time Employees May Face Difficulty Showing Real Estate Professional Status

To qualify as a real estate professional, a taxpayer must devote more than 50 percent of his or her personal services to real property trades or businesses. This requirement typically would make it very difficult for a person with a full-time job to qualify for this status because the efforts as an employee likely would comprise the bulk of the taxpayer's labor.

If you were a judge, how reasonable would a taxpayer's assertion be that he worked more time on his real estate properties than his full-time, 40-hour-a-week job? One taxpayer, who faced such a challenge before the Tax Court (*Mohammad Hassanipour* 105 TCM 1542, T.C.Memo. 2013–88), was unable to convince the judge. Consequently, he was required to pay additional taxes and penalties—over

\$45,000—for inappropriately claiming deductions as a real estate professional.

Essentially, the taxpayer reported that he worked 1,936 hours for his employer and was not able to persuade the judge that he spent more than this working on his real estate properties. In the end, the Tax Court stated that the taxpayer's testimony was undermined by "his questionable claims about the contemporaneous calendar, and by the vagueness and inherent improbability of his estimates."

A basic premise of tax compliance illustrated by the case is that a taxpayer should never claim a deduction unless it can be supported with adequate and convincing documentation.

As discussed earlier, a spouse's work is taken into consideration in satisfying the material participation requirement. However, the hours worked by a spouse are *not* taken into account when ascertaining whether a taxpayer has worked for more than 750 hours in real property trades or businesses during a year.²⁵ Services performed by an employee are not treated as being related to a real estate trade or business unless the employee performing the services owns more than a 5 percent interest in the employer. In addition, a closely held C corporation may also qualify for the passive loss relief if more than 50 percent of its gross receipts for the year are derived from real property trades or businesses in which it materially participates.



ETHICS & EQUITY Punching the Time Clock at Year-End

As the end of the tax year approaches, Ralph, a successful full-time real estate developer and investor, recognizes that his income tax situation for the year could be bleak. Unless he and his wife are able to generate more hours of participation in one of his real estate rental activities, they will not reach the material participation threshold. Consequently, the tax losses from the venture will not be deductible. To ensure deductibility, Ralph suggests the following plan:

- He will document the time he spends "thinking" about his rental activities.
- During the week, his wife will visit the apartment building to oversee (in a management role) the operations of the rentals.

- On weekends, he and his wife will visit the same units to further evaluate the operations.
- Also on the weekends, while they are doing their routine household shopping, they will be on the lookout for other rental properties to buy. Ralph plans to count both his and his wife's weekend hours toward the tally of total participation.

Ralph contends that the law clearly allows the efforts of one's spouse to count for purposes of the material participation tests. Likewise, nothing in the tax law requires taxpayers to be efficient in their hours of participation. How do you react?

Real Estate Rental Activities

The second exception to the passive loss limits is more significant in that it is not restricted to real estate professionals. This exception allows individuals to deduct up to

²⁵§ 469(c)(7)(B) and Reg. § 1.469–9.

\$25,000 of losses from real estate rental activities against active and portfolio income.²⁶ The potential annual \$25,000 deduction is reduced by 50 percent of the taxpayer's AGI in excess of \$100,000. Thus, the entire deduction is phased out at \$150,000 of AGI. If married individuals file separately, the \$25,000 deduction is reduced to zero unless they lived apart for the entire year, in which case the loss amount is \$12,500 each and the phaseout begins at \$50,000. AGI for purposes of the phaseout is calculated without regard to IRA deductions, Social Security benefits, interest deductions on education loans, and net losses from passive activities.

To qualify for the \$25,000 exception, a taxpayer must meet both of the following requirements:²⁷

- Actively participate in the real estate rental activity.
- Own 10 percent or more (in value) of all interests in the activity during the entire taxable year (or shorter period during which the taxpayer held an interest in the activity).

The difference between *active participation* and *material participation* is that the former can be satisfied without regular, continuous, and substantial involvement in operations as long as the taxpayer participates in making management decisions in a significant and bona fide sense. In this context, relevant management decisions include decisions such as approving new tenants, deciding on rental terms, and approving capital or repair expenditures.

The Big Picture

EXAMPLE

31

Return to the facts of *The Big Picture* on p. 11-1. If the Reswicks invest in the apartment rental limited partnership, their \$25,000 loss would be deductible under the real estate rental activities exception. This assumes that they actively participate and own at least a 10% interest in the partnership. The loss will be deductible in each of the first four years of their investment before their at-risk basis has been exhausted (as explained earlier, the Reswick's original at-risk basis of \$100,000 will be reduced to \$0 over four years) even if they do not have passive income from other sources.

The \$25,000 allowance is available after all active participation rental losses and gains are netted and applied to other passive income. If a taxpayer has a real estate rental loss in excess of the amount that can be deducted under the real estate rental exception, that excess is treated as a passive loss.

EXAMPLE

32

Brad, who has \$90,000 of AGI before considering rental activities, has \$85,000 of losses from a real estate rental activity in which he actively participates. He also actively participates in another real estate rental activity from which he has \$25,000 of income. He has other passive income of \$36,000. Of the net rental loss of \$60,000 (\$85,000 – \$25,000), \$36,000 is absorbed by the passive income, leaving \$24,000 that can be deducted against active or portfolio income because of the availability of the \$25,000 allowance.

The \$25,000 offset allowance is an aggregate of both deductions and credits in deduction equivalents. The deduction equivalent of a passive activity credit is the amount of deductions that reduces the tax liability for the taxable year by an amount equal to the credit.²⁸ A taxpayer with \$5,000 of credits and a tax bracket of 25 percent would have a deduction equivalent of \$20,000 ($\$5,000 \div 25\%$).

If the total deduction and deduction equivalent exceed \$25,000, the taxpayer must allocate the allowance on a pro rata basis, first among the losses (including real estate rental activity losses suspended in prior years) and then to credits in the following order:

²⁶ § 469(i).

²⁷ § 469(i)(6).

²⁸ § 469(j)(5).

(1) credits other than rehabilitation and low-income housing credits, (2) rehabilitation credits, and (3) low-income housing credits.

Deduction Equivalent Considerations

Kevin is an active participant in a real estate rental activity that produces \$8,000 of income, \$26,000 of deductions, and \$1,500 of credits. Kevin, who is in the 25% tax bracket, may deduct the net passive loss of \$18,000 (\$8,000 – \$26,000). After deducting the loss, he has an available deduction equivalent of \$7,000 (\$25,000 – \$18,000 passive loss). Because the actual credits produce a deduction equivalent (\$1,500 ÷ 25% = \$6,000) that is less than \$7,000, Kevin may claim the entire \$1,500 credit.

EXAMPLE

33

Kelly, who is in the 25% tax bracket, is an active participant in three separate real estate rental activities. The relevant tax results for each activity are as follows:

- Activity A: \$20,000 of losses.
- Activity B: \$10,000 of losses.
- Activity C: \$4,200 of credits.

Kelly’s deduction equivalent from the credits is \$16,800 (\$4,200 ÷ 25%). Therefore, the total passive deductions and deduction equivalents are \$46,800 (\$20,000 + \$10,000 + \$16,800), which exceeds the maximum allowable amount of \$25,000. Consequently, Kelly must allocate pro rata first from among losses and then from among credits. Deductions from losses are limited as follows:

- Activity A { \$25,000 × [\$20,000 ÷ (\$20,000 + \$10,000)] } = \$16,667.
- Activity B { \$25,000 × [\$10,000 ÷ (\$20,000 + \$10,000)] } = \$8,333.

Because the amount of passive deductions exceeds the \$25,000 maximum, the deduction balance of \$5,000 and passive credits of \$4,200 must be carried forward. Kelly’s suspended losses and credits by activity are as follows:

	Total	Activity		
		A	B	C
Allocated losses	\$ 30,000	\$ 20,000	\$10,000	\$ –0–
Allocated credits	4,200	–0–	–0–	4,200
Utilized losses	(25,000)	(16,667)	(8,333)	–0–
Suspended losses	5,000	3,333	1,667	–0–
Suspended credits	4,200	–0–	–0–	4,200

EXAMPLE

34

11-3f Dispositions of Passive Interests

Recall from an earlier discussion that if a taxpayer disposes of an entire interest in a passive activity, any suspended losses (and in certain cases, suspended credits) may be utilized when calculating the final economic gain or loss on the investment. In addition, if a loss ultimately results, that loss can offset other types of income. However, the consequences may differ if the activity is disposed of in a transaction that is other than a fully taxable transaction. The following sections discuss the treatment of suspended passive losses in other types of dispositions.

Disposition of a Passive Activity at Death

When a transfer of a taxpayer’s interest occurs because of the taxpayer’s death, suspended losses are allowed (to the decedent) to the extent they exceed the amount, if any, of the allowed step-up in basis.²⁹ Suspended losses that are equal to or less than

LO.9

Determine the proper tax treatment upon the disposition of a passive activity.

²⁹§ 469(g)(2).

the amount of the basis increase are, however, lost. The losses allowed generally are reported on the final return of the deceased taxpayer.

Disposition of Suspended Passive Losses at Death

EXAMPLE

35

Alyson dies with passive activity property having an adjusted basis of \$40,000, suspended losses of \$10,000, and a fair market value at the date of her death of \$75,000. The increase (i.e., step-up) in basis (see Chapter 13) is \$35,000 (fair market value at date of death in excess of adjusted basis). None of the \$10,000 suspended loss is deductible on Alyson's final return or by the beneficiary. The suspended losses (\$10,000) are lost because they do not exceed the step-up in basis (\$35,000).

EXAMPLE

36

Assume the same facts as in the previous example except that the property's fair market value at the date of Alyson's death is \$47,000. Because the step-up in basis is only \$7,000 (\$47,000 – \$40,000), the suspended losses allowed are limited to \$3,000 (\$10,000 suspended loss at time of death – \$7,000 increase in basis). The \$3,000 loss available to Alyson is reported on her final income tax return.

Disposition of a Passive Activity by Gift

In a disposition of a taxpayer's interest in a passive activity by gift, the suspended losses are added to the basis of the property.³⁰ As such, the suspended losses become permanently nondeductible to both the donor and the donee. Nonetheless, a tax *benefit* may be available to the donee for another reason. Due to the increase in the property's basis, greater depreciation deductions can result, and there will be less gain (or more loss) on a subsequent sale of the property. The side benefits of increased basis do not materialize if the recipient is a charity, as such organizations generally are not subject to income taxation.

EXAMPLE

37

Carlton makes a gift to Yolanda of passive activity property having an adjusted basis of \$40,000, suspended losses of \$10,000, and a fair market value at the date of the gift of \$100,000. Carlton cannot deduct the suspended losses in the year of the disposition. However, the suspended losses transfer with the property and are added to the adjusted basis of the property, thus becoming \$50,000 in Yolanda's hands. Assuming Yolanda is able to sell the property for \$105,000 soon after she receives the gift, her taxable gain would be \$55,000 (\$105,000 – \$50,000), which reflects the benefit from the increased basis.

Installment Sale of a Passive Activity

An installment sale of a taxpayer's entire interest in a passive activity triggers recognition of the suspended losses.³¹ The losses are allowed each year as payments are received on the installment obligation in the ratio that the gain recognized in each year bears to the total gain on the sale.

EXAMPLE

38

Stan sells his entire interest in a passive activity for \$100,000. His adjusted basis in the property is \$60,000. If he uses the installment method, his gross profit ratio is 40% (\$40,000/\$100,000). If Stan receives a \$20,000 down payment, he will recognize a gain of \$8,000 (40% of \$20,000). If the activity has a suspended loss of \$25,000, Stan will deduct \$5,000 [$(\$8,000 \div \$40,000) \times \$25,000$] of the suspended loss in the first year.

The general rules relating to passive activity losses are reviewed in Concept Summary 11.4.

³⁰§ 469(j)(6).

³¹§ 469(g)(3).

Concept Summary 11.4

Passive Activity Loss Rules: Key Issues and Answers

What is the fundamental passive activity rule?	Passive activity losses may be deducted only against passive activity income and gains. Losses not allowed are suspended and used in future years.
Who is subject to the passive activity rules?	Individuals. Estates. Trusts. Personal service corporations. Closely held C corporations.
What is a passive activity?	Trade or business or income-producing activity in which the taxpayer does not materially participate during the year or rental activities, subject to certain exceptions, regardless of the taxpayer's level of participation.
What is an activity?	One or more trade or business or rental activities that comprise an appropriate economic unit.
How is an appropriate economic unit determined?	Based on a reasonable application of the relevant facts and circumstances.
What is material participation?	In general, the taxpayer participates on a regular, continuous, and substantial basis. More specifically, when the taxpayer meets the conditions of one of the seven tests provided in the Regulations.
What is a rental activity?	In general, an activity where payments are received for the use of tangible property. Special rules apply to rental real estate.

11-4 INVESTMENT INTEREST LIMITATION

As just described, well-to-do investors tried to use the Code for many years to generate deductible tax losses. As a result, Congress imposed special rules placing limitations on losses where the taxpayer was not at risk or where the losses were from passive activities. Another approach in using the tax law to create wealth involved the use of the interest deduction. By borrowing to purchase investments that would appreciate in the future, the interest on the debt was claimed as an ordinary deduction when paid. Later, when the asset was sold at a gain, only a capital gains tax was due on the appreciation. Thus, today's interest deduction could lead to tomorrow's capital gain.

11-4a Limitation Imposed

In response, Congress has limited the deductibility of **investment interest**, which is interest paid on debt borrowed for the purpose of purchasing or continuing to hold investment property. The deduction for investment interest allowed during the tax year is limited to the lesser of the investment interest paid or net investment income.³²

LO.10

Identify restrictions placed on the deductibility of other investor losses and deductions, including those that apply to investment interest.

The Big Picture

Return to the facts of *The Big Picture* on p. 11-1. If the Reswicks invest in the high-growth, low-yield portfolio of marketable securities, most of the investment return will consist of appreciation, which will not be taxed until the securities are sold. Relatively little of the current return will consist of currently taxable interest and dividend income. Assume that the interest and dividend income for the year from these securities equals \$500 and that all of it is treated as investment income. If the investment interest expense on the \$100,000 loan is \$8,000, only \$500 of this interest will be deductible this year (i.e., the deduction for the investment interest is limited to the \$500 of net investment income).

EXAMPLE

39

³²§ 163(d)(1).

Investment Income and Expenses

Net investment income, which serves as the ceiling on the deductibility of investment interest, is the excess of investment income over investment expenses. **Investment income** includes gross income from interest, annuities, and royalties not derived in the ordinary course of a trade or business.³³ However, investment income does not include any income taken into account when calculating income or loss from a passive activity.

Investment expenses are those deductible expenses directly connected with the production of investment income, such as brokerage and investment counsel fees. Investment expenses do not include interest expense.

11-4b Computation of Allowable Deduction

After net investment income is determined, the allowable deductible investment interest expense is calculated.

EXAMPLE

40

Ethan's financial records for the year reflect the following:

Interest income from bank savings account	\$10,000
Taxable annuity receipts	5,500
Investment counsel fee	1,100
Safe deposit box rental (to hold annuity documents)	200
Investment interest expense	17,000

Ethan's investment income amounts to \$15,500 (\$10,000 + \$5,500), and investment expenses total \$1,300 (\$1,100 + \$200). Therefore, his net investment income is \$14,200 (\$15,500 – \$1,300). Consequently, the investment interest deduction is limited to \$14,200, the lesser of investment interest paid or net investment income.

The amount of investment interest disallowed is carried over to future years. In Example 40, therefore, the amount that is carried over to the following year is \$2,800 (\$17,000 investment interest expense – \$14,200 deduction allowed). No limit is placed on the length of the carryover period.³⁴ The investment interest expense deduction is determined by completing Form 4952 (Investment Interest Deduction).

11-5 OTHER INVESTMENT LOSSES

The investment activities summarized below are discussed elsewhere in this text as shown in Concept Summary 11.5.

- Sales of securities held as investments for less than basis result in capital losses. These losses can offset capital gains. In the case of individual taxpayers, excess losses are applied against ordinary income up to \$3,000 (§ 1211). Any remaining excess capital losses are carried over for use in future years (§ 1212).
- When an activity is classified as a hobby, any losses resulting are limited to the income from the activity [§ 183(b)(2)]. If the activity is not a hobby (i.e., a profit motive controls), however, full deduction of the losses is allowed [§§ 162 and 212(2)].
- Losses on small business stock (i.e., stock that qualifies under § 1244) are treated as ordinary losses up to a maximum of \$100,000. Thus, the limitations placed on capital losses (see above) are avoided.
- Vacation homes that are rented for part of the year may generate investment losses depending on the extent of the rental period as compared to time devoted to personal use (§ 280A). If sufficient rental activity takes place, the facility may be treated as rental property. As such, any losses could be subject to the passive loss rules.

³³§ 163(d)(4)(B).

³⁴§ 163(d)(2).



Concept Summary 11.5

Common Investment Loss Limitation Provisions

Item	Refer to Chapter	General Nature of Limitation
At-risk rules	11	Losses in excess of the at-risk basis are not deducted in the current year. Losses not deducted are suspended and used in future years when the at-risk basis increases.
Capital losses	14	Individuals may offset capital gains by capital losses realized. Up to \$3,000 of realized net capital losses may offset ordinary income. Remaining excess capital losses are carried over to future years.
Hobby losses	6	Losses from hobby activities may be deducted to the extent of income from hobby activities. Excess hobby losses are carried forward to future years.
Investment interest	11	The deduction of investment interest is limited to the taxpayer's net investment income. Excess investment interest is deductible in following years.
Passive loss limitations	11	Generally, passive losses are deducted only to the extent of passive income. Excess passive losses are suspended and used in future years.
Small business (§ 1244) stock	7	Losses from the disposition of small business stock are given ordinary treatment up to a maximum of \$100,000 per year.
Vacation homes	6	The deductibility of losses from vacation homes may be limited, depending on the relative number of rental use days and personal use days of the property.
Worthless securities	7	Losses arising from investment securities that become worthless are treated as occurring on the last day of the tax year.

- Securities held as an investment that become worthless produce capital losses. The losses are usually long term because they are treated as occurring on the last day of the year in which the securities become worthless [§ 165(g)(1)]. Because the securities must be completely worthless, determining the year when this takes place is often difficult.

11-6 TAX PLANNING

11-6a Utilizing Passive Losses

Perhaps the biggest challenge individuals face with the passive loss rules is to recognize the potential impact of the rules and then to structure their affairs to minimize this impact. Taxpayers who have passive activity losses (PALs) should adopt a strategy of generating passive activity income that can be sheltered by existing passive losses. One approach is to buy an interest in a passive activity that is generating income (referred to as passive income generators, or PIGs). Then the PAL can offset income from the PIG. From a tax perspective, it would be foolish to buy a loss-generating passive activity unless one has other passive income to shelter or the activity is rental real estate that can qualify for the \$25,000 exception or the exception available to real estate professionals.

If a taxpayer does invest in an activity that produces losses subject to the passive loss rules, the following strategies may help minimize the loss of current deductions:

- If money is borrowed to finance the purchase of a passive activity, the associated interest expense is generally treated as part of any passive loss. Consequently, by using more available (i.e., not borrowed) cash to purchase the passive investment, the investor will need less debt and will incur less interest expense. By incurring less interest expense, a possible suspended passive loss deduction is reduced.

LO.11

Suggest tax planning strategies to minimize the effect of the passive loss and investment interest limitations and recognize the general impact of the surtax on net investment income.

- If the investor does not have sufficient cash readily available for the larger down payment, cash can be obtained by borrowing against the equity in his or her personal residence. The interest expense on such debt will be deductible under the qualified residence interest provisions (see Chapter 10) and will not be subject to the passive loss limitations. Thus, the taxpayer avoids the passive loss limitation and secures a currently deductible interest expense.

As explained earlier, unusable passive losses often accumulate and provide no current tax benefit because the taxpayer has no passive income. When the taxpayer disposes of the entire interest in a passive activity, however, any suspended losses from that activity are used to reduce the taxable gain. If any taxable gain still remains, it can be offset by losses from other passive activities. As a result, the taxpayer should carefully select the year in which to dispose of a passive activity. It is to the taxpayer's advantage to wait until sufficient passive losses have accumulated to offset any gain recognized on the asset's disposition.

EXAMPLE

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Bill, a calendar year taxpayer, owns interests in two passive activities: Activity A, which he plans to sell in December of this year at a gain of \$100,000, and Activity B, which he plans to keep indefinitely. Current and suspended losses associated with Activity B total \$60,000, and Bill expects losses from the activity to be \$40,000 next year. If Bill sells Activity A this year, the \$100,000 gain can be offset by the current and suspended losses of \$60,000 from Activity B, producing a net taxable gain of \$40,000. However, if Bill delays the sale of Activity A until January of next year, the \$100,000 gain will be fully offset by the \$100,000 of losses generated by Activity B (\$60,000 current and prior losses + \$40,000 next year's loss). Consequently, by postponing the sale by one month, he could avoid recognizing \$40,000 of gain that would otherwise result.

Taxpayers with passive losses should consider the level of their involvement in all other trades or businesses in which they have an interest. If they show that they do not materially participate in a profitable activity, the activity becomes a passive activity. Any income generated by the profitable business then could be sheltered by current and suspended passive losses. Family partnerships in which certain members do not materially participate would qualify. The silent partner in any general partnership engaged in a trade or business would also qualify.

EXAMPLE

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Gail has an investment in a limited partnership that produces annual passive losses of approximately \$25,000. She also owns a newly acquired interest in a convenience store where she works. Her share of the store's income is \$35,000. If she works enough to be classified as a material participant, her \$35,000 share of income is treated as active income. This results in \$35,000 being subject to tax every year, while her \$25,000 loss is suspended. However, if Gail reduces her involvement at the store so that she is not a material participant, the \$35,000 of income receives passive treatment. Consequently, the \$35,000 of income can be offset by the \$25,000 passive loss, resulting in only \$10,000 being subject to tax. Thus, by reducing her involvement, Gail ensures that the income from the profitable trade or business receives passive treatment and can then be used to absorb passive losses from other passive activities.

The impact of the passive loss rules often extend to other seemingly unrelated Code sections. For example, because of the restrictive nature of the passive activity loss rules, it may be advantageous for a taxpayer to use a vacation home enough to convert it to a second residence. This would enable all of the qualified interest and real estate taxes to be deducted without limitation. However, this strategy would lead to the loss of other deductions, such as repairs, maintenance, and insurance. See Examples 24 and 26 and the related discussion in Chapter 6.

As this chapter has shown, the passive loss rules can have a dramatic effect on a taxpayer's ability to claim passive losses currently. As a result, it is important to keep accurate records of all sources of income and losses, particularly any suspended passive losses and credits and the activities to which they relate, so that their potential tax benefit will not be lost.

11-6b Planning with Investment Interest Limitation

The term *investment income* includes net capital gain and qualified dividend income only if the taxpayer *elects* to treat them as such. For this purpose,

- net capital gain includes gain attributable to property held for investment and
- qualified dividend income includes dividends that are taxed at the same marginal rate that is applicable to a net capital gain.

By electing to include net capital gain and qualified dividend income as components of investment income, the amount of investment interest deductible in a particular year likewise increases. Form 4952 is used to make such an election. However, the election comes with a cost and is available only if the taxpayer agrees to reduce amounts qualifying for the preferential tax rates that otherwise apply to net capital gain (see Chapter 14) and qualified dividends (refer to Chapter 4) by an equivalent amount.³⁵

Terry incurred \$13,000 of interest expense related to her investments during the year. Her investment income included \$4,000 of interest, \$2,000 of qualified dividends, and a \$5,000 net capital gain on the sale of investment securities. If Terry does not make the election to include the net capital gain and qualified dividends in investment income, her investment income for purposes of computing the investment income limitation is \$4,000 (interest income). If she does make the election, her investment income is \$11,000 (\$4,000 interest + \$2,000 qualified dividends + \$5,000 net capital gain). In that case, \$11,000 of her interest expense, rather than \$4,000, is deductible currently.

EXAMPLE

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Should Terry in the previous example make the election to include the additional \$7,000 of qualified dividends and net capital gain as investment income? By doing so, the current-year investment interest deduction increases by \$7,000, and the investment interest deduction potentially carried forward to future years is reduced by the same amount. That is, the election allows for an acceleration of the investment interest deduction. As Terry evaluates her decision, she should consider the following points:

- The election would make sense only if her marginal ordinary income tax rate exceeds the applicable capital gains rate.
- Using time value of money concepts, she should compare the tax cost of postponing the interest deduction to a subsequent year with the impact of losing the benefit from the preferential capital gains rate. In performing this analysis, consideration should be given to the length of the deferral of the investment interest deduction and the current and future years' tax brackets.

11-6c Effect of Medicare Contribution Surtax on Net Investment Income

As if the passive loss and investment interest limitations are not complicated enough, individuals, estates, and trusts also are subject to a 3.8 percent surtax on net investment income. This new tax provision arose as a part of the Federal health care reform enacted in 2010.³⁶ Net investment income *for this purpose* generally includes amounts such as interest, dividends, long- and short-term capital gains, royalties, rents, and income from passive activities. The tax is levied at the flat 3.8 percent rate on the lesser of the taxpayer's net investment income or the excess of modified AGI over a threshold amount. The threshold amounts for individuals are \$250,000 for surviving spouses and taxpayers filing a joint return, \$125,000 for married taxpayers filing separate returns, and \$200,000 for all other individual taxpayers. As a consequence, this tax is aimed at higher-income taxpayers. Unfortunately, this tax could very well come as a surprise to taxpayers, potentially increasing the marginal capital gain tax rate to 23.8 percent (from 20 percent) and the marginal ordinary income tax bracket to 43.4 percent (from 39.6 percent). See Chapter 12 for a complete discussion of this surtax.

³⁵Reg. §1.1163(d)-1.

³⁶§ 1411.

REFOCUS ON THE BIG PICTURE

INVESTOR LOSS LIMITATIONS CAN SIGNIFICANTLY AFFECT INVESTMENT RETURNS

The objective for most investors should be to maximize after-tax wealth from among investment alternatives. This requires an understanding of the relevant tax restrictions that apply to certain expenses and losses arising from various investment choices. The after-tax returns from the three alternatives the Reswicks are considering may be affected by the at-risk, passive activity, and investment interest limitations.

The high-growth, low-yield portfolio is expected to generate very little, if any, current interest and dividend income (i.e., investment income). Nonetheless, if the broker's prediction is correct, the market value of the securities will grow by approximately 10 percent a year. However, the annual \$8,000 interest expense on the debt incurred to purchase the securities may not be deductible as investment interest due to the lack of investment income. Unless investment income is generated from this or some other source, the interest will not be deductible until the securities are sold (see Example 39). In addition, to the extent that any capital gain from the portfolio's sale is treated as investment income, the gain will not be subject to preferential capital gains rates (see Example 43). As a result, the net after-tax return will be impaired because of the investment interest limitation.

The net returns from the other two investment choices will be diminished by the at-risk and passive activity loss rules in addition to the investment interest limitation. The projected 10 percent return is apparently contingent on the investor being able to utilize the current tax losses as they arise. These benefits will be deferred because the at-risk and passive activity loss rules delay the timing of the deductions. For example, in the case of the orange grove investment, none of the passive losses are deductible until year 6, when the investment is expected to produce passive income (see Example 29). In the real estate rental venture, however, the Reswicks could deduct the \$25,000 passive loss under the exception for rental real estate for the first four years (see Example 31); the at-risk rules would limit any additional losses in year 5 to the at-risk amount. Consequently, because the at-risk and passive loss rules limit the tax losses flowing to the Reswicks, the after-tax return will not be nearly as high as their broker predicts.

What If?

If the Reswicks decide that the investment in marketable securities is their best option, could they modify their plan so that they avoid the restriction imposed by the investment interest limitation? The Reswicks' net after-tax return would improve if the interest cost of financing their investment could be deducted as incurred. They could finance their investment by borrowing up to \$100,000 against the equity in their home (see Chapter 10). The interest on the home equity loan would be fully deductible; consequently, the after-tax return from their investment would increase. Furthermore, any gain recognition would be deferred until the securities are sold, and the tax on the gain would be subject to the preferential capital gains rate.

Key Terms

Active income, 11-6	Material participation, 11-14	Rental activity, 11-15
At-risk limitation, 11-3	Net investment income, 11-24	Significant participation activity, 11-15
Closely held corporation, 11-10	Passive loss, 11-3	Tax shelters, 11-2
Investment income, 11-24	Personal service corporation, 11-10	
Investment interest, 11-23	Portfolio income, 11-6	

Discussion Questions

- LO.1, 2, 3** Identify two provisions designed to limit the tax benefits a taxpayer may obtain from a tax shelter investment. Describe how these rules reduce or defer the recognition of tax losses.
- LO.2** List some events that increase or decrease an investor's at-risk amount. What are some strategies that a taxpayer can employ to increase the at-risk amount to claim a higher deduction for losses?
- LO.2, 3** Roberto invested \$18,000 in a chicken production operation. Using nonrecourse notes, the business purchases \$120,000 worth of grain to feed the chickens. If Roberto's share of the expense is \$26,000, how much can he deduct?
- LO.3** Explain the meaning of the terms *active income*, *portfolio income*, and *passive income*.
- LO.3** Carlos owns an interest in an activity that produces a \$100,000 loss during the year. Would he prefer to have the activity classified as active or passive? Explain.
- LO.3** Kim owns an interest in an activity that produces \$100,000 of income during the year. Would Kim prefer to have the activity classified as active or passive? Discuss.
- LO.3** Upon a taxable disposition of a passive activity, the taxpayer can utilize any suspended losses and credits related to that activity. Do you agree? Explain.
- LO.3** Discuss whether the passive loss rules apply to the following: individuals, closely held C corporations, S corporations, partnerships, and personal service corporations.
- LO.3** Bronze Corporation has \$100,000 of active income, \$55,000 of portfolio income, and a \$55,000 passive loss. Under what circumstances is Bronze prohibited from deducting the loss? Allowed to deduct the loss?
- LO.4** Discuss what constitutes a passive activity.
- LO.5** What is the significance of the term *material participation*? Why is the extent of a taxpayer's participation in an activity important in determining whether a loss from the activity is deductible or nondeductible?
- LO.5** How many hours must a participant work in a nonrental activity to be guaranteed material participation status?
- LO.5** Suzanne owns interests in a bagel shop, a lawn and garden store, and a convenience store. Several full-time employees work at each of the enterprises. As of the end of November of the current year, Suzanne has worked 150 hours in the bagel shop, 250 hours at the lawn and garden store, and 70 hours at the convenience store. In reviewing her financial records, you learn that she has no passive investments

Decision Making

that are generating income and that she expects these three ventures collectively to produce a loss. What recommendation would you offer Suzanne as she plans her activities for the remainder of the year?

14. **LO.5, 11** John, an engineer, operates a separate business that he acquired eight years ago. If he participates 85 hours in the business and it incurs a loss of \$34,000, under what circumstances can John claim an active loss?
- Issue ID** 15. **LO.2, 3, 5** Rita retired from public accounting after a long and successful career of 45 years. As part of her retirement package, she continues to share in the profits and losses of the firm, albeit at a lower rate than when she was working full-time. Because Rita wants to stay busy during her retirement years, she has invested and works in a local hardware business, operated as a partnership. Unfortunately, the business has recently gone through a slump and has not been generating profits. Identify relevant tax issues for Rita.
16. **LO.5** Some types of work are counted in applying the material participation standards, and some types are not counted. Discuss and give examples of each type.
- Issue ID** 17. **LO.5** Last year Alan's accountant informed him that he could not claim any of his passive activity losses on his income tax return because of his lack of material participation. To circumvent the tax problem this year, Alan tells his wife that she may have to put in some time at the various businesses. Identify the tax issues that Alan faces.
18. **LO.5** Sean, a limited partner in Ivy Nursery, is informed that his portion of the entity's current loss is \$18,000. As a limited partner, can Sean assume that his share of the partnership loss is a passive loss? Explain.
19. **LO.6** Explain why some rental activities may not be *treated* as such under the passive loss rules.
20. **LO.3, 4, 5, 6** How is *passive activity* defined in the Code? What aspects of the definition have been clarified by final or Temporary Regulations?
21. **LO.8** What is a *real estate professional*? Why could qualifying for this status be beneficial under the passive loss rules?
22. **LO.8** Caroline owns a real estate rental activity that produces a loss of \$65,000 during the current year. Under what circumstances can Caroline treat the entire loss as nonpassive?
- Issue ID** 23. **LO.4** Since his college days, Charles has developed an entrepreneurial streak. After working in his family's grocery business, he starts several ventures on his own. Even though Charles is independently wealthy, he is looking forward to working in each of the ventures. He plans to "drop in" on the businesses from time to time between personal trips to Europe and the Caribbean. As of the end of the year, he has established computer software stores in Dayton (Ohio), Austin, and Seattle; bagel bakeries in Albany, Athens (Georgia), and Tallahassee; and mountain bike and ski rental shops in small towns in Vermont, West Virginia, Colorado, and California. Identify the tax issues facing Charles.
24. **LO.8** Brad owns a small townhouse complex that generates a loss during the year. Under what circumstances can Brad deduct a loss from the rental activity? What limitations apply?
25. **LO.8** In connection with passive activities, what is a *deduction equivalent* and how is it computed?
26. **LO.10** What is *investment interest expense*? Describe the basic rules that may limit its deductibility.

Computational Exercises

27. **LO.2** In the current year, Ed invests \$30,000 in an oil partnership. He has taxable income for the current year of \$2,000 from the oil partnership and withdraws \$10,000. What is Ed's at-risk amount at the end of the year?
28. **LO.3** Lucy sells her partnership interest, a passive activity, with an adjusted basis of \$305,000 for \$330,000. In addition, she has current and suspended losses of \$28,000 associated with the partnership and has no other passive activities. Calculate Lucy's total gain and her current deductible loss. Describe the type of income that the deductible loss may offset.
29. **LO.4, 5** Forrester owns a nonrental business with two separate departments. Department A generates net income of \$70,000, and Department B generates a net loss of \$58,000. Forrester participates 800 hours in the operations of Department A and 300 hours in the operations of Department B. If Forrester is allowed to treat the departments as components of a single activity, calculate the amount of the Department B loss that can be offset against the income from Department A in the current year.
30. **LO.7** Rhonda has an adjusted basis and an at-risk amount of \$7,500 in a passive activity at the beginning of the year. She also has a suspended passive loss of \$1,500 carried over from the prior year. During the current year, she has a loss of \$12,000 from the passive activity. Rhonda has no passive income from other sources this year. Determine the following items relating to Rhonda's passive activity as of the end of the year.
- Adjusted basis and at-risk amount in the passive activity.
 - Loss suspended under the at-risk rules.
 - Suspended passive loss.
31. **LO.8** Noah, who has \$62,000 of AGI before considering rental activities, has \$70,000 of losses from a real estate rental activity in which he actively participates. He also actively participates in another real estate rental activity from which he has \$33,000 of income. He has other passive income of \$20,000. What amount of rental loss can Noah use to offset active or portfolio income in the current year?
32. **LO.9** Rose dies with passive activity property having an adjusted basis of \$65,000, suspended losses of \$13,000, and a fair market value at the date of her death of \$90,000. Of the \$13,000 suspended loss existing at the time of Rose's death, how much is deductible on her final return or by the beneficiary?
33. **LO.10** Troy's financial records for the year reflect the following:

Interest income from bank savings account	\$ 900
Taxable annuity receipts	1,800
Safe deposit box rental (to hold annuity documents)	125
Investment interest expense	3,200

Calculate Troy's net investment income and his current investment interest deduction. Assume that Troy does not itemize his personal deductions. How is any potential excess investment interest deduction treated?

Problems

34. **LO.2** In 2014, Fred invested \$50,000 in a general partnership. Fred's interest is not considered to be a passive activity. If his share of the partnership losses is \$35,000 in 2014 and \$25,000 in 2015, how much can he deduct in each year?

- Communications** 35. **LO.2** In the current year, Bill Parker (54 Oak Drive, St. Paul, MN 55164) is considering making an investment of \$60,000 in Best Choice Partnership. The prospectus provided by Bill's broker indicates that the partnership investment is not a passive activity and that Bill's share of the entity's loss in the current year will likely be \$40,000, while his share of the partnership loss next year will probably be \$25,000. Write a letter to Bill in which you indicate how the losses would be treated for tax purposes in the current year and the following year.

- Decision Making** 36. **LO.2, 11** Heather wants to invest \$40,000 in a relatively safe venture and has discovered two alternatives that would produce the following reportable ordinary income and loss over the next three years:

Year	Alternative 1 Income (Loss)	Alternative 2 Income (Loss)
1	(\$20,000)	(\$48,000)
2	(28,000)	32,000
3	72,000	40,000

She is interested in the after-tax effects of these alternatives over a three-year horizon. Assume that Heather's investment portfolio produces sufficient passive income to offset any potential passive loss that may arise from these alternatives, that her cost of capital is 6% (the present value factors are .9434, .8900, and .8396), that she is in the 25% tax bracket, that each investment alternative possesses equal growth potential, and that each alternative exposes her to comparable financial risk. In addition, assume that in the loss years for each alternative, there is no cash flow from or to the investment (i.e., the loss is due to depreciation), while in those years when the income is positive, cash flows to Heather equal the amount of the income. Based on these facts, compute the present value of these two investment alternatives and determine which option Heather should choose.

37. **LO.1, 3** Dorothy acquired a 100% interest in two passive activities: Activity A in January 2010 and Activity B in 2011. Through 2013, Activity A was profitable, but it produced losses of \$200,000 in 2014 and \$100,000 in 2015. Dorothy has passive income from Activity B of \$20,000 in 2014 and \$40,000 in 2015. After offsetting passive income, how much of the net losses may she deduct?
38. **LO.1, 3** A number of years ago, Kay acquired an interest in a partnership in which she is not a material participant. Kay's basis in her partnership interest at the beginning of 2014 is \$40,000. Kay's share of the partnership loss is \$35,000 in 2014, while her share of the partnership income is \$15,000 in 2015. How much may Kay deduct in 2014 and 2015, assuming she owns no other passive activities?
39. **LO.3** Mike, an attorney, earns \$200,000 from his law practice and receives \$45,000 in dividends and interest during the year. In addition, he incurs a loss of \$50,000 from an investment in a passive activity acquired three years ago. What is Mike's net income for the current year after considering the passive investment?

- Decision Making** 40. **LO.3, 11** Emily has \$100,000 that she wants to invest and is considering the following two options:
- Option A: Investment in Redbird Mutual Fund, which is expected to produce interest income of \$8,000 per year.

- Option B: Investment in Cardinal Limited Partnership (buys, sells, and operates wine vineyards). Emily's share of the partnership's ordinary income and loss over the next three years would be as follows:

Year	Income (Loss)
1	(\$ 8,000)
2	(2,000)
3	34,000

Emily is interested in the after-tax effects of these alternatives over a three-year horizon. Assume that Emily's investment portfolio produces ample passive income to offset any passive losses that may be generated. Her cost of capital is 8% (the present value factors are .92593, .85734, and .79383), and she is in the 28% tax bracket. The two investment alternatives possess equal growth potential and comparable financial risk. Based on these facts, compute the present value of these two investment alternatives and determine which option Emily should choose.

41. **LO.3** Ray acquired an activity several years ago, and in the current year, it generates a loss of \$50,000. Ray has AGI of \$140,000 before considering the loss from the activity. If the activity is a bakery and Ray is not a material participant, what is his AGI?
42. **LO.3, 11** Jorge owns two passive investments, Activity A and Activity B. He plans to dispose of Activity A in the current year or next year. Juanita has offered to buy Activity A this year for an amount that would produce a taxable passive gain to Jorge of \$115,000. However, if the sale, for whatever reason, is not made to Juanita, Jorge believes that he could find a buyer who would pay about \$7,000 less than Juanita. Passive losses and gains generated (and expected to be generated) by Activity B follow:

Two years ago	(\$35,000)
Last year	(35,000)
This year	(8,000)
Next year	(30,000)
Future years	Minimal profits

All of Activity B's losses are suspended. Should Jorge close the sale of Activity A with Juanita this year, or should he wait until next year and sell to another buyer? Jorge is in the 28% tax bracket.

43. **LO.3** Sarah has investments in four passive activity partnerships purchased several years ago. Last year the income and losses were as follows:

Activity	Income (Loss)
A	\$ 30,000
B	(30,000)
C	(15,000)
D	(5,000)

In the current year, she sold her interest in Activity D for a \$10,000 gain. Activity D, which had been profitable until last year, had a current loss of \$1,500. How will the sale of Activity D affect Sarah's taxable income in the current year?

44. **LO.3** Leon sells his interest in a passive activity for \$100,000. Determine the tax effect of the sale based on each of the following independent facts:
- Adjusted basis in this investment is \$35,000. Losses from prior years that were not deductible due to the passive loss restrictions total \$40,000.

Decision Making

- b. Adjusted basis in this investment is \$75,000. Losses from prior years that were not deductible due to the passive loss restrictions total \$40,000.
- c. Adjusted basis in this investment is \$75,000. Losses from prior years that were not deductible due to the passive loss restrictions total \$40,000. In addition, suspended credits total \$10,000.
45. **LO.3** Ash, Inc., a closely held personal service corporation, has \$100,000 of passive losses. In addition, Ash has \$80,000 of active business income and \$20,000 of portfolio income. How much of the passive loss may Ash use to offset the other types of income?
46. **LO.3** In the current year, White, Inc., earns \$400,000 from operations and receives \$36,000 in dividends and interest from various portfolio investments. White also pays \$150,000 to acquire a 20% interest in a passive activity that produces a \$200,000 loss.
- a. Assuming that White is a personal service corporation, how will these transactions affect its taxable income?
- b. Same as (a), except that White is closely held but not a personal service corporation.

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47. **LO.2, 3, 7, 11** Kristin Graf (123 Baskerville Mill Road, Jamison, PA 18929) is trying to decide how to invest a \$10,000 inheritance. One option is to make an additional investment in Rocky Road Excursions in which she has an at-risk basis of \$0, suspended losses under the at-risk rules of \$7,000, and suspended passive losses of \$1,000. If Kristin makes this investment, her share of the expected profits this year will be \$8,000. If her investment stays the same, her share of profits from Rocky Road Excursions will be \$1,000. Another option is to invest \$10,000 as a limited partner in the Ragged Mountain Winery; this investment will produce passive income of \$9,000. Write a letter to Kristin to review the tax consequences of each alternative. Kristin is in the 28% tax bracket.

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48. **LO.2, 3, 7, 11** The end of the year is approaching, and Maxine has begun to focus on ways of minimizing her income tax liability. Several years ago she purchased an investment in Teal Limited Partnership, which is subject to the at-risk and the passive activity loss rules. (Last year Maxine sold a different investment that was subject to these rules and that produced passive income.) She believes that her investment in Teal has good long-term economic prospects. However, it has been generating tax losses for several years in a row. In fact, when she was discussing last year's income tax return with her tax accountant, he said that unless "things change" with respect to her investments, she would not be able to deduct losses this year.
- a. What was the accountant referring to in his comment?
- b. You learn that Maxine's current at-risk basis in her investment is \$1,000 and that her share of the current loss is expected to be \$13,000. Based on these facts, how will her loss be treated?
- c. After reviewing her situation, Maxine's financial adviser suggests that she invest at least an additional \$12,000 in Teal to ensure a full loss deduction in the current year. How do you react to his suggestion?
- d. What would you suggest Maxine consider as she attempts to maximize her current-year deductible loss?
49. **LO.2, 3, 7** A number of years ago, Lee acquired a 20% interest in the BlueSky Partnership for \$60,000. The partnership was profitable through 2014, and Lee's amount at risk in the partnership interest was \$120,000 at the beginning of 2015. BlueSky incurred a loss of \$400,000 in 2015 and reported income of \$200,000 in 2016. Assuming that Lee is not a material participant, how much of his loss from BlueSky Partnership is deductible in 2015 and 2016? Consider the at-risk and passive loss rules, and assume Lee owns no other passive investments.

- 50. **LO.2, 3, 5, 7** Grace acquired an activity four years ago. The loss from the activity is \$50,000 in the current year (at-risk basis of \$40,000 as of the beginning of the year). Without considering the loss from the activity, she has gross income of \$140,000. If the activity is a convenience store and Grace is a material participant, what is the effect of the activity on her taxable income?
- 51. **LO.2, 3, 5, 7** Jonathan, a physician, earns \$200,000 from his practice. He also receives \$18,000 in dividends and interest from various portfolio investments. During the year, he pays \$45,000 to acquire a 20% interest in a partnership that produces a \$300,000 loss. Compute Jonathan's AGI, assuming that:
 - a. He does not participate in the operations of the partnership.
 - b. He is a material participant in the operations of the partnership.
- 52. **LO.2, 3, 7** Five years ago Gerald invested \$150,000 in a passive activity, his sole investment venture. On January 1, 2014, his amount at risk in the activity was \$30,000. His shares of the income and losses were as follows:

Year	Income (Loss)
2014	(\$40,000)
2015	(30,000)
2016	50,000

How much can Gerald deduct in 2014 and 2015? What is his taxable income from the activity in 2016? Consider the at-risk rules as well as the passive loss rules.

- 53. **LO.3, 8** Several years ago Benny Jackson (125 Hill Street, Charleston, WV 25311) acquired an apartment building that currently generates a loss of \$60,000. Benny's AGI is \$130,000 before considering the loss. The apartment building is in an exclusive part of the city, and Benny is an active participant. Write a letter to Benny explaining what effect the loss will have on his AGI.
- 54. **LO.3, 5, 8** This year Maria works 1,200 hours as a computer consultant, 320 hours in a real estate development business, and 400 hours in real estate rental activities. Juan, her husband, works 250 hours in the real estate development business and 180 hours in the real estate rental business. Maria earns \$60,000 as a computer consultant, while she and Juan lost \$18,000 in the real estate development business and \$26,000 in the real estate rental business. How should they treat the losses?
- 55. **LO.3, 8, 11** Bonnie and Jake (ages 35 and 36, respectively) are married with no dependents and live in Montana (not a community property state). Because Jake has large medical expenses, they seek your advice about filing separately to save taxes. Their income and expenses for 2015 are as follows:

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Bonnie's salary	\$ 42,500
Jake's salary	26,000
Interest income (joint)	1,500
Rental loss from actively managed rental property	(23,000)
Jake's unreimbursed medical expenses	8,500
All other itemized deductions:*	
Bonnie	9,000
Jake	3,400

*None subject to limitations

Determine whether Bonnie and Jake should file jointly or separately for 2015.

- 56. **LO.3, 8, 11** Mary and Charles have owned a beach cottage on the New Jersey shore for several years and have always used it as a family retreat. When they acquired the property, they had no intentions of renting it. Because family

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circumstances have changed, they are considering using the cottage for only two weeks a year and renting it for the remainder of the year. Their AGI approximates \$80,000 per year, and they are in the 32% tax bracket (combined Federal and state). Interest and real estate taxes total \$8,000 per year and are expected to continue at this level in the foreseeable future. If Mary and Charles rent the property, their *incremental* revenue and expenses are projected to be:

Rent income	\$ 22,000
Rental commissions	(4,000)
Maintenance expenses	(9,000)
Depreciation expense	(10,000)

If the cottage is converted to rental property, they plan to be actively involved in key rental and maintenance decisions. Given the tax effects of converting the property to rental use, would the cash flow from renting the property be enough to meet the \$12,000 annual mortgage payment? Explain.

57. **LO.3, 8** During the current year, Gene, a CPA, performs services as follows: 1,800 hours in his tax practice and 50 hours in an apartment leasing operation in which he has a 15% interest. Because of his oversight duties, Gene is considered to be an active participant. He expects that his share of the loss realized from the apartment leasing operation will be \$30,000 and that his tax practice will show a profit of approximately \$80,000. Gene is single and has no other income. Discuss the character and treatment of the income and losses generated by these activities.
58. **LO.3, 8** Ida, who has AGI of \$80,000 before considering rental activities, is active in three separate real estate rental activities and is in the 28% tax bracket. She has \$12,000 of losses from Activity A, \$18,000 of losses from Activity B, and income of \$10,000 from Activity C. She also has \$2,100 of tax credits from Activity A. Calculate the deductions and credits that she is allowed and the suspended losses and credits.
59. **LO.8** Ella has \$105,000 of losses from a real estate rental activity in which she actively participates. She has other rental income of \$25,000 and other passive income of \$32,000. Her AGI before considering these items of income and loss is \$95,000. How much rental loss can Ella deduct against active and portfolio income (ignoring the at-risk rules)? Does she have any suspended losses to carry over? Explain.
60. **LO.9** At death, Francine owns an interest in a passive activity property (adjusted basis of \$160,000, suspended losses of \$16,000, and fair market value of \$170,000). What is deductible on Francine's final income tax return?
61. **LO.9** In the current year, Abe gives an interest in a passive activity to his daughter, Andrea. The value of the interest at the date of the gift is \$25,000, and its adjusted basis to Abe is \$13,000. During the time that Abe owned the investment, losses of \$3,000 could not be deducted because of the passive loss limitations. What is the tax treatment of the suspended passive activity losses to Abe and Andrea?
62. **LO.9** Tonya sells a passive activity in the current year for \$150,000. Her adjusted basis in the activity is \$50,000, and she uses the installment method of reporting the gain. The activity has suspended losses of \$12,000. Tonya receives \$60,000 in the year of sale. What is her gain? How much of the suspended losses can she deduct?
63. **LO.10, 11** In 2015, Kathleen Tweardy incurs \$30,000 of interest expense related to her investments. Her investment income includes \$7,500 of interest, \$6,000 of qualified dividends, and a \$12,000 net capital gain on the sale of securities. Kathleen asks you to compute the amount of her deduction for investment interest, taking into consideration any options she might have. In addition, she wants your

Decision Making Communications

suggestions as to any tax planning alternatives that are available. Write a letter to her that contains your advice. Kathleen lives at 11934 Briarpatch Drive, Midlothian, VA 23113.

64. **LO.10** Helen borrowed \$150,000 to acquire a parcel of land to be held for investment purposes. During 2015, she paid interest of \$12,000 on the loan. She had AGI of \$90,000 for the year. Other items related to Helen's investments include the following:

Investment income	\$11,000
Long-term capital gain on sale of stock	3,500
Investment counsel fees	200

Helen is unmarried and does not itemize her deductions.

- Determine Helen's investment interest deduction for 2015.
- Discuss the treatment of the portion of Helen's investment interest that is disallowed in 2015.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Carol is a successful physician who owns 100% of her incorporated medical practice. She and her husband, Dick, are considering the purchase of a commercial office building located near the local community hospital. If they purchase the building, Carol will move her medical practice to the new location and rent space for an arm's length price. The rent income Carol and Dick receive will be available to absorb passive losses generated by other passive activities they own. The net effect of this arrangement is a reduction in their income tax liability. Will Carol and Dick's plan work? Why or why not?

Research Problem 2. Five years ago Bridget decided to purchase a limited partnership interest in a fast-food restaurant conveniently located near the campus of Southeast State University. The general partner of the restaurant venture promised her that the investment would prove to be a winner. During the process of capitalizing the business, \$2 million was borrowed from Northside Bank; however, each of the partners was required to pledge personal assets as collateral to satisfy the bank loan in the event that the restaurant defaulted. Bridget pledged shares of publicly traded stock (worth \$200,000, basis of \$75,000) to satisfy the bank's requirement.

The restaurant did a good business until just recently, when flagrant health code violations were discovered and widely publicized by the media. As a result, business has declined to a point where the restaurant's continued existence is doubtful. In addition, the \$2 million loan is now due for payment. Because the restaurant cannot pay, the bank has called for the collateral provided by the partners to be used to satisfy the debt. Bridget sells the pledged stock for \$200,000 and forwards the proceeds to the bank. Bridget believes that her share of the restaurant's current and suspended passive losses can offset the \$125,000 gain from the stock sale. As a result, after netting the passive losses against the gain, none of the gain is subject to tax.

How do you react to Bridget's position?

Research Problem 3. Ida Ross has decided to purchase a new home in a retirement community for \$400,000. She has \$50,000 in cash for the down payment but needs to borrow the remaining \$350,000 to finance the purchase. Her financial adviser, Marc, suggests that rather than seeking a conventional mortgage, she should borrow the funds from State Bank using her portfolio of appreciated securities as collateral. Selling the securities to generate \$350,000 in cash would lead to a substantial tax on the capital gain recognized. Therefore, a better strategy would be to borrow against her securities and then claim a deduction for the interest paid on the loan. How do you react to the financial adviser's strategy?

Partial list of research aids:
Temp.Reg. § 1.163-8T(c).

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. Investment advisers and tax professionals are continuously striving to create sophisticated transactions and investment vehicles (i.e., tax-advantaged investments) that are designed to provide economic benefits to investors by reducing their taxes. These professionals might like to patent such schemes. Identify whether patenting a tax strategy is a legal possibility.

Research Problem 5. Oil and gas ventures operating as publicly traded partnerships typically attract sophisticated investors who purchase limited partnership interests. Investments in these types of publicly traded partnerships are subject to a restrictive set of passive loss rules. Identify three publicly traded oil and gas partnerships that are currently marketed to investors, describe the benefits the promoters claim will result from such investments, and briefly review the basic nature of the unique passive loss restrictions placed on such investments.

Roger CPA Review Questions

- Lee, a married individual, is an employee with three rental properties in which Lee does not actively participate. In 20X14, Property 1 had a net loss of \$10,000, Property 2 had a net gain of \$25,000, and Property 3 had a net loss of \$5,000. Lee's W-2 income in 20X14 was \$110,000. Considering only the foregoing facts, what is Lee's 20X14 adjusted gross income?
 - \$120,000
 - \$125,000
 - \$110,000
 - \$135,000
- Anscomb is an employee who also solely owns and actively participates in a rental activity which produced a \$20,000 loss in the current year. Anscomb's W-2 income in the current year is \$115,000. Considering only the foregoing facts, what should Anscomb's adjusted gross income be for the current year?
 - \$97,500
 - \$115,000
 - \$107,500
 - \$102,500
- Lewis is not an active participant in three rental activities, which have turned profits in recent years. The following gain and losses apply to the current year for Lewis:

	Gain or (Loss)
Rental Activity 1	(\$10,000)
Rental Activity 2	12,000
Rental Activity 3	(8,000)
Total	<u>(\$ 6,000)</u>

What amount of the suspended loss should Lewis allocate to Rental Activity 3?

- a. \$4,500
 - b. \$2,667
 - c. \$0
 - d. Suspended losses may be allocated according to the taxpayer's preference
4. Smith bought a rental property in Year 1 for \$100,000. In Year 1, Smith's Adjusted Gross Income (AGI) was \$125,000 and Smith sustained a \$30,000 loss on the property. In Year 2, Smith's AGI was \$175,000 and Smith sustained a \$20,000 loss on the property. In Year 3, Smith sold the property for \$155,000. What amount of gain or loss must Smith report on Smith's Year 3 tax return as a result of the sale? Assume Smith actively participated in the rental activity in all three years, but is not considered a real estate professional for tax purposes.
- a. \$17,500 gain
 - b. \$0 (no gain or loss)
 - c. \$22,500 gain
 - d. \$20,000 gain
5. Patel bought a rental property in Year 1 for \$150,000. In Year 1, Patel's Adjusted Gross Income (AGI) was \$100,000 and Patel sustained a \$15,000 loss on the property. In Year 2, Patel's AGI was \$140,000 and Patel sustained a \$10,000 loss on the property. In Year 3, Patel sold the property for \$175,000. What amount of gain or loss must Patel report on Patel's Year 3 tax return as a result of the sale? Assume Patel did not actively participate in the rental activity in any of the three years.
- a. \$25,000
 - b. \$0 (no income or loss)
 - c. \$5,000
 - d. \$20,000
6. The following chart applies to Bettelli, an investor who owns two rental activities, Property A and Property B, and has no other involvement in passive activities:

	Property	Income (Loss)
Year 1	A	(\$12,000)
	B	5,000
Year 2	A	(6,000)
	B	1,000

Bettelli met the requirements for active participation in Year 1 but not in Year 2. Bettelli's AGI in Year 1 was \$140,000; in Year 2, \$180,000. In Year 3, Bettelli sells Property A for a \$15,000 gain. How much of the gain must Bettelli report on Bettelli's Year 3 tax return?

- a. \$0
 - b. \$3,000
 - c. \$8,000
 - d. \$13,000
7. In 20X4 Albert, Berry, and Collins formed ABC Partnership. Collins, a limited partner, contributed \$20,000 in cash to the partnership and also pledged \$10,000 of personal property as collateral to meet any partnership debts that may arise. ABC Partnership loss is \$50,000. How much of the loss is deductible by Collins under the at risk rules?
- a. \$0
 - b. \$10,000
 - c. \$20,000
 - d. \$30,000

Tax Credits and Payments

LEARNING OBJECTIVES: *After completing Chapter 12, you should be able to:*

- | | |
|--|---|
| <p>LO.1 Explain how tax credits are used as a tool of Federal tax policy.</p> <p>LO.2 Distinguish between refundable and nonrefundable credits and understand the order in which they can be used by taxpayers.</p> <p>LO.3 Identify various business-related tax credits.</p> <p>LO.4 Determine various tax credits that are available primarily to individual taxpayers.</p> | <p>LO.5 Apply the tax withholding and payment procedures used by employers.</p> <p>LO.6 Execute the tax payment procedures used by self-employed persons.</p> <p>LO.7 Identify tax planning opportunities related to tax credits and payments.</p> |
|--|---|

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- 12-2b General Business Credit, 12-5
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THE BIG PICTURE

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EDUCATION TAX CREDITS

Tom and Jennifer Snyder have two children in college. Lora is a freshman, and her tuition and required fees total \$14,000. Lora has a partial scholarship amounting to \$6,500, and the Snyders paid the balance of her tuition (\$7,500), plus room and board of \$8,500. Sam is a junior, and the Snyders paid \$8,100 for his tuition, plus \$7,200 for his room and board. Both students qualify as Tom and Jennifer's dependents.

The Snyders report AGI of \$158,000. They would like to know what tax options are available to them related to these education expenses. They have heard about various education-related deductions and credits, but they believe that their income is too high for them to get any benefit. Are they correct?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income	<u>(x,xxx)</u>
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)
Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>)	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>

FORM 1040 (p. 2)

48	Foreign tax credit. Attach Form 1116 if required	48		
49	Credit for child and dependent care expenses. Attach Form 2441	49		
50	Education credits from Form 8863, line 19	50		
51	Retirement savings contributions credit. Attach Form 8880	51		
52	Child tax credit. Attach Schedule 8812, if required	52		
53	Residential energy credits. Attach Form 5695	53		
54	Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/> _____	54		
55	Add lines 48 through 54. These are your total credits			

Tax due (*or refund*)

\$	<u>xxx</u>
----	------------

Federal tax law often serves purposes other than merely raising revenue for the government. Evidence of equity, social, and economic considerations, among others, is found throughout the tax law. These considerations also bear heavily in the area of **tax credits**.

EXAMPLE

1

Paul and Peggy, husband and wife, are both employed outside the home. Their combined salaries are \$50,000. However, after paying for child care expenses of \$2,000 on behalf of their daughter, Polly, the pre-tax economic benefit from both spouses working is \$48,000. The child care expenses are, in a sense, business-related, because they would not have been incurred if both spouses did not work outside the home. If no tax benefits are associated with the child care expenditures, \$50,000 is subject to tax.

Another couple, Alicia and Diego, also have a child, John. Diego stays at home to care for John (the value of those services is \$2,000) while Alicia earns a \$48,000 salary. Because the value of Diego's services rendered is not subject to tax, only Alicia's earnings of \$48,000 are subject to tax.

The credit for child and dependent care expenses mitigates the inequity felt by working taxpayers who must pay for child care services to work outside the home.

EXAMPLE

2

Jane is a single parent who depends on the government's "safety net" for survival—she receives benefits under the Temporary Assistance to Needy Families program in the amount of \$15,000 per year. However, she very much wants to work. Jane has located a job that will pay \$15,500 per year and has found an individual to care for her child at no cost. But, with the \$1,185.75 (\$15,500 × 7.65%) withholding for Social Security and Medicare taxes, the economic benefit from working is less than remaining reliant on the government (\$14,314.25 versus \$15,000).

To help offset the effect of Social Security and Medicare taxes on wages of the working poor and to provide an incentive to work, the earned income credit is used to increase the after-tax earnings of qualified individuals. In addition, the earned income credit helps offset the regressive nature of certain taxes, such as the Social Security and Medicare taxes, which impose a relatively larger burden on low-income taxpayers than on more affluent taxpayers.

These and many of the other tax credits available to individuals and other taxpayers are a major focus of this chapter. Also addressed are the procedures used by which individuals submit their tax liabilities to the U.S. Treasury, and additional taxes that support the Federal Medicare system.

12-1 TAX POLICY CONSIDERATIONS

Congress generally has used tax credits to achieve social or economic objectives or to promote equity among different types of taxpayers. For example, the disabled access credit was enacted to accomplish a social objective: to encourage taxpayers to renovate older buildings so that they would be in compliance with the Americans with Disabilities Act. Businesses and institutions must make their facilities more accessible to persons with various disabilities. As another example, the foreign tax credit, which has been a part of the law for decades, has as its purpose the economic and equity objectives of mitigating the burden of multiple taxation on a single stream of income of a multinational taxpayer.

A tax credit should not be confused with an income tax deduction. Certain expenditures of individuals (e.g., business expenses) are permitted as deductions from gross income in arriving at adjusted gross income (AGI). In addition, individuals are allowed to deduct certain nonbusiness and investment-related expenses *from* AGI. While the tax benefit received from a tax deduction depends on the tax rate, a tax credit is not affected by the tax rate of the taxpayer.

Congress wants to encourage a certain type of expenditure. One way to accomplish this objective is to allow a tax credit of 25% for such expenditures. Another way is to allow an itemized deduction for the expenditures. Abby's tax rate is 15%, while Bill's tax rate is 35%, and both itemize deductions. Carmen does not incur enough qualifying expenditures to itemize deductions. The following tax benefits are available to each taxpayer for a \$1,000 expenditure.

	Abby	Bill	Carmen
Tax benefit if a 25% credit is allowed	\$250	\$250	\$250
Tax benefit if an itemized deduction is allowed	150	350	-0-

As these results indicate, tax credits provide benefits on a more equitable basis than do tax deductions. Equally apparent is that the deduction approach in this case benefits only taxpayers who itemize deductions, while the credit approach benefits all taxpayers who make the specified expenditure.

Congress has used the tax credit provisions of the Code liberally in implementing tax policy. Although budget constraints and economic considerations often have dictated the repeal of some credits, other credits, such as those applicable to expenses incurred for child and dependent care, have been kept to respond to important social policy considerations. Still other credits, such as the one available for hiring low-income workers, have been retained based on economic and equity considerations.

12-2 TAX CREDITS

12-2a Refundable versus Nonrefundable Credits

As illustrated in Exhibit 12.1, certain credits are refundable while others are nonrefundable. **Refundable credits** are paid to the taxpayer even if the amount of the credit (or credits) exceeds the taxpayer's tax liability.

LO.1

Explain how tax credits are used as a tool of Federal tax policy.

EXAMPLE

3

LO.2

Distinguish between refundable and nonrefundable credits and understand the order in which they can be used by taxpayers.

EXHIBIT 12.1

Partial Listing of Refundable and Nonrefundable Credits

Refundable Credits

Taxes withheld on wages
Earned income credit

Nonrefundable Credits

General business credit, which includes:

- Tax credit for rehabilitation expenditures
- Work opportunity tax credit
- Research activities credit
- Low-income housing credit
- Disabled access credit
- Credit for small employer pension plan startup costs
- Credit for employer-provided child care

Credit for elderly or disabled

Foreign tax credit

Adoption expenses credit

Child tax credit*

Credit for child and dependent care expenses

Education tax credits**

Energy credits

Credit for certain retirement plan contributions

Small employer health insurance credit

*The credit is refundable to the extent of 15% of the taxpayer's earned income in excess of \$3,000. Parents with three or more qualifying children may compute the refundable portion using an alternative method.

**Forty percent of the American Opportunity credit is refundable.

EXAMPLE

4

Ted, who is single, reported taxable income of \$21,000 in 2015. His income tax liability is \$2,689. Ted's employer withheld income tax of \$3,200. Ted is entitled to a refund of \$511; the credit for tax withheld on wages is a refundable credit.

Nonrefundable credits are not paid if they exceed the taxpayer's tax liability.

EXAMPLE

5

Tina is single, age 27. Her taxable income is \$1,320, and the tax on this amount is \$132. Tina's tax credit for child care expenses is \$225. This credit can be used to reduce her net tax liability to zero, but it will not result in a refund, even though the credit (\$225) exceeds Tina's tax liability (\$132). The child care credit is nonrefundable.

Some nonrefundable credits, such as the foreign tax credit, are subject to carryover provisions if they exceed the amount allowable as a credit in a given year. Other nonrefundable credits, such as the child care credit (refer to Example 5), are not subject to carryover provisions and are lost if they exceed the limitations. Because some credits are refundable and others are not, and because some credits are subject to carryover provisions while others are not, the order in which credits are offset against the tax liability is important.

EXAMPLE

6

Elijah's tax liability before credits is \$1,000. He qualifies for two tax credits: a \$400 Credit A (non-refundable) and an \$800 Credit B (refundable). The order in which the credits are applied affects Elijah's tax refund for the year.

continued

If Refundable Credit Is Applied First		If Nonrefundable Credit Is Applied First	
Precredit tax liability	\$1,000	Precredit tax liability	\$1,000
Credit B	<u>(800)</u>	Credit A	<u>(400)</u>
Remaining tax due	\$ 200	Remaining tax due	\$ 600
Credit A (as limited)	<u>(200)</u>	Credit B	<u>(800)</u>
Tax due/(Refund)	\$ -0-	Tax due/(Refund)	(\$ 200)

12-2b General Business Credit

The **general business credit** is composed of a number of other credits, each of which is computed separately under its own set of rules.¹ The general business credit combines these credits into one amount to limit the amount of business credits that can be used to offset a taxpayer's income tax liability.

Two special rules apply to the general business credit. First, any unused credit is carried back 1 year, then forward 20 years. Second, for any tax year, the general business credit is limited to the taxpayer's net income tax reduced by the greater of:²

- The tentative minimum tax. This amount relates to the alternative minimum tax. See Chapter 15.
- 25 percent of *net regular tax liability* that exceeds \$25,000.³

Net regular tax liability is the regular tax liability reduced by certain nonrefundable credits (e.g., credit for child and dependent care expenses, foreign tax credit).

Floyd's general business credit for the current year is \$70,000. His net income tax is \$150,000, the tentative minimum tax is \$130,000, and Floyd's net regular tax liability is \$150,000. He has no other tax credits. Floyd's general business credit allowed for the tax year is computed as follows.

Net income tax	\$ 150,000
Less: The greater of	
• \$130,000 (tentative minimum tax)	
• \$31,250 [25% × (\$150,000 – \$25,000)]	<u>(130,000)</u>
Amount of general business credit allowed for tax year	<u>\$ 20,000</u>

Floyd now holds \$50,000 (\$70,000 – \$20,000) of unused general business credits that may be carried back or forward to other tax years.

EXAMPLE

7

12-2c Treatment of Unused General Business Credits

Unused general business credits initially are carried back one tax year, to reduce the tax liability during that year. Thus, the taxpayer may receive a tax refund as a result of the carryback. Any remaining unused credits then are carried forward for up to 20 tax years.⁴

A FIFO method is applied to the carrybacks, carryovers, and utilization of credits earned during a tax year. The oldest credits are used first in determining the amount of the general business credit. The FIFO method minimizes the potential for loss of a general business credit benefit due to the expiration of credit carryovers, because the earliest years are used before the current credit for the taxable year.

¹The separate credits are listed in § 38(b).

²§ 38(c).

³This amount is \$12,500 for married taxpayers filing separately, unless one of the spouses is not entitled to the general business credit.

⁴§ 39(a)(1).

EXAMPLE

8

This example illustrates the use of general business credit carryovers.

General business credit carryovers		
2012	\$ 4,000	
2013	6,000	
2014	<u>2,000</u>	
Total carryovers	<u>\$12,000</u>	
2015 general business credit		\$ 40,000
Total credit allowed in 2015 (based on tax liability)	\$50,000	
Less: Utilization of carryovers		
2012	(4,000)	
2013	(6,000)	
2014	<u>(2,000)</u>	
Remaining credit allowed in 2015	<u>\$38,000</u>	
Applied against		
2015 general business credit		<u>(38,000)</u>
2015 unused amount carried forward to 2016		<u>\$ 2,000</u>

LO.3

Identify various business-related tax credits.

12-3 SPECIFIC BUSINESS-RELATED TAX CREDIT PROVISIONS

Each component of the general business credit is determined separately under its own set of rules. Some of the more important credits that make up the general business credit are explained here in the order listed in Exhibit 12.1.

12-3a Rehabilitation Expenditures

Taxpayers are allowed a tax credit for expenditures incurred to rehabilitate industrial and commercial buildings and certified historic structures. The **rehabilitation expenditures credit** is intended to discourage businesses from moving from older, economically distressed areas (e.g., inner cities) to newer locations and to encourage the preservation of historic structures.⁵

Rate of the Credit for Rehabilitation Expenses	Nature of the Property
10%	Nonresidential buildings and residential rental property, other than certified historic structures, originally placed in service before 1936
20%	Nonresidential and residential certified historic structures

When taking the credit, the basis of a rehabilitated building is reduced by the full rehabilitation credit allowed.⁶

EXAMPLE

9

Juan spent \$60,000 to rehabilitate a building (adjusted basis of \$40,000) that had been placed in service in 1932. He is allowed a \$6,000 ($10\% \times \$60,000$) credit for rehabilitation expenditures. Juan then increases the basis of the building by \$54,000 [$\$60,000$ (rehabilitation expenditures) – \$6,000 (credit allowed)]. If the building were a historic structure, the credit allowed would be \$12,000 ($20\% \times \$60,000$), and the building's depreciable basis would increase by \$48,000 [$\$60,000$ (rehabilitation expenditures) – \$12,000 (credit allowed)].

⁵§ 47.

⁶§ 50(c).

To qualify for the credit, buildings must be substantially rehabilitated. A building has been *substantially rehabilitated* if qualified rehabilitation expenditures exceed the greater of:

- The adjusted basis of the property before the rehabilitation expenditures, or
- \$5,000.

Qualified rehabilitation expenditures do not include the cost of acquiring a building, the cost of facilities related to a building (such as a parking lot), and the cost of enlarging an existing building.

Recapture of Tax Credit for Rehabilitation Expenditures

A rehabilitation credit must be recaptured if the rehabilitated property is disposed of prematurely or if it ceases to be qualifying property. The **rehabilitation expenditures credit recapture** is based on a holding period requirement of five years and is added to the taxpayer's regular tax liability in the recapture year. The recapture amount also is *added* to the adjusted basis of the property for purposes of determining gain or loss realized upon disposition.

The portion of the credit recaptured is a specified percentage of the credit that was taken by the taxpayer. This percentage is based on the period the property was held by the taxpayer, as shown in Exhibit 12.2.

On March 15, 2013, Rashad placed in service \$30,000 of rehabilitation expenditures on a building qualifying for the 10% credit. A credit of \$3,000 ($\$30,000 \times 10\%$) was allowed, and the basis of the building was increased by \$27,000 ($\$30,000 - \$3,000$). The building was sold on December 15, 2016. Rashad must recapture a portion of the rehabilitation credit, based on the schedule in Exhibit 12.2. Because he held the rehabilitated property for more than two years but fewer than four, 40% of the credit, or \$1,200, is added to his 2016 tax liability. The adjusted basis of the rehabilitation expenditures is increased by the \$1,200 recapture amount.

EXAMPLE

10



ETHICS & EQUITY The Rehabilitation Tax Credit

Your brother—who buys, modernizes, and sells buildings in a large metropolitan city—has come to you for advice. Given the recent credit market conditions, business has been tough, and he has sold only a few buildings. One of your brother's buildings is a certified historic structure that would qualify for the 20 percent rehabilitation tax credit. Based on several recent appraisals, the building currently is worth \$400,000. The expenditures needed to rehabilitate the building would be about

\$250,000, all of which would qualify for the rehabilitation tax credit.

Your brother has been approached by an individual who is interested in buying the building. The customer has offered to pay your brother \$300,000 for the building and \$350,000 for the rehabilitation work. This approach would provide the customer with a larger tax credit ($\$350,000 \times 20\%$ versus $\$250,000 \times 20\%$) and provide a needed sale for your brother's business. How do you respond?

EXHIBIT 12.2

Recapture Calculation for Rehabilitation Expenditures Credit

If the Property Is Held for	The Recapture Percentage Is
Less than 1 year	100
One year or more but less than 2 years	80
Two years or more but less than 3 years	60
Three years or more but less than 4 years	40
Four years or more but less than 5 years	20
Five years or more	0

12-3b Work Opportunity Tax Credit

The **work opportunity tax credit** was enacted to encourage employers to hire individuals from one or more of a number of targeted and economically disadvantaged groups.⁷ Examples of such targeted persons include qualified ex-felons, high-risk youths, food stamp recipients, veterans, summer youth employees, and long-term family assistance recipients.

Work Opportunity Tax Credit: General

The credit generally is equal to 40 percent of the first \$6,000 of wages (per eligible employee) for the first 12 months of employment. If the credit is taken, the employer's tax deduction for wages is reduced by the amount of the credit.

For an employer to qualify for the 40 percent credit, the employee must (1) be certified by a designated local agency as being a member of one of the targeted groups and (2) have completed at least 400 hours of service to the employer. If an employee meets the first condition but not the second, the credit rate is reduced to 25 percent provided the employee has completed a minimum of 120 hours of service to the employer.

Computing the Credit and the Wages Deduction

EXAMPLE

11

In January 2015, Green Company hires four individuals who are certified to be members of a qualifying targeted group. Each employee works 800 hours and is paid wages of \$8,000 during the year. Green Company's work opportunity credit is \$9,600 [$(\$6,000 \times 40\%) \times 4$ employees]. If the tax credit is taken, Green must reduce its deduction for wages paid by \$9,600. No credit is available for wages paid to these employees after their first year of employment.

EXAMPLE

12

On June 1, 2015, Maria, a calendar year taxpayer, hires Joe, a certified member of a targeted group. During the last seven months of 2015, Joe is paid \$3,500 for 500 hours of work. Maria is allowed a credit of \$1,400 ($\$3,500 \times 40\%$) for 2015. Joe continues to work for Maria in 2016 and is paid \$7,000 through May 31, 2016.

Because up to \$6,000 of first-year wages are eligible for the credit, Maria is allowed a 40% credit on \$2,500 [$\$6,000 - \$3,500$ (wages paid in 2015)] of wages paid in 2016. The credit equals \$1,000 ($\$2,500 \times 40\%$). None of Joe's wages paid after May 31, the end of the first year of employment, are eligible for the credit.

Work Opportunity Tax Credit: Qualified Summer Youth Employees

The credit for qualified summer youth employees is allowed on wages for services during any 90-day period between May 1 and September 15.⁸ The maximum wages eligible for the credit are \$3,000 per summer youth employee. The credit rate is the same as that for the work opportunity tax credit. If the employee continues employment after the 90-day period as a member of another targeted group, the amount of the wages eligible for the general work opportunity tax credit as a member of the new target group is reduced by the wages paid to the employee as a qualified summer youth employee.

A *qualified summer youth employee* must be age 16 or 17 on the hiring date. In addition, the individual's principal place of abode must be within an empowerment zone, enterprise community, or renewal community.

⁷§ 51. The credit is available if qualifying employees start work by December 31, 2014. As Congress is expected to extend this credit, though, the examples that follow and the end-of-chapter materials assume that the law continues unchanged.

⁸§ 51(d)(7).



TAX IN THE NEWS A Credit Can Be Too Complex to Claim

Tax credits can be wonderful things: Congress effectively gives out a rebate for a purchase that the taxpayer has made, and perhaps one that the taxpayer would have made without the credit. If the expenditure matches a Congressional initiative (e.g., to reduce carbon emissions or conduct basic research), a tax reduction results.

Tax credits can be seen as more attractive than tax deductions (see Example 3) in that a credit affects all taxpayers in the same way, regardless of the marginal income tax rate that would apply. And the construction of a new tax credit can provide much flexibility in its design: it can be structured as refundable or nonrefundable, it can carry over to past and future tax years, and the carryover can be allowed for any desirable period of tax years.

But this is starting to sound complicated. In fact, several Federal income tax credits have been criticized as being “more trouble than they are worth” (i.e., the compliance and

documentation requirements that accompany the credit can outweigh the benefits of the credit in dollar terms).

For instance, before an employer can claim the work opportunity credit, the employee must substantiate that he or she was, for instance, an ex-felon or a food-stamp recipient. Some employees would rather not release this information to the human resources department of an employer, so the credit again could go unclaimed.

Regulations and interpretations accompany every tax law, but some taxpayers find certain rules concerning tax credits to be excessive. Consulting firms are available at a fee to do some of the processing work, but doesn't the need for such consultants chiefly indicate that the credit has been “over-engineered” and should be simplified? Congressional intent is foiled with every tax credit dollar that goes unclaimed due to excessive complexity in computation or compliance.

Work Opportunity Tax Credit: Long-Term Family Assistance Recipient

A tax credit is available to employers hiring individuals who have been long-term recipients of family assistance welfare benefits. In general, *long-term recipients* are those individuals who are certified by a designated local agency as being a member of a family receiving assistance under a public aid program for at least an 18-month period ending on the hiring date. The family assistance credit is available for qualified wages paid in the *first two years* of employment. An employee's first and second work years may fall within two or more of the employer's tax years.

The credit is equal to 40 percent of the first \$10,000 of qualified wages paid to an employee in the first year of employment, plus 50 percent of the first \$10,000 of qualified wages paid in the second year of employment, resulting in a maximum credit per qualified employee of \$9,000 [\$4,000 (year 1) + \$5,000 (year 2)]. The credit rate is higher for second-year wages to encourage employers to retain qualified individuals, thereby promoting the overall welfare-to-work goal.

In April 2015, Blue Company hired four individuals who are certified as long-term family assistance recipients. Each employee is paid \$9,000 during 2015. Three of the four individuals continue to work for Blue in 2016, earning \$11,000 each during the year.

Blue's work opportunity tax credit is \$14,400 [(40% × \$9,000) × 4 employees] for 2015 and \$15,000 [(50% × \$10,000) × 3 employees] for 2016. In each year, Blue reduces its deduction for wages paid by the amount of the credit for that year.

EXAMPLE

13

12-3c Research Activities Credits

To encourage research and experimentation, usually described as research and development (R&D), a credit is allowed for certain qualifying expenditures paid or incurred by a taxpayer. The **research activities credit** is the *sum* of three components: an incremental research activities credit, a basic research credit, and an energy research credit.⁹

⁹§ 41. Each component of the research credit is available only if qualifying expenditures are paid or incurred by December 31, 2014. As Congress is

expected to extend the credit, though, the examples that follow and the end-of-chapter materials assume that the law continues unchanged.

Credit for Incremental Research Activities

The incremental research activities credit is 20 percent of the *excess* of qualified research expenses for the taxable year over the base amount.¹⁰

In general, *research expenditures* qualify if the research relates to discovering technological information that is intended for use in the development of a new or improved business component of the taxpayer. Such expenses qualify fully if the research is performed in-house (by the taxpayer or employees). If the research is conducted by persons outside the taxpayer's business (e.g., by a third-party contractor), only 65 percent of the amount paid qualifies for the credit.¹¹

EXAMPLE

14

George incurs the following research expenditures.

In-house wages, supplies, computer time	\$50,000
Paid to Cutting Edge Scientific Foundation for research	30,000

George's qualified research expenditures are \$69,500 [$\$50,000 + (\$30,000 \times 65\%)$].

Beyond the general guidelines described above, the Code does not give specific examples of qualifying research. However, the credit is *not* allowed for research that falls into certain categories, including the following.¹²

- Research conducted after the beginning of commercial production of the business component.
- Surveys and studies such as market research, testing, or routine data collection.
- Research conducted *outside* the United States (other than research undertaken in Puerto Rico or possessions of the United States).
- Research in the social sciences, arts, or humanities.

Determining the *base amount* involves a relatively complex series of computations, meant to approximate recent historical levels of research activity by the taxpayer. Thus, the credit is allowed only for increases in research expenses.

EXAMPLE

15

Jack, a calendar year taxpayer, incurs qualifying research expenditures of \$200,000 at the beginning of the year. If Jack's base amount is \$120,000, the incremental research activities credit is \$16,000 [$(\$200,000 - \$120,000) \times 20\%$].

Qualified research and experimentation expenditures are not only eligible for the 20 percent credit, but they also can be *deducted* in the year incurred.¹³ In this regard, a taxpayer has two choices.¹⁴

- Use the full credit and reduce the expense deduction for research expenses by 100 percent of the credit.
- Retain the full expense deduction and reduce the credit by the product of the full credit times the maximum corporate tax rate (35 percent).

As an alternative to the expense deduction, the taxpayer may capitalize the research expenses and amortize them over 60 months or more. In this case, the amount capitalized and subject to amortization is reduced by the full amount of the credit only if the credit exceeds the amount allowable as a deduction.

¹⁰In lieu of determining the incremental research credit as described here, a taxpayer may elect to calculate the credit using an alternative simplified credit procedure. See §§ 41(c)(4) and (5).

¹¹In the case of payments to a qualified research consortium, § 41(b)(3)(A) provides that 75% of the amount paid qualifies for the credit. In contrast, for amounts paid to an energy research consortium, § 41(b)(3)(D) allows the full amount to qualify for the credit.

¹²§ 41(d). Reg. §§ 1.41-1 through 1.41-7.

¹³§ 174. Refer to the discussion of rules for deducting research and experimental expenditures in Chapter 7.

¹⁴§ 280C(c).

Assume the same facts as in Example 15, which shows that the potential incremental research activities credit is \$16,000. The current-year deduction and corresponding credit are computed as follows.

EXAMPLE

16

	Credit Amount	Deduction Amount
• Full credit and reduced deduction		
\$16,000 – \$0	\$16,000	
\$200,000 – \$16,000		\$184,000
• Reduced credit and full deduction		
\$16,000 – [(100% × \$16,000) × 35%]	10,400	
\$200,000 – \$0		200,000
• Full credit and capitalize and elect to amortize costs over 60 months		
\$16,000 – \$0	16,000	
(\$200,000/60) × 12		40,000

Credit for Basic Research

Corporations (other than S corporations or personal service corporations) are allowed an additional 20 percent credit for basic research payments made in excess of a base amount. This credit is not available to individual taxpayers. Basic research payments are amounts paid in cash to a qualified basic research organization, such as a college or university, or a tax-exempt organization operated primarily to conduct scientific research.

Basic research is any original investigation for the advancement of scientific knowledge not having a specific commercial objective. The definition excludes basic research conducted outside the United States and basic research in the social sciences, arts, or humanities. This reflects the intent of Congress to encourage high-tech research in the United States.

The calculation of this additional credit for basic research expenditures is based on expenditures in excess of a specially defined base amount. The portion of the basic research expenditures not in excess of the base amount is treated as a part of the qualifying expenditures for purposes of the regular credit for incremental research activities.

Orange Corporation pays \$75,000 to a university for basic research. Orange's base amount for the basic research credit is \$50,000. The basic research activities credit allowed is \$5,000 [(\$75,000 – \$50,000) × 20%]. The \$50,000 base amount for basic research is treated as research expenses for purposes of the regular incremental research activities credit.

EXAMPLE

17

Energy Research Credit

This credit was designed to stimulate additional energy research. The credit is 20 percent of the amounts paid or incurred by a taxpayer to an energy research consortium for energy research.

12-3d Low-Income Housing Credit

To encourage building owners to make available affordable housing for low-income individuals, Congress has made a credit available to owners of qualified low-income housing projects.¹⁵

More than any other, the **low-income housing credit** is influenced by nontax factors. For example, the property must be certified by an appropriate state or local agency. These credits are issued based on a nationwide allocation of congressional funding.

¹⁵§ 42.

The credit is based on the qualified basis of the property. The qualified basis depends on the number of units rented to low-income tenants. Occupants are low-income tenants if their income does not exceed a specified percentage of the area median gross income. The credit is determined by multiplying the qualified basis by a credit rate. The credit is allowed over a 10-year period, as long as the property continues to meet the required conditions.

EXAMPLE

18

Sarah spends \$1 million to build a qualified low-income housing project that is completed on January 1 of the current year. The entire project is rented to low-income families. The credit rate for property placed in service during January is 7.38%.¹⁶ Sarah claims a credit of \$73,800 ($\$1,000,000 \times 7.38\%$) in the current year and in each of the following nine years.

Recapture of a portion of the credit may be required if the number of units set aside for low-income tenants falls below a minimum threshold, if the taxpayer disposes of the property or the interest in it, or if the taxpayer's amount at risk decreases.

12-3e Disabled Access Credit

The **disabled access credit** is designed to encourage small businesses to retrofit their existing facilities, to make them more accessible to disabled individuals. The credit is calculated at the rate of 50 percent of the eligible expenditures that exceed \$250 but do not exceed \$10,250. Thus, the maximum amount for the credit is \$5,000 ($\$10,000 \times 50\%$).¹⁷

An *eligible small business* is one that during the previous year either had gross receipts of \$1 million or less or had no more than 30 full-time employees. An eligible business can include a sole proprietorship, partnership, regular corporation, or S corporation.

Eligible access expenditures include reasonable and necessary amounts that are paid or incurred to make certain changes to facilities. These changes must involve the removal of architectural, communication, physical, or transportation barriers that would otherwise make a business inaccessible to disabled and handicapped individuals. Examples of qualifying projects include installing ramps, widening doorways, and adding raised markings on elevator control buttons. However, eligible expenditures do *not* include amounts that are paid or incurred in connection with any facility that first was placed in service after November 5, 1990.

To the extent a disabled access credit is available, no deduction or credit is allowed under any other provision of the tax law. The adjusted basis for depreciation is reduced by the amount of the credit.

EXAMPLE

19

Red, Inc., an eligible business, makes \$11,000 of capital improvements to business realty that had been placed in service in June 1990. The expenditures are intended to make Red's business more accessible to the disabled and are considered eligible expenditures for purposes of the disabled access credit. The amount of the credit is \$5,000 [$(\$10,250 - \$250) \times 50\%$].

Although \$11,000 of eligible expenditures are incurred, only the excess of \$10,250 over \$250 qualifies for the credit. The depreciable basis of the capital improvement is \$6,000, because the basis is reduced by the amount of the credit [$\$11,000$ (cost) $-$ \$5,000 (amount of the credit)].

12-3f Small Employer Pension Plan Startup Costs

Small businesses are entitled to a nonrefundable credit for administrative costs associated with establishing and maintaining certain qualified retirement plans.¹⁸ While such costs (e.g., payroll system changes, consulting fees) generally are deductible as ordinary

¹⁶The rate is subject to a monthly adjustment by the IRS.

¹⁸§ 45E.

¹⁷§ 44.

and necessary business expenses, the credit is intended to lower the after-tax cost of establishing a qualified retirement program and thereby to encourage qualifying businesses to offer retirement plans for their employees.

The **credit for small employer pension plan startup costs** is available for eligible employers at the rate of 50 percent of qualified startup costs. An eligible employer is one with fewer than 100 employees who have earned at least \$5,000 of compensation. Qualified startup costs include ordinary and necessary expenses incurred in connection with establishing or maintaining an employer pension plan and retirement-related education costs.¹⁹

The maximum credit is \$500 (based on a maximum \$1,000 of qualifying expenses), and the deduction for the startup costs incurred is reduced by the amount of the credit. The credit can be claimed for qualifying costs incurred in each of the three years beginning with the tax year in which the retirement plan becomes effective (maximum total credit over three years of \$1,500).

Maple Company decides to establish a qualified retirement plan for its employees. In the process, it pays consulting fees of \$1,200 to a firm that provides educational seminars to Maple's employees and assists in making necessary changes to the payroll system. Maple may claim a credit for the pension plan startup costs of \$500 (\$1,200 of qualifying costs, limited to \$1,000 × 50%), and its deduction for these expenses is reduced to \$700 (\$1,200 – \$500).

EXAMPLE

20

12-3g Employer-Provided Child Care

An employer's expenditures incurred to provide for the care of children of employees can be deducted as ordinary and necessary business expenses. Alternatively, employers may claim a credit for qualifying expenditures incurred while providing child care facilities to their employees during normal working hours.²⁰ The **credit for employer-provided child care**, limited annually to \$150,000, is composed of the aggregate of two components: 25 percent of qualified child care expenses and 10 percent of qualified child care resource and referral services.

Qualified child care expenses include the costs of acquiring, constructing, rehabilitating, expanding, and operating a child care facility. *Child care resource and referral services* include amounts paid or incurred under a contract to provide child care resource and referral services to an employee.

Any qualifying expenses otherwise deductible by the taxpayer are reduced by the amount of the credit. In addition, the taxpayer's basis for any property acquired or constructed and used for qualifying purposes is reduced by the amount of the credit. If within 10 years of being placed in service, a child care facility ceases to be used for a qualified use, the taxpayer recaptures a portion of the credit previously claimed.²¹

During the year, Tan Company constructed a child care facility for \$400,000 to be used by its employees who have preschool-aged children in need of child care services while their parents are at work. In addition, Tan incurred salaries for child care workers and other administrative costs associated with the facility of \$100,000.

As a result, Tan's credit for employer-provided child care is \$125,000 [(\$400,000 + \$100,000) × 25%]. Correspondingly, the basis of the facility is reduced to \$300,000 (\$400,000 – \$100,000), and Tan's deduction for salaries and administrative costs is reduced to \$75,000 (\$100,000 – \$25,000).

EXAMPLE

21

¹⁹ §§ 45E(c)(1) and (d)(1).

²⁰ § 45F.

²¹ § 45F(d).

LO.4

Determine various tax credits that are available primarily to individual taxpayers.

12-4 OTHER TAX CREDITS

12-4a Earned Income Credit

The **earned income credit** can be justified as a means of providing tax equity to the working poor. Roughly, the credit has been designed to eliminate the Federal income tax and reimburse the taxpayer for certain other Federal taxes, such as the gasoline and Social Security taxes. In this way, the credit is intended to encourage economically disadvantaged individuals to become contributing members of the workforce.²²

The earned income credit is determined by multiplying a maximum amount of earned income by the appropriate credit percentage. Generally, earned income includes employee compensation and net earnings from self-employment but excludes items such as interest, dividends, retirement benefits, nontaxable employee compensation, and alimony/child support. If a taxpayer has children, the credit percentage used in the calculation depends on the number of qualifying children.

To simplify the compliance process, the IRS issues an Earned Income Credit Table for the determination of the appropriate amount of the credit. This table and a worksheet are included in the instructions available to individual taxpayers.

Eligibility Requirements

Eligibility for the credit depends not only on the taxpayer meeting the earned income and AGI thresholds (shown in the IRS tables), but also on whether he or she has a qualifying child. The term *qualifying child* generally has the same meaning here as it does for purposes of determining who qualifies as a dependent (see Chapter 3).

In addition to being available for taxpayers with qualifying children, the earned income credit is available to certain *workers without children*.²³ However, this provision is available only to taxpayers ages 25 through 64 who cannot be claimed as a dependent on another taxpayer's return.

For 2015, the maximum earned income credit is \$3,359 for a taxpayer with one qualifying child, \$5,548 for a taxpayer with two qualifying children, and \$6,242 for a taxpayer with three or more qualifying children. A taxpayer with no qualifying children can qualify for an earned income credit up to a maximum of \$503.

The credit is available for a taxpayer who is married filing jointly, is single, or is filing as a head of household. The credit for those with qualifying children phases out to zero as earned income increases from about \$23,600 to about \$53,250.²⁴ Amounts in the IRS table are indexed annually.

Qualification for Credit

EXAMPLE

22

Maria, age 30, reports earned income for the year of \$6,000. She is single and has no children. Maria can qualify for an earned income credit.

EXAMPLE

23

Willa, age 20, reports earned income for the year of \$6,000. She is single and has no children. Willa does not qualify for an earned income credit until she reaches age 25.

²²§ 32. The 2015 earned income credit is not available if the taxpayer's unearned income (e.g., interest, dividends) exceeds \$3,400.

²⁴§ 32(a)(2)(B).

²³§ 32(c)(1)(A)(ii).



ETHICS & EQUITY Holding on to the Earned Income Credit with the Aid of a Transient Child

For many years, Loretta Johnson, a single mother of three children, has been struggling to make ends meet by working two jobs that barely pay the minimum wage and together provide just over \$10,000. Fortunately, her housing and food costs have been partially subsidized through various government programs. In addition, she has been able to take advantage of the earned income credit, which has provided almost \$3,000 annually to help her with living expenses.

The credit truly has made a difference in the lives of Loretta and her family by helping them keep their creditors at bay. Loretta is proud that she has worked hard and provided for her family for many years without having to accept government assistance.

Now, however, Loretta faces a problem as her children have grown up and moved out of her home. With no qualifying children in her household, she no longer qualifies for the earned income credit. Although she will continue working her two jobs, such a significant loss to her household budget cuts into her ability to be self-reliant.

As a survival strategy and as a way of keeping the earned income credit, Loretta arranges to have one of her grandchildren live with her for just over six months every year. This enables almost 30 percent of her household budget to be secure. How do you react to Loretta's tax strategy?

12-4b Elderly or Disabled Taxpayers

The credit for the elderly was enacted to provide tax relief on retirement income for individuals who were not receiving substantial benefits from tax-free Social Security payments.²⁵ Currently, the **tax credit for the elderly or disabled** is available to the following.

- Taxpayers age 65 or older.
- Taxpayers under age 65 who are retired with a **permanent and total disability** and who have disability income from a public or private employer on account of the disability. A person generally is considered permanently and totally disabled if he or she is unable to engage in any substantial gainful activity due to a physical or mental impairment for a period of at least 12 months (or lesser period if the disability results in death).

The *maximum* allowable credit is \$1,125 ($15\% \times \$7,500$ of qualifying income), but the credit is less for a taxpayer who receives Social Security benefits or records AGI exceeding specified amounts. Most taxpayers receive Social Security benefits or report AGI high enough to reduce the base for the credit to zero. In addition, because the credit is nonrefundable, the allowable credit cannot exceed the taxpayer's tax liability.

Usually, an individual uses an IRS table or elects to have the IRS compute his or her tax credit. Schedule R of Form 1040 is used to calculate and report the credit.

12-4c Foreign Tax Credit

Individual taxpayers and corporations may claim a tax credit for foreign income tax paid on income earned and subject to tax in another country or a U.S. possession.²⁶ As an alternative, a taxpayer may claim a deduction instead of a credit.²⁷ In most instances, the **foreign tax credit (FTC)** is more advantageous because it provides a direct offset against the U.S. tax liability.

²⁵§ 22. This credit is not subject to indexation.

²⁷§ 164.

²⁶Section 27 provides for the credit, but the qualifications and calculation procedure for the credit are contained in §§ 901–908.

GLOBAL TAX ISSUES Sourcing Income in Cyberspace—Getting It Right When Calculating the Foreign Tax Credit

The limitation on the foreign tax credit (FTC) plays a critical role in restricting the amount of the credit available to a taxpayer. In the FTC formula, the taxpayer characterizes the year's taxable income as either earned (or sourced) inside the United States or earned from sources outside the United States. As a general rule, a greater percentage of foreign-source income in the formula leads to a larger FTC. Therefore, determining the source of various types of income is critical in calculating the credit. However, classifying income as either foreign or U.S. source is not always a simple matter.

Consumers and businesses use the Internet to conduct commerce involving both products and services. But the existing income-sourcing rules were developed long before the existence of the Internet, and taxing authorities are finding it challenging to apply these rules to Internet transactions. Where does a sale take place when the web server is in Scotland, the seller is in India, and the customer is in Illinois? Where is a service performed when all activities take place over the Net?

The FTC is designed to mitigate double taxation because income earned in a foreign country by a U.S. person is subject to both U.S. and foreign taxes. However, the FTC ceiling still may result in some form of double taxation or taxation at rates in excess of U.S. rates when the effective foreign tax rates are higher than the corresponding U.S. rates.

Other special tax treatments applicable to taxpayers working outside the United States include the foreign earned income exclusion (refer to Chapter 5) and deductions for expenses of employees working outside the United States (refer to Chapter 9).

Unused FTCs are carried back 1 year and forward 10 years.²⁸ The FTC is discussed in greater detail in Chapter 25.

Computation

The FTC allowed is the *lesser* of the foreign taxes imposed or the FTC *overall limitation*, which is equal to the Federal income tax paid on the double-taxed income.²⁹

Foreign Tax Credit and Its Limitations

EXAMPLE

24

Yellow, based in the United States, sells widgets in Peru. Profits for the year in that country total \$2 million. Yellow is subject to a 34% U.S. income tax rate, and a 20% marginal income tax rate applies to Yellow in Peru. Thus, attributable income taxes for this double-taxed income are \$680,000 for the U.S. tax and \$400,000 for the Peru tax.

Yellow pays the full \$400,000 tax to Peru. Its U.S. tax on this income is \$680,000 minus the \$400,000 foreign tax credit (lesser of \$400,000 foreign tax paid or \$680,000 attributable U.S. tax), or \$280,000. The FTC allows a full recovery of the \$400,000 tax paid to Peru.

EXAMPLE

25

Continue with the facts of Example 24, except that the applicable Peru tax rate is 40%, for an \$800,000 liability. Yellow pays the full \$800,000 tax to Peru. Its U.S. tax on this income is \$680,000 minus the \$680,000 foreign tax credit (lesser of \$800,000 foreign tax paid or \$680,000 attributable U.S. tax), or \$0.

The FTC overall limitation did not allow a full recovery of the \$800,000 Peru liability. The widget profits are subject to a \$120,000 double tax this year, even after the FTC is applied. The \$120,000 excess amount is carried back 1 tax year and then forward 10 years.

Only foreign income taxes and excess profits taxes (or taxes paid in lieu of such taxes) qualify for the credit.³⁰ In determining whether a tax is an income tax, U.S. criteria are applied. Thus, value added taxes (VAT), severance taxes, property taxes, and

²⁸§ 904(c) and Reg. § 1.904-2(g), Example 1.

²⁹§ 904.

³⁰Reg. § 1.901-1(a)(3)(i).

sales taxes do not qualify because they are not regarded as taxes on income. Such taxes still are deducted by the taxpayer, however.

12-4d Adoption Expenses Credit

Adoption expenses paid or incurred by a taxpayer may give rise to the **adoption expenses credit**.³¹ The provision assists taxpayers who incur nonrecurring costs directly associated with the adoption process, such as adoption fees, attorney fees, court costs, social service review costs, and transportation costs.

In 2015, up to \$13,400 of costs incurred to adopt an eligible child qualify for the credit.³² An eligible child is one who is:

- Under 18 years of age at the time of the adoption or
- Physically or mentally incapable of taking care of himself or herself.

A taxpayer may claim the credit in the year qualifying expenses were paid or incurred if they were paid or incurred *during or after* the tax year in which the adoption was finalized. For qualifying expenses paid or incurred in a tax year *prior* to the year when the adoption was finalized, the credit is claimed in the tax year following the tax year during which the expenses are paid or incurred. A married couple must file a joint return to claim the credit.

In late 2014, Sam and Martha pay \$5,000 in legal fees, adoption fees, and other expenses directly related to the adoption of an infant daughter, Susan. In 2015, the year in which the adoption becomes final, they pay an additional \$18,000. Sam and Martha are eligible for a \$13,400 credit in 2015 (expenses of \$23,000, limited by the credit ceiling, paid in the two tax years).

EXAMPLE

26

The amount of the credit that otherwise is available is phased out for taxpayers whose AGI (modified for this purpose) exceeds \$201,010 in 2015, and the credit is completely eliminated when AGI reaches \$241,010. The reduced credit is calculated by using the ratio of the excess of the taxpayer's AGI over \$201,010 to \$40,000.³³

Assume the same facts as in the previous example, except that Sam and Martha's AGI is \$226,010 in 2015. As a result, their available 2015 credit is reduced from \$13,400 to \$5,025 [$\$13,400 - [\$13,400 \times (\$25,000/\$40,000)]$].

EXAMPLE

27

The credit is nonrefundable and is available to taxpayers only in a year in which this credit and the other nonrefundable credits do not exceed the taxpayer's tax liability. However, any unused adoption expenses credit may be carried over for up to five years, being utilized on a first-in, first-out basis.

12-4e Child Tax Credit

The **child tax credit** provisions allow individual taxpayers to take a tax credit based solely on the *number* of their qualifying children. This credit is one of several "family-friendly" provisions that currently are part of the tax law. To be eligible for the credit, the child must be under age 17, a U.S. citizen, and claimed as a dependent on the taxpayer's return. A portion of the credit is refundable.

Maximum Credit and Phaseouts

The maximum credit available is \$1,000 per child.³⁴ The available credit is phased out for higher-income taxpayers beginning when AGI reaches \$110,000 for joint filers (\$55,000 for married taxpayers filing separately) and \$75,000 for single taxpayers. The

³¹§ 23.

³²§ 23(b)(1). Different rules are used in calculating the credit when adopting "a child with special needs." See § 23(d)(3).

³³§ 23(b)(2). The AGI threshold amount is indexed for inflation.

³⁴§ 24. The maximum credit per child is scheduled to remain at \$1,000 through 2017.

credit is phased out by \$50 for each \$1,000 (or part thereof) of AGI above the threshold amounts.³⁵ Because the maximum credit amount available to taxpayers depends on the number of qualifying children, the income level at which the credit is phased out completely also depends on the number of children qualifying for the credit.

EXAMPLE

28

Juanita and Alberto are married and file a joint tax return claiming their two children, ages 6 and 8, as dependents. Their AGI is \$122,400. Juanita and Alberto's maximum child tax credit is \$2,000 ($\$1,000 \times 2$ children). Because Juanita and Alberto's AGI is in excess of the \$110,000 threshold, the credit reduction equals \$650 [$\50×13 (rounded from 12.4)], and the couple's child tax credit is \$1,350.

12-4f Child and Dependent Care Expenses

The **credit for child and dependent care expenses** mitigates the inequity felt by working taxpayers who must pay for child care services to work outside the home.³⁶ This credit is a specified percentage of expenses incurred to enable the taxpayer to work or to seek employment. Expenses on which the credit for child and dependent care expenses is based are subject to limitations.

Eligibility

To be eligible for the credit, an individual must have either of the following.

- A dependent under age 13.
- A dependent or spouse who is physically or mentally incapacitated and who lives with the taxpayer for more than one-half of the year.

Generally, married taxpayers must file a joint return to obtain the credit.

Eligible Employment-Related Expenses

Eligible expenses include amounts paid for household services and care of a qualifying individual that are incurred to enable the taxpayer to be employed. Child and dependent care expenses include expenses incurred in the home, such as payments for a housekeeper. Out-of-the-home expenses incurred for the care of a dependent under the age of 13 also qualify for the credit.

Out-of-the-home expenses incurred for an older dependent or spouse who is physically or mentally incapacitated qualify for the credit if that person regularly spends at least eight hours each day in the taxpayer's household. This makes the credit available to taxpayers who keep handicapped older children and elderly relatives in the home, instead of institutionalizing them. Out-of-the-home expenses incurred for services provided by a dependent care center qualify only if the center complies with all applicable laws and regulations of a state or unit of local government.

Child care payments to a relative are eligible for the credit unless the relative is a child (under age 19) of the taxpayer.

EXAMPLE

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Wilma is an employed mother of an 8-year-old child. She pays her mother, Rita, \$1,500 per year to care for the child after school. Wilma pays her daughter Eleanor, age 17, \$900 for the child's care during the summer. Of these amounts, only the \$1,500 paid to Rita qualifies as employment-related child care expenses.

Earned Income Ceiling

Qualifying employment-related expenses are limited in amount to an individual's earned income. For married taxpayers, this limitation applies to the spouse with the *lesser* amount of earned income.

³⁵AGI is modified for purposes of this calculation. The threshold amounts are *not* indexed for inflation. See §§ 24(a) and (b). ³⁶§ 21.

Special rules are provided for taxpayers with nonworking spouses who are disabled or are full-time students. If a nonworking spouse is physically or mentally disabled or is a full-time student, he or she is *deemed* to have earned income for purposes of this limitation. The deemed amount is \$250 per month if there is one qualifying individual in the household or \$500 per month if there are two or more qualifying individuals in the household. In the case of a student-spouse, the student's income is *deemed* to be earned only for the months that the student is enrolled on a full-time basis at an educational institution.³⁷

Calculating the Credit

In general, the credit is equal to a percentage of *unreimbursed* employment-related expenses up to \$3,000 for one qualifying individual and \$6,000 for two or more individuals. The credit rate varies between 20 percent and 35 percent, depending on the taxpayer's AGI, as indicated in Exhibit 12.3.

Nancy, who has two children under age 13, worked full-time while her husband, Raji, was attending college for 10 months during the year. Nancy earned \$22,000 and incurred \$6,200 of child care expenses. Raji is *deemed* to be fully employed and to have earned \$500 for each of the 10 months (or a total of \$5,000) that he was in school. Because Nancy and Raji report AGI of \$22,000, they are allowed a credit rate of 31%.

Nancy and Raji are limited to \$5,000 in qualified child care expenses (\$6,000 maximum expenses, limited to Raji's \$5,000 earned income). Therefore, the couple is entitled to a tax credit of \$1,550 (31% × \$5,000) for the year.

EXAMPLE

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EXHIBIT 12.3

Computing the Child and Dependent Care Credit

Adjusted Gross Income		Applicable Rate of Credit
Over	But Not Over	
\$ 0	\$15,000	35%
15,000	17,000	34%
17,000	19,000	33%
19,000	21,000	32%
21,000	23,000	31%
23,000	25,000	30%
25,000	27,000	29%
27,000	29,000	28%
29,000	31,000	27%
31,000	33,000	26%
33,000	35,000	25%
35,000	37,000	24%
37,000	39,000	23%
39,000	41,000	22%
41,000	43,000	21%
43,000	No limit	20%

³⁷§ 21(d).

Dependent Care Assistance Program

Recall from Chapter 5 that a taxpayer is allowed an exclusion from gross income for a limited amount reimbursed for child or dependent care expenses. However, the taxpayer is not allowed both an exclusion from gross income and a child and dependent care credit on the same amount. The \$3,000 and \$6,000 ceilings for allowable child and dependent care expenses are reduced dollar for dollar by the amount of reimbursement.³⁸

EXAMPLE

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Assume the same facts as in Example 30, except that of the \$6,200 paid for child care, Nancy was reimbursed \$2,500 by her employer under a qualified dependent care assistance program. Under the employer's plan, the reimbursement reduces Nancy's taxable wages. Thus, Nancy and Raji report AGI of \$19,500 (\$22,000 – \$2,500), and their credit rate increases to 32%.

The maximum amount of child care expenses for two or more dependents of \$6,000 is reduced by the \$2,500 reimbursement, resulting in a tax credit of \$1,120 [32% × (\$6,000 – \$2,500)].

Reporting Requirements

The credit is claimed by completing and filing Form 2441, Credit for Child and Dependent Care Expenses.

ETHICS & EQUITY Using the Credit for Child and Dependent Care Expenses

Your friends, Bob and Carol, have hired a child care provider (Dolores) to come into their home for three hours a day to care for their child while they both are at work. Dolores charges \$2,400 for her services for the year.

Bob and Carol have learned that up to \$3,000 of qualifying expenditures will generate a credit for child and dependent care expenses and that qualifying expenditures can include payments for housecleaning services. As a result, they ask Dolores whether she would be interested in working several hours more per week, after Bob returns from work, for the sole purpose of cleaning the house.

Bob offers to pay \$600 for the additional work, and Dolores seems interested. For Bob and Carol, the net cost of the additional services would be \$480 [\$600 – (\$600 × 20%)] due to the availability of the credit for child and dependent care expenses.

You learn of Bob and Carol's opportunity, but you think it is unfair. If you hired Dolores to perform similar housecleaning services, your net cost would be \$600, not \$480, because you do not qualify for the credit. You are not sure that Bob and Carol should "take advantage" of the system in this way. How do you suppose Bob and Carol will feel, or should feel, about this "abuse" if you approach them about it?

12-4g Education Tax Credits

Two credits, the **American Opportunity credit** and the **lifetime learning credit**,³⁹ are available to help qualifying low- and middle-income individuals defray the cost of higher education. The credits are available for qualifying tuition and related expenses incurred by students pursuing undergraduate or graduate degrees or vocational training. Books and other course materials are eligible for the American Opportunity credit (but not the lifetime learning credit). Room and board are ineligible for both credits.

Maximum Credit

The American Opportunity credit permits a maximum credit of \$2,500 per year (100 percent of the first \$2,000 of tuition expenses plus 25 percent of the next \$2,000 of tuition expenses) for the *first four years* of postsecondary education.⁴⁰ The lifetime learning

³⁸§ 21(c).

³⁹§ 25A.

⁴⁰§ 25A(i)(1).

credit permits a credit of 20 percent of qualifying expenses (up to \$10,000 per year) incurred in a year in which the American Opportunity credit is not claimed with respect to a given student.⁴¹ Generally, the lifetime learning credit is used for individuals who are beyond the first four years of postsecondary education.

Eligible Individuals

Both education credits are available for qualified expenses incurred by a taxpayer, taxpayer's spouse, or taxpayer's dependent. The American Opportunity credit is available for each eligible student, while the lifetime learning credit is calculated per taxpayer. To be eligible for the American Opportunity credit, a student must take at least one-half of the full-time course load for at least one academic term at a qualifying educational institution. No comparable requirement exists for the lifetime learning credit. Therefore, taxpayers who take graduate training or continuing education are eligible for the lifetime learning credit. Taxpayers who are married must file joint returns to claim either education credit.

Income Limitations and Refundability

The education credits are subject to different income limitations. In addition, the American Opportunity credit is partially refundable and may be used to offset a taxpayer's alternative minimum tax (AMT) liability. The lifetime learning credit is neither refundable nor an AMT liability offset.

The American Opportunity credit amount is phased out, beginning when the taxpayer's AGI (modified for this purpose) reaches \$80,000 (\$160,000 for married taxpayers filing jointly). The reduction is equal to the extent to which AGI exceeds \$80,000 (\$160,000 for married taxpayers filing jointly) as a percentage of a \$10,000 phaseout range (\$20,000 for married taxpayers filing jointly). As a result, the credit is eliminated completely when modified AGI reaches \$90,000 (\$180,000 for married taxpayers filing jointly). The credit may be used to reduce a taxpayer's AMT liability. Forty percent of the American Opportunity credit is refundable.⁴²

For 2015, the lifetime learning credit amount is phased out, beginning when the taxpayer's AGI (modified for this purpose) reaches \$55,000 (\$110,000 for married taxpayers filing jointly).⁴³ The reduction is equal to the extent to which modified AGI exceeds \$55,000 (or \$110,000) as a percentage of a \$10,000 (\$20,000 for married filing jointly) phaseout range. The credit thus is eliminated when AGI reaches \$65,000 (or \$130,000).

The Big Picture

Return to the facts of *The Big Picture* on p. 12-1. Recall that Tom and Jennifer Snyder are married and file a joint tax return. The Snyders report modified AGI of \$158,000. They have two children, Lora and Sam. The Snyders paid \$7,500 of tuition and \$8,500 for room and board for Lora (a freshman) and \$8,100 of tuition plus \$7,200 for room and board for Sam (a junior).

Lora and Sam are full-time students and are Tom and Jennifer's dependents. Lora's tuition and Sam's tuition are qualified expenses for the American Opportunity credit. For 2015, Tom and Jennifer may claim a \$2,500 American Opportunity credit for both Lora's and Sam's expenses $[(100\% \times \$2,000) + (25\% \times \$2,000)]$. This totals to a \$5,000 American Opportunity credit on the Snyders' return.

EXAMPLE

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⁴¹§ 25A(c).

⁴²If the credit is claimed for a taxpayer subject to § 1(g) (the "kiddie tax"), the credit is not refundable.

⁴³§ 25A(d). The phaseout amounts are indexed annually. For 2014, the AGI limits were \$54,000 and \$108,000.

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 12-1. Assume that Tom and Jennifer's 2015 modified AGI is \$172,000, instead of \$158,000. The Snyders are eligible to claim a \$2,000 (rather than \$5,000) American Opportunity credit. Their available credit is reduced because AGI exceeds the \$160,000 limit for married taxpayers.

The percentage reduction is computed as the amount by which modified AGI exceeds the limit, expressed as a percentage of the phaseout range, or $[(\$172,000 - \$160,000)/\$20,000]$, resulting in a 60% reduction. Therefore, the maximum available credit is \$2,000 ($\$5,000 \times 40\%$ allowable portion).

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 12-1. Now assume that Tom and Jennifer's 2015 modified AGI is \$122,000. In addition, assume that Tom is going to school on a part-time basis to complete a graduate degree and pays qualifying tuition and fees of \$4,000. As the Snyders' modified AGI is below \$160,000, a \$5,000 American Opportunity credit is available to them relative to the two children (i.e., \$2,500 each for Lora and Sam).

In addition, Tom's qualifying expenses are eligible for the lifetime learning credit. The potential lifetime learning credit ($\$800 = \$4,000 \times 20\%$) is reduced because modified AGI exceeds the \$110,000 limit for married taxpayers. As modified AGI exceeds the limit by \$12,000 and the phaseout range is \$20,000, the lifetime learning credit is reduced by 60%.

Therefore, the Snyders' lifetime learning credit is \$320 ($\$800 \times 40\%$ after the phaseout), and total education credits amount to \$5,320 (\$5,000 American Opportunity credit + \$320 lifetime learning credit).

Restrictions on Double Tax Benefit

Taxpayers are prohibited from receiving a double tax benefit associated with qualifying educational expenses. Therefore, taxpayers who claim an education credit may not deduct the expenses, nor may they claim the credit for amounts that are otherwise excluded from gross income (e.g., scholarships, employer-paid educational assistance).

12-4h Energy Credits

The Internal Revenue Code contains a variety of credits for businesses and individuals to encourage the conservation of natural resources and the development of energy sources other than oil and gas. The **energy tax credits** include incentives to:

- Install energy-efficient windows, insulation, and heating and cooling equipment;
- Purchase solar and other energy-efficient water heaters; and
- Install equipment in a business to produce electricity using solar, wind, or geothermal sources.

Expiration dates differ for the various energy credits, as scheduled under the law.

12-4i Certain Retirement Plan Contributions

Taxpayers may claim a nonrefundable **credit for certain retirement plan contributions** based on eligible contributions of up to \$2,000 to certain qualified retirement plans, such as traditional and Roth IRAs and § 401(k) plans.⁴⁴ This credit, sometimes referred to as the "saver's credit," is intended to encourage lower- and middle-income taxpayers to contribute to qualified retirement plans. The benefit provided by this credit is in addition to any deduction or exclusion that otherwise is available due to the qualifying contribution.

⁴⁴§ 25B(a) through (d). In calculating the credit, the qualifying contributions are reduced by taxable distributions from any of the qualifying plans received by the taxpayer and spouse during the tax year, during the two

previous tax years, and during the period prior to the due date of the current year's return.

The credit rate applied to the eligible expenses depends on the taxpayer's AGI⁴⁵ and filing status, as shown in Exhibit 12.4. However, the maximum credit allowed to an individual is \$1,000 ($\$2,000 \times 50\%$). As the taxpayer's AGI increases, the rate applied to contributions in calculating the credit is reduced, and once AGI exceeds the upper end of the applicable range, no credit is available. To qualify for the credit, the taxpayer must be at least 18 years of age and cannot be a dependent of another taxpayer or a full-time student.

Earl and Josephine, married taxpayers, each contribute \$2,500 to their respective § 401(k) plans offered through their employers. The AGI reported on their joint return is \$45,000.

The maximum amount of contributions that may be taken into account in calculating the credit is limited to \$2,000 for Earl and \$2,000 for Josephine. As a result, Earl and Josephine may claim a credit for their retirement plan contributions of \$400 [$(\$2,000 \times 2) \times 10\%$]. They would not qualify for the credit if their AGI had exceeded \$61,000.

EXAMPLE

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12-4j Small Employer Health Insurance Credit

A tax credit is provided for a qualified small employer for nonelective contributions to purchase health insurance for its employees.

To qualify for the 2015 credit, the employer must have no more than 25 full-time equivalent employees whose annual full-time wages average no more than \$51,600. The employer must pay at least half the cost of the health insurance premiums.⁴⁶

The credit is 50 percent of the health insurance premiums paid. The credit is subject to a phaseout if the employer has more than 10 full-time equivalent employees and/or has annual full-time wages that average more than \$25,800.

The various tax credits discussed in this chapter are summarized in Concept Summary 12.1.

12-5 TAX PAYMENTS

Taxes generally are remitted to the Treasury with the tax return. Withholdings are required, though, as to wages and a few other income items received by individuals; the employer directly transfers a portion of the paycheck to the Federal government. Using a Form W-4, the employee instructs the employer as to how much of the wage should be withheld, so that the taxes on the wages are remitted to the government on a "pay as you go" basis.

LO.5

Apply the tax withholding and payment procedures used by employers.

EXHIBIT 12.4

"Saver's" Credit Rate and AGI Thresholds (2015)

Joint Return		Head of Household		All Other Cases		Applicable Percentage
Over	Not Over	Over	Not Over	Over	Not Over	
\$ 0	\$36,500	\$ 0	\$27,375	\$ 0	\$18,250	50%
36,500	39,500	27,375	29,625	18,250	19,750	20%
39,500	61,000	29,625	45,750	19,750	30,500	10%
61,000		45,750		30,500		0%

⁴⁵The AGI thresholds are indexed annually for inflation. For purposes of this credit, the AGI thresholds are modified to include certain income exclusions. See § 25B(e).

⁴⁶§§ 45R(d)(1) and (4). The wage amount is indexed for inflation.



Concept Summary 12.1

Major Tax Credits

Credit	Computation	Comments
Tax withheld on wages (§ 31)	Amount is reported to employee on Form W-2.	Refundable credit.
Earned income (§ 32)	Amount is determined by reference to Earned Income Credit Table published by IRS.	Refundable credit. A form of negative income tax to assist low-income taxpayers. Earned income and AGI must be less than certain threshold amounts. Generally, one or more qualifying children must reside with the taxpayer.
Child and dependent care (§ 21)	Rate ranges from 20% to 35% depending on AGI. Maximum base for credit is \$3,000 for one qualifying individual, \$6,000 for two or more.	Nonrefundable personal credit. No carryback or carryforward. Benefits taxpayers who incur employment-related child or dependent care expenses in order to work or seek employment. Eligible taxpayers must have a dependent under age 13 or a dependent (any age) or spouse who is physically or mentally incapacitated.
Elderly or disabled (§ 22)	Usually taken from an IRS table.	Nonrefundable personal credit. No carryback or carryforward. Provides relief for taxpayers not receiving substantial tax-free retirement benefits.
Adoption expenses (§ 23)	Up to \$13,400 of costs incurred to adopt an eligible child qualify for the credit. Taxpayer claims the credit in the year qualified expenses were paid or incurred if they were paid or incurred during or after year in which adoption was finalized. For expenses paid or incurred in a year prior to when adoption was finalized, credit must be claimed in tax year following the tax year during which the expenses are paid or incurred.	Nonrefundable credit. Unused credit may be carried forward five years. Purpose is to assist taxpayers who incur nonrecurring costs associated with the adoption process.
Child (§ 24)	Credit is based on <i>number</i> of qualifying children under age 17. Maximum credit is \$1,000 per child. Credit is phased out for higher-income taxpayers.	Generally a nonrefundable credit. Refundable in certain cases. Purpose is to provide tax relief for low- to moderate-income families with children.
Education (§ 25A)	American Opportunity credit is available for qualifying education expenses of students in first four years of postsecondary education. Maximum credit is \$2,500 per year per eligible student. Credit is phased out for higher-income taxpayers. Lifetime learning credit permits a credit of 20% of qualifying expenses (up to \$10,000 per year) provided American Opportunity credit is not claimed with respect to those expenses. Credit is calculated per taxpayer, not per student, and is phased out for higher-income taxpayers.	Credit is designed to help low- to middle-income families defray costs of the first four years of higher education. The credit is partially refundable. Nonrefundable credit. Credit is designed to help low- to middle-income taxpayers defray costs of higher education beyond the first four years.
Certain retirement plan contributions (§ 25B)	Calculation is based on amount of contribution multiplied by a percentage that depends on the taxpayer's filing status and AGI.	Nonrefundable credit. Purpose is to encourage contributions to qualified retirement plans by low- and middle-income taxpayers.
Foreign taxes paid (§ 27)	Foreign-source taxable income/total worldwide taxable income \times U.S. tax = overall limitation. Lesser of foreign taxes imposed or overall limitation.	Nonrefundable credit. Unused credits may be carried back 1 year and forward 10 years. Purpose is to prevent double taxation of offshore income.
Energy credits	Various items to encourage individuals and businesses to "go green."	The credits are subject to various expiration dates.

continued

Major Tax Credits—(Continued)

Credit	Computation	Comments
General business (§ 38)	May not exceed net income tax minus the greater of tentative minimum tax or 25% of net regular tax liability that exceeds \$25,000.	Nonrefundable credit. Components include tax credit for rehabilitation expenditures, work opportunity tax credit, research activities credit, low-income housing credit, disabled access credit, credit for small employer pension plan startup costs, and credit for employer-provided child care. Unused credit may be carried back 1 year and forward 20 years. FIFO method applies to carrybacks, carryovers, and credits earned during current year.
Rehabilitation expenditures (§ 47)	Qualifying investment times rehabilitation percentage, depending on type of property. Regular rehabilitation rate is 10%; rate for certified historic structures is 20%.	Nonrefundable credit. Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to discourage businesses from moving from economically distressed areas to newer locations.
Increased research activities (§ 41)	Incremental credit is 20% of excess of computation year expenditures over the base amount. Basic research credit is allowed to certain corporations for 20% of cash payments to qualified organizations that exceed a specially calculated base amount. An energy research credit is allowed for 20% of qualifying payments made to an energy research consortium.	Nonrefundable credit. Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage high-tech and energy research in the United States.
Low-income housing (§ 42)	Appropriate rate times eligible basis (portion of project attributable to low-income units). Credit is available each year for 10 years. Recapture may apply.	Nonrefundable credit. Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage construction of housing for low-income individuals.
Disabled access (§ 44)	Credit is 50% of eligible access expenditures that exceed \$250, but do not exceed \$10,250. Maximum credit is \$5,000. Available only to eligible small businesses.	Nonrefundable credit. Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage small businesses to become more accessible to disabled individuals.
Small employer pension plan startup costs (§ 45E)	Credit equals 50% of qualified startup costs incurred by eligible employers. Maximum annual credit is \$500. Deduction for related expenses is reduced by the amount of the credit.	Nonrefundable credit. Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage small employers to establish qualified retirement plans for their employees.
Employer-provided child care (§ 45F)	Credit is equal to 25% of qualified child care expenses plus 10% of qualified expenses for child care resource and referral services. Maximum credit is \$150,000. Deduction for related expenses or basis must be reduced by the amount of the credit.	Nonrefundable credit. Part of general business credit and therefore subject to same carryback, carryover, and FIFO rules. Purpose is to encourage employers to provide child care for their employees' children during normal working hours.
Small employer health insurance costs (§ 45R)	50 percent of health insurance premiums paid on behalf of employees.	The employer can have no more than 25 full-time employees, subject to a wage-level maximum. The employer must pay at least 50% of the employees' total health insurance premiums.
Work opportunity (§ 51)	Credit is limited to 40% of the first \$6,000 of wages paid to each eligible employee. For long-term family assistance recipients, credit is limited to 40% of first \$10,000 of wages paid to each eligible employee in first year of employment, plus 50% of first \$10,000 of wages paid to each eligible employee in second year of employment.	Nonrefundable credit. Part of the general business credit and therefore subject to the same carryback, carryover, and FIFO rules. Purpose is to encourage employment of individuals in specified groups.

Corporations and other taxpayers make quarterly payments to the Treasury of the estimated taxes that relate to their taxable income for the period. Taxpayers then claim on the annual tax return a credit against the tax due for the withholdings and estimated payments that have been prepaid in this manner.

In addition, the employer withholds a portion of the wage payment that relates to **employment taxes**, that is, the FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) liabilities that relate to the employee's wages for the period.

Self-employed taxpayers do not have employers, so no withholding occurs, but income and employment taxes are prepaid nonetheless. Self-employed are responsible for remitting their own income and employment taxes, in the form of quarterly estimated tax payments.

12-5a **Payments by Employers**

The employer usually is responsible for withholding the employee's share of FICA (commonly referred to as the Social Security tax) and appropriate amounts for income taxes. In addition, the employer matches the FICA portion withheld, and it pays the full cost of FUTA. The sum of the employment taxes and the income tax withholdings is paid to the IRS at specified intervals.

Amount of FICA Taxes

The FICA tax has two components: Social Security tax (old age, survivors, and disability insurance; rate 6.2 percent) *and* Medicare tax (hospital insurance; rate 1.45 percent). Both the employer and the employee pay the tax at these rates.

The tax rates and wage base under FICA have increased substantially over the years. The base amount is adjusted each year for inflation.

Withholdings from employees continue until the maximum base amount is reached. For 2015, for example, FICA withholding ceases for the Social Security portion (6.2 percent) once the employee has earned FICA wages of \$118,500. No wage limit applies for the Medicare portion (1.45 percent) of the tax.

EXAMPLE

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In 2015, Keshia earned a salary of \$140,000 from Kopps, her employer. Therefore, FICA taxes withheld from her salary are \$7,347 ($\$118,500 \times 6.2\%$) plus \$2,030 ($\$140,000 \times 1.45\%$) for a total of \$9,377. In addition to remitting the amount withheld from Keshia's salary to the government, Kopps pays its own tax of \$9,377 relative to her salary.

A spouse employed by another spouse is subject to FICA tax payments. However, children under the age of 18 who are employed in a parent's trade or business are exempted.

LO.6

Execute the tax payment procedures used by self-employed persons.

12-5b **Payments by Self-Employed Persons**

Although the following discussion largely centers on self-employed taxpayers, estimated tax may be required from some employees. An employee may be required to pay estimated tax for income other than wages that is not subject to withholding (e.g., investment income). Further, the taxpayer may conduct a second trade or business (e.g., as a sole proprietor), and these profits may require the payment of income and self-employment tax.

Estimated Tax

Estimated tax is the amount of tax (including any AMT and self-employment tax) an individual expects to owe for the year after subtracting tax credits and income tax withheld. Any individual who has estimated tax for the year of \$1,000 or more in excess of withholdings must make quarterly estimated tax payments.⁴⁷ No penalty applies if the

⁴⁷ §§ 6654(c)(1) and 6654(e)(1).

taxpayer had a zero tax liability for the preceding tax year *and* the preceding tax year was a taxable year of 12 months *and* the taxpayer was a U.S. citizen or resident for the entire preceding tax year.

First, the *required annual payment* is computed. This is the *smaller* of:

- Ninety percent of the tax shown on the current year's return.
- One hundred percent of the tax shown on the preceding year's return (the return must cover the full 12 months of the preceding year). If the AGI on the preceding year's return exceeds \$150,000 (\$75,000 if married filing separately), the 100 percent requirement is increased to 110 percent.

In general, one-fourth of this required annual payment is due on each of April 15, June 15, and September 15 of the tax year and January 15 of the following year.

An equal part of withholding is deemed paid on each due date. Thus, the estimated tax due on each date is the quarterly installment of the required annual payment, reduced by the quarter's share of the year's withholdings for the individual. Payments are accompanied by the payment voucher, Form 1040-ES.

Self-Employment Tax

The tax on self-employment income is levied to provide Social Security and Medicare benefits (old age, survivors, and disability insurance and hospital insurance) for self-employed individuals. Individuals with net earnings of \$400 or more from self-employment are subject to the **self-employment tax**.⁴⁸ For 2015, the self-employment tax is 12.4 percent of self-employment earnings up to \$118,500 (for the Social Security portion) *plus* 2.9 percent of the total amount of self-employment earnings (the Medicare portion).

Self-employed taxpayers deduct a portion of the self-employment tax in determining the self-employment tax *and* in computing AGI.⁴⁹

If an individual also receives wages subject to FICA tax, the ceiling amount of the Social Security portion on which the self-employment tax is computed is reduced. Thus, the self-employment tax may be reduced to zero if a self-employed individual also receives FICA wages in excess of the ceiling amount.

In 2015, Kelly recorded \$76,000 of net earnings from a data transfer service that she owns. During the year, Kelly also received \$54,000 in wages as an employee of a small video imaging firm.

Kelly's self-employment income subject to the Social Security portion (12.4%) is \$64,500 (\$118,500 – \$54,000), not \$76,000. This produces a self-employment tax of \$7,998 (\$64,500 × 12.4%). All of Kelly's net self-employment earnings are subject to the Medicare portion of the self-employment tax of 2.9%; no income limit applies for that tax.

EXAMPLE

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Net earnings from self-employment includes gross income from a trade or business less allowable trade or business deductions, the distributive share of any partnership income or loss derived from a trade or business activity, and net income from rendering personal services as an independent contractor. Gain or loss from the disposition of property (including involuntary conversions) is excluded from the computation of self-employment income unless the property involved is inventory.

12-5c Additional Medicare Taxes

Additional Tax on Wages

An additional .9 percent Medicare tax is imposed on wages received in excess of \$250,000 for married taxpayers filing a joint return (\$125,000 if married filing separately) and \$200,000 for all other taxpayers.⁵⁰ Unlike the general 1.45 percent Medicare tax on

⁴⁸§ 6017.

⁴⁹§§ 164(f) and 1402(a)(12).

⁵⁰§ 3101(b)(2).

wages, the additional tax on a joint return is on the *combined* wages of the employee and the employee's spouse. As a result, the Medicare tax rate is:

1. 1.45 percent on the first \$200,000 of wages (\$125,000 on a married filing separate return; \$250,000 of combined wages on a married filing joint return), and
2. 2.35 percent (1.45% + .9%) on wages in excess of \$200,000 (\$125,000 on a married filing separate return; \$250,000 of combined wages on a married filing joint return).

Additional Medicare Tax on Wages

EXAMPLE

38

Jenna, who is single, earns wages of \$500,000. Jenna pays \$2,900 of Medicare taxes on the first \$200,000 of her wages ($\$200,000 \times 1.45\%$) and \$7,050 of Medicare taxes on her wages in excess of \$200,000 ($\$300,000 \times 2.35\%$). In total, her Medicare tax is \$9,950. Jenna's additional Medicare tax totals \$2,700.

EXAMPLE

39

Patrick and Paula file a joint return. During the year, Patrick earns wages of \$125,000, and Paula earns wages of \$175,000—their total wages are \$300,000. Patrick and Paula pay total Medicare taxes of \$4,800 [$(\$250,000 \times 1.45\%) + (\$50,000 \times 2.35\%)$]. The couple's additional Medicare tax is \$450.

The additional Medicare tax also applies to self-employed individuals—with net earnings from self-employment being used for the threshold computations. As a result, the tax rate for the Medicare tax on self-employment income is:

1. 2.9 percent on the first \$200,000 of net earnings from self-employment (\$125,000 on a married filing separate return; \$250,000 on a married filing joint return), and
2. 3.8 percent (2.9% + .9%) on net earnings from self-employment in excess of \$200,000 (\$125,000 on a married filing separate return; \$250,000 on a married filing joint return).

Additional Tax on Unearned Income

An additional 3.8 percent Medicare tax is imposed on the unearned income of individuals, estates, and trusts.⁵¹ For individuals, the tax is 3.8 percent of the lesser of:

1. Net investment income, or
2. The excess of modified adjusted gross income over \$250,000 for married taxpayers filing a joint return (\$125,000 if married filing separately) and \$200,000 for all other taxpayers.⁵²

In general, “net investment income” includes interest, dividends, annuities, royalties, rents, income from passive activities, and net gains from the sale of investment property less deductions allowed in generating that income.⁵³

Additional Medicare Tax on Unearned Income

EXAMPLE

40

Jill records net investment income of \$50,000 and MAGI of \$180,000, and she files as a single taxpayer. As Jill's MAGI does not exceed \$200,000, Jill need not pay the additional Medicare tax on unearned income.

⁵¹§1411.

⁵²§1411(b). AGI is modified by adding back any foreign earned income exclusion.

⁵³§1411(c). Certain income, including qualified retirement plan distributions, tax-exempt income, and any untaxed gain from the sale of a principal residence, are excluded from this definition.

Additional Medicare Tax on Unearned Income

Assume the same facts as in Example 40, except that Jill reports net investment income of \$85,000 and MAGI of \$220,000. Now Jill pays a Medicare tax on the lesser of (1) \$85,000 (net investment income) or (2) \$20,000 (the amount by which MAGI exceeds \$200,000). Jill's additional Medicare tax on unearned income is \$760 ($\$20,000 \times 3.8\%$).

EXAMPLE

41

Assume the same facts as in Example 41, except that Jill's MAGI is \$290,000. Because Jill's MAGI exceeds the threshold amount by \$90,000, she pays a Medicare tax on the entire \$85,000 of net investment income. As a result, Jill's additional Medicare tax on unearned income is \$3,230 ($\$85,000 \times 3.8\%$).

EXAMPLE

42

The 3.8 percent additional Medicare tax on unearned income is *in addition to* the additional .9 percent Medicare tax on wages or self-employment income. Taxpayers who generate both high wages (or self-employment income) *and* high investment income may be subject to both taxes.

Assume the same facts as Example 42, except that Jill records MAGI of \$325,000 (including \$240,000 of wages and \$85,000 of net investment income). In this case, in addition to her \$3,230 additional Medicare tax on unearned income, Jill also is subject to an additional Medicare tax of \$360 ($\$40,000 \times .9\%$, her wages in excess of \$200,000).

EXAMPLE

43

12-6 TAX PLANNING

One of the traditional goals of family tax planning is to minimize the total tax burden within the family unit. With proper planning and implementation, the credit for child and dependent care expenses can be used to help achieve this goal.

12-6a Credit for Child and Dependent Care Expenses

Payments to certain relatives for the care of qualifying dependents and children qualify for the credit if the care provider is not a child (under age 19) of the taxpayer. Thus, if the care provider is in a lower tax bracket than the taxpayer, the following benefits result.

- Income is shifted to a lower-bracket family member.
- The taxpayer qualifies for the credit for child and dependent care expenses.

LO.7

Identify tax planning opportunities related to tax credits and payments.



TAX IN THE NEWS The Tax Gap Includes \$58 Billion in Payroll Taxes

The "tax gap"—a term describing the difference between what taxpayers owe to the Federal government in taxes and what they pay—is about \$385 billion annually. A significant portion of that amount consists of delinquent payroll taxes—the money withheld from employees' salaries by employers for FICA taxes (Social Security and Medicare taxes).

According to studies by the IRS and the Government Accountability Office (GAO), businesses annually underpay about \$76 billion related to payroll taxes. In contrast, businesses owe \$71 billion in delinquent corporate income taxes. Businesses in the construction, professional services,

and health care industries have the largest payroll tax delinquencies.

Collecting payroll taxes seems to be a perennial problem. The payroll tax part of the tax gap today is slightly higher than it was a decade ago. Today, though, payroll tax debts are likely to be outstanding for a longer time period. About 500 employers owe at least 10 years' worth of taxes, and nearly 15,000 owe 5 years' worth.

The IRS has stepped up its enforcement efforts concerning employment taxes, and it targets this part of the tax gap with three-year audits of about 5,000 randomly selected employers.

In addition, to the extent that child care payments can be shifted to future tax years, the benefit from the credit may be preserved on these excess expenditures.

EXAMPLE

44

Andre, a calendar year and cash basis taxpayer, has spent \$3,000 by December 1 on qualifying child care expenditures for his dependent 11-year-old son. The \$250 that is due the care provider for child care services rendered in December does not generate a tax credit benefit if the amount is paid in the current year because the \$3,000 ceiling has been reached. However, if the payment can be delayed until the next year, the total credit over the two-year period for which Andre is eligible may be increased.

A similar shifting of expenditures to a subsequent year may be wise if the potential credit otherwise generated would exceed the tax liability available to absorb the credit.

REFOCUS ON THE BIG PICTURE

EDUCATION TAX CREDITS

Lora and Sam qualify for the American Opportunity credit as they are both in their first four years of postsecondary education. Lora and Sam both qualify for a \$2,500 credit (100 percent of the first \$2,000 and 25 percent of the next \$2,000 of qualified expenses).

These credits phase out over an income range of \$20,000 once married taxpayers' AGI exceeds \$160,000. The total education credits available to the Snyders amount to \$5,320 (see Example 34), and they may claim this amount as a credit on their Form 1040. Further, the education credits may be used to offset any AMT liability, and a portion of the credits is refundable to the Snyders.

What If?

What if the Snyders' AGI is \$188,000? In that case, the Snyders would not qualify for any education credits (their income exceeds the limits for both the American Opportunity and the lifetime learning credits). Although a deduction *for* AGI is allowed for qualified tuition and related expenses involving higher education, the taxpayers' AGI exceeds the \$160,000 maximum allowed for a deduction (see Chapter 9 for additional details).

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Key Terms

Adoption expenses credit, 12-17

American Opportunity credit, 12-20

Child tax credit, 12-17

Credit for certain retirement plan contributions, 12-22

Credit for child and dependent care expenses, 12-18

Credit for employer-provided child care, 12-13

Credit for small employer pension plan startup costs, 12-13

Disabled access credit, 12-12

Earned income credit, 12-14

Employment taxes, 12-26

Energy tax credits, 12-22

Estimated tax, 12-26

Foreign tax credit (FTC), 12-15

General business credit, 12-5

Lifetime learning credit, 12-20

Low-income housing credit, 12-11

Nonrefundable credits, 12-4

Permanent and total disability, 12-15

Refundable credits, 12-3

Rehabilitation expenditures credit, 12-6

Rehabilitation expenditures credit recapture, 12-7

Research activities credit, 12-9

Self-employment tax, 12-27

Tax credit for the elderly or disabled, 12-15

Tax credits, 12-2

Work opportunity tax credit, 12-8

Discussion Questions

1. **LO.1** Would an individual taxpayer receive greater benefit from deducting an expenditure or from taking a credit equal to 25% of the expenditure? How would your response change if the item would only be deductible *from* AGI?
2. **LO.3** Clint, a self-employed engineering consultant, is contemplating purchasing an old building for renovation. After the work is completed, Clint plans to rent out two-thirds of the floor space to businesses; he would live and work in the remaining portion. Identify the relevant tax issues for Clint. Issue ID
3. **LO.3** Sonja is considering the purchase and renovation of an old building. She has heard about the tax credit for rehabilitation expenditures, but Sonja does not know the specific rules applicable to the credit. Explain the most important and relevant provisions for her. Issue ID
4. **LO.4** Can the earned income credit be characterized as a form of negative income tax? Why or why not?
5. **LO.4** How does the earned income credit fit into the Federal government's plan to fight poverty?
6. **LO.4, 7** Polly and her husband, Leo, file a joint return and expect to report 2015 AGI of \$75,000. Polly's employer offers a child and dependent care reimbursement plan that allows up to \$5,000 of qualifying expenses to be reimbursed in exchange for a \$5,000 reduction in the employee's salary. Because Polly and Leo have two minor children requiring child care that costs \$5,800 each year, Polly is wondering if she should sign up for the program instead of taking advantage of the credit for child and dependent care expenses. Decision Making
 Polly and Leo are in the 25% tax bracket. Analyze the effect of the two alternatives. How would your answer differ if Polly and Leo's AGI was \$25,000 instead of \$75,000? Assume in that case that their marginal tax rate is 10%.
7. **LO.4** Mark and Lisa are approaching an exciting time in their lives as their oldest son, Austin, graduates from high school and moves on to college. What are some of the tax issues that Mark and Lisa should consider as they think about paying for Austin's college education? Issue ID
8. **LO.5** Kathy owns and operates a grocery store as a sole proprietor. She pays wages to her husband Joe and their 17-year-old daughter Marla, both of whom work at the store. Should Kathy withhold FICA taxes from the wages paid to Joe and Marla? Explain.
9. **LO.6** Joan is a self-employed consultant. What is her 2015 exposure to the Federal self-employment tax? Discuss the tax rates that apply to Joan's profits and the income base amounts for the year.
10. **LO.6** Chloe, a self-employed dentist, tells you "My profits for the year total \$300,000, so I don't need to pay any more Federal self-employment taxes." Evaluate Chloe's comment. Issue ID

Computational Exercises

11. **LO.2** Carlson's general business credit (before limitations) for the current year is \$84,000. His net income tax is \$190,000, tentative minimum tax is \$175,000, and net regular tax liability is \$185,000. He reports no other Federal income tax credits for the year. Compute the amount of the general business credit that Carlson can claim for this year.

12. **LO.3** Emily spent \$135,000 to rehabilitate a building (adjusted basis of \$90,000) that originally had been placed in service in 1935.
- Compute Emily's credit for rehabilitation expenditures.
 - How would your answer change if the building were a historic structure?
13. **LO.3** During 2015, Lincoln Company hires seven individuals who are certified to be members of a qualifying targeted group. Each employee works in excess of 600 hours and is paid wages of \$7,500 during the year. Determine the amount of Lincoln's work opportunity credit.
14. **LO.3** Dorcas incurs the following research expenditures.
- | | |
|--|----------|
| In-house wages | \$60,000 |
| In-house supplies | 5,000 |
| Paid to ABC, Inc., for research services | 80,000 |
- Determine the amount of Dorcas's qualified research expenditures for the tax year.
 - If the taxpayer's base amount is \$50,000, what is Dorcas's incremental research activities credit?
15. **LO.4** In late 2014, Randy and Rachel Erwin paid \$7,000 in legal fees, adoption fees, and other expenses directly related to the adoption of an infant son, Jameson. The adoption becomes final in 2015, and the Erwins they pay an additional \$8,000 in adoption fees. Their 2015 AGI amounts to \$135,000.
- Determine the amount of the couple's 2015 adoption tax credit.
 - How does your answer change if the Erwins' 2015 AGI is \$210,000?
16. **LO.4** Santiago and Amy are married and file a joint tax return, claiming as dependents their three children, ages 12, 14, and 18. Their AGI is \$140,000. Determine the amount of the couple's child tax credit.
17. **LO.4** Ivanna, who has three children under age 13, worked full-time while her husband, Sergio, was attending college for nine months during the year. Ivanna earned \$28,000 and incurred \$9,100 of child care expenses. Determine the amount of Ivanna and Sergio's child and dependent care credit.
18. **LO.4** Paolo and Isadora Shaw are married, file a joint tax return, and have one dependent child, Dante. The Shaws report modified AGI of \$148,000. The couple paid \$12,000 of tuition and \$10,000 for room and board for Dante, a full-time first-year student at Serene College. Determine the amount of the Shaws' American Opportunity credit for the year.
19. **LO.4** Rafael and Lucy Gonzalez, married taxpayers, each contribute \$2,900 to their respective § 401(k) plans offered through their employers. The AGI reported on their joint return is \$38,000. Determine the amount of the couple's "Saver's Credit."
20. **LO.5** In 2015, Bianca earned a salary of \$164,000 from her employer, CallMart. How much in FICA and Medicare taxes will CallMart withhold from Bianca's salary?
21. **LO.7** Determine the appropriate amount of 2015 additional Medicare tax for Mario, a single individual. His wages total \$440,000.

Problems

22. **LO.2** Charles generated a tentative general business credit of \$42,000 for the current year. His net regular tax liability before the general business credit is \$107,000, and his tentative minimum tax is \$88,000. Compute Charles's allowable general business credit for the year.

23. **LO.2** Oak Corporation holds the following general business credit carryovers.

2012	\$ 5,000
2013	15,000
2014	6,000
2015	<u>19,000</u>
Total carryovers	<u>\$45,000</u>

If Oak's general business credit generated by 2016 activities equals \$36,000 and the total credit allowed during the current year is \$60,000 (based on tax liability), what amounts of the current general business credit and carryovers are utilized against the 2016 income tax liability? What is the amount of unused credit carried forward to 2017?

24. **LO.3, 7** Paul Chaing (4522 Fargo Street, Geneva, IL 60134) acquires a qualifying historic structure for \$350,000 (excluding the cost of the land) and plans to substantially rehabilitate the structure. He is planning to spend either \$320,000 or \$380,000 on rehabilitation expenditures. Write a letter to Paul and a memo for the tax research files explaining the following for the two alternative expenditures.

Decision Making
Communications

- The computation that determines the rehabilitation expenditures tax credit available.
- The effect of the credit on Paul's adjusted basis in the property.
- The cash-flow differences as a result of the tax consequences related to his expenditure choice.

25. **LO.3** Green Corporation hires six individuals on January 4, 2015, all of whom qualify for the work opportunity credit. Three of these individuals receive wages of \$8,500 during 2015, and each individual works more than 400 hours during the year. The other three individuals each work 300 hours and receive wages of \$5,000 during the year.

- Calculate the amount of Green's work opportunity credit.
- If Green pays total wages of \$140,000 to its employees during the year, how much of this amount can Green deduct, assuming that the work opportunity credit is taken?

26. **LO.3** In March 2015, Sparrow Corporation hired three individuals—Austin, Adam, and Angela—all of whom are certified as long-term family assistance recipients. Each of these individuals earned \$11,000 during 2015. Only Adam continued to work for Sparrow in 2016, and he earned \$13,500 then.

In March 2016, Sparrow hired Sam, who also is certified as a long-term family assistance recipient. During 2016, Sam earned \$12,000.

- Compute Sparrow's work opportunity credit for 2015 and 2016.
- If Sparrow pays total wages to its employees of \$325,000 in 2015 and \$342,000 in 2016, what is the entity's wage deduction for those years?

27. **LO.3, 7** Tom, a calendar year taxpayer, informs you that during the year, he incurs expenditures of \$40,000 that qualify for the incremental research activities credit. In addition, Tom's research-credit base amount for the year is \$32,800.

Decision Making

- Determine Tom's incremental research activities credit for the year.
- Tom is in the 25% tax bracket. Determine which approach to the research expenditures and the research activities credit (other than capitalization and subsequent amortization) would provide the greater tax benefit.

28. **LO.3** Ahmed Zinna (16 Southside Drive, Charlotte, NC 28204), one of your clients, owns two retail establishments in downtown Charlotte and has come to you seeking advice concerning the tax consequences of complying with the Americans with Disabilities Act. He understands that he needs to install various features at his

Communications

stores (e.g., ramps, doorways, and restrooms that are handicap accessible) to make them more accessible to disabled individuals. He asks whether any tax credits are available to help offset the cost of the necessary changes. He estimates the cost of the planned changes to his facilities as follows.

Location	Projected Cost
Calvin Street	\$22,000
Stowe Avenue	8,500

Ahmed reminds you that the Calvin Street store was constructed in 2004 and that the Stowe Avenue store is in a building that was constructed in 1947. Ahmed operates his business as a sole proprietorship and has approximately eight employees at each location. Write a letter to Ahmed in which you summarize your conclusions concerning the tax consequences of his proposed capital improvements.

29. **LO.3** Jimmy Limited added elevators, access ramps, and several technological improvements to the 1923 building in which it operates a consulting business. Jimmy is an LLC with five full-time employees and about \$3 million in gross receipts. The improvements were made to improve access to the building. Expenditures for the accessibility project totaled \$7,500. Compute Jimmy's disabled access credit for the tax year.
30. **LO.3** Employees at the Hobby Hut requested that the company provide assistance in locating professional-quality child care services during business hours. The Hut, a C corporation, contracts with the local Kiddie Kare agency to provide Hut employees with information about child care providers' location, pricing, customer ratings, and operating hours. This year, the Hut paid \$15,000 under this contract, which includes a flat fee for a guaranteed number of employee contacts and a per-service charge after that. Compute the Hobby Hut's credit for employer-provided child care for the tax year.

Decision Making

31. **LO.4** Which of the following individuals qualify for the earned income credit?
- Thomas is single, 21 years old, with no qualifying children. His income consists of \$9,000 in wages.
 - Shannon, who is 27 years old, maintains a household for a dependent 11-year-old son and is eligible for head-of-household tax rates. Her income consists of \$16,050 of salary and \$50 of taxable interest (Shannon's AGI is \$16,100).
 - Keith and Susan, both age 30, are married and file a joint return. Keith and Susan have no dependents. Their combined income consists of \$28,500 of salary and \$100 of taxable interest (i.e., their AGI is \$28,600).
 - Colin is a 26-year-old, self-supporting, single taxpayer. He has no qualifying children and generates earnings of \$9,000.
32. **LO.4, 7** Cooper National is incorporated in Alabama. It generated a \$5 million profit on its overseas operations this year. Cooper paid the following to various other countries.
- \$1 million in income taxes.
 - \$1.5 million in value added taxes.

What are Cooper's alternatives as to the treatment of these tax payments on its U.S. Federal income tax returns?

33. **LO.4** Jimenez Enterprises is incorporated in Arkansas. It generated a \$5 million profit on its overseas operations this year. Jimenez paid \$1 million in income taxes to various countries on these profits. Jimenez's marginal Federal income tax rate is 35%. Compute the Jimenez foreign tax credit and carryovers for the year.
34. **LO.4** Same as Problem 33, except that Jimenez paid \$2 million in income taxes to other countries.

35. **LO.4** Ann and Bill were on the list of a local adoption agency for several years seeking to adopt a child. Finally, in 2014, good news comes their way and an adoption seems imminent. They pay qualified adoption expenses of \$5,000 in 2014 and \$11,000 in 2015. The adoption becomes final in 2015. Ann and Bill always file a joint income tax return.
- Determine the amount of the adoption expenses credit available to Ann and Bill if their combined annual income is \$120,000. What year(s) will they benefit from the credit?
 - If Ann and Bill's modified AGI in 2014 and 2015 is \$220,000, calculate the amount of the adoption expenses credit.
36. **LO.4** Durell and Earline are married, file a joint return, and claim dependency exemptions for their two children, ages 5 years and 6 months. They also claim Earline's 18-year-old son from a previous marriage as a dependent. Durell and Earline's combined AGI is \$68,000.
- Compute Durell and Earline's child tax credit.
 - Assume the same facts, except that Durell and Earline's combined AGI is \$122,000. Compute their child tax credit.
37. **LO.4** Paul and Karen are married, and both are employed (Paul earned \$44,000 and Karen earned \$9,000 this year). Paul and Karen have two dependent children, both under the age of 13. Paul and Karen pay \$3,800 to various unrelated parties to care for their children while they are working. Assuming that Paul and Karen file a joint return, what, if any, is their tax credit for child and dependent care expenses?
38. **LO.4** Jim and Mary Jean are married and have two dependent children under the age of 13. Both parents are gainfully employed and earn salaries as follows: \$16,000 (Jim) and \$5,200 (Mary Jean). To care for their children while they work, Jim and Mary Jean pay Eleanor (Jim's mother) \$5,600. Eleanor does not qualify as a dependent of Jim and Mary Jean. Jim and Mary Jean file a joint Federal income tax return. Compute their credit for child and dependent care expenses.
39. **LO.4, 7** Bernadette Rosen, a longtime client of yours, is an architect and the president of the local Rotary chapter. To keep up to date with the latest developments in her profession, she attends continuing education seminars offered by the architecture school at State University. This year, Bernadette spends \$2,000 on course tuition to attend such seminars. She spends another \$400 on architecture books during the year.
- Bernadette's dependent son Colin is a senior majoring in engineering at the University of the Midwest. During the calendar year, Colin incurs the following expenses: \$8,200 for tuition (\$4,100 per semester) and \$750 for books and course materials. Colin lives at home while attending school full-time.
- Bernadette is married, files a joint return, and reports a combined AGI with her husband Morrie of \$112,000.
- Calculate Bernadette's 2015 education tax credit.
 - In her capacity as president of the local Rotary chapter, Bernadette has asked you to present a 20- to 30-minute speech outlining the different ways the tax law helps defray (1) the cost of higher education and (2) the cost of continuing education once someone is in the workforce. Prepare an outline of possible topics for presentation. A tentative title for your presentation is "How Can the Tax Law Help Pay for College and Continuing Professional Education?"
40. **LO.4** Kathleen and Glenn decide that this is the year to begin getting serious about saving for their retirement by participating in their employers' § 401(k) plans. As a result, they each have \$3,000 of their salary set aside in their qualified plans.

Communications

- a. Calculate the credit for certain retirement plan contributions available to Kathleen and Glenn if the AGI on their joint return is \$35,000.
- b. Kathleen and Glenn persuade their dependent 15-year-old son, Joel, to put \$500 of his part-time earnings into a Roth IRA during the year. What is the credit for certain retirement plan contributions available to Joel? His AGI is \$7,000.

Cumulative Problems

Tax Return Problem



41. Beth R. Jordan lives at 2322 Skyview Road, Mesa, AZ 85201. She is a tax accountant with Mesa Manufacturing Company, 1203 Western Avenue, Mesa, AZ 85201 (employer identification number 11-1111111). She also writes computer software programs for tax practitioners and has a part-time tax practice. Beth is single and has no dependents. Beth was born on July 4, 1972, and her Social Security number is 123-45-6789. She wants to contribute \$3 to the Presidential Election Campaign Fund.

The following information is shown on Beth's 2014 Wage and Tax Statement (Form W-2).

Line	Description	Amount
1	Wages, tips, other compensation	\$65,000.00
2	Federal income tax withheld	10,500.00
3	Social Security wages	65,000.00
4	Social Security tax withheld	4,030.00
5	Medicare wages and tips	65,000.00
6	Medicare tax withheld	942.50
15	State	Arizona
16	State wages, tips, etc.	65,000.00
17	State income tax withheld	1,650.00

Other 2014 transactions include the following.

Beth received interest of \$1,300 from Arizona Federal Savings and Loan and \$400 from Arizona State Bank. Each financial institution reported the interest income on a Form 1099-INT. She received qualified dividends of \$800 from Blue Corporation, \$750 from Green Corporation, and \$650 from Orange Corporation. Each corporation reported Beth's dividend payments on a Form 1099-DIV.

Beth received a \$1,100 income tax refund from the state of Arizona on April 29, 2014. On her 2013 Federal income tax return, she reported total itemized deductions of \$8,200, which included \$2,200 of state income tax withheld by her employer.

Fees earned from her part-time tax practice totaled \$3,800. She paid \$600 to have the tax returns processed by a computerized tax return service.

On February 8, Beth bought 500 shares of Gray Corporation common stock for \$17.60 a share. On September 12, Beth sold the stock for \$14 a share.

Beth bought a used sport utility vehicle for \$6,000 on June 5. She purchased the vehicle from her brother-in-law, who was unemployed and was in need of cash. On November 2, she sold the vehicle to a friend for \$6,500.

On January 2, Beth acquired 100 shares of Blue Corporation common stock for \$30 a share. She sold the stock on December 19 for \$55 a share.

Beth records revenues of \$16,000 from the sale of a software program she developed. Beth incurred the following expenditures in connection with her software development business.

Cost of personal computer (100% business use)	\$7,000
Cost of printer (100% business use)	2,000
Furniture	3,000
Supplies	650
Fee paid to computer consultant	3,500

Beth elected to deduct the maximum portion of the cost of the computer, printer, and furniture allowed under the provisions of § 179. These items were placed in service on January 15 and used 100 percent in her business.

Although her employer suggested that Beth attend a convention on current developments in corporate taxation, Beth was not reimbursed for the travel expenses of \$1,420 she incurred in attending the conference. The \$1,420 included \$200 for meals.

Beth paid \$300 for prescription medicines and \$2,875 in physician and hospital bills. Medical insurance premiums were paid by her employer. Beth paid real property taxes of \$1,766 on her home. Interest on her home mortgage was \$3,845, and interest paid to credit card companies totaled \$320.

Beth electronically contributed \$30 each week to her church and \$10 each week to the United Way. Professional dues and subscriptions totaled \$350.

Beth paid \$1,000 in estimated Federal income taxes throughout the year. She was covered for the entire year by Mesa Manufacturing's health insurance policy.

Part 1—Tax Computation

Compute the 2014 net tax payable or refund due for Beth R. Jordan. If you use tax forms for your solution, you will need Forms 1040, 2106-EZ, and 4562 and Schedules A, B, C, D, and SE. Suggested software: H&R BLOCK Tax Software.

Part 2—Tax Planning

Beth is anticipating significant changes in her life in 2015, and she has asked you to estimate her taxable income and tax liability for that year. She just received word that she has been qualified to adopt a 2-year-old daughter. Beth expects that the adoption will be finalized in 2015 and that she will incur approximately \$2,000 of adoption expenses. In addition, she expects to incur approximately \$3,500 of child and dependent care expenses relating to the care of her new daughter, which will enable her to keep her job at Mesa Manufacturing. However, with the additional demands on her time because of her daughter, she has decided to discontinue her two part-time jobs (i.e., the part-time tax practice and her software business), and she will cease making estimated income tax payments. In your computations, assume that all other income and expenditures will remain at approximately the same levels as in 2014.

42. Tim and Sarah Lawrence are married and file a joint return. Tim's Social Security number is 123-45-6789, and Sarah's Social Security number is 111-11-1111. They reside at 100 Olive Lane, Covington, LA 70434. They have two dependent children, Sean and Debra, ages 12 and 16, respectively. Sean's Social Security number is 123-45-6788, and Debra's Social Security number is 123-45-6787. Tim is self-employed as the sole proprietor of an unincorporated business, and Sarah is a corporate executive. Tim reports the following 2015 income and expenses from his business.

Tax Computation Problem

Gross income	\$325,000
Business expenses	201,000

Sarah was covered for the entire year by her employer's health insurance policy. Other records related to Sarah's employment provide the following information.

Salary	\$145,000
Unreimbursed travel expenses (including \$200 of meals)	1,100
Unreimbursed entertainment expenses	500

Other pertinent 2015 information follows.

Proceeds from sale of stock acquired on July 15, 2015 (cost of \$12,000), and sold on August 1, 2015	\$ 9,800
Proceeds from sale of stock acquired on September 18, 2014 (cost of \$5,000), and sold on October 5, 2015	3,800
Wages paid to full-time domestic worker for housekeeping and child supervision	10,000
Interest income received	7,000
Total itemized deductions (not including any potential deductions above)	27,900
Federal income tax withheld	31,850
Estimated payments, Federal income tax	34,000

Compute the 2015 net tax payable or refund due for Tim and Sarah Lawrence.

Research Problems

THOMSON REUTERS

CHECKPOINT
 Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Ashby and Curtis, a professional couple, have a 2-year-old son, Jason. Curtis works full-time as an electrical engineer, but Ashby has not worked outside the home since Jason was born. As Jason is getting older, Ashby thinks that Jason would benefit from attending nursery school several times a week, which would give her an opportunity to reinvigorate her love of painting at a nearby art studio. Ashby thinks that if she is lucky, the proceeds from the sale of her paintings will pay for the nursery school tuition. But in addition, she is planning to claim the credit for child and dependent care expenses because the care provided Jason at the nursery school is required for her to pursue her art career. Can Ashby and Curtis claim the credit for child and dependent care expenses for the nursery school expenditure? Why or why not?

Decision Making

Research Problem 2. During a recent Sunday afternoon excursion, Miriam, an admirer of early twentieth-century architecture, discovers a 1920s-era house in the countryside outside Mobile, Alabama. She wants not only to purchase and renovate this house, but also to move the structure into Mobile so that her community can enjoy its architectural features.

Being aware of the availability of the tax credit for rehabilitation expenditures, Miriam wants to maximize her use of the provision, if it is available in this case, once the renovation work begins in Mobile. Miriam informs you that she will pursue the purchase, relocation, and renovation of the house only if the tax credit is available.

Comment on Miriam's decision and on whether any renovation expenditures incurred qualify for the tax credit for rehabilitation expenditures.

Partial list of research aids:

George S. Nalle III v. Comm., 72 AFTR 2d 93-5705, 93-2 USTC ¶50,468, 997 F.2d 1134 (CA-5).

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 3. The IRS makes available a web-based tool to help taxpayers determine whether they are eligible for the earned income credit. Locate this tool at the IRS website; then apply the facts related to at least three hypothetical taxpayers, and determine whether the earned income credit is available.

Communications

Research Problem 4. For your state and three of its neighbors, determine how many tax returns claimed an earned income credit. On a line or bar chart, track these data for the last five years, using www.irs.gov. Send your results in an e-mail to your instructor.

Communications

Research Problem 5. Some observers believe that the earned income tax credit is riddled with fraud, including claims involving nonexistent relatives and misreported income amounts. Others believe that the credit is too complex to compute and that it should provide more generous aid to low-income families. Find three articles or postings discussing the operation of the credit and addressing the issue of fraud concerning its application. Summarize the articles in no more than four PowerPoint slides designed to help you present to your classmates.

Roger CPA Review Questions

1. The following facts apply to Brooke, a self-employed individual.

Income	\$50,000
Student loan interest	1,000
Alimony received	6,000
Child support received	12,000

The FICA/Medicare tax rate is 15.3%. Considering only the above, what is Brooke's adjusted gross income?

- | | |
|-------------|-------------|
| a. \$47,350 | c. \$53,350 |
| b. \$51,175 | d. \$57,175 |
2. Kellye is a calendar year taxpayer who makes and sells custom dog collars. This year, her cash receipts were \$10,000, and her cost to make the collars was \$2,000. Additionally, Kellye contributed \$2,000 to a retirement plan. What amount will be the basis for Kellye's self-employment tax?
- | | |
|-------------|------------|
| a. \$10,000 | c. \$7,000 |
| b. \$8,000 | d. \$6,000 |
3. Which of the following is correct regarding the deduction for self-employment taxes?
- a. Self-employment taxes are deductible in full to arrive at Adjusted Gross Income.
 - b. Self-employment taxes are deductible on Schedule A, subject to a 10% AGI limitation.
 - c. 50% of self-employment taxes are deductible on Schedule A.
 - d. 50% of self-employment taxes are deductible to arrive at Adjusted Gross Income.
4. What are the due dates for estimated tax payments for a calendar-year taxpayer who is self-employed?
- a. April, June, and September 15 of the current year, and January 15 of the subsequent year.
 - b. March, June, September, and December 15 of the current year.
 - c. January, April, July, and October 15 of the current year.
 - d. April, July, and October 15 of the current year, and January 15 of the subsequent year.
5. Which of the following education-related expenses can be used to claim an education credit?

	Tuition	Fees	Room & Board	Meals
a.	Yes	Yes	Yes	Yes
b.	Yes	Yes	Yes	No
c.	Yes	Yes	No	Yes
d.	Yes	Yes	No	No

6. Michael and Kathy have one dependent, Dustin, who is in his third year of college. Michael is taking classes in the evening toward an MBA. What credits can Michael and Kathy claim as to these amounts?
- I. American Opportunity Tax Credit
 - II. Lifetime Learning Credit

- a. I only
 - b. II only
 - c. I and II
 - d. I or II
7. Which of the following best describes the effect of a tax credit?
- a. It reduces a person's gross income.
 - b. It reduces a person's adjusted gross income.
 - c. It reduces a person's taxable income.
 - d. It reduces a person's tax liability.



PART

4

PROPERTY TRANSACTIONS

CHAPTER 13

**Property Transactions: Determination of Gain or Loss,
Basis Considerations, and Nontaxable Exchanges**

CHAPTER 14

**Property Transactions: Capital Gains and Losses, § 1231,
and Recapture Provisions**

Part 4 presents the tax treatment of sales, exchanges, and other dispositions of property. Included are the determination of the realized gain or loss, recognized gain or loss, and the classification of the recognized gain or loss as capital or ordinary. The topic of basis is evaluated both in terms of its effect on the calculation of the gain or loss and in terms of the determination of the basis of any contemporaneous or related subsequent acquisitions of property.

Property Transactions: Determination of Gain or Loss, Basis Considerations, and Nontaxable Exchanges

LEARNING OBJECTIVES: After completing Chapter 13, you should be able to:

- | | |
|--|--|
| <p>LO.1 Perform the computation of realized gain or loss on property dispositions.</p> <p>LO.2 Distinguish between realized and recognized gain or loss.</p> <p>LO.3 Review and illustrate how basis is determined for various methods of asset acquisition.</p> <p>LO.4 Describe various loss disallowance provisions.</p> <p>LO.5 State and explain the rationale for nonrecognition (postponement) of gain or loss in certain property transactions.</p> | <p>LO.6 Apply the nonrecognition provisions and basis determination rules for like-kind exchanges.</p> <p>LO.7 Explain the nonrecognition provisions available on the involuntary conversion of property.</p> <p>LO.8 Describe the provision for the permanent exclusion of gain on the sale of a personal residence.</p> <p>LO.9 Identify other nonrecognition provisions contained in the Code.</p> <p>LO.10 Review and apply various tax planning opportunities related to selected property transactions.</p> |
|--|--|

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THE BIG PICTURE

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SALE OR GIFT OF INHERITED HOUSE AND OTHER PROPERTY TRANSACTIONS

Alice owns a house that she inherited from her grandmother seven months ago. Her grandmother lived in the house for over 50 years. Alice has many fond memories associated with the house, because she spent many summer vacations there. This has caused her to delay making a decision regarding what she is going to do with the house.

Based on the estate tax return, the fair market value of the house at the date of her grandmother's death was \$475,000. According to the grandmother's attorney, the grandmother's basis for the house was \$275,000. The real estate market for residential housing has recovered in the city in which the house is located. So based on an appraisal, the house currently is worth \$600,000. Alice is considering two options. The first is to give the house to her son, Michael. Michael, his wife Sandra, and their daughter Peggy would live in the house. The second option is to sell the house. Projected selling expenses would be about 7 percent of the selling price.

Alice would also like to know the tax consequences of selling her boat, which she purchased for \$22,000 four months ago and has used exclusively for personal use. She has been disappointed with its layout and capacity. Because it is a new model, there is significant demand for the boat, and based on listings in her area, she anticipates that she can sell it for \$20,000 to \$23,000.

In addition, earlier this year, Alice sold some stock at a \$2,000 realized loss (\$8,000 amount realized – \$10,000 adjusted basis) and 10 days later repurchased some shares of the same stock for \$7,000.

Alice also has owned a building (adjusted basis \$50,000) that was used in her business. The building was recently destroyed by a fire, but fortunately, it was fully insured. The insurance company paid Alice \$100,000 to compensate her for the loss. Now she is looking to acquire suitable replacement property for her business. If possible, she would like to claim a casualty loss, but certainly does not want to recognize any taxable gain from this event.

Alice has come to you for advice regarding the tax consequences of these various transactions. Alice's objectives are to minimize the recognition of any realized gain and to maximize the recognition of any realized loss.

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	(x,xxx)
Gross income	\$xx,xxx

FORM 1040 (p. 1)

- | | | |
|-----------|--|--------------------------|
| 12 | Business income or (loss). Attach Schedule C or C-EZ | <input type="checkbox"/> |
| 13 | Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ | <input type="checkbox"/> |
| 14 | Other gains or (losses). Attach Form 4797 | |

Less: Deductions for adjusted gross income.....	(x,xxx)
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)
Personal and dependency exemptions	(x,xxx)
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	(xxx)
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

This chapter and Chapter 14 are concerned with the income tax consequences of property transactions (the sale or other disposition of property). The following questions are considered with respect to the sale or other disposition of property:

- Is there a realized gain or loss?
- If so, is the gain or loss recognized?
- If the gain or loss is recognized, is it ordinary or capital?
- What is the basis of any replacement property that is acquired?

This chapter discusses the determination of realized and recognized gain or loss and the basis of property. Chapter 14 covers the classification of the recognized gain or loss as ordinary or capital.

LO.1
Perform the computation of realized gain or loss on property dispositions.

13-1 DETERMINATION OF GAIN OR LOSS

13-1a Realized Gain or Loss

Realized gain or loss is the difference between the amount realized from the sale or other disposition of property and the property's adjusted basis on the date of disposition. If the amount realized exceeds the property's adjusted basis, the result is a **realized gain**. Conversely, if the property's adjusted basis exceeds the amount realized, the result is a **realized loss**.¹

¹§ 1001(a) and Reg. § 1.1001-1(a).

Tab sells Swan Corporation stock with an adjusted basis of \$3,000 for \$5,000. Tab's realized gain is \$2,000. If Tab had sold the stock for \$2,000, he would have had a realized loss of \$1,000.

EXAMPLE

1

Sale or Other Disposition

The term *sale or other disposition* is defined broadly in the tax law and includes virtually any disposition of property. Thus, transactions such as trade-ins, casualties, condemnations, thefts, and bond retirements are treated as dispositions of property. The most common disposition of property is through a sale or exchange. Usually, the key factor in determining whether a disposition has taken place is whether an identifiable event has occurred² as opposed to a mere fluctuation in the value of the property.³

Lori owns Tan Corporation stock that cost \$3,000. The stock has appreciated in value by \$2,000 since Lori purchased it. Lori has no realized gain because mere fluctuation in value is not a disposition or an identifiable event for tax purposes. Nor would Lori have a realized loss if the stock declined in value by \$2,000.

EXAMPLE

2

Amount Realized

The **amount realized** from a sale or other disposition of property is the sum of any money received plus the fair market value of other property received. The amount realized also includes any real property taxes treated as imposed on the seller that are actually paid by the buyer.⁴ The reason for including these taxes in the amount realized is that by paying the taxes, the purchaser is, in effect, paying an additional amount to the seller of the property.

The amount realized also includes any liability on the property disposed of, such as a mortgage debt, if the buyer assumes the mortgage or the property is sold subject to the mortgage.⁵ The amount of the liability is included in the amount realized even if the debt is nonrecourse and the amount of the debt is greater than the fair market value of the mortgaged property.⁶

Barry sells property on which there is a mortgage of \$20,000 to Cole for \$50,000 cash. Barry's amount realized from the sale is \$70,000 if Cole assumes the mortgage or takes the property subject to the mortgage.

EXAMPLE

3

The **fair market value** of property received in a sale or other disposition has been defined by the courts as the price at which property will change hands between a willing seller and a willing buyer when neither is compelled to sell or buy.⁷ Fair market value is determined by considering the relevant factors in each case.⁸ An expert appraiser is often required to evaluate these factors in arriving at fair market value. When the fair market value of the property received cannot be determined, the value of the property given up by the taxpayer may be used.⁹

In calculating the amount realized, selling expenses (such as advertising, commissions, and legal fees) relating to the disposition are deducted. The amount realized is the net amount the taxpayer received directly or indirectly, in the form of cash or anything else of value, from the disposition of the property.

²Reg. § 1.1001-1(c)(1).

³*Lynch v. Turrish*, 1 USTC ¶18, 3 AFTR 2986, 38 S.Ct. 537 (USSC, 1918).

⁴§ 1001(b) and Reg. § 1.1001-1(b). Refer to Chapter 10 for a discussion of this subject.

⁵*Crane v. Comm.*, 47-1 USTC ¶9217, 35 AFTR 776, 67 S.Ct. 1047 (USSC, 1947). Although a legal distinction exists between the direct assumption of a mortgage and the taking of property subject to a mortgage, the tax consequences in calculating the amount realized are the same.

⁶*Comm. v. Tufts*, 83-1 USTC ¶9328, 51 AFTR 2d 83-1132, 103 S.Ct. 1826 (USSC, 1983).

⁷*Comm. v. Marshman*, 60-2 USTC ¶9484, 5 AFTR 2d 1528, 279 F.2d 27 (CA-6, 1960).

⁸*O'Malley v. Ames*, 52-1 USTC ¶9361, 42 AFTR 19, 197 F.2d 256 (CA-8, 1952).

⁹*U.S. v. Davis*, 62-2 USTC ¶9509, 9 AFTR 2d 1625, 82 S.Ct. 1190 (USSC, 1962).

Adjusted Basis

The **adjusted basis** of property disposed of is the property's original basis adjusted to the date of disposition.¹⁰ Original basis is the cost or other basis of the property on the date the property is acquired by the taxpayer. Considerations involving original basis are discussed later in this chapter. *Capital additions* increase and *recoveries of capital* decrease the original basis so that on the date of disposition the adjusted basis reflects the unrecovered cost or other basis of the property.¹¹ Adjusted basis is determined as follows:

$$\begin{aligned} & \text{Cost (or other adjusted basis) on date of acquisition} \\ & + \text{Capital additions} \\ & - \text{Capital recoveries} \\ & = \text{Adjusted basis on date of disposition} \end{aligned}$$

Capital Additions

Capital additions include the cost of capital improvements and betterments made to the property by the taxpayer. These expenditures are distinguishable from expenditures for the ordinary repair and maintenance of the property, which are neither capitalized nor added to the original basis (refer to Chapter 6). The latter expenditures are deductible in the current taxable year if they are related to business or income-producing property. Amounts representing real property taxes treated as imposed on the seller but paid or assumed by the buyer are part of the cost of the property.¹² Any liability on property that is assumed by the buyer is also included in the buyer's original basis of the property. The same rule applies if property is acquired subject to a liability. Amortization of the discount on bonds increases the adjusted basis of the bonds.¹³

Capital Recoveries

Capital recoveries decrease the adjusted basis of property. The prominent types of capital recoveries are discussed below.

Depreciation and Cost Recovery Allowances The original basis of depreciable property is reduced by the annual depreciation charges (or cost recovery allowances) while the property is held by the taxpayer. The amount of depreciation that is subtracted from the original basis is the greater of the *allowed* or *allowable* depreciation calculated on an annual basis.¹⁴ In most circumstances, the allowed and allowable depreciation amounts are the same (refer to Chapter 8).

Casualties and Thefts A casualty or theft may result in the reduction of the adjusted basis of property.¹⁵ The adjusted basis is reduced by the amount of the deductible loss. In addition, the adjusted basis is reduced by the amount of insurance proceeds received. However, the receipt of insurance proceeds may result in a recognized gain rather than a deductible loss. The gain increases the adjusted basis of the property.¹⁶

Capital Recoveries: Casualties and Thefts

EXAMPLE

4

An insured truck that Marvin used in his trade or business is destroyed in an accident. At the time of the accident, the adjusted basis was \$8,000, and the fair market value was \$6,500. Marvin receives insurance proceeds of \$6,500. The amount of the casualty loss is \$1,500 (\$6,500 insurance proceeds – \$8,000 adjusted basis). The truck's adjusted basis is reduced by the \$1,500 casualty loss and the \$6,500 of insurance proceeds received (\$8,000 basis before casualty – \$1,500 casualty loss – \$6,500 insurance proceeds = \$0 adjusted basis).

¹⁰§ 1011(a) and Reg. § 1.1011-1.

¹¹§ 1016(a) and Reg. § 1.1016-1.

¹²Reg. §§ 1.1001-1(b)(2) and 1.1012-1(b). Refer to Chapter 10 for a discussion of this subject.

¹³See Chapter 14 for a discussion of bond discount and the related amortization.

¹⁴§ 1016(a)(2) and Reg. § 1.1016-3(a)(1)(i).

¹⁵Refer to Chapter 7 for the discussion of casualties and thefts.

¹⁶Reg. § 1.1016-6(a).

Capital Recoveries: Casualties and Thefts

An insured truck that Marvin used in his trade or business is destroyed in an accident. At the time of the accident, the adjusted basis was \$6,500, and the fair market value was \$8,000. Marvin receives insurance proceeds of \$8,000. The amount of the casualty gain is \$1,500 (\$8,000 insurance proceeds – \$6,500 adjusted basis). The truck's adjusted basis is increased by the \$1,500 casualty gain and is reduced by the \$8,000 of insurance proceeds received (\$6,500 basis before casualty + \$1,500 casualty gain – \$8,000 insurance proceeds = \$0 adjusted basis).

EXAMPLE

5

Certain Corporate Distributions A corporate distribution to a shareholder that is not taxable is treated as a return of capital, and it reduces the basis of the shareholder's stock in the corporation.¹⁷ For example, if a corporation makes a cash distribution to its shareholders and has no earnings and profits, the distributions are treated as a return of capital. Once the basis of the stock is reduced to zero, the amount of any subsequent distributions is a capital gain if the stock is a capital asset. These rules are illustrated in Example 8 of Chapter 19.

Amortizable Bond Premium The basis in a bond purchased at a premium is reduced by the amortizable portion of the bond premium.¹⁸ Investors in taxable bonds may *elect* to amortize the bond premium.¹⁹ The amount of the amortized premium on taxable bonds is allowed as an interest deduction. Therefore, the election enables the taxpayer to take an annual interest deduction to offset ordinary income in exchange for a larger capital gain or smaller capital loss on the disposition of the bond. The amortization deduction is allowed for taxable bonds because the premium is viewed as a cost of earning the taxable interest from the bonds. The reason the basis of taxable bonds is reduced is that the amortization deduction is a recovery of the cost or basis of the bonds.

Unlike taxable bonds, the premium on tax-exempt bonds *must be* amortized (and the basis is reduced even though the amortization is not allowed as a deduction). No amortization deduction is permitted on tax-exempt bonds because the interest income is exempt from tax and the amortization of the bond premium merely represents an adjustment of the effective amount of such income.

Antonio purchases Eagle Corporation taxable bonds with a face value of \$100,000 for \$110,000, thus paying a premium of \$10,000. The annual interest rate is 7%, and the bonds mature 10 years from the date of purchase. The annual interest income is \$7,000 (7% × \$100,000). If Antonio elects to amortize the bond premium, the \$10,000 premium is deducted over the 10-year period. Antonio's basis for the bonds is reduced each year by the amount of the amortization deduction. Note that if the bonds were tax-exempt, amortization of the bond premium and the basis adjustment would be mandatory. However, no deduction would be allowed for the amortization.

EXAMPLE

6

Easements An easement is the legal right to use another's land for a special purpose. Historically, easements were commonly used to obtain rights-of-way for utility lines, roads, and pipelines. In recent years, grants of conservation easements have become a popular means of obtaining charitable contribution deductions and reducing the value of real estate for transfer tax (i.e., estate and gift) purposes. Likewise, scenic easements are used to reduce the value of land as assessed for ad valorem property tax purposes.

If the taxpayer does not retain any right to the use of the land, all of the basis is assigned to the easement. However, if the use of the land is only partially restricted, an allocation of some of the basis to the easement is appropriate.

¹⁷§ 1016(a)(4) and Reg. § 1.1016-5(a).

¹⁹§ 171(c).

¹⁸§ 1016(a)(5) and Reg. § 1.1016-5(b). The accounting treatment of bond premium amortization is the same as for tax purposes. The amortization results in a decrease in the bond investment account.

LO.2

Distinguish between realized and recognized gain or loss.

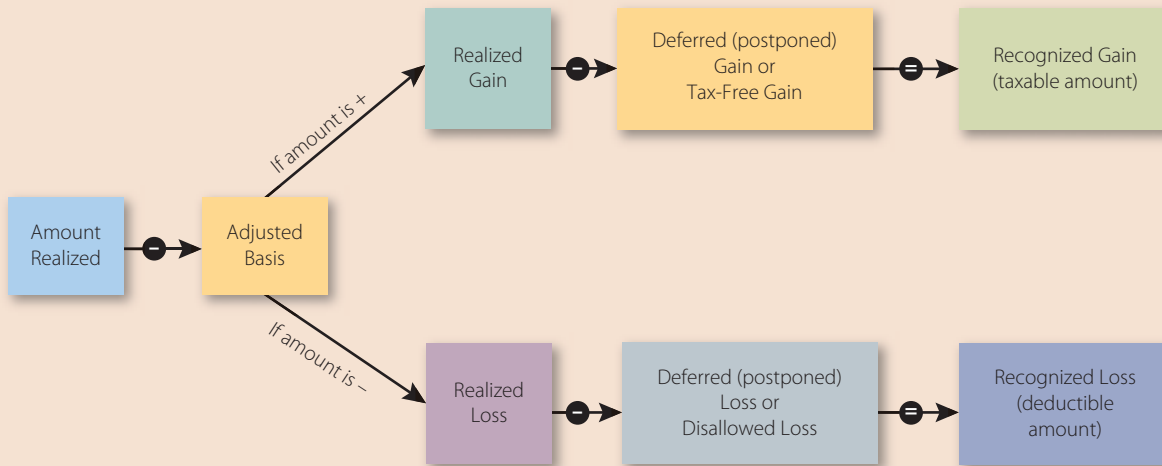
13-1b **Recognized Gain or Loss**

Recognized gain is the amount of the realized gain that is included in the taxpayer's gross income.²⁰ A **recognized loss**, on the other hand, is the amount of a realized loss that is deductible for tax purposes.²¹ As a general rule, the entire amount of a realized gain or loss is recognized.²²

Concept Summary 13.1 summarizes the realized gain or loss and recognized gain or loss concepts.

Concept Summary 13.1

Recognized Gain or Loss



13-1c **Nonrecognition of Gain or Loss**

In certain cases, a realized gain or loss is not recognized upon the sale or other disposition of property. One such case involves nontaxable exchanges, which are covered later in this chapter. Others include losses realized upon the sale, exchange, or condemnation of personal use assets (as opposed to business or income-producing property) and gains realized upon the sale of a residence. In addition, realized losses from the sale or exchange of business or income-producing property between certain related parties are not recognized.²³

Sale, Exchange, or Condemnation of Personal Use Assets

A realized loss from the sale, exchange, or condemnation of personal use assets (e.g., a personal residence or an automobile not used at all for business or income-producing purposes) is not recognized for tax purposes. An exception exists for casualty or theft losses from personal use assets (see Chapter 7). In contrast, any gain realized from the sale or other disposition of personal use assets is, generally, fully taxable.

The Big Picture

EXAMPLE

7

Return to the facts of *The Big Picture* on p. 13-1. Assume that Alice sells the boat, which she has held exclusively for personal use, for \$23,000. Recall that her adjusted basis for the boat is \$22,000. Alice has a realized and recognized gain of \$1,000.

²⁰§ 61(a)(3) and Reg. § 1.61-6(a).

²¹§ 165(a) and Reg. § 1.165-1(a).

²²§ 1001(c) and Reg. § 1.1002-1(a).

²³§ 267(a)(1).



TAX IN THE NEWS Tax Implications of Virtual Currency (Bitcoin)

On March 25, 2014, the Internal Revenue Service issued Notice 2014-21 (2014-16 I.R.B. 938), which, through a series of questions and answers, “describes how existing tax principles apply to transactions using virtual currency.”

Background. Bitcoin is a decentralized virtual store of value that is beginning to gain greater acceptance as a medium of exchange in the mainstream marketplace. Notice 2014-21 describes virtual currencies such as Bitcoin as follows:

“[A] digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value.... Virtual currency that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as ‘convertible’ virtual currency....”

Bitcoin derives value not from governmental backing or a link to an underlying commodity, but purely from its finite nature, the effort required to generate new Bitcoin, and the value its users place on it and its acceptance as a medium of exchange in certain segments of the market. Bitcoin supply is finite (the maximum number of Bitcoin that will ever exist is approximately 21 million). A good summary of fundamental questions and answers surrounding Bitcoin can be found at <http://bitcoin.org/en/faq>.

IRS Guidance. Notice 2014-21 provides answers to frequently asked questions (FAQs) on virtual currency such as Bitcoin. These FAQs provide basic information on the U.S. Federal tax implications of transactions in, or transactions

that use, virtual currency. In some environments, virtual currency operates like “real” currency (e.g., the coin and paper money of the United States) but it does not have legal tender status in any jurisdiction.

In its guidance, the IRS indicates that Bitcoin is *not* currency; rather, virtual currency is treated as *property* for U.S. Federal tax purposes. General tax principles that apply to property transactions apply to transactions using virtual currency. Among other things, this means that:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to Federal income tax withholding and payroll taxes.
- Payments using virtual currency made to independent contractors and other service providers are taxable, and self-employment tax rules generally apply. Payers are subject to the same information reporting requirements as any other payer (so, for example, a Form 1099-MISC must be issued to an independent contractor if Bitcoin payments exceed \$600 per year).
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.

The full set of 16 questions and answers provided by the IRS can be found at www.irs.gov/pub/irs-drop/n-14-21.pdf.

The Big Picture

Return to the facts of *The Big Picture* on p. 13-1. Assume that Alice sells the boat in Example 7 for \$20,000. She has a realized loss of \$2,000, but the loss is not recognized.

EXAMPLE

8

13-2 BASIS CONSIDERATIONS

13-2a Determination of Cost Basis

As noted earlier, the basis of property is generally the property’s cost. Cost is the amount paid for the property in cash or other property.²⁴ This general rule follows logically from the recovery of capital doctrine; that is, the cost or other basis of property is to be recovered tax-free by the taxpayer.

A *bargain purchase* of property is an exception to the general rule for determining basis. A bargain purchase may result when an employer transfers property to an employee at less than the property’s fair market value (as compensation for services) or

LO.3

Review and illustrate how basis is determined for various methods of asset acquisition.

²⁴§ 1012 and Reg. § 1.1012-1(a).



TAX IN THE NEWS Brokers Provide Cost Basis Data to Taxpayers (and the IRS)

Brokers and others in similar enterprises are now required to provide investors with an annual report on the cost basis of their stocks sold during the year (to be included on Form 1099-B and reported to the IRS).

The primary reason for the requirement is to enable taxpayers to use the correct basis in calculating the gain or loss on the sale of the stock (perhaps many years after the initial purchase). Nontaxable stock dividends, stock splits, and spin-offs may create confusion and result in unreliable data being used to determine the basis. For the investor who has multiple lots of the same stock, the likelihood of making an incorrect determination of cost basis is even greater.

A secondary reason for the reporting requirement is to generate more revenue for the Treasury. The Treasury

believes that it will collect an additional \$6 billion to \$9 billion per year as a result of this requirement. Tax professionals will also benefit by providing consulting related to the requirements—some estimate the related compliance costs will exceed \$500 million per year.

Although the primary burden for determining cost basis is placed on the broker, the ultimate responsibility for reporting the information correctly remains on the taxpayer (and his or her tax adviser).

Sources: Based on "Cost Basis Reporting: Why Corporate Issuers (and Not Just Brokers) Should Care," *A&M Tax Advisor Weekly*, www.taxand.com, July 14, 2011; Laura Saunders, "When Your Broker 'Outs' You," *Wall Street Journal*, March 2, 2013, p. D3; Tara Siegel Bernard, "New Tax Laws Take Guesswork Out of Investment Tax Liability," *New York Times*, March 15, 2013.

when a corporation transfers property to a shareholder at less than the property's fair market value (a dividend). The amount included in income either as compensation for services or dividend income is the difference between the bargain purchase price and the property's fair market value. The basis of property acquired in a bargain purchase is the property's fair market value.²⁵ If the basis of the property were not increased by the bargain amount, the taxpayer would be taxed on this amount again at disposition.

EXAMPLE

9

Wade buys land from his employer for \$10,000 on December 30. The fair market value of the land is \$15,000. Wade must include the \$5,000 difference between the cost and the fair market value of the land in gross income for the taxable year. The bargain element represents additional compensation to Wade. His basis for the land is \$15,000, the land's fair market value.

Identification Problems

Cost identification problems are frequently encountered in securities transactions. For example, the Regulations require that the taxpayer adequately identify the particular stock that has been sold (specific identification).²⁶ A problem arises when the taxpayer has purchased separate lots of stock on different dates or at different prices and cannot adequately identify the lot from which a particular sale takes place. In this case, the stock is presumed to come from the first lot or lots purchased (a FIFO presumption).²⁷ When securities are left in the custody of a broker, it may be necessary to provide specific instructions and receive written confirmation as to which securities are being sold.

EXAMPLE

10

Polly purchases 100 shares of Olive Corporation stock on July 1, 2013, for \$5,000 (\$50 a share) and another 100 shares of Olive stock on July 1, 2014, for \$6,000 (\$60 a share). She sells 50 shares of the stock on January 2, 2015. The cost of the stock sold, assuming that Polly cannot adequately identify the shares, is \$50 a share, or \$2,500. This is the cost Polly will compare with the amount realized in determining the gain or loss from the sale.

²⁵Reg. §§ 1.61-2(d)(2)(i) and 1.301-1(j). See the discussion in Chapter 5 of the circumstances under which what appears to be a taxable bargain purchase is an excludable qualified employee discount.

²⁶Reg. § 1.1012-1(c)(1).

²⁷*Kluger Associates, Inc.*, 69 T.C. 925 (1978).

Allocation Problems

When a taxpayer acquires *multiple assets in a lump-sum purchase*, the total cost must be allocated among the individual assets.²⁸ Allocation is necessary for several reasons:

- Some of the assets acquired may be depreciable (e.g., buildings), while others may not be (e.g., land).
- Only a portion of the assets acquired may be sold.
- Some of the assets may be capital or § 1231 assets that receive special tax treatment upon subsequent sale or other disposition.

The lump-sum cost is allocated on the basis of the fair market values of the individual assets acquired.

Harry purchases a building and land for \$800,000. Because of the depressed nature of the industry in which the seller was operating, Harry was able to negotiate a very favorable purchase price. Appraisals of the individual assets indicate that the fair market value of the building is \$600,000 and that of the land is \$400,000. Harry's basis for the building is \$480,000 $[(\$600,000/\$1,000,000) \times \$800,000]$, and his basis for the land is \$320,000 $[(\$400,000/\$1,000,000) \times \$800,000]$.

EXAMPLE

11

If a business is purchased and **goodwill** is involved, a special allocation rule applies. Initially, the purchase price is assigned to the assets, excluding goodwill, to the extent of their total fair market value. This assigned amount is allocated among the assets on the basis of the fair market value of the individual assets acquired. Goodwill is then assigned the residual amount of the purchase price. The resultant allocation is applicable to both the buyer and the seller.²⁹

Rocky sells his business to Paul. They agree that the values of the individual assets are as follows:

Inventory	\$ 50,000
Building	500,000
Land	200,000
Goodwill	150,000

After negotiations, Rocky and Paul agree on a sales price of \$1 million. Applying the residual method with respect to goodwill results in the following allocation of the \$1 million purchase price:

Inventory	\$ 50,000
Building	500,000
Land	200,000
Goodwill	250,000

The residual method requires that all of the excess of the purchase price over the fair market value of the assets ($\$1,000,000 - \$900,000 = \$100,000$) be allocated to goodwill. Without this requirement, the purchaser could allocate the excess pro rata to all of the assets, including goodwill, based on their respective fair market values. This would have resulted in only \$166,667 $[\$150,000 + (\$150,000 \div \$900,000 \times \$100,000)]$ being assigned to goodwill.

EXAMPLE

12

In the case of *nontaxable stock dividends*, the allocation depends on whether the dividend is a common stock dividend on common stock or a preferred stock dividend on common stock. If the stock dividend is common on common, the cost of the original common shares is allocated to the total shares owned after the dividend.³⁰

²⁸Reg. § 1.61-6(a).

³⁰§§ 305(a) and 307(a).

²⁹§ 1060. The classification of the seller's recognized gain associated with the goodwill is discussed in Chapter 14.

EXAMPLE

13

Susan owns 100 shares of Sparrow Corporation common stock for which she paid \$1,100. She receives a 10% common stock dividend, giving her a new total of 110 shares. Before the stock dividend, Susan's basis was \$11 per share ($\$1,100 \div 100$ shares). The basis of each share after the stock dividend is \$10 ($\$1,100 \div 110$ shares).

If the nontaxable stock dividend is preferred stock on common, the cost of the original common shares is allocated between the common and preferred shares on the basis of their relative fair market values on the date of distribution.³¹

EXAMPLE

14

Fran owns 100 shares of Cardinal Corporation common stock for which she paid \$1,000. She receives a nontaxable stock dividend of 50 shares of preferred stock on her common stock. The fair market values on the date of distribution of the preferred stock dividend are \$30 a share for common stock and \$40 a share for preferred stock.

Fair market value of common ($\$30 \times 100$ shares)	\$3,000
Fair market value of preferred ($\$40 \times 50$ shares)	2,000
	<u>\$5,000</u>
Basis of common: $\frac{3}{5} \times \$1,000$	\$ 600
Basis of preferred: $\frac{2}{5} \times \$1,000$	\$ 400

The basis per share for the common stock is \$6 ($\$600/100$ shares). The basis per share for the preferred stock is \$8 ($\$400/50$ shares).

The holding period for a nontaxable stock dividend, whether received in the form of common stock or preferred stock, includes the holding period of the original shares.³² The significance of the holding period for capital assets is discussed in Chapter 14.

13-2b Gift Basis

When a taxpayer receives property as a gift, there is no cost to the donee (recipient). Thus, under the cost basis provision, the donee's basis would be zero. However, this would violate the statutory intent that gifts not be subject to the income tax.³³ With a zero basis, if the donee sold the property, all of the amount realized would be treated as realized gain. Therefore, a basis is assigned to the property received depending on the following:

- The date of the gift.
- The basis of the property to the donor.
- The amount of the gift tax paid.
- The fair market value of the property.

Gift Basis Rules If No Gift Tax Is Paid

Property received by gift can be referred to as *dual basis* property; that is, the basis for gain and the basis for loss might not be the same amount. The present basis rules for gifts of property are as follows:

- If the donee disposes of gift property in a transaction that results in a gain, the basis to the donee is the same as the donor's adjusted basis.³⁴ The donee's basis in this case is referred to as the *gain basis*. Therefore, a *realized gain* results if the amount realized from the disposition exceeds the donee's gain basis.

³¹Reg. § 1.307-1(a).

³²§ 1223(5) and Reg. § 1.1223-1(e).

³³§ 102(a).

³⁴§ 1015(a) and Reg. § 1.1015-1(a)(1). See Reg. § 1.1015-1(a)(3) for cases in which the facts necessary to determine the donor's adjusted basis are unknown. Refer to Example 18 for the effect of depreciation deductions by the donee.

Melissa purchased stock in 2014 for \$10,000. She gave the stock to her son, Joe, in 2015, when the fair market value was \$15,000. No gift tax is paid on the transfer, and Joe subsequently sells the property for \$15,000. Joe's basis is \$10,000, and he has a realized gain of \$5,000.

EXAMPLE

15

- If the donee disposes of gift property in a transaction that results in a loss, the basis to the donee is the *lower* of the donor's adjusted basis or the fair market value on the date of the gift. The donee's basis in this case is referred to as the *loss basis*. Therefore, a *realized loss* results if the amount realized from the disposition is less than the donee's loss basis.

Burt purchased stock in 2014 for \$10,000. He gave the stock to his son, Cliff, in 2015, when the fair market value was \$7,000. No gift tax is paid on the transfer. Cliff later sells the stock for \$6,000. Cliff's basis is \$7,000 (fair market value is less than donor's adjusted basis of \$10,000), and the realized loss from the sale is \$1,000 (\$6,000 amount realized – \$7,000 basis).

EXAMPLE

16

The amount of the loss basis will *differ* from the amount of the gain basis only if, at the date of the gift, the adjusted basis of the property exceeds the property's fair market value. Note that the loss basis rule prevents the donee from receiving a tax benefit from a decline in value that occurred while the donor held the property. Therefore, in Example 16, Cliff has a loss of only \$1,000 rather than a loss of \$4,000. The \$3,000 difference represents the decline in value that occurred while Burt held the property. Ironically, however, the gain basis rule may result in the donee being subject to income tax on the appreciation that occurred while the donor held the property, as illustrated in Example 15.

If the amount realized from a sale or other disposition is *between* the basis for loss and the basis for gain, no gain or loss is realized.

Assume the same facts as in Example 16, except that Cliff sells the stock for \$8,000. Application of the gain basis rule produces a loss of \$2,000 (\$8,000 – \$10,000). Application of the loss basis rule produces a gain of \$1,000 (\$8,000 – \$7,000). Because the amount realized is between the gain basis and the loss basis, Cliff recognizes neither a gain nor a loss.

EXAMPLE

17

Adjustment for Gift Tax

Because of the size of the unified estate and gift tax exemption (\$5.43 million in 2015), basis adjustments for gift taxes paid are rare. If, however, gift taxes are paid by the donor, the portion of the gift tax paid that is related to any appreciation is taken into account in determining the donee's gain basis.³⁵

For *gifts made before 1977*, the full amount of the gift tax paid is added to the donor's basis, with basis capped at the donor's fair market value at the date of the gift.

Holding Period

The **holding period** for property acquired by gift begins on the date the donor acquired the property if the gain basis rule applies.³⁶ The holding period starts on the date of the gift if the loss basis rule applies.³⁷ The significance of the holding period for capital assets is discussed in Chapter 14.

Basis for Depreciation

The basis for depreciation on depreciable gift property is the donee's gain basis.³⁸ This rule is applicable even if the donee later sells the property at a loss and uses the loss basis rule in calculating the amount of the realized loss.

³⁵§ 1015(d)(6) and Reg. § 1.1015-5(c)(2). Examples illustrating these rules can be found in Reg. § 1.1015-5(c)(5) and IRS Publication 551 (*Basis of Assets*), p. 9.

³⁶§ 1223(2) and Reg. § 1.1223-1(b).

³⁷Rev.Rul. 59-86, 1959-1 C.B. 209.

³⁸§ 1011 and Reg. §§ 1.1011-1 and 1.167(g)-1.

EXAMPLE

18

Vito gave a machine to Tina in 2015. At that time, the adjusted basis was \$32,000 (cost of \$40,000 – accumulated depreciation of \$8,000), and the fair market value was \$26,000. No gift tax was paid. Tina's gain basis at the date of the gift is \$32,000, and her loss basis is \$26,000. During 2015, Tina deducts depreciation (cost recovery) of \$6,400 ($\$32,000 \times 20\%$). (Refer to Chapter 8 for the cost recovery tables.) At the end of 2015, Tina's gain basis and loss basis are calculated as follows:

	Gain Basis	Loss Basis
Donor's basis or fair market value	\$32,000	\$26,000
Depreciation	(6,400)	(6,400)
	<u>\$25,600</u>	<u>\$19,600</u>

13-2c **Property Acquired from a Decedent****General Rules**

The basis of property acquired from a decedent is generally the property's fair market value at the date of death (referred to as the *primary valuation amount*).³⁹ The property's basis is the fair market value six months after the date of death if the executor or administrator of the estate *elects* the alternate valuation date for estate tax purposes. This amount is referred to as the *alternate valuation amount*.

The Big Picture

EXAMPLE

19

Return to the facts of *The Big Picture* on p. 13-1. Alice and various other family members inherited property from Alice's grandmother, who died recently. At the date of death, her grandmother's adjusted basis for the property Alice inherited was \$275,000. The house's fair market value at the date of death was \$475,000. The alternate valuation date was not elected. Alice's basis for income tax purposes is \$475,000. This is commonly referred to as a *stepped-up basis*.

The Big Picture

EXAMPLE

20

Return to the facts of *The Big Picture* on p. 13-1. Assume the same facts as in Example 19, except that the house's fair market value at the date of the grandmother's death was \$260,000. Alice's basis for income tax purposes is \$260,000. This is commonly referred to as a *stepped-down basis*.

The alternate valuation date and amount are only available to estates for which an estate tax return must be filed [generally, estates with a valuation in excess of \$5.43 million in 2015 (\$5.34 million in 2014)]. Even if an estate tax return is filed and the executor elects the alternate valuation date, the six months after death date is available only for property the executor has not distributed before this date.⁴⁰

The alternate valuation date can be elected *only if*, as a result of the election, both the value of the gross estate and the estate tax liability are lower than they would have been if the primary valuation date had been used.⁴¹

Income in Respect of a Decedent

Income in respect of a decedent (IRD) is income earned by a decedent to the point of death but not reportable on the final income tax return under the method of accounting

³⁹ §§ 1014(a) and 1022. See Chapter 27 for additional information.

⁴⁰ § 2032(a)(1) and Rev.Rul. 56–60, 1956–1 C.B. 443. For any property distributed by the executor during the six-month period preceding the alternate valuation date, the adjusted basis to the beneficiary will equal the fair market value on the date of distribution.

⁴¹ § 2032(c). This provision prevents the alternate valuation election from being used to increase the basis of the property to the beneficiary for income tax purposes without simultaneously increasing the estate tax liability (because of estate tax deductions or credits).

used. IRD is most frequently applicable to decedents using the cash basis of accounting. IRD also occurs, for example, when a taxpayer at the time of death held installment notes receivable on which the gain was deferred. For both cash and accrual taxpayers, IRD includes most post-death distributions from retirement plans [e.g., traditional IRA, § 401(k), H.R. 10 (Keogh), § 403(b), and other qualified plans]. With the exception of Roth IRAs, distributions from retirement plans invariably contain an income component that has not yet been subject to income tax.

George, age 58, was entitled to a salary payment of \$18,000 and a bonus of \$20,000 at the time of his death. In addition, George had been contributing to a traditional IRA for over 20 years. The IRA has a basis of \$83,000 (due to some nondeductible contributions over the years) and a current value of \$560,000. George’s estate collects the salary and bonus payments, and George’s wife (his only beneficiary) cashes in the IRA.

EXAMPLE

21

Both the estate and George’s wife have income in respect of a decedent (IRD) and must include ordinary income in their computation of taxable income for the year. The estate has IRD of \$38,000 (salary of \$18,000 plus bonus of \$20,000), and George’s wife has IRD of \$477,000 (\$560,000 proceeds less \$83,000 basis). A better outcome might be achieved for George’s wife if she rolled over the inherited IRA into an IRA in her name and deferred receiving distributions until required. (Note: Only a surviving spouse can roll over an inherited IRA without tax consequences.⁴²)

IRD is included in the gross estate at its fair market value on the appropriate valuation date. Because IRD is not subject to the step-up or step-down rules applicable to property passed by death, the income tax basis of the decedent transfers to the estate or heirs.⁴³ Furthermore, the recipient of IRD must classify it in the same manner (e.g., ordinary income or capital gain) as the decedent would have.⁴⁴

Survivor’s Share of Property

Both the decedent’s share and the survivor’s share of *community property* have a basis equal to the fair market value on the date of the decedent’s death.⁴⁵ This result applies to the decedent’s share of the community property because the property flows to the surviving spouse from the estate (fair market value basis is assigned to inherited property). Likewise, the surviving spouse’s share of the community property is deemed to be acquired by bequest, devise, or inheritance from the decedent. Therefore, it also has a basis equal to the fair market value.

Floyd and Vera are married and reside in a community property state. They own as community property 200 shares of Crow stock acquired in 1990 for \$100,000. Floyd dies in 2015, when the securities are valued at \$300,000. One-half of the Crow stock is included in Floyd’s estate. If Vera inherits Floyd’s share of the community property, the basis for gain or loss is \$300,000, determined as follows:

EXAMPLE

22

Vera’s one-half of the community property (stepped up from \$50,000 to \$150,000 due to Floyd’s death)	\$150,000
Floyd’s one-half of the community property (stepped up from \$50,000 to \$150,000 due to inclusion in his gross estate)	<u>150,000</u>
Vera’s new basis	<u><u>\$300,000</u></u>

In a *common law* state, only one-half of jointly held property of spouses (tenants by the entirety or joint tenants with rights of survivorship) is included in the estate.⁴⁶ In such a case, no adjustment of the basis is permitted for the excluded property interest (the surviving spouse’s share).

⁴²See Chapter 27 for additional information.

⁴⁵§ 1014(b)(6). See the listing of community property states in Chapter 4.

⁴³§ 1014(c).

⁴⁶§ 2040(b).

⁴⁴§ 691(a)(3).

EXAMPLE

23

Assume the same facts as in the previous example, except that the property is jointly held by Floyd and Vera, who reside in a common law state. Floyd purchased the property and made a gift of one-half of the property to Vera when the stock was acquired. No gift tax was paid. Only one-half of the Crow stock is included in Floyd's estate. Vera's basis for determining gain or loss in the excluded half is not adjusted upward for the increase in value to date of death. Therefore, Vera's basis is \$200,000, determined as follows:

Vera's one-half of the jointly held property (carryover basis of \$50,000)	\$ 50,000
Floyd's one-half of the jointly held property (stepped up from \$50,000 to \$150,000 due to inclusion in his gross estate)	150,000
Vera's new basis	<u>\$200,000</u>

Holding Period of Property Acquired from a Decedent

The holding period of property acquired from a decedent is *deemed to be long term* (held for the required long-term holding period). This provision applies regardless of whether the property is disposed of at a gain or at a loss.⁴⁷

LO.4

Describe various loss disallowance provisions.

13-2d Disallowed Losses

Related Taxpayers

Section 267 provides that realized losses from sales or exchanges of property, directly or indirectly, between certain related parties are not recognized. This loss disallowance provision applies to several types of related-party transactions. The most common involve (1) members of a family and (2) an individual and a corporation in which the individual owns, directly or indirectly, more than 50 percent in value of the corporation's outstanding stock. Section 707 provides a similar loss disallowance provision where the related parties are a partner and a partnership in which the partner owns, directly or indirectly, more than 50 percent of the capital interests or profits interests in the partnership. The rules governing the relationships covered by § 267 were discussed in Chapter 6. See the discussion of the special rules under § 1041 for property transfers between spouses or incident to divorce later in this chapter.

If income-producing or business property is transferred to a related taxpayer and a loss is disallowed, the basis of the property to the recipient is the property's cost to the transferee. However, if a subsequent sale or other disposition of the property by the original transferee results in a realized gain, the amount of gain is reduced by the loss that was previously disallowed.⁴⁸ This *right of offset* is not applicable if the original sale involved the sale of a personal use asset (e.g., the sale of a personal residence between related taxpayers). Furthermore, the right of offset is available only to the original transferee (the related-party buyer).⁴⁹

EXAMPLE

24

Pedro sells business property with an adjusted basis of \$50,000 to his daughter, Josefina, for its fair market value of \$40,000. Pedro's realized loss of \$10,000 is not recognized.

- How much gain does Josefina recognize if she sells the property for \$52,000? Josefina recognizes a \$2,000 gain. Her realized gain is \$12,000 (\$52,000 less her basis of \$40,000), but she can offset Pedro's \$10,000 loss against the gain.

continued

⁴⁷§ 1223(11).

⁴⁸§ 267(d) and Reg. § 1.267(d)-1(a).

⁴⁹The loss disallowance rules (1) prevent a taxpayer from directly transferring an unrealized loss to a related taxpayer in a higher tax bracket who could receive a greater tax benefit from recognition of the loss and

(2) eliminate a substantial administrative burden on the Internal Revenue Service as to the appropriateness of the selling price (i.e., fair market value or not). The loss disallowance rules are applicable even when the selling price is equal to the fair market value and can be validated (e.g., listed stocks).

- How much gain does Josefina recognize if she sells the property for \$48,000? Josefina recognizes no gain or loss. Her realized gain is \$8,000 (\$48,000 less her basis of \$40,000), but she can offset \$8,000 of Pedro's \$10,000 loss against the gain. Note that Pedro's loss can only offset Josefina's gain. It cannot create a loss for Josefina.
- How much loss does Josefina recognize if she sells the property for \$38,000? Josefina recognizes a \$2,000 loss, the same as her realized loss (\$38,000 less \$40,000 basis). Pedro's loss does not increase Josefina's loss. His loss can be offset only against a gain. Because Josefina has no realized gain, Pedro's loss cannot be used and is never recognized. This part of the example assumes that the property is business or income-producing property to Josefina. If not, her \$2,000 loss is personal and is not recognized.

The holding period of the buyer for the property is not affected by the holding period of the seller. That is, the buyer's *holding period* includes only the period of time he or she has held the property.⁵⁰

Wash Sales

Section 1091 stipulates that in certain cases, a realized loss on the sale or exchange of stock or securities is not recognized. Specifically, if a taxpayer sells or exchanges stock or securities and within 30 days before *or* after the date of the sale or exchange acquires substantially identical stock or securities, any loss realized from the sale or exchange is not recognized because the transaction is a **wash sale**.⁵¹ The term *acquire* means acquire by purchase or in a taxable exchange and includes an option to purchase substantially identical securities. *Substantially identical* means the same in all important particulars. Corporate bonds and preferred stock normally are not considered substantially identical to the corporation's common stock. However, if the bonds and preferred stock are convertible into common stock, they may be considered substantially identical under certain circumstances.⁵² Attempts to avoid the application of the wash sales rules by having a related taxpayer repurchase the securities have been unsuccessful.⁵³ The wash sales provisions do *not* apply to gains.

Recognition of the loss is disallowed because the taxpayer is considered to be in substantially the same economic position after the sale and repurchase as before the sale and repurchase. This disallowance rule does not apply to taxpayers engaged in the business of buying and selling securities.⁵⁴ Investors, however, are not allowed to create losses through wash sales to offset income for tax purposes.

Realized loss that is not recognized is added to the *basis* of the substantially identical stock or securities whose acquisition resulted in the nonrecognition of loss.⁵⁵ In other words, the basis of the replacement stock or securities is increased by the amount of the unrecognized loss. If the loss were not added to the basis of the newly acquired stock or securities, the taxpayer would never recover the entire basis of the old stock or securities.

The basis of the new stock or securities includes the unrecovered portion of the basis of the formerly held stock or securities. Therefore, the *holding period* of the new stock or securities begins on the date of acquisition of the old stock or securities.⁵⁶

The Big Picture

Return to the facts of *The Big Picture* on p. 13-1. Alice owned 100 shares of Green Corporation stock (adjusted basis of \$20,000). She sold 50 shares for \$8,000. Ten days later, she purchased 50 shares of the same stock for \$7,000. Alice's realized loss of \$2,000 (\$8,000 amount realized – \$10,000 adjusted basis of 50 shares) is not recognized because it resulted from a wash sale. Alice's basis in the newly acquired stock is \$9,000 (\$7,000 purchase price + \$2,000 unrecognized loss from the wash sale).

EXAMPLE

25

⁵⁰ §§ 267(d) and 1223(2) and Reg. § 1.267(d)-1(c)(3).

⁵¹ § 1091(a) and Reg. §§ 1.1091-1(a) and (f).

⁵² Rev. Rul. 56-406, 1956-2 C.B. 523.

⁵³ *McWilliams v. Comm.*, 47-1 USTC ¶9289, 35 AFTR 1184, 67 S.Ct. 1477 (USSC, 1947).

⁵⁴ Reg. § 1.1091-1(a).

⁵⁵ § 1091(d) and Reg. § 1.1091-2(a).

⁵⁶ § 1223(4) and Reg. § 1.1223-1(d).

A taxpayer may acquire fewer shares than the number sold in a wash sale. In this case, the loss from the sale is prorated between recognized and unrecognized loss on the basis of the ratio of the number of shares acquired to the number of shares sold.⁵⁷

13-2e Conversion of Property from Personal Use to Business or Income-Producing Use

As discussed previously, losses from the sale of personal use assets are not recognized for tax purposes, but losses from the sale of business and income-producing assets are deductible. Can a taxpayer convert a personal use asset that has declined in value to business or income-producing use and then sell the asset to recognize a business or income-producing loss? The tax law prevents this practice by specifying that the *original basis for loss* on personal use assets converted to business or income-producing use is the *lower* of the property's adjusted basis or fair market value on the date of conversion.⁵⁸ The *gain basis* for converted property is the property's adjusted basis on the date of conversion. The tax law is not concerned with gains on converted property because gains are recognized regardless of whether property is business, income-producing, or personal use.

EXAMPLE

26

Diane's personal residence has an adjusted basis of \$175,000 and a fair market value of \$160,000. Diane converts the personal residence to rental property. Her basis for loss is \$160,000 (lower of \$175,000 adjusted basis and fair market value of \$160,000). The \$15,000 decline in value is a personal loss and can never be recognized for tax purposes. Diane's basis for gain is \$175,000.

The basis for loss is also the *basis for depreciating* the converted property.⁵⁹ This is an exception to the general rule that the basis for depreciation is the gain basis (e.g., property received by gift). This exception prevents the taxpayer from recovering a personal loss indirectly through depreciation of the higher original basis. After the property is converted, both its basis for loss and its basis for gain are adjusted for depreciation deductions from the date of conversion to the date of disposition. These rules apply only if a conversion from personal to business or income-producing use has actually occurred.

EXAMPLE

27

At a time when his personal residence (adjusted basis of \$140,000) is worth \$150,000, Keith converts one-half of it to rental use. Assume that the property is not MACRS recovery property. At this point, the estimated useful life of the residence is 20 years, and there is no estimated salvage value. After renting the converted portion for five years, Keith sells the property for \$144,000. All amounts relate only to the building; the land has been accounted for separately. Keith has a \$2,000 realized gain from the sale of the personal use portion of the residence and a \$19,500 realized gain from the sale of the rental portion. These gains are computed as follows:

	Personal Use	Rental
Original basis for gain and loss—adjusted basis on date of conversion (fair market value is greater than the adjusted basis)	\$70,000	\$ 70,000
Depreciation—five years	(–0–)	(17,500)
Adjusted basis—date of sale	\$70,000	\$ 52,500
Amount realized	<u>72,000</u>	<u>72,000</u>
Realized gain	<u>\$ 2,000</u>	<u>\$ 19,500</u>

⁵⁷§ 1091(b) and Reg. § 1.1091-1(c).

⁵⁸Reg. § 1.165-9(b)(2).

⁵⁹Reg. § 1.167(g)-1.

As discussed later in this chapter, Keith may be able to exclude the \$2,000 realized gain from the sale of the personal use portion of the residence under § 121. If the § 121 exclusion applies, only \$17,500 (equal to the depreciation deducted) of the \$19,500 realized gain from the rental portion is recognized.

Assume the same facts as in the previous example, except that the fair market value on the date of conversion is \$130,000 and the sales proceeds are \$90,000. Keith has a \$25,000 realized loss from the sale of the personal use portion of the residence and a \$3,750 realized loss from the sale of the rental portion. These losses are computed as follows:

EXAMPLE

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	Personal Use	Rental
Original basis for loss—fair market value on date of conversion (fair market value is less than the adjusted basis)	*	\$65,000
Depreciation—five years	(–0–)	(16,250)
Adjusted basis—date of sale	\$70,000	\$48,750
Amount realized	45,000	45,000
Realized loss	<u>(\$25,000)</u>	<u>(\$ 3,750)</u>

*Not applicable.

The \$25,000 loss from the sale of the personal use portion of the residence is not recognized. The \$3,750 loss from the rental portion is recognized.

13-2f Additional Complexities in Determining Realized Gain or Loss

Amount Realized

The calculation of the amount realized may appear to be one of the least complex areas associated with property transactions. However, because numerous positive and negative adjustments may be required, this calculation can be complex and confusing. In addition, determining the fair market value of the items received by the taxpayer can be difficult. The following example provides insight into various items that can affect the amount realized.

Ridge sells an office building and the associated land on October 1, 2015. Under the terms of the sales contract, Ridge is to receive \$600,000 in cash. The purchaser is to assume Ridge’s mortgage of \$300,000 on the property. To enable the purchaser to obtain adequate financing, Ridge is to pay the \$15,000 in points charged by the lender. The broker’s commission on the sale is \$45,000. The purchaser agrees to pay the \$12,000 in property taxes for the entire year. The amount realized by Ridge is calculated as follows:

EXAMPLE

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Selling price:		
Cash	\$600,000	
Mortgage assumed by purchaser	300,000	
Seller’s property taxes paid by purchaser (\$12,000 × 9/12)	<u>9,000</u>	\$909,000
Less:		
Broker’s commission	\$ 45,000	
Points paid by seller	<u>15,000</u>	<u>(60,000)</u>
Amount realized		<u>\$849,000</u>



TAX IN THE NEWS Triple the Misery!

Although short sales have traditionally involved stocks, today the term *short sale* also refers to the sale of a personal residence by a homeowner who is “underwater,” owing more on the home than it is worth. In a short sale, the homeowner sells the residence for its fair market value, which is less than the mortgage (or mortgages) on the property. One possible result of this transaction is that the taxpayer incurs a realized loss—the selling price is less than his or her basis in the property.

Unfortunately, the realized loss cannot be recognized because a residence is a personal use asset. To add to the trauma of losing the home in a nondeductible loss sale, the mortgage company may require the taxpayer to keep paying on the portion of the mortgage still outstanding (i.e., the amount of the mortgage in excess of the net sales price). Thus, the taxpayer has triple misery: no home, a nondeductible loss, and an outstanding debt to pay.

Adjusted Basis

Three types of issues tend to complicate the determination of adjusted basis. First, the applicable tax provisions for calculating the adjusted basis depend on how the property was acquired (e.g., purchase, taxable exchange, nontaxable exchange, gift, or inheritance). Second, if the asset is subject to depreciation, cost recovery, amortization, or depletion, adjustments must be made to the basis during the time period the asset is held by the taxpayer. Upon disposition of the asset, the taxpayer’s records for both of these items may be deficient. For example, the donee does not know the amount of the donor’s basis or the amount of gift tax paid by the donor, or the taxpayer does not know how much depreciation he or she has deducted. Third, the complex positive and negative adjustments encountered in calculating the amount realized are also involved in calculating the adjusted basis.

EXAMPLE

30

Jane purchased a personal residence in 2006. The purchase price and the related closing costs were as follows:

Purchase price	\$325,000
Recording costs	140
Title fees and title insurance	815
Survey costs	225
Attorney’s fees	750
Appraisal fee	250

Other relevant tax information for the house during the time Jane owned it is as follows:

- Constructed a swimming pool for medical reasons. The cost was \$20,000, of which \$5,000 was deducted as a medical expense.
- Added a solar heating system. The cost was \$18,000.
- Deducted home office expenses of \$6,000. Of this amount, \$5,200 was for depreciation.

The adjusted basis for the house is calculated as follows:

Purchase price	\$325,000
Recording costs	140
Title fees and title insurance	815
Survey costs	225
Attorney’s fees	750
Appraisal fee	250
Swimming pool (\$20,000 – \$5,000)	15,000
Solar heating system	18,000
	<u>\$360,180</u>
Less: Depreciation deducted on home office	(5,200)
Adjusted basis	<u>\$354,980</u>

13-2g **Summary of Basis Adjustments**

Some of the more common items that either increase or decrease the basis of an asset appear in Concept Summary 13.2.

**Concept Summary 13.2****Adjustments to Basis**

Item	Effect	Refer to Chapter	Explanation
Amortization of bond discount	Increase	14	Amortization is mandatory for certain taxable bonds and elective for tax-exempt bonds.
Amortization of bond premium	Decrease	13	Amortization is mandatory for tax-exempt bonds and elective for taxable bonds.
Amortization of covenant not to compete	Decrease	8	Covenant must be for a definite and limited time period. The amortization period is a statutory period of 15 years.
Amortization of intangibles	Decrease	8	Intangibles are amortized over a 15-year period.
Assessment for local benefits	Increase	10	To the extent not deductible as taxes (e.g., assessment for streets and sidewalks that increase the value of the property versus one for maintenance or repair or for meeting interest charges).
Bad debts	Decrease	7	Only the specific charge-off method is permitted.
Capital additions	Increase	13	Certain items, at the taxpayer's election, can be capitalized or deducted (e.g., selected medical expenses).
Casualty	Decrease	7	For a casualty loss, the amount of the adjustment is the sum of the deductible loss and the insurance proceeds received. For a casualty gain, the amount of the adjustment is the insurance proceeds received reduced by the recognized gain.
Condemnation	Decrease	13	See casualty explanation.
Cost recovery	Decrease	8	§ 168 is applicable to tangible assets placed in service after 1980 whose useful life is expressed in terms of years.
Depletion	Decrease	8	Use the greater of cost or percentage depletion. Percentage depletion can still be deducted when the basis is zero.
Depreciation	Decrease	8	§ 167 is applicable to tangible assets placed in service before 1981 and to tangible assets not depreciated in terms of years.
Easement	Decrease	13	If the taxpayer does not retain any use of the land, all of the basis is allocable to the easement transaction. However, if only part of the land is affected by the easement, only part of the basis is allocable to the easement transaction.
Improvements by lessee to lessor's property	Increase	5	Adjustment occurs only if the lessor is required to include the fair market value of the improvements in gross income under § 109.
Imputed interest	Decrease	16	Amount deducted is not part of the cost of the asset.
Inventory: lower of cost or market	Decrease	16	Not available if the LIFO method is used.
Limited expensing under § 179	Decrease	8	Occurs only if the taxpayer elects § 179 treatment.
Medical capital expenditure permitted as a medical expense	Decrease	10	Adjustment is the amount of the deduction (the effect on basis is to increase it by the amount of the capital expenditure net of the deduction).
Real estate taxes: apportionment between the buyer and seller	Increase or decrease	10	To the extent the buyer pays the seller's pro rata share, the buyer's basis is increased. To the extent the seller pays the buyer's pro rata share, the buyer's basis is decreased.
Rebate from manufacturer	Decrease		Because the rebate is treated as an adjustment to the purchase price, it is not included in the buyer's gross income.

continued

Adjustments to Basis—Continued

Item	Effect	Refer to Chapter	Explanation
Stock dividend	Decrease	5	Adjustment occurs only if the stock dividend is nontaxable. While the basis per share decreases, the total stock basis does not change.
Stock rights	Decrease	13	Adjustment to stock basis occurs only for nontaxable stock rights and only if the fair market value of the rights is at least 15% of the fair market value of the stock or, if less than 15%, the taxpayer elects to allocate the basis between the stock and the rights.
Theft	Decrease	7	See casualty explanation.

In discussing the topic of basis, a number of specific techniques for determining basis have been presented. Although the various techniques are responsive to and mandated by transactions occurring in the marketplace, they do possess enough common characteristics to be categorized as follows:

- The basis of the asset may be determined by reference to the asset's cost.
- The basis of the asset may be determined by reference to the basis of another asset.
- The basis of the asset may be determined by reference to the asset's fair market value.
- The basis of the asset may be determined by reference to the basis of the asset to another taxpayer.

LO.5

State and explain the rationale for nonrecognition (postponement) of gain or loss in certain property transactions.

13-3 GENERAL CONCEPT OF A NONTAXABLE EXCHANGE

A taxpayer who is going to replace a productive asset (e.g., machinery) used in a trade or business may structure the transactions as a sale of the old asset and the purchase of a new asset. When this approach is used, any realized gain or loss on the asset sale is recognized. The basis of the new asset is its cost. Alternatively, the taxpayer may be able to trade the old asset for the new asset. This exchange of assets may produce beneficial tax consequences by qualifying for nontaxable exchange treatment.

The tax law recognizes that nontaxable exchanges result in a change in the *form* but not in the *substance* of the taxpayer's relative economic position. The replacement property received in the exchange is viewed as substantially a continuation of the old investment.⁶⁰ Additional justification for nontaxable exchange treatment is that this type of transaction does not provide the taxpayer with the wherewithal to pay the tax on any realized gain.

The nonrecognition provisions for nontaxable exchanges do not apply to realized losses from the sale or exchange of personal use assets. Such losses are not recognized (are disallowed) because they are personal in nature and not because of any nonrecognition provision.

In a **nontaxable exchange**, realized gains or losses are not recognized. However, the nonrecognition is usually temporary. The recognition of gain or loss is *postponed* (deferred) until the property received in the nontaxable exchange is subsequently disposed of in a taxable transaction. This is accomplished by assigning a carryover basis to the replacement property.

⁶⁰Reg. § 1.1002-1(c).

Debra completes a nontaxable exchange of property with an adjusted basis of \$10,000 and a fair market value of \$12,000 for property with a fair market value of \$12,000. Debra has a realized gain of \$2,000 (\$12,000 amount realized – \$10,000 adjusted basis). Her recognized gain is \$0. Her basis in the replacement property is a carryover basis of \$10,000. Assume that the replacement property is nondepreciable and Debra subsequently sells it for \$12,000. Her realized and recognized gain will be the \$2,000 gain that was postponed (deferred) in the nontaxable transaction. If the replacement property is depreciable, the carryover basis of \$10,000 is used in calculating depreciation.

EXAMPLE

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In some nontaxable exchanges, only part of the property involved in the transaction qualifies for nonrecognition treatment. If the taxpayer receives cash or other nonqualifying property, part or all of the realized gain from the exchange is recognized. In these instances, gain is recognized because the taxpayer has changed or improved his or her relative economic position and has the wherewithal to pay income tax to the extent of cash or other property received.

It is important to distinguish between a nontaxable disposition, as the term is used in the statute, and a tax-free transaction. First, a direct exchange is not required in all circumstances (e.g., replacement of involuntarily converted property). Second, as previously mentioned, the term *nontaxable* refers to postponement of recognition via a carryover basis. In a *tax-free* transaction, the nonrecognition is permanent (e.g., see the discussion later in the chapter of the § 121 exclusion of realized gain on the sale of a personal residence). Therefore, the basis of any property acquired in a tax-free transaction does not depend on the basis of the property disposed of by the taxpayer.

13-4 LIKE-KIND EXCHANGES—§ 1031

Section 1031 provides for nontaxable exchange treatment if the following requirements are satisfied:⁶¹

- The form of the transaction is an exchange.
- Both the property transferred and the property received are held either for productive use in a trade or business or for investment.
- The property is like-kind property.

Like-kind exchanges include business for business, business for investment, investment for business, or investment for investment property. Property held for personal use, inventory, and partnership interests (both limited and general) do not qualify under the like-kind exchange provisions. Securities, even though held for investment, do not qualify for like-kind exchange treatment.

The nonrecognition provision for like-kind exchanges is *mandatory* rather than elective. A taxpayer who wants to recognize a realized gain or loss will have to structure the transaction in a form that does not satisfy the statutory requirements for a like-kind exchange. This topic is discussed further under Tax Planning later in the chapter.

13-4a Like-Kind Property

“The words ‘like-kind’ refer to the nature or character of the property and not to its grade or quality. One kind or class of property may not ... be exchanged for property of a different kind or class.”⁶²

The term *like-kind* is intended to be interpreted very broadly. However, three categories of exchanges are not included. First, livestock of different sexes do not qualify as like-kind property. Second, real estate can be exchanged only for other real estate, and personalty can be exchanged only for other personalty. For example, the exchange of a machine (personalty) for an office building (realty) is not a like-kind exchange. *Real estate* (or realty) includes principally rental buildings, office and store buildings,

LO.6

Apply the nonrecognition provisions and basis determination rules for like-kind exchanges.

⁶¹§ 1031(a) and Reg. § 1.1031(a)-1(a).

⁶²Reg. § 1.1031(a)-1(b).

manufacturing plants, warehouses, and land. It is immaterial whether real estate is improved or unimproved. Thus, unimproved land can be exchanged for an apartment house. Personalty includes principally machines, equipment, trucks, automobiles, furniture, and fixtures. Third, real property located in the United States exchanged for foreign real property (and vice versa) does not qualify as like-kind property.

EXAMPLE

32

Wade made the following exchanges during the taxable year:

- a. Inventory for a machine used in business.
- b. Land held for investment for a building used in business.
- c. Stock held for investment for equipment used in business.
- d. A light-duty business truck for a light-duty business truck.
- e. An automobile used for personal transportation for an automobile used in business.
- f. Livestock for livestock of a different sex.
- g. Land held for investment in New York for land held for investment in London.

Exchanges (b), investment real property for business real property, and (d), business personalty for business personalty, qualify as exchanges of like-kind property. The other exchanges do not qualify because they involve (a), inventory; (c), stock; (e), personal use automobile (not held for business or investment purposes); (f), livestock of different sexes; and (g), U.S. and foreign real estate.

Regulations dealing with § 1031 like-kind exchange treatment provide that if the exchange transaction involves multiple assets of a business (e.g., a television station for another television station), the determination of whether the assets qualify as like-kind property will not be made at the business level.⁶³ Instead, the underlying assets must be evaluated.

Special Rule for Depreciable Tangible Personal Property

The Regulations also provide for greater specificity in determining whether depreciable tangible personal property is of a like kind or class. Such property held for productive use in a business is of a like class only if the exchanged property is within the same *general business asset class* (as specified by the IRS in Revenue Procedure 87-57 or as subsequently modified) or the same *product class* (as specified by the Department of Commerce). Property included in a general business asset class is evaluated under this system rather than under the product class system.

The following are examples of general business asset classes:

- Office furniture, fixtures, and equipment.
- Information systems (computers and peripheral equipment).
- Airplanes.
- Automobiles and taxis.
- Buses.
- Light general-purpose trucks.
- Heavy general-purpose trucks.

These Regulations have made it more difficult for depreciable tangible personal property to qualify for § 1031 like-kind exchange treatment. For example, the exchange of office equipment for a computer does not qualify as an exchange of like-kind property. Even though both assets are depreciable tangible personal property, they are not like-kind property because they are in different general business asset classes.

13-4b Exchange Requirement

The transaction must involve a direct exchange of property to qualify as a like-kind exchange. The sale of old property and the purchase of new property, even though like

⁶³Reg. § 1.1031(j)-1.

kind, is generally not an exchange. However, if the two transactions are mutually dependent, the IRS may treat them as a like-kind exchange. For example, if the taxpayer sells an old business machine to a dealer and purchases a new one from the same dealer, like-kind exchange treatment could result.⁶⁴

The taxpayer may want to avoid nontaxable exchange treatment. Recognition of gain gives the taxpayer a higher basis for depreciation (see Example 63). To the extent that such gains would, if recognized, either receive favorable capital gain treatment or be passive activity income that could be offset by passive activity losses, it might be preferable to avoid the nonrecognition provisions through an indirect exchange transaction. For example, a taxpayer may sell property to one individual, recognize the gain, and subsequently purchase similar property from another individual. The taxpayer may also want to avoid nontaxable exchange treatment so that a realized loss can be recognized.

Time Limitations

Like-kind exchanges—especially those involving real estate—can be complex. Further, it can be extremely difficult to coordinate a simultaneous transaction if the properties being exchanged are located in different counties or states. As a result, delayed (non-simultaneous) exchanges are allowed, but there are time limits on their completion. In a delayed like-kind exchange, one party fails to take immediate title to the new property because it has not yet been identified. The Code provides that the delayed swap will qualify as a like-kind exchange if the following requirements are satisfied:

- *Identification period.* The new property must be identified within 45 days of the date when the old property was transferred.
- *Exchange period.* The new property must be received by the earlier of the following:
 - Within 180 days of the date when the old property was transferred.
 - The due date (including extensions) for the tax return covering the year of the transfer.

Are these time limits firm, or can they be extended due to unforeseen circumstances? Indications are that the IRS will allow no deviation from either the identification period or the exchange period even when events outside the taxpayer's control preclude strict compliance. See the exception to strict compliance provided for in Revenue Procedure 2010-14 in the "Tax in the News" on the next page.



ETHICS & EQUITY A Delayed § 1031 Like-Kind Exchange: If at First You Don't Succeed, Try Again

Randall owns an office building (adjusted basis of \$250,000) that he has been renting to a group of physicians. During negotiations over a new seven-year lease, the physicians offer to purchase the building for \$900,000. Randall accepts the offer with the stipulation that the sale be structured as a delayed § 1031 transaction. Consequently, the sales proceeds are paid to a qualified third-party intermediary on the closing date of September 30, 2015.

On October 2, 2015, Randall properly identifies an office building that he would like to acquire. Unfortunately, on November 10, 2015, the property Randall selected is

withdrawn from the market. Working with the intermediary, on November 12, 2015, Randall identifies another office building that meets his requirements. The purchase of this property closes on December 15, 2015, and the title is transferred to Randall.

Randall treats the transaction as a § 1031 like-kind exchange. Even though the original office building identified was not acquired, Randall concludes that in substance, he has satisfied the 45-day rule. He identified the acquired office building as soon as the negotiations ceased on his first choice. Should the IRS accept Randall's attempt to comply?

⁶⁴Rev.Rul. 61-119, 1961-1 C.B. 395.



TAX IN THE NEWS What Happens to § 1031 Deferral If the Qualified Intermediary Defaults?

Normally, the IRS takes the position that the provisions of § 1031 are to be interpreted narrowly with respect to delayed § 1031 like-kind exchanges. In Revenue Procedure 2010-14, however, the IRS has announced an exception to this strict compliance requirement.

The exception applies if the 180-day time requirement for a delayed § 1031 like-kind exchange is not satisfied

because the qualified intermediary defaults due to a bankruptcy or receivership proceeding. In this situation, no gain is recognized by the taxpayer until a payment is received from the qualified intermediary or the bankruptcy trustee. As payments are received, gain is recognized using the gross profit ratio method.

13-4c Boot

If the taxpayer in a like-kind exchange gives or receives some property that is not like-kind property, recognition may occur. Property that is not like-kind property, including cash, is referred to as **boot**. Although the term *boot* does not appear in the Code, tax practitioners commonly use it rather than saying “property that is not like-kind property.”

The *receipt* of boot will trigger recognition of gain if there is realized gain. The amount of the recognized gain is the *lesser* of the boot received or the realized gain (realized gain serves as the ceiling on recognition).

Implications of Boot Received

EXAMPLE

33

Emily and Fran exchange machinery, and the exchange qualifies as like kind under § 1031. Because Emily's machinery (adjusted basis of \$20,000) is worth \$24,000 and Fran's machine has a fair market value of \$19,000, Fran also gives Emily cash of \$5,000. Emily's recognized gain is \$4,000, the lesser of the realized gain (\$24,000 amount realized – \$20,000 adjusted basis = \$4,000) or the fair market value of the boot received (\$5,000).

EXAMPLE

34

Assume the same facts as in the previous example, except that Fran's machine is worth \$21,000 (not \$19,000). Under these circumstances, Fran gives Emily cash of \$3,000 to make up the difference. Emily's recognized gain is \$3,000, the lesser of the realized gain of \$4,000 (\$24,000 amount realized – \$20,000 adjusted basis) or the fair market value of the boot received of \$3,000.

The receipt of boot does not result in recognition if there is realized loss.

Implications of Boot Received

EXAMPLE

35

Assume the same facts as in Example 33, except that the adjusted basis of Emily's machine is \$30,000. Emily's realized loss is \$6,000 (\$24,000 amount realized – \$30,000 adjusted basis). The receipt of the boot of \$5,000 does not trigger recognition. Therefore, the recognized loss is \$0.

The *giving* of boot usually does not trigger recognition. If the boot given is cash, no realized gain or loss is recognized.

Implications of Boot Given

EXAMPLE

36

Sarah and Gary exchange equipment in a like-kind exchange. Sarah receives equipment with a fair market value of \$75,000 and transfers equipment worth \$63,000 (adjusted basis of \$45,000) and cash of \$12,000. Sarah's realized gain is \$18,000 (\$75,000 amount realized – \$45,000 adjusted basis – \$12,000 cash). However, none of the realized gain is recognized.

If, however, the boot given is appreciated or depreciated property, gain or loss is recognized to the extent of the difference between the adjusted basis and the fair market

value of the boot. For this purpose, *appreciated or depreciated property* is defined as property whose adjusted basis is not equal to the fair market value.

Implications of Boot Given

Assume the same facts as in the previous example, except that Sarah transfers equipment worth \$30,000 (adjusted basis of \$36,000) and boot worth \$45,000 (adjusted basis of \$27,000). Sarah's net gain on this exchange is \$12,000 [\$75,000 amount realized – adjusted basis of \$63,000 (\$36,000 + \$27,000)]. But she is transferring two pieces of property: equipment (like-kind property) with a built-in realized loss of \$6,000 (\$30,000 fair market value – \$36,000 adjusted basis) and non-like-kind property (boot) with a built-in realized gain of \$18,000 (\$45,000 fair market value – \$27,000 adjusted basis).

In this case, the \$6,000 realized loss on the like-kind property is *deferred* (not recognized) and the \$18,000 realized gain on the non-like-kind property is recognized. In other words, the realized loss on the like-kind property *cannot* be used to offset the realized gain on the boot given up as part of the transaction.

EXAMPLE

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13-4d Basis and Holding Period of Property Received

If an exchange does not qualify as nontaxable under § 1031, gain or loss is recognized and the basis of property received in the exchange is the property's fair market value. If the exchange qualifies for nonrecognition, the basis of property received must be adjusted to reflect any postponed (deferred) gain or loss. The *basis of like-kind property* received in the exchange is the property's fair market value less postponed gain or plus postponed loss. If the exchange partially qualifies for nonrecognition (if recognition is associated with boot), the basis of like-kind property received in the exchange is the property's fair market value less postponed gain or plus postponed loss. The *basis of any boot* received is the boot's fair market value.

If there is a postponed loss, nonrecognition creates a situation in which the taxpayer has recovered *less* than the cost or other basis of the property exchanged in an amount equal to the unrecognized loss. If there is a postponed gain, the taxpayer has recovered *more* than the cost or other basis of the property exchanged in an amount equal to the unrecognized gain.

Basis of Like-Kind Property Received

Jaime exchanges a building (used in his business) with an adjusted basis of \$30,000 and a fair market value of \$38,000 for land with a fair market value of \$38,000. The land is to be held as an investment. The exchange qualifies as like kind (an exchange of business real property for investment real property). Thus, the basis of the land is \$30,000 (land's fair market value of \$38,000 – \$8,000 postponed gain on the building). If the land is later sold for its fair market value of \$38,000, the \$8,000 postponed gain is recognized.

EXAMPLE

38

Assume the same facts as in the previous example, except that the building has an adjusted basis of \$48,000 and a fair market value of only \$38,000. The basis in the newly acquired land is \$48,000 (fair market value of \$38,000 + \$10,000 postponed loss on the building). If the land is later sold for its fair market value of \$38,000, the \$10,000 postponed loss is recognized.

EXAMPLE

39

The Code provides an alternative approach for determining the basis of like-kind property received:

$$\begin{aligned}
 &\text{Adjusted basis of like-kind property surrendered} \\
 &+ \text{Adjusted basis of boot given} \\
 &+ \text{Gain recognized} \\
 &- \text{Fair market value of boot received} \\
 &- \text{Loss recognized} \\
 &= \text{Basis of like-kind property received}
 \end{aligned}$$

This approach is logical in terms of the recovery of capital doctrine. That is, the unrecovered cost or other basis is increased by additional cost (boot given) or decreased by cost recovered (boot received). Any gain recognized is included in the basis of the new property. The taxpayer has been taxed on this amount and is now entitled to recover it tax-free. Any loss recognized is deducted from the basis of the new property. The taxpayer has received a tax benefit on that amount.

The holding period of the property surrendered in the exchange carries over and *tacks on* to the holding period of the like-kind property received.⁶⁵ The holding period for boot received in a like-kind exchange begins with the date of the exchange. See Chapter 14 for a discussion of the relevance of the holding period.

Depreciation recapture potential carries over to the property received in a like-kind exchange.⁶⁶ See Chapter 14 for a discussion of this topic.

The following comprehensive example illustrates the like-kind exchange rules.

EXAMPLE
40

Vicki exchanged the following old machines for new machines in five independent like-kind exchanges:

Exchange	Adjusted Basis of Old Machine	Fair Market Value of Old Machine	Fair Market Value of New Machine	Adjusted Basis of Boot Given	Fair Market Value of Boot Received
1	\$4,000	\$ 9,000	\$9,000	\$ -0-	\$ -0-
2	4,000	6,000	9,000	3,000	-0-
3	4,000	3,000	9,000	6,000	-0-
4	4,000	12,000	9,000	-0-	3,000
5	4,000	3,800	3,500	-0-	300

Vicki's realized and recognized gains and losses and the basis of each of the like-kind properties received are as follows:

Exchange	Realized Gain (Loss)	Recognized Gain (Loss)	New Basis Calculation								
			Old Adj. Basis	+	Boot Given	+	Gain Recognized	-	Boot Received	=	New Basis
1	\$ 5,000	\$ -0-	\$4,000	+	\$ -0-	+	\$ -0-	-	\$ -0-	=	\$ 4,000*
2	2,000	-0-	4,000	+	3,000	+	-0-	-	-0-	=	7,000*
3	(1,000)	(-0-)	4,000	+	6,000	+	-0-	-	-0-	=	10,000**
4	8,000	3,000	4,000	+	-0-	+	3,000	-	3,000	=	4,000*
5	(200)	(-0-)	4,000	+	-0-	+	-0-	-	300	=	3,700**

*Basis may be determined in gain situations under the alternative method by subtracting the gain not recognized from the fair market value of the new property:

\$9,000 - \$5,000 = \$4,000 for exchange 1.

\$9,000 - \$2,000 = \$7,000 for exchange 2.

\$9,000 - \$5,000 = \$4,000 for exchange 4.

**In loss situations, basis may be determined by adding the loss not recognized to the fair market value of the new property:

\$9,000 + \$1,000 = \$10,000 for exchange 3.

\$3,500 + \$200 = \$3,700 for exchange 5.

The basis of the boot received is the boot's fair market value.

If the taxpayer either assumes a liability or takes property subject to a liability, the amount of the liability is treated as boot given. For the taxpayer whose liability is assumed or whose property is taken subject to the liability, the amount of the liability is treated as boot received. Example 41 illustrates the effect of such a liability. In addition, the example illustrates the tax consequences for both parties involved in the like-kind exchange.

⁶⁵§ 1223(1) and Reg. § 1.1223-1(a). For this carryover holding period rule to apply to like-kind exchanges after March 1, 1954, the like-kind property surrendered must have been either a capital asset or § 1231 property.

⁶⁶Reg. §§ 1.1245-2(a)(4) and 1.1250-2(d)(1).

Jill Saunders and Rick Thompson exchange real estate investments. Jill gives up property with an adjusted basis of \$250,000 (fair market value of \$420,000) that is subject to a mortgage of \$80,000 (assumed by Rick). In return for this property, Jill receives property with a fair market value of \$340,000 (Rick's adjusted basis in the property is \$200,000). Jill's and Rick's realized and recognized gains and their basis in the like-kind property received are computed as follows.⁶⁷

EXAMPLE

41

	Jill	Rick
Compute Realized Gain (Loss)		
FMV of like-kind property received	\$ 340,000	\$ 420,000
+ FMV of other property received		
+ Cash received		
+ Debt relief	80,000	
- Cash paid		
- Debt assumed		(80,000)
= Net consideration received	\$ 420,000	\$ 340,000
- Adjusted basis of property given	(250,000)	(200,000)
= Realized gain (loss)	<u>\$ 170,000</u>	<u>\$ 140,000</u>
Compute Boot Received		
Debt relief	\$ 80,000	\$ -0-
+ Cash received		-0-
+ FMV of other property received		
= Boot received	<u>\$ 80,000</u>	<u>\$ -0-</u>
Compute Recognized Gain		
Lesser of realized gain or boot received	<u>\$ 80,000</u>	<u>\$ -0-</u>
Compute Basis for New Property (Other Than Cash)		
Adjusted basis of property given	\$ 250,000	\$ 200,000
+ Boot given (cash paid, debt assumed)	-0-	80,000
+ Gain recognized	80,000	-0-
- Boot received	(80,000)	-0-
= Basis of new property	<u>\$ 250,000</u>	<u>\$ 280,000</u>

13-4e **Reporting Considerations**

Section 1031 transactions are reported on Form 8824 (Like-Kind Exchanges). Part III of Form 8824 has been completed based on the information provided for Jill Saunders's exchange.

Form 8824 (2014) Page **2**
 Name(s) shown on tax return. Do not enter name and social security number if shown on other side. Your social security number
 Jill Saunders (Example 41)

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred **and** received (a) more than one group of like-kind properties or (b) cash or other (not like-kind) property, see **Reporting of multi-asset exchanges** in the instructions.

Note: Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.

12	Fair market value (FMV) of other property given up	12			
13	Adjusted basis of other property given up	13			
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14			
	Caution: If the property given up was used previously or partly as a home, see Property used as home in the instructions.				
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)	15			80,000
16	FMV of like-kind property you received	16			340,000
17	Add lines 15 and 16	17			420,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15 (see instructions)	18			250,000
19	Realized gain or (loss). Subtract line 18 from line 17	19			170,000
20	Enter the smaller of line 15 or line 19, but not less than zero	20			80,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)	21			-0-
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)	22			80,000
23	Recognized gain. Add lines 21 and 22	23			80,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24			90,000
25	Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23	25			250,000

⁶⁷Example (2) of Reg. § 1.1031(d)-2 illustrates a special situation in which both the buyer and the seller transfer liabilities that are assumed by the other party or both parties acquire property that is subject to a liability.

This form should be used even if the like-kind exchange transaction results in no recognized gain or loss. It must be filed with the regular return for the tax year in which the taxpayer transfers property in a like-kind exchange.

If the like-kind exchange is with a related party, additional Forms 8824 must be filed for the following two years.

LO.7

Explain the nonrecognition provisions available on the involuntary conversion of property.

13-5 INVOLUNTARY CONVERSIONS—§ 1033

Section 1033 provides that a taxpayer who suffers an involuntary conversion of property may postpone recognition of *gain* realized from the conversion. The objective of this provision is to provide relief to the taxpayer who has suffered hardship and does not have the wherewithal to pay the tax on any gain realized from the conversion. Postponement of realized gain is permitted to the extent the taxpayer *reinvests* the amount realized from the conversion in replacement property. The rules for nonrecognition of gain are as follows:

- If the amount reinvested in replacement property *equals or exceeds* the amount realized, realized gain is *not recognized*.
- If the amount reinvested in replacement property is *less than* the amount realized, realized gain is *recognized* to the extent of the deficiency.

If a *loss* occurs on an involuntary conversion, § 1033 does not modify the normal rules for loss recognition. That is, if a realized loss would otherwise be recognized, § 1033 does not change the result.

13-5a Involuntary Conversion Defined

An **involuntary conversion** results from the destruction (complete or partial), theft, seizure, requisition or condemnation, or sale or exchange under threat or imminence of requisition or condemnation of the taxpayer's property.⁶⁸ To prove the existence of a threat or imminence of condemnation, the taxpayer must obtain confirmation that there has been a decision to acquire the property for public use. In addition, the taxpayer must have reasonable grounds to believe the property will be taken.⁶⁹ The property does not have to be sold to the authority threatening to condemn it to qualify for § 1033 postponement. If the taxpayer satisfies the confirmation and reasonable grounds requirements, he or she can sell the property to another party.⁷⁰ Likewise, the sale of property to a condemning authority by a taxpayer who acquired the property from its former owner with the knowledge that the property was under threat of condemnation also qualifies as an involuntary conversion under § 1033.⁷¹ A voluntary act, such as a taxpayer destroying the property by arson, is not an involuntary conversion.⁷²

13-5b Computing the Amount Realized

The amount realized from an involuntary conversion is normally any insurance proceeds received. In the case of the condemnation of property, the amount realized usually includes only the amount received as compensation for the property.⁷³ Any amount received that is designated as severance damages by both the government and the taxpayer is not included in the amount realized. *Severance awards* usually occur when only a portion of the property is condemned (e.g., a strip of land is taken to build a highway). Severance damages are awarded because the value of the taxpayer's remaining property has declined as a result of the condemnation. Such damages are a tax-free recovery of capital and reduce the basis of the property. However, if either of the

⁶⁸§ 1033(a) and Reg. §§ 1.1033(a)-1(a) and -2(a).

⁶⁹Rev.Rul. 63-221, 1963-2 C.B. 332, and *Joseph P. Balistrieri*, 38 TCM 526, T.C.Memo. 1979-115.

⁷⁰Rev.Rul. 81-180, 1981-2 C.B. 161.

⁷¹Rev.Rul. 81-181, 1981-2 C.B. 162.

⁷²Rev.Rul. 82-74, 1982-1 C.B. 110.

⁷³*Pioneer Real Estate Co.*, 47 B.T.A. 886 (1942), *acq.* 1943 C.B. 18.

following requirements is satisfied, the nonrecognition provision of § 1033 applies to the severance damages:

- The severance damages are used to restore the usability of the remaining property.
- The usefulness of the remaining property is destroyed by the condemnation, and the property is sold and replaced at a cost equal to or exceeding the sum of the condemnation award, severance damages, and sales proceeds.

§ 1033 and Severance Damages

The government condemns a portion of Ron's farmland to build part of an interstate highway. Because the highway denies his cattle access to a pond and some grazing land, Ron receives severance damages in addition to the condemnation proceeds for the land taken. Ron must reduce the basis of the property by the amount of the severance damages. If the amount of the severance damages received exceeds the adjusted basis, Ron recognizes gain.

EXAMPLE

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Assume the same facts as in the previous example, except that Ron uses the proceeds from the condemnation and the severance damages to build another pond and to clear woodland for grazing. Therefore, all of the proceeds are eligible for § 1033 treatment. There is no possibility of gain recognition as the result of the amount of the severance damages received exceeding the adjusted basis.

EXAMPLE

43

13-5c Replacement Property

The requirements for replacement property generally are more restrictive than those for like-kind property under § 1031. The basic requirement is that the replacement property be similar or related in service or use to the involuntarily converted property.⁷⁴

Different interpretations of the phrase *similar or related in service or use* apply depending on whether the involuntarily converted property is held by an *owner-user* or by an *owner-investor* (e.g., lessor). A taxpayer who uses the property in his or her trade or business is subject to a more restrictive test in terms of acquiring replacement property. For an owner-investor, the *taxpayer use* test applies, and for an owner-user, the *functional use test* applies. Furthermore, a special test applies in the case of involuntary conversions that result from condemnations.

Taxpayer Use Test

The taxpayer use test for owner-investors provides the taxpayer with more flexibility in terms of what qualifies as replacement property than does the functional use test for owner-users. Essentially, the properties must be used by the taxpayer (the owner-investor) in similar endeavors. For example, rental property held by an owner-investor qualifies if replaced by other rental property, regardless of the type of rental property involved. The test is met when an investor replaces a manufacturing plant with a wholesale grocery warehouse if both properties are held for the production of rent income.⁷⁵ The replacement of a rental residence with a personal residence does not meet the test.⁷⁶

Functional Use Test

The functional use test applies to owner-users (e.g., a manufacturer whose manufacturing plant is destroyed by fire is required to replace the plant with another facility of similar functional use). Under this test, the taxpayer's use of the replacement property and of the involuntarily converted property must be the same. Replacing a manufacturing

⁷⁴§ 1033(a) and Reg. § 1.1033(a)-1.

⁷⁶Rev.Rul. 70-466, 1970-2 C.B. 165.

⁷⁵*Loco Realty Co. v. Comm.*, 62-2 USTC ¶9657, 10 AFTR 2d 5359, 306 F.2d 207 (CA-8, 1962).

plant with a wholesale grocery warehouse does not meet this test. Replacing a rental residence with a personal residence also does not pass the test.

Special Rule for Condemnations

Under one set of circumstances, the broader replacement rules for like-kind exchanges are substituted for the narrow replacement rules normally used for involuntary conversions. This beneficial provision applies if business real property or investment real property is condemned. This provision gives the taxpayer substantially more flexibility in selecting replacement property. For example, improved real property can be replaced with unimproved real property.

The rules concerning the nature of replacement property are illustrated in Concept Summary 13.3.

Concept Summary 13.3

Involuntary Conversions: Replacement Property Tests

Type of Property and User	Taxpayer Use Test	Functional Use Test	Special Rule for Condemnations*
An investor's rented shopping mall is destroyed by fire; the mall may be replaced with other rental properties (e.g., an apartment building).	X		
A manufacturing plant is destroyed by fire; replacement property must consist of another manufacturing plant that is functionally the same as the property converted.		X	
Personal residence of a taxpayer is condemned by a local government authority; replacement property must consist of another personal residence.		X	
Land used by a manufacturing company is condemned by a local government authority.			X
Apartment and land held by an investor are sold due to the threat or imminence of condemnation.			X

*Applies the same test as in the case of like-kind exchanges.

13-5d Time Limitation on Replacement

The taxpayer normally has a two-year period after the close of the taxable year in which gain is realized from an involuntary conversion to replace the property.⁷⁷ This rule affords as much as three years from the date of realization of gain to replace the property if the realization of gain took place on the first day of the taxable year.⁷⁸

EXAMPLE

44

Megan's warehouse is destroyed by fire on December 16, 2014. The adjusted basis is \$325,000. Megan receives \$400,000 from the insurance company on January 10, 2015. She is a calendar year and cash method taxpayer. The latest date for replacement is December 31, 2017 (the end of the taxable year in which realized gain occurred plus two years). The critical date is not the date the involuntary conversion occurred, but rather the date of gain realization.

In the case of a condemnation of real property used in a trade or business or held for investment, a three-year period is substituted for the normal two-year period. In this case, the taxpayer can actually have as many as four years from the date of realization of gain to replace the property.

⁷⁷ §§ 1033(a)(2)(B) and (g)(4) and Reg. § 1.1033(a)-2(c)(3). The two-year period is extended to a four-year period if the property is located in a Presidentially-declared disaster area.

⁷⁸ The taxpayer can apply for an extension of this time period anytime before its expiration [Reg. § 1.1033(a)-2(c)(3)]. Also, the period for filing the application for extension can be extended if the taxpayer shows reasonable cause.

Assume the same facts as in the previous example, except that Megan's warehouse is condemned. Megan receives notification of the future condemnation on November 1, 2014. The condemnation occurs on December 16, 2014, with the condemnation proceeds being received on January 10, 2015. The latest date for replacement is December 31, 2018 (the end of the taxable year in which realized gain occurred plus three years).

EXAMPLE

45

The *earliest date* for replacement typically is the date the involuntary conversion occurs. However, if the property is condemned, it is possible to replace the condemned property before this date. In this case, the earliest date is the date of the threat or imminence of requisition or condemnation of the property. The purpose of this provision is to enable the taxpayer to make an orderly replacement of the condemned property.

Assume the same facts as in Example 45. The earliest date that Megan can replace the warehouse is November 1, 2014, which is the date of the condemnation of the warehouse.

EXAMPLE

46

13-5e Nonrecognition of Gain

Nonrecognition of gain can be either mandatory or elective, depending on whether the conversion is direct (into replacement property) or indirect (into money).

Direct Conversion

If the conversion is directly into replacement property rather than into money, nonrecognition of realized gain is *mandatory*. In this case, the basis of the replacement property is the same as the adjusted basis of the converted property. Direct conversion is rare in practice and usually involves condemnations.

Lupe's property, with an adjusted basis of \$20,000, is condemned by the state. Lupe receives property with a fair market value of \$50,000 as compensation for the property taken. Because the nonrecognition of realized gain is mandatory for direct conversions, Lupe's realized gain of \$30,000 is not recognized and the basis of the replacement property is \$20,000 (adjusted basis of the condemned property).

EXAMPLE

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Conversion into Money

If the conversion is into money, the realized gain is recognized only to the extent the amount realized from the involuntary conversion exceeds the cost of the qualifying replacement property.⁷⁹ This is the usual case, and nonrecognition (postponement) is *elective*. If the election is not made, the realized gain is recognized.

The basis of the replacement property is the property's cost less any postponed (deferred) gain.⁸⁰ If the election to postpone gain is made, the holding period of the replacement property includes the holding period of the converted property.

Section 1033 applies *only to gains* and *not to losses*. Losses from involuntary conversions are recognized if the property is held for business or income-producing purposes. Personal casualty losses are recognized, but condemnation losses related to personal use assets (e.g., a personal residence) are neither recognized nor postponed.

The Big Picture

Return to the facts of *The Big Picture* on p. 13-1. Alice's building (used in her trade or business), with an adjusted basis of \$50,000, is destroyed by fire on October 5, 2015. Alice is a calendar year taxpayer. On November 17, 2015, she receives an insurance reimbursement of \$100,000 for the loss.

EXAMPLE

48

continued

⁷⁹§ 1033(a)(2)(A) and Reg. § 1.1033(a)-2(c)(1).

⁸⁰§ 1033(b).

Alice invests \$80,000 in a new building. Alice uses the other \$20,000 of insurance proceeds to pay off credit card debt.

- Alice has until December 31, 2017, to make the new investment and qualify for the non-recognition election.
- Alice's realized gain is \$50,000 (\$100,000 insurance proceeds received – \$50,000 adjusted basis of old building).
- Assuming that the replacement property qualifies as similar or related in service or use, Alice's recognized gain is \$20,000. She reinvested \$20,000 less than the insurance proceeds received (\$100,000 proceeds – \$80,000 reinvested). Therefore, her realized gain is recognized to that extent.
- Alice's basis in the new building is \$50,000. This is the building's cost of \$80,000 less the postponed gain of \$30,000 (realized gain of \$50,000 – recognized gain of \$20,000).

The Big Picture

EXAMPLE

49

Return to the facts of *The Big Picture* on p. 13-1. Assume the same facts as in the previous example, except that Alice receives only \$45,000 of insurance proceeds. She has a realized and recognized loss of \$5,000. The basis of the new building is the building's cost of \$80,000.

If the destroyed building in Example 49 had been held for personal use, the recognized loss would have been subject to the following additional limitations.⁸¹ The loss of \$5,000 would have been limited to the decline in fair market value of the property, and the amount of the loss would have been reduced first by \$100 and then by 10 percent of adjusted gross income (refer to Chapter 7).

13-5f Reporting Considerations

Involuntary conversions from casualty and theft are reported first on Form 4684, Casualties and Thefts. Casualty and theft losses on personal use property for the individual taxpayer are carried from Form 4684 to Schedule A of Form 1040. For other casualty and theft items, the Form 4684 amounts are generally reported on Form 4797, Sales of Business Property, unless Form 4797 is not required. In the latter case, the amounts are reported directly on the tax return involved.

Except for personal use property, recognized gains and losses from involuntary conversions other than by casualty and theft are reported on Form 4797. As stated previously, if the property involved in the involuntary conversion (other than by casualty and theft) is personal use property, any realized loss is not recognized. Any realized gain is treated as gain on a voluntary sale.

What procedure should be followed if the taxpayer intends to acquire qualifying replacement property but has not done so by the time the tax return is filed? The taxpayer should elect § 1033 and report all of the details of the transaction on a statement attached to the return. Although a tax form (Form 8824) is available for § 1031 like-kind exchanges, no special form is provided for § 1033 transactions. When the qualifying replacement property is acquired, the taxpayer should attach a statement to the tax return that contains relevant information on the replacement property.

An amended return must be filed if qualified replacement property is not acquired during the statutory time period allowed. An amended return also is required if the cost of the replacement property is less than the amount realized from the involuntary conversion. In this case, the return would recognize the portion of the realized gain that can no longer be deferred.

⁸¹§ 165(c)(3) and Reg. § 1.165-7.

13-6 SALE OF A RESIDENCE—§ 121

A taxpayer's **personal residence** is a personal use asset. Therefore, a realized loss from the sale of a personal residence is not recognized.⁸²

A realized gain from the sale of a personal residence is subject to taxation. However, favorable relief from recognition of gain is provided in the form of the **§ 121 exclusion**. Under this provision, a taxpayer can exclude up to \$250,000 (\$500,000 on certain joint returns) of realized gain on the sale of a taxpayer's principal residence.⁸³

13-6a Principal Residence

Whether property is the taxpayer's principal residence "depends upon all of the facts and circumstances in each case."⁸⁴ A residence does not have to be a house. For example, a houseboat, a house trailer, or a motor home can qualify.⁸⁵ Land, under certain circumstances, can qualify for exclusion treatment. The lot on which a house is built obviously qualifies. An adjacent lot can qualify if it is regularly used by the owner as part of the residential property. To qualify, the land must be sold along with the residence or within two years before or after the sale of the residence.

Mitch graduates from college and moves to Boston, where he is employed. He decides to rent an apartment in Boston because of its proximity to his place of employment. He purchases a beach condo in the Cape Cod area that he occupies most weekends. Mitch does not intend to live at the beach condo except on weekends. The apartment in Boston is his principal residence.

EXAMPLE

50

13-6b Requirements for Exclusion Treatment

To qualify for exclusion treatment, at the date of the sale, the residence must have been *owned and used* by the taxpayer as the principal residence for at least two years during the five-year period ending on the date of the sale of a taxpayer's principal residence.⁸⁶

Melissa sells her principal residence on September 18, 2015. She had purchased it on July 5, 2013, and lived in it since then. The sale of Melissa's residence qualifies for the § 121 exclusion.

EXAMPLE

51

The five-year window enables the taxpayer to qualify for the § 121 exclusion even though the property is not his or her principal residence at the date of the sale.

Benjamin sells his former principal residence on August 16, 2015. He had purchased it on April 1, 2007, and lived in it until July 1, 2014, when he converted it to rental property. Even though the property is rental property on August 16, 2015, rather than Benjamin's principal residence, the sale qualifies for the § 121 exclusion.⁸⁷ During the five-year period from August 16, 2010, to August 16, 2015, Benjamin owned and used the property as his principal residence for at least two years.

EXAMPLE

52

Taxpayers might be tempted to make liberal use of the § 121 exclusion as a means of speculating when the price of residential housing is rising. Without any time restriction on its use, § 121 would permit the exclusion of realized gain on multiple sales of principal residences. The Code curbs this approach by denying the application of the § 121 exclusion to sales occurring within two years of its last use.⁸⁸

⁸²§ 165(c).

⁸³§ 121(b).

⁸⁴Regulation § 1.121-1(b)(2) includes factors to be considered in determining a taxpayer's principal residence.

⁸⁵Reg. § 1.1034-1(c)(3)(i).

⁸⁶§ 121(a). However, § 121(d)(10) provides that exclusion treatment does not apply if the residence was acquired in a like-kind exchange within the prior five years of the sale of the residence.

⁸⁷However, any realized gain on the sale that is attributable to depreciation is not eligible for the § 121 exclusion. See Example 68.

⁸⁸§ 121(b)(3).

EXAMPLE

53

Mike sells his principal residence (the first residence) in June 2014 for \$150,000 (realized gain of \$60,000). He then buys and sells the following (all of which qualify as principal residences):

	Date of Purchase	Date of Sale	Amount Involved
Second residence	July 2014		\$160,000
Second residence		April 2015	180,000
Third residence	May 2015		200,000

Because multiple sales have taken place within a period of two years, § 121 does not apply to the sale of the second residence. Thus, the realized gain of \$20,000 [\$180,000 (selling price) – \$160,000 (purchase price)] must be recognized.

13-6c Exceptions to the Two-Year Ownership Rule

The two-year ownership and use requirement and the “only once every two years” provision could create a hardship for taxpayers in certain situations that are beyond their control. Thus, under the following special circumstances, the requirements are waived:⁸⁹

- Change in place of employment.
- Health.
- To the extent provided in the Regulations, other unforeseen circumstances.

These three exceptions have been amplified by Treasury Department Regulations and are discussed in the sections that follow.⁹⁰ Each of these exceptions provides a *partial* exclusion. The calculation of the partial exclusion is discussed later in this chapter (see Relief Provision in Section 13-6d).

Change in Place of Employment

For this exception to apply, the distance requirements applicable to the deductibility of moving expenses must be satisfied (see Chapter 9). Consequently, the location of the taxpayer’s new employment must be at least 50 miles further from the old residence than the old residence was from the old job. The house must be used as the principal residence of the taxpayer at the time of the change in the place of employment. Employment includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment.

EXAMPLE

54

Assume the same facts as in the previous example, except that in March 2015, Mike’s employer transfers him to a job in another state that is 400 miles away. Thus, the sale of the second residence and the purchase of the third residence were due to relocation of employment. Consequently, the § 121 exclusion is partially available on the sale of the second residence.

Health Considerations

For the health exception to apply, health must be the primary reason for the sale or exchange of the residence. A sale or exchange that is merely beneficial to the general health or well-being of the individual will not qualify. The health exception can be satisfied under either a general facts and circumstances approach or by a safe harbor established in the Regulations. The safe harbor applies if there is a physician’s recommendation for a change of residence (1) to obtain, provide, or facilitate the

⁸⁹§ 121(c)(2)(B).

⁹⁰See Reg. § 1.121-3 and IRS Publication 523 (*Selling Your Home*) for further details and illustrations.



TAX IN THE NEWS Living in a High-Crime Neighborhood

Normally, a taxpayer must satisfy the ownership and use requirements and the only once-every-two-years provision to be eligible for the § 121 exclusion. However, under the unforeseen circumstances exception, a taxpayer who does not satisfy these three requirements may be eligible for a reduced § 121 exclusion.

In several letter rulings, the IRS has been sympathetic to crime victims. One ruling involved a taxpayer who was

accosted leaving his home, driven to several locations, and forced to withdraw money from an ATM. In another ruling, the taxpayers and their son were hospitalized after being assaulted by neighbors. In both cases, the taxpayers sold their homes. Although the taxpayers had not satisfied the three time period requirements, the IRS held that they were eligible for reduced § 121 exclusion treatment under the unforeseen circumstances exception.

diagnosis, cure, mitigation, or treatment of disease, illness, or injury or (2) to obtain or provide medical or personal care for an individual suffering from a disease, an illness, or an injury.

Unforeseen Circumstances

For the unforeseen circumstances exception to apply, the primary reason for the sale or exchange of the residence must be an event the taxpayer did not anticipate before purchasing and occupying the residence. This exception can be satisfied under either a general facts and circumstances approach or by a safe harbor established in the Regulations. The safe harbor applies in any of the following instances:

- Involuntary conversion of the residence.
- Natural or human-made disasters or acts of war or terrorism resulting in a casualty to the residence.
- Death of a qualified individual.
- Cessation of employment that results in eligibility for unemployment compensation.
- Change in employment or self-employment that results in the taxpayer being unable to pay housing costs and reasonable basic living expenses for the taxpayer's household.
- Divorce or legal separation.
- Multiple births resulting from the same pregnancy.

Debra and Roy are engaged and buy a house (sharing the mortgage payments) and live in it as their personal residence. Eighteen months after the purchase, they cancel their wedding plans, and Roy moves out of the house. Because Debra cannot afford to make the payments alone, they sell the house. While the sale does not fit under the safe harbor, the sale does qualify under the unforeseen circumstances exception.

EXAMPLE

55

13-6d Calculation of the Amount of the Exclusion

General Provisions

The amount of the available § 121 exclusion on the sale of a principal residence is \$250,000.⁹¹ If the realized gain does not exceed \$250,000, there is no recognized gain.

Realized gain is calculated in the normal manner. The *amount realized* is the selling price less the selling expenses, which include items such as the cost of advertising the property for sale, real estate broker commissions, legal fees in connection with the sale, and loan placement fees paid by the taxpayer as a condition of arranging financing for

⁹¹§ 121(b)(1).

the buyer. Repairs and maintenance performed by the seller to aid in selling the property are treated neither as selling expenses nor as adjustments to the taxpayer's adjusted basis for the residence.

The § 121 Exclusion Amount

EXAMPLE

56

Mandy, who is single, sells her personal residence (adjusted basis of \$130,000) for \$290,000. She has owned and lived in the residence for three years. Her selling expenses are \$18,000. Three weeks prior to the sale, Mandy paid a carpenter and a painter \$1,000 to make some repairs and paint the two bathrooms. Her recognized gain is calculated as follows:

Amount realized (\$290,000 – \$18,000)	\$ 272,000
Adjusted basis	<u>(130,000)</u>
Realized gain	\$ 142,000
§ 121 exclusion	<u>(142,000)</u>
Recognized gain	<u>\$ -0-</u>

Because the available § 121 exclusion of \$250,000 exceeds Mandy's realized gain of \$142,000, her recognized gain is \$0.

EXAMPLE

57

Assume the same facts as in the previous example, except that the selling price is \$490,000.

Amount realized (\$490,000 – \$18,000)	\$ 472,000
Adjusted basis	<u>(130,000)</u>
Realized gain	\$ 342,000
§ 121 exclusion	<u>(250,000)</u>
Recognized gain	<u>\$ 92,000</u>

Because the realized gain of \$342,000 exceeds the § 121 exclusion amount of \$250,000, Mandy's recognized gain is \$92,000 (\$342,000 – \$250,000).

Effect on Married Couples

If a married couple files a joint return, the \$250,000 amount is increased to \$500,000 if the following requirements are satisfied:⁹²

- Either spouse meets the at-least-two-years *ownership* requirement.
- Both spouses meet the at-least-two-years *use* requirement.
- Neither spouse is ineligible for the § 121 exclusion on the sale of the current principal residence because of the sale of another principal residence within the prior two years.

EXAMPLE

58

Margaret sells her personal residence (adjusted basis of \$150,000) for \$650,000. She has owned and lived in the residence for six years. Her selling expenses are \$40,000. Margaret is married to Ted, and they file a joint return. Ted has lived in the residence since they were married two and one-half years ago.

Amount realized (\$650,000 – \$40,000)	\$ 610,000
Adjusted basis	<u>(150,000)</u>
Realized gain	\$ 460,000
§ 121 exclusion	<u>(460,000)</u>
Recognized gain	<u>\$ -0-</u>

Because the realized gain of \$460,000 is less than the available § 121 exclusion amount of \$500,000, no gain is recognized.

⁹²§ 121(b)(2).

A surviving spouse can continue to use the \$500,000 exclusion amount on the sale of a personal residence for the next two years following the year of the deceased spouse's death. If the sale occurs in the year of death, however, a joint return must be filed by the surviving spouse.

Relief Provision

As discussed earlier in Exceptions to the Two-Year Ownership Rule, partial § 121 exclusion treatment may be available when not all of the statutory requirements are satisfied. Under the relief provision, the § 121 exclusion amount (\$250,000 or \$500,000) is multiplied by a fraction, the numerator of which is the number of qualifying months and the denominator of which is 24 months. The resulting amount is the excluded gain.⁹³

On October 1, 2014, Rich and Audrey, who file a joint return and live in Chicago, sell their personal residence, which they have owned and lived in for eight years. The realized gain of \$325,000 is excluded under § 121. They purchase another personal residence for \$525,000 on October 2, 2014. Audrey's employer transfers her to the Denver office in August 2015. Rich and Audrey sell their Chicago residence on August 2, 2015, and purchase a residence in Denver shortly thereafter. The realized gain on the sale is \$300,000.

The \$325,000 gain on the first Chicago residence is excluded under § 121. The sale of the second Chicago residence is within the two-year window of the prior sale, but because it resulted from a change in employment, Rich and Audrey can qualify for partial § 121 exclusion treatment as follows:

Realized gain	\$ 300,000
§ 121 exclusion:	
$\frac{10 \text{ months}}{24 \text{ months}} \times \$500,000 = \$208,333$	(208,333)
Recognized gain	<u><u>\$ 91,667</u></u>

EXAMPLE

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Basis of New Residence

Because § 121 is an exclusion provision rather than a postponement of gain provision, the basis of a new residence is its cost.⁹⁴

13-6e **Involuntary Conversion and Using §§ 121 and 1033**

A taxpayer can use both the § 121 exclusion of gain provision and the § 1033 postponement of gain provision.⁹⁵ The taxpayer initially can elect to exclude realized gain under § 121 to the extent of the statutory amount. Then a qualified replacement of the residence under § 1033 can be used to postpone the remainder of the realized gain. In applying § 1033, the amount of the required reinvestment is reduced by the amount of the § 121 exclusion.

Angel's principal residence is destroyed by a tornado. Her adjusted basis for the residence is \$140,000. She receives insurance proceeds of \$480,000.

If Angel does not elect to use the § 121 exclusion, her realized gain on the involuntary conversion of her principal residence is \$340,000 (\$480,000 amount realized – \$140,000 adjusted basis). Thus, to postpone the \$340,000 realized gain under § 1033, she would need to acquire qualifying property costing at least \$480,000.

Using the § 121 exclusion enables Angel to reduce the amount of the required reinvestment for § 1033 purposes from \$480,000 to \$230,000. That is, by using § 121 in conjunction with § 1033, the amount realized, for § 1033 purposes, is reduced to \$230,000 (\$480,000 – \$250,000 § 121 exclusion).

Note that if Angel does not acquire qualifying replacement property for § 1033 purposes, her recognized gain is \$90,000 (\$480,000 – \$140,000 adjusted basis – \$250,000 § 121 exclusion).

EXAMPLE

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⁹³§ 121(c)(1).

⁹⁴§ 1012.

⁹⁵§ 121(d)(5).

LO.9

Identify other nonrecognition provisions contained in the Code.

13-7 OTHER NONRECOGNITION PROVISIONS

The typical taxpayer experiences the sale of a personal residence or an involuntary conversion more frequently than the other types of nontaxable exchanges. Several less common nonrecognition provisions are treated briefly in the remainder of this chapter.

13-7a Exchange of Stock for Property—§ 1032

Under § 1032, a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock (including treasury stock). In other words, a corporation does not recognize gain or loss when it deals in its own stock. This provision is consistent with the accounting treatment of such transactions.

13-7b Certain Exchanges of Insurance Policies—§ 1035

Under § 1035, no gain or loss is recognized from the exchange of certain insurance contracts or policies. The rules relating to exchanges not solely in kind and the basis of the property acquired are the same as under § 1031. Exchanges qualifying for nonrecognition include the following:

- The exchange of life insurance contracts.
- The exchange of a life insurance contract for an endowment or annuity contract.
- The exchange of an endowment contract for another endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged.
- The exchange of an endowment contract for an annuity contract.
- The exchange of annuity contracts.

13-7c Exchange of Stock for Stock of the Same Corporation—§ 1036

Section 1036 provides that a shareholder does not recognize gain or loss on the exchange of common stock solely for common stock in the same corporation or from the exchange of preferred stock for preferred stock in the same corporation. Exchanges between individual shareholders as well as between a shareholder and the corporation are included. The rules relating to exchanges not solely in kind and the basis of the property acquired are the same as under § 1031. For example, a nonrecognition exchange occurs when common stock with different rights, such as voting for nonvoting, is exchanged. A shareholder usually recognizes gain or loss from the exchange of common for preferred or preferred for common even though the stock exchanged is in the same corporation.

13-7d Certain Reacquisitions of Real Property—§ 1038

Under § 1038, no loss is recognized from the repossession of real property sold on an installment basis. Gain is recognized to a limited extent.

13-7e Transfers of Property between Spouses or Incident to Divorce—§ 1041

Section 1041 provides that transfers of property *between spouses or former spouses incident to divorce* are nontaxable transactions. Therefore, the basis to the recipient is a carryover basis. To be treated as incident to the divorce, the transfer must be related to the cessation of marriage or occur within one year after the date on which the marriage ceases.

Section 1041 also provides for nontaxable exchange treatment on property transfers *between spouses during marriage*. The basis to the recipient spouse is a carryover basis.

13-7f Rollovers into Specialized Small Business Investment Companies—§ 1044

A postponement opportunity is available for some sellers of publicly traded securities under § 1044. If the amount realized is reinvested in the common stock or partnership interest of a specialized small business investment company (SSBIC), the realized gain is not recognized. Any amount not reinvested will trigger recognition of the realized gain to the extent of the deficiency. The taxpayer must reinvest the proceeds within 60 days of the date of sale to qualify. Various statutory ceilings apply to the amount of realized gain that can be postponed, and time limitations are also imposed.⁹⁶

13-8 TAX PLANNING

13-8a Cost Identification and Documentation Considerations

When multiple assets are acquired in a single transaction, the contract price must be allocated for several reasons. First, some of the assets may be depreciable, while others are not. From the different viewpoints of the buyer and the seller, this may produce a tax conflict that needs to be resolved. That is, the seller prefers a high allocation for non-depreciable assets, whereas the purchaser prefers a high allocation for depreciable assets (see Chapter 14). Second, the seller needs to know the amount realized on the sale of the capital assets and the ordinary income assets so that the recognized gains and losses can be classified as capital or ordinary. For example, an allocation to goodwill or to a covenant not to compete (see Chapters 8 and 14) produces different tax consequences to the seller. Third, the buyer needs the adjusted basis of each asset to calculate the realized gain or loss on a subsequent sale or other disposition of each asset.

13-8b Selection of Property for Making Gifts

A donor can achieve several tax advantages by making gifts of appreciated property. The donor avoids income tax on the unrealized gain that would have occurred had the donor sold the property. A portion of this amount can be permanently avoided because the donee's adjusted basis is increased by part or all of any gift tax paid by the donor. Even without this increase in basis, the income tax liability on the sale of the property by the donee can be less than the income tax liability that would have resulted from the donor's sale of the property if the donee is in a lower tax bracket than the donor. In addition, any subsequent appreciation during the time the property is held by the lower tax bracket donee results in a tax savings on the sale or other disposition of the property. Such gifts of appreciated property can be an effective tool in family tax planning.

Taxpayers should generally not make gifts of depreciated property (property that, if sold, would produce a realized loss) because the donor does not receive an income tax deduction for the unrealized loss element. In addition, the donee receives no benefit from this unrealized loss upon the subsequent sale of the property because of the loss basis rule. The loss basis rule provides that the donee's basis is the lower of the donor's basis or the fair market value at the date of the gift. If the donor anticipates that the donee will sell the property upon receiving it, the donor should sell the property and take the loss deduction, assuming the loss is deductible. The donor can then give the proceeds from the sale to the donee.

13-8c Selection of Property for Making Bequests

A taxpayer should generally make bequests of appreciated property in his or her will. Doing so enables both the decedent and the heir to avoid income tax on the unrealized gain because the recipient takes the fair market value as his or her basis.

LO.10

Review and apply various tax planning opportunities related to selected property transactions.

⁹⁶See IRS Publication 550 (*Investment Income and Expenses*), Chapter 4, p. 66.

Taxpayers generally should not make bequests of depreciated property (property that, if sold, would produce a realized loss) because the decedent does not receive an income tax deduction for the unrealized loss element. In addition, the heir will receive no benefit from this unrealized loss upon the subsequent sale of the property.

EXAMPLE

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On the date of her death in 2015, Marta owned land held for investment purposes. The land had an adjusted basis of \$130,000 and a fair market value of \$100,000. If Marta had sold the property before her death, the recognized loss would have been \$30,000. If Roger inherits the property and later sells it for \$90,000, the recognized loss is \$10,000 (the decline in value since Marta's death). In addition, regardless of the period of time Roger holds the property, the holding period is long term (see Chapter 14).

From an income tax perspective, it is preferable to transfer appreciated property as a bequest rather than as a gift. The reason is that inherited property receives a step-up in basis, whereas property received by gift has a carryover basis to the donee. However, in making this decision, the estate tax consequences of the bequest should also be weighed against the gift tax consequences of the gift.

13-8d Disallowed Losses

Section 267 Disallowed Losses

Taxpayers should be aware of the desirability of avoiding transactions that activate the loss disallowance provisions for related parties. This is so even in light of the provision that permits the related-party buyer to offset his or her realized gain by the related-party seller's disallowed loss. Even with this offset, several inequities exist. First, the tax benefit associated with the disallowed loss ultimately is realized by the wrong party (the related-party buyer rather than the related-party seller). Second, the tax benefit of this offset to the related-party buyer does not occur until the buyer disposes of the property. Therefore, the longer the time period between the purchase and disposition of the property by the related-party buyer, the less the economic benefit. Third, if the property does not appreciate to at least its adjusted basis to the related-party seller during the time period the related-party buyer holds it, part or all of the disallowed loss is permanently lost. Fourth, because the right of offset is available only to the original transferee (the related-party buyer), all of the disallowed loss is permanently lost if the original transferee subsequently transfers the property by gift or bequest.

EXAMPLE

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Tim sells property with an adjusted basis of \$35,000 to Wes, his brother, for \$25,000, the fair market value of the property. The \$10,000 realized loss to Tim is disallowed by § 267. If Wes subsequently sells the property to an unrelated party for \$37,000, he has a recognized gain of \$2,000 (realized gain of \$12,000 reduced by disallowed loss of \$10,000). Therefore, from the perspective of the family unit, the original \$10,000 realized loss ultimately is recognized. However, if Wes sells the property for \$29,000, he has a recognized gain of \$0 (realized gain of \$4,000 reduced by disallowed loss of \$4,000 necessary to offset the realized gain). From the perspective of the family unit, \$6,000 of the realized loss of \$10,000 is permanently wasted (\$10,000 realized loss – \$4,000 offset permitted).

Wash Sales

The wash sales provisions can be avoided if the security that was sold is replaced within the statutory time period with a similar rather than a substantially identical security. For example, a sale of Dell, Inc. common stock accompanied by a purchase of Hewlett-Packard common stock is not treated as a wash sale. Such a procedure can enable the taxpayer to use an unrealized capital loss to offset a recognized capital gain. The taxpayer can sell the security before the end of the taxable year, offset the recognized capital loss against the capital gain, and invest the sales proceeds in a similar security.

Because the wash sales provisions do not apply to gains, it may be desirable to engage in a wash sale before the end of the taxable year. The recognized capital gain may be used to offset capital losses or capital loss carryovers from prior years. Because the basis of the replacement stock or securities will be the purchase price, the taxpayer in effect has exchanged a capital gain for an increased basis for the stock or securities.



ETHICS & EQUITY Washing a Loss Using an IRA

Sam owns 1,500 shares of Eagle, Inc. stock that he purchased over 10 years ago for \$80,000. Although the stock has a current market value of \$52,000, Sam still views the stock as a solid long-term investment. He has sold other stock during the year with overall gains of \$30,000, so he would like to sell the Eagle stock and offset

the \$28,000 loss against these gains—but somehow keep his Eagle investment. He has devised a plan to keep his Eagle investment by using funds in his traditional IRA to purchase 1,500 Eagle shares immediately after selling the shares he currently owns. Evaluate Sam's treatment of these stock transactions. Can his plan work?

13-8e Like-Kind Exchanges

Because application of the like-kind exchange provisions is mandatory rather than elective, in certain instances, it may be preferable to avoid qualifying for § 1031 nonrecognition. To avoid the application of a deferral under § 1031, the taxpayer should structure the transaction so that at least one of the statutory requirements for a § 1031 like-kind exchange is not satisfied. If the like-kind exchange provisions do not apply, the end result may be the recognition of capital gain in exchange for a higher basis in the newly acquired asset. Also, the immediate recognition of gain may be preferable in certain situations. Examples in which immediate recognition is beneficial include the following:

- Taxpayer has unused net operating loss carryovers.
- Taxpayer has unused general business credit carryovers.
- Taxpayer has suspended or current passive activity losses.

Alicia disposes of a machine (used in her business) with an adjusted basis of \$3,000 for \$4,000. She also acquires a new business machine for \$9,000. If § 1031 applies, the \$1,000 realized gain is not recognized and the basis of the new machine is reduced by \$1,000 (from \$9,000 to \$8,000). If § 1031 does not apply, a \$1,000 gain is recognized and may receive favorable capital gain treatment to the extent the gain is not recognized as ordinary income due to the depreciation recapture provisions (see Chapter 14). In addition, the basis for depreciation on the new machine is \$9,000 rather than \$8,000 because there is no unrecognized gain.

EXAMPLE

63

The application of § 1031 nonrecognition treatment should also be avoided when the adjusted basis of the property being disposed of exceeds the fair market value.

Assume the same facts as in the previous example, except that the fair market value of the machine is \$2,500. If § 1031 applies, the \$500 realized loss is not recognized. To recognize the loss, Alicia should sell the old machine and purchase the new one. The purchase and sale transactions should be with different taxpayers.

EXAMPLE

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On the other hand, the like-kind exchange procedure can be utilized to control the amount of recognized gain.

Rex has property with an adjusted basis of \$40,000 and a fair market value of \$100,000. Sandra wants to buy Rex's property, but Rex wants to limit the amount of recognized gain on the proposed transaction. Sandra acquires other like-kind property (from an outside party) for \$80,000.

EXAMPLE

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continued

She then exchanges this property and \$20,000 cash for Rex's property. Rex has a realized gain of \$60,000 (\$100,000 amount realized – \$40,000 adjusted basis). His recognized gain is only \$20,000, the lower of the \$20,000 boot received or the \$60,000 realized gain. Rex's basis for the like-kind property is \$40,000 (\$40,000 adjusted basis + \$20,000 gain recognized – \$20,000 boot received). If Rex had sold the property to Sandra for its fair market value of \$100,000, the result would have been a \$60,000 recognized gain (\$100,000 amount realized – \$40,000 adjusted basis) to him. It is permissible for Rex to identify the like-kind property that he wants Sandra to purchase.⁹⁷

In the present economic environment, however, there is another consideration. The beneficial result of tax deferral of realized gain could be more than offset by future tax rate increases. Some real estate investors were following this approach in 2012, particularly with respect to undeveloped land. They were willing to accept current taxation at 15 percent to avoid the possibility of future taxation at a much higher rate. Note that the capital gain rate did increase to 20 percent in 2013 for certain high-income taxpayers. Although turning down a tax deferral may sound like a strange strategy, it fits the notion of “pay a tax today to avoid a higher tax tomorrow.”

13-8f Involuntary Conversions

In certain cases, a taxpayer may prefer to recognize gain from an involuntary conversion. Keep in mind that § 1033, unlike § 1031 (dealing with like-kind exchanges), generally is an elective provision.

EXAMPLE

66

Ahmad has a \$40,000 realized gain from the involuntary conversion of an office building. He reinvests the entire proceeds of \$450,000 in a new office building. He does not elect to postpone gain under § 1033, however, because of an expiring net operating loss carryover that is offset against the gain. Therefore, none of the realized gain of \$40,000 is postponed. Because Ahmad did not elect § 1033 postponement, his basis in the replacement property is the property's cost of \$450,000 rather than \$410,000 (\$450,000 reduced by the \$40,000 realized gain).

13-8g Sale of a Principal Residence

Election to Forgo

The § 121 exclusion automatically applies if the taxpayer is eligible. That is, the taxpayer does not have to make an election. However, if the taxpayer wants to avoid § 121 exclusion treatment on an otherwise eligible sale, the taxpayer may elect to do so.⁹⁸

EXAMPLE

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George owns two personal residences that satisfy the two-year ownership and use test with respect to the five-year window. The Elm Street residence has appreciated by \$25,000, and the Maple Street residence has appreciated by \$230,000. He intends to sell both of them and move into rental property. He sells the Elm Street residence in December 2015 and expects to sell the Maple Street residence early next year.

Unless George elects not to apply the § 121 exclusion to the sale of the Elm Street residence, he will exclude the \$25,000 realized gain on that residence in 2015. In 2016, however, he will have a recognized gain of \$230,000 on the sale of the Maple Street residence.

If George makes the election to forgo, he will report a recognized gain of \$25,000 on the sale of the Elm Street residence in 2015. But by using the § 121 exclusion in 2016, he will eliminate the recognized gain of \$230,000 on the sale of the Maple Street residence.

⁹⁷Franklin B. Biggs, 69 T.C. 905 (1978); Rev.Rul. 73-476, 1973-2 C.B. 300; and *Starker v. U.S.*, 79-2 USTC ¶9541, 44 AFTR 2d 79-5525, 602 F.2d 1341 (CA-9, 1979).

⁹⁸§ 121(f).

Negative Effect of Renting or Using a Residence as a Home Office

The residence does not have to be the taxpayer's principal residence at the date of sale to qualify for the § 121 exclusion. During part of the five-year window, it could have been rental property (e.g., either a vacation home or entirely rental property). In addition, the taxpayer can have used part of the principal residence as a qualifying home office. In either of these circumstances, the taxpayer may claim deductions for the expenses attributable to the rental or business use. But what effect, if any, do such deductions have on a later sale of the residence? Will the sales proceeds still qualify for nonrecognition of gain treatment under § 121?

Concern that the § 121 exclusion might be denied may have deterred some taxpayers from claiming legitimate deductions, particularly in the case of an office in the home. As noted below, however, the IRS has clarified its position regarding the effect of any such depreciation.

In either the rental or the home office setting, the taxpayer will have deducted depreciation. Any realized gain on the sale that is attributable to depreciation claimed after May 5, 1997, is not eligible for the § 121 exclusion.⁹⁹

On December 5, 2015, Amanda sells her principal residence, which qualifies for the § 121 exclusion. Her realized gain is \$190,000. From January through November 2014, she was temporarily out of town on a job assignment in another city and rented the residence to a college student. For this period, she deducted MACRS cost recovery of \$7,000. Without the depreciation provision, Amanda could exclude the \$190,000 realized gain. However, the depreciation taken requires her to recognize \$7,000 of the realized gain.

EXAMPLE

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Qualification for § 121 Exclusion

The key requirement for the § 121 exclusion is that the taxpayer must have *owned* and *used* the property as a principal residence for at least two years during the five-year window. As taxpayers advance in age, they quite frequently make decisions such as the following:

- Sell the principal residence and buy a smaller residence or rent the principal residence.
- Sell vacation homes they own.
- Sell homes they are holding as rental property.

These properties may have experienced substantial appreciation during the ownership period. Clearly, the sale of the principal residence is eligible for the § 121 exclusion. Less clear, however, is that proper planning can make it possible for a vacation home or rental property to qualify for the exclusion. Although this strategy may require taxpayers to be flexible about where they live, it can result in substantial tax savings.

Thelma and David are approaching retirement. They have substantial appreciation on their principal residence and on a house they own at the beach (about two hours away). After retirement, they plan to move to Florida. They have owned and lived in the principal residence for 28 years and have owned the beach house for 9 years. If they sell their principal residence, it qualifies for the § 121 exclusion. At retirement, they could move into their beach house for two years and make it eligible for the exclusion. If the beach house were close enough, they could sell the principal residence now and move into the beach house to start the running of the two-year use period. Note that any realized gain on the beach house attributable to depreciation is not eligible for the § 121 exclusion. In addition, a reduction in the § 121 exclusion for prior use as a vacation home is required.¹⁰⁰

EXAMPLE

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⁹⁹§ 121(d)(6).

¹⁰⁰Additional information and examples of “nonqualified use” can be found on p. 15 of IRS Publication 523 (*Selling Your Home*).

REFOCUS ON THE BIG PICTURE

SALE OR GIFT OF INHERITED HOUSE AND OTHER PROPERTY TRANSACTIONS



Gift of Inherited House

Based on an inquiry you made of Alice, this is the only gift she would make to Michael this year. She has made no prior gifts to any individual that exceeded the annual per donee exclusion amount (i.e., currently \$14,000).

With this information, you inform Alice that no gift tax would be due on the gift of the house to Michael. However, she would use up \$586,000 (\$600,000 – \$14,000) of her lifetime gift tax exemption of \$5.43 million. Michael's basis for the house would be a carryover of Alice's basis of \$475,000 (i.e., for inherited property, the fair market value at the date of the decedent's death).

Sale of Inherited House

You advise Alice that her adjusted basis for the house in calculating gain or loss on the sale of the house is the \$475,000 fair market value on the date of her grandmother's death. If Alice sells the house for \$600,000, her projected selling expenses (i.e., real estate agent's commission, attorney fees, other closing costs) would be \$42,000 (\$600,000 × 7%). She would have a recognized gain of \$83,000 as calculated below. The house is a capital asset, and Alice's holding period is long term because she inherited the house. Thus, the gain would be classified as a long-term capital gain (i.e., subject to the 15% or 20% tax rate). So the Federal income tax due would be \$12,450 (\$83,000 × 15%) if the 15 percent rate applies.

Amount realized (\$600,000 – \$42,000)	\$ 558,000
Less: Adjusted basis	<u>(475,000)</u>
Realized gain	<u>\$ 83,000</u>
Recognized gain	<u>\$ 83,000</u>

Other Issues

See Example 7 and 8 for the tax consequences associated with Alice's questions regarding selling the boat. See Example 25 for the tax consequences associated with Alice's questions regarding the wash sale of the stock.

See Examples 48 and 49 for Alice's tax consequences associated with the involuntary conversion.

What If?

Alice is leaning toward selling the house. However, she knows that her grandmother would not want her to have to pay income taxes on the sale. Alice inquires as to whether there is any way she could reduce the Federal income tax on the sale to \$0.

You inform Alice of the exclusion provision under § 121 of the Code. She can qualify for this exclusion of realized gain provision if she satisfies the at least two-out-of-five-years ownership and use requirements. This would necessitate her moving into the house for at least two years and occupying it as her principal residence.

From a tax planning perspective, what could Alice have done so that none of the \$50,000 of realized gain in Example 48 from the involuntary conversion was recognized?

To have full postponement of the \$50,000 realized gain, Alice would have to reinvest all of the \$100,000 of insurance proceeds received in another building. Under this circumstance, the basis of a replacement building costing \$100,000 would be a carryover basis of \$50,000 (\$100,000 cost – \$50,000 deferred gain).

Key Terms

Adjusted basis, 13-4	Involuntary conversion, 13-28	Recognized gain, 13-6
Amount realized, 13-3	Like-kind exchanges, 13-21	Recognized loss, 13-6
Boot, 13-24	Nontaxable exchange, 13-20	Section 121 exclusion, 13-33
Fair market value, 13-3	Personal residence, 13-33	Wash sale, 13-15
Goodwill, 13-9	Realized gain, 13-2	
Holding period, 13-11	Realized loss, 13-2	

Discussion Questions

- LO.1** Ivan invests in land, and Grace invests in taxable bonds. The land appreciates by \$8,000 each year, and the bonds earn interest of \$8,000 each year. After holding the land and bonds for five years, Ivan and Grace sell them. There is a \$40,000 realized gain on the sale of the land and no realized gain or loss on the sale of the bonds. Are the tax consequences to Ivan and Grace the same for each of the five years? Explain.

Decision Making
- LO.1** Carol and Dave each purchase 100 shares of stock of Burgundy, Inc., a publicly owned corporation, in July for \$10,000 each. Carol sells her stock on December 31 for \$8,000. Because Burgundy's stock is listed on a national exchange, Dave is able to ascertain that his shares are worth \$8,000 on December 31. Does the tax law treat the decline in value of the stock differently for Carol and Dave? Explain.
- LO.1** If a taxpayer sells property for cash, the amount realized consists of the net proceeds from the sale. For each of the following, indicate the effect on the amount realized:

 - The property is sold on credit.
 - A mortgage on the property is assumed by the buyer.
 - A mortgage on the property is assumed by the seller.
 - The buyer acquires the property subject to a mortgage of the seller.
 - Stock that has a basis to the purchaser of \$6,000 and a fair market value of \$10,000 is received by the seller as part of the consideration.
- LO.1** Taylor is negotiating to buy some land. Under the first option, Taylor will give Ella \$150,000 and assume her mortgage on the land for \$100,000. Under the second option, Taylor will give Ella \$250,000, and she will immediately pay off the mortgage. Taylor wants his basis for the land to be as high as possible. Given this objective, which option should Taylor select?

Decision Making
- LO.1** Marge owns land and a building (held for investment) with an adjusted basis of \$75,000 and a fair market value of \$250,000. The property is subject to a mortgage of \$400,000. Because Marge is in arrears on the mortgage payments, the creditor is willing to accept the property in return for canceling the amount of the mortgage.

 - How can the adjusted basis of the property be less than the amount of the mortgage?
 - If the creditor's offer is accepted, what are the effects on the amount realized, the adjusted basis, and the realized gain or loss for Marge?
 - Does it matter in (b) if the mortgage is recourse or nonrecourse? Explain.

6. **LO.4** On July 16, 2015, Logan acquires land and a building for \$500,000 to use in his sole proprietorship. Of the purchase price, \$400,000 is allocated to the building, and \$100,000 is allocated to the land. Cost recovery of \$4,708 is deducted in 2015 for the building (nonresidential real estate).
 - a. What is the adjusted basis for the land and the building at the acquisition date?
 - b. What is the adjusted basis for the land and the building at the end of 2015?
7. **LO.1** Auralia owns stock in Orange Corporation and Blue Corporation. She receives a \$10,000 distribution from both corporations. The instructions from Orange state that the \$10,000 is a dividend. The instructions from Blue state that the \$10,000 is not a dividend. What could cause the instructions to differ as to the tax consequences?

Decision Making

8. **LO.2** Wanda is considering selling two personal use assets that she owns. One has appreciated in value by \$20,000, and the other has declined in value by \$17,000. Wanda believes that she should sell both assets in the same tax year so that the loss of \$17,000 can offset the gain of \$20,000.
 - a. Advise Wanda regarding the tax consequences of her plan.
 - b. Could Wanda achieve better tax results by selling the assets in different tax years? Explain.

Issue ID

9. **LO.2** Ron sold his sailboat for a \$5,000 loss in the current year because he was diagnosed with skin cancer. His spouse wants him to sell his Harley Davidson motorcycle because her brother broke his leg while riding his motorcycle. Because Ron no longer has anyone to ride with, he is seriously considering accepting his wife's advice. Because the motorcycle is a classic, Ron has received two offers. Each offer would result in a \$5,000 gain. Joe would like to purchase the motorcycle before Christmas, and Jeff would like to purchase it after New Year's. Identify the relevant tax issues Ron faces in making his decision.

Issue ID

10. **LO.1, 2, 3, 10** Simon owns stock that has declined in value since acquired. He has decided either to give the stock to his nephew, Fred, or to sell it and give Fred the proceeds. If Fred receives the stock, he will sell it to obtain the proceeds. Simon is in the 15% tax bracket, while Fred's bracket is 25%. In either case, the holding period for the stock will be short term. Identify the tax issues relevant to Simon in deciding whether to give the stock or the sale proceeds to Fred.
11. **LO.3** Robin inherits 1,000 shares of Wal-Mart stock from her aunt in 2015. According to the information received from the executor of her aunt's estate, Robin's adjusted basis for the stock is \$55,000. Albert, Robin's fiancé, receives 1,000 shares of Wal-Mart stock from his uncle as a gift in 2015. His uncle tells Albert that his adjusted basis for the Wal-Mart stock is \$7,000. What could cause the substantial difference in the adjusted basis for Robin's and Albert's respective 1,000 shares of Wal-Mart stock?
12. **LO.3** Thelma inherited land from Sadie on June 7, 2015. The land appreciated in value by 100% during the six months it was owned by Sadie. The value has remained stable during the three months Thelma has owned it, and she expects it to continue to do so in the near future. Although she would like to sell the land now, Thelma has decided to postpone the sale for another three months. The delay is to enable the recognized gain to qualify for long-term capital gain treatment. Evaluate Thelma's understanding of the tax law.
13. **LO.4** Marilyn owns land that she acquired three years ago as an investment for \$250,000. Because the land has not appreciated in value as she anticipated, she sells it to her brother, Amos, for its fair market value of \$180,000. Amos sells the land two years later for \$240,000.
 - a. Explain why Marilyn's realized loss of \$70,000 (\$180,000 amount realized – \$250,000 adjusted basis) is disallowed.

- b. Explain why Amos has neither a recognized gain nor a recognized loss on his sale of the land.
- c. Is the family unit treated fairly under the related-party disallowance rule under § 267? Explain.
- d. Which party wins, and which party loses?
- e. How could Marilyn have avoided the loss disallowance on her sale of the land?
14. **LO.4, 5** Comment on the following transactions:
- a. Mort owns 500 shares of Pear, Inc. stock with an adjusted basis of \$22,000. On July 28, 2015, he sells 100 shares for \$3,000. On August 16, 2015, he purchases another 100 shares for \$3,400. Mort's realized loss of \$1,400 ($\$3,000 - \$4,400$) on the July 28 sale is not recognized, and his adjusted basis for the 100 shares purchased on August 16 is \$4,800. Explain.
- b. How would your answer in (a) change if Mort purchased the 100 shares on December 27, 2015, rather than on August 16, 2015?
15. **LO.6** Karla exchanges personal use property for property to be held for productive use in a trade or business. Can this transaction qualify for like-kind exchange treatment? Explain.
16. **LO.6** Which of the following qualify as like-kind exchanges under § 1031?
- a. Improved for unimproved real estate.
- b. Vending machine (used in business) for inventory.
- c. Rental house for personal residence.
- d. Business equipment for securities.
- e. Warehouse for office building (both used for business).
- f. Truck for computer (both used in business).
- g. Rental house for land (both held for investment).
- h. Ten shares of stock in Blue Corporation for 10 shares of stock in Red Corporation.
- i. Office furniture for office equipment (both used in business).
- j. Unimproved land in Jackson, Mississippi, for unimproved land in Toledo, Spain.
- k. General partnership interest for a general partnership interest.
17. **LO.6** Ross would like to dispose of some land he acquired five years ago because he believes that it will not continue to appreciate. Its value has increased by \$50,000 over the five-year period. He also intends to sell stock that has declined in value by \$50,000 during the eight-month period he has owned it. Ross has four offers to acquire the stock and land:
- | | |
|-----------------|--------------------------|
| Buyer number 1: | Exchange land. |
| Buyer number 2: | Purchase land for cash. |
| Buyer number 3: | Exchange stock. |
| Buyer number 4: | Purchase stock for cash. |
- Identify the tax issues relevant to Ross in disposing of this land and stock.
18. **LO.6** Edith exchanges a machine used in her business for another machine and stock of Teal, Inc. If Edith had sold her machine, she would have had a realized gain. Explain why the new machine will have a different holding period than the stock.
19. **LO.6** Mortgaged real estate may be received in a like-kind exchange. If the taxpayer's mortgage is assumed, what effect does the mortgage have on the recognition of realized gain? On the basis of the real estate received?

20. **LO.7** Sheila's appreciated property is involuntarily converted. She receives insurance proceeds equal to the fair market value of the property. What is the minimum amount Sheila must reinvest in qualifying property to defer recognition of realized gain?
21. **LO.7** Vera owns an office building that she leases to tenants. If the building is destroyed by a tornado, is the functional use test or the taxpayer use test applied as to replacement property? Explain the differences between the two tests.
22. **LO.7** Reba, a calendar year taxpayer, owns an office building that she uses in her business. The building is involuntarily converted on November 15, 2015. On January 5, 2016, Reba receives enough proceeds to produce a realized gain. What is the latest date she can replace the building and qualify for § 1033 postponement treatment if the conversion event is:
- A flood?
 - A condemnation?
 - A tornado?
23. **LO.7** Bob is notified by the city public housing authority on May 3, 2015, that his apartment building is going to be condemned as part of an urban renewal project. On June 1, 2015, Carol offers to buy the building from Bob. Bob sells the building to Carol on June 30, 2015. Condemnation occurs on September 1, 2015, and Carol receives the condemnation proceeds from the city. Assume that both Bob and Carol are calendar year taxpayers.
- What is the earliest date on which Bob can dispose of the building and qualify for § 1033 postponement treatment?
 - Does the sale to Carol qualify as a § 1033 involuntary conversion? Why or why not?
 - What is the latest date on which Carol can acquire qualifying replacement property and qualify for postponement of the realized gain?
 - What type of property will be qualifying replacement property?
- Issue ID** 24. **LO.7** A warehouse owned by Martha and used in her business (i.e., to store inventory) is being condemned by the city to provide a right of way for a highway. The warehouse has appreciated by \$180,000 based on Martha's estimate of its fair market value. In the negotiations, the city is offering \$35,000 less than what Martha believes the property is worth. Alan, a real estate broker, has offered to purchase Martha's property for \$20,000 more than the city's offer. Martha plans to invest the proceeds she will receive in an office building she will lease to various tenants.
- Identify the relevant tax issues for Martha.
 - Would the answer in (a) change if Martha's warehouse was property being held for investment rather than being used in her business? Explain.
25. **LO.8** To qualify for exclusion treatment on the sale of a principal residence, the residence must have been owned and used by the taxpayer for at least two years during the five-year period ending on the date of the sale. Are there any exceptions to this provision? Explain.

Computational Exercises

26. **LO.1** Sally owns real property for which the annual property taxes are \$8,000. She sells the property to Shelley on February 28, 2015, for \$550,000. Shelley pays the real property taxes for the entire year on October 1.
- How much of the property taxes can be deducted by Sally and how much by Shelley?

- b. What effect does the property tax apportionment have on Shelley's adjusted basis in the property?
- c. What effect does the apportionment have on Sally's amount realized from the sale?
- d. How would the answers in (b) and (c) differ if the taxes were paid by Sally?
27. **LO.1** Melba purchases land from Adrian. Melba gives Adrian \$225,000 in cash and agrees to pay Adrian an additional \$400,000 one year later plus interest at 5%.
- a. What is Melba's adjusted basis for the land at the acquisition date?
- b. What is Melba's adjusted basis for the land one year later?
28. **LO.1** On July 1, 2015, Katrina purchased tax-exempt bonds (face value of \$75,000) for \$82,000. The bonds mature in five years, and the annual interest rate is 6%. The market rate of interest is 2%.
- a. How much interest income and/or interest expense must Katrina report in 2015?
- b. What is Katrina's adjusted basis for the bonds on January 1, 2016?
29. **LO.3** Luciana, a nonshareholder, purchases a condominium from her employer for \$85,000. The fair market value of the condominium is \$120,000. What is Luciana's basis in the condominium and the amount of any income as a result of this purchase?
30. **LO.3** Sebastian purchases two pieces of equipment for \$100,000. Appraisals of the equipment indicate that the fair market value of the first piece of equipment is \$72,000 and that of the second piece of equipment is \$108,000. What is Sebastian's basis in these two assets?
31. **LO.3** Juliana purchased land in 2012 for \$50,000. She gave the land to Tom, her brother, in 2015, when the fair market value was \$70,000. No gift tax is paid on the transfer. Tom subsequently sells the property for \$63,000.
- a. What is Tom's basis in the land, and what is his realized gain or loss on the sale?
- b. Assume instead that the land has a fair market value of \$45,000 and that Tom sold the land for \$43,000. Now what is Tom's basis in the land, and what is his realized gain or loss on the sale?
32. **LO.4** Lisa sells business property with an adjusted basis of \$130,000 to her son, Alfred, for its fair market value of \$100,000.
- a. What is Lisa's realized and recognized gain or loss?
- b. What is Alfred's recognized gain or loss if he subsequently sells the property for \$138,000? For \$80,000?
33. **LO.4** Arianna's personal residence has an adjusted basis of \$230,000 and a fair market value of \$210,000. Arianna converts the personal residence to rental property. What is Arianna's gain basis? What is her loss basis?
34. **LO.4** Peyton sells an office building and the associated land on May 1, 2015. Under the terms of the sales contract, Peyton is to receive \$1,600,000 in cash. The purchaser is to assume Peyton's mortgage of \$950,000 on the property. To enable the purchaser to obtain adequate financing, Peyton is to pay the \$9,000 in points charged by the lender. The broker's commission on the sale is \$75,000. The purchaser agrees to pay the \$24,000 in property taxes for the entire year. What is Peyton's amount realized?
35. **LO.6, 10** Andrew owns a lathe (adjusted basis of \$40,000) that he uses in his business. He exchanges the lathe and \$20,000 in cash for a new lathe worth \$50,000. May Andrew avoid like-kind exchange treatment to recognize his realized loss of \$10,000? Explain.

36. **LO.6** Sue exchanges a sport utility vehicle (adjusted basis of \$16,000; fair market value of \$19,500) for cash of \$2,000 and a pickup truck (fair market value of \$17,500). Both vehicles are for business use. Sue believes that her basis for the truck is \$17,500. In calculating her basis, what has Sue failed to consider?
37. **LO.6** Logan and Johnathan exchange land, and the exchange qualifies as like kind under § 1031. Because Logan's land (adjusted basis of \$85,000) is worth \$100,000 and Johnathan's land has a fair market value of \$80,000, Johnathan also gives Logan cash of \$20,000.
- What is Logan's recognized gain?
 - Assume instead that Johnathan's land is worth \$90,000 and he gives Logan \$10,000 cash. Now what is Logan's recognized gain?
38. **LO.7** On June 5, 2015, Brown, Inc., a calendar year taxpayer, receives cash of \$750,000 from the county upon condemnation of its warehouse building (adjusted basis of \$500,000 and fair market value of \$750,000).
- What must Brown do to qualify for § 1033 postponement of gain treatment?
 - How would your advice to Brown differ if the adjusted basis was \$795,000?
39. **LO.7** Camilo's property, with an adjusted basis of \$155,000, is condemned by the state. Camilo receives property with a fair market value of \$180,000 as compensation for the property taken.
- What is Camilo's realized and recognized gain?
 - What is the basis of the replacement property?
40. **LO.7** On February 24, 2015, Allison's building, with an adjusted basis of \$1.3 million (and used in her trade or business), is destroyed by fire. On March 31, 2015, she receives an insurance reimbursement of \$1.65 million for the loss. Allison invests \$1.55 million in a new building and buys stock with the balance of insurance proceeds. Allison is a calendar year taxpayer.
- By what date must Allison make the new investment to qualify for the nonrecognition election?
 - Assuming that the replacement property qualifies as similar or related in service or use, what is Allison's realized gain, recognized gain, and basis in the replacement building?
41. **LO.8** Gary, who is single, sells his principal residence (owned and occupied by him for seven years) in November 2015 for a realized gain of \$148,000. He had purchased a more expensive new residence eight months prior to the sale. He anticipates that he will occupy this new house as his principal residence for only about 18 additional months. He expects it to appreciate substantially while he owns it. Gary would like to recognize the realized gain on the 2015 sale to offset a large investment loss from the sale of stock. Can he recognize the realized gain of \$148,000 on the sale of his principal residence in 2015?
42. **LO.8** Constanza, who is single, sells her current personal residence (adjusted basis of \$165,000) for \$450,000. She has owned and lived in the house for 30 years. Her selling expenses are \$22,500. What is Constanza's realized and recognized gain?
43. **LO.8** On August 31, 2014, Harvey and Margaret, who file a joint return and live in Charleston, South Carolina, sell their personal residence, which they have owned and lived in for 10 years. The realized gain of \$292,000 was excluded under § 121. They purchased another personal residence in Charleston for \$480,000 on September 1, 2014. However, in 2015, Harvey's employer transfers him to Houston, Texas. They sell their Charleston home on February 28, 2015, and purchase a new home in Houston. The realized gain on the second sale is \$180,000. What is Harvey and Margaret's recognized gain on the second sale?

Problems

44. **LO.1** Anne sold her home for \$290,000 in 2015. Selling expenses were \$17,400. She purchased it in 2009 for \$200,000. During the period of ownership, Anne had done the following:
- Deducted \$50,500 office-in-home expenses, which included \$4,500 in depreciation. (Refer to Chapter 9.)
 - Deducted a casualty loss in 2011 for residential trees destroyed by a hurricane. The total loss was \$19,000 (after the \$100 floor and the 10%-of-AGI floor), and Anne's insurance company reimbursed her for \$13,500. (Refer to Chapter 7.)
 - Paid street paving assessment of \$7,000 and added sidewalks for \$8,000.
 - Installed an elevator for medical reasons. The total cost was \$20,000, and Anne deducted \$13,000 as medical expenses. (Refer to Chapter 10.)

What is Anne's realized gain?

45. **LO.1** Kareem bought a rental house in March 2010 for \$300,000, of which \$50,000 is allocated to the land and \$250,000 to the building. Early in 2012, he had a tennis court built in the backyard at a cost of \$7,500. Kareem has deducted \$30,900 for depreciation on the house and \$1,300 for depreciation on the court. In January 2015, he sells the house and tennis court for \$330,000 cash.
- a. What is Kareem's realized gain or loss?
 - b. If an original mortgage of \$80,000 is still outstanding and the buyer assumes the mortgage in addition to the cash payment, what is Kareem's realized gain or loss?
 - c. If the buyer takes the property subject to the \$80,000 mortgage, rather than assuming it, what is Kareem's realized gain or loss?
46. **LO.1** Norm is negotiating the sale of a tract of his land to Pat. Use the following classification scheme to classify each of the items contained in the proposed sales contract:

Legend

DARN	=	Decreases amount realized by Norm
IARN	=	Increases amount realized by Norm
DABN	=	Decreases adjusted basis to Norm
IABN	=	Increases adjusted basis to Norm
DABP	=	Decreases adjusted basis to Pat
IABP	=	Increases adjusted basis to Pat

- a. Norm is to receive cash of \$50,000.
 - b. Norm is to receive Pat's note payable for \$25,000, payable in three years.
 - c. Pat assumes Norm's mortgage of \$5,000 on the land.
 - d. Pat agrees to pay the realtor's sales commission of \$8,000.
 - e. Pat agrees to pay the property taxes on the land for the entire year. If each party paid his or her respective share, Norm's share would be \$1,000 and Pat's share would be \$3,000.
 - f. Pat pays legal fees of \$500.
 - g. Norm pays legal fees of \$750.
47. **LO.1, 2** Pam owns a personal use boat that has a fair market value of \$35,000 and an adjusted basis of \$45,000. Pam's AGI is \$100,000. Calculate the realized and recognized gain or loss if:

- a. Pam sells the boat for \$35,000.
 - b. Pam exchanges the boat for another boat worth \$35,000.
 - c. The boat is stolen and Pam receives insurance proceeds of \$35,000.
 - d. Would your answer in (a) change if the fair market value and the selling price of the boat were \$48,000? Explain.
48. **LO.1** Chee purchases Tan, Inc. bonds for \$108,000 on January 2, 2015. The face value of the bonds is \$100,000, the maturity date is December 31, 2019, and the annual interest rate is 5%. Chee will amortize the premium only if he is required to do so. Chee sells the bonds on July 1, 2017, for \$106,000.
- a. Determine the interest income Chee should report for 2015.
 - b. Calculate Chee's recognized gain or loss on the sale of the bonds in 2017.
49. **LO.1, 2** Which of the following results in a recognized gain or loss?
- a. Kay sells her vacation cabin (adjusted basis of \$100,000) for \$150,000.
 - b. Adam sells his personal residence (adjusted basis of \$150,000) for \$100,000.
 - c. Carl's personal residence (adjusted basis of \$65,000) is condemned by the city. He receives condemnation proceeds of \$55,000.
 - d. Olga's land is worth \$40,000 at the end of the year. She had purchased the land six months earlier for \$25,000.
 - e. Vera's personal vehicle (adjusted basis of \$22,000) is stolen. She receives \$23,000 from the insurance company and does not plan to replace the automobile.
 - f. Jerry sells used clothing (adjusted basis of \$500) to a thrift store for \$50.
50. **LO.1, 2** Yancy's personal residence is condemned as part of an urban renewal project. His adjusted basis for the residence is \$480,000. He receives condemnation proceeds of \$460,000 and invests the proceeds in stocks and bonds.
- a. Calculate Yancy's realized and recognized gain or loss.
 - b. If the condemnation proceeds are \$505,000, what are Yancy's realized and recognized gain or loss?
 - c. What are Yancy's realized and recognized gain or loss in (a) if the house was rental property?
- Communications** 51. **LO.3** Buddy Morgan is a real estate agent for Coastal Estates, a residential real estate development. Because of his outstanding sales performance, Buddy is permitted to buy a lot for \$300,000 that normally would sell for \$500,000. Buddy is the only real estate agent for Coastal Estates who is permitted to do so.
- a. Does Buddy have gross income from the transaction? Explain.
 - b. What is Buddy's adjusted basis for the land?
 - c. Write a letter to Buddy informing him of the tax consequences of his acquisition of the lot. His address is 100 Tower Road, San Diego, CA 92182.
52. **LO.1, 2, 3** Karen makes the following purchases and sales of stock:

Transaction	Date	Number of Shares	Company	Price per Share
Purchase	1-1-2013	300	MDG	\$ 75
Purchase	6-1-2013	150	GRU	300
Purchase	11-1-2013	60	MDG	70
Sale	12-3-2013	200	MDG	80
Purchase	3-1-2014	120	GRU	375
Sale	8-1-2014	90	GRU	330
Sale	1-1-2015	150	MDG	90
Sale	2-1-2015	75	GRU	500

Assuming that Karen is unable to identify the particular lots that are sold with the original purchase, determine the recognized gain or loss on each type of stock:

- a. As of July 1, 2013.
 - b. As of December 31, 2013.
 - c. As of December 31, 2014.
 - d. As of July 1, 2015.
53. **LO.1, 2, 3** Kevin purchases 1,000 shares of Bluebird Corporation stock on October 3, 2015, for \$300,000. On December 12, 2015, Kevin purchases an additional 750 shares of Bluebird stock for \$210,000. According to market quotations, Bluebird stock is selling for \$285 per share on December 31, 2015. Kevin sells 500 shares of Bluebird stock on March 1, 2016, for \$162,500.
- a. What is the adjusted basis of Kevin’s Bluebird stock on December 31, 2015?
 - b. What is Kevin’s recognized gain or loss from the sale of Bluebird stock on March 1, 2016, assuming that the shares sold are from the shares purchased on December 12, 2015?
 - c. What is Kevin’s recognized gain or loss from the sale of Bluebird stock on March 1, 2016, assuming that Kevin cannot adequately identify the shares sold?
54. **LO.3** Rod Clooney purchases Agnes Mitchell’s sole proprietorship for \$990,000 on August 15, 2015. The assets of the business are as follows:

Communications

Asset	Agnes’s Adjusted Basis	FMV
Accounts receivable	\$ 70,000	\$ 70,000
Inventory	90,000	100,000
Equipment	150,000	160,000
Furniture and fixtures	95,000	130,000
Building	190,000	250,000
Land	<u>25,000</u>	<u>75,000</u>
Total	<u>\$620,000</u>	<u>\$785,000</u>

Rod and Agnes agree that \$50,000 of the purchase price is for Agnes’s five-year covenant not to compete.

- a. Calculate Agnes’s realized and recognized gain.
 - b. Determine Rod’s basis for each of the assets.
 - c. Write a letter to Rod informing him of the tax consequences of the purchase. His address is 300 Riverview Drive, Delaware, OH 43015.
55. **LO.1, 2, 3** Roberto has received various gifts over the years. He has decided to dispose of the following assets he received as gifts:
- a. In 1951, he received land worth \$32,000. The donor’s adjusted basis was \$35,000. Roberto sells the land for \$95,000 in 2015.
 - b. In 1956, he received stock in Gold Company. The donor’s adjusted basis was \$19,000. The fair market value on the date of the gift was \$34,000. Roberto sells the stock for \$40,000 in 2015.
 - c. In 1962, he received land worth \$15,000. The donor’s adjusted basis was \$20,000. Roberto sells the land for \$9,000 in 2015.
 - d. In 2003, he received stock worth \$30,000. The donor’s adjusted basis was \$42,000. Roberto sells the stock for \$38,000 in 2015.

What is the recognized gain or loss from each of the preceding transactions? Assume for each of the gift transactions that no gift tax was paid.

56. **LO.1, 2, 3** Nicky receives a car from Sam as a gift. Sam paid \$48,000 for the car. He had used it for business purposes and had deducted \$10,000 for depreciation up to the time he gave the car to Nicky. The fair market value of the car is \$33,000.
- Assuming that Nicky uses the car for business purposes, what is her basis for depreciation?
 - Assume that Nicky deducts depreciation of \$6,500 and then sells the car for \$32,500. What is her recognized gain or loss?
 - Assume that Nicky deducts depreciation of \$6,500 and then sells the car for \$20,000. What is her recognized gain or loss?
57. **LO.3** Margo receives a gift of real estate with an adjusted basis of \$175,000 and a fair market value of \$100,000. The donor paid gift tax of \$15,000 on the transfer. If Margo later sells the property for \$110,000, what is her recognized gain or loss?
58. **LO.3** On September 18, 2015, Gerald received land and a building from Frank as a gift. Frank's adjusted basis and the fair market value at the date of the gift are as follows:

Asset	Adjusted Basis	FMV
Land	\$100,000	\$212,000
Building	80,000	100,000

No gift tax was paid on the transfer.

- Determine Gerald's adjusted basis for the land and building.
 - Assume instead that the fair market value of the land was \$87,000 and that of the building was \$65,000. Determine Gerald's adjusted basis for the land and building.
59. **LO.1, 2, 3, 10** Ira Cook is planning to make a charitable contribution to the Boy Scouts of Crystal, Inc. stock worth \$20,000. The stock has an adjusted basis of \$15,000. A friend has suggested that Ira sell the stock and contribute the \$20,000 in proceeds rather than contribute the stock.
- Should Ira follow the friend's advice? Why or why not?
 - Assume that the fair market value is only \$13,000. In this case, should Ira follow the friend's advice? Why or why not?
 - Rather than make a charitable contribution to the Boy Scouts, Ira is going to make a gift to Nancy, his niece. Advise Ira regarding (a) and (b).
 - Write a letter to Ira regarding whether in (a) he should sell the stock and contribute the cash or contribute the stock. He has informed you that he purchased the stock six years ago. Ira's address is 500 Ireland Avenue, DeKalb, IL 60115.
60. **LO.3** As sole heir, Dazie receives all of Mary's property (adjusted basis of \$1,400,000 and fair market value of \$3,820,000). Six months after Mary's death in 2015, the fair market value is \$3,835,000.
- Can the executor of Mary's estate elect the alternate valuation date and amount? Explain.
 - What is Dazie's basis for the property?
 - Assume instead that the fair market value six months after Mary's death is \$3,800,000. Respond to (a) and (b).
61. **LO.3** Dan bought a hotel for \$2,600,000 in January 2011. In May 2015, he died and left the hotel to Ed. While Dan owned the hotel, he deducted \$289,000 of cost recovery. The fair market value in May 2015 was \$2,800,000. The fair market value six months later was \$2,850,000.
- What is the basis of the property to Ed?

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- b. What is the basis of the property to Ed if the fair market value six months later was \$2,500,000 (not \$2,850,000) and the objective of the executor was to minimize the estate tax liability?
62. **LO.3** Helene and Pauline are twin sisters who live in Louisiana and Mississippi, respectively. Helene is married to Frank, and Pauline is married to Richard. Frank and Richard are killed in an auto accident in 2015 while returning from a sporting event.
- Helene and Frank jointly owned some farmland in Louisiana (value of \$940,000, cost of \$450,000). Pauline and Richard jointly owned some farmland in Mississippi (value of \$940,000, cost of \$450,000). Assume that all of Frank's and Richard's property passes to their surviving wives.
- Calculate Helene's basis in the land.
 - Calculate Pauline's basis in the land.
 - What causes the difference?
63. **LO.3, 4** Sheila sells land to Elane, her sister, for the fair market value of \$40,000. Six months later when the land is worth \$45,000, Elane gives it to Jacob, her son. (No gift tax resulted.) Shortly thereafter, Jacob sells the land for \$48,000.
- Assuming that Sheila's adjusted basis for the land is \$24,000, what are Sheila's and Jacob's recognized gain or loss on the sales?
 - Assuming that Sheila's adjusted basis for the land is \$60,000, what are Sheila's and Jacob's recognized gain or loss on the sales?
64. **LO.1, 2, 3, 4** Louis owns three pieces of land with an adjusted basis as follows: parcel A, \$75,000; parcel B, \$125,000; and parcel C, \$175,000. Louis sells parcel A to his uncle for \$50,000, parcel B to his partner for \$120,000, and parcel C to his mother for \$150,000.
- What is the recognized gain or loss from the sale of each parcel?
 - If Louis's uncle eventually sells his land for \$90,000, what is his recognized gain or loss?
 - If Louis's partner eventually sells his land for \$130,000, what is his recognized gain or loss?
 - If Louis's mother eventually sells her land for \$165,000, what is her recognized gain or loss?
65. **LO.1, 2, 3, 4** Tyneka inherited 1,000 shares of Aqua, Inc. stock from Joe. Joe's basis was \$35,000, and the fair market value on July 1, 2015 (the date of death) was \$45,000. The shares were distributed to Tyneka on July 15, 2015. Tyneka sold the stock on July 30, 2016, for \$33,000. After giving the matter more thought, she decides that Aqua is a good investment and purchases 1,000 shares for \$30,000 on August 20, 2016.
- What is Tyneka's basis for the 1,000 shares purchased on August 20, 2016?
 - Could Tyneka have obtained different tax consequences in (a) if she had sold the 1,000 shares on December 27, 2015, and purchased the 1,000 shares on January 5, 2016? Explain.
66. **LO.1, 2, 4** Abby's home had a basis of \$360,000 (\$160,000 attributable to the land) and a fair market value of \$340,000 (\$155,000 attributable to the land) when she converted 70% of it to business use by opening a bed-and-breakfast. Four years after the conversion, Abby sells the home for \$500,000 (\$165,000 attributable to the land).
- Calculate Abby's basis for gain, loss, and cost recovery for the portion of her personal residence that was converted to business use.

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- b. Calculate the cost recovery deducted by Abby during the four-year period of business use, assuming that the bed-and-breakfast is opened on January 1 of year 1 and the house is sold on December 31 of year 4.
- c. What is Abby's recognized gain or loss on the sale of the business use portion?

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67. **LO.4** Surendra's personal residence originally cost \$340,000 (ignore land). After living in the house for five years, he converts it to rental property. At the date of conversion, the fair market value of the house is \$320,000. As to the rental property, calculate Surendra's basis for:
 - a. Loss.
 - b. Depreciation.
 - c. Gain.
 - d. Could Surendra have obtained better tax results if he had sold his personal residence for \$320,000 and then purchased another house for \$320,000 to hold as rental property? Explain.
68. **LO.6** Katrina owns undeveloped land with an adjusted basis of \$300,000. She exchanges it for other undeveloped land worth \$750,000.
 - a. What are Katrina's realized and recognized gain or loss?
 - b. What is Katrina's basis in the undeveloped land she receives?
 - c. Would the answers in (a) and (b) change if Katrina exchanged the undeveloped land for land and a building? Explain.
69. **LO.6** Kareem owns a pickup truck that he uses exclusively in his business. The adjusted basis is \$22,000, and the fair market value is \$14,000. Kareem exchanges the truck for a truck that he will use exclusively in his business.
 - a. What are Kareem's realized and recognized gain or loss?
 - b. What is his basis in the new truck?
 - c. What are the tax consequences to Kareem in (a) and (b) if he used the old truck and will use the new truck exclusively for personal purposes?

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Communications

70. **LO.6** Tanya Fletcher owns undeveloped land (adjusted basis of \$80,000 and fair market value of \$92,000) on the East Coast. On January 4, 2015, she exchanges it with Lisa Martin (an unrelated party) for undeveloped land on the West Coast and \$3,000 cash. Lisa has an adjusted basis of \$72,000 for her land, and its fair market value is \$89,000. As the real estate market on the East Coast is thriving, on September 1, 2016, Lisa sells the land she acquired for \$120,000.
 - a. What are Tanya's recognized gain or loss and adjusted basis for the West Coast land on January 4, 2015?
 - b. What are Lisa's recognized gain or loss and adjusted basis for the East Coast land on January 4, 2015?
 - c. What is Lisa's recognized gain or loss from the September 1, 2016 sale?
 - d. What effect does Lisa's 2016 sale have on Tanya?
 - e. Write a letter to Tanya advising her of the tax consequences of this exchange. Her address is The Corral, El Paso, TX 79968.
71. **LO.6** Sarah exchanges a yellow bus (used in her business) for Tyler's gray bus and some garage equipment (used in his business). The assets have the following characteristics:

	Adjusted Basis	Fair Market Value
Yellow bus	\$6,000	\$15,000
Gray bus	3,000	11,000
Equipment	2,000	4,000

- a. What are Sarah's recognized gain or loss and basis for the gray bus and garage equipment?
- b. What are Tyler's recognized gain or loss and basis for the yellow bus?
72. **LO.6, 10** In two unrelated transactions, Laura exchanges property that qualifies for like-kind exchange treatment. In the first exchange, Laura gives up office equipment purchased in May 2013 (adjusted basis of \$20,000; fair market value of \$17,000) in exchange for new office equipment (fair market value of \$15,000) and \$2,000 cash. In the second exchange, Laura receives a parking garage (to be used in her business) with a fair market value of \$50,000 in exchange for a plot of land she had held for investment. The land was purchased in April 2007 for \$12,000 and has a current fair market value of \$48,000. In addition to transferring the land, Laura pays an additional \$2,000 to the other party.
- a. What is Laura's adjusted basis for the office equipment?
- b. When does the holding period begin?
- c. What is Laura's adjusted basis for the parking garage?
- d. When does the holding period begin?
- e. How could Laura structure either of the transactions differently to produce better tax consequences?
73. **LO.6** Susan owns a car that she uses exclusively for personal purposes. Its original cost was \$26,000, and the fair market value is \$12,000. She exchanges the car and \$18,000 cash for a new car.
- a. Calculate Susan's realized and recognized gain or loss.
- b. Calculate Susan's basis for the new car.
- c. Determine when Susan's holding period for the new car begins.
74. **LO.6** Stephanie owns a machine (adjusted basis of \$90,000; fair market value of \$125,000) that she uses in her business. She exchanges it for another machine (worth \$100,000) and stock (worth \$25,000). Determine Stephanie's:
- a. Realized and recognized gain or loss on the exchange.
- b. Basis in the new machine.
- c. Basis in the stock she received.
75. **LO.6** Ed owns investment land with an adjusted basis of \$35,000. Polly has offered to purchase the land from Ed for \$175,000 for use in a real estate development. The amount offered by Polly is \$10,000 in excess of what Ed perceives as the fair market value of the land. Ed would like to dispose of the land to Polly but does not want to incur the tax liability that would result. He identifies an office building with a fair market value of \$175,000 that he would like to acquire. Polly purchases the office building and then exchanges the office building for Ed's land.
- a. Calculate Ed's realized and recognized gain on the exchange and his basis for the office building.
- b. Calculate Polly's realized and recognized gain on the exchange and her basis in the land.
76. **LO.6** Steve owns Machine A (adjusted basis of \$12,000 and fair market value of \$15,000), which he uses in his business. Steve sells Machine A for \$15,000 to Aubry (a dealer) and then purchases Machine B for \$15,000 from Joan (also a dealer). Machine B would normally qualify as like-kind property.
- a. What are Steve's realized and recognized gain on the sale of Machine A?
- b. What is Steve's basis for Machine B?
- c. What factors would motivate Steve to sell Machine A and purchase Machine B rather than exchange one machine for the other?
- d. Assume that the adjusted basis of Machine A is \$15,000 and the fair market value of both machines is \$12,000. Respond to (a) through (c).

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Decision Making

77. **LO.6** Tab exchanges real estate used in his business along with stock for real estate to be held for investment. The stock transferred has an adjusted basis of \$45,000 and a fair market value of \$50,000. The real estate transferred has an adjusted basis of \$85,000 and a fair market value of \$190,000. The real estate acquired has a fair market value of \$240,000.
- What is Tab's realized gain or loss?
 - His recognized gain or loss?
 - The basis of the newly acquired real estate?

Decision Making

78. **LO.6, 10** Tom and Frank are brothers. Each owns investment property in the other's hometown. To make their lives easier, they decide to legally exchange the investment properties. Under the terms of the exchange, Frank will transfer realty (adjusted basis of \$52,000; fair market value of \$80,000) and Tom will exchange realty (adjusted basis of \$60,000; fair market value of \$92,000). Tom's property is subject to a mortgage of \$12,000 that will be assumed by Frank.
- What are Frank's and Tom's recognized gains?
 - What are their adjusted bases?
 - As an alternative, Frank has proposed that rather than assuming the mortgage, he will transfer cash of \$12,000 to Tom. Tom would use the cash to pay off the mortgage. Advise Tom on whether this alternative would be beneficial to him from a tax perspective.
79. **LO.6** Determine the realized, recognized, and postponed gain or loss and the new basis for each of the following like-kind exchanges:

	Adjusted Basis of Old Machine	Boot Given	Fair Market Value of New Asset	Boot Received
a.	\$ 7,000	\$ -0-	\$12,000	\$4,000
b.	14,000	2,000	15,000	-0-
c.	3,000	7,000	8,000	500
d.	15,000	-0-	29,000	-0-
e.	10,000	-0-	11,000	1,000
f.	17,000	-0-	14,000	-0-

80. **LO.6** Shontelle owns an apartment house that has an adjusted basis of \$760,000 but is subject to a mortgage of \$192,000. She transfers the apartment house to Dave and receives from him \$120,000 in cash and an office building with a fair market value of \$780,000 at the time of the exchange. Dave assumes the \$192,000 mortgage on the apartment house.
- What is Shontelle's realized gain or loss?
 - What is her recognized gain or loss?
 - What is the basis of the newly acquired office building?
81. **LO.7** Howard's roadside vegetable stand (adjusted basis of \$275,000) is destroyed by a tractor-trailer accident. He receives insurance proceeds of \$240,000 (\$300,000 fair market value - \$60,000 coinsurance). Howard immediately uses the proceeds plus additional cash of \$45,000 to build another roadside vegetable stand at the same location. What are the tax consequences to Howard?
82. **LO.7** Albert owns 100 acres of land on which he grows spruce Christmas trees. His adjusted basis for the land is \$100,000. He receives condemnation proceeds of \$10,000 when the city's new beltway takes 5 acres along the eastern boundary of his property. He also receives a severance award of \$6,000 associated with the possible harmful effects of exhaust fumes on his Christmas trees. Albert invests the \$16,000 in a growth mutual fund. Determine the tax consequences to Albert of the:
- Condemnation proceeds.
 - Severance award.

83. **LO.7** Mitchell, a calendar year taxpayer, is the sole proprietor of a fast-food restaurant. His adjusted basis for the building and the related land is \$450,000. On March 4, 2015, state authorities notify Mitchell that his property is going to be condemned so that the highway can be widened. On June 20, Mitchell's property is officially condemned, and he receives an award of \$625,000. Because Mitchell's business has been successful in the past, he would like to reopen the restaurant in a new location.
- What is the earliest date Mitchell can acquire a new restaurant and qualify for § 1033 postponement?
 - On June 30, Mitchell purchases land and a building for \$610,000. Assuming that he elects postponement of gain under § 1033, what is his recognized gain?
 - What is Mitchell's adjusted basis for the new land and building?
 - If he does not elect § 1033, what are Mitchell's recognized gain and adjusted basis?
 - Suppose he invests the \$625,000 condemnation proceeds in the stock market on June 30. What is Mitchell's recognized gain?
84. **LO.7** Edith's warehouse (adjusted basis of \$450,000) is destroyed by a hurricane in October 2015. Edith, a calendar year taxpayer, receives insurance proceeds of \$525,000 in January 2016. Calculate Edith's realized gain or loss, recognized gain or loss, and basis for the replacement property if she:
- Acquires a new warehouse for \$550,000 in January 2016.
 - Acquires a new warehouse for \$500,000 in January 2016.
 - Does not acquire replacement property.
85. **LO.7** Cabel's warehouse, which has an adjusted basis of \$380,000 and a fair market value of \$490,000, is condemned by an agency of the Federal government to make way for a highway interchange. The initial condemnation offer is \$425,000. After substantial negotiations, the agency agrees to transfer to Cabel a surplus warehouse that he believes is worth \$490,000. Cabel is a calendar year taxpayer. The condemnation and related asset transfer occur during September 2015.
- What are the recognized gain or loss and the basis of the replacement warehouse if Cabel's objective is to recognize as much gain as possible?
 - Advise Cabel regarding what he needs to do by what date to achieve his objective.
86. **LO.7** What are the *maximum* postponed gain or loss and the basis for the replacement property for the following involuntary conversions?

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Property	Type of Conversion	Amount Realized	Adjusted Basis	Amount Reinvested
a. Drugstore (business)	Casualty	\$160,000	\$130,000	\$110,000
b. Apartments (investment)	Condemned	100,000	125,000	175,000
c. Grocery store (business)	Casualty	400,000	300,000	450,000
d. Residence (personal)	Casualty	16,000	18,000	17,000
e. Vacant lot (investment)	Condemned	240,000	160,000	220,000
f. Residence (personal)	Casualty	20,000	18,000	19,000
g. Residence (personal)	Condemned	18,000	20,000	26,000
h. Apartments (investment)	Condemned	150,000	100,000	200,000

87. **LO.7, 10** Wanda, a calendar year taxpayer, owned a building (adjusted basis of \$250,000) in which she operated a bakery that was destroyed by fire in December 2015. She receives insurance proceeds of \$290,000 for the building the following March. Wanda is considering two options regarding the investment of the

Decision Making

insurance proceeds. First, she could purchase a local building (suitable for a bakery) that is for sale for \$275,000. Second, she could buy a new home for \$290,000 and go back to college and finish her degree.

- To minimize her tax liability, which of these alternatives should Wanda choose?
- What is the latest date on which Wanda can replace the involuntarily converted property to qualify for § 1033?
- What is the latest date on which Wanda can replace the involuntarily converted property to qualify for § 1033 if the involuntary conversion is a condemnation?

Decision Making

88. **LO.8, 10** Karl purchased his residence on January 2, 2014, for \$260,000, after having lived in it during 2013 as a tenant under a lease with an option to buy clause. On August 1, 2015, Karl sells the residence for \$315,000. On June 13, 2015, Karl purchases a new residence for \$367,000.

- What is Karl's recognized gain? His basis for the new residence?
- Assume instead that Karl purchased his original residence on January 2, 2013 (rather than January 2, 2014). What is Karl's recognized gain? His basis for the new residence?
- In (a), what could Karl do to minimize his recognized gain?

89. **LO.8** Wesley, who is single, listed his personal residence with a real estate agent on March 3, 2015, at a price of \$390,000. He rejected several offers in the \$350,000 range during the summer. Finally, on August 16, 2015, he and the purchaser signed a contract to sell for \$363,000. The sale (i.e., closing) took place on September 7, 2015. The closing statement showed the following disbursements:

Real estate agent's commission	\$ 21,780
Appraisal fee	600
Exterminator's certificate	300
Recording fees	800
Mortgage to First Bank	305,000
Cash to seller	34,520

Wesley's adjusted basis for the house is \$200,000. He owned and occupied the house for seven years. On October 1, 2015, Wesley purchases another residence for \$325,000.

- Calculate Wesley's recognized gain on the sale.
- What is Wesley's adjusted basis for the new residence?
- Assume instead that the selling price is \$800,000. What is Wesley's recognized gain? His adjusted basis for the new residence?

90. **LO.8** Pedro, age 57, is the sole owner of his principal residence, which he has owned and occupied for 10 years. Maria, his spouse, has also lived there 10 years. He sells the house for a realized gain of \$340,000.

- Can Pedro use the § 121 exclusion if he and Maria file a joint return? If so, what are the available amount of the exclusion and the recognized gain?
- Can Pedro use the § 121 exclusion if he files a separate return? If so, what are the available amount of the exclusion and the recognized gain?
- Assume instead that the realized gain is \$550,000 and a joint return is filed.
- Assume instead that the realized gain is \$550,000 and separate returns are filed.
- Assume instead that Maria and Pedro have been married for only 18 months and that she has lived in his house only since their marriage. They file a joint return.

Communications

91. **LO.8** Nell, Nina, and Nora Sanders, who are sisters, sell their principal residence (owned as tenants in common) in which they have lived for the past 25 years. The youngest of the sisters is age 60. The selling price is \$960,000, selling expenses and legal fees are \$63,000, and the adjusted basis is \$120,000 (the fair market value

of the residence when inherited from their parents 25 years ago; they made no capital improvements during the time they held the residence). Because the sisters are going to live in rental housing, they do not plan to acquire another residence. Nell has contacted you on behalf of the three sisters regarding the tax consequences of the sale.

- a. Write a letter to Nell advising her of the tax consequences and how taxes can be minimized. Nell's address is 100 Oak Avenue, Billings, MT 59101.
 - b. Prepare a memo for the tax files.
92. **LO.8** Lloyd owns a beach house (four years) and a cabin in the mountains (six years). His adjusted basis is \$300,000 in the beach house and \$315,000 in the mountain cabin. Lloyd also rents a townhouse in the city where he is employed. During the year, he occupies each of the three residences as follows:

Decision Making

Townhouse	135 days
Beach house	155 days
Mountain cabin	75 days

The beach house is close enough to the city so that he can commute to work during the spring and summer. While this level of occupancy may vary slightly from year to year, it is representative during the time period that Lloyd has owned the two residences.

As Lloyd plans on retiring in several years, he sells both the beach house and the mountain cabin. The mountain cabin is sold on March 3, 2015, for \$540,000 (related selling expenses of \$35,000). The beach house is sold on December 10, 2015, for \$700,000 (related selling expenses of \$42,000).

- a. Calculate Lloyd's lowest recognized gain on the sale of the two residences.
 - b. Assume instead that both residences satisfy the two-year ownership and use tests as Lloyd's principal residence. Because the mountain cabin is sold first, is it possible for Lloyd to apply the § 121 exclusion to the sale of the beach house? Why or why not?
93. **LO.8, 10** Missy, age 30, has owned her principal residence (adjusted basis of \$225,000) for five years. During the first three years of ownership, she occupied it as her principal residence. During the past two years, she was in graduate school and rented the residence. After graduate school, Missy returned to the same location where she previously worked. At this point, she purchased another residence for \$400,000 and listed her old residence for sale at \$340,000. Due to a slow real estate market, 11 months later Missy finally receives an offer of \$330,000.
- a. What is Missy's recognized gain if she immediately accepts the \$330,000 offer (i.e., 11 months after the listing date)? Selling expenses are \$20,000.
 - b. What is Missy's recognized gain if she rejects the \$330,000 offer and accepts another offer of \$340,000 three months later (i.e., 14 months after the listing date)?
 - c. Advise Missy on which offer she should accept (assume that she is in the 28% tax bracket).
94. **LO.9** Roby and James have been married for nine years. Roby sells Plum, Inc. stock that she has owned for four years to James for its fair market value of \$180,000. Her adjusted basis is \$200,000.
- a. Calculate Roby's recognized gain or recognized loss.
 - b. Calculate James's adjusted basis for the stock.
 - c. How would the tax consequences in (a) and (b) differ if Roby had made a gift of the stock to James? Which form of the transaction would you recommend?

Decision Making

Decision Making

95. **LO.9** On September 1, 2015, Marsha sells stock in Orange, Inc., for \$90,000. The stock is specialized small business investment company (SSBIC) stock and was purchased on August 16, 2014, for \$60,000. On September 30, 2015, Marsha purchases \$85,000 of Blue, Inc., also SSBIC stock.
- What is Marsha's realized and recognized gain (or loss) on the sale of the Orange stock?
 - What is Marsha's basis in the Blue stock?

Cumulative Problems

Tax Return Problem



96. Alton Newman, age 67, is married and files a joint return with his wife, Clair, age 65. Alton and Clair are both retired, and during 2014, they received Social Security benefits of \$10,000. Alton's Social Security number is 111-11-1111, and Clair's is 123-45-6789. They reside at 210 College Drive, Columbia, SC 29201.

Alton, who retired on January 1, 2014, receives benefits from a qualified pension plan of \$2,750 a month for life. His total contributions to the plan (none of which were deductible) were \$168,250. In January 2014, he received a bonus of \$2,000 from his former employer for service performed in 2013. Although the former employer accrued the bonus in 2013, it was not paid until 2014.

Clair, who retired on December 31, 2013, started receiving benefits of \$1,400 a month on January 1, 2014. Her contributions to the qualified pension plan (none of which were deductible) were \$74,100.

On September 27, 2014, Alton and Clair received a pro rata 10% stock dividend on 600 shares of stock they owned. They had bought the stock on March 5, 2007, for \$20 a share. On December 16, 2014, they sold the 60 dividend shares for \$55 a share.

On October 10, 2014, Clair sold the car she had used in commuting to and from work for \$17,000. She had paid \$31,000 for the car in 2008.

On July 14, 2006, Alton and Clair received a gift of 1,000 shares of stock from their son, Thomas. Thomas's basis in the stock was \$35 a share (fair market value at the date of gift was \$25). No gift tax was paid on the transfer. Alton and Clair sold the stock on October 8, 2014, for \$24 a share.

On May 1, 2014, Clair's mother died, and Clair inherited her personal residence. In February 2014, her mother had paid the property taxes for 2014 of \$2,100. The residence had a fair market value of \$235,000 and an adjusted basis to the mother of \$160,000 on the date of her death. Clair listed the house with a real estate agent, who estimated it was worth \$240,000 as of December 31, 2014.

Clair received rent income of \$6,000 on a beach house she inherited three years ago from her uncle Charles. She had rented the property for one week during the July 4 weekend and one week during the Thanksgiving holiday. Charles's adjusted basis in the beach house was \$150,000, and its fair market value on the date of his death was \$240,000. Clair and Alton used the beach house for personal purposes for 56 days during the year. Expenses associated with the house were \$3,700 for utilities, maintenance, and repairs; \$2,200 for property taxes; and \$800 for insurance. There are no mortgages on the property.

Clair and Alton paid estimated Federal income tax of \$3,100 and had itemized deductions of \$6,800 (excluding any itemized deductions associated with the beach house). If they have overpaid their Federal income tax, they want the amount refunded. Both Clair and Alton want \$3 to go to the Presidential Election Campaign Fund.

Compute their net tax payable or refund due for 2014. If you use tax forms for your computations, you will need at a minimum Form 1040 and Schedule D. Suggested software: H&R BLOCK Tax Software.

97. Devon Bishop, age 45, is single. He lives at 1507 Rose Lane, Albuquerque, NM 87131. His Social Security number is 111-11-1111. Devon does not want \$3 to go to the Presidential Election Campaign Fund. **Tax Return Problem**



Devon's wife, Ariane, passed away in 2010. Devon's son, Tom, who is age 16, resides with Devon. Tom's Social Security number is 123-45-6788.

Devon owns a sole proprietorship for which he uses the accrual method of accounting and maintains no inventory. His revenues and expenses for 2014 are as follows:

Sales revenue	\$740,000
Cost of goods sold (based on purchases for the year)	405,000
Salary expense	88,000
Rent expense	30,000
Utilities	8,000
Telephone	6,500
Advertising	4,000
Bad debts	5,000
Depreciation	21,000
Health insurance*	26,000
Accounting and legal fees	7,000
Supplies	1,000

*\$18,000 for employees and \$8,000 for Devon.

Other income received by Devon includes the following:

Dividend income (qualified dividends):	
Swan, Inc.	\$10,000
Wren, Inc.	2,000
Interest income:	
First Bank	11,000
Second Bank	2,500
City of Asheville bonds	17,000

During the year, Devon and his sole proprietorship had the following property transactions:

- Sold Blue, Inc. stock for \$45,000 on March 12, 2014. He had purchased the stock on September 5, 2011, for \$50,000.
- Received an inheritance of \$300,000 from his uncle, Henry. Devon used \$200,000 to purchase Green, Inc. stock on May 15, 2014, and invested \$100,000 in Gold, Inc. stock on May 30, 2014.
- Received Orange, Inc. stock worth \$9,500 as a gift from his aunt, Jane, on June 17, 2014. Her adjusted basis for the stock was \$5,000. No gift taxes were paid on the transfer. Jane had purchased the stock on April 1, 2008. Devon sold the stock on July 1, 2014, for \$22,000.
- On July 15, 2014, Devon sold one-half of the Green, Inc. stock for \$40,000.
- Devon was notified on August 1, 2014, that Yellow, Inc. stock he purchased from a colleague on September 1, 2013, for \$52,500 had become worthless. While he perceived that the investment was risky, he did not anticipate that the corporation would declare bankruptcy.
- On August 15, 2014, Devon received a parcel of land in Phoenix worth \$220,000 in exchange for a parcel of land he owned in Tucson. Because the Tucson parcel was worth \$245,000, he also received \$25,000 cash. Devon's adjusted basis for the Tucson parcel was \$210,000. He originally purchased it on September 18, 2011.

- g. On December 1, 2014, Devon sold the condominium in which he had been living for the past 20 years. The sales price was \$480,000, selling expenses were \$28,500, and repair expenses related to the sale were \$9,400. Devon purchased the condominium for \$180,000.

Devon's potential itemized deductions, exclusive of the aforementioned information, are as follows:

Medical expenses (before the 10% floor)	\$ 9,500
Property taxes on residence	5,800
State income taxes	4,000
Charitable contributions	10,000
Mortgage interest on residence	9,900
Sales taxes paid	5,000

During the year, Devon makes estimated Federal income tax payments of \$40,000.

Compute Devon's lowest net tax payable or refund due for 2014 assuming that he makes any available elections that will reduce the tax. If you use tax forms for your computations, you will need Forms 1040, 4562, 8332, and 8824 and Schedules A, B, C, D, and SE. Suggested software: H&R BLOCK Tax Software.

Tax Computation Problem
Decision Making
Communications

98. Tom and Alice Honeycutt, ages 35 and 36, live at 101 Glass Road, Delton, MI 49046. Tom is a county employee, and Alice is a self-employed accountant. Tom's Social Security number is 111-11-1111; Alice's Social Security number is 123-45-6789. The income and expenses associated with Alice's accounting practice for 2015 are as follows:

Revenues (cash receipts during 2015)	<u>\$185,000</u>
Expenses	
Salaries	\$ 45,000
Office supplies	3,200
Postage	2,900
Depreciation of equipment	42,000
Telephone	800
	<u>\$ 93,900</u>

Because Alice is a cash method taxpayer, she does not record her receivables as revenue until she receives cash payment. At the beginning of 2015, her accounts receivable were \$48,000, and the balance had decreased to \$8,000 by the end of the year.

Alice used one room in their 10-room house as the office for her accounting practice (400 square feet out of a total square footage of 4,000). They paid the following expenses related to the house during 2015:

Utilities	\$4,500
Insurance	2,100
Property taxes	5,200
Repairs	3,500

Tom and Alice purchased the house on September 1, 2014, for \$400,000 (exclusive of land cost).

Tom and Alice have one child, Connor, age 16. Connor's Social Security number is 123-45-6788.

Tom received a salary of \$50,000 during 2015. The appropriate amounts of Social Security tax and Medicare tax were withheld. In addition, \$5,000 of Federal income taxes and \$2,000 of state income taxes were withheld.

Alice provides part of the support of her father, age 69. Her father's Social Security number is 123-45-6787. The total support in 2015 for her father was as follows:

Social Security benefits	\$5,200
From Alice	3,200
From Bob, Alice's brother	2,200
From Susan, Alice's sister	2,300

Bob and Susan have both indicated their willingness to sign a multiple support waiver form if it will benefit Alice.

Tom and Alice's allowable itemized deductions during 2015, excluding any itemized deductions related to the house, were \$11,000. They made estimated tax payments of \$25,000.

Part 1—Tax Computation

Compute Tom and Alice's lowest net tax payable or refund due for 2015.

Part 2—Tax Planning

Tom and Alice have 30 acres of prime farmland that they inherited from Tom's father several years ago. At that time, the fair market value of the land was \$150,000 (which became their basis in the land). The Honeycutts have been holding the land as an investment. The property was recently appraised for \$190,000, and there is an outstanding mortgage on the land of \$28,000. They are considering trading this land for property in the mountains of southern Colorado. Ultimately, they would like to build a vacation home on the Colorado property. The Colorado property owner—who has significant land holdings in the area—has provided two options to Tom and Alice (in both cases, the Colorado property owner would assume the mortgage as part of the exchange):

1. 15 acres of property with a fair market value of \$135,000 plus \$27,000 of cash; or
2. 10 acres of property with a fair market value of \$160,000 plus \$2,000 of cash.

The Honeycutts have come to you for advice, believing either transaction to be a like-kind exchange that will allow them to defer any gain. Assume that Tom and Alice expect their marginal tax rate to remain the same for 2016. Write a letter to Tom and Alice that contains your advice on the proposed transactions. Also prepare a memo for the tax files.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.



Research Problem 1. Terry owns real estate with an adjusted basis of \$600,000 and a fair market value of \$1.1 million. The amount of the nonrecourse mortgage on the property is \$2.5 million. Because of substantial past and projected future losses associated with the real estate development (occupancy rate of only 37% after three years), Terry deeds the property to the creditor.

- a. What are the tax consequences to Terry?
- b. Assume that the data are the same, except that the fair market value of the property is \$2,525,000. Therefore, when Terry deeds the property to the creditor, she also receives \$25,000 from the creditor. What are the tax consequences to Terry?

Research Problem 2. Your client, Jacob, turned 66 years old this year. Jacob has no heirs and has decided that he would like to sell a life insurance policy to fund a trip to Africa that he has wanted to take.

Jacob knew that he could surrender the policy (a whole-life policy) back to the insurance company, but a friend told him he could get more for the policy if he sold it to a life settlement company. A life settlement company buys life insurance policies from policyholders who are not ill and who generally have a life expectancy of between 2 and 15 years. In return, the seller of the policy receives a lump-sum payment. The life settlement company either holds the policy to maturity or resells the policy to an investor.

The lump sum received depends on factors such as age, health, and the terms and conditions of the policy, but is generally more than the policy's cash surrender value (which would be received from the life insurance company upon surrender of the policy).

In November 2015, Jacob (who was not terminally or chronically ill) sold his policy to a life settlement company for \$160,000. During the time he owned the policy, Jacob did not borrow against the policy or receive any distributions. Jacob also had paid premiums totaling \$122,000 (of which \$32,000 was paid for the provision of insurance before the sale of the policy).

How should Jacob calculate his basis in the life insurance policy to determine if he has a realized gain or loss on the surrender of the policy?

Research Problem 3. Ted and Marvin Brown purchased an apartment building in 2004 as equal tenants in common. After a hectic decade of co-ownership, the brothers decided that their business association should be terminated. This led to the sale of the apartment building and a division of the proceeds.

The realized gain on the sale of the apartment building for each brother was \$350,000. Ted recognized gain on his share and used the net proceeds to invest in stock. Marvin wanted to defer any recognized gain, so he worked with a realtor to identify property that would be eligible for § 1031 like-kind exchange treatment. After one prospect failed, the realtor identified a single-family home on Lake Tahoe that was currently being rented by the owner. Marvin agreed with the choice and acquired the single-family house using the proceeds from the apartment building. Because the single-family house qualified as like-kind property, Marvin deferred all of his realized gain.

After attempting to rent the property for eight months without success, Marvin concluded that he could not continue to make the mortgage payments on his primary residence and this rental property. To ease his financial liquidity problem, Marvin sold his principal residence for a realized gain of \$190,000 and moved into the Lake Tahoe house. He reported no recognized gain on the sale of his principal residence as the sale qualified for § 121 exclusion treatment.

The IRS issued a deficiency notice to Marvin associated with the sale of the apartment building. The position of the IRS was that Marvin did not hold the single-family residence for investment purposes as required by § 1031. Instead, his intention was personal—to use it as a replacement for his current residence that he planned on selling.

Who should prevail?

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Communications

Research Problem 4. Many see the “step-up in basis at death” rule of § 1014 as an expensive tax loophole enjoyed by the wealthy. Find the latest estimates of the revenue loss to the Treasury that is attributable to this rule.

- How does Canada's tax law determine the basis of property acquired from a decedent?
- Send an e-mail message to a member of the House Ways and Means Committee expressing a preference for the preservation of the current § 1014 rule or the modifications made to it by the Tax Relief Reconciliation Act of 2001 and the Tax Relief Act of 2010.

Research Problem 5. In general, the 45-day identification period and the 180-day exchange period for like-kind exchanges cannot be extended. Does this rule change if the like-kind property or the taxpayer involved in the exchange is located in a Presidentially declared disaster area? Use the IRS's website (www.irs.gov) to find the answer.

Roger CPA Review Questions

1. Stephen purchased a video game console five years ago for \$500. In order to raise money for the “latest and greatest” console, Stephen sold his console for \$100. Because of advances in technology, Stephen can purchase the new console for \$400. What is the tax treatment of Stephen’s sale of his console?
 - a. Stephen recognizes a \$400 loss
 - b. Stephen does not report the sale
 - c. Stephen recognizes a \$300 loss
 - d. Stephen recognizes a \$100 gain
2. Uncle Ubb gave his nephew, Leroy Lamprey, a gift of stock worth \$10,000. Uncle Ubb’s basis in the stock was \$15,000. Leroy sold the stock to an unrelated party for \$11,000. What amount of gain or loss should Leroy report as a result of this sale?
 - a. \$0
 - b. \$4,000 loss
 - c. \$200 gain
 - d. \$1,000 gain
3. On June 1, 20X12, Heloise gave Henrietta a gift of stock worth \$10,000. Heloise had purchased the stock on January 1, 20X12 for \$13,000. Henrietta sold the stock to an unrelated party on January 1, 20X13 for \$13,500. What is the amount and character of Henrietta’s gain or loss upon the sale?
 - a. \$500 short-term capital gain
 - b. \$3,500 short-term capital gain
 - c. \$500 long-term capital gain
 - d. \$3,500 long-term capital gain
4. On July 1, 20X14, Penelope gave Peter a gift of stock worth \$9,000. Penelope had purchased the stock for \$10,000 in 20X12. On November 1, 20X14, Peter sold the stock to an unrelated party for \$8,500. What is the amount and character of Peter’s gain or loss upon the sale?
 - a. \$500 short-term capital loss
 - b. \$1,500 long-term capital loss
 - c. \$500 long-term capital loss
 - d. \$1,500 short-term capital loss
5. On June 1, 20X13, Gary gave Gertrude a gift of stock worth \$10,000, paying no gift tax on the transaction. Gary had purchased the stock for \$7,500 in 20X11. On October 1, 20X13, Gertrude sold the stock to an unrelated party for \$11,000. What is the amount and character of Gertrude’s gain upon the sale?
 - a. \$1,000 short-term capital gain
 - b. \$3,500 long-term capital gain
 - c. \$1,000 long-term capital gain
 - d. \$3,500 short-term capital gain
6. Shomit purchases 100 shares of stock in Classy Corporation for \$500 in Year 1. On December 20 of Year 2, he purchases an additional 100 shares in the company for \$400. On December 27 of Year 2, Shomit sells the 100 shares acquired in Year 1 for \$410. What is Shomit’s resulting basis in the shares acquired on December 20 of Year 2?
 - a. \$400
 - b. \$500
 - c. \$490
 - d. \$410
7. Helmut purchases 100 shares of stock in Caisson Corporation for \$1,000 in Year 1. On December 1 of Year 2, he purchases an additional 100 shares in the company for \$1,500. On December 28 of Year 2, Helmut sells the 100 shares acquired in Year 1 for \$1,200. What is Helmut’s recognized gain or loss from the December 28 sale, and what is his resulting basis in the stock purchased on December 1 of Year 2?

	Recognized Gain or Loss on Sale	Resulting Basis in December 1 Purchase
a.	\$ 0	\$1,800
b.	0	1,500
c.	300 loss	1,200
d.	200 gain	1,500

8. Sengupta died on February 1, 20X14, and bequeathed two different assets to a beneficiary, Roberts. Asset One was distributed to Roberts on April 24, 20X14; Asset Two was distributed to Roberts on October 25, 20X14. The executor of Sengupta's estate makes a qualified alternate valuation date election. The basis of each bequeathed asset will thus be the fair market value on which date?

	Asset One	Asset Two
a.	August 1, 20X14	August 1, 20X14
b.	April 24, 20X14	August 1, 20X14
c.	April 24, 20X14	October 25, 20X14
d.	August 1, 20X14	October 25, 20X14

9. Kellye purchased her home in 20X4 for \$140,000. After living in it for five years, she sold it in 20X9 for \$170,000, its market value. What is the tax treatment of the sale of Kellye's home?
- A \$30,000 gain is recognized, but not reported
 - A \$30,000 gain is recognized and reported
 - A \$30,000 gain is carried forward
 - The transaction is not reported
10. Ike, a single taxpayer, is reassigned for his job and must move to a new state. While searching for a place to live, he encounters a person who is selling their home in order to move to Ike's current city. The two agree to trade their properties to each other without any further consideration. Ike's house has a fair market value of \$200,000 and basis of \$130,000. He has lived in the house for one year. The house he is acquiring in the trade has a fair market value of \$300,000. What gain will Ike recognize for Federal tax purposes?
- \$50,000
 - \$100,000
 - \$0
 - \$300,000
11. Kathryn has lived in her house for one year. Her company recently relocated to a city 100 miles away, forcing her to move. She purchased her house a year ago for \$400,000, and sold it for \$525,000, its current fair market value. What amount of gain will Kathryn recognize for Federal tax purposes?
- \$0
 - \$62,500
 - \$125,000
 - \$250,000
12. An office building owned by Milo was destroyed by Hurricane Mel on September 25, 20X14. On October 2, 20X14 the President of the United States declared the area where the office building was located a Federal disaster area. Milo received settlement of his insurance claim for the destruction of his building on January 2, 20X15. In order to qualify for nonrecognition of gain on this involuntary conversion, what is the last date for Milo to acquire qualified replacement property?
- December 31, 20X18
 - October 2, 20X18
 - December 31, 20X19
 - January 2, 20X19
13. Mikhail owns real estate with a basis of \$400,000 and a fair market value of \$650,000. He exchanges it for other real estate with a fair market value of \$480,000. In addition, Mikhail is relieved of a mortgage on the old property of \$200,000, assumes a mortgage on the new property of \$100,000, and receives \$70,000 in cash. Under § 1031, what is Mikhail's recognized gain on the exchange?
- \$170,000
 - \$270,000
 - \$70,000
 - \$350,000

Property Transactions: Capital Gains and Losses, § 1231, and Recapture Provisions

LEARNING OBJECTIVES: *After completing Chapter 14, you should be able to:*

- | | |
|---|--|
| <p>LO.1 Explain the general scheme of taxation for capital gains and losses.</p> <p>LO.2 Distinguish capital assets from ordinary assets.</p> <p>LO.3 Explain the relevance of a sale or exchange to classification as a capital gain or loss and apply the special rules for the capital gain or loss treatment of the retirement of corporate obligations, options, patents, franchises, and lease cancellation payments.</p> <p>LO.4 Determine whether the holding period for a capital asset is long term or short term.</p> <p>LO.5 Describe the beneficial tax treatment for capital gains and the detrimental tax treatment for capital losses for noncorporate taxpayers.</p> <p>LO.6 Describe the tax treatment for capital gains and the detrimental tax treatment for capital losses for corporate taxpayers.</p> <p>LO.7 State and explain the rationale for and the nature and treatment of gains and losses from the disposition of business assets.</p> | <p>LO.8 Distinguish § 1231 assets from ordinary assets and capital assets and calculate the § 1231 gain or loss.</p> <p>LO.9 Determine when § 1245 recapture applies and how it is computed.</p> <p>LO.10 Determine when § 1250 recapture applies.</p> <p>LO.11 State and explain considerations common to §§ 1245 and 1250.</p> <p>LO.12 Apply the special recapture provisions for related parties and intangible drilling costs (IDCs) and be aware of the special recapture provision for corporations.</p> <p>LO.13 Describe and apply the reporting procedures for §§ 1231, 1245, and 1250.</p> <p>LO.14 Identify tax planning opportunities arising from the sale or exchange of capital assets and avoid pitfalls associated with the recapture provisions.</p> |
|---|--|

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THE BIG PICTURE

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MANAGING CAPITAL ASSET TRANSACTIONS

Maurice has come to you for tax advice regarding his investments. He inherited \$750,000 from his Uncle Joe. A financial adviser suggested that he make the following investments, which he did nine months ago.

- \$5,000 for 100 shares of Eagle Company stock.
- \$50,000 for a 50 percent interest in a patent that Kevin, a college roommate who is an unemployed inventor, obtained for a special battery he developed to power green cars. To date, Kevin has been unable to market the battery to an auto manufacturer or supplier, but he has high hopes of doing so in the future.
- \$95,000 to purchase a franchise from Orange, Inc.
- \$200,000 in the stock of Purple, a publicly held bank that follows a policy of occasionally paying dividends. At one time, the stock appreciated to \$300,000, but now it is worth only \$210,000. Maurice is considering unloading this stock.
- \$50,000 in tax-exempt bonds. The interest rate on the bonds is only 3 percent. Maurice is considering moving this money into taxable bonds that pay 3.5 percent.
- \$100,000 for a 10 percent ownership interest as a limited partner in a real estate development. Lots in the development are selling well.

Maurice read an article that talked about the beneficial tax rates for capital assets and dividends. He really liked the part about “costless” capital gains, although he did not understand it.

Maurice has retained his job as a toll booth supervisor at the municipal airport. His annual compensation is \$35,000. He likes the job and has met some interesting people there.

Respond to Maurice’s request for tax advice.

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$ xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income	\$xx,xxx

FORM 1040 (p. 1)

- | | | |
|-----------|--|--------------------------|
| 12 | Business income or (loss). Attach Schedule C or C-EZ | <input type="checkbox"/> |
| 13 | Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ | <input type="checkbox"/> |
| 14 | Other gains or (losses). Attach Form 4797 | <input type="checkbox"/> |

Less: Deductions for adjusted gross income.....	<u>(x,xxx)</u>
Adjusted gross income.....	\$ xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)
Personal and dependency exemptions	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx

FORM 1040 (p. 2)

- | | |
|-----------|--|
| 44 | Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> _____ |
|-----------|--|

Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>
Tax due (<i>or refund</i>).....	\$ <u>xxx</u>

Fourteen years ago, a taxpayer purchased 100 shares of IBM stock for \$17 a share. This year the taxpayer sells the shares for \$186 a share. Should the \$169 per share gain receive any special tax treatment? The \$169 gain has built up over 14 years, so it may not be fair to tax it the same as income that was all earned this year.

What if the stock had been purchased for \$186 per share and sold for \$17 a share? Should the \$169 loss be fully deductible? The tax law has an intricate approach to answering these investment activity-related questions.

As you study this chapter, keep in mind that how investment-related gains and losses are taxed can dramatically affect whether taxpayers make investments and which investments are made. Except for a brief discussion in Chapter 3, earlier chapters dwelt on how to determine the amount of gain or loss from a property disposition, but did not discuss the classification of gains and losses. This chapter will focus on that topic.

The tax law requires **capital gains** and **capital losses** to be separated from other types of gains and losses. There are two reasons for this treatment. First, long-term capital gains may be taxed at a lower rate than ordinary gains. The second reason the Code requires separate reporting of gains and losses and a determination of their tax character is that a net capital loss is subject to deduction limitations. For noncorporate taxpayers, a net capital loss is only deductible up to \$3,000 per year. Any excess loss over the annual limit carries over and may be deductible in a future tax year.

For these reasons, capital gains and losses must be distinguished from other types of gains and losses. Most of this chapter describes the intricate rules for determining what type of gains and losses the taxpayer has.

14-1 GENERAL SCHEME OF TAXATION

Recognized gains and losses must be properly classified. Proper classification depends upon three characteristics:

- The tax status of the property.
- The manner of the property's disposition.
- The holding period of the property.

The three possible tax statuses are capital asset, § 1231 asset, and ordinary asset. Property disposition may be by sale, exchange, casualty, theft, or condemnation.

There are two holding periods: short term and long term. The short-term holding period is one year or less. The long-term holding period is more than one year. (More explanation of the holding period is provided later in the chapter.)

A major focus of this chapter is capital gains and losses. Capital gains and losses usually result from the disposition of a capital asset. The most common disposition is a sale of the asset. Capital gains and losses can also result from the disposition of § 1231 assets, which is discussed later in this chapter.

14-2 CAPITAL ASSETS

Personal use assets and investment assets are the most common capital assets owned by individual taxpayers. Personal use assets usually include items such as clothing, recreational equipment, a residence, and automobiles. Investment assets usually include investments in mutual funds, corporate stocks and bonds, government bonds, and vacant land. Remember, however, that losses from the sale or exchange of personal use assets are not recognized. Therefore, the classification of such losses as capital losses can be ignored.

The crux of capital asset determination hinges on whether the asset is held for personal use purposes (capital asset), investment purposes (capital asset), or business purposes (ordinary asset). The taxpayer's use of the property often provides objective evidence.

David buys an expensive painting.

- If David purchased the painting for personal use (as a decoration in his home) and it is not of investment quality, it is a capital asset. However, any loss on its sale is not usable, whereas gain from its sale is taxable. Investment quality generally means that the painting is expected to appreciate in value.
- If the painting is used to decorate David's business office and is of investment quality, the painting is not depreciable and, therefore, is a capital asset.
- If David's business is buying and selling paintings, the painting is inventory and, therefore, an ordinary asset.
- If the painting is not of investment quality and the business did not purchase it for investment, the painting is an ordinary asset and it is depreciable even though it serves a decorative purpose in David's office.
- If David depreciates the painting, that is objective evidence that the painting is held for use in his business, is not being held for investment or as inventory, and is not a capital asset.

Due to the historical preferential treatment of capital gains, taxpayers have preferred that gains be capital gains rather than ordinary gains. As a result, a great many statutes, cases, and rulings have accumulated in the attempt to define what is and what is not a capital asset.

LO.1

Explain the general scheme of taxation for capital gains and losses.

LO.2

Distinguish capital assets from ordinary assets.

EXAMPLE

1

14-2a Definition of a Capital Asset (§ 1221)

Capital assets are not directly defined in the Code. Instead, § 1221(a) defines what is *not* a capital asset. A **capital asset** is property held by the taxpayer (when it is connected with the taxpayer's business) that is *not* any of the following:

- Inventory or property held primarily for sale to customers in the ordinary course of a business. The Supreme Court, in *Malat v. Riddell*, defined *primarily* as meaning *of first importance* or *principally*.¹
- Accounts and notes receivable acquired from the sale of inventory or acquired for services rendered in the ordinary course of business.
- Depreciable property or real estate used in a business.
- Certain copyrights; literary, musical, or artistic compositions; or letters, memoranda, or similar property held by (1) a taxpayer whose efforts created the property; (2) in the case of a letter, a memorandum, or similar property, a taxpayer for whom it was produced; or (3) a taxpayer in whose hands the basis of the property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of a taxpayer described in (1) or (2). When a sale or exchange involves musical compositions or copyrights in musical works either (1) created by the taxpayer's personal efforts or (2) having a basis determined by reference to the basis in the hands of a taxpayer whose personal efforts created the compositions or copyrights, the taxpayer may elect to treat the sale or exchange as the disposition of a capital asset.²
- U.S. government publications that are (1) received by a taxpayer from the U.S. government other than by purchase at the price at which they are offered for sale to the public or (2) held by a taxpayer whose basis, for purposes of determining gain from a sale or exchange, is determined by reference to a taxpayer described in (1).
- Supplies of a type regularly used or consumed in the ordinary course of a business.

The Code defines what is not a capital asset. From the preceding list, it is apparent that inventory, accounts and notes receivable, supplies, and most fixed assets of a business are not capital assets. Often, the only business asset that is a capital asset is "self-generated" goodwill (purchased goodwill is a § 1231 asset). The following discussion provides further detail on each part of the capital asset definition.

Inventory

What constitutes inventory is determined by the taxpayer's business.

Inventory Determination

EXAMPLE

2

Green Company buys and sells used cars. Its cars are inventory. Its gains from the sale of the cars are ordinary income.

EXAMPLE

3

Soong sells her personal use automobile at a \$500 gain. The automobile is a personal use asset and, therefore, a capital asset. The gain is a capital gain.

Accounts and Notes Receivable

Collection of an accrual basis account receivable usually does not result in a gain or loss because the amount collected equals the receivable's basis. The sale of an account or note receivable may generate a gain or loss, and the gain or loss is ordinary because the

¹66-1 USTC ¶9317, 17 AFTR 2d 604, 86 S.Ct. 1030 (USSC, 1966).

²§ 1221(b)(3).

receivable is not a capital asset. The sale of an accrual basis receivable may result in a gain or loss because it will probably be sold for more or less than its basis. A cash basis account receivable has no basis. Sale of such a receivable generates a gain. Collection of a cash basis receivable generates ordinary income rather than a gain. A gain usually requires a sale of the receivable. See the discussion of Sale or Exchange later in this chapter.

Oriole Company has accounts receivable of \$100,000. Because Oriole needs working capital, it sells the receivables for \$83,000 to a financial institution.

If Oriole is an accrual basis taxpayer, it has a \$17,000 ordinary loss. Revenue of \$100,000 would have been recorded and a \$100,000 basis would have been established when the receivable was created.

If Oriole is a cash basis taxpayer, it has \$83,000 of ordinary income because it would not have recorded any revenue earlier; thus, the receivable has no tax basis.

EXAMPLE

4

Business Fixed Assets

Depreciable personal property and real estate (both depreciable and nondepreciable) used by a business are not capital assets. Thus, *business fixed assets* are generally not capital assets.

The Code has a very complex set of rules pertaining to such property. One of these rules is discussed under Real Property Subdivided for Sale (§ 1237); the remainder of the rules are discussed later in this chapter. Although business fixed assets are not capital assets, a long-term capital gain can sometimes result from their sale. The potential capital gain treatment for business fixed assets under § 1231 is also discussed later in this chapter.

Copyrights and Creative Works

Generally, the person whose efforts led to the copyright or creative work has an ordinary asset, not a capital asset. *Creative works* include the works of authors, composers, and artists. Also, the person for whom a letter, a memorandum, or another similar property was created has an ordinary asset. Finally, a person receiving a copyright, a creative work, a letter, a memorandum, or similar property by gift from the creator or the person for whom the work was created has an ordinary asset. Note the exception mentioned earlier that permits the taxpayer to elect to treat the sale or exchange of a musical composition or a copyright of a musical work as the disposition of a capital asset. (Patents are subject to special statutory rules discussed later in the chapter.)

Creative Works

Wanda is a part-time music composer. A music publisher purchases one of her songs for \$5,000. Wanda has a \$5,000 ordinary gain from the sale of an ordinary asset unless she elects to treat the gain as a capital gain.

EXAMPLE

5

Ed received a letter from the President of the United States in 1982. In the current year, Ed sells the letter to a collector for \$300. Ed has a \$300 ordinary gain from the sale of an ordinary asset (because the letter was created for Ed).

EXAMPLE

6

Isabella gives a song she composed to her son. The son sells the song to a music publisher for \$5,000. The son has a \$5,000 ordinary gain from the sale of an ordinary asset unless he elects to treat the gain as a capital gain. If the son inherits the song from Isabella, his basis for the song is its fair market value at Isabella's death. In this situation, the song is a capital asset because the son's basis is not related to Isabella's basis for the song.

EXAMPLE

7



ETHICS & EQUITY Sculpture as a Capital Asset

Cynthia is a successful sculptor who created a work that is now worth \$400,000 and has no tax basis. Cynthia forms a corporation and contributes the sculpture to it in exchange for the corporation's shares. Fourteen

months later, she sells all the stock for \$400,000. She wants to treat the sale of the stock as a long-term capital gain. Evaluate the propriety of Cynthia's actions.

U.S. Government Publications

U.S. government publications received from the U.S. government (or its agencies) for a reduced price are not capital assets. This prevents a taxpayer from later donating the publications to charity and claiming a charitable contribution equal to the fair market value of the publications. A charitable contribution of a capital asset generally yields a deduction equal to the fair market value. A charitable contribution of an ordinary asset generally yields a deduction equal to less than the fair market value. If such property is received by gift from the original purchaser, the property is not a capital asset to the donee. (For a more comprehensive explanation of charitable contributions of property, refer to Chapter 10.)

14-2b Effect of Judicial Action

Court decisions play an important role in the definition of capital assets. Because the Code only lists categories of what are *not* capital assets, judicial interpretation is sometimes required to determine whether a specific item fits into one of those categories. The Supreme Court follows a literal interpretation of the categories. For instance, corporate stock is not mentioned in § 1221. Thus, corporate stock is *usually* a capital asset. However, what if corporate stock is purchased for resale to customers? Then it is *inventory* and not a capital asset because inventory is one of the categories in § 1221. (See the discussion of Dealers in Securities below.)

A Supreme Court decision was required to distinguish between capital asset and non-capital asset status when a taxpayer who did not normally acquire stock for resale to customers acquired stock with the intention of resale.³ The Court decided that because the stock was not acquired primarily for sale to customers (the taxpayer did not sell the stock to its regular customers), the stock was a capital asset.

Because of the uncertainty associated with capital asset status, Congress has enacted several Code Sections to clarify the definition. These statutory expansions of the capital asset definition are discussed in the following section.

14-2c Statutory Expansions

Congress has often expanded the § 1221 general definition of what is *not* a capital asset.

Dealers in Securities

As a general rule, securities (stocks, bonds, and other financial instruments) held by a dealer are considered to be inventory and are, therefore, not subject to capital gain or loss treatment. A *dealer in securities* is a merchant (e.g., a brokerage firm) that regularly engages in the purchase and resale of securities to customers. The dealer must identify any securities being held for investment. Generally, if a dealer clearly identifies certain securities as held for investment purposes by the close of business on the acquisition date, gain from the securities' sale will be capital gain. However, the gain will not be capital gain if the dealer ceases to hold the securities for investment prior to the sale. Losses are capital losses if at any time the securities have been clearly identified by the dealer as held for investment.

³*Arkansas Best v. Comm.*, 88-1 USTC ¶9210, 61 AFTR 2d 88-655, 108 S.Ct. 971 (USSC, 1988).

Tracy is a securities dealer. She purchases 100 shares of Swan stock. If Tracy takes no further action, the stock is inventory and an ordinary asset. If she designates in her records that the stock is held for investment, the stock is a capital asset. Tracy must designate the investment purpose by the close of business on the acquisition date. If Tracy maintains her investment purpose and later sells the stock, the gain or loss is capital gain or loss. If Tracy redesignates the stock as held for resale (inventory) and then sells it, any gain is ordinary, but any loss is capital loss.

EXAMPLE

8

Real Property Subdivided for Sale (§ 1237)

Substantial real property development activities may result in the owner being considered a dealer for tax purposes. Income from the sale of real estate property lots is treated as the sale of inventory (ordinary income) if the owner is considered to be a dealer. However, § 1237 allows real estate investors capital gain treatment if they engage *only* in *limited* development activities. To be eligible for § 1237 treatment, the following requirements must be met:

- The taxpayer may not be a corporation.
- The taxpayer may not be a real estate dealer.
- No substantial improvements may be made to the lots sold. *Substantial* generally means more than a 10 percent increase in the value of a lot. Shopping centers and other commercial or residential buildings are considered substantial, while filling, draining, leveling, and clearing operations are not.
- The taxpayer must have held the lots sold for at least 5 years, except for inherited property. The substantial improvements test is less stringent if the property is held at least 10 years.

If the preceding requirements are met, all gain is capital gain until the tax year in which the *sixth* lot is sold. Sales of contiguous lots to a single buyer in the same transaction count as the sale of one lot. Beginning with the tax year the *sixth* lot is sold, some of the gain may be ordinary income. Five percent of the revenue from lot sales is potential ordinary income. That potential ordinary income is offset by any selling expenses from the lot sales. Practically, sales commissions often are at least 5 percent of the sales price, so none of the gain is treated as ordinary income.

Section 1237 does not apply to losses. A loss from the sale of subdivided real property is an ordinary loss unless the property qualifies as a capital asset under § 1221. The following example illustrates the application of § 1237.

Jack owns a large tract of land and subdivides it for sale. Assume that Jack meets all of the requirements of § 1237 and during the tax year sells the first 10 lots to 10 different buyers for \$10,000 each. Jack's basis in each lot sold is \$3,000, and he incurs total selling expenses of \$4,000 on the sales. Jack's gain is computed as follows:

Selling price (10 × \$10,000)	\$100,000	
Less: Selling expenses (10 × \$400)	<u>(4,000)</u>	
Amount realized		\$ 96,000
Basis (10 × \$3,000)		<u>(30,000)</u>
Realized and recognized gain		\$ 66,000
Classification of recognized gain:		
Ordinary income		
Five percent of selling price (5% × \$100,000)	\$ 5,000	
Less: Selling expenses	<u>(4,000)</u>	
Ordinary gain		<u>1,000</u>
Capital gain		<u>\$ 65,000</u>

Note that a portion of the gain is given ordinary treatment because the *sixth* lot is sold in the current year.

EXAMPLE

9

Nonbusiness Bad Debts

A loan not made in the ordinary course of business is classified as a nonbusiness receivable. In the year the receivable becomes completely worthless, it is a *nonbusiness bad debt*, and the bad debt is treated as a short-term capital loss. Even if the receivable was outstanding for more than one year, the loss is still a short-term capital loss. Chapter 7 discusses nonbusiness bad debts more thoroughly.

LO.3

Explain the relevance of a sale or exchange to classification as a capital gain or loss and apply the special rules for the capital gain or loss treatment of the retirement of corporate obligations, options, patents, franchises, and lease cancellation payments.

14-3 SALE OR EXCHANGE

Recognition of capital gain or loss usually requires a sale or exchange of a capital asset. The Code uses the term **sale or exchange**, but does not define it. Generally, a property sale involves the receipt of money by the seller and/or the assumption by the purchaser of the seller's liabilities. An exchange involves the transfer of property for other property. Thus, an involuntary conversion (casualty, theft, or condemnation) is not a sale or exchange. In several situations, the determination of whether a sale or exchange has taken place has been clarified by the enactment of Code Sections that specifically provide for sale or exchange treatment.

Recognized gains or losses from the cancellation, lapse, expiration, or any other termination of a right or obligation with respect to personal property (other than stock) that is or would be a capital asset in the hands of the taxpayer are capital gains or losses.⁴ See the discussion under Options later in the chapter for more details.

14-3a Worthless Securities and § 1244 Stock

Occasionally, securities such as stock and, especially, bonds may become worthless due to the insolvency of their issuer. If such a security is a capital asset, the loss is deemed to have occurred as the result of a sale or exchange on the *last day* of the tax year.⁵ This last-day rule may have the effect of converting what otherwise would have been a short-term capital loss into a long-term capital loss. (See Treatment of Net Capital Losses later in this chapter.) Worthless securities are discussed in Chapter 7.

Section 1244 allows an ordinary deduction on disposition of stock at a loss. The stock must be that of a small business corporation, and the ordinary deduction is limited to \$50,000 (\$100,000 for married taxpayers filing jointly) per year. For a more detailed discussion, refer to Chapter 7.

14-3b Special Rule—Retirement of Corporate Obligations

A debt obligation (e.g., a bond or note payable) may have a tax basis in excess of or less than its redemption value because it may have been acquired at a premium or discount. Consequently, the collection of the redemption value may result in a loss or gain. Generally, the collection of a debt obligation is *treated* as a sale or exchange.⁶ Therefore, any loss or gain can be a capital loss or capital gain because a sale or exchange has taken place.

EXAMPLE

10

Fran acquires \$1,000 of Osprey Corporation bonds for \$980 in the open market. If the bonds are held to maturity, the \$20 difference between Fran's collection of the \$1,000 redemption value and her cost of \$980 is treated as capital gain.

Original Issue Discount (§§ 1272–1288)

The benefit of the sale or exchange exception that allows a capital gain from the collection of certain obligations is reduced when the obligation has original issue discount. **Original issue discount (OID)** arises when the issue price of a debt obligation is less than the maturity value of the obligation. OID must generally be amortized over the life of the debt obligation using the effective interest method. The OID amortization increases the basis of the bond. Most new publicly traded bond issues do not carry OID

⁴§ 1234A.

⁵§ 165(g)(1).

⁶§ 1271.

because the stated interest rate is set to make the market price on issue the same as the bond's face amount. In addition, even if the issue price is less than the face amount, the difference is not considered to be OID if the difference is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of years to maturity.⁷

In the case where OID does exist, it may or may not have to be amortized, depending upon the date the obligation was issued. When OID is amortized, the amount of gain upon collection, sale, or exchange of the obligation is correspondingly reduced. The obligations covered by the OID amortization rules and the method of amortization are presented in §§ 1272–1275. Similar rules for other obligations can be found in §§ 1276–1288.

Jerry purchases \$10,000 of newly issued White Corporation bonds for \$6,000. The bonds have OID of \$4,000. Jerry must amortize the discount over the life of the bonds. The OID amortization increases his interest income. (The bonds were selling at a discount because the market rate of interest was greater than the bonds' stated interest rate.) After Jerry has amortized \$1,800 of OID, he sells the bonds for \$8,000. Jerry has a capital gain of \$200 [$\$8,000 - (\$6,000 \text{ cost} + \$1,800 \text{ OID amortization})$].

The OID amortization rules prevent him from converting ordinary interest income into capital gain. Without the OID amortization, Jerry would have capital gain of \$2,000 ($\$8,000 - \$6,000 \text{ cost}$).

EXAMPLE

11

14-3c Options

Frequently, a potential buyer of property wants some time to make the purchase decision, but wants to control the sale and/or the sale price in the meantime. **Options** are used to achieve these objectives. The potential purchaser (grantee) pays the property owner (grantor) for an option on the property. The grantee then becomes the option holder. The option, which usually sets a price at which the grantee can buy the property, expires after a specified period of time.

Sale of an Option

A grantee may sell or exchange the option rather than exercise it or let it expire. Generally, the grantee's sale or exchange of the option results in capital gain or loss if the option property is (or would be) a capital asset to the grantee.⁸

Rosa wants to buy some vacant land for investment purposes. She cannot afford the full purchase price. Instead, Rosa (grantee) pays the landowner (grantor) \$3,000 to obtain an option to buy the land for \$100,000 anytime in the next two years. The option is a capital asset for Rosa because if she actually purchased the land, the land would be a capital asset.

Three months after purchasing the option, Rosa sells it for \$7,000. She has a \$4,000 ($\$7,000 - \$3,000$) short-term capital gain on this sale because she held the option for one year or less.

EXAMPLE

12

Failure to Exercise Options

If an option holder (grantee) fails to exercise the option, the lapse of the option is considered a sale or exchange on the option expiration date. Thus, the loss is a capital loss if the property subject to the option is (or would be) a capital asset in the hands of the grantee.

The grantor of an option on *stocks, securities, commodities, or commodity futures* receives short-term capital gain treatment upon the expiration of the option. Options on property *other than* stocks, securities, commodities, or commodity futures (for instance, vacant land) result in ordinary income to the grantor when the option expires. For example, an individual investor who owns certain stock (a capital asset) may sell a call option, entitling the buyer of the option to acquire the stock at a specified price higher than the value at the date the option is granted. The writer of the call receives a premium (e.g., 10 percent) for writing the option. If the price of the stock does not increase during the option period, the option will expire unexercised. Upon the expiration of the option, the grantor

⁷§ 1273(a)(3).

⁸§ 1234(a) and Reg. § 1.1234-1(a)(1).

must recognize short-term capital gain (whereas the grantee recognizes a loss, the character of which depends on the underlying asset). These provisions do not apply to options held for sale to customers (the inventory of a securities dealer).

Exercise of Options by Grantee

If the option is exercised, the amount paid for the option is added to the optioned property's selling price. This increases the gain (or reduces the loss) to the grantor resulting from the sale of the property. The grantor's gain or loss is capital or ordinary depending on the tax status of the property. The grantee adds the cost of the option to the basis of the property purchased.

The Big Picture

EXAMPLE

13

Return to the facts of *The Big Picture* on p. 14-1. On February 1, 2015, Maurice purchases 100 shares of Eagle Company stock for \$5,000. On April 1, 2015, he writes a call option on the stock, giving the grantee the right to buy the stock for \$6,000 during the following six-month period. Maurice (the grantor) receives a call premium of \$500 for writing the call.

- If the call is exercised by the grantee on August 1, 2015, Maurice has \$1,500 ($\$6,000 + \$500 - \$5,000$) of short-term capital gain from the sale of the stock. The grantee has a \$6,500 ($\500 option premium + $\$6,000$ purchase price) basis for the stock.
- Investors sometimes get nervous and want to "lock in" gains or losses. Assume that Maurice, prior to exercise of the grantee's call, decides to sell his stock for \$6,000 and enters into a closing transaction by purchasing a call on 100 shares of Eagle Company stock for \$5,000. Because the Eagle stock is selling for \$6,000, Maurice must pay a call premium of \$1,000. He recognizes a \$500 short-term capital loss [$\$500$ (call premium received) – $\$1,000$ (call premium paid)] on the closing transaction. On the actual sale of the Eagle stock, Maurice has a short-term capital gain of \$1,000 [$\$6,000$ (selling price) – $\$5,000$ (cost)]. The original grantee is not affected by Maurice's closing transaction. The original option is still in existence, and the grantee's tax consequences depend on what action the grantee takes—exercising the option, letting the option expire, or selling the option.
- Assume that the original option expired unexercised. Maurice has a \$500 short-term capital gain equal to the call premium received for writing the option. This gain is not recognized until the option expires. The grantee has a loss from expiration of the option. The nature of the loss will depend upon whether the option was a capital asset or an ordinary asset.

Concept Summary 14.1 summarizes the consequences of various transactions involving options, to both the grantor and grantee.

Concept Summary 14.1

Options: Consequences to the Grantor and Grantee

Event	Effect on	
	Grantor	Grantee
Option is granted.	Receives value and has a contract obligation (a liability).	Pays value and has a contract right (an asset).
Option expires.	Has a short-term capital gain if the option property is stocks, securities, commodities, or commodity futures. Otherwise, gain is ordinary income.	Has a loss (capital loss if option property would have been a capital asset for the grantee).
Option is exercised.	Amount received for option increases proceeds from sale of the option property.	Amount paid for option becomes part of the basis of the option property purchased.
Option is sold or exchanged by grantee.	Result depends upon whether option later expires or is exercised (see above).	Could have gain or loss (capital gain or loss if option property would have been a capital asset for the grantee).

14-3d Patents

Transfer of a **patent** is treated as the sale or exchange of a long-term capital asset when all substantial rights to the patent (or an undivided interest that includes all such rights) are transferred by a holder.⁹ The transferor/holder may receive payment in virtually any form. Lump-sum or periodic payments are most common. The amount of the payments may also be contingent on the transferee/purchaser's productivity, use, or disposition of the patent. If the transfer meets these requirements, any gain or loss is *automatically a long-term* capital gain or loss. Whether the asset was a capital asset for the transferor, whether a sale or exchange occurred, and how long the transferor held the patent are not relevant.

Copyrights for authors, composers, and artists are not capital assets, as discussed earlier. Example 14 illustrates the special treatment for patents.

Substantial Rights

To receive favorable capital gain treatment, all *substantial rights* to the patent (or an undivided interest in it) must be transferred. All substantial rights to a patent means all rights (whether then held by the grantor) that are valuable at the time the patent rights (or an undivided interest in the patent) are transferred. All substantial rights have not been transferred when the transfer is limited geographically within the issuing country or when the transfer is for a period less than the remaining life of the patent. The circumstances of the entire transaction, rather than merely the language used in the transfer instrument, are to be considered in deciding whether all substantial rights have been transferred.¹⁰

The Big Picture

Return to the facts of *The Big Picture* on p. 14-1. Kevin transfers his 50% rights in the patent to the Green Battery Company, Inc., in exchange for a \$1 million lump-sum payment plus \$.50 for each battery sold. Assuming that Kevin has transferred all substantial rights, the question of whether the transfer is a sale or exchange of a capital asset is not relevant. Kevin automatically has a long-term capital gain from both the \$1 million lump-sum payment received and the \$.50 per battery royalty to the extent those proceeds exceed his basis for the patent. Kevin also had an automatic long-term capital gain when he sold 50% of his rights in the patent to Maurice, because Kevin transferred an undivided interest that included all substantial rights in the patent.

Whether Maurice gets long-term capital gain treatment depends upon whether Maurice is a holder. See the following discussion and Example 15.

EXAMPLE

14

Holder Defined

The *holder* of a patent must be an *individual* and is usually the invention's creator. A holder may also be an individual who purchases the patent rights from the creator before the patented invention is reduced to practice. However, the creator's employer and certain parties related to the creator do not qualify as holders. Thus, in the common situation where an employer has all rights to an employee's inventions, the employer is not eligible for long-term capital gain treatment. More than likely, the employer will have an ordinary asset because the patent was developed as part of its business.

The Big Picture

Return to the facts of *The Big Picture* on p. 14-1. Continuing with the facts of Example 14, Kevin is clearly a holder of the patent because he is the inventor and was not an employee when he invented the battery. When Maurice purchased a 50% interest in the patent nine months ago, he became a holder if the patent had not yet been reduced to practice. Because the patent apparently was not being utilized in the manufacturing process at the time of the purchase, it had not been reduced to practice.

continued

EXAMPLE

15

⁹§ 1235.

¹⁰Reg. § 1.1235-2(b)(1).

Consequently, Maurice is also a holder, and he has an automatic long-term capital gain or loss if he transfers all substantial rights in his 50% interest to the Green Battery Company. Maurice's basis for his share of the patent is \$50,000, and the proceeds from Green Battery Company equal \$1 million plus \$.50 for each battery sold. Thus, Maurice has a long-term capital gain even though he has not held his interest in the patent for more than one year.

14-3e **Franchises, Trademarks, and Trade Names (§ 1253)**

A mode of operation, a widely recognized brand name (trade name), and a widely known business symbol (trademark) are all valuable assets. These assets may be licensed (commonly known as franchising) by their owner for use by other businesses. Many fast-food restaurants (such as McDonald's and Taco Bell) are franchises. The franchisee usually pays the owner (franchisor) an initial fee plus a contingent fee. The contingent fee is often based upon the franchisee's sales volume.

For Federal income tax purposes, a **franchise** is an agreement that gives the franchisee the right to distribute, sell, or provide goods, services, or facilities within a specified area.¹¹ A franchise transfer includes the grant of a franchise, a transfer by one franchisee to another person, or the renewal of a franchise.

Section 1253 provides that a transfer of a franchise, trademark, or trade name is not a transfer of a capital asset when the transferor retains any significant power, right, or continuing interest in the property transferred.

Significant Power, Right, or Continuing Interest

Significant powers, rights, or continuing interests include control over assignment, quality of products and services, sale or advertising of other products or services, and the right to require that substantially all supplies and equipment be purchased from the transferor. Also included are the right to terminate the franchise at will and the right to substantial contingent payments. Most franchising operations involve some or all of these powers, rights, or continuing interests.

In the unusual case where no significant power, right, or continuing interest is retained by the transferor, a sale or exchange may occur, and capital gain or loss treatment may be available. For capital gain or loss treatment to be available, the asset transferred must qualify as a capital asset.

The Big Picture

EXAMPLE

16

Return to the facts of *The Big Picture* on p. 14-1. Maurice sells for \$210,000 to Mauve, Inc., the franchise purchased from Orange, Inc., nine months ago. The \$210,000 received by Maurice is not contingent, and all significant powers, rights, and continuing interests are transferred. The \$115,000 gain (\$210,000 proceeds – \$95,000 adjusted basis) is a short-term capital gain because Maurice has held the franchise for only nine months.

Noncontingent Payments

When the transferor retains a significant power, right, or continuing interest, the transferee's noncontingent payments to the transferor are ordinary income to the transferor. The franchisee capitalizes the payments and amortizes them over 15 years. If the franchise is sold, the amortization is subject to recapture under § 1245.¹²

EXAMPLE

17

Grey Company signs a 10-year franchise agreement with DOH Donuts. Grey (the franchisee) makes payments of \$3,000 per year for the first 8 years of the franchise agreement—a total of \$24,000. Grey cannot deduct \$3,000 per year as the payments are made. Instead, Grey may amortize the \$24,000 total over 15 years. Thus, Grey may deduct \$1,600 per year for each of the 15 years of the amortization period.

continued

¹¹§ 1253(b)(1).

¹²The recapture provisions are discussed later in this chapter.

The same result would occur if Grey made a \$24,000 lump-sum payment at the beginning of the franchise period. Assuming that DOH Donuts (the franchisor) retains significant powers, rights, or a continuing interest, it will have ordinary income when it receives the payments from Grey.

Contingent Payments

The contingent franchise payments are ordinary income for the franchisor and an ordinary deduction for the franchisee when the transferor retains a significant power, right, or continuing interest. For this purpose, a payment qualifies as a contingent payment only if the following requirements are met:

- The contingent amounts are part of a series of payments that are paid at least annually throughout the term of the transfer agreement.
- The payments are substantially equal in amount or are payable under a fixed formula.

TAK, a spicy chicken franchisor, transfers an eight-year franchise to Otis. TAK retains a significant power, right, or continuing interest. Otis, the franchisee, agrees to pay TAK 15% of sales. This contingent payment is ordinary income to TAK and a business deduction for Otis as the payments are made.

EXAMPLE

18

Sports Franchises

Professional sports franchises (e.g., the Detroit Tigers) are subject to § 1253.¹³ Player contracts are usually one of the major assets acquired with a sports franchise. These contracts last only for the time stated in the contract. By being classified as § 197 intangibles, the player contracts and other intangible assets acquired in the purchase of the sports franchise are amortized over a statutory 15-year period.¹⁴

Concept Summary 14.2 reviews the effects of transactions involving franchises on both the franchisor and franchisee.



Concept Summary 14.2

Franchises: Consequences to the Franchisor and Franchisee

Event	Effect on	
	Franchisor	Franchisee
Franchisor Retains Significant Powers and Rights		
Noncontingent payment	Ordinary income.	Capitalized and amortized over 15 years as an ordinary deduction; if franchise is sold, amortization is subject to recapture under § 1245.
Contingent payment	Ordinary income.	Ordinary deduction.
Franchisor Does Not Retain Significant Powers and Rights		
Noncontingent payment	Ordinary income if franchise rights are an ordinary asset; capital gain if franchise rights are a capital asset (unlikely).	Capitalized and amortized over 15 years as an ordinary deduction; if the franchise is sold, amortization is subject to recapture under § 1245.
Contingent payment	Ordinary income.	Ordinary deduction.

¹³§ 1253(e) previously exempted sports franchises from § 1253, but was repealed for franchises acquired after October 22, 2004.

¹⁴§ 197(a).

14-3f Lease Cancellation Payments

The tax treatment of payments received for canceling a lease depends on whether the recipient is the **lessor** or the **lessee** and whether the lease is a capital asset.

Lessee Treatment

Lease cancellation payments received by a lessee are treated as an exchange.¹⁵ Thus, these payments are capital gains if the lease is a capital asset. Generally, a lessee's lease is a capital asset if the property (either personalty or realty) is used for the lessee's personal use (e.g., his or her residence). A lessee's lease is an ordinary asset if the property is used in the lessee's trade or business and the lease has existed for one year or less when it is canceled. A lessee's lease is a § 1231 asset if the property is used in the lessee's trade or business and the lease has existed for more than a year when it is canceled.¹⁶

EXAMPLE

19

Mark owns an apartment building that he is going to convert into an office building. Vicki is one of the apartment tenants and receives \$1,000 from Mark to cancel the lease. Vicki has a capital gain of \$1,000 (which is long term or short term depending upon how long she has held the lease). Mark has an ordinary deduction of \$1,000.

Lessor Treatment

Payments received by a lessor for a lease cancellation are always ordinary income because they are considered to be in lieu of rental payments.¹⁷

EXAMPLE

20

Floyd owns an apartment building near a university campus. Hui-Fen is one of the tenants. Hui-Fen is graduating early and offers Floyd \$800 to cancel the apartment lease. Floyd accepts the offer. Floyd has ordinary income of \$800. Hui-Fen has a nondeductible payment because the apartment was personal use property.

LO.4

Determine whether the holding period for a capital asset is long term or short term.

14-4 HOLDING PERIOD

Property must be held more than one year to qualify for long-term capital gain or loss treatment.¹⁸ Property not held for the required long-term period results in short-term capital gain or loss. To compute the **holding period**, start counting on the day after the property was acquired and include the day of disposition.

The Big Picture

EXAMPLE

21

Return to the facts of *The Big Picture* on p. 14-1. Assume that Maurice purchased the Purple stock on January 15, 2014. If he sells it on January 16, 2015, Maurice's holding period is more than one year, and therefore, long term.

If, instead, Maurice sells the stock on January 15, 2015, the holding period is exactly one year and the gain or loss is short term.

To be held for more than one year, a capital asset acquired on the last day of any month must not be disposed of until on or after the first day of the thirteenth succeeding month.¹⁹

EXAMPLE

22

Leo purchases a capital asset on February 28, 2014. If Leo sells the asset on February 28, 2015, the holding period is one year and Leo will have a short-term capital gain or loss.

If Leo sells the asset on March 1, 2015, the holding period is more than one year and he will have a long-term capital gain or loss.

¹⁵§ 1241 and Reg. § 1.1241-1(a).

¹⁶Reg. § 1.1221-1(b) and PLR 200045019.

¹⁷Reg. § 1.61-8(b).

¹⁸§ 1222.

¹⁹Rev.Rul. 66-7, 1966-1 C.B. 188.

14-4a Review of Special Holding Period Rules

There are several special holding period rules.²⁰ The application of these rules depends upon the type of asset and how it was acquired.

Nontaxable Exchanges

The holding period of property received in a like-kind exchange includes the holding period of the former asset if the property that has been exchanged is a capital asset or a § 1231 asset. In certain nontaxable transactions involving a substituted basis, the holding period of the former property is *tacked on* to the holding period of the newly acquired property.

On April 22, 2015, Vern exchanges a business truck he acquired on March 15, 2012, for another truck in a qualifying like-kind exchange.

The holding period of the replacement truck begins March 15, 2012, because the holding period of the truck given up in the exchange *tacks* to the holding period of the replacement truck.

EXAMPLE

23

Certain Nontaxable Transactions Involving a Carryover of Another Taxpayer's Basis

A former owner's holding period is tacked on to the present owner's holding period if the transaction is nontaxable and the former owner's basis carries over to the present owner. Transactions of this nature are discussed in Chapter 13.

Carryover Basis

Kareem acquires 100 shares of Robin Corporation stock for \$1,000 on December 31, 2011. He transfers the shares by gift to Megan on December 31, 2014, when the stock is worth \$2,000. Kareem's basis of \$1,000 becomes the basis for determining gain or loss on a subsequent sale by Megan. Megan's holding period begins with the date the stock was acquired by Kareem.

EXAMPLE

24

Assume the same facts as in Example 24, except that the fair market value of the shares is only \$800 on the date of the gift. The holding period begins on the date of the gift if Megan sells the stock for a loss. The value of the shares on the date of the gift is used in determining her basis for loss. If she sells the shares for \$500 on April 1, 2015, Megan has a \$300 recognized capital loss and the holding period is from December 31, 2014, to April 1, 2015 (thus, the loss is short term).

EXAMPLE

25

Certain Disallowed Loss Transactions

Under several Code provisions, realized losses are disallowed. When a loss is disallowed, there is no carryover of holding period. Losses can be disallowed under § 267 (sale or exchange between related taxpayers) and § 262 (sale or exchange of personal use assets) as well as other Code Sections. Taxpayers who acquire property in a disallowed loss transaction will have a new holding period begin and will have a basis equal to the purchase price.

Janet sells her personal automobile at a loss. She may not deduct the loss because it arises from the sale of personal use property. Janet purchases a replacement automobile for more than the selling price of her former automobile. Janet has a basis equal to the cost of the replacement automobile, and her holding period begins when she acquires the replacement automobile.

EXAMPLE

26

²⁰§ 1223.

Inherited Property

The holding period for inherited property is treated as long term no matter how long the property is actually held by the heir. The holding period of the decedent or the decedent's estate is not relevant for the heir's holding period.

EXAMPLE

27

Shonda inherits Blue Company stock from her father, who died in 2015. She receives the stock on April 1, 2015, and sells it on November 1, 2015. Even though Shonda did not hold the stock more than one year, she receives long-term capital gain or loss treatment on the sale.

14-4b Special Rules for Short Sales

General

The Code provides special rules for determining the holding period of property sold short.²¹ A **short sale** occurs when a taxpayer sells borrowed property and repays the lender with substantially identical property either held on the date of the sale or purchased after the sale. Short sales usually involve corporate stock. The seller's objective is to make a profit in anticipation of a decline in the stock's price. If the price declines, the seller in a short sale recognizes a profit equal to the difference between the sales price of the borrowed stock and the price paid for the replacement stock.

EXAMPLE

28

Chris does not own any shares of Brown Corporation. However, Chris sells 30 shares of Brown. The shares are borrowed from Chris's broker and must be replaced within 45 days. Chris has a short sale because he was short the shares he sold. He will *close* the short sale by purchasing Brown shares and delivering them to his broker.

If the original 30 shares were sold for \$10,000 and Chris later purchased 30 shares for \$8,000, he would have had a gain of \$2,000. Chris's hunch that the price of Brown stock would decline was correct. Chris was able to profit from selling high and buying low.

If Chris had to purchase Brown shares for \$13,000 to close the short sale, he would have a loss of \$3,000. In this case, Chris would have sold low and bought high—not the result he wanted. Chris would be making a short sale against the box if he borrowed shares from his broker to sell and then closed the short sale by delivering other Brown shares he owned at the time he made the short sale.

A short sale gain or loss is a capital gain or loss to the extent that the short sale property constitutes a capital asset of the taxpayer. The gain or loss is not recognized until the short sale is closed. Generally, the holding period of the short sale property is determined by how long the property used to close the short sale was held. However, when substantially identical property (e.g., other shares of the same stock) is held by the taxpayer, the holding period is determined as follows:

- The short sale gain or loss is short term when, on the short sale date, the substantially identical property has been held short term (i.e., for one year or less). (See Examples 29 and 30.)
- The short sale gain is long term when, on the short sale date, the substantially identical property has been held long term (i.e., for more than one year) and is used to close the short sale. If the long-term substantially identical property is not used to close the short sale, the short sale gain is short term. (See Example 31.)
- The short sale loss is long term when, on the short sale date, the substantially identical property has been held long term (i.e., for more than one year).
- The short sale gain or loss is short term if the substantially identical property is acquired after the short sale date and on or before the closing date. (See Example 32.)

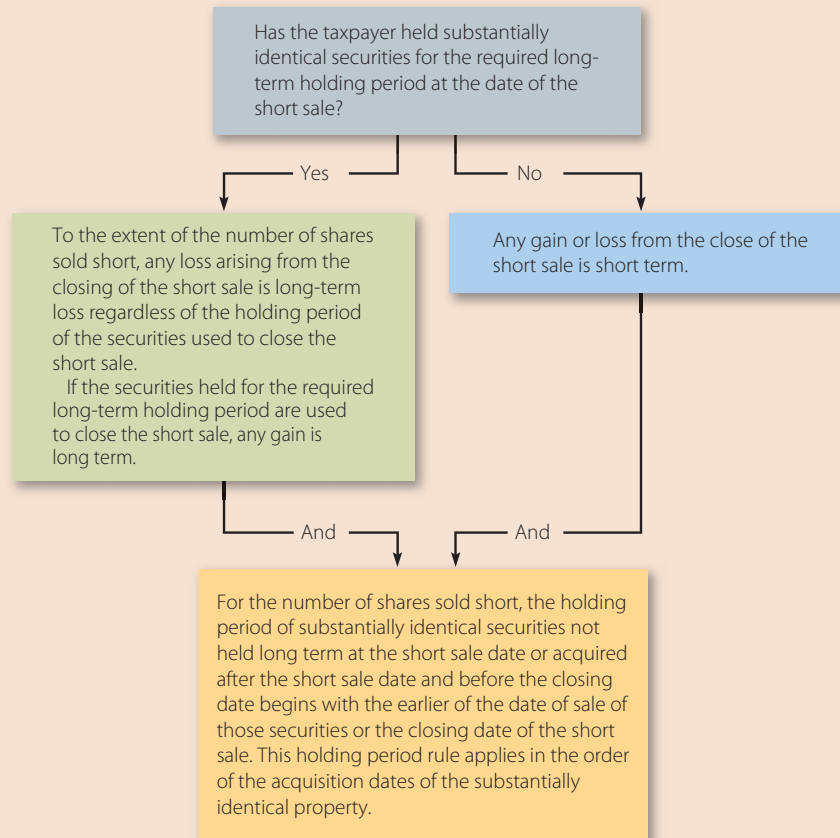
²¹§ 1233.

Concept Summary 14.3 summarizes the short sale rules. These rules are intended to prevent the conversion of short-term capital gains into long-term capital gains and long-term capital losses into short-term capital losses.



Concept Summary 14.3

Short Sales of Securities



Disposition Rules for Short Sales against the Box

A short sale against the box occurs when the stock is borrowed from a broker by a seller and the seller already owns the substantially identical securities on the short sale date or acquires them before the closing date.²² To remove the taxpayer's flexibility as to when the short sale gain must be reported, a constructive sale approach is used. If the taxpayer has not closed the short sale by delivering the short sale securities to the broker *before* January 31 of the year following the short sale, the short sale is deemed to have been closed on the *earlier* of two events:

- On the short sale date if the taxpayer owned substantially identical securities at that time.
- On the date during the year of the short sale that the taxpayer acquired substantially identical securities.²³

²²The "box" is the safe deposit box stock owners routinely used to keep stock certificates. Although stockbrokers today generally keep stock for their customers, the terminology *short sale against the box* is still used.

²³§ 1259.



TAX IN THE NEWS Short Sales in Real Estate

Recently, the term *short sale* has taken on a meaning in real estate transactions that is different from its use with regard to securities transactions. A short sale in real estate may take place when the mortgage on property exceeds the property's fair market value. A property owner in this predicament negotiates with the lender to allow the property to be sold at its fair market value to a third party

with the lender accepting the sales price in full satisfaction of the mortgage. Lenders typically will not negotiate with such property owners until the owner has failed to make required mortgage payments and foreclosure by the lender is imminent. If the negotiations are successful, the property owner avoids foreclosure but may have debt cancellation income for the difference between the mortgage and the sales price.

The basis of the shares in the deemed transfer of shares is used to compute the gain or loss on the short sale. As Examples 31 and 32 illustrate, when shares are *actually* transferred to the broker to close the short sale, there may be a gain or loss because the shares transferred will have a basis equal to the short sale date price and the value at the *actual* short sale closing date may be different from the short sale date price.

Illustrations

The following examples illustrate the treatment of short sales and short sales against the box.

Short Sales and Short Sales Against the Box

EXAMPLE

29

On January 4, 2015, Donald purchases five shares of Osprey Corporation common stock for \$100. On April 14, 2015, he engages in a short sale of five shares of the same stock for \$150. On August 15, Donald closes the short sale by repaying the borrowed stock with the five shares purchased on January 4. Because his substantially identical shares were held short term as of the short sale date, Donald's \$50 capital gain is short term.

EXAMPLE

30

Assume the same facts as in the previous example, except that Donald closes the short sale on January 28, 2016, by repaying the borrowed stock with five shares purchased on January 27, 2016, for \$200. Because Donald's substantially identical property (purchased on January 4, 2015) was short-term property at the April 14, 2015 short sale date, his \$50 capital loss (\$200 cost of stock purchased on January 27, 2016, and a short sale selling price of \$150) is short term.

EXAMPLE

31

On January 18, 2014, Rita purchases 200 shares of Owl Corporation stock for \$1,000. On November 11, 2015, she sells short, for \$1,300, 200 shares of Owl Corporation stock that she borrows from her broker. On February 10, 2016, Rita closes the short sale by delivering the 200 shares of Owl Corporation stock that she had acquired in 2014. On that date, Owl Corporation stock had a market price of \$3 per share.

Because Rita owned substantially identical stock on the date of the short sale and did not close the short sale before January 31, 2016, she is *deemed* to have closed the short sale on November 11, 2015 (the date of the short sale). On her 2015 tax return, she reports a \$300 long-term capital gain (\$1,300 short sale price – \$1,000 basis).

On February 10, 2016, Rita has a \$700 short-term capital loss [\$600 short sale closing date price (200 shares × \$3 per share) – \$1,300 basis] because the holding period of the shares used to close the short sale commences with the date of the short sale.

EXAMPLE

32

Assume the same facts as in Example 31, except that Rita did not own any Owl Corporation stock on the short sale date and acquired the 200 shares of Owl Corporation stock for \$1,000 on December 12, 2015 (after the November 11, 2015 short sale date).

The *deemed* closing of the short sale is December 12, 2015, because Rita held substantially identical shares at the end of 2015 and did not close the short sale before January 31, 2016. Her 2015 short sale gain is a *short-term* gain of \$300 (\$1,300 short sale price – \$1,000 basis), and she still has a short-term capital loss of \$700 on February 10, 2016.

14-5 TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF NONCORPORATE TAXPAYERS

LO.5

Describe the beneficial tax treatment for capital gains and the detrimental tax treatment for capital losses for noncorporate taxpayers.

All taxpayers net their capital gains and losses. Short-term gains and losses (if any) are netted against one another, and long-term gains and losses (if any) are netted against one another. The results will be net short-term gain or loss and net long-term gain or loss. If these two net positions are of opposite sign (one is a gain and one is a loss), they are netted against each other.

Six possibilities exist for the result after all possible netting has been completed. Three of these final results are gains, and three are losses. One possible result is a net long-term capital gain (NLTCG). Net long-term capital gains of noncorporate taxpayers are eligible for an alternative tax calculation that normally results in a lower tax liability. A second possibility is a net short-term capital gain (NSTCG). Third, the netting may result in both NLTCG and NSTCG. The NLTCG portion of these results is eligible for an alternative tax calculation, which is discussed later in the chapter under Alternative Tax on Net Capital Gain.

The last three results of the capital gain and loss netting process are losses. Thus, a fourth possibility is a net long-term capital loss (NLTCCL). A fifth result is a net short-term capital loss (NSTCL). Finally, a sixth possibility includes both an NLTCCL and an NSTCL. Neither NLTCCLs nor NSTCLs are treated as ordinary losses. Treatment as an ordinary loss generally is preferable to capital loss treatment because ordinary losses are deductible in full while the deductibility of capital losses is subject to certain limitations. An individual taxpayer may deduct a maximum of \$3,000 of net capital losses for a taxable year.²⁴

14-5a Capital Gain and Loss Netting Process

Net short-term capital gain is not eligible for any special tax rate. It is taxed at the same rate as the taxpayer's other taxable income.

Net long-term capital gain is eligible for one or more of *four* alternative tax rates: 0 percent, 15 percent, 20 percent, 25 percent, and 28 percent. The 25 percent and 28 percent rates are used only in unique circumstances, so the discussion below concentrates more heavily on the other three rates. The net long-term capital gain components are referred to as the *0%/15%/20% gain*, the *25% gain*, and the *28% gain*.

The *25% gain* is technically called the **unrecaptured § 1250 gain** and is related to gain from disposition of § 1231 assets. Gains and losses from disposition of § 1231 assets are discussed later in this chapter. The following discussion will focus only on how the *25% gain* is taxed and not how it is determined. The *28% gain* relates to collectibles and qualified small business stock (§ 1202, see discussion in Chapter 18). The definition of collectibles is discussed later in this section.

The *0% gain* portion of the *0%/15%/20% gain* applies when the taxable income (before taxing the *0%/15%/20% gain*) does not put the taxpayer out of the 15 percent bracket. Once the taxable income (including any portion of the *0%/15%/20% gain* taxed at 0 percent) puts the taxpayer above the 15 percent bracket, the remaining portion of the *0%/15%/20% gain* is taxed at 15 percent rather than at the regular tax rate until the taxable income reaches the 39.6 percent bracket. Once the taxable income (including any portion of the *0%/15%/20% gain* taxed at 0 percent or 15 percent) puts the taxpayer above the 35 percent bracket, the remaining portion of the *0%/15%/20% gain* is taxed at 20 percent rather than at the 39.6 percent regular tax rate.

When the long-term capital gain exceeds the short-term capital loss, a **net capital gain (NCG)** exists.²⁵ Net capital gain qualifies for beneficial alternative tax treatment (see the coverage later in the chapter).

²⁴§ 1211(b).

²⁵§ 1222(11).

Because there are both short- and long-term capital gains and losses and because the long-term capital gains may be taxed at various rates, an *ordering procedure* is required. The ordering procedure is intended to preserve the lowest long-term capital gain tax rate when there is a net long-term capital gain. This ordering procedure is explained in the following steps and then illustrated by several examples.

- Step 1. Group all gains and losses into short term and 28%, 25%, and 0%/15%/20% long term.
- Step 2. Net the gains and losses within each group.
- Step 3. Offset the net 28% and net 25% amounts if they are of opposite sign.
- Step 4. Offset the results after step 3 against the 0%/15%/20% amount if they are of opposite sign. If the 0%/15%/20% amount is a loss, offset it against the *highest-taxed gain first*. After this step, there is a net long-term capital gain or loss. If there is a net long-term capital gain, it may consist of only 28% gain, only 25% gain, only 0%/15%/20% gain, or some combination of all of these gains. If there is a net long-term capital loss, it is simply a net long-term capital loss.
- Step 5. Offset the net short-term amount against the results of step 4 if they are of opposite sign. The netting rules offset net short-term capital loss against the *highest taxed gain first*. Consequently, if there is a net short-term capital loss and a net gain from step 4, the short-term capital loss offsets first the 28% gain, then the 25% gain, and finally the 0%/15%/20% gain.

If the result of step 5 is *only* a short-term capital gain, the taxpayer is not eligible for a reduced tax rate. If the result of step 5 is a loss, the taxpayer may be eligible for a *capital loss deduction* (discussed later in this chapter). If there was no offsetting in step 5 because the short-term and step 4 results were both gains *or* if the result of the offsetting is a long-term gain, a net capital gain exists and the taxpayer may be eligible for a reduced tax rate. The net capital gain may consist of *28% gain, 25% gain, and/or 0%/15%/20% gain*.

The five steps outlined above can have many unique final results. See Concept Summary 14.5 later in the chapter for a summary of the outcomes of the netting rules and how capital gains and losses are taxed. The following series of examples illustrates the capital gain and loss netting process.

Capital Gain and Loss Netting Process

EXAMPLE

33

This example shows how a *net short-term capital gain* may result from the netting process.

Step	Short Term	Long-Term Gains and Losses			Comment
		28%	25%	0% / 15% / 20%	
1	\$13,000	\$ 12,000		\$ 3,000	
	(2,000)	(20,000)			
2	\$11,000	(\$ 8,000)		\$ 3,000	
3					No 28% / 25% netting because no opposite sign.
4		3,000	→	(3,000)	Netted because of opposite sign.
		(\$ 5,000)		\$ -0-	
5	(5,000)	←	5,000		The net short-term capital gain is taxed as ordinary income.
	\$ 6,000	\$ -0-			
	Net short-term capital gain				

Capital Gain and Loss Netting Process

This example shows how a *net long-term capital gain* may result from the netting process.

EXAMPLE

34

Step	Short Term	Long-Term Gains and Losses			Comment
		28%	25%	0% / 15% / 20%	
1	\$ 3,000	\$15,000	\$4,000	\$ 3,000	
	(5,000)	(7,000)		(8,000)	
2	(\$ 2,000)	\$ 8,000	\$4,000	(\$ 5,000)	
3					No 28% / 25% netting because no opposite sign.
4		(5,000)	←	5,000	Netted because of opposite sign. Net 0% / 15% / 20% loss is netted against 28% gain first.
		\$ 3,000			
5	2,000 →	(2,000)		\$ -0-	The net short-term capital loss is netted against 28% gain first. The net long-term capital gain is \$5,000 (\$1,000 + \$4,000).
	\$ -0-	\$ 1,000	\$4,000		
		Net 28% gain	Net 25% gain		

This example shows how a *net long-term capital loss* may result from the netting process.

EXAMPLE

35

Step	Short Term	Long-Term Gains and Losses			Comment
		28%	25%	0% / 15% / 20%	
1	\$ 3,000	\$ 1,000		\$ 3,000	
				(8,000)	
2	\$ 3,000	\$ 1,000		(\$ 5,000)	
3					No 28% / 25% netting because no opposite sign.
4		(1,000)	→	1,000	Netted because of opposite sign.
		\$ -0-		(\$ 4,000)	
5	(3,000)	→	→	3,000	The net short-term capital gain is netted against the net long-term capital loss, and the remaining loss is eligible for the capital loss deduction.
	\$ -0-			(\$ 1,000)	
			Net long-term capital loss		

Use of Capital Loss Carryovers

A short-term capital loss carryover to the current year retains its character as short term and is combined with the short-term items of the current year. A net long-term capital loss carries over as a long-term capital loss and is combined with the current-year long-term items. The long-term loss carryover is first offset with 28% gain of the current year, then 25% gain, and then 0%/15%/20% gain until it is absorbed.

In 2015, Abigail has a \$4,000 short-term capital gain, a \$36,000 28% long-term capital gain, and a \$13,000 0% / 15% / 20% long-term capital gain. She also has a \$3,000 short-term capital loss carryover and a \$2,000 long-term capital loss carryover from 2014.

Thus, in 2015, Abigail has a \$1,000 net short-term capital gain (\$4,000 – \$3,000), a \$34,000 net 28% long-term capital gain (\$36,000 – \$2,000), and a \$13,000 net 0% / 15% / 20% long-term capital gain.

EXAMPLE

36

Definition of Collectibles

Capital assets that are collectibles, even though they are held long term, are not eligible for the 0%/15%/20% alternative tax rate. Instead, a 28 percent alternative tax rate applies.

For capital gain or loss purposes, **collectibles** include:²⁶

- Any work of art.
- Any rug or antique.
- Any metal or gem.
- Any stamp.
- Any alcoholic beverage.
- Most coins.
- Any historical objects (documents, clothes, etc.).

14-5b Qualified Dividend Income

Dividends paid from current or accumulated earnings and profits of domestic and certain foreign corporations are eligible to be taxed at the 0%/15%/20% long-term capital gain rates if they are **qualified dividend income**. The question of which dividends constitute qualified dividend income is discussed more fully in Chapter 4. Here the discussion focuses on how the qualified dividend income is taxed.

The Big Picture

EXAMPLE

37

Return to the facts of *The Big Picture* on p. 14-1. After holding the Purple stock for 10 months, Maurice receives \$350 of dividends. If Purple is a domestic or qualifying foreign corporation, these are qualified dividends eligible for the 0% / 15% / 20% tax rate.

After the net capital gain or loss has been determined, the qualified dividend income is added to the net long-term capital gain portion of the net capital gain and is taxed as 0%/15%/20% gain. If there is a net capital loss, the net capital loss is still deductible *for* AGI up to \$3,000 per year with the remainder of the loss (if any) carrying forward. In this case, the qualified dividend income is still eligible to be treated as 0%/15%/20% *gain* in the alternative tax calculation (it is *not* offset by the net capital loss).

EXAMPLE

38

Refer to Example 34, but assume that there is qualified dividend income of \$2,500 in addition to the items shown. The qualified dividend income is not netted against the capital gains and losses. Instead, the taxpayer has \$1,000 of 28% gain, \$4,000 of 25% gain, and \$2,500 of qualified dividend income taxed at 0% / 15% / 20%.

Refer to Example 35, but assume that there is qualified dividend income of \$2,500 in addition to the items shown. The qualified dividend income is not netted against the net capital loss. The taxpayer has a \$1,000 capital loss deduction and \$2,500 of qualified dividend income taxed at 0% / 15% / 20%.

14-5c Alternative Tax on Net Capital Gain

Section 1 contains the statutory provisions that enable the *net capital gain* to be taxed at special rates (0, 15, 20, 25, and 28 percent). This calculation is referred to as the **alternative tax** on net capital gain.²⁷ The alternative tax applies only if taxable income includes some long-term capital gain (there is net capital gain). Taxable income includes *all* of the net capital gain unless taxable income is less than the net capital gain. In addition, the net capital gain is taxed *last*, after other taxable income (including any short-term capital gain).

²⁶ § 408(m) (2) and Reg. § 1.408-10(b).

²⁷ § 1(h). Note: Examples 40, 41, and 42 use the 2015 Tax Rate Schedules rather than the 2015 Tax Tables (which are not yet available) to calculate the tax on the non-long-term capital gain portion of taxable income. This

approach is used to better illustrate the concepts under discussion. The actual tax on the non-long-term portion of taxable income would be calculated using the Tax Tables because that income is less than \$100,000.

Joan, an unmarried taxpayer, has taxable income of \$108,000, including a \$12,000 net capital gain. The last \$12,000 of her \$108,000 taxable income is the layer related to the net capital gain. The first \$96,000 (\$108,000 – \$12,000) of her taxable income is not subject to any special tax rate, so it is taxed using the regular tax rates.

EXAMPLE

39

Because the net capital gain may be made up of various *rate layers*, it is important to know in what order those layers are taxed. (Review the five-step ordering procedure discussed on p. 14-20 and the examples that follow the discussion.) For *each* of the layers, the taxpayer compares the regular tax rate on that layer of income and the alternative tax rate on that portion of the net capital gain.

The layers are taxed in the following order:

- Any 25% gain,
- Any 28% gain,
- The 0 percent portion of the 0%/15%/20% gain,
- The 15 percent portion of the 0%/15%/20% gain, and then
- The 20 percent portion of the 0%/15%/20% gain.

As a result of this layering, the taxpayer benefits from the 0 percent portion of the net capital gain if the taxpayer is still in the 10 percent or 15 percent regular rate bracket after taxing other taxable income and the 25 percent and 28 percent portions of the net capital gain. The taxpayer benefits from the 15 percent portion of the net capital gain if the taxpayer is still in the 25 percent, 28 percent, 33 percent, or 35 percent regular rate bracket after taxing other taxable income and the 25 percent, 28 percent, and 0 percent portions of the net capital gain. The taxpayer benefits from the 20 percent portion of the net capital gain when taxable income reaches the 39.6 percent regular tax bracket.

Concept Summary 14.4 summarizes the alternative tax computation.



Concept Summary 14.4

Income Layers for Alternative Tax on Capital Gain Computation

Compute tax on:	Ordinary taxable income (including net short-term capital gain) using the regular tax rates.
Compute tax on:	Each of the layers below using the <i>lower</i> of the alternative tax rate or the regular tax rate for that layer (or portion of a layer) of taxable income.
+	25% long-term capital gain (unrecaptured § 1250 gain) portion of taxable income.
+	28% long-term capital gain.
+	0% long-term capital gain (portion of 0% / 15% / 20% capital gain that is taxed at 0%; available only if ordinary taxable income plus 25% and 28% capital gain layers do not put the taxpayer above the 15% bracket; 0% rate is no longer available once income, including the portion of the gain taxed at 0%, puts the taxpayer out of the 15% bracket).*
+	15% long-term capital gain (portion of 0% / 15% / 20% capital gain that is taxed at 15%; available only if ordinary taxable income plus the 25%, 28%, and 0% capital gain layers put the taxpayer above the 15% regular tax bracket and only until ordinary taxable income plus the 25%, 28%, 0%, and 15% capital gain layers put the taxpayer above the 35% regular tax bracket).*
+	20% long-term capital gain (portion of 0% / 15% / 20% capital gain that is taxed at 20%; available when ordinary taxable income plus the 25%, 28%, 0%, and 15% capital gain layers put the taxpayer above the 35% regular tax bracket).*
=	Alternative tax on taxable income

*May include qualified dividend income.

Alternative Tax on Net Capital Gain

EXAMPLE

40

Assume that Joan's \$12,000 net capital gain in Example 39 is made up of \$10,000 25% gain and \$2,000 0%/15%/20% gain. Examination of the 2015 tax rates reveals that \$96,000 of taxable income for a single individual puts Joan at a marginal tax rate of 28%. Consequently, she uses the alternative tax on both the \$10,000 gain and the \$2,000 gain.

Her alternative tax liability for 2015 is \$22,751 [\$19,951 (tax on \$96,000 of taxable income) + \$2,500 (\$10,000 × .25) + \$300 (\$2,000 × .15)]. Because the combination of the \$96,000 taxable income and her \$10,000 25% gain puts her above the 15% regular tax bracket, none of the \$2,000 0%/15%/20% gain is taxed at 0%.

Her regular tax liability on \$108,000 is \$23,311. Thus, Joan saves \$560 (\$23,311 – \$22,751) by using the alternative tax calculation. Because none of Joan's taxable income puts her in the 39.6% tax bracket, none of her 0%/15%/20% gain is taxed at the 20% alternative tax rate.

EXAMPLE

41

Assume that Joan, an unmarried taxpayer, has 2015 taxable income of \$25,000. Of this amount, \$12,000 is net capital gain and \$13,000 is other taxable income. The net capital gain is made up of \$8,300 of 25% gain and \$3,700 of 0%/15%/20% gain (including \$1,000 of qualified dividend income).

Her alternative tax liability for 2015 is \$2,734 [\$1,489 (tax on \$13,000 of taxable income) + \$1,245 (tax on \$8,300 25% gain at 15%) + \$0 (tax on \$3,700 0%/15%/20% gain at 0%)]. Because her marginal rate is still 15% after taxing the \$13,000 of other taxable income, she uses the 15% regular tax rate rather than the 25% alternative tax rate on the \$8,300 25% gain. After taxing the \$13,000 and the \$8,300, a total of \$21,300 of the \$25,000 taxable income has been taxed. Because her marginal rate is still 15%, she uses the 0% alternative rate for the \$3,700 of 0%/15%/20% gain. The \$1,000 qualified dividend income is included in the \$3,700 and, thus, is also taxed at 0%.

Joan's regular tax liability on \$25,000 is \$3,289. Thus, she saves \$555 (\$3,289 – \$2,734) by using the alternative tax calculation.

The alternative tax computation allows the taxpayer to receive the *lower* of the regular tax or the alternative tax on *each layer* of net capital gain or *portion of each layer* of net capital gain.

EXAMPLE

42

Assume the same facts as in Example 41, except that Joan's taxable income is \$40,000, consisting of \$12,000 of net capital gain and \$28,000 of other taxable income. Not all of the \$3,700 of 0%/15%/20% gain is taxed at 0% because Joan's taxable income exceeds \$37,450, taking her out of the 15% bracket. Consequently, the last \$2,550 (\$40,000 – \$37,450) of the \$3,700 of 0%/15%/20% gain is taxed at 15% rather than 0%.

Her tax liability using the alternative tax computation is \$5,367 (\$3,739 on \$28,000 of taxable income) + \$1,245 (tax on \$8,300 25% gain at 15%) + \$0 (tax on \$1,150 of 0%/15%/20% gain at 0%) + \$383 (tax on \$2,550 of 0%/15%/20% gain at 15%).

Joan's regular tax liability on \$40,000 is \$5,794. Thus, she saves \$427 (\$5,794 – \$5,367) by using the alternative tax calculation.

14-5d **Treatment of Net Capital Losses****Computation of Net Capital Loss**

A **net capital loss (NCL)** results if capital losses exceed capital gains for the year. An NCL may be all long term, all short term, or part long and part short term.²⁸ The characterization of an NCL as long or short term is important in determining the capital loss deduction (discussed next).

²⁸Section 1222(10) defines a net capital loss as the net loss after the capital loss deduction. However, that definition confuses the discussion of net capital loss. Therefore, net capital loss is used here to mean the result after

netting capital gains and losses and before considering the capital loss deduction. The capital loss deduction is discussed later in this section.



TAX IN THE NEWS Losses from Day Trading

Many investors were caught up with “rising market frenzy” during 2014. One such investor made 15,000 trades during the year. No stock was held more than one year, so each transaction resulted in a short-term capital gain or loss. Each trade had to be documented as to the basis for the stock sold, its holding period, and the selling price net of the sales commission. Unfortunately, there was a \$75,000 net short-term capital loss after all transactions were

accounted for. Only \$3,000 of this loss was deductible in 2014 because the investor had no long-term capital gains to offset the loss and there is an annual \$3,000 capital loss deduction limit. The \$72,000 balance of the loss carried forward could be deducted against capital gains of later years. However, the investor had no capital left to invest. Consequently, his annual loss deduction will be limited to \$3,000 for many years to come.

Three different individual taxpayers have the following capital gains and losses during the year:

Taxpayer	LTCG	LTCL	STCG	STCL	Result of Netting	Description of Result
Robert	\$1,000	(\$2,800)	\$1,000	(\$ 500)	(\$1,300)	NLTCL
Carlos	1,000	(500)	1,000	(2,800)	(1,300)	NSTCL
Troy	400	(1,200)	500	(1,200)	(1,500)	NLTCL (\$800) NSTCL (\$700)

Robert’s NCL of \$1,300 is all long term. Carlos’s NCL of \$1,300 is all short term. Troy’s NCL is \$1,500, \$800 of which is long term and \$700 of which is short term.

EXAMPLE

43

Capital Loss Deduction

An NCL is deductible from gross income to the extent of \$3,000 per tax year.²⁹ Although there may or may not be beneficial treatment for capital gains, there is *unfavorable* treatment for capital losses in terms of the \$3,000 annual limitation on deducting NCL against ordinary income. If the NCL includes both long-term and short-term capital loss, the short-term capital loss is counted first toward the \$3,000 annual limitation.

Burt has an NCL of \$5,500, of which \$2,000 is STCL and \$3,500 is LTCL. Burt has a capital loss deduction of \$3,000 (\$2,000 of STCL and \$1,000 of LTCL). He has an LTCL carryforward of \$2,500 (\$3,500 – \$1,000).

EXAMPLE

44

Carryovers

Taxpayers are allowed to carry over unused capital losses indefinitely. The short-term capital loss (STCL) retains its character as STCL. Likewise, the long-term capital loss retains its character as LTCL.

In 2015, Mark incurred \$1,000 of STCL and \$11,000 of LTCL. In 2016, Mark has a \$400 LTCG.

- Mark’s NCL for 2015 is \$12,000. Mark deducts \$3,000 (\$1,000 STCL and \$2,000 LTCL). He has \$9,000 of LTCL carried forward to 2016.
- Mark combines the \$9,000 LTCL carryforward with the \$400 LTCG for 2016. He has an \$8,600 NLTCL for 2016. Mark deducts \$3,000 of LTCL in 2016 and carries forward \$5,600 of LTCL to 2017.

EXAMPLE

45

When a taxpayer has both a capital loss deduction and negative taxable income, a special computation of the capital loss carryover is required.³⁰ Specifically, the capital loss carryover is the NCL minus the lesser of:

- The capital loss deduction claimed on the return.
- The negative taxable income increased by the capital loss deduction claimed on the return and the personal and dependency exemption deduction.

²⁹§ 1211(b)(1). Married taxpayers filing separate returns are limited to a \$1,500 deduction per tax year. ³⁰§ 1212(b).

Without this provision, some of the tax benefit of the capital loss deduction would be wasted when the deduction drives taxable income below zero. However, the capital loss deduction is not reduced if taxable income before the exemption deduction is a positive number or zero. In that situation, it is the exemption deduction, and not the capital loss deduction, that is creating the negative taxable income.

EXAMPLE

46

In 2015, Joanne has a \$13,000 NCL (all long term), a \$4,000 personal exemption deduction, and \$6,000 negative taxable income. The negative taxable income includes a \$3,000 capital loss deduction. The capital loss carryover to 2016 is \$12,000 computed as follows:

- The \$6,000 negative taxable income is treated as a negative number, but the capital loss deduction and exemption deduction are treated as positive numbers.
- The normal ceiling on the capital loss deduction is \$3,000.
- However, if the \$3,000 capital loss deduction and the \$4,000 exemption deduction are added back to the \$6,000 negative taxable income, only \$1,000 ($\$3,000 + \$4,000 - \$6,000$) of the \$3,000 capital loss deduction is needed to make taxable income equal to zero.
- Therefore, this special computation results in only \$1,000 of the \$13,000 NCL being consumed. The LTCL carryforward is \$12,000 ($\$13,000 - \$1,000$).

Concept Summary 14.5 summarizes the rules for noncorporate taxpayers' treatment of capital gains and losses.

Concept Summary 14.5

Some Possible Final Results of the Capital Gain and Loss Netting Process and How They Are Taxed

Result	Maximum Tax Rate	Comments
Net short-term capital loss	—	Eligible for capital loss deduction (\$3,000 maximum per year).
Net long-term capital loss	—	Eligible for capital loss deduction (\$3,000 maximum per year).
Net short-term capital loss <i>and</i> net long-term capital loss	—	Eligible for capital loss deduction (\$3,000 maximum per year). Short-term capital losses are counted first toward the deduction.
Net short-term capital gain	10%–39.6%	Taxed as ordinary income.
Net long-term capital gain	0%–28%	The net long-term capital gain may have as many as five tax rate components: 25%, 28%, and 0% / 15% / 20%.
<ul style="list-style-type: none"> • The net long-term capital gain is the <i>last</i> portion of taxable income. 		The components are taxed in the following order: 25%, 28%, 0%, 15%, 20%. They are taxed <i>after</i> the non-long-term capital gain portion of taxable income has been taxed. The 0% / 15% / 20% component may include qualified dividend income.
<ul style="list-style-type: none"> • Each net long-term capital gain component of taxable income is taxed at the <i>lower</i> of the regular tax on that component or the alternative tax. 		The alternative tax on net long-term capital gain can never increase the tax on taxable income, but it can reduce the tax on taxable income.
Net short-term capital gain <i>and</i> net long-term capital gain	10%–39.6% on net short-term capital gain; 0%–28% on net long-term capital gain	The net short-term capital gain is taxed as ordinary income; the net long-term capital gain is taxed as discussed above for just net long-term capital gain.

14-6 TAX TREATMENT OF CAPITAL GAINS AND LOSSES OF CORPORATE TAXPAYERS

The treatment of a corporation's net capital gain or loss differs from the rules for individuals. Briefly, the differences are as follows:

- There is an NCG alternative tax rate of 35 percent.³¹ However, because the maximum corporate tax rate is 35 percent, the alternative tax is not beneficial.
- Capital losses offset only capital gains. No deduction of capital losses is permitted against ordinary taxable income (whereas a \$3,000 deduction is allowed to individuals).³²
- Corporations may carry back net capital losses (whether long term or short term) as short-term capital losses for three years; if losses still remain after the carryback, the remaining losses may be carried forward five years.³³ Individuals may carry forward unused capital losses indefinitely, but there is no carryback.

Sparrow Corporation has a \$15,000 NLTCL for the current year and \$57,000 of ordinary taxable income. Sparrow may not offset the \$15,000 NLTCL against its ordinary income by taking a capital loss deduction. The \$15,000 NLTCL becomes a \$15,000 STCL for carryback and carryover purposes. This amount may be offset against capital gains in the three-year carryback period or, if not absorbed there, offset capital gains in the five-year carryforward period.

LO.6

Describe the tax treatment for capital gains and the detrimental tax treatment for capital losses for corporate taxpayers.

EXAMPLE

47

14-7 OVERVIEW OF § 1231 AND THE RECAPTURE PROVISIONS

Generic Manufacturing LLC (a limited liability company) sold machinery, office furniture, and unneeded production plants for \$100 million last year. The company's disposition of these assets resulted in \$60 million of gains and \$13 million of losses. How are these gains and losses treated for tax purposes? Do any special tax rules apply? Could any of the gains and losses receive capital gain or loss treatment? The remainder of this chapter answers these questions by explaining how to *classify* gains and losses from the disposition of assets that are used in the business rather than held for resale. Chapter 8 discussed how to *depreciate* such assets. Chapter 13 discussed how to determine the *adjusted basis* and the *amount* of gain or loss from their disposition.

A long-term capital gain was defined earlier in this chapter as the recognized gain from the sale or exchange of a capital asset held for the required long-term holding period.³⁴ Long-term capital assets are capital assets held more than one year.

The remainder of this chapter is concerned with classification under § 1231, which applies to the sale or exchange of business properties and to certain involuntary conversions. Section 1221(a)(2) provides that such properties are not capital assets because they are depreciable and/or real property used in business or for the production of income. Nonetheless, these business properties may be held for long periods of time and may be sold at a gain.

Congress decided many years ago that such assets deserved limited capital gain-type treatment, which sometimes gives too much tax advantage when assets are eligible for depreciation (or cost recovery). Thus, certain recapture rules may prevent the capital gain treatment when depreciation is taken. This chapter also covers the recapture provisions that tax as ordinary income certain gains that might otherwise qualify for long-term capital gain treatment.

³¹§ 1201.

³²§ 1211(a).

³³§ 1212(a)(1).

³⁴§ 1222(3). To be eligible for any beneficial tax treatment, the holding period must be more than one year.

LO.7

State and explain the rationale for and the nature and treatment of gains and losses from the disposition of business assets.

14-8 SECTION 1231 ASSETS

14-8a Relationship to Capital Assets

Because depreciable property and real property used in business are not capital assets, the recognized gains from the disposition of this property would appear to be ordinary income rather than capital gain.³⁵ Due to § 1231, however, *net gain* from the disposition of this property is sometimes *treated as long-term capital gain*. A long-term holding period requirement must be met; the disposition must generally be from a sale, exchange, or involuntary conversion; and certain recapture provisions must be satisfied for this result to occur. Section 1231 may also apply to involuntary conversions of capital assets even though such a disposition, which is not a sale or exchange, normally would not result in a capital gain.

If the disposition of depreciable property and real property used in business results in a *net loss*, § 1231 *treats the loss as an ordinary loss* rather than as a capital loss. Ordinary losses are fully deductible for adjusted gross income (AGI). Capital losses offset capital gains, and if any loss remains, the loss is deductible to the extent of \$3,000 per year for individuals and currently is not deductible at all by regular corporations. It seems, therefore, that § 1231 provides the *best* of both potential results: Net gain may be treated as long-term capital gain, and net loss is treated as ordinary loss.

Section 1231 Treatment

EXAMPLE

48

Roberto sells a building at a \$5,000 gain and equipment at a \$3,000 loss. Both properties were § 1231 assets because they were used in Roberto's trade or business and held for the long-term holding period.

Roberto's net gain is \$2,000, and that net gain may (depending on various recapture rules discussed later in this chapter) be treated as a long-term capital gain under § 1231.

EXAMPLE

49

Samantha sells business equipment at a \$10,000 loss and business land at a \$2,000 gain.

Both properties were held for the long-term holding period and, therefore, are § 1231 assets. Samantha's net loss is \$8,000, and that net § 1231 loss is an ordinary loss.

The rules regarding § 1231 treatment do *not* apply to *all* business property. Important in this regard are the holding period requirements and the fact that the property must be either depreciable property or real estate used in business. Nor is § 1231 necessarily limited to business property. Transactions involving certain capital assets may fall into the § 1231 category. Thus, § 1231 singles out only some types of business property.

As discussed earlier in this chapter, long-term capital gains receive beneficial tax treatment. Section 1231 requires netting of **§ 1231 gains and losses**. If the result is a gain, it may be treated as a long-term capital gain. The net gain is added to the "real" long-term capital gains (if any) and netted with capital losses (if any). Thus, the net § 1231 gain may eventually be eligible for beneficial capital gain treatment or help avoid the unfavorable net capital loss result. As noted earlier, if the § 1231 gain and loss netting results in a loss, it is an ordinary loss. Finally, § 1231 assets are treated the same as capital assets for purposes of the appreciated property charitable contribution provisions (refer to Chapter 10).

14-8b Justification for Favorable Tax Treatment

The favorable capital gain/ordinary loss treatment sanctioned by § 1231 can be explained by examining several historical developments. Before 1938, business property had been included in the definition of capital assets. Thus, if such property was sold for a loss (not an unlikely possibility during the depression years of the 1930s), a capital loss resulted. If, however, the property was depreciable and could be retained for its estimated useful life, much (if not all) of its costs could be recovered in the form of depreciation. Because the allowance for depreciation was fully deductible whereas

³⁵§ 1221(a)(2).

capital losses were not, the tax law favored those who did not dispose of an asset. Congress recognized this inequity when it removed business property from the capital asset classification. During the period 1938–1942, therefore, all such gains and losses were ordinary gains and losses.

With the advent of World War II, two developments in particular forced Congress to reexamine the situation regarding business assets. First, the sale of business assets at a gain was discouraged because the gain would be ordinary income. Gains were common because the war effort had inflated prices. Second, taxpayers who did not want to sell their assets often were required to because the government acquired them through condemnation. Often, as a result of the condemnation awards, taxpayers who were forced to part with their property experienced large gains and were deprived of the benefits of future depreciation deductions. Of course, the condemnations constituted involuntary conversions, so taxpayers could defer the gain by timely reinvestment in property that was “similar or related in service or use.” But where was such property to be found in view of wartime restrictions and other governmental condemnations? The end result did not seem equitable: a large ordinary gain due to government action and no possibility of deferral due to government restrictions.

In recognition of these conditions, in 1942, Congress eased the tax bite on the disposition of some business property by allowing preferential capital gain treatment. Thus, the present scheme of § 1231 and the dichotomy of capital gain/ordinary loss treatment evolved from a combination of economic considerations existing in 1938 and 1942.

14-8c **Property Included**

Section 1231 property generally includes the following assets if they are held for more than one year:

- Depreciable or real property used in business or for the production of income (principally machinery and equipment, buildings, and land).
- Timber, coal, or domestic iron ore to which § 631 applies.
- Livestock held for draft, breeding, dairy, or sporting purposes.
- Unharvested crops on land used in business.
- Certain *purchased* intangible assets (such as patents and goodwill) that are eligible for amortization.

These assets are ordinary assets until they have been held for more than one year. Only then do they become § 1231 assets.

14-8d **Property Excluded**

Section 1231 property generally does *not* include the following:

- Property not held for the long-term holding period. Because the benefit of § 1231 is long-term capital gain treatment, the holding period must correspond to the more-than-one-year holding period that applies to capital assets. Livestock must be held at least 12 months (24 months in some cases).³⁶ Unharvested crops do not have to be held for the required long-term holding period, but the land must be held for the long-term holding period.
- Nonpersonal use property where casualty losses exceed casualty gains for the taxable year. If a taxpayer has a net casualty loss, the individual casualty gains and losses are treated as ordinary gains and losses.
- Inventory and property held primarily for sale to customers.
- Copyrights; literary, musical, or artistic compositions, etc.; and certain U.S. government publications.
- Accounts receivable and notes receivable arising in the ordinary course of the trade or business.

LO.8

Distinguish § 1231 assets from ordinary assets and capital assets and calculate the § 1231 gain or loss.

³⁶Note that the holding period is “12 months or more” and not “more than 12 months.”

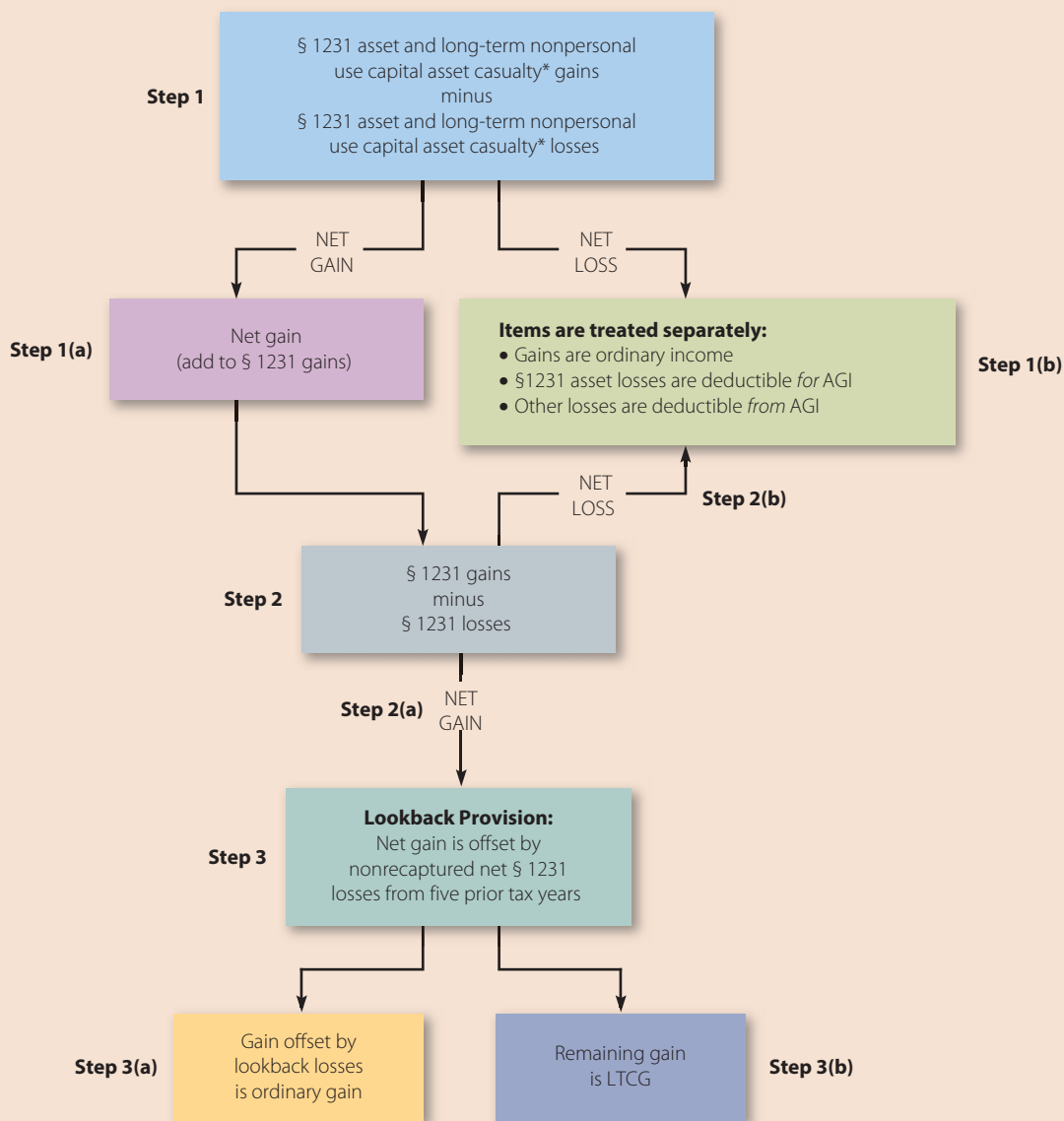
14-8e **Section 1231 Assets Disposed of by Casualty or Theft**

When § 1231 assets are disposed of by casualty or theft, a special netting rule is applied. For simplicity, the term *casualty* is used to mean both casualty and theft dispositions. First, the casualty gains and losses from § 1231 assets *and* the casualty gains and losses from **long-term nonpersonal use capital assets** are determined. A nonpersonal use capital asset might be art held as an investment or a baseball card collection held by a nondealer.

Next, the § 1231 asset casualty gains and losses and the nonpersonal use capital asset casualty gains and losses are netted together (see Concept Summary 14.6). If the result is a *net loss*, the § 1231 casualty gains and the nonpersonal use capital asset casualty gains are treated as ordinary gains, the § 1231 casualty losses are deductible *for* AGI, and the nonpersonal use capital asset casualty losses are deductible *from* AGI subject to the 2 percent-of-AGI limitation.

Concept Summary 14.6

Section 1231 Netting Procedure (Discussed in Section 14-8f)



*Includes casualties and thefts.

If the result of the netting is a *net gain*, the net gain is treated as a § 1231 gain. Thus, a § 1231 asset disposed of by casualty may or may not get § 1231 treatment, depending on whether the netting process results in a gain or a loss. Also, a nonpersonal use capital asset disposed of by casualty may get § 1231 treatment or ordinary treatment, but will not get capital gain or loss treatment.

Personal use property casualty gains and losses are not subject to the § 1231 rules. If the result of netting these gains and losses is a gain, the net gain is a capital gain. If the netting results in a loss, the net loss is a deduction *from* AGI to the extent it exceeds 10 percent of AGI.

Casualties, thefts, and condemnations are *involuntary conversions*. Involuntary conversion gains may be deferred if conversion proceeds are reinvested; involuntary conversion losses are recognized currently (refer to Chapter 13) regardless of whether the conversion proceeds are reinvested. Thus, the special netting process discussed previously for casualties and thefts would not include gains that are not currently recognizable because the insurance proceeds are reinvested.

The special netting process for casualties and thefts also does not include condemnation gains and losses. Consequently, a § 1231 asset disposed of by condemnation will receive § 1231 treatment. This variation between recognized casualty and condemnation gains and losses sheds considerable light on what § 1231 is all about. Section 1231 has no effect on whether *realized* gain or loss is recognized. Instead, § 1231 merely dictates how such *recognized* gain or loss is *classified* (ordinary, capital, or § 1231) under certain conditions.

Personal use property condemnation gains and losses are not subject to the § 1231 rules. The gains are capital gains (because personal use property is a capital asset), and the losses are nondeductible because they arise from the disposition of personal use property.

14-8f **General Procedure for § 1231 Computation**

The tax treatment of § 1231 gains and losses depends on the results of a rather complex *netting* procedure. The steps in this netting procedure are as follows.

Step 1: Casualty Netting

Net all recognized long-term gains and losses from casualties of § 1231 assets and nonpersonal use capital assets. Casualty gains result when insurance proceeds exceed the adjusted basis of the property. This casualty netting is beneficial because if there is a net gain, the gain may receive long-term capital gain treatment. If there is a net loss, it receives ordinary loss treatment.

- a. If the casualty gains exceed the casualty losses, add the excess to the other § 1231 gains for the taxable year.
- b. If the casualty losses exceed the casualty gains, exclude all casualty losses and gains from further § 1231 computation. If this is the case, all casualty gains are ordinary income. Section 1231 asset casualty losses are deductible *for* AGI. Other casualty losses are deductible *from* AGI.

Step 2: § 1231 Netting

After adding any net casualty gain from step 1a to the other § 1231 gains and losses (including recognized § 1231 asset condemnation gains and losses), net all § 1231 gains and losses.

- a. If the gains exceed the losses, the net gain is offset by the “lookback” nonrecaptured §1231 losses (see step 3).
- b. If the losses exceed the gains, all gains are ordinary income. Section 1231 asset losses are deductible *for* AGI. Other casualty losses are deductible *from* AGI.

Step 3: § 1231 Lookback Provision

The net § 1231 gain from step 2a is offset by the nonrecaptured net § 1231 losses for the five preceding taxable years (the **§ 1231 lookback** provision). For 2015, the lookback years are 2010, 2011, 2012, 2013, and 2014.

- To the extent of the nonrecaptured net § 1231 loss, the current-year net § 1231 gain is ordinary income. The *nonrecaptured* net § 1231 losses are those that have not already been used to offset net § 1231 gains.
- Only the net § 1231 gain exceeding this net § 1231 loss carryforward is given long-term capital gain treatment.

Concept Summary 14.6 summarizes the § 1231 computational procedure. Examples 50 through 53 illustrate the application of the § 1231 computation procedure. Examples 52 and 53 illustrate the § 1231 lookback provision.

Section 1231 Computations

EXAMPLE

50

During 2015, Ross had \$125,000 of AGI before considering the following recognized gains and losses:

Capital Gains and Losses

Long-term capital gain	\$3,000
Long-term capital loss	(400)
Short-term capital gain	1,000
Short-term capital loss	(200)

Casualties

Theft of diamond ring (owned four months)	(\$ 800)*
Fire damage to personal residence (owned 10 years)	(400)*
Gain from insurance recovery on fire loss to business building (owned two years)	200

§ 1231 Gains and Losses from Sale of Depreciable Business Assets Held Long Term

Asset A	\$ 300
Asset B	1,100
Asset C	(500)

Gains and Losses from Sale of Depreciable Business Assets Held Short Term

Asset D	\$ 200
Asset E	(300)

*As adjusted for the \$100 floor on personal casualty losses.

Ross had no net § 1231 losses in tax years before 2015.

Disregarding the recapture of depreciation (discussed later in the chapter), Ross's gains and losses receive the following tax treatment:

- The diamond ring and the residence are personal use assets. Therefore, these casualties are not § 1231 transactions. The \$800 (ring) plus \$400 (residence) losses are potentially deductible from AGI. However, the total loss of \$1,200 does not exceed 10% of AGI.
- Step 1:** Only the business building (a § 1231 asset) casualty gain remains. The netting of the § 1231 asset and nonpersonal use capital asset casualty gains and losses contains only one item—the \$200 gain from the business building. Consequently, there is a net gain, and that gain is treated as a § 1231 gain (and added to the § 1231 gains).

continued

- **Step 1(a):** The gains from § 1231 transactions (Assets A and B and the § 1231 asset casualty gain) exceed the losses (Asset C) by \$1,100 (\$1,600 – \$500). This excess is a long-term capital gain and is added to Ross's other long-term capital gains.
- **Step 2:** Ross's net long-term capital gain is \$3,700 (\$3,000 + \$1,100 from § 1231 transactions – \$400 long-term capital loss). Ross's net short-term capital gain is \$800 (\$1,000 – \$200). The result is capital gain net income of \$4,500. The \$3,700 net long-term capital gain portion is eligible for beneficial capital gain treatment [assume that all of the gain is 0%/15%/20% gain (see the discussion earlier in this chapter)]. The \$800 net short-term capital gain is subject to tax as ordinary income.³⁷
- Ross treats the gain and loss from Assets D and E (depreciable business assets held for less than the long-term holding period) as ordinary gain and loss.

Results of the Gains and Losses on Ross's Tax Computation

NLTCG	\$ 3,700
NSTCG	800
Ordinary gain from sale of Asset D	200
Ordinary loss from sale of Asset E	(300)
AGI from other sources	<u>125,000</u>
AGI	<u><u>\$129,400</u></u>

- Ross will have personal use property casualty losses of \$1,200 [\$800 (diamond ring) + \$400 (personal residence)]. A personal use property casualty loss is deductible only to the extent it exceeds 10% of AGI. Thus, none of the \$1,200 is deductible (\$129,400 × 10% = \$12,940).

Assume the same facts as in Example 50, except that the loss from Asset C was \$1,700 instead of \$500.

- The treatment of the casualty losses is the same as in Example 50.
- **Step 1(b):** The losses from § 1231 transactions now exceed the gains by \$100 (\$1,700 – \$1,600). As a result, the gains from Assets A and B and the § 1231 asset casualty gain are ordinary income, and the loss from Asset C is a deduction *for* AGI (a business loss). The same result can be achieved by simply treating the \$100 net loss as a deduction *for* AGI.
- Capital gain net income is \$3,400 (\$2,600 long term + \$800 short term). The \$2,600 net long-term capital gain portion is eligible for beneficial capital gain treatment, and the \$800 net short-term capital gain is subject to tax as ordinary income.

Results of the Gains and Losses on Ross's Tax Computation

NLTCG	\$ 2,600
NSTCG	800
Net ordinary loss on Assets A, B, and C and § 1231 casualty gain	(100)
Ordinary gain from sale of Asset D	200
Ordinary loss from sale of Asset E	(300)
AGI from other sources	<u>125,000</u>
AGI	<u><u>\$128,200</u></u>

- None of the personal use property casualty losses will be deductible because \$1,200 does not exceed 10% of \$128,200.

EXAMPLE**51**

³⁷Ross's taxable income (unless his itemized deductions and his personal and dependency exemptions are extremely large) will put him in at least

the 28% bracket. Thus, the alternative tax computation will yield a lower tax. See Example 40.

Section 1231 Computations

EXAMPLE

52

Assume the same facts as in Example 50, except that Ross has a \$700 nonrecaptured net § 1231 loss from 2014.

- The treatment of the casualty losses is the same as in Example 50.
- **Step 3(a):** The 2015 net § 1231 gain of \$1,100 is treated as ordinary income to the extent of the 2014 nonrecaptured § 1231 loss of \$700.
- **Step 3(b):** The remaining \$400 net § 1231 gain is a long-term capital gain and is added to Ross's other long-term capital gains.
- Ross's net long-term capital gain is \$3,000 (\$3,000 + \$400 from § 1231 transactions – \$400 long-term capital loss). Ross's net short-term capital gain is still \$800 (\$1,000 – \$200). The result is capital gain net income of \$3,800. The \$3,000 net long-term capital gain portion is eligible for beneficial capital gain treatment, and the \$800 net short-term capital gain is subject to tax as ordinary income.

Results of the Gains and Losses on Ross's Tax Computation

NLTCG	\$ 3,000
NSTCG	800
Ordinary gain from recapture of § 1231 losses	700
Ordinary gain from sale of Asset D	200
Ordinary loss from sale of Asset E	(300)
AGI from other sources	<u>125,000</u>
AGI	<u><u>\$129,400</u></u>

- None of the personal use property casualty losses will be deductible because \$1,200 does not exceed 10% of \$129,400.

EXAMPLE

53

Assume the same facts as in Example 50, except that Ross had a net § 1231 loss of \$2,700 in 2013 and a net § 1231 gain of \$300 in 2014.

- The treatment of the casualty losses is the same as in Example 50.
- **Step 3(a):** The 2013 net § 1231 loss of \$2,700 will have carried over to 2014 and been offset against the 2014 net § 1231 gain of \$300. Thus, the \$300 gain will have been classified as ordinary income, and \$2,400 of nonrecaptured 2013 net § 1231 loss will carry over to 2015. The 2015 net § 1231 gain of \$1,100 will be offset against this loss, resulting in \$1,100 of ordinary income. The nonrecaptured net § 1231 loss of \$1,300 (\$2,400 – \$1,100) carries over to 2016.
- Capital gain net income is \$3,400 (\$2,600 net long-term capital gain + \$800 net short-term capital gain). The \$2,600 net long-term capital gain portion is eligible for beneficial capital gain treatment, and the \$800 net short-term capital gain is subject to tax as ordinary income.

Results of the Gains and Losses on Ross's Tax Computation

NLTCG	\$ 2,600
NSTCG	800
Ordinary gain from recapture of § 1231 losses	1,100
Ordinary gain from sale of Asset D	200
Ordinary loss from sale of Asset E	(300)
AGI from other sources	<u>125,000</u>
AGI	<u><u>\$129,400</u></u>

- None of the personal use property casualty losses will be deductible because \$1,200 does not exceed 10% of \$129,400.

14-9 SECTION 1245 RECAPTURE

Now that the basic rules of § 1231 have been introduced, it is time to add some complications. The Code contains two major *recapture* provisions—§§ 1245 and 1250. These provisions cause *gain* to be treated *initially* as ordinary gain. Thus, what may appear to be a § 1231 gain is ordinary gain instead. These recapture provisions may also cause a gain in a nonpersonal use casualty to be *initially* ordinary gain rather than casualty gain. Classifying gains (and losses) properly initially is important because improper initial classification may lead to incorrect mixing and matching of gains and losses. This section discusses the § 1245 recapture rules, and the next section discusses the § 1250 recapture rules.

Section 1245 requires taxpayers to treat all gain as ordinary gain unless the property is disposed of for more than its original cost. This result is accomplished by requiring that all gain be treated as ordinary gain to the extent of the depreciation taken on the property disposed of. The excess of the sales price over the original cost is § 1231 gain. Section 1245 applies *primarily* to non-real-estate property such as machinery, trucks, and office furniture. Section 1245 does not apply if property is disposed of at a loss. Generally, the loss will be a § 1231 loss unless the form of the disposition is a casualty.

Alice purchased a \$100,000 business machine and deducted \$70,000 depreciation before selling it for \$80,000. If it were not for § 1245, the \$50,000 gain would be § 1231 gain (\$80,000 amount realized – \$30,000 adjusted basis). Section 1245 prevents this potentially favorable result by treating as ordinary income (not as § 1231 gain) any gain to the extent of depreciation taken. In this example, the entire \$50,000 gain would be ordinary income.

If Alice had sold the machine for \$120,000, she would have a gain of \$90,000 (\$120,000 amount realized – \$30,000 adjusted basis). The § 1245 gain would be \$70,000 (equal to the depreciation taken), and the § 1231 gain would be \$20,000 (equal to the excess of the sales price over the original cost).

Section 1245 recapture provides, in general, that the portion of recognized gain from the sale or other disposition of § 1245 property that represents depreciation [including § 167 depreciation, § 168 cost recovery, § 179 immediate expensing, § 168(k) additional first-year depreciation, and § 197 amortization] is *recaptured* as ordinary income. Thus, in Example 54, \$50,000 of the \$70,000 depreciation taken is recaptured as ordinary income when the business equipment is sold for \$80,000. Only \$50,000 is recaptured rather than \$70,000 because Alice is only required to recognize § 1245 recapture ordinary gain equal to the *lower* of the depreciation taken or the gain recognized.

The method of depreciation (e.g., accelerated or straight-line) does not matter. All depreciation taken is potentially subject to recapture. Thus, § 1245 recapture is often referred to as *full recapture*. Any remaining gain after subtracting the amount recaptured as ordinary income will usually be § 1231 gain. If the property is disposed of in a casualty event, however, the remaining gain will be casualty gain. If the business machine in Example 54 had been disposed of by casualty and the \$80,000 received had been an insurance recovery, Alice would still have a gain of \$50,000, and the gain would still be recaptured by § 1245 as ordinary gain. The § 1245 recapture rules apply before there is any casualty gain. Because all the \$50,000 gain is recaptured, no casualty gain arises from the casualty.

The following examples illustrate the general application of § 1245.

LO.9

Determine when § 1245 recapture applies and how it is computed.

EXAMPLE

54

Section 1245 Recapture Computations

In the current year, Gary sold for \$13,000 a machine acquired several years ago for \$12,000. He had taken \$10,000 of depreciation on the machine.

- The recognized gain from the sale is \$11,000. This is the amount realized of \$13,000 less the adjusted basis of \$2,000 (\$12,000 cost – \$10,000 depreciation taken).
- Depreciation taken is \$10,000. Therefore, because § 1245 recapture gain is the lower of depreciation taken or gain recognized, \$10,000 of the \$11,000 recognized gain is ordinary income, and the remaining \$1,000 gain is § 1231 gain.
- The § 1231 gain of \$1,000 is also equal to the excess of the sales price over the original cost of the property (\$13,000 – \$12,000 = \$1,000 § 1231 gain).

EXAMPLE

55

Section 1245 Recapture Computations

EXAMPLE

56

Assume the same facts as in the previous example, except that the asset is sold for \$9,000 instead of \$13,000.

- The recognized gain from the sale is \$7,000. This is the amount realized of \$9,000 less the adjusted basis of \$2,000.
- Depreciation taken is \$10,000. Therefore, because the \$10,000 depreciation taken exceeds the recognized gain of \$7,000, the entire \$7,000 recognized gain is ordinary income.
- The § 1231 gain is zero. There is no § 1231 gain because the selling price (\$9,000) does not exceed the original purchase price (\$12,000).

EXAMPLE

57

Assume the same facts as in Example 55, except that the asset is sold for \$1,500 instead of \$13,000.

- The recognized loss from the sale is \$500. This is the amount realized of \$1,500 less the adjusted basis of \$2,000.
- Because there is a loss, there is no depreciation recapture. All of the loss is § 1231 loss.

If § 1245 property is disposed of in a transaction other than a sale, exchange, or involuntary conversion, the maximum amount recaptured is the excess of the property's fair market value over its adjusted basis. See the discussion under Considerations Common to §§ 1245 and 1250 later in the chapter.

14-9a Section 1245 Property

Generally, **§ 1245 property** includes all depreciable personal property (e.g., machinery and equipment), including livestock. Buildings and their structural components generally are not § 1245 property. The following property is *also* subject to § 1245 treatment:

- Amortizable personal property such as goodwill, patents, copyrights, and leaseholds of § 1245 property. Professional baseball and football player contracts are § 1245 property.
- Amortizable reforestation expenditures.
- Expensed costs to remove architectural and transportation barriers that restrict the handicapped and/or elderly.
- Immediately expensed depreciable tangible personal property costs under § 179.
- Elevators and escalators acquired before January 1, 1987.
- Certain depreciable tangible real property (other than buildings and their structural components) employed as an integral part of certain activities such as manufacturing and production. For example, a natural gas storage tank where the gas is used in the manufacturing process is § 1245 property.
- Pollution control facilities, railroad grading and tunnel bores, on-the-job training, and child care facilities on which amortization is taken.
- Single-purpose agricultural and horticultural structures and petroleum storage facilities (e.g., a greenhouse or silo).
- Fifteen-year, 18-year, and 19-year nonresidential real estate for which accelerated cost recovery is used is subject to the § 1245 recapture rules, although it is technically not § 1245 property. Such property would have been placed in service after 1980 and before 1987.

James acquired nonresidential real property on December 1, 1986, for \$100,000. He used the statutory percentage method to compute the ACRS cost recovery. He sells the asset on January 15, 2015, for \$120,000. The amount and nature of James's gain are computed as follows:

Amount realized		\$120,000
Adjusted basis		
Cost	\$ 100,000	
Less cost recovery: 1986–2009	(100,000)	
2010–2015	<u>(–0–)</u>	
January 15, 2015 adjusted basis		<u>(–0–)</u>
Gain realized and recognized		<u>\$120,000</u>

The gain of \$120,000 is treated as ordinary income to the extent of *all* depreciation taken because the property is 19-year nonresidential real estate for which accelerated depreciation was used. Thus, James reports ordinary income of \$100,000 and § 1231 gain of \$20,000 (\$120,000 – \$100,000).

EXAMPLE

58

14-9b Observations on § 1245

- In most instances, the total depreciation taken will exceed the recognized gain. Therefore, the disposition of § 1245 property usually results in ordinary income rather than § 1231 gain. Thus, generally, no § 1231 gain will occur unless the § 1245 property is disposed of for more than its original cost. Refer to Examples 55 and 56.
- Recapture applies to the total amount of depreciation allowed or allowable regardless of the depreciation method used.
- Recapture applies regardless of the holding period of the property. Of course, the entire recognized gain would be ordinary income if the property were held for less than the long-term holding period because § 1231 would not apply.
- Section 1245 does not apply to losses, which receive § 1231 treatment.
- Gains from the disposition of § 1245 assets may also be treated as passive activity gains (see Chapter 11).

14-10 SECTION 1250 RECAPTURE

Generally, **§ 1250 property** is depreciable real property (principally buildings and their structural components) that is not subject to § 1245.³⁸ Intangible real property, such as leaseholds of § 1250 property, is also included.

Section 1250 recapture rarely applies because only the amount of *additional depreciation* is subject to recapture. To have additional depreciation, accelerated depreciation must have been taken on the asset. Straight-line depreciation is not recaptured (except for property held one year or less). Because depreciable real property placed in service after 1986 can generally only be depreciated using the straight-line method, there will usually be *no § 1250 depreciation recapture* on such property. Nor does § 1250 apply if the real property is sold at a loss.

It is important to know what assets are defined as § 1250 property because even when there is no additional depreciation, the gain from such property may be subject to a special 25 percent tax rate. See the discussion of Unrecaptured § 1250 Gain (Real Estate 25% Gain), which follows.

LO.10

Determine when § 1250 recapture applies.

³⁸As noted previously, in one limited circumstance, § 1245 does apply to non-residential real estate. If the nonresidential real estate was placed in service

after 1980 and before 1987 and accelerated depreciation was used, the § 1245 recapture rules rather than the § 1250 recapture rules apply.

EXAMPLE

59

Sanjay acquires a residential rental building on January 1, 2014, for \$300,000. He receives an offer of \$450,000 for the building in 2015 and sells it on December 23, 2015.

- Sanjay takes \$20,909 $\{(\$300,000 \times .03485) + [\$300,000 \times .03636 \times (11.5/12)] = \$20,909\}$ of total depreciation for 2014 and 2015, and the adjusted basis of the property is \$279,091 $(\$300,000 - \$20,909)$.
- Sanjay's recognized gain is \$170,909 $(\$450,000 - \$279,091)$.
- All of the gain is § 1231 gain.

14-10a **Section 1250 Recapture Situations**

In addition to residential real estate acquired before 1987 and nonresidential real estate acquired before 1981, accelerated depreciation may be taken on other types of real property. The § 1250 recapture rules apply to the following property for which accelerated depreciation was used:

- Real property used predominantly outside the United States.
- Certain government-financed or low-income housing.³⁹

Concept Summary 14.7 compares and contrasts the § 1245 and § 1250 depreciation recapture rules.



Concept Summary 14.7

Comparison of § 1245 and § 1250 Depreciation Recapture

	§ 1245	§ 1250
Property affected	All depreciable personal property, but also nonresidential real property acquired after December 31, 1980, and before January 1, 1987, for which accelerated cost recovery was used. Also includes miscellaneous items such as § 179 expense and § 197 amortization of intangibles such as goodwill, patents, and copyrights.	Nonresidential real property acquired after December 31, 1969, and before January 1, 1981, on which accelerated depreciation was taken. Residential rental real property acquired after December 31, 1975, and before January 1, 1987, on which accelerated depreciation was taken.
Depreciation recaptured	Potentially all depreciation taken. If the selling price is greater than or equal to the original cost, all depreciation is recaptured. If the selling price is between the adjusted basis and the original cost, only some depreciation is recaptured.	Normally, there is no depreciation recapture, but in the special situations listed above, there can be § 1250 depreciation recapture of additional depreciation (the excess of accelerated cost recovery over straight-line cost recovery or the excess of accelerated depreciation over straight-line depreciation).
Limit on recapture	Lower of depreciation taken or gain recognized.	Lower of additional depreciation or gain recognized.
Treatment of gain exceeding recapture gain	Usually § 1231 gain.	Usually § 1231 gain.
Treatment of loss	No depreciation recapture; loss is usually § 1231 loss.	No depreciation recapture; loss is usually § 1231 loss.

14-10b **Unrecaptured § 1250 Gain (Real Estate 25% Gain)**

Certain gains are subject to a 25 percent tax rate on unrecaptured § 1250 gain. This gain is used in the alternative tax computation for net capital gain discussed earlier in this chapter. Unrecaptured § 1250 gain (25% gain) is some or all of the § 1231 gain that is treated as long-term capital gain and relates to a sale of depreciable real estate.

³⁹Described in § 1250(a)(1)(B).



TAX IN THE NEWS Building or Tangible Personal Property?

Many taxpayers have “cost-segregated” their buildings. This means that an engineering study is done to determine whether some of a building’s cost can be segregated into tangible personal property (generally a 5-year or 7-year MACRS life with accelerated depreciation) rather than real property (a 27.5-year or 39-year MACRS life with straight-line depreciation). The faster depreciation for the

tangible personal property yields significant tax savings. However, there is a downside. When the property is sold, the tangible personal property gains are taxable as ordinary income due to § 1245 depreciation recapture, whereas the gain from the sale of the building is not subject to recapture, is a § 1231 gain, and may receive long-term capital gain treatment.

The maximum amount of this 25% gain is the depreciation taken on real property sold at a recognized gain. That maximum amount is computed in one or more of the following ways:

- The recognized gain from disposition is more than the depreciation taken. The 25% gain is equal to the depreciation taken. Refer to Example 59. The depreciation taken was \$20,909, but the recognized gain was \$170,909. Consequently, *some* of the recognized gain is potential 25% § 1231 gain.
- The recognized gain from disposition is less than or equal to the depreciation taken. In this case, the 25% gain is all of the recognized gain. Refer to Example 59, but assume the building sales price is \$285,000. The recognized gain is \$5,909 (\$285,000 – \$279,091), all of this gain is a § 1231 gain, and it is entirely a 25% § 1231 gain.
- There is § 1245 depreciation recapture because the property is nonresidential real estate acquired in 1981–1986 on which accelerated depreciation was taken. No 25% § 1231 gain will be left because § 1245 will recapture all of the depreciation or the recognized gain, whichever is less. Refer to Example 58. Depreciation of \$100,000 was taken, but all of it was recaptured as ordinary income by § 1245. Thus, there is no remaining potential 25% § 1231 gain. The entire \$20,000 § 1231 gain in Example 58 is potential 0%/15%/20% gain.
- Section 1231 loss from disposition of other § 1231 assets held long term reduces the gain from real estate.
- Section 1231 lookback losses convert some or all of the potential 25% § 1231 gain to ordinary income.

Special 25% Gain Netting Rules

Where there is a § 1231 gain from real estate and that gain includes both potential 25% gain and potential 0%/15%/20% gain, any § 1231 loss from disposition of other § 1231 assets *first offsets* the 0%/15%/20% portion of the § 1231 gain and then offsets the 25% portion of the § 1231 gain. Also, any § 1231 lookback loss *first recharacterizes* the 25% portion of the § 1231 gain and then recharacterizes the 0%/15%/20% portion of the § 1231 gain as ordinary income.

Net § 1231 Gain Limitation

The amount of unrecaptured § 1250 gain may not exceed the net § 1231 gain that is eligible to be treated as long-term capital gain. The unrecaptured § 1250 gain is the *lesser* of the unrecaptured § 1250 gain or the net § 1231 gain that is treated as capital gain. Thus, if there is a net § 1231 gain but it is all converted to ordinary income by the five-year § 1231 lookback loss provision, there is no surviving § 1231 gain or unrecaptured § 1250 gain.

Refer to Example 52. There was \$200 of § 1231 gain from the building fire that would also be potential 25% gain if at least \$200 of depreciation was taken. The net § 1231 gain was \$1,100 including the \$200 building gain. (The \$500 loss from Asset C would offset the potential 0%/15%/20% § 1231 gain and not the potential 25% gain, so all of the

potential 25% gain of \$200 is in the \$1,100 net § 1231 gain.) However, the \$700 of § 1231 lookback losses would *first* absorb the \$200 building gain, so the \$400 of § 1231 gain that is treated as long-term capital gain includes no 25% gain.

Section 1250 Property for Purposes of the Unrecaptured § 1250 Gain

Section 1250 property includes any real property (other than § 1245 property) that is or has been depreciable. Land is *not* § 1250 property because it is not depreciable.

EXAMPLE

60

Bill is a single taxpayer with 2015 taxable income of \$120,000 composed of:

- \$100,000 ordinary taxable income,
- \$3,000 short-term capital loss,
- \$15,000 long-term capital gain from sale of stock, and
- \$8,000 § 1231 gain that is all unrecaptured § 1250 gain (the actual unrecaptured gain was \$11,000, but net § 1231 gain is only \$8,000).

Bill's net capital gain is \$20,000 (\$15,000 long-term capital gain + \$8,000 unrecaptured § 1250 gain/net § 1231 gain – \$3,000 short-term capital loss). The \$3,000 short-term capital loss is offset against the \$8,000 unrecaptured § 1250 gain, reducing that gain to \$5,000 (see the discussion earlier in the chapter concerning netting of capital losses). Bill's adjusted net capital gain is \$15,000 (\$20,000 net capital gain – \$5,000 unrecaptured § 1250 gain).

Bill's total tax (using the alternative tax calculation discussed earlier) is \$24,571 [\$21,071 (tax on \$100,000 ordinary taxable income) + \$1,250 (\$5,000 unrecaptured § 1250 gain × 25%) + \$2,250 (\$15,000 adjusted net capital gain × 15%)].

ETHICS & EQUITY The Sale of a “Cost-Segregated” Building

Many taxpayers have “cost-segregated” their buildings. This means that an engineering study is done to determine whether some of a building's cost can be segregated into tangible personal property (generally a 5-year or 7-year MACRS life with accelerated depreciation) rather than real property (a 27.5-year or 39-year MACRS life with straight-line depreciation). The faster depreciation for the tangible personal property yields significant tax savings.

A CPA is determining the gain or loss from disposition of an office building. A sale document details the selling price of the land and building. However, the building was cost-segregated and the CPA finds records of cost and related depreciation for the tangible personal property that was part of the cost segregation. No mention of this tangible personal property was made in the sale agreement, but the building and all of its contents were sold. What should the CPA do?

LO.11

State and explain considerations common to §§ 1245 and 1250.

14-11 CONSIDERATIONS COMMON TO §§ 1245 AND 1250

14-11a Exceptions

Gifts

The recapture potential carries over to the donee.⁴⁰

EXAMPLE

61

Wade gives his daughter, Helen, § 1245 property with an adjusted basis of \$1,000. The amount of recapture potential is \$700. Helen uses the property in her business and claims further depreciation of \$100 before selling it for \$1,900.

Helen's recognized gain is \$1,000 (\$1,900 amount realized – \$900 adjusted basis), of which \$800 is recaptured as ordinary income (\$100 depreciation taken by Helen + \$700 recapture potential carried over from Wade). The remaining gain of \$200 is § 1231 gain. Even if Helen used the property for personal purposes, the \$700 recapture potential would still be carried over.

⁴⁰ §§ 1245(b)(1) and 1250(d)(1) and Reg. §§ 1.1245-4(a)(1) and 1.1250-3(a)(1).

Death

Although not a very attractive tax planning approach, death eliminates all recapture potential.⁴¹ In other words, any recapture potential does not carry over from a decedent to an estate or heir.

Assume the same facts as in Example 61, except that Helen receives the property as a result of Wade's death. The \$700 recapture potential from Wade is extinguished. Helen has a basis for the property equal to the property's fair market value at Wade's death (assume the FMV is \$1,700).

Helen will have a \$300 gain when the property is sold because the selling price (\$1,900) exceeds the property's adjusted basis of \$1,600 (\$1,700 original basis to Helen – \$100 depreciation) by \$300. Because of § 1245, \$100 is ordinary income. The remaining gain of \$200 is § 1231 gain.

EXAMPLE

62

Charitable Transfers

Depreciation recapture potential reduces the amount of the charitable contribution deduction under § 170.⁴²

Kanisha donates to her church § 1245 property with a fair market value of \$10,000 and an adjusted basis of \$7,000. Assume that the amount of recapture potential is \$2,000 (the amount of recapture that would occur if the property were sold). Her charitable contribution deduction (subject to the limitations discussed in Chapter 10) is \$8,000 (\$10,000 fair market value – \$2,000 recapture potential).

EXAMPLE

63

Certain Nontaxable Transactions

In certain transactions, the transferor's adjusted basis of property carries over to the transferee.⁴³ The recapture potential also carries over to the transferee.⁴⁴ Included in this category are transfers of property pursuant to the following:

- Nontaxable incorporations under § 351 (see Chapter 18).
- Certain liquidations of subsidiary companies under § 332 (see Chapter 20).
- Nontaxable contributions to a partnership under § 721 (see Chapter 21).
- Nontaxable reorganizations (see Chapter 20).

Gain may be recognized in these transactions if boot is received. If gain is recognized, it is treated as ordinary income to the extent of the recapture potential or recognized gain, whichever is lower.⁴⁵

Like-Kind Exchanges (§ 1031) and Involuntary Conversions (§ 1033)

Realized gain will be recognized to the extent of boot received under § 1031. Realized gain also will be recognized to the extent the proceeds from an involuntary conversion are not reinvested in similar property under § 1033. Such recognized gain is subject to recapture as ordinary income under §§ 1245 and 1250. The remaining recapture potential, if any, carries over to the property received in the exchange. Realized losses are not recognized in like-kind exchanges, but are recognized in involuntary conversions (see Chapter 13).

⁴¹ §§ 1245(b)(2) and 1250(d)(2).

⁴² § 170(e)(1)(A) and Reg. § 1.170A-4(b)(1). In certain circumstances, § 1231 gain also reduces the amount of the charitable contribution. See § 170(e)(1)(B).

⁴³ §§ 1245(b)(3) and 1250(d)(3) and Reg. §§ 1.1245-4(c) and 1.1250-3(c).

⁴⁴ Reg. §§ 1.1245-2(a)(4) and -2(c)(2) and 1.1250-2(d)(1) and (3) and -3(c)(3).

⁴⁵ §§ 1245(b)(3) and 1250(d)(3) and Reg. §§ 1.1245-4(c) and 1.1250-3(c).

GLOBAL TAX ISSUES Depreciation Recapture in Other Countries

The rules for dispositions of depreciated property are more complex in the United States than in any other country. Most countries treat the gain or loss from the disposition of business depreciable assets as ordinary income or loss. Consequently, although the U.S. rules are

more complex, they can be more beneficial than those of other countries because at least some gains from the disposition of depreciable business property may be taxed at the lower capital gain rates.

EXAMPLE

64

Anita exchanges § 1245 property with an adjusted basis of \$300 for § 1245 property with a fair market value of \$6,000. The exchange qualifies as a like-kind exchange under § 1031. Anita also receives \$1,000 cash (boot).

Her realized gain is \$6,700 (\$7,000 amount realized – \$300 adjusted basis of property). Assuming that the recapture potential is \$7,500, Anita recognizes § 1245 gain of \$1,000 because she received boot of \$1,000. The remaining recapture potential of \$6,500 carries over to the like-kind property received.

14-11b Other Applications

Sections 1245 and 1250 apply notwithstanding any other provisions in the Code.⁴⁶ That is, the recapture rules under these Sections *override* all other Sections. Special applications include installment sales and property dividends.

Installment Sales

Recapture gain is recognized in the year of the sale regardless of whether gain is otherwise recognized under the installment method.⁴⁷ All gain is ordinary income until the recapture potential is fully absorbed. Nonrecapture (§ 1231) gain is recognized under the installment method as cash is received.

EXAMPLE

65

Seth sells § 1245 property for \$20,000, to be paid in 10 annual installments of \$2,000 each plus interest at 10%. Seth realizes a \$6,000 gain from the sale, of which \$4,000 is attributable to depreciation taken.

If Seth uses the installment method, he recognizes the entire \$4,000 of recapture gain as ordinary income in the year of the sale. The \$2,000 of nonrecapture (§ 1231) gain will be recognized at the rate of \$200 per year for 10 years.

Gain is also recognized on installment sales in the year of the sale in an amount equal to the § 179 (immediate expensing) deduction taken with respect to the property sold.

Property Dividends

A corporation generally recognizes gain if it distributes appreciated property as a dividend. Recapture under §§ 1245 and 1250 applies to the extent of the *lower* of the recapture potential or the excess of the property's fair market value over the adjusted basis.⁴⁸

EXAMPLE

66

Emerald Corporation distributes § 1245 property as a dividend to its shareholders. The amount of the recapture potential is \$300, and the excess of the property's fair market value over the adjusted basis is \$800. Emerald recognizes \$300 of ordinary income and \$500 of § 1231 gain.

⁴⁶ §§ 1245(d) and 1250(i).

⁴⁷ § 453(i). The installment method of reporting gains on the sale of property is discussed in Chapter 16.

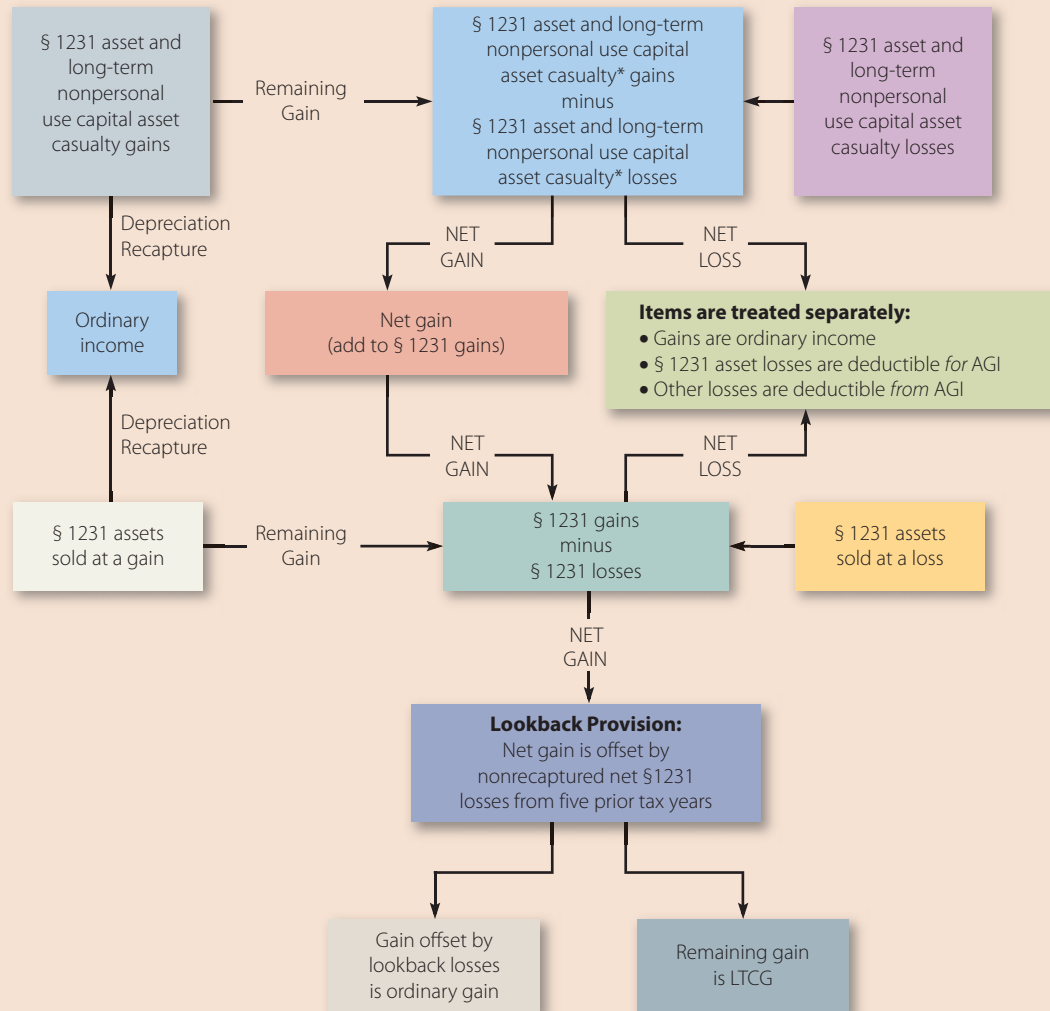
⁴⁸ § 311(b) and Reg. §§ 1.1245-1(c) and -6(b) and 1.1250-1(a)(4), -1(b)(4), and -1(c)(2).

Concept Summary 14.8 integrates the depreciation recapture rules with the § 1231 netting process. It is an expanded version of Concept Summary 14.6.



Concept Summary 14.8

Depreciation Recapture and § 1231 Netting Procedure



* Includes casualties and thefts.

14-12 SPECIAL RECAPTURE PROVISIONS

14-12a Special Recapture for Corporations

Corporations selling depreciable real estate may have ordinary income in addition to that required by § 1250.⁴⁹ Under this provision, corporations selling depreciable real property are required to recapture as ordinary income the smaller of two amounts: (1) 20 percent of the recognized gain or (2) 20 percent of the depreciation taken. See Chapter 17 for further discussion.

⁴⁹§ 291(a)(1).

LO.12

Apply the special recapture provisions for related parties and intangible drilling costs (IDCs) and be aware of the special recapture provision for corporations.

14-12b Gain from Sale of Depreciable Property between Certain Related Parties

When the sale or exchange of property, which in the hands of the *transferee* is depreciable property (principally machinery, equipment, and buildings, but not land), is between certain related parties, any gain recognized is ordinary income.⁵⁰ This provision applies to both direct and indirect sales or exchanges. A **related party** is defined as an individual and his or her controlled corporation or partnership or a taxpayer and any trust in which the taxpayer (or the taxpayer's spouse) is a beneficiary.

EXAMPLE

67

Isabella sells a personal use automobile (therefore nondepreciable) to her controlled corporation. The automobile, which was purchased two years ago, originally cost \$5,000 and is sold for \$7,000. The automobile is to be used in the corporation's business. If the related-party provision did not exist, Isabella would realize a \$2,000 long-term capital gain. The income tax consequences would be favorable because Isabella's controlled corporation is entitled to depreciate the automobile based upon the purchase price of \$7,000. Under the related-party provision, Isabella's \$2,000 gain is ordinary income.

14-12c Intangible Drilling Costs

Taxpayers may elect to either *expense* or *capitalize* intangible drilling and development costs for oil, gas, or geothermal properties.⁵¹ **Intangible drilling and development costs (IDCs)** include operator (one who holds a working or operating interest in any tract or parcel of land) expenditures for wages, fuel, repairs, hauling, and supplies. These expenditures must be incident to and necessary for the drilling of wells and preparation of wells for production. In most instances, taxpayers elect to expense IDCs to maximize tax deductions during drilling.

Intangible drilling and development costs are subject to § 1254 recapture when the property is disposed of. The gain on the disposition of the property is subject to recapture as ordinary income.

LO.13

Describe and apply the reporting procedures for §§ 1231, 1245, and 1250.

14-13 REPORTING PROCEDURES

Noncapital gains and losses are reported on Form 4797, Sales of Business Property. However, before Form 4797 is filled out, Part B of Form 4684 (Casualties and Thefts) must be completed to determine whether any casualties will enter into the § 1231 computation procedure. Recall that recognized gains from § 1231 asset casualties may be recaptured by § 1245 or § 1250. These gains will not appear on Form 4684. The § 1231 gains and nonpersonal use long-term capital gains are netted against § 1231 losses and nonpersonal use long-term capital losses on Form 4684 to determine if there is a net gain to transfer to Form 4797, Part I.

ETHICS & EQUITY Incorrect Depreciation and Recognized Gain

A staff accountant for a large international company is calculating the tax gain from disposition of business equipment. The equipment was seven-year MACRS property and has been fully depreciated for tax purposes. The staff accountant notices that the equipment was used in Germany, not the United States, although it is listed as an asset of the U.S.

company for which the staff accountant works. Because the property was used outside the United States, it should have been depreciated using straight-line over a nine-year life. Consequently, the tax depreciation has been overstated, and the tax basis should be greater than zero, causing a smaller gain. What should the staff accountant do?

⁵⁰§ 1239.

⁵¹§ 263(c).

14-14 TAX PLANNING

14-14a Importance of Capital Asset Status

Why is capital asset status important? Capital asset status enables the taxpayer to be eligible for the alternative tax on net capital gain. Individuals who receive income in the form of long-term capital gains or qualified dividend income have an advantage over taxpayers who cannot receive income in these forms.

Capital asset status is also important because capital gains must be offset by capital losses. If a net capital loss results, the maximum deduction is \$3,000 per year.

Consequently, capital gains and losses must be segregated from other types of gains and losses and must be reported separately on Schedule D of Form 1040.

14-14b Planning for Capital Asset Status

It is important to keep in mind that capital asset status often is a question of objective evidence. Thus, property that is not a capital asset to one party may qualify as a capital asset to another party.

Diane, a real estate dealer, transfers by gift a tract of land to Jeff, her son. The land was recorded as part of Diane's inventory (it was held for resale) and was therefore not a capital asset to her. Jeff, however, treats the land as an investment. The land is a capital asset in Jeff's hands, and any later taxable disposition of the property by him will yield a capital gain or loss.

LO.14

Identify tax planning opportunities arising from the sale or exchange of capital assets and avoid pitfalls associated with the recapture provisions.

EXAMPLE

68

If proper planning is carried out, even a dealer may obtain long-term capital gain treatment on the sale of the type of property normally held for resale.

Jim, a real estate dealer, segregates Tract A from the real estate he regularly holds for resale and designates the property as being held for investment purposes. The property is not advertised for sale and is disposed of several years later. The negotiations for the subsequent sale were initiated by the purchaser and not by Jim. Under these circumstances, it would appear that any gain or loss from the sale of Tract A should be a capital gain or loss.⁵²

EXAMPLE

69

When a business is being sold, one of the major decisions usually concerns whether a portion of the sales price is for goodwill. For the seller, goodwill generally represents the disposition of a capital asset. Goodwill has no basis and represents a residual portion of the selling price that cannot be allocated reasonably to the known assets. The amount of goodwill thus represents capital gain.

From a legal perspective, the buyer may prefer that the residual portion of the purchase price be allocated to a covenant not to compete (a promise that the seller will not compete against the buyer by conducting a business similar to the one the buyer has purchased). Both purchased goodwill and a covenant not to compete are § 197 intangibles. Thus, both must be capitalized and can be amortized over a 15-year statutory period.

To the seller, a covenant produces ordinary income. Thus, the seller would prefer that the residual portion of the selling price be allocated to goodwill—a capital asset. If the buyer does not need the legal protection provided by a covenant, the buyer is neutral regarding whether the residual amount is allocated to a covenant or to goodwill. Because the seller would receive a tax advantage from labeling the residual amount as goodwill, the buyer should factor this into the negotiation of the purchase price.

⁵²*Toledo, Peoria & Western Railroad Co.*, 35 TCM 1663, T.C.Memo. 1976-366.

GLOBAL TAX ISSUES Capital Gain Treatment in the United States and Other Countries

The United States currently requires a very complex tax calculation when taxable income includes net long-term capital gain. However, the alternative tax on net long-term capital gain can generate tax savings even when the taxpayer is in the lowest regular tax bracket (10 percent) because there is an alternative tax rate of 0 percent. Many

other countries do not have an alternative tax rate on long-term capital gains. Instead, those gains are taxed the same as other income. Consequently, even though the U.S. system is complex, it may be preferable because of the lower tax rates and because the lower rates are available to taxpayers in all tax brackets.

EXAMPLE

70

Marcia is buying Jack's dry cleaning proprietorship. An appraisal of the assets indicates that a reasonable purchase price would exceed the value of the known assets by \$30,000. If the purchase contract does not specify the nature of the \$30,000, the amount will be for goodwill and Jack will have a long-term capital gain of \$30,000. Marcia will have a 15-year amortizable \$30,000 asset.

If Marcia is paying the extra \$30,000 to prevent Jack from conducting another dry cleaning business in the area (a covenant not to compete), Jack will have \$30,000 of ordinary income. Marcia will have a \$30,000 deduction over the statutory 15-year amortization period rather than over the actual life of the covenant (e.g., 5 years).

14-14C Effect of Capital Asset Status in Transactions Other Than Sales

The nature of an asset (capital or ordinary) is important in determining the tax consequences that result when a sale or exchange occurs. It may, however, be just as significant in circumstances other than a taxable sale or exchange. When a capital asset is disposed of, the result is not always a capital gain or loss. Rather, in general, the disposition must be a sale or exchange. Collection of a debt instrument having a basis less than the face value results in a capital gain if the debt instrument is a capital asset. The collection is a sale or exchange. Sale of the debt shortly before the due date for collection will produce a capital gain.⁵³ If selling the debt in such circumstances could produce a capital gain but collecting could not, the consistency of what constitutes a capital gain or loss would be undermined. Another illustration of the sale or exchange principle involves a donation of certain appreciated property to a qualified charity. Recall that in certain circumstances, the measure of the charitable contribution is fair market value when the property, if sold, would have yielded a long-term capital gain (refer to the discussion of contributions of capital gain property in Chapter 10).

EXAMPLE

71

Sharon wants to donate a tract of unimproved land (basis of \$40,000 and fair market value of \$200,000) held for the required long-term holding period to State University (a qualified charitable organization). However, Sharon currently is under audit by the IRS for capital gains she reported on certain real estate transactions during an earlier tax year. Although Sharon is not a licensed real estate broker, the IRS agent conducting the audit is contending that she has achieved dealer status by virtue of the number and frequency of the real estate transactions she has conducted.

Under these circumstances, Sharon would be well advised to postpone the donation to State University until her status is clarified. If she has achieved dealer status, the unimproved land may be inventory (refer to Example 69 for another possible result) and Sharon's charitable contribution deduction would be limited to \$40,000. If not and if the land is held as an investment, Sharon's deduction is \$200,000 (the fair market value of the property).

⁵³§ 1271(b).

14-14d **Stock Sales**

The following rules apply in determining the date of a stock sale:

- The date the sale is executed is the date of the sale. The execution date is the date the broker completes the transaction on the stock exchange.
- The settlement date is the date the cash or other property is paid to the seller of the stock. This date is *not* relevant in determining the date of sale.

Lupe, a cash basis taxpayer, sells stock that results in a gain. The sale was executed on December 29, 2014. The settlement date is January 2, 2015. The date of sale is December 29, 2014 (the execution date). The holding period for the stock sold ends with the execution date.

EXAMPLE

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14-14e **Maximizing Benefits**

Ordinary losses generally are preferable to capital losses because of the limitations imposed on the deductibility of net capital losses and the requirement that capital losses be used to offset capital gains. The taxpayer may be able to convert what would otherwise have been capital loss to ordinary loss. For example, business (but not nonbusiness) bad debts, losses from the sale or exchange of small business investment company stock, and losses from the sale or exchange of small business corporation stock all result in ordinary losses.⁵⁴

Although capital losses can be carried over indefinitely, *indefinite* becomes definite when a taxpayer dies. Any loss carryovers not used by the taxpayer are permanently lost. That is, no tax benefit can be derived from the carryovers subsequent to death.⁵⁵ Therefore, the potential benefit of carrying over capital losses diminishes when dealing with older taxpayers.

It is usually beneficial to spread gains over more than one taxable year. In some cases, this can be accomplished through the installment sales method of accounting.

14-14f **Year-End Planning**

The following general rules can be applied for timing the recognition of capital gains and losses near the end of a taxable year:

- If the taxpayer already has recognized more than \$3,000 of capital loss, sell assets to generate capital gain equal to the excess of the capital loss over \$3,000.

Kevin has already incurred a \$7,000 STCL. Kevin should generate \$4,000 of capital gain. The gain will be offset by \$4,000 of the loss. The remaining loss of \$3,000 can be deducted against ordinary income.

EXAMPLE

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- If the taxpayer already has recognized capital gain, sell assets to generate capital loss equal to the capital gain. The gain will not be taxed, and the loss will be fully *deductible* against the gain.
- Generally, if the taxpayer has a choice between recognizing short-term capital gain or long-term capital gain, long-term capital gain should be recognized because it is subject to a lower tax rate.

14-14g **Timing of § 1231 Gain**

Although §§ 1245 and 1250 recapture much of the gain from the disposition of business property, sometimes § 1231 gain is still substantial. For instance, land held as a business asset will generate either § 1231 gain or § 1231 loss. If the taxpayer already has a capital

⁵⁴§§ 166(d), 1242, and 1244. Refer to the discussion in Chapter 7.

⁵⁵Rev.Rul. 74-175, 1974-1 C.B. 52.

loss for the year, the sale of land at a gain should be postponed so that the net § 1231 gain is not netted against the capital loss. The capital loss deduction will therefore be maximized for the current tax year, and the capital loss carryforward (if any) may be offset against the gain when the land is sold. If the taxpayer already has a § 1231 loss, § 1231 gains might be postponed to maximize the ordinary loss deduction this year. However, the carryforward of unrecaptured § 1231 losses will make the § 1231 gain next year an ordinary gain.

Section 1231 Planning

EXAMPLE

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Mark has a \$2,000 net STCL for 2015. He could sell business land held 27 months for a \$3,000 § 1231 gain. He will have no other capital gains and losses or § 1231 gains and losses in 2015 or 2016. He has no nonrecaptured § 1231 losses from prior years. Mark is in the 28% tax bracket in 2015 and will be in the 25% bracket in 2016. If he sells the land in 2015, he will have a \$1,000 net LTCG (\$3,000 § 1231 gain – \$2,000 STCL) and will pay a tax of \$150 ($\$1,000 \times 15\%$).

If Mark sells the land in 2016, he will have a 2015 tax savings of \$560 ($\$2,000$ capital loss deduction \times 28% tax rate on ordinary income). In 2016, he will pay tax of \$450 ($\$3,000 \times 15\%$).

By postponing the sale by a year, Mark gets the use of \$710 ($\$560 + \150) of tax savings until he has to pay \$450 in 2016, for a net savings of \$260 between the two years without considering the time value of money and other factors.

EXAMPLE

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Beth has a \$15,000 § 1231 loss in 2015. She could sell business equipment held 30 months for a \$20,000 § 1231 gain and a \$12,000 § 1245 gain. Beth is in the 28% tax bracket in 2015 and will be in the 25% bracket in 2016. She has no nonrecaptured § 1231 losses from prior years. If she sold the equipment in 2015, she would have a \$5,000 net § 1231 gain and \$12,000 of ordinary gain. Her tax would be \$4,110 [$(\$5,000 \text{ § 1231 gain} \times 15\%) + (\$12,000 \text{ ordinary gain} \times 28\%)$].

If Beth postponed the equipment sale until 2016, she would have a 2015 ordinary loss of \$15,000 and tax savings of \$4,200 ($\$15,000 \times 28\%$). In 2016, she would have \$5,000 of § 1231 gain (the 2015 § 1231 loss carries over and recaptures \$15,000 of the 2016 § 1231 gain as ordinary income) and \$27,000 of ordinary gain. Her tax would be \$7,500 [$(\$5,000 \text{ § 1231 gain} \times 15\%) + (\$27,000 \text{ ordinary gain} \times 25\%)$].

By postponing the sale of the § 1231 property until 2016, Beth gets the use of \$8,310 ($\$4,200 + \$4,110$) of tax savings until she has to pay \$7,500 in 2016, for a net savings of \$810 between the two years without considering the time value of money and other factors.

14-14h Timing of Recapture

Because recapture is usually not triggered until the property is sold or disposed of, it may be possible to plan for recapture in low-bracket or loss years. If a taxpayer has net operating loss (NOL) carryovers that are about to expire, the recognition of ordinary income from recapture may be advisable to absorb the loss carryovers.

EXAMPLE

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Ahmad has a \$15,000 NOL carryover that will expire this year. He owns a machine that he plans to sell in the early part of next year. The expected gain of \$17,000 from the sale of the machine will be recaptured as ordinary income under § 1245. Ahmad sells the machine before the end of this year and uses the \$15,000 NOL carryover to offset \$15,000 of the ordinary income.

14-14i Postponing and Shifting Recapture

It is also possible to postpone recapture or to shift the burden of recapture to others. For example, recapture is avoided upon the disposition of a § 1231 asset if the taxpayer replaces the property by entering into a like-kind exchange. In this instance, recapture potential is merely carried over to the newly acquired property (refer to Example 64).

Recapture can be shifted to others through the gratuitous transfer of § 1245 or § 1250 property to family members. A subsequent sale of such property by the donee will trigger recapture to the donee rather than the donor (refer to Example 61). This procedure would be advisable only if the donee was in a lower income tax bracket compared with the donor.

14-14j **Avoiding Recapture**

The immediate expensing election (§ 179) is subject to § 1245 recapture. If the election is not made, the § 1245 recapture potential will accumulate more slowly (refer to Chapter 8). Because using the immediate expense deduction complicates depreciation and book accounting for the affected asset, not taking the deduction may make sense even though the time value of money might indicate that it should be taken.

REFOCUS ON THE BIG PICTURE

MANAGING CAPITAL ASSET TRANSACTIONS

You explain to Maurice that your area of expertise is tax, so you are providing tax advice and not investment advice. From an overall perspective, he is correct that certain capital gains and dividends are eligible for either a 0 percent, a 15 percent, or a 20 percent tax rate rather than the regular income tax rates that go as high as 39.6 percent. You then discuss the potential tax consequences of each of his investments.

- *Purple stock and Eagle stock.* To qualify for the beneficial tax rate, the holding period for the stock must be longer than one year. From a tax perspective, Maurice should retain his stock investments for at least an additional three months and a day. To be eligible for the “costless” capital gains as a single taxpayer (i.e., taxed at the 0 percent rate), his taxable income should not exceed \$37,450 for 2015. The dividends received on the Purple stock are “qualified dividends” eligible for the 0%/15%/20% alternative tax rate.
- *Patent.* Because he is a “holder” of the patent, it will qualify for the beneficial capital gain rate regardless of the holding period if the patent should produce income in excess of his \$50,000 investment. However, if he loses money on the investment, he will be able to deduct only \$3,000 of the loss per year against his ordinary income (assuming that there are no offsetting capital gains). See Examples 14 and 15.
- *Tax-exempt bonds.* The after-tax return on the taxable bonds would be less than the 3 percent on the tax-exempt bonds. In addition, the interest on the taxable bonds would increase his taxable income, possibly moving it out of the desired 15 percent marginal tax rate into the 25 percent marginal tax rate.
- *Franchise rights.* The franchise rights purchased from Orange, Inc., probably require the payment of a franchise fee based upon the sales in the franchise business. Maurice should either start such a business or sell the franchise rights.
- *Partnership interest.* Whether Maurice receives capital or ordinary treatment associated with his partnership interest depends on whether he is reporting his share of profits or losses (ordinary income or ordinary loss) or is reporting recognized gain or loss from the sale of his partnership interest (capital gain or capital loss).

You conclude your tax advice to Maurice by telling him that whatever he does regarding his investments should make economic sense. There are no 100 percent tax rates. For example, disposing of the bank stock in the current market could be the wise thing to do.



Key Terms

Alternative tax, 14-22	Long-term nonpersonal use capital assets, 14-30	Section 1231 lookback, 14-32
Capital asset, 14-4	Net capital gain (NCG), 14-19	Section 1231 property, 14-29
Capital gains, 14-2	Net capital loss (NCL), 14-24	Section 1245 property, 14-36
Capital losses, 14-2	Options, 14-9	Section 1245 recapture, 14-35
Collectibles, 14-22	Original issue discount (OID), 14-8	Section 1250 property, 14-37
Franchise, 14-12	Patent, 14-11	Section 1250 recapture, 14-37
Holding period, 14-14	Qualified dividend income, 14-22	Short sale, 14-16
Intangible drilling and development costs (IDCs), 14-44	Related party, 14-44	Unrecaptured § 1250 gain, 14-19
Lessee, 14-14	Sale or exchange, 14-8	
Lessor, 14-14	Section 1231 gains and losses, 14-28	

Discussion Questions

- Issue ID** 1. **LO.2, 4, 5** Sheila inherited 300 shares of stock, 100 shares of Magenta and 200 shares of Purple. She has a stockbroker sell the shares for her, uses the proceeds for personal expenses, and thinks nothing further about the transactions. What issues does she face when she prepares her Federal income tax return?
- Issue ID** 2. **LO.2** An individual taxpayer sells some used assets at a garage sale. Why are none of the proceeds taxable in most situations?
- Issue ID** 3. **LO.2, 4** Alison owns a painting that she received as a gift from her aunt 10 years ago. The aunt created the painting. Alison has displayed the painting in her home and has never attempted to sell it. Recently, a visitor noticed the painting and offered Alison \$5,000 for it. If Alison decides to sell the painting, what tax issues does she face?
4. **LO.2** Is a note receivable that arose in the ordinary course of the taxpayer's retail business a capital asset? Why or why not?
5. **LO.2** Anwar owns vacant land that he purchased many years ago as an investment. After getting approval to subdivide it into 35 lots, he made minimal improvements and then sold the entire property to a real estate developer. Anwar's recognized gain on the sale was \$1.2 million. Is this transaction eligible for the "real property subdivided for sale" provisions? Why or why not?
- Issue ID** 6. **LO.3** Hubert purchases all of the rights in a patent from the inventor who developed the patented product. After holding the patent for two years, Hubert sells all of the rights in the patent for a substantial gain. What issues does Hubert face if he wants to treat the gain as a long-term capital gain?
7. **LO.3** Blue Corporation and Fuchsia Corporation are engaged in a contract negotiation over the use of Blue's trademarked name, DateSiteForSeniors. For a one-time payment of \$45,000, Blue licensed Fuchsia to use the name DateSiteForSeniors, and the license requires that Fuchsia pay Blue a royalty every time a new customer signs up on Fuchsia's website. Blue is a developer of "website ideas" that it then licenses to other companies such as Fuchsia. Did Fuchsia purchase a franchise right from Blue, or did Fuchsia purchase the name DateSiteForSeniors from Blue?
8. **LO.4** At the date of a short sale, Sylvia has held substantially identical securities for more than 12 months. What is the nature of any gain or loss from the close of her short sale?

9. **LO.5** After netting all of her short-term and long-term capital gains and losses, Misty has a net short-term capital loss and a net long-term capital loss. Can she net these against each other? Why or why not?
10. **LO.2, 5** Charlie sells his antique farm tractor collection at a loss. He had acquired all of the tractors for his personal pleasure and sold all of them for less than he paid for them. What is the tax status of the tractors? Is his gain a 28% loss? Explain.
11. **LO.7, 8** Hakim's rental building was not insured when it was destroyed by a hurricane. His adjusted basis for the building was substantial, but was less than he had paid for the building in 2011. The building was Hakim's only asset that was damaged by the hurricane. How should Hakim handle this situation? Issue ID
12. **LO.8** An individual taxpayer had a net § 1231 loss in 2015. Could any of this loss be treated as a long-term capital loss? Why or why not?
13. **LO.8** Steven established a sole proprietorship in 2010. He sold § 1231 assets at a loss in 2013 and 2014. He had only sold § 1231 assets at a gain before 2013. In 2015, he could sell a § 1231 asset at a gain and would like to have the gain taxed as a long-term capital gain. What issue is Steven facing? Issue ID
14. **LO.8** Review Examples 50 and 52 in the text. In both examples, the taxpayer's AGI is \$129,400 even though in Example 52 there is \$700 of nonrecaptured § 1231 loss from 2014. Explain why the two AGI amounts are the same.
15. **LO.8** A depreciable business dump truck has been owned for four years and is no longer useful to the taxpayer. What would have to be true for the disposition of the dump truck to generate at least some § 1231 loss?
16. **LO.7, 9** If depreciable equipment used in a business is sold at a recognized gain on July 10, 2015, and it was purchased on August 21, 2014, does § 1245 depreciation recapture apply to the asset? Explain.
17. **LO.9** A retailer's store is destroyed by a tornado, but is insured for its replacement cost. Consequently, the retailer has a \$40,000 gain after receiving the insurance proceeds. The store is not replaced because the retailer spends the insurance proceeds on additional inventory. What is the nature of the gain if the store originally cost \$100,000 three years ago and had an adjusted basis of \$82,000 at the time of its destruction?
18. **LO.10** In the current year, an individual taxpayer has net long-term capital gain from disposition of capital assets and has unrecaptured § 1250 gain. What would the circumstances have to be for the unrecaptured § 1250 gain to be taxed at 25%?
19. **LO.9, 11** Mary receives tangible personal property as a gift. The property was depreciated by the donor, and Mary will also depreciate it. At the date of the gift, the property was worth more than the donor's adjusted basis. What is the impact of these facts on Mary when she sells the property at a gain several years after she acquired it?
20. **LO.9, 11** Thomas receives tangible personal property as an inheritance from a decedent who died in 2015. The property was depreciated by the deceased, and Thomas will also depreciate it. At the date of the deceased's death, the property was worth more than the deceased's adjusted basis. What is the impact of these facts on Thomas when he sells the property at a gain several years after he acquired it?

21. **LO.9, 11** Dino contributes to charity some tangible personal property that he had used in his business and depreciated. At the date of the donation, the property has a fair market value greater than its adjusted basis, but less than the original cost. What is the impact of these facts on Dino's charitable contribution?
22. **LO.9, 11** A corporation distributes a truck it has owned for three years to its sole shareholder. The shareholder will use the truck for personal use activity. The truck's fair market value at the time of the distribution is greater than its adjusted basis, but less than its original cost. Does the corporation recognize a gain? If so, what is the character of the gain?
23. **LO.12** A corporation distributes a truck it has owned for three years to its sole shareholder. The shareholder will use the truck for business activity. The truck's fair market value at the time of the distribution is greater than its adjusted basis, but less than its original cost. Does the corporation recognize a gain? If so, what is the character of the gain?

Computational Exercises

24. **LO.2** Dexter owns a large tract of land and subdivides it for sale. Assume that Dexter meets all of the requirements of § 1237 and during the tax year sells the first eight lots to eight different buyers for \$22,000 each. Dexter's basis in each lot sold is \$15,000, and he incurs total selling expenses of \$900 on each sale. What is the amount of Dexter's capital gain and ordinary income?
25. **LO.3** Shelia purchases \$50,000 of newly issued Gingo Corporation bonds for \$45,000. The bonds have original issue discount (OID) of \$5,000. After Sheila amortized \$2,300 of OID and held the bonds for four years, she sold the bonds for \$48,000. What is the amount and character of her gain or loss?
26. **LO.3** Olivia wants to buy some vacant land for investment purposes. She cannot afford the full purchase price. Instead, Olivia pays the landowner \$8,000 to obtain an option to buy the land for \$175,000 anytime in the next four years. Fourteen months after purchasing the option, Olivia sells the option for \$10,000. What is the amount and character of Olivia's gain or loss?
27. **LO.3** On May 9, 2015, Glenna purchases 500 shares of Ignaz Company stock for \$7,500. On June 30, 2015, she writes a call option on the stock, giving the grantee the right to buy the stock for \$9,000 during the following 12-month period. Glenna receives a call premium of \$750 for writing the call. The call is exercised by the grantee on December 15, 2015.
 - a. What is the amount and character of Glenna's gain or loss?
 - b. Assume that the original option expired unexercised. What is the amount and character of Glenna's gain or loss?
28. **LO.4** Shen purchased corporate stock for \$20,000 on April 10, 2013. On July 14, 2015, when the stock was worth \$12,000, Shen died and his son, Mijo, inherited the stock. Mijo sold the stock for \$14,200 on November 12, 2015. What is the amount and character of Mijo's gain or loss?
29. **LO.5** Coline has the following capital gain and loss transactions for 2015.

Short-term capital gain	\$ 5,000
Short-term capital loss	(2,100)
Long-term capital gain (28%)	6,000
Long-term capital gain (15%)	2,000
Long-term capital loss (28%)	(10,500)

After the capital gain and loss netting process, what is the amount and character of Coline's gain or loss?

30. **LO.5** Elliott has the following capital gain and loss transactions for 2015.

Short-term capital gain	\$ 1,500
Short-term capital loss	(3,600)
Long-term capital gain (28%)	12,000
Long-term capital gain (25%)	4,800
Long-term capital gain (15%)	6,000
Long-term capital loss (28%)	(4,500)
Long-term capital loss (15%)	(9,000)

After the capital gain and loss netting process, what is the amount and character of Elliott's gain or loss?

31. **LO.7** Lena is a sole proprietor. In April of this year, she sold equipment purchased four years ago for \$26,000 with an adjusted basis of \$15,500 for \$17,000. Later in the year, Lena sold another piece of equipment purchased two years ago with an adjusted basis of \$8,200 for \$5,500. What is the amount and character of Lena's gain or loss?
32. **LO.9** Renata Corporation purchased equipment in 2013 for \$180,000 and has taken \$83,000 of regular MACRS depreciation. Renata Corporation sells the equipment in 2015 for \$110,000. What is the amount and character of Renata's gain or loss?
33. **LO.9** Jacob purchased business equipment for \$56,000 in 2012 and has taken \$35,000 of regular MACRS depreciation. Jacob sells the equipment in 2015 for \$26,000. What is the amount and character of Jacob's gain or loss?
34. **LO.7, 8, 9** Sissie owns two items of business equipment. Both were purchased in 2011 for \$100,000, both have a 7-year MACRS recovery period, and both have an adjusted basis of \$37,490. Sissie is considering selling these assets in 2015. One of them is worth \$60,000, and the other is worth \$23,000. Because both items were used in her business, Sissie simply assumes that the loss on one will offset the gain from the other and that the net gain or loss will increase or reduce her business income. What is the amount and character of Sissie's gain or loss?
35. **LO.10** An apartment building was acquired in 2006. The depreciation taken on the building was \$123,000, and the building was sold for a \$34,000 gain. What is the maximum amount of 25% gain?
36. **LO.10** Enzo is a single taxpayer with the following gains and losses for 2015:
- \$2,100 short-term capital loss.
 - \$24,000 long-term capital gain from sale of stock.
 - \$14,000 § 1231 gain that is all unrecaptured § 1250 gain.
- What is the amount and character of Enzo's gain or loss?
37. **LO.11** In a § 1031 like-kind exchange, Rafael exchanges a piece of equipment that originally cost \$200,000. On the date of the exchange, the equipment given up has an adjusted basis of \$85,000 and a fair market value of \$110,000. Rafael pays \$15,000 and receives equipment with a fair market value of \$125,000. What is the amount and character of Rafael's gain or loss?

Problems

38. **LO.2** During the year, Eugene had the four property transactions summarized on the next page. Eugene is a collector of antique glassware and occasionally sells a piece to get funds to buy another. What are the amount and nature of the gain or loss from each of these transactions?

Property	Date Acquired	Date Sold	Adjusted Basis	Sales Price
Antique vase	06/18/04	05/23/15	\$37,000	\$42,000
Blue Growth Fund (100 shares)	12/23/06	11/22/15	22,000	38,000
Orange bonds	02/12/07	04/11/15	34,000	42,000*
Green stock (100 shares)	02/14/15	11/23/15	11,000	13,000

*The sales price included \$750 of accrued interest.

- Decision Making**
39. **LO.2, 5** Rennie owns a video game arcade. He buys vintage video games from estates, often at much less than the retail value of the property. He usually installs the vintage video games in a special section of his video game arcade that appeals to players of “classic” video games. Recently, Rennie sold a classic video game that a customer “just had to have.” Rennie paid \$11,250 for it, owned it for 14 months, and sold it for \$18,000. Rennie had suspected that this particular classic video game would be of interest to collectors; so he had it refurbished, put it on display in his video arcade, and listed it for sale on the Internet. No customers in the arcade had played it other than those testing it before considering it for purchase. Rennie would like the gain on the sale of the classic video game to be a long-term capital gain. Did he achieve that objective? Why or why not?
40. **LO.2** George is the owner of numerous classic automobiles. His intention is to hold the automobiles until they increase in value and then sell them. He rents the automobiles for use in various events (e.g., antique automobile shows) while he is holding them. In 2015, he sold a classic automobile for \$1.5 million. He had held the automobile for five years, and it had a tax basis of \$750,000. Was the automobile a capital asset? Why or why not?
41. **LO.2, 4** Barbella purchased a wedding ring for \$15 at a yard sale in May. She thought the ring was costume jewelry, but it turned out to be a real diamond ring. She is not in the business of buying and selling anything. She researched the ring on the Internet and discovered that it was worth at least \$1,000. She sold it on an Internet auction site for \$1,100 in July. Was the ring a capital asset? What were the amount and nature of the gain or loss from its sale by Barbella?
42. **LO.2** Puce is a corporation that buys and sells financial assets. It purchases notes receivable from manufacturers that need cash immediately and cannot wait to collect the notes. Puce pays about 88% of the face value of the receivables and then collects them. Because of the quality of the notes, Puce collected less than it paid for some of the notes. Does Puce have a capital loss when it collects the receivables for less than it paid for them? Explain.
- Communications**
43. **LO.2** Faith Godwin is a dealer in securities. She has spotted a fast-rising company and would like to buy and hold its stock for investment. The stock is currently selling for \$2 per share, and Faith thinks it will climb to \$40 a share within two years. Faith’s coworkers have told her that there is “no way” she can get long-term capital gain treatment when she purchases stock because she is a securities dealer. Faith has asked you to calculate her potential gain and tell her whether her coworkers are right. Draft a letter to Faith, responding to her request. Her address is 200 Catamon Drive, Great Falls, MT 59406.
44. **LO.2** Maria meets all of the requirements of § 1237 (subdivided realty). In 2015, she begins selling lots and sells four separate lots to four different purchasers. She also sells two contiguous lots to another purchaser. The sales price of each lot is \$30,000. Maria’s basis for each lot is \$15,000. Selling expenses are \$500 per lot.
- What are the realized and recognized gain?
 - Explain the nature of the gain (i.e., ordinary income or capital gain).
 - Would your answers change if, instead, the lots sold to the fifth purchaser were not contiguous? If so, how?

45. **LO.2, 3, 5** Melaney has had a bad year with her investments. She lent a friend \$8,000; the friend did not repay the loan when it was due and then declared bankruptcy. The loan is totally uncollectible. Melaney also was notified by her broker that the Oak corporate bonds she owned became worthless on October 13, 2015. She had purchased the bonds for \$22,000 on November 10, 2014. Melaney also had a \$60,000 loss on the disposition of § 1244 corporate stock that she purchased several years ago. Melaney is single. **Decision Making**
- What are the nature and amount of Melaney's losses?
 - What is Melaney's AGI for 2015 assuming that she has \$65,000 of ordinary gross income from sources other than those discussed?
 - What are the nature and amount of Melaney's loss carryforwards?
46. **LO.2, 3** Benny purchased \$400,000 of Peach Corporation face value bonds for \$320,000 on November 13, 2014. The bonds had been issued with \$80,000 of original issue discount because Peach was in financial difficulty in 2014. On December 3, 2015, Benny sold the bonds for \$283,000 after amortizing \$1,000 of the original issue discount. What are the nature and amount of Benny's gain or loss?
47. **LO.3** Fred is an investor in vacant land. When he thinks he has identified property that would be a good investment, he approaches the landowner, pays the landowner for a "right of first refusal" to purchase the land, records this right in the property records, and then waits to see if the land increases in value. The right of first refusal is valid for four years. Fourteen months ago, Fred paid a landowner \$9,000 for a right of first refusal. The land was selected as the site of a new shopping center, and the landowner was offered \$1 million for the land. In its title search on the land, the buyer discovered Fred's right of first refusal and involved him in the purchase negotiations. Ultimately, the landowner paid Fred \$220,000 to give up his right of first refusal; the landowner then sold the land to the buyer for \$4,220,000. Fred has a marginal tax rate of 39.6%. **Decision Making**
- What difference does it make whether Fred treats the right of first refusal as an option to purchase the land?
 - What difference does it make whether Fred is a "dealer" in land?
48. **LO.3** Carla was the owner of vacant land that she was holding for investment. She paid \$1 million for the land in 2013. Raymond was an investor in vacant land. He thought Carla's land might be the site of an exit ramp from a new freeway. Raymond gave Carla \$836,000 for an option on her land in 2014. The option was good for two years and gave Raymond the ability to purchase Carla's land for \$4,765,000. The freeway was not approved by the government, and Raymond's option expired in 2015. Does Carla have \$836,000 of long-term capital gain upon the expiration of the option? Explain.
49. **LO.3** Hilde purchased all of the rights to a patent on a new garden tool developed by a friend of hers who is an amateur inventor. The inventor obtained the patent rights, set up a manufacturing company to produce and sell the garden tool, and produced substantial quantities of the tool, but he then became discouraged when no large garden company would agree to distribute the tool for him. Hilde purchased the patent rights (but not the manufacturing company) for \$120,000 on October 24, 2014. Hilde had never engaged in such a transaction before, but she is a salesperson in the garden industry and thought she could succeed where her friend had failed. On June 27, 2015, she sold all patent rights to Garden Tool Company for \$1,233,000. Garden Tool will manufacture the tool in its own factory and sell it to its customers. What is the nature of Hilde's gain from this transaction?
50. **LO.3, 4, 14** Mac, an inventor, obtained a patent on a chemical process to clean old aluminum siding so that it can be easily repainted. Mac has a \$500,000 tax basis in the patent. Mac does not have the capital to begin manufacturing and **Decision Making**

selling this product, so he has done nothing with the patent since obtaining it two years ago. Now a group of individuals has approached him and offered two alternatives. Under one alternative, they will pay Mac \$600,000 (payable evenly over the next 15 years) for the exclusive right to manufacture and sell the product. Under the other, they will form a business and contribute capital to it to begin manufacturing and selling the product; Mac will receive 20% of the company's shares of stock in exchange for all of his patent rights. Discuss which alternative is better for Mac.

51. **LO.3** Freys, Inc., sells a 12-year franchise to Reynaldo. The franchise contains many restrictions on how Reynaldo may operate his store. For instance, Reynaldo cannot use less than Grade 10 Idaho potatoes, must fry the potatoes at a constant 410 degrees, must dress store personnel in Freys-approved uniforms, and must have a Freys sign that meets detailed specifications on size, color, and construction. When the franchise contract is signed, Reynaldo makes a noncontingent \$160,000 payment to Freys. During the same year, Reynaldo pays Freys \$300,000—14% of Reynaldo's sales. How does Freys treat each of these payments? How does Reynaldo treat each of the payments?

- Issue ID** 52. **LO.3** Angie owns numerous strip malls. A major tenant of one of the strip malls wanted to cancel its lease because it was moving to another city. After lengthy negotiations, the tenant paid Angie \$60,000 to cancel its obligations under the lease. If the tenant had fulfilled the lease terms, Angie would have received rent of \$700,000. What factors should Angie consider to determine the amount and character of her income from these circumstances?
53. **LO.3** Consuela was a tenant in a campus apartment. She is a student at State University. Her lease began on August 1, 2015, and was due to expire on July 31, 2016. However, her landlord sold the building, and the new owner wanted to demolish it to build a retail building. Consuela's landlord paid her \$1,000 to cancel the lease. Consuela received the \$1,000 on November 30, 2015; moved out; and rented another apartment. How should Consuela treat the \$1,000?
54. **LO.4** Maria held vacant land that qualified as an investment asset. She purchased the vacant land on April 10, 2011. She exchanged the vacant land for a rental house in a qualifying like-kind exchange on January 22, 2015. Maria was going to hold the house for several years and then sell it. However, she got an "offer she could not refuse" and sold it on November 22, 2015, for a substantial gain. What was Maria's holding period for the house?
55. **LO.4** Roger inherited 100 shares of Periwinkle stock when his mother, Emily, died. Emily had acquired the stock for a total of \$60,000 on November 15, 2011. She died on August 10, 2015, and the shares were worth a total of \$55,000 at that time. Roger sold the shares for \$36,000 on December 22, 2015. How much gain or loss does Roger recognize? What is the nature of that gain or loss?
56. **LO.4** Sarah received a gift of farmland from her father. The land was worth \$4 million at the date of the gift, had been farmed by her father for 40 years, and had a tax basis for her father of \$30,000. Sarah never farmed the land and sold it eight months after receiving it from her father for \$4.2 million. What is Sarah's holding period for the farmland? What is the nature of the gain from its disposition?
57. **LO.5** Dennis sells short 100 shares of ARC stock at \$20 per share on January 15, 2015. He buys 200 shares of ARC stock on April 1, 2015, at \$25 per share. On May 2, 2015, he closes the short sale by delivering 100 of the shares purchased on April 1.
- What are the amount and nature of Dennis's loss upon closing the short sale?
 - When does the holding period for the remaining 100 shares begin?
 - If Dennis sells (at \$27 per share) the remaining 100 shares on January 20, 2016, what will be the nature of his gain or loss?

58. **LO.5** Elaine Case (single with no dependents) has the following transactions in 2015: **Communications**

AGI (exclusive of capital gains and losses)	\$240,000
Long-term capital gain	22,000
Long-term capital loss	(8,000)
Short-term capital gain	19,000
Short-term capital loss	(23,000)

What is Elaine's net capital gain or loss? Draft a letter to Elaine describing how the net capital gain or loss will be treated on her tax return. Assume that Elaine's income from other sources puts her in the 39.6% bracket. Elaine's address is 300 Ireland Avenue, Shepherdstown, WV 25443.

59. **LO.3, 5** In 2015, Bertha Jarow (head of household with three dependents) had a \$28,000 loss from the sale of a personal residence. She also purchased from an individual inventor for \$7,000 (and resold in two months for \$18,000) a patent on a rubber bonding process. The patent had not yet been reduced to practice. Bertha purchased the patent as an investment. In addition, she had the following capital gains and losses from stock transactions: **Communications**

Long-term capital loss	(\$ 6,000)
Long-term capital loss carryover from 2014	(12,000)
Short-term capital gain	21,000
Short-term capital loss	(7,000)

What is Bertha's net capital gain or loss? Draft a letter to Bertha, explaining the tax treatment of the sale of her personal residence. Assume that Bertha's income from other sources puts her in the 28% bracket. Bertha's address is 1120 West Street, Ashland, OR 97520.

60. **LO.2, 4, 5** Bridgette is known as the "doll lady." She started collecting dolls as a child, always received one or more dolls as gifts on her birthday, never sold any dolls, and eventually owned 600 dolls. She is retiring and moving to a small apartment and has decided to sell her collection. She lists the dolls on an Internet auction site and, to her great surprise, receives an offer from another doll collector of \$45,000 for the entire collection. Bridgette sells the entire collection, except for five dolls she purchased during the last year. She had owned all of the dolls sold for more than a year. What tax factors should Bridgette consider in deciding how to report the sale? **Issue ID**
61. **LO.5** Phil and Susan are married taxpayers, filing a joint return. The couple have two dependent children. Susan has wages of \$34,000 in 2015. Phil does not work due to a disability, but he is a buyer and seller of stocks on the Internet. He generally buys and holds for long-term gain, but occasionally gets in and out of a stock quickly. The couple's 2015 stock transactions are detailed below. In addition, they have \$2,300 of qualifying dividends.

Item	Date Acquired	Date Sold	Cost	Sales Price
Blue stock	11/10/14	03/12/15	\$ 3,000	\$ 6,000
Puce stock	12/13/13	05/23/15	36,000	32,000
Beige stock	12/14/10	07/14/15	13,000	14,500
Red stock	06/29/14	05/18/15	26,000	27,000
Black stock	05/15/14	10/18/15	67,000	67,800
Gray stock	04/23/13	10/18/15	89,000	88,200

What is Phil and Susan's AGI?

62. **LO.5** Paul has the following long-term capital gains and losses for 2015: \$62,000 28% gain, \$21,000 28% loss, \$18,000 25% gain, and \$64,000 0%/15%/20% gain. He also has a \$53,000 short-term loss and a \$5,000 short-term gain. What is Paul's AGI from these transactions? If he has a net long-term capital gain, what is its makeup in terms of the alternative tax rates?
63. **LO.5** Helena has the following long-term capital gains and losses for 2015: \$65,000 28% gain, \$53,000 28% loss, \$28,000 25% gain, and \$24,000 0%/15%/20% loss. She also has a \$33,000 short-term loss and a \$65,000 short-term gain. What is Helena's AGI from these transactions? If she has a net long-term capital gain, what is its makeup in terms of the alternative tax rates?
64. **LO.5** For 2015, Ashley has gross income of \$8,500 and a \$5,000 long-term capital loss. She claims the standard deduction. Ashley is 35 years old and single with two dependent children. How much of Ashley's \$5,000 capital loss carries over to 2016?
65. **LO.5** Jane and Blair are married taxpayers filing jointly and have 2015 taxable income of \$97,000. The taxable income includes \$5,000 of gain from a capital asset held five years, \$2,100 of gain from a capital asset held seven months, and \$13,000 of gain from a capital asset held four years. All of the capital assets were stock in publicly traded corporations. Jane and Blair also have qualified dividend income of \$3,000. What is the couple's tax on taxable income?
66. **LO.5** For 2015, Wilma has properly determined taxable income of \$36,000, including \$3,000 of unrecaptured § 1250 gain and \$8,200 of 0%/15%/20% gain. Wilma qualifies for head-of-household filing status. Compute Wilma's tax liability and the tax savings from the alternative tax on net capital gain.
67. **LO.5** Asok's AGI for 2015 is \$133,050. Included in this AGI is a \$45,000 25% long-term capital gain and a \$13,000 0%/15%/20% long-term capital gain. Asok is single, uses the standard deduction, and has only his personal exemption. Compute his taxable income, the tax liability, and the tax savings from the alternative tax on net capital gain.
68. **LO.6** Gray, Inc., a C corporation, has taxable income from operations of \$1,452,000 for 2015. It also has a net long-term capital loss of \$355,000 from the sale of a subsidiary's stock. The year 2015 is the first year in the last 10 years that Gray has not had at least \$500,000 per year of net long-term capital gains. What is Gray's 2015 taxable income? What, if anything, can it do with any unused capital losses?

Decision Making 69. **LO.3, 14** Harriet, who is single, is the owner of a sole proprietorship. Two years ago, Harriet developed a process for preserving doughnuts that gives the doughnuts a much longer shelf life. The process is not patented or copyrighted, but only Harriet knows how it works. Harriet has been approached by a company that would like to buy the process. Harriet insists that she receive a long-term employment contract with the acquiring company as well as be paid for the rights to the process. The acquiring company offers Harriet a choice of two options: (1) \$650,000 in cash for the process and a 10-year covenant not to compete at \$65,000 per year or (2) \$650,000 in cash for a 10-year covenant not to compete and \$65,000 per year for 10 years in payment for the process. Which option should Harriet accept? What is the tax effect on the acquiring company of each approach?

Communications 70. **LO.8** A sculpture that Korliss Kane held for investment was destroyed in a flood. The sculpture was insured, and Korliss had a \$60,000 gain from this casualty. He also had a \$17,000 loss from an uninsured antique vase that was destroyed by the flood. The vase was also held for investment. Korliss had no other property transactions during the year and has no nonrecaptured § 1231 losses from prior years. Both the sculpture and the vase had been held more than one year when the flood occurred. Compute Korliss's net gain or loss, and identify how it would be treated. Also write a letter to Korliss, explaining the nature of the gain or loss. Korliss's address is 2367 Meridian Road, Hannibal, MO 63401.

71. **LO.8** Keshara has the following net § 1231 results for each of the years shown. What would be the nature of the net gains in 2014 and 2015?

Tax Year	Net § 1231 Loss	Net § 1231 Gain
2010	\$18,000	
2011	33,000	
2012	42,000	
2013		\$41,000
2014		30,000
2015		41,000

72. **LO.8, 14** Jingie owns two parcels of business land (§ 1231 assets). One parcel can be sold at a loss of \$60,000, and the other parcel can be sold at a gain of \$70,000. Jingie has no nonrecaptured § 1231 losses from prior years. The parcels could be sold at any time because potential purchasers are abundant. Jingie has a \$35,000 short-term capital loss carryover from a prior tax year and no capital assets that could be sold to generate long-term capital gains. Both land parcels have been held more than one year. What should Jingie do based upon these facts? (Assume that tax rates are constant, and ignore the present value of future cash flow.)
73. **LO.7, 8, 9** Siena Industries (a sole proprietorship) sold three § 1231 assets during 2015. Data on these property dispositions are as follows:

Decision Making

Asset	Cost	Acquired	Depreciation	Sold for	Sold on
Rack	\$100,000	10/10/11	\$62,000	\$85,000	10/10/15
Forklift	35,000	10/16/12	23,000	5,000	10/10/15
Bin	87,000	03/12/14	34,000	60,000	10/10/15

- a. Determine the amount and the character of the recognized gain or loss from the disposition of each asset.
- b. Assuming that Siena has no nonrecaptured net § 1231 losses from prior years, how much of the 2015 recognized gains is treated as capital gains?
74. **LO.8, 9** Copper Industries (a sole proprietorship) sold three § 1231 assets during 2015. Data on these property dispositions are as follows:

Asset	Cost	Acquired	Depreciation	Sold for	Sold on
Rack	\$110,000	10/10/12	\$70,000	\$55,000	10/10/15
Forklift	45,000	10/16/11	21,000	15,000	10/10/15
Bin	97,000	03/12/14	31,000	60,000	10/10/15

- a. Determine the amount and the character of the recognized gain or loss from the disposition of each asset.
- b. Assuming that Copper has \$6,000 nonrecaptured net § 1231 losses from prior years, how much of the 2015 recognized gains is treated as capital gains?
75. **LO.8, 9** On December 1, 2013, Lavender Manufacturing Company (a corporation) purchased another company's assets, including a patent. The patent was used in Lavender's manufacturing operations; \$49,500 was allocated to the patent, and it was amortized at the rate of \$275 per month. On July 30, 2015, Lavender sold the patent for \$95,000. Twenty months of amortization had been taken on the patent. What are the amount and nature of the gain Lavender recognizes on the

Communications

disposition of the patent? Write a letter to Lavender, discussing the treatment of the gain. Lavender's address is 6734 Grover Street, Boothbay Harbor, ME 04538. The letter should be addressed to Bill Cubit, Controller.

76. **LO.8, 10** On June 1, 2011, Skylark Enterprises (not a corporation) acquired a retail store building for \$500,000 (with \$100,000 being allocated to the land). The store building was 39-year real property, and the straight-line cost recovery method was used. The property was sold on June 21, 2015, for \$385,000.
- Compute the cost recovery and adjusted basis for the building using Exhibit 8.9 from Chapter 8.
 - What are the amount and nature of Skylark's gain or loss from disposition of the building? What amount, if any, of the gain is unrecaptured § 1250 gain?
77. **LO.8, 9, 10** On May 2, 1987, Hannah acquired residential real estate for \$450,000. Of the cost, \$100,000 was allocated to the land and \$350,000 to the building. On August 20, 2015, the building, which then had an adjusted basis of \$0, was sold for \$545,000 and the land for \$200,000.
- Determine the amount and character of the recognized gain from the sale of the building.
 - Determine the amount and character of the recognized gain from the sale of the land.
78. **LO.8, 9, 10** Larry is the sole proprietor of a trampoline shop. During 2015, the following transactions occurred:
- Unimproved land adjacent to the store was condemned by the city on February 1. The condemnation proceeds were \$15,000. The land, acquired in 1985, had an allocable basis of \$40,000. Larry has additional parking across the street and plans to use the condemnation proceeds to build his inventory.
 - A truck used to deliver trampolines was sold on January 2 for \$3,500. The truck was purchased on January 2, 2011, for \$6,000. On the date of sale, the adjusted basis was zero.
 - Larry sold an antique rowing machine at an auction. Net proceeds were \$4,900. The rowing machine was purchased as used equipment 17 years ago for \$5,200 and is fully depreciated.
 - Larry sold an apartment building for \$300,000 on September 1. The rental property was purchased on September 1, 2012, for \$150,000 and was being depreciated over a 27.5-year life using the straight-line method. At the date of sale, the adjusted basis was \$124,783.
 - Larry's personal yacht was stolen on September 5. The yacht had been purchased in August at a cost of \$25,000. The fair market value immediately preceding the theft was \$19,600. Larry was insured for 50% of the original cost, and he received \$12,500 on December 1.
 - Larry sold a Buick on May 1 for \$9,600. The vehicle had been used exclusively for personal purposes. It was purchased on September 1, 2011, for \$20,800.
 - Larry's trampoline stretching machine (owned two years) was stolen on May 5, but the business's insurance company will not pay any of the machine's value because Larry failed to pay the insurance premium. The machine had a fair market value of \$8,000 and an adjusted basis of \$6,000 at the time of theft.
 - Larry had AGI of \$102,000 from sources other than those described above.
 - Larry has no nonrecaptured § 1231 lookback losses.
- For each transaction, what are the amount and nature of recognized gain or loss?
 - What is Larry's 2015 AGI?

79. **LO.8, 10** On January 1, 2006, Stephanie Bridges acquired depreciable real property for \$50,000. She used straight-line depreciation to compute the asset's cost recovery. The asset was sold for \$96,000 on January 3, 2015, when its adjusted basis was \$38,000. **Communications**
- What are the amount and nature of the gain if the real property is residential?
 - Stephanie is curious about how the recapture rules differ for tangible personal property and for residential rental real estate acquired in 1987 and thereafter. Write a letter to Stephanie, explaining the differences. Her address is 2345 Westridge Street #23, Edna, KS 67342.
80. **LO.8, 9, 11, 14** Joanne is in the 28% tax bracket and owns depreciable business equipment that she purchased several years ago for \$135,000. She has taken \$100,000 of depreciation on the equipment, and it is worth \$55,000. Joanne's niece, Susan, is starting a new business and is short of cash. Susan has asked Joanne to gift the equipment to her so that Susan can use it in her business. Joanne no longer needs the equipment. Identify the alternatives available to Joanne if she wants to help Susan and the tax effects of those alternatives. (Assume that all alternatives involve the business equipment in one way or another, and ignore the gift tax.) **Decision Making**
81. **LO.8, 9, 11** Anna received tangible personal property with a fair market value of \$65,000 as a gift in 2013. The donor had purchased the property for \$77,000 and had taken \$77,000 of depreciation. Anna used the property in her business. Anna sells the property for \$23,000 in 2015. What are the tax status of the property and the nature of the recognized gain when she sells the property?
82. **LO.8, 9, 11** Miguel receives tangible personal property as an inheritance in 2013. The property was depreciated by the deceased (Miguel's father), and Miguel will also depreciate it. At the date of the deceased's death, the property was worth \$532,000. The deceased had purchased it for \$900,000 and taken \$523,000 of depreciation on the property. Miguel takes \$223,000 of depreciation on the property before selling it for \$482,000 in 2015. What are the tax status of the property and the nature of the recognized gain when Miguel sells the property?
83. **LO.11** David contributes to charity some tangible personal property that he had used in his business and depreciated. At the date of the donation, the property has a fair market value of \$233,000 and an adjusted basis of zero; it was originally acquired for \$400,000. What is the amount of David's charitable contribution?
84. **LO.8, 9, 11** Dedria contributes to her wholly owned corporation some tangible personal property that she had used in her sole proprietorship business and depreciated. She had acquired the property for \$566,000 and had taken \$431,000 of depreciation on it before contributing it to the corporation. At the date of the contribution, the property had a fair market value of \$289,000. The corporation took \$100,000 of depreciation on the property and then sold it for \$88,000 in 2015. What are the tax status of the property to the corporation and the nature of the recognized gain or loss when the corporation sells the property?
85. **LO.8, 9, 12** Tan Corporation purchased depreciable tangible personal property for \$100,000 in 2013 and immediately expensed the entire cost under § 179. In 2015, when the property was worth \$80,000, Tan distributed it as a dividend to the corporation's sole shareholder. What was the tax status of this property for Tan? What is the nature of the recognized gain or loss from the distribution of the property?

86. **LO.7, 8, 10** Jasmine owned rental real estate that she sold to her tenant in an installment sale. Jasmine acquired the property in 2003 for \$400,000; took \$178,000 of depreciation on it; and sold it for \$210,000, receiving \$25,000 immediately and the balance (plus interest at a market rate) in equal payments of \$18,500 for 10 years. What is the nature of the recognized gain or loss from this transaction?

- Decision Making** 87. **LO.9** Jay sold three items of business equipment for a total of \$300,000. None of the equipment was appraised to determine its value. Jay's cost and adjusted basis for the assets are shown below.

Asset	Cost	Adjusted Basis
Skidder	\$230,000	\$ 40,000
Driller	120,000	60,000
Platform	620,000	-0-
Total	<u>\$970,000</u>	<u>\$100,000</u>

Jay has been unable to establish the fair market values of the three assets. All he can determine is that combined they were worth \$300,000 to the buyer in this arm's length transaction. How should Jay allocate the sales price and figure the gain or loss on the sale of the three assets?

Cumulative Problems

Tax Return Problem



88. Ashley Panda lives at 1310 Meadow Lane, Wayne, OH 43466, and her Social Security number is 123-45-6789. Ashley is single and has a 20-year-old son, Bill. His Social Security number is 111-11-1111. Karl lives with Ashley, and she fully supports him. Bill spent 2014 traveling in Europe and was not a college student. He had gross income of \$4,655 in 2014.

Ashley owns the Enterprises, LLC sole proprietorship, a data processing service (98-7654321), which is located at 456 Hill Street, Wayne, OH 43466. The business activity code is 514210. Her 2014 Form 1040, Schedule C for Panda Enterprises shows revenues of \$315,000, office expenses of \$66,759, employee salary of \$63,000, employee payroll taxes of \$3,560, meals and entertainment expenses (before the 50% reduction) of \$22,000, and rent expense of \$34,000. The rent expense includes payments related to renting an office (\$30,000) and payments related to renting various equipment (\$4,000). There is no depreciation because all depreciable equipment owned has been fully depreciated in previous years. No fringe benefits are provided to the employee. Ashley personally purchases health insurance on herself and Bill. The premiums are \$23,000 per year.

Ashley has an extensive stock portfolio and has prepared the following analysis:

Stock	Number of Shares	Date Purchased	Date Sold	Per-Share Cost	Per-Share Selling Price	Total Dividends
Beige	10	10/18/13	10/11/14	\$80	\$ 74	\$30
Garland	30	10/11/07	10/11/14	43	157	70
Puce	15	3/10/14	8/11/14	62	33	45

NOTE: Ashley received a Form 1099-B from her stockbroker that included the adjusted basis and sales proceeds for each of her stock transactions. The per-share cost includes commissions, and the per-share selling price is net of commissions. Also, the dividends are the actual dividends received in 2014 and these are qualified dividends.

Ashley had \$800 of interest income from State of Ohio bonds and \$600 of interest income on her Wayne Savings Bank account. She paid \$25,000 of alimony to her former husband. His Social Security number is 123-45-6788.

Ashley itemizes her deductions and had the following items, which may be relevant to her return:

Item	Amount	Comment
Unreimbursed medical expenses for Ashley (all for visits to doctors)	\$1,786	Does not include health insurance premiums.
State income taxes paid	1,830	
Real property taxes on personal residence	3,230	
Interest paid on home mortgage (Form 1098)	8,137	The loan is secured by the residence and was incurred when the home was purchased.
Charitable contributions	940	Cash paid to Ashley's church.
Sales taxes	619	Amount per sales tax table.

Ashley made a \$30,000 estimated Federal income tax payment, does not want any of her taxes to finance presidential elections, has no foreign bank accounts or trusts, and wants any refund to be applied against her 2015 taxes.

Compute Ashley's net tax payable or refund due for 2014. If you use tax forms for your computations, you will need Form 1040 and its Schedules A, C, D, and SE and Form 8949. Suggested software: H&R BLOCK Tax Software.

89. Justin Stone was an employee of DataCare Services, Inc. His salary was \$45,000 through November 10, 2014, when he was laid off. DataCare Services provided medical insurance for Justin and his family during his employment and agreed to continue this coverage through the end of 2014. He received \$7,000 of unemployment compensation from November 11, 2014 through December 31, 2014. FICA withholdings were as follows: Social Security of \$2,790 ($\$45,000 \times 6.2\%$) and Medicare of \$653 ($\$45,000 \times 1.45\%$). Justin lives at 112 Green Road, Crown City, OH 45623. His Social Security number is 111-11-1111. Justin owned an apartment building until November 22, 2014, when he sold it for \$200,000. For 2014, he had rent revenue of \$33,000. He incurred and paid expenses as follows: \$4,568 of repairs, \$22,000 of mortgage interest, and \$1,000 of miscellaneous expenses. He purchased the building on January 2, 2008, for \$125,000. The building generated an operating profit each year that Justin owned it.

Other information follows:

- On November 22, 2014, Justin sold for \$3,500 equipment that had been used for repairing various items in the apartments. The equipment was purchased for \$25,000 on July 10, 2007, and was fully depreciated prior to 2014.
- Justin has \$3,000 of unrecaptured § 1231 losses from prior years.
- Justin is age 38; is single; is divorced; and has custody of his 9-year-old son, Flint. Justin provides more than 50% of Flint's support. Flint's Social Security number is 123-45-6789.
- Justin had \$1,000 interest income from Blue Corporation bonds.
- Justin had \$1,500 interest income from a State Bank certificate of deposit.
- Justin had a \$2,000 0%/15%/20% long-term capital gain distribution from the Brown Stock Investment Fund.
- Justin had the following itemized deductions: \$4,600 real estate taxes on his home; \$8,900 mortgage interest on his home; \$4,760 charitable contributions (all in cash, properly documented, and no single contribution exceeded \$25); \$4,300 state income tax withholding during 2014; \$2,000 state estimated income tax payments during 2014; \$2,600 sales taxes paid.
- Justin does not want to donate to the Presidential Election Campaign Fund.
- He had \$12,000 of Federal income tax withholding during 2014 and made total Federal estimated income tax payments of \$14,000 during 2014.

Tax Return Problem



Compute Justin's 2014 net tax payable or refund due. If you use tax forms for your computations, you will need Form 1040 and Schedules A, B, D, and E. You will also need Form 4797. Suggested software: H&R BLOCK Tax Software.

See Appendix E for Comprehensive Tax Return Problems—Form 1040

Research Problems



Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Siva Nathaniel owns various plots of land in Fulton County, Georgia. He acquired the land at various times during the last 20 years. About every fourth year, Siva subdivides into lots one of the properties he owns. He then has water, sewer, natural gas, and electricity hookups put in each lot and paves new streets. Siva has always treated his sales of such lots as sales of capital assets. His previous tax returns were prepared by an accountant whose practice you recently purchased. Has the proper tax treatment been used on the prior tax returns? Explain.

Partial list of research aids:

§§ 1221 and 1237 and *Jesse W. and Betty J. English*, 65 TCM 2160, T.C.Memo. 1993-111.

Research Problem 2. Clyde had worked for many years as the chief executive of Red Industries, Inc., and had been a major shareholder. Clyde and the company had a falling out, and Clyde was terminated. Clyde and Red executed a document under which Clyde's stock in Red would be redeemed and Clyde would agree not to compete against Red in its geographic service area. After extensive negotiations between the parties, Clyde agreed to surrender his Red stock in exchange for \$600,000. Clyde's basis in his shares was \$143,000, and he had held the shares for 17 years. The agreement made no explicit allocation of any of the \$600,000 to Clyde's agreement not to compete against Red. How should Clyde treat the \$600,000 payment on his 2015 tax return?

Research Problem 3. Your client, Alternate Fuel, Inc. (a regular corporation), owns three sandwich shops in the Philadelphia area. In 2012, the year Alternate Fuel incorporated, it acquired land on the outskirts of Philadelphia with the hope of someday farming the land to cultivate humanely harvested meat and grow organic fruits and vegetables to use in its sandwich shops. In 2014, Alternate Fuel drew up plans for the farm and began consulting with agricultural experts about the best locations for crops and the number of animals that could be sustained on the acreage. After reviewing those plans, Alternate Fuel's CEO decided that the plans are not currently financially feasible and would like to sell the land in 2015. The land has appreciated substantially in value, and the company could use the cash infusion. Given that the land has not been used in the business, will any gain realized be categorized as a § 1231 gain or as a long-term capital gain? Explain.

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. Perform a Google search to find information about capital gains tax rates worldwide (and across U.S. states). Try searching for "capital gains rate by country (state)." What jurisdiction has the highest capital gains tax rate? What U.S. states have high capital gains tax rates?

Research Problem 5. Search for the phrase "mortgage and real estate fraud" on the IRS's website (www.irs.gov). Read the articles you find, and explain why this type of fraud is often unearthed by the IRS.

Roger CPA Review Questions

1. Identify which of the following is a capital asset:
 - I. A canvas painting of a portrait client, in the painter's hands
 - II. Depreciable fixtures in a business parking lot
 - III. Treasury stock
 - a. II only
 - b. II and III only
 - c. III only
 - d. None of the above

 2. On January 15 of the current year Kreutzer, an individual, inherited from Gladstone shares of stock worth \$25,000. Gladstone had purchased the shares in June of the previous year for \$20,000, and the shares were worth \$23,000 at Gladstone's date of death. The executor of Gladstone's estate did not elect to use the alternate valuation date. In March of the current year, Kreutzer sold the shares for \$27,000. As a result of the sale, what will be the amount and type of gain reported by Kreutzer?
 - a. \$4,000 long-term capital gain
 - b. \$2,000 short-term capital gain
 - c. \$7,000 short-term capital gain
 - d. \$2,000 long-term capital gain

 3. The following facts apply to Collins, an individual:

In February of the current year, Hodge, who had owed a \$5,000 personal debt to Collins for the past three years, declared bankruptcy.

Collins sold land used in Collins's business for a \$10,000 gain. The land had been purchased by Collins five years prior.

In July of the current year, Collins received shares of stock as a gift from Bellamy. Bellamy had purchased the shares in January of the current year. In November, Collins sold the stock for a gain of \$3,000.

Considering only the above facts, what will Collins report on the current year tax return?
- a. \$2,000 long-term capital gain
 - b. \$8,000 long-term capital gain
 - c. \$10,000 ordinary income and \$2,000 short-term capital loss
 - d. \$5,000 long-term capital gain and \$3,000 short-term capital gain
-
4. In 20X14 Colossus Corporation incurred a net capital loss in the amount of \$25,000. Colossus had the following net capital gains in the previous five years:

20X13 - \$7,000

20X12 - \$2,000

20X11 - \$5,000

20X10 - \$4,000

20X09 - \$3,000

How much of the 20X14 net capital loss may Colossus carry over to 20X15?
 - a. \$0
 - b. \$8,000
 - c. \$11,000
 - d. \$1,000

5. The following facts apply to Eliot, an individual, in the current year:

April 1: Sold shares of stock, purchased on April 1 of the previous year, for a \$2,000 gain

May 15: Sold equipment used in Eliot's business, which had been purchased in July of the previous year, for a \$2,000 gain

July 12: Sold shares of stock, purchased in February of the previous year, for a \$7,000 gain

November 3: Sold equipment used in Eliot's business, which had been purchased in January of the current year, for a \$1,000 loss

December 9: Sold shares of stock, purchased on February 22 of the current year, for a \$3,000 loss

Considering only the above facts, what is Eliot's net capital gain for the current year?

- \$7,000 long-term capital gain
 - \$9,000 long-term capital gain
 - \$5,000 long-term capital gain
 - \$6,000 long-term capital gain
6. In Year 1, Gardner used funds earmarked for use in Gardner's business to make a personal loan to Carson. In Year 3, Carson declared bankruptcy, having paid off only \$500 of the loan at that time. In Year 1, Gardner purchased equipment for use in Gardner's business. In Year 3, Gardner sold the equipment at a \$5,000 loss. In January of Year 3, Gardner received shares of stock as a gift from Smith; the shares had been purchased by Smith in Year 1. In November of Year 3, Gardner sold the shares of stock for a \$5,000 gain.

Which of the above transactions will Gardner report as long-term capital gains or losses for Year 3?

- The bad debt write-off
 - The sale of equipment
 - The sale of shares
- II and III only
 - I only
 - III only
 - None of the above
7. On March 1 of the current year Reiter, an individual, sold an office building for \$300,000 that had an adjusted basis of \$220,000, resulting in a gain of \$80,000. Reiter had purchased the building for \$260,000 on April 1 of the previous year, and \$30,000 of the total depreciation taken took advantage of a special tax incentive program Reiter qualified for. How should Reiter report this gain on the current year tax return?
- \$80,000 ordinary gain
 - \$30,000 ordinary gain and \$50,000 long-term capital gain
 - \$50,000 ordinary gain and \$30,000 long-term capital gain
 - \$40,000 ordinary gain and \$40,000 short-term capital gain
8. In Year 3, Daniels, an individual, sold Section 1245 property for \$21,000 that had an adjusted basis of \$12,000, resulting in a \$9,000 gain. The property had cost Daniels \$20,000 when purchased in Year 1, and \$8,000 of MACRS depreciation had been taken. How should Daniels report the gain on Daniels' Year 3 tax return?
- As a long-term capital gain of \$9,000
 - As an ordinary gain of \$1,800 and a long-term capital gain of \$7,200
 - As an ordinary gain of \$8,000 and a long-term capital gain of \$1,000
 - As an ordinary gain of \$7,200 and a long-term capital gain of \$1,800

9. Cowabunga Corp. had a highly profitable Year 4, during which it purchased \$1,000,000 in tangible personal property and elected to claim the highest depreciation expense allowed for tax purposes under Code Section 179. In Year 6, Cowabunga sells the tangible personal property, which now has an adjusted basis of \$200,000 as a result of the heavy depreciation taken in Years 4 and 5. Had only MACRS depreciation been taken on the property, its adjusted basis at the time of sale would have been \$800,000. At a sales price of \$930,000, how much of the \$730,000 realized gain must be reported as ordinary gain for tax purposes?
- a. \$720,000
 - b. \$600,000
 - c. \$0
 - d. \$730,000



PART

5

SPECIAL TAX COMPUTATIONS AND ACCOUNTING PERIODS AND METHODS

CHAPTER **15**

Alternative Minimum Tax

CHAPTER **16**

Accounting Periods and Methods

The taxpayer must calculate the tax liability not only in accordance with the basic tax formula, but also in accordance with the tax formula for the alternative minimum tax (AMT). The basic tax formula was presented in Part 1, and the AMT formula is covered here. This part also provides a more comprehensive examination of the accounting periods and accounting methods that were introduced in Part 2.

Alternative Minimum Tax

LEARNING OBJECTIVES: *After completing Chapter 15, you should be able to:*

- | | |
|---|--|
| <p>LO.1 Explain the rationale for the alternative minimum tax (AMT).</p> <p>LO.2 Enumerate the formula for computing the AMT for individuals.</p> <p>LO.3 Identify the adjustments made in calculating the AMT tax base.</p> <p>LO.4 Identify the tax preferences that are included in calculating the AMT.</p> | <p>LO.5 Apply the formula for computing the AMT and complete a Form 6251.</p> <p>LO.6 Illustrate the role of the AMT credit in the alternative minimum tax structure.</p> <p>LO.7 Illustrate the basic features of the corporate AMT.</p> <p>LO.8 Identify tax planning opportunities to minimize the AMT.</p> |
|---|--|

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THE BIG PICTURE

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EFFECTS OF THE AMT

Bob and Carol are unmarried individuals who have been engaged for four months. They work for the same employer and earn identical compensation. They have the same amount of gross income, including the same amount of investment income, which consists solely of interest income; they have similar investments in tax-exempt bonds that produce identical amounts of interest income. They also have the same amount of deductions.

Bob's tax return is prepared by Adam, and Carol's tax return is prepared by Ava. While discussing their tax liability one day at lunch, Carol is dismayed to learn that she paid \$15,000 more in Federal income taxes than Bob did for the tax year. Carol meets with Ava that evening. Ava reviews Carol's tax return and assures her that her tax liability was calculated properly.

The above events raise a number of interesting questions for Bob and Carol. Why didn't Bob and Carol have the same tax liability? Were both tax returns properly prepared? Should Carol consider replacing her tax return preparer, Ava, with Adam? Is it possible and/or desirable for Carol to file an amended return? Should Bob do anything?

Read the chapter and formulate your response.

FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$xx,xxx
Less: Exclusions	<u>(x,xxx)</u>
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income	<u>(x,xxx)</u>
Adjusted gross income.....	\$xx,xxx
Less: The greater of total itemized deductions <i>or</i> the standard deduction	(x,xxx)
Personal and dependency exemptions.....	<u>(x,xxx)</u>
Taxable income	<u>\$xx,xxx</u>
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (<i>including income taxes withheld and prepaid</i>)	<u>(xxx)</u>
Tax due (<i>or refund</i>).....	<u>\$ xxx</u>

FORM 1040 (p. 2)

45 Alternative minimum tax (see instructions). Attach Form 6251

LO.1
Explain the rationale for the alternative minimum tax (AMT).

The tax law contains many incentives that are intended to influence the economic and social behavior of taxpayers (refer to Chapter 1). Some taxpayers can take advantage of enough of these incentives to significantly minimize or entirely avoid any liability for Federal income tax. Although these taxpayers were legally minimizing tax liabilities, Congress is concerned about the inequity that results when taxpayers with substantial economic incomes can avoid paying any income tax.¹ To attempt to alleviate this inequity, the **alternative minimum tax (AMT)** was enacted. The goal of the AMT is to ensure that all taxpayers with more than modest economic income pay some amount of federal income tax.

The AMT applies to individuals, C corporations, trusts, and estates. While the calculations involved are similar for all taxpayers subject to the AMT, some portions of the AMT formula are unique to particular taxpayers. As to individual taxpayers, about 4 million Forms 1040 include a positive AMT liability, raising more than \$25 billion in net revenues for the U.S. Treasury annually. Most of these revenues are raised on tax returns with economic incomes between \$200,000 and \$500,000.

The first part of this chapter presents a discussion of the AMT for individual taxpayers; the corporate AMT is presented in the second part of the chapter. The AMT provisions specific to trusts and estates are not addressed in this chapter.

LO.2
Enumerate the formula for computing the AMT for individuals.

15-1 INDIVIDUAL ALTERNATIVE MINIMUM TAX

In theory, all individual taxpayers subject to the Federal income tax also are subject to AMT. As will be seen in this chapter, whether a taxpayer incurs an AMT liability depends on a number of factors, including the taxpayer's income, geographic location, and family situation, as well as the exclusions, deductions, and credits utilized in the calculation of the regular Federal income tax liability.

¹General Explanation of the Tax Reform Act of 1986 ("Blue Book"), prepared by The Staff of the Joint Committee on Taxation, May 4, 1987, H.R. 3838, 99th Cong., pp. 432-433.

15-1a **Alternative Minimum Taxable Income (AMTI)**

The tax base used to determine an AMT liability is alternative minimum taxable income (AMTI) (Exhibit 15.1). The calculation of AMTI does not follow the direct approach taken in the calculation of the taxpayer's regular taxable income.² In the regular computation, gross income is reduced by deductions to arrive at taxable income. However, in calculating AMTI, the tax law provides for an indirect approach. Rather than having taxpayers recalculate the components of the individual income tax formula using a different set of AMT rules, the calculation of AMTI *begins* with regular taxable income as shown in Exhibit 15.1. In other words, the AMT calculation requires a taxpayer to reconcile taxable income to AMTI.

Part of the reason for this indirect approach may be that many items of income and expense are treated the same way for both regular income tax and AMT purposes. For example, a taxpayer's salary is included in computing both taxable income and AMTI. Alimony paid and certain itemized deductions, such as charitable contributions and gambling losses, also are allowed for both regular income tax and AMT purposes.

While many amounts are left unchanged, the tax law provides that certain income and expense items are treated differently for regular income tax and AMT purposes. For example, interest income on bonds issued by state, county, or local governments is excluded in computing taxable income. However, if such bonds are private activity bonds, the interest income earned is included in AMTI.

In other cases, the income or expense amount is considered in both the regular income tax and AMT computations, but the amount differs. For example, the completed contract method can be used to report income from some long-term contracts for regular income tax purposes, but the percentage of completion method is required for AMT purposes. Thus, in a given tax year, the amount of income from the contract included in regular taxable income will differ from that included in AMTI. Similarly, medical expenses are deductible in calculating both taxable income and AMTI, but the floor for the regular-tax deduction is lower when taxpayers are older than 65.³

As shown in Exhibit 15.1, differences between regular tax and AMT income and expense amounts are categorized as either adjustments or preferences. Most adjustments relate to timing differences that arise because of different regular income tax and AMT treatments. Adjustments that are caused by timing differences will eventually reverse: positive adjustments will be offset by future negative adjustments, and vice versa.⁴

Depreciation provides a good example of a timing difference. In general, AMT depreciation methods are slower than regular tax depreciation methods. Initially then, there

EXHIBIT 15.1

Alternative Minimum Tax (AMT) Formula

Regular taxable income (after add-back of standard deduction and personal or dependency exemptions)

Plus or minus: Adjustments

Plus: Preferences

Equals: Alternative minimum taxable income (AMTI)

Minus: AMT Exemption

Equals: Alternative minimum tax base

Times: 26% or 28% rate

Equals: Tentative minimum tax before credits

Minus: Alternative minimum tax foreign tax credit and other credits

Equals: Tentative minimum tax (TMT)

Minus: Regular tax liability (after foreign tax credit)

Equals: Alternative minimum tax (not less than zero)

²§ 55(b)(2).

⁴§ 56.

³§ 213(f).

will be less depreciation for AMT purposes than for regular tax purposes. This difference will result in positive timing differences until AMT depreciation is larger than regular tax depreciation, when the timing difference will become negative. However, over time, the same amount of depreciation will be deducted for regular tax and AMT purposes because the basis for regular tax and AMT depreciation is the same.

In contrast, in the reconciliation of taxable income to AMTI, preference items will always increase AMTI relative to the taxable income amount.⁵ Certain deductions and exclusions allowed to taxpayers for regular income tax purposes provide significant tax savings. Most AMT preferences are designed to take back all or part of the tax benefit derived from specified deductions and exclusions in the calculation of regular taxable income. The effect of adding back these preference items is to disallow them for AMT purposes. Examples of preferences include percentage depletion in excess of the property's adjusted basis, and excess intangible drilling costs. Both adjustments and preferences are discussed in more detail later in the chapter.



ETHICS & EQUITY Effect of the AMT on Accelerating Expenses

Maurice, a single, cash method taxpayer, projects his taxable income for this year to be about \$300,000. For AMT purposes, he reports positive adjustments and tax preferences of \$200,000. He anticipates that his taxable income and positive adjustments and preferences will be about the same next year. He is evaluating several proposed transactions that could affect his current-year tax liability.

One proposal involves an office building for which he is currently negotiating a lease. The lease has a starting date of July 1 of this year. It provides for annual rent of \$24,000, and it carries an 18-month prepayment clause. Although Maurice favors a five-year lease, his tax adviser has suggested an 18-month period with an option to renew for 42 months. The adviser points out the tax advantage of

being able to deduct the \$36,000 of rent at the inception of the lease. The projected tax liability under each option would be as follows.

	18-Month Lease	5-Year Lease
Regular income tax liability	\$ 70,726	\$ 78,646
AMT	55,486	54,286
Total	<u>\$126,212</u>	<u>\$132,932</u>

After comparing these results, Maurice takes his adviser's suggestion. The shorter-term lease reduces his taxes by about 5 percent.

Is it appropriate for the tax law to allow Maurice to avoid taxes in this manner? Should Maurice take the shorter lease?

15-1b AMT Formula: Other Components

Calculating AMTI is the first step in determining whether a taxpayer must report an alternative minimum tax liability. To complete the AMT calculation, as shown in Exhibit 15.1, the AMT exemption, rates, credit, and regular tax liability must be considered.

Exemption Amount

After calculating AMTI, the taxpayer determines the **AMT exemption** amount. The exemption amounts for AMT are higher than the exemption amounts for regular tax liability purposes.

The AMT exemption amount can be thought of as a materiality provision. Taxpayers with few or minimal positive adjustments and preferences will avoid being subject to the AMT as a result of the exemption.

The initial exemption amount for 2015 depends upon the taxpayer's filing status.⁶ The AMT exemption is phased out at a rate of 25 cents on the dollar when AMTI exceeds certain amounts.

The exemption phaseout is an application of the wherewithal to pay concept. Congress believes that as a taxpayer's AMTI increases, so does the taxpayer's ability to pay income taxes.

⁵ § 57.

⁶ § 55(d)(4)(A).

The 2015 AMT exemption is computed as follows. At the end of the phaseout range, the taxpayer's AMT exemption is zero.

Status	Exemption	Phaseout	
		Begins at	Ends at
Married, joint	\$83,400	\$158,900	\$492,500
Single or head of household	53,600	119,200	333,600
Married, separate	41,700	79,450	246,250

Harry, who is single, reports AMTI of \$192,500 for the year. His \$53,600 initial AMT exemption is reduced by \$18,325 $[(\$192,500 - \$119,200) \times 25\% \text{ phaseout rate}]$. Harry's AMT exemption is \$35,275 (\$53,600 exemption - \$18,325 reduction).

EXAMPLE

1

AMT Liability

After the exemption amount is calculated, a taxpayer's AMT liability can be determined. As shown in Exhibit 15.1, AMTI less the exemption amount equals the taxpayer's tentative minimum tax (TMT). The relationship between the regular tax liability and the TMT is key to the AMT calculation. If the regular tax liability exceeds the TMT, the taxpayer's AMT liability is zero. However, if the TMT exceeds the regular tax liability, the excess is the taxpayer's AMT liability.

**ETHICS & EQUITY The AMT: Problem or Solution?**

The AMT can be traced to the end of the Lyndon Johnson presidency and the beginning of Richard Nixon's in 1969. The theme of the AMT resonates to this day, though, as the tax is characterized as a way to ensure that all taxpayers pay a fair share toward the operations of the Federal government.

Is not the presence of an AMT itself an admission by Congress that it cannot design a tax law that accommodates the circumstances of all taxpayers? If a soak-the-rich approach is desired, a number of popular tax deductions and credits would need to be repealed, but this would also raise the taxes of those in the middle- and lower-income classes. If various

deductions and credits are "good for the economy," in that they increase the disposable income of U.S. citizens, should not wealthy taxpayers also benefit from these tax incentives?

Could you support a system that would assess one type of income tax on low- and middle-income taxpayers and a completely different system that would apply to those of significant wealth? Is it discriminatory to assess higher taxes from those of greater means, as an AMT does? Or is it unfair that wealthier taxpayers can reduce their effective tax rates with tax planning techniques, thereby forcing Congress to use an AMT as a corrective device? Can't Congress fix the Federal income tax so that an AMT is not needed?

Technically, the AMT is a surtax; both tax law and the Form 6251 categorize any excess of TMT over the taxpayer's regular tax liability as the AMT amount.⁷ For practical purposes, the taxpayer will pay whichever tax liability is greater—that calculated using the regular income tax rules or that calculated using the AMT rules.

A graduated, two-tier AMT rate schedule applies to noncorporate taxpayers. A 26 percent rate applies on an AMT base up to \$185,400 (\$92,700 for married, filing separately), and a 28 percent rate applies to that base amount and above.⁸ Any net capital gain or qualified dividend income included in the AMT base is taxed at the favorable alternative tax rates for capital gains (15 percent, 20 percent, or 0 percent) rather than at the AMT statutory rates. See the discussion of the alternative tax on capital gains in Chapter 16.

⁷§ 55(a).

⁸§§ 55(b)(1)(A), (d)(4)(B).

EXAMPLE

2

Anna, an unmarried individual, records regular taxable income of \$100,000. She incurs positive adjustments of \$40,000 and AMT preferences of \$25,000. Anna's regular tax liability for 2015 is \$19,951. Her AMT then is calculated as follows.

Taxable income (TI) prior to exemption amounts	\$100,000
Plus: Adjustments	40,000
Plus: Preferences	25,000
Equals: AMTI	\$165,000
Minus: AMT exemption (\$53,600 – \$11,450)	42,150
Equals: AMT base	\$122,850
Times: AMT rate	× 26%
Equals: TMT	\$ 31,941
Minus: Regular tax liability	19,951
Equals: AMT	<u>\$ 11,990</u>

Anna will pay a total Federal income tax of \$31,951, consisting of her regular tax liability \$19,951 plus her AMT \$11,990.

Tax credits against regular tax liability (see Chapter 12) are allowed to some taxpayers depending on their economic circumstances or the type of business activity in which they engage. The foreign tax credit (FTC) and any personal nonrefundable credits (e.g., Adoption Credit, Lifetime Learning Credit, and Retirement Savings Contribution Credit) can offset any individual AMT liability.⁹

EXAMPLE

3

Michael records personal nonrefundable credits of \$11,000, regular tax liability of \$33,000, and tentative minimum tax of \$36,000. He can claim the \$11,000 credits against either the regular or AMT tax liability.

LO.3

Identify the adjustments made in calculating the AMT tax base.

15-1c AMT Adjustments

As discussed previously, **AMT adjustments** relate to timing differences that arise because of differences in how an item is treated for regular income tax and AMT purposes. As a result, it is necessary to determine not only the amount of an adjustment but also whether the adjustment is positive or negative.

Remember that the AMTI calculation begins with the regular taxable income amount, before the standard deduction and any exemptions. Where the regular tax and AMT treatment of an item of expense (or deduction) differ, the direction of the adjustment is determined as follows.

$$\begin{aligned} \text{Regular tax deduction} > \text{AMT deduction} &= \text{Positive AMT adjustment} \\ \text{Regular tax deduction} < \text{AMT deduction} &= \text{Negative AMT adjustment} \end{aligned}$$

Conversely, the direction of an adjustment attributable to an income item can be determined as follows.

$$\begin{aligned} \text{Regular tax income item} > \text{AMT income item} &= \text{Negative AMT adjustment} \\ \text{Regular tax income item} < \text{AMT income item} &= \text{Positive AMT adjustment} \end{aligned}$$

Depreciation of Post-1986 Real Property

As discussed in Chapter 8, for regular income tax purposes, real property is depreciated using the straight-line method. The cost of residential real property is recovered over 27.5 years, and the cost of all other real property is recovered over 39 years.¹⁰ Whether

⁹§ 26(a)(2).

¹⁰The 39-year life generally applies to nonresidential real property placed in service on or after May 13, 1993.

an AMT adjustment is required for real property depreciation depends on when the property was placed in service.

For real property placed in service after 1986 (MACRS property) and before 1999, AMT depreciation is computed using the straight-line method, but the alternative depreciation system (ADS) recovery period of 40 years is used (see Exhibit 8.10 in Chapter 8). Any difference in these depreciation amounts results in an AMT adjustment. Usually, these adjustments are positive during the real property's regular income tax recovery period, because a shorter recovery period is used for the regular income tax. For example, for residential real property, during the 27.5-year regular tax recovery period, the regular income tax depreciation exceeds the AMT depreciation because the latter is computed over a 40-year period. These adjustments will be negative later in the recovery life of the asset.

For real property placed in service after 1998, no AMT adjustment is required.¹¹ Because straight-line depreciation and the same recovery period (see Exhibit 8.9 in Chapter 8) are used for both regular tax and AMT purposes, the regular and AMT deductions are identical, and no AMT adjustment is necessary.

Depreciation of Post-1986 Personal Property

For most personal property that is subject to MACRS, the depreciation deduction for regular income tax purposes is calculated using the 200 percent declining-balance method, with a switch to straight-line depreciation when that method produces a larger depreciation deduction. The MACRS recovery period is the general depreciation system (GDS) prescribed recovery period (see Exhibit 8.4 in Chapter 8). Similar to the real property calculations, for AMT purposes, the depreciation calculation and the resulting adjustment depend on when the property was placed in service.

For property placed in service after 1986 and before 1999, the taxpayer calculates depreciation for AMT using the 150 percent declining-balance method, with a similar switch to straight-line depreciation. In addition, the recovery period is the ADS prescribed recovery period rather than the GDS recovery period.¹² (See Exhibit 8.7 in Chapter 8.) Thus, for property placed in service prior to 1999, the difference between regular income tax depreciation and AMT depreciation is caused by both longer recovery periods (GDS recovery period versus ADS recovery period) and a larger accelerated depreciation percentage (200 percent declining balance versus 150 percent declining balance).

For property placed in service after 1998, the taxpayer continues to calculate AMT depreciation using the 150 percent declining-balance method with the switch to straight-line depreciation. However, the recovery period is the GDS recovery period for both AMT and regular tax purposes.¹³ (See Exhibit 8.7 in Chapter 8.) Thus, for personal property placed in service after 1998, the difference between regular income tax depreciation and AMT depreciation is caused only by a larger accelerated depreciation percentage (200 percent declining balance versus 150 percent declining balance).

Sawyer placed an \$8,000 prime breeding hog in service in year 1. The MACRS recovery period for breeding hogs is three years. Regular tax (using 200% declining balance) and AMT depreciation (using 150% declining balance) amounts over the recovery period of the asset are computed as follows.

Tax Year	Regular Income Tax Deduction	AMT Deduction	AMT Adjustment
1	\$2,666	\$2,000	\$ 666
2	3,556	3,000	556
3	1,185	2,000	(815)
4	593	1,000	(407)

EXAMPLE

4

¹¹§ 56(a)(1)(A).

¹²§ 56(a)(1)(A)(i).

¹³§ 56(a)(1)(A)(ii).

As shown in Example 4, the same conventions are used for regular tax and AMT depreciation. Thus, the asset is fully depreciated over four years for both regular tax and AMT purposes, because the same recovery period is used and the half-year convention applies for both calculations. The AMT depreciation deduction is initially smaller because of the lesser declining balance percentage used for AMT purposes. As a result, the adjustments in tax years 1 and 2 are positive; taxable income will be increased by these amounts to arrive at the AMT depreciation amount. In the last two years of the asset's life, the AMT adjustments are negative. Taxable income will be decreased by these amounts to arrive at the AMT depreciation amount. In total, the same amount of depreciation will be taken for both regular tax and AMT purposes.

All personal property is taken into consideration in computing one net AMT depreciation adjustment, regardless of the date placed in service. Using this netting process, the AMT adjustment for a tax year is the difference between the total regular tax depreciation for all personal property and the total depreciation computed for that property for AMT purposes.

A taxpayer may elect to use the AMT depreciation method for personal property for regular income tax purposes. If this election is made, no AMT adjustment is required because the depreciation deduction is the same for regular income tax and for the AMT. This election eliminates the necessity to maintain two sets of tax depreciation records.

Additional First-Year Depreciation

As discussed in Chapter 8, for regular tax purposes, an additional first-year depreciation deduction equal to 50 percent of the unadjusted depreciable basis of qualified property is available for property placed in service after 2011 and before 2015. For property to which this additional first-year depreciation deduction (also known as bonus depreciation) is elected, no depreciation adjustment for AMT purposes is required.¹⁴

Pollution Control Facilities

To encourage private industry to abate pollution, the tax law provides beneficial amortization provisions for certified pollution control facilities in lieu of depreciation. For regular income tax purposes, a taxpayer may elect to amortize the cost of certified facilities over 60 months. For AMT purposes, such amortization is not allowed. Instead, the cost of certified pollution control facilities is recovered through depreciation. Similar to the depreciation provisions discussed previously, the method is dictated by when the facility was placed in service.

Facilities placed in service after 1986 and before 1999 are depreciated using the alternative depreciation system (ADS) method. Thus, costs are recovered using the straight-line method over 40 years for real property or over the class life for personal property.¹⁵ For facilities placed in service after 1998, AMT depreciation is calculated using the straight-line method over the recovery period that would be used for regular tax (MACRS) purposes. Irrespective of when the property was placed in service, the adjustment for AMTI is equal to the difference between the regular tax amortization deduction and the AMT depreciation amount. The adjustment may be positive or negative.

Circulation Expenditures

Circulation expenditures are incurred to establish, maintain, or increase the circulation of a newspaper, a magazine, or another periodical. For regular income tax purposes, circulation expenditures, other than those the taxpayer elects to charge to a capital account, may be expensed in the year incurred.¹⁶ For AMT purposes, circulation expenditures are not deductible in the year incurred. In computing AMTI, these expenditures must be capitalized and amortized ratably over the three-year period beginning in the year the expenditures were made.¹⁷

The AMT adjustment for circulation expenditures is calculated by comparing the amount expensed for regular income tax purposes with the amount that can be

¹⁴§ 168(k).

¹⁵§56(a)(5).

¹⁶§ 173(a).

¹⁷§ 56(b)(2)(A)(i).

amortized for AMT purposes. As shown in Example 5, in the year the circulation expenditures are incurred, the adjustment generally is positive; more circulation expenditures are deducted for regular tax purposes than are allowed for AMT purposes. In the second and third years, the adjustment usually is negative; a deduction is allowed for AMT purposes that was taken in the first year for regular tax purposes.

In 2015, Lindsay's sole proprietorship incurred \$30,000 of circulation expenditures. These expenditures were deducted in full for regular tax purposes but amortized over three years for AMT purposes. Thus, in 2016, Lindsay will not have a regular tax deduction for circulation expenditures, but she can deduct \$10,000 of circulation expenditures for AMT purposes. As a result, a negative AMT adjustment is required in 2016, and AMTI is \$10,000 less than regular taxable income.

EXAMPLE**5**

2016 taxable income		\$ 95,000
Plus or minus: AMT adjustments		
Circulation expenditures deducted for regular income tax purposes	\$ -0-	
Circulation expenditures allowed for AMT purposes	<u>(10,000)</u>	
Negative adjustment		(10,000)
Plus: AMT preferences		<u>-0-</u>
AMTI		<u>\$ 85,000</u>

A taxpayer can avoid an AMT adjustment for circulation expenditures by electing to amortize the expenditures over a three-year period for regular income tax purposes.¹⁸

Expenditures Requiring 10-Year Amortization for AMT Purposes

Certain expenditures that may be deducted in the year incurred for regular income tax purposes must be written off over a 10-year period for AMT purposes. These rules apply to (1) mining exploration and development costs and (2) research and experimental expenditures.

In computing taxable income, taxpayers can deduct expenditures paid or incurred during the taxable year for exploration (ascertaining the existence, location, extent, or quality of a deposit or mineral) and for development of a mine or other natural deposit, other than an oil or gas well.¹⁹ Mining development expenditures are expenses paid or incurred after the existence of ores and minerals in commercially marketable quantities has been disclosed.

For AMT purposes, however, mining exploration and development costs are capitalized and amortized ratably over a 10-year period.²⁰ The AMT adjustment is calculated by comparing the amount of mining exploration and development costs expensed (if any) for regular tax purposes with the AMT amortization for the year. In general, the adjustment will be positive in the year these expenses are incurred and negative thereafter. This provision does not apply to costs relating to an oil or gas well.

This year, Audrey incurs \$150,000 of mining exploration expenditures and deducts this amount for regular income tax purposes. For AMT purposes, these mining exploration expenditures are amortized over a 10-year period. Audrey makes a positive AMT adjustment of \$135,000 (\$150,000 allowed for regular income tax — \$15,000 for AMT) for this year. In each of the next nine years, Audrey makes a negative AMT adjustment of \$15,000 (\$0 allowed for regular income tax — \$15,000 for AMT).

EXAMPLE**6**

To avoid the AMT adjustments for mining exploration and development costs, a taxpayer may elect to write off the expenditures over a 10-year period for regular income tax purposes.²¹

Similarly, for regular tax purposes, rather than capitalize the incurred costs of research and experimentation, a taxpayer can elect to deduct those costs in the year incurred. For AMT purposes, such costs must be amortized over a 10-year time period.

¹⁸§ 59(e)(2)(a).

¹⁹§§ 616(a), 617(a).

²⁰§ 56(a)(2).

²¹§§ 59(e)(2)(D),(E).

As a result, the calculation of the adjustment for research and experimental expenditures is similar to the mining development and exploration costs adjustment.

Completed Contract Method

For a long-term contract, taxpayers must use the percentage of completion method for AMT purposes.²² However, in limited circumstances, taxpayers can use the completed contract method for regular income tax purposes.²³ In that case, a taxpayer recognizes a different amount of income for regular income tax purposes than for the AMT. The resulting AMT adjustment is the difference between the gross income reported under the percentage of completion method and the amount reported using the completed contract method. The adjustment can be either positive or negative, depending on the amount of income recognized under the different methods.

A taxpayer can avoid an AMT adjustment on long-term contracts by using the percentage of completion method for regular income tax purposes rather than the completed contract method.

Incentive Stock Options

Incentive stock options (ISOs) are granted by employers to help attract new personnel and retain those already employed. The rationale underlying this type of compensation contract is to provide employees an incentive to behave in ways that will increase the employer's stock price, which would benefit both the employer and the employee.

At the time an ISO is granted, the option likely has a zero value. The employer corporation grants the option either *at the money* (the exercise price equals the stock's price on the date of grant) or *out of the money* (the exercise price is greater than the stock's price on the date of grant). If the value of the stock increases during the option period, the employee can obtain stock at a favorable price by exercising the option. For regular tax purposes, because the option has a zero value at issuance, no gross income is recognized at the date of grant. For AMT purposes, the tax treatment is the same, so no adjustment is required then.

Employees are restricted as to when they can dispose of stock acquired under an ISO (e.g., a certain length of employment may be required). Therefore, the stock may not be freely transferable until some specified period has passed.

The exercise of an ISO does not increase regular taxable income.²⁴ However, for AMT purposes, the excess of the fair market value of the stock over the exercise price (the *spread* or the *bargain element*) is treated as an adjustment in the taxable year in which the option is exercised.²⁵

EXAMPLE

7

In 2016, Manuel exercised an ISO that had been granted by his employer, Gold Corporation in 2010. Manuel acquired 1,000 shares of Gold stock for the strike price of \$20 per share. The fair market value of the stock at the date of exercise was \$50 per share.

These events do not trigger a regular income tax in either 2010 or 2016. For AMT purposes, Manuel reports a positive 2016 AMT adjustment of \$30,000 (\$50,000 fair market value – \$20,000 strike price).

As a result of this adjustment, the regular income tax basis of the stock acquired through the exercise of ISOs is different from the AMT basis. The regular income tax basis of the stock is equal to its cost, the exercise price of the option, whereas the AMT basis is equal to the fair market value of the stock on the date the option is exercised. Consequently, the amount of any gain or loss upon disposition of the stock likely will differ for regular income tax and AMT purposes.

No adjustment is required if the taxpayer exercises the option and disposes of the stock in the same tax year, because the bargain element gain is reported for both regular income tax and AMT purposes in the same tax year.

²²§ 56(a)(3).

²³See Chapter 16 for a detailed discussion of the completed contract and percentage of completion methods of accounting.

²⁴§ 421(a).

²⁵§ 56(b)(3).

Continue with the facts as in the previous example, and assume that Manuel sells the stock that he acquired with the option for \$60,000 in late 2017. His gain for regular income tax purposes is \$40,000 (\$60,000 amount realized – \$20,000 regular income tax basis).

For AMT purposes, the gain is \$10,000 (\$60,000 amount realized – \$50,000 AMT basis). Therefore, Manuel reports a \$30,000 negative 2017 AMT adjustment (\$40,000 regular income tax gain – \$10,000 AMT gain). Note that the \$30,000 negative adjustment upon disposition offsets the \$30,000 positive adjustment that was triggered in the year of the exercise of the option.

EXAMPLE**8****Adjusted Gain or Loss**

When property is disposed of during the year, gain or loss reported for regular income tax may differ from the gain or loss determined for the AMT. This difference occurs because the adjusted basis of the property for AMT purposes reflects any current and prior AMT adjustments for each of the following.²⁶

- Depreciation.
- Circulation expenditures.
- Research and experimental expenditures.
- Mining exploration and development costs.
- Amortization of certified pollution control facilities.

A negative gain or loss adjustment is required if:

- The gain for AMT purposes is less than the gain for regular income tax purposes,
- The loss for AMT purposes is more than the loss for regular income tax purposes, or
- A loss is computed for AMT purposes and a gain is computed for regular income tax purposes.

Otherwise, the AMT gain or loss adjustment is positive.

Gain/Loss Adjustment

Chang used different methods for regular tax and AMT purposes, in computing her cost recovery deductions in a telecomm business. She sold an asset this year for \$100,000. The resulting AMT adjustment for gain or loss is computed as follows for each of the indicated independent sets of facts.

Case	Regular Tax Gain/Loss	AMT Gain/Loss	AMT Gain/Loss Adjustment in Year of Sale
1	\$ 40,000	\$ 10,000	–\$30,000
2	40,000	50,000	+10,000
3	(40,000)	(50,000)	–10,000
4	40,000	(10,000)	–50,000

EXAMPLE**9**

Assume the same facts as in Example 4, and that Sawyer sells the breeding hog he placed in service in year 1 on September 1 of year 3, for \$12,500. When Sawyer sells the animal, two AMT adjustments result: the depreciation adjustment for year 3 and any gain (or loss) adjustment resulting from the sale.

The regular income tax depreciation for year 3 is \$592 [\$8,000 cost × 14.81% (Chapter 8, Exhibit 8.9) × .5]. AMT depreciation for that year is \$1,000 [\$8,000 × 25% (Chapter 8, Exhibit 8.10) × .5]. Sawyer's negative AMT adjustment for year 3, reflecting the additional depreciation for AMT purposes, is \$408 (\$592 regular income tax depreciation – \$1,000 AMT depreciation).

*continued***EXAMPLE****10**

²⁶§ 56(a)(6).

In computing gain (or loss) as a result of the sale, the adjusted basis in the animal is different for regular income tax and AMT purposes because of the prior depreciation differences. The adjusted basis for each purpose is determined as follows.

	Regular Income Tax	AMT
Cost	\$ 8,000	\$ 8,000
Less: Depreciation for prior tax years	(6,222)	(5,000)
Depreciation for year 3	<u>(592)</u>	<u>(1,000)</u>
Adjusted basis	<u>\$ 1,186</u>	<u>\$ 2,000</u>

Now the tax year's regular and AMT gain is computed.

	Regular Income Tax	AMT
Amount realized	\$12,500	\$12,500
Adjusted basis	<u>(1,186)</u>	<u>(2,000)</u>
Recognized gain	<u>\$11,314</u>	<u>\$10,500</u>

Because the regular income tax gain is greater than the AMT gain on the sale of the animal, Sawyer incurs a negative AMT adjustment of \$814 (\$11,314 regular income tax gain – \$10,500 AMT gain). Note that this negative adjustment offsets the prior and current year AMT adjustments for depreciation.

Passive Activity Losses

Losses on passive activities are not deductible in computing either the regular income tax or the AMT. Cost recovery and basis computations may differ between the AMT and regular tax regimes for an asset. Therefore, a *passive loss* computed for regular income tax purposes may differ from the passive loss computed for AMT purposes.²⁷

EXAMPLE

11

Soong acquired two passive activities. He received net passive income of \$10,000 from Activity A and incurred no AMT adjustments or preferences in connection with the activity. Activity B generated gross income of \$27,000 and operating expenses (not affected by AMT adjustments or preferences) of \$19,000. Soong claimed MACRS depreciation of \$20,000 for Activity B; AMT depreciation totaled \$15,000. In addition, Soong deducted \$10,000 of percentage depletion in excess of basis (an AMT preference).

The following comparison illustrates the differences in the computation of the passive loss for regular income tax and AMT purposes for Activity B.

	Regular Income Tax	AMT
Gross income	<u>\$27,000</u>	<u>\$27,000</u>
Deductions		
Operating expenses	(\$19,000)	(\$19,000)
Depreciation	(20,000)	(15,000)
Depletion	<u>(10,000)</u>	<u>-0-</u>
Total deductions	<u>(\$49,000)</u>	<u>(\$34,000)</u>
Passive loss	<u>(\$22,000)</u>	<u>(\$ 7,000)</u>

Because the adjustment for depreciation (\$5,000) applies and the preference for depletion (\$10,000) is not allowed in computing AMTI (as discussed later in the chapter), the regular income tax passive activity loss of \$22,000 for Activity B becomes a \$7,000 AMT passive activity loss.

²⁷See Chapter 11.



TAX IN THE NEWS Does the AMT Accomplish Its Goals?

The AMT was enacted to ensure that taxpayers with economic income pay some tax. And yet according to the IRS, in a recent year, approximately 19,000 taxpayers with at least \$200,000 of adjusted gross income legally avoided any Federal income tax liability, regular or AMT.

In its report discussing this finding, the IRS notes that no single specific exclusion or deduction drives this outcome. For some taxpayers, the exclusion for state and local government interest eliminates the entire tax liability. For others, the taxes paid deduction, even in the presence of the AMT adjustment, and the itemized deductions that do not require an AMT adjustment, including charitable contributions and medical expenses, contribute significantly to the elimination of tax liability.

Does this mean the AMT is not working? If the goal is to ensure that all taxpayers with economic income pay some amount of tax, then even though the percentage of returns showing a zero tax liability is relatively low (.013 percent of all returns filed for the tax year), the AMT is not working perfectly.

However, if the goal is to collect more tax revenue while still allowing the regular income tax to be progressive and provide favorable tax treatment for certain activities, then the AMT seems to be working. In 1970, the original minimum tax collected approximately \$685 million (in current dollars) of individual income tax revenues; today, the AMT collects more than \$25 billion in net revenues.

Sources: www.irs.gov/pub/irs-soi/13insprbulhignincome.pdf; www.taxpolicycenter.org/briefing-book/key-elements/amt/revenue.cfm.

For regular income tax purposes, Soong would offset the \$10,000 of net passive income from Activity A with \$10,000 of the passive loss from Activity B. For AMT purposes, he would offset the \$10,000 of net passive income from Activity A with the \$7,000 passive activity loss allowed from Activity B, resulting in passive activity income of \$3,000. Thus, in computing AMTI, Soong makes a positive passive loss adjustment of \$3,000 [\$10,000 (passive activity loss allowed for regular income tax) – \$7,000 (passive activity loss allowed for the AMT)].

Assume the same facts as in the previous example. For regular income tax purposes, Soong incurs a suspended passive loss of \$12,000 [\$22,000 (total loss) – \$10,000 (amount used)]. This suspended passive loss can offset passive income in the future, or it can offset active or portfolio income when Soong disposes of the loss activity (refer to Chapter 11). For AMT purposes, Soong's suspended passive loss is \$0 [\$7,000 (total loss) – \$7,000 (amount used)].

EXAMPLE

12

Alternative Tax Net Operating Loss Deduction

In computing regular taxable income, taxpayers deduct net operating loss (NOL) carryovers and carrybacks (refer to Chapter 7). An NOL deduction is allowed for AMT purposes, but the regular income tax NOL must be modified in computing AMTI.

The starting point in computing the **alternative tax NOL deduction (ATNOLD)** is the NOL computed for regular income tax purposes. The regular income tax NOL then is modified for AMT adjustments and tax preferences, with the result being the ATNOLD. Thus, preferences and adjustment items that have benefited the taxpayer in computing the regular income tax NOL are added back, thereby reducing or eliminating the ATNOLD.²⁸

In 2015, Max incurred an NOL of \$100,000. Max reported no AMT adjustments, but his deductions included tax preferences of \$18,000. His ATNOLD carryback is \$82,000 (\$100,000 regular income tax NOL – \$18,000 tax preferences deducted in computing the NOL).

If the adjustment was not made to the regular income tax NOL, the \$18,000 in tax preference items deducted in 2015 would have the effect of reducing AMTI in the year (or years) in which the 2015 NOL is utilized. Such an outcome would be contradictory to the purpose of the AMT.

EXAMPLE

13

²⁸§ 56(a)(4).

In keeping with the goal of ensuring that taxpayers with economic income pay some minimum amount of tax, a ceiling exists on the amount of the ATNOLD that can be deducted in the carryback or carryforward year. The deduction is limited to 90 percent of AMTI (before the ATNOLD) for the carryback or carryforward year.²⁹

EXAMPLE

14

Assume the same facts as in the previous example, except that Max's AMTI (before the ATNOLD) in 2013 is \$90,000. Therefore, of the \$82,000 ATNOLD carried back to 2013 from 2015, only \$81,000 ($\$90,000 \times 90\%$) can be used in recalculating the 2013 AMT. The unused \$1,000 of 2015 ATNOLD is now carried to 2014 for use in recalculating that year's AMT.

A taxpayer who has an ATNOLD that is carried back or over to another year must use the ATNOLD against AMTI in the carryback or carryforward year, even if the taxpayer is not liable for the AMT in that year. This can result in the loss of an ATNOLD, even when the taxpayer does not report an AMT liability.

EXAMPLE

15

Emily's ATNOLD carryover is \$10,000. This year, AMTI before considering the ATNOLD is \$25,000. If Emily's regular income tax exceeds the AMT, the AMT does not apply. Nevertheless, Emily's ATNOLD of \$10,000 is "used up" and is not available for a later year.

For regular income tax purposes, the NOL generally can be carried back 2 years and forward 20 years. However, the taxpayer may elect to forgo the 2-year carryback. These rules generally apply to the ATNOLD as well, except that the election to forgo the 2-year carryback is available for the ATNOLD only if the taxpayer elected it for the regular income tax NOL.

Itemized Deductions

Most of the itemized deductions allowed for regular income tax purposes also are allowed for AMT purposes. As discussed below, for AMT purposes, the itemized deduction for certain taxes, miscellaneous itemized deductions (MIDs), medical expenses, and interest requires adjustment. The itemized deduction phaseout also triggers an AMT adjustment.

Taxes and MIDs State, local, and foreign income taxes, sales taxes, and property taxes are not allowed as a deduction in computing AMTI.³⁰ Miscellaneous itemized deductions (MIDs) that are subject to the 2 percent-of-AGI floor also are not allowed in computing AMTI.³¹ A positive AMT adjustment equal to the total amount of the regular income tax deduction for each is required.

Under the tax benefit rule, a tax refund is included in regular taxable income to the extent the taxpayer obtained a tax benefit by deducting the tax in a prior year. If the taxpayer's gross income includes the recovery of any tax deducted as an itemized deduction for regular income tax purposes, a negative AMT adjustment in the amount of the recovery is allowed for AMTI purposes.³² For example, state, local, and foreign income taxes can be deducted for regular income tax purposes, but they cannot be deducted in computing AMTI. Because of this, any refund of such taxes from a prior year that would be included in the calculation of regular taxable income is not included in AMTI.

Medical Expenses For regular income tax purposes, medical expenses are deductible to the extent they exceed 10 percent of AGI, except for taxpayers and their spouses

²⁹§ 56(d)(1)(A)(i)(II).

³⁰§ 56(b)(1)(A).

³¹§ 56(b)(1)(A).

³²§ 56(b)(1)(D).

who are age 65 and older. For these taxpayers, from 2013–2016, medical expenses that exceed 7.5 percent of AGI are deductible. However, for AMT purposes, regardless of the taxpayer's age, medical expenses are deductible only to the extent they exceed 10 percent of AGI.³³

Joann, age 66, incurred uninsured medical expenses of \$16,000 this year. She reported AGI of \$100,000 for the year. Her AMT adjustment for medical expenses is computed as follows.

EXAMPLE

16

	Regular Income Tax	AMT
Medical expenses incurred	\$16,000	\$ 16,000
Less reduction:		
\$100,000 AGI × 7.5%	(7,500)	
\$100,000 AGI × 10%		(10,000)
Medical expense deduction	<u>\$ 8,500</u>	<u>\$ 6,000</u>

Joann's positive AMT adjustment for medical expenses is \$2,500 (\$8,500 regular income tax deduction – \$6,000 AMT deduction).

Interest in General The AMT itemized deduction allowed for interest expense includes only qualified housing interest³⁴ and investment interest to the extent of net investment income that is included in the determination of AMTI.³⁵ Any interest that is deducted in calculating the regular income tax that is not permitted in calculating AMTI is treated as a positive adjustment.

In computing regular taxable income, taxpayers who itemize (refer to Chapter 10) can deduct:

- Qualified residence interest.
- Investment interest, subject to the investment interest limitations (discussed under Investment Interest below).
- Qualified interest on student loans.

Housing Interest Taxpayers who itemize can deduct *qualified residence interest* on up to two residences. The deduction is limited to interest on acquisition indebtedness up to \$1 million and home equity indebtedness up to \$100,000. Acquisition indebtedness is debt that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and is secured by the residence. Home equity indebtedness is debt secured by a qualified residence of the taxpayer, but does not include acquisition indebtedness.

The mortgage interest deduction for AMT purposes is limited to *qualified housing interest*, rather than *qualified residence interest*. Qualified housing interest includes only interest incurred to acquire, construct, or substantially improve the taxpayer's principal residence and such interest on one other qualified dwelling used for personal purposes. Thus, interest on a home equity loan is deductible for AMT purposes only if the loan meets the definition of qualified housing interest, which is not always the case.

When additional mortgage interest is incurred (e.g., a mortgage refinancing), interest paid is deductible as qualified housing interest for AMT purposes only if all of the following occur.

- The proceeds are used to acquire or substantially improve a qualified residence.
- Interest on the prior loan was qualified housing interest.
- The amount of the loan was not increased.

³³§§ 56(b)(1)(B), 213(f).

³⁵§ 56(b)(1)(C)(v).

³⁴§ 56(b)(1)(C)(i).

A positive AMT adjustment is required in the amount of the difference between qualified *residence* interest allowed as an itemized deduction for regular income tax purposes and qualified *housing* interest allowed in the determination of AMTI.

Investment Interest Investment interest is deductible for regular income tax purposes and for AMT purposes to the extent of qualified net investment income. However, because the categorization of interest as investment interest may differ for regular tax and AMT purposes, an adjustment is required if the amount of investment interest deductible for regular income tax purposes differs from the amount deductible for AMT purposes.

For example, an adjustment arises if proceeds from a home equity loan are used to purchase investments. Interest on a home equity loan is deductible as qualified residence interest for regular income tax purposes, but such interest is not deductible for AMT purposes unless the proceeds are used to acquire or substantially improve a qualified residence. For AMT purposes, however, interest on a home equity loan is deductible as investment interest expense if proceeds from the loan are used for investment purposes.

To determine the AMT adjustment for investment interest expense, one must compute the investment interest deduction for both regular income tax and AMT purposes.

EXAMPLE
17

Tom earned \$20,000 interest income from corporate bonds and \$5,000 dividends from preferred stock. He reported the following amounts of investment income for regular income tax and AMT purposes.

	Regular Income Tax	AMT
Corporate bond interest	\$20,000	\$20,000
Preferred stock dividends	5,000	5,000
Net investment income	<u>\$25,000</u>	<u>\$25,000</u>

Tom incurred investment interest expense of \$10,000 related to the corporate bonds. He also incurred \$4,000 interest on a home equity loan and used the proceeds of the loan to purchase preferred stock. For regular income tax purposes, this \$4,000 is deductible as qualified residence interest. His *investment* interest expense for regular income tax and AMT purposes is computed as:

	Regular Income Tax	AMT
To carry corporate bonds	\$10,000	\$10,000
On home equity loan to carry preferred stock (i.e., not to acquire or improve a qualified residence)	-0-	4,000
Total investment interest expense	<u>\$10,000</u>	<u>\$14,000</u>

Investment interest expense is deductible to the extent of net investment income. Because the amount deductible for regular income tax purposes (\$10,000) differs from the amount deductible for AMT purposes (\$14,000), an AMT adjustment is required.

AMT deduction for investment interest expense	\$ 14,000
Regular income tax deduction for investment interest expense	(10,000)
Negative AMT adjustment	<u>\$ 4,000</u>



TAX IN THE NEWS AMT: It Matters Where You Live

The Tax Policy Center uses Federal tax return information to compile a profile of AMT liabilities by state. The states with the highest and lowest percentages of taxpayers in AMT for a recent year are as follows.

States with Highest Number of Taxpayers in AMT (% of returns)	States with Lowest Number of Taxpayers in AMT (% of returns)
1. New Jersey (9.05)	50. Alaska (1.58)
2. New York (7.92)	49. South Dakota (1.74)
3. Connecticut (7.69)	48. Tennessee (1.80)
4. District of Columbia (7.44)	47. Wyoming (1.80)
5. California (7.05)	46. Nevada (1.91)

What explains the variance by state? Given that the AMT is intended to target wealthy taxpayers, some of the

variance may have to do with income levels in a particular state. However, remember that the AMT disallows state and local tax deductions. According to the Tax Policy Center, this disallowed deduction, along with disallowed personal and dependency exemptions, accounts for nearly 80 percent of the difference between the TMT and regular income tax amounts.

Further, of the states at the bottom of the list, only Tennessee has an income tax (and even then, Tennessee's income tax is quite limited). As a consequence, living in high-tax states may make a taxpayer more likely to owe an AMT.

Sources: State percentages: www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=535; Causes of AMT: www.taxpolicycenter.org/UploadedPDF/311212_TPC_DiscussionPaper_25.pdf.

As discussed subsequently under AMT Preferences, the interest on private activity bonds usually is an AMT preference item. Such interest also can affect the calculation of the AMT investment interest deduction in that it is included in the calculation of net investment income.

Other Adjustments

The standard deduction and the personal and dependency exemption also give rise to AMT adjustments.³⁶ However, these adjustments enter the AMTI calculation indirectly by being removed from the taxable income amount that begins the AMTI calculation.³⁷ If a taxpayer itemizes deductions, the starting point for the AMTI calculation is adjusted gross income (AGI) less itemized deductions. If a taxpayer takes the standard deduction, the starting point for the AMTI calculation is AGI.³⁸

As discussed later in the chapter, a separate exemption (see Exemption Amount) is allowed for AMT purposes.

Lucky is single and has no dependents. He earned a salary of \$110,000 in 2015, and his itemized deductions totaled \$18,000. Based on this information, Lucky's taxable income is \$88,000 (\$110,000 – \$18,000 itemized deductions – \$4,000 exemption). However, Lucky's taxable income starting point for the AMTI calculation is \$92,000.

EXAMPLE

18

The *cutback adjustment* that applies to the regular income tax itemized deductions of certain high-income taxpayers (refer to Chapter 10) does not apply in computing the AMT. The effect of this computation is to disallow a portion of the taxpayer's regular-tax itemized deductions. Any deductions disallowed under the cutback provision constitute a negative AMT adjustment.

Concept Summary 15.1 summarizes the key points related to AMT adjustments.

³⁶§ 56(b)(1)(F).

³⁷Service Center Advice 200103073.

³⁸§ 56(b)(1)(E).

Concept Summary 15.1

Summary of AMT Adjustment Provisions

- Adjustments that reflect *timing differences* can be either positive or negative.
- Apart from adjustments related to itemized deductions, many adjustments *can be avoided* if the taxpayer adopts the same tax treatment for regular tax purposes as is required for AMT purposes.
- Not all* itemized deductions trigger adjustments.
- When bonus depreciation is claimed, *no depreciation adjustment* is required for the asset either in the year placed in service or in subsequent years in which depreciation is claimed.
- Adjustments for the standard deduction and personal exemption *enter the AMT calculation indirectly*, by adjusting the taxable income amount that begins the AMTI computation.

LO.4

Identify the tax preferences that are included in calculating the AMT.

15-1d AMT Preferences

AMT adjustments can be positive or negative in amount, but **AMT preferences** are always positive. All preferences are added back to taxable income in the calculation of AMTI. The following section discusses AMT preferences available to individual taxpayers.

Percentage Depletion

Congress enacted the percentage depletion rules to provide taxpayers with incentives to invest in the development of certain natural resources. Percentage depletion is computed by multiplying a rate specified in the Code by the gross income from the property (refer to Chapter 8).³⁹ This rate is based on the type of mineral involved.

Generally, the basis of the property is reduced by the amount of depletion taken until the basis reaches zero. However, because percentage depletion is based on gross income, rather than the investment in the property, taxpayers can continue to take percentage depletion deductions even after the basis of the property reaches zero. Thus, over the life of the property, depletion deductions may greatly exceed the cost of the property.

The percentage depletion preference is equal to the excess of the regular income tax deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year.⁴⁰ The preference is calculated separately for each mineral property owned by the taxpayer.⁴¹ As a result, a taxpayer cannot use basis in one property to reduce the preference for excess depletion on another property.

EXAMPLE

19

Kim owns a mineral property that qualifies for a 22% depletion rate. The basis of the property at the beginning of the year is \$10,000. Gross income from the property for the year is \$100,000. For regular income tax purposes, Kim's percentage depletion deduction is \$22,000. For AMT purposes, Kim records a tax preference of \$12,000 (\$22,000 – \$10,000).

Intangible Drilling Costs

In computing regular taxable income, taxpayers can deduct certain intangible drilling and development costs in the year incurred, although such costs are normally capital in nature (refer to Chapter 8). The deduction is allowed for costs incurred in connection with oil and gas wells and geothermal wells.

³⁹§ 613(a).

⁴⁰§ 57(a)(1).

⁴¹§ 614(a).



TAX IN THE NEWS Tax-Free Municipal Bonds: Market Reaction to Being Taxed

Municipal bonds are not subject to Federal income tax. Therefore, assuming equal risk, the market assigns a lower interest rate to municipal bonds than it does to taxable bonds.

Generally, interest received from municipal bonds is not subject to the AMT. However, an exception exists for most issuances that are classified as private activity bonds. These bonds are used to finance projects such as airports, housing developments, wastewater treatment plants, and athletic stadiums. The vulnerability to current taxation of some municipal bond interest becomes a cause for concern when devising an investment strategy.

When an investor purchases individual bonds issued by a state or municipality, the issuer informs the investor which are private activity bonds. Many investors, however, choose bond mutual funds rather than purchasing specific bond issues. According to the Securities and Exchange Commission's rules, tax-exempt mutual funds can have as much as one-fifth of their holdings in private activity bonds, creating a potential tax pitfall for investors who are not informed as to the holdings of their bond funds.

A number of companies that offer mutual funds have responded by creating funds that are both AMT-free and regular income tax-free.

For AMT purposes, excess intangible drilling costs (IDC) for the year are a preference item.⁴²

IDC expensed in the year incurred

Minus: Deduction if IDC were capitalized and amortized over 10 years

Equals: Excess of IDC expense over amortization

Minus: 65% of net income from oil and gas and geothermal wells

Equals: Tax preference item

Ben, who incurred IDC of \$50,000 during the year, elected to expense that amount. His net oil and gas income for the year was \$60,000. Ben's tax preference for IDC is \$6,000 [(\$50,000 IDC – \$5,000 amortization) – (65% × \$60,000 income)].

EXAMPLE

20

A taxpayer can avoid the preference for IDC by electing to amortize the expenditures over a 10-year period for regular income tax purposes.

Interest on Private Activity Bonds

In general, **private activity bonds** (PABs) are issued by states or municipalities to support third-party business activities with a public purpose. For example, a bond issued by a city whose proceeds are used to construct a new football stadium likely would be categorized as a PAB.⁴³

Like interest income earned on other municipal bonds, income from private activity bonds is not included in taxable income, and expenses related to carrying such bonds are not deductible for regular income tax purposes. However, interest on private activity bonds usually is a preference in computing AMTI. Expenses incurred in carrying the bonds are offset against the interest income in computing the preference.⁴⁴

Interest from PABs issued in 2009 and 2010 does not constitute a tax preference.⁴⁵ The vast majority of tax-exempt bonds issued by states and municipalities are not classified as private activity bonds. The interest income from such bonds is not a tax preference item.

⁴²§ 57(a)(2).

⁴³§ 141.

⁴⁴§ 57(a)(5).

⁴⁵§ 57(a)(5)(C)(vi).



TAX IN THE NEWS The AMT Nightmare

Nina Olson is the National Taxpayer Advocate for the IRS. She reports to Congress annually on the problems facing taxpayers. In a recent report, she identified complexity as the most serious problem and called for a “simpler tax code.”

In discussing the complexity of the Code, she describes the AMT as a nightmare. Not only does the taxpayer have to

compute regular tax liability with all its complexity, but the AMT requires that the computation be done twice. In Olson’s opinion, the AMT is a “hideously complex parallel tax structure.” Obviously, she does not think it should be retained in achieving a “simpler tax code.”

The Big Picture

EXAMPLE

21

Return to the facts of *The Big Picture* on p. 15-1. Bob and Carol both have invested substantial amounts in private activity bonds. All of the private activity bonds that each of them owns were issued in 2010. Consequently, a tax preference does not result for either Carol or Bob.

Exclusion for Certain Small Business Stock

Taxpayers other than C corporations can exclude from regular-tax gross income some or all of the gain realized when certain small business stock is sold. For this purpose, a “small business” is a C corporation that has assets of \$50 million or less when the stock is issued. At least 80 percent of the entity’s assets must be used in an active trade or business.

The exclusion is available if the taxpayer held the stock for more than five years. The gain to be excluded cannot exceed the greater of \$10 million or 10 times the taxpayer’s basis in the stock. The exclusion then is computed using the following amounts.

If the Stock Was Acquired	Then the Taxpayer Excludes This Percentage of the Gain Realized ⁴⁶
Before 2009 or after 2013	50
From January 1, 2009 through September 27, 2010	75
From September 28, 2010 through 2013	100

When the investor realizes such a gain, a portion of the excluded amount becomes an AMT tax preference.⁴⁷

Key points related to AMT preferences are summarized in Concept Summary 15.2. A broader summary of AMT adjustments and preferences for individual taxpayers is included in Concept Summary 15.3.

Concept Summary 15.2

Summary of AMT Preference Provisions

1. Preferences are *always* positive in amount. A preference reflects a permanent difference between the regular tax and the AMT treatment of an amount.
2. With the exception of the IDC preference, preferences *cannot be avoided* by adopting the same tax treatment for regular tax and AMT purposes. In general, preferences can be avoided by not engaging in the activity that causes the preference, which may not be economically rational.
3. On occasion, Congress changes the tax code to stimulate economic activity. To the extent that an AMT preference could hinder this economic goal, the *preference may also be modified* (e.g., private activity bond interest, small business stock gain).

⁴⁶§ 1202(a)(4)(A).

⁴⁷§ 57(a)(7).

15-1e Computing the AMT

The computation of the AMT is illustrated in Example 22. The solution to Example 22 also is presented on Form 6251 on the following page. Note that the 2014 form was used because the 2015 form had not been released by our press date.

LO.5

Apply the formula for computing the AMT and complete a Form 6251.

Molly Seims, who is single and age 66, reports 2014 taxable income as follows.

Salary		\$ 92,000	
Interest		<u>8,000</u>	
Adjusted gross income		\$100,000	
Less itemized deductions:			
Medical expenses (\$17,500 – 7.5% of \$100,000 AGI) ^a	\$10,000		
State income taxes	4,000		
Interest ^b			
Home mortgage (for qualified housing)	20,000*		
Investment interest	3,300*		
Contributions to charities (cash)	5,000*		
Casualty losses (\$14,000 – 10% of \$100,000 AGI)	<u>4,000*</u>	(46,300)	
Taxable income before exemptions		\$ 53,700	
Less personal exemption		<u>(3,950)</u>	
Taxable income		<u>\$ 49,750</u>	

EXAMPLE

22

^aTotal medical expenses were \$17,500, reduced by 7.5% of AGI, as the taxpayer is over age 65. This results in an itemized deduction of \$10,000. However, for AMT purposes, the AGI floor is 10%, which leaves an AMT itemized deduction of \$7,500 (\$17,500 – 10% of \$100,000 AGI). Therefore, an adjustment of \$2,500 (\$10,000 – \$7,500) is required for medical expenses disallowed for AMT purposes.

^bIn this illustration, all interest is deductible in computing AMTI. Qualified housing interest is deductible without adjustment. Investment interest (\$3,300) is deductible to the extent of net investment income included in AMTI. For this purpose, the \$8,000 of interest income is treated as net investment income.

Deductions marked with an asterisk are allowed in computing ATI without adjustment. AMT adjustments are required for state income taxes and for medical expenses (see note [a]). In addition, Molly recorded interest on 2012 private activity bonds (usually an exclusion tax preference), and she exercised an incentive stock option. Regular tax liability is \$8,294, using the Tax Table method. AMTI is computed as follows.

Taxable income before exemptions	\$ 53,700
Plus: Adjustments	
State income taxes	4,000
Medical expenses (see note [a])	2,500
“Spread” on exercise of incentive stock options	35,000
Plus: Preference (interest on private activity bonds)	<u>40,000</u>
Equals: AMTI	\$135,200
Minus: AMT exemption ^c	<u>(48,325)</u>
Equals: Minimum tax base	\$ 86,875
Times: AMT tax rate	× 26%
Equals: Tentative minimum tax	\$ 22,588
Minus: Regular tax liability	<u>(8,294)</u>
Equals: AMT	<u>\$ 14,294</u>

^c[\$52,800 – .25 × (\$135,200 – \$117,300)].

Form **6251**
 Department of the Treasury
 Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

► Information about Form 6251 and its separate instructions is at www.irs.gov/form6251.
 ► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2014
 Attachment
 Sequence No. **32**

Name(s) shown on Form 1040 or Form 1040NR

Molly Seims

Your social security number

111-11-1111

Part I Alternative Minimum Taxable Income (See instructions for how to complete each line.)

1	If filing Schedule A (Form 1040), enter the amount from Form 1040, line 41, and go to line 2. Otherwise, enter the amount from Form 1040, line 38, and go to line 7. (If less than zero, enter as a negative amount.)	1	53,700
2	Medical and dental. If you or your spouse was 65 or older, enter the smaller of Schedule A (Form 1040), line 4, or 2.5% (.025) of Form 1040, line 38. If zero or less, enter -0-	2	2,500
3	Taxes from Schedule A (Form 1040), line 9	3	4,000
4	Enter the home mortgage interest adjustment, if any, from line 6 of the worksheet in the instructions for this line	4	
5	Miscellaneous deductions from Schedule A (Form 1040), line 27	5	
6	If Form 1040, line 38, is \$152,525 or less, enter -0-. Otherwise, see instructions	6	()
7	Tax refund from Form 1040, line 10 or line 21	7	()
8	Investment interest expense (difference between regular tax and AMT)	8	
9	Depletion (difference between regular tax and AMT)	9	
10	Net operating loss deduction from Form 1040, line 21. Enter as a positive amount	10	
11	Alternative tax net operating loss deduction	11	()
12	Interest from specified private activity bonds exempt from the regular tax	12	40,000
13	Qualified small business stock (7% of gain excluded under section 1202)	13	
14	Exercise of incentive stock options (excess of AMT income over regular tax income)	14	35,000
15	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	15	
16	Electing large partnerships (amount from Schedule K-1 (Form 1065-B), box 6)	16	
17	Disposition of property (difference between AMT and regular tax gain or loss)	17	
18	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	18	
19	Passive activities (difference between AMT and regular tax income or loss)	19	
20	Loss limitations (difference between AMT and regular tax income or loss)	20	
21	Circulation costs (difference between regular tax and AMT)	21	
22	Long-term contracts (difference between AMT and regular tax income)	22	
23	Mining costs (difference between regular tax and AMT)	23	
24	Research and experimental costs (difference between regular tax and AMT)	24	
25	Income from certain installment sales before January 1, 1987	25	()
26	Intangible drilling costs preference	26	
27	Other adjustments, including income-based related adjustments	27	
28	Alternative minimum taxable income. Combine lines 1 through 27. (If married filing separately and line 28 is more than \$242,450, see instructions.)	28	135,200

Part II Alternative Minimum Tax (AMT)

29	Exemption. (If you were under age 24 at the end of 2014, see instructions.) IF your filing status is . . . AND line 28 is not over . . . THEN enter on line 29 . . . Single or head of household . . . \$117,300 . . . \$52,800 Married filing jointly or qualifying widow(er) . . . 156,500 . . . 82,100 Married filing separately . . . 78,250 . . . 41,050 If line 28 is over the amount shown above for your filing status, see instructions.	29	48,325
30	Subtract line 29 from line 28. If more than zero, go to line 31. If zero or less, enter -0- here and on lines 31, 33, and 35, and go to line 34	30	86,875
31	<ul style="list-style-type: none"> If you are filing Form 2555 or 2555-EZ, see instructions for the amount to enter. If you reported capital gain distributions directly on Form 1040, line 13; you reported qualified dividends on Form 1040, line 9b; or you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 64 here. All others: If line 30 is \$182,500 or less (\$91,250 or less if married filing separately), multiply line 30 by 26% (.26). Otherwise, multiply line 30 by 28% (.28) and subtract \$3,650 (\$1,825 if married filing separately) from the result. 	31	22,588
32	Alternative minimum tax foreign tax credit (see instructions)	32	
33	Tentative minimum tax. Subtract line 32 from line 31	33	22,588
34	Add Form 1040, line 44 (minus any tax from Form 4972), and Form 1040, line 46. Subtract from the result any foreign tax credit from Form 1040, line 48. If you used Schedule J to figure your tax on Form 1040, line 44, refigure that tax without using Schedule J before completing this line (see instructions)	34	8,294
35	AMT. Subtract line 34 from line 33. If zero or less, enter -0-. Enter here and on Form 1040, line 45	35	14,294

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 13600G

Form **6251** (2014)



Concept Summary 15.3

AMT Adjustments and Preferences for Individuals

Adjustments	Positive	Negative	Either*
Adjusted gain or loss (on property dispositions)			X
Alternative tax NOL deduction (ATNOLD)			X
Circulation expenditures			X
Completed contract method			X
Depreciation of post-1986 personal property			X
Depreciation of post-1986 real property			X
Incentive stock options	X**		
Itemized deductions:			
Medical expenses	X		
Miscellaneous itemized deductions	X		
Private activity bond interest that is AMT investment interest		X	
Property tax on personalty	X		
Property tax on realty	X		
Qualified interest on student loans	X		
Qualified residence interest that is AMT investment interest		X	
Qualified residence interest that is not qualified housing interest	X		
State income taxes	X		
Tax benefit rule for state income tax refund		X	
Mining exploration and development costs			X
Passive activity losses			X
Personal and dependency exemptions	X		
Pollution control facilities			X
Research and experimental expenditures			X
Standard deduction	X		
Preferences			
Exclusion for gains from certain small business stock	X		
Intangible drilling costs	X		
Percentage depletion in excess of adjusted basis	X		
Private activity bond interest income	X***		

*Timing differences.

** While the adjustment is a positive adjustment, the AMT basis for the stock is increased by the amount of the positive adjustment.

*** Not for such bonds issued or restructured in 2009 and 2010.

15-1f **AMT Credit**

As discussed previously, timing differences that give rise to adjustments in computing AMTI eventually will reverse. To provide equity for taxpayers, a tax credit is created in a year in which a taxpayer pays AMT as a result of these timing differences. The credit is used to offset the tax liability in a year when the taxpayer pays only a regular income tax.⁴⁸ The **alternative minimum tax credit** is carried over indefinitely. Therefore, there is no need to keep track of the year in which the minimum tax credit arose.⁴⁹

LO.6

Illustrate the role of the AMT credit in the alternative minimum tax structure.

⁴⁸§ 53.

⁴⁹S Rept No. 99-313 (PL 99-514) p. 536.

This credit, known as the AMT credit or minimum tax credit, is created only by the AMT liability that results from timing differences. A credit is not created or increased by any permanent differences between regular taxable income and AMTI. Such permanent differences include the following amounts.

- The standard deduction.
- Personal exemptions.
- Medical expenses, to the extent deductible for regular income tax purposes but not deductible in computing AMTI.
- Other itemized deductions not allowable for AMT purposes, including miscellaneous itemized deductions, taxes, and interest expense.
- Excess percentage depletion.
- Tax-exempt interest on private activity bonds.

To determine the amount of AMT credit to carry over, the AMT is recomputed, reflecting only the effects of AMT timing differences.⁵⁰

LO.7

Illustrate the basic features of the corporate AMT.

15-2 CORPORATE ALTERNATIVE MINIMUM TAX

The AMT computations for C corporations are similar to those for noncorporate taxpayers. However, there are several important differences.

- The corporate AMT rate is 20 percent, instead of rates of 26 and 28 percent that are used by noncorporate taxpayers.⁵¹
- The AMT exemption for corporations is not indexed for inflation. The exemption is \$40,000 reduced by 25 percent of the amount by which AMTI exceeds \$150,000.⁵²
- Many of the adjustments and preferences applicable to individual taxpayers are computed and used in the same way by corporate taxpayers.

Although there are a few computational differences, the corporate AMT and the noncorporate AMT have the identical objective: to ensure that all taxpayers with economic income pay some amount of Federal income tax. The formula for determining the corporate AMT appears in Exhibit 15.2.

EXHIBIT 15.2 AMT Formula for Corporations

Taxable income

Plus: Income tax NOL deduction

Plus or minus: AMT adjustments

Plus: AMT preferences

Plus or minus: ACE adjustment

Equals: AMTI before ATNOLD

Minus: ATNOLD (limited to 90% of AMTI before ATNOLD)

Equals: AMTI

Minus: Exemption

Equals: AMT base

Times: 20% rate

Equals: Tentative minimum tax before credits

Minus: AMT foreign tax credit and other credits

Equals: Tentative minimum tax (TMT)

Minus: Regular tax liability before credits minus regular foreign tax credit

Equals: AMT (not less than zero)

⁵⁰§ 53(d)(1).

⁵¹§ 55(b)(1)(B).

⁵²§§ 55(d)(2) and (3).

Form 4626 (Alternative Minimum Tax—Corporations) is used for the corporate AMT. Any AMT then is carried over to Schedule J of the entity's Form 1120 (U.S. Corporation Income Tax Return).

15-2a **AMT and Small Corporations**

Two provisions exist that allow small corporations to avoid the AMT. For these purposes, a corporation is classified as a small corporation based on the amount of its annual gross receipts.

In its first tax year of existence, a corporation automatically is classified as a small corporation; thus, a new corporation is not subject to AMT in its first year of existence.⁵³

For each succeeding tax year, the prior year's average annual gross receipts must be less than a certain threshold for the corporation to continue to be exempt from AMT. In its second year of operations, if a corporation's annual average gross receipts in the prior year were less than \$5 million, the corporation is not subject to AMT. For the third year and thereafter, if the corporation's average annual gross receipts for the three-year period ending before the current tax year do not exceed \$7.5 million, the corporation continues to be exempt from AMT. However, if a corporation ever fails the gross receipts test, it is ineligible for small corporation classification in any future tax year.⁵⁴

15-2b **AMT Adjustments**

The following adjustments that were discussed in connection with the individual AMT also apply to the corporate AMT calculation. As we have seen, adjustments usually relate to timing differences between regular taxable income and AMTI.

- Excess of MACRS over AMT depreciation on real and personal property placed in service after 1986.
- Pollution control facilities placed in service after 1986.
- Mining and exploration expenditures.
- Income from long-term contracts.
- Adjusted gain or loss on the dispositions of assets.
- An NOL deduction is available, but any allowable ATNOLD cannot exceed 90 percent of AMTI (before deduction for ATNOLD).⁵⁵

ACE Adjustment

The adjusted current earnings (ACE) adjustment applies only to C corporations.⁵⁶ The **ACE adjustment** can have a significant effect on both tax and financial accounting.⁵⁷ This adjustment is intended to bring AMTI to approximate a corporation's economic income and, as a result, the corporation's true tax-paying ability. Thus, the ACE adjustment is intended to limit the benefits of certain tax provisions that the other adjustments, by their nature, cannot limit.

The corporation arrives at ACE by making additional adjustments to AMTI. Generally, these adjustments include additional income items, eliminate certain deductions, accelerate income recognition, and defer selected deductions. Using the ACE amount, the taxpayer then computes the ACE adjustment.

⁵³§ 55(e)(1)(C).

⁵⁴§§ 55(e)(1)(A) and (B). About 95% of incorporated businesses qualify for this exemption.

⁵⁵§ 56(d).

⁵⁶§ 56(c).

⁵⁷For additional coverage of the calculation of ACE, refer to Chapter 3 in *South-Western Federal Taxation: Corporations, Partnerships, Estates & Trusts*. The instructions for Form 4626 illustrate the ACE adjustment in a worksheet for its computation.

The ACE adjustment can be a positive or negative amount. AMTI is increased by 75 percent of the excess of ACE over unadjusted AMTI.⁵⁸ Alternatively, AMTI is reduced by 75 percent of the excess of unadjusted AMTI over ACE. The negative adjustment is limited to the aggregate of the positive adjustments under ACE for prior years, reduced by the previously claimed negative adjustments. Thus, the ordering of the timing differences is crucial, because a negative ACE adjustment could be permanently lost. Unadjusted AMTI is AMTI before the ACE adjustment and the ATNOLD.⁵⁹

EXAMPLE**23**

A calendar year C corporation showed the following results.

	2014	2015	2016
Adjusted current earnings	\$4,000	\$3,000	\$2,000
Pre-adjusted AMTI	3,000	3,000	3,100

In 2014, because ACE exceeds unadjusted AMTI by \$1,000, \$750 (75% × \$1,000) is a positive adjustment to AMTI. No adjustment is necessary for 2015. As unadjusted AMTI exceeds ACE by \$1,100 in 2016, there is a potential negative adjustment to AMTI of \$825 (\$1,100 × 75%).

Because the total increases to AMTI for prior years equal \$750 and there are no previously claimed negative adjustments, only \$750 of the potential negative adjustment reduces AMTI for 2015. Unfortunately for the taxpayer, \$75 of the negative adjustment is lost forever.

15-2c AMT Preferences

A corporation's AMTI includes designated tax preference items. In some cases, this has the effect of subjecting nontaxable income to the AMT. Tax preference items that apply to individuals also are required in computing AMTI for corporations.

EXAMPLE**24**

The following information applies to Brown Corporation (a calendar year taxpayer).

Taxable income	\$4,000,000
Mining exploration costs	500,000
Percentage depletion claimed (the property has a zero adjusted basis)	2,600,000

Brown is not a small corporation for AMT purposes. Brown's AMTI is determined as follows.

Taxable income	\$4,000,000
Adjustments:	
Excess mining exploration costs [\$500,000 (amount expensed) – \$50,000 (amount allowed over a 10-year amortization period)]	450,000
Preferences:	
Excess depletion	<u>2,600,000</u>
AMTI	<u><u>\$7,050,000</u></u>

15-2d Exemption Amount

A corporation's tentative minimum tax (TMT) is computed as 20 percent of its AMTI that exceeds the AMT exemption. The exemption amount for a corporation is \$40,000 reduced by 25 percent of the amount by which AMTI exceeds \$150,000.⁶⁰ The corporate AMT exemption phases out to zero when AMTI reaches \$310,000. No part of the corporate AMT exemption is indexed for inflation.

⁵⁸§ 56(g).

⁵⁹§§ 56(g)(1) and (2).

⁶⁰§§ 55(d)(2),(3).

Blue Corporation reports AMTI of \$180,000. Blue's exemption amount is reduced by \$7,500 [$25\% \times (\$180,000 - \$150,000)$], and the amount remaining is \$32,500 ($\$40,000 - \$7,500$). Thus, Blue's AMT base (refer to Exhibit 15.2) is \$147,500 ($\$180,000 - \$32,500$).

EXAMPLE**25**

15-2e Other Aspects of the Corporate AMT

In a year in which the corporation is subject to AMT, the AMT amount creates a minimum tax credit available for carryover to future years, to reduce a regular tax liability. Unlike the individual minimum tax credit calculation, the entire AMT amount is available for a corporation to carry over. No distinction is made between permanent and timing differences.

Certain small corporations can use specified tax credits to reduce the AMT liability. For all other corporations, only the foreign tax credit can be claimed in an AMT year.⁶¹

15-3 TAX PLANNING

LO.8

Identify tax planning opportunities to minimize the AMT.

15-3a Avoiding Preferences and Adjustments

Several strategies and elections are available to help taxpayers avoid AMT preferences and adjustments.

- A taxpayer who expects to be subject to an AMT liability should not invest in most tax-exempt private activity bonds unless doing so makes good investment sense. Any AMT triggered by the AMT tax preference for interest income on private activity bonds reduces the yield on an investment in such bonds. Other tax-exempt bonds or taxable corporate bonds might yield a better after-tax return.
- Many AMT adjustments (e.g., depreciation, circulation expenditures, mining exploration and development costs, and research and experimental expenditures) can be avoided if the taxpayer elects to use the AMT tax treatment for regular tax purposes.

15-3b Controlling the Timing of Preferences and Adjustments

If preference and adjustment amounts cannot be avoided, behaving strategically about the timing of these amounts may help to mitigate AMT liabilities.

- The AMT exemption often keeps the taxpayer from being subject to the AMT. To use the AMT exemption effectively, taxpayers should attempt to control the timing of adjustment and preference items, so that the exemption amount is not wasted (i.e., because AMTI before the exemption already is zero or negative).
- In a year in which the calendar-year taxpayer expects to be subject to the AMT, real estate or fourth-quarter estimated state tax payments should not be made in December. Any benefit received from the regular income tax deduction for these amounts will be offset by the corresponding positive AMT adjustment.

15-3c Other AMT Tax Planning Strategies

A potential AMT liability can be reduced by decreasing adjusted gross income (AGI). Certain contributions to qualified retirement savings plans are excluded from gross income, which would result in a decreased AGI amount. When a taxpayer participates in a § 401(k), § 457(b), or SIMPLE IRA plan (see Chapter 9), the maximum allowable salary deferral contributions to such a plan should be made. This technique would reduce AGI, which is beneficial for both regular tax and AMT purposes (as well as for retirement planning).

⁶¹§ 38(c)(5)(A).

REFOCUS ON THE BIG PICTURE

EFFECTS OF THE AMT



Bob contacts Adam, his tax return preparer, and explains that he believes that he underpaid his Federal income tax liability by \$15,000. He is worried about the negative effects of any underpayment if it is discovered during an IRS audit, including the effect on his future marriage to Carol. Adam reviews Bob's tax return and assures him that it was properly prepared. Bob indicates that Carol has provided him with a copy of her tax return. He asks Adam to compare the returns and then explain the tax liability difference to him. He faxes a copy of Carol's return to Adam.

Adam examines the two tax returns and discovers that the difference relates to the treatment of the interest earned on the tax-exempt bonds. Although both Bob and Carol own 2009 tax-exempt bonds, those owned by Carol are private activity bonds that usually are subject to the AMT. However, Carol's accountant, Ava, apparently overlooked the fact that there is no AMT preference for such bonds that were issued in 2010. So the \$15,000 AMT that was reported on Carol's Form 6251 is in error. Bob texts the good news to Carol that she is eligible for a Federal income tax refund.

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Key Terms

ACE adjustment, 15-25

Alternative minimum tax (AMT), 15-2

Alternative minimum tax credit, 15-23

Alternative tax NOL deduction (ATNOLD), 15-13

AMT adjustments, 15-6

AMT exemption, 15-4

AMT preferences, 15-18

Incentive stock options (ISOs), 15-10

Private activity bonds, 15-19

Discussion Questions

- LO.1** Kelly recently was promoted and received a substantial raise. She talks to her tax adviser about the potential tax ramifications. After making some projections, her adviser "welcomes her to the AMT club." Kelly believes that it is unfair that she must pay more than the regular income tax, as she is a "HENRY" (high earner not rich yet) with substantial college-related debts. Explain to Kelly the purpose of the AMT and why it applies to her.
- LO.2** How could the AMT be calculated without using regular taxable income as a starting point? Be specific.
- LO.2, 3, 4** Identify which of the following regular tax amounts create AMT preferences.
 - Depletion expense.
 - Exclusion to the employee for the employer's contribution to the employee's retirement plan.
 - Exercise of incentive stock option.
 - Student loan interest expense.
 - Exclusion for gains on the sales of certain small business stock.
 - Medical expenses.

4. **LO.2** An AMT liability results if the tentative minimum tax (TMT) exceeds the regular income tax liability. But what happens if the regular income tax liability exceeds the TMT? Does this create a negative AMT that can be carried to other years? Explain.
5. **LO.2** Andrew and Monica, unrelated individuals, use the same Federal income tax filing status (head of household). However, Monica's AMT exemption amount is \$52,800, while Andrew's is \$0. Explain.
6. **LO.2** Alfred is single, and his AMTI of \$350,000 consists of the following. What tax rates are applicable in calculating Alfred's TMT?

Ordinary income	\$250,000
Long-term capital gains	70,000
Qualified dividends	30,000

7. **LO.3** Nell recently purchased a weekly newspaper business that has been generating losses. Nell is convinced that she can turn around the fortunes of the newspaper with a new editorial style and increased circulation expenditures. What are the tax benefits and potential income tax pitfalls, if any, of increasing the circulation expenses?
8. **LO.3** If the stock received under an incentive stock option (ISO) is sold in the year of exercise, there is no AMT adjustment. If the stock is sold in a later year, there will be an AMT adjustment then. Evaluate the validity of these statements.
9. **LO.3** In 1998, Douglas purchased an office building for \$500,000 to be used in a business. Douglas sells the building in the current tax year. Explain why the recognized gain or loss for regular income tax purposes is different from any recognized gain or loss for AMT purposes.

10. **LO.3, 8** Celine will be subject to the AMT in 2015. She owns an investment building and is considering disposing of it and investing in other realty. Based on an appraisal of the building's value, the realized gain would be \$85,000.

Issue ID

Ed has offered to purchase the building from Celine, with the closing date being December 29, 2015. Ed wants to close the transaction in 2015 because certain beneficial tax consequences will result only if the transaction is closed prior to the beginning of 2016.

Abby has offered to purchase the building with the closing date being January 2, 2016. The building has a \$95,000 greater AMT adjusted basis.

For regular income tax purposes, Celine expects to be in the 25% tax bracket in 2015 and the 28% tax bracket in 2016. What are the relevant income tax issues that Celine faces in making her decision?

11. **LO.3, 4, 8** Matt, who is single, always has elected to itemize deductions rather than take the standard deduction. In prior years, his itemized deductions always exceeded the standard deduction by a substantial amount. As a result of paying off the mortgage on his residence, he projects that his itemized deductions will exceed the standard deduction by only \$500. Matt anticipates that the amount of his itemized deductions will remain about the same in the foreseeable future. Matt's AGI is \$150,000. He is investing the amount of his former mortgage payment each month in tax-exempt bonds; the bonds were issued in 2002. A friend recommends that Matt buy a beach house, to increase his itemized deductions with the mortgage interest deduction. What are the relevant tax issues for Matt?

Issue ID

12. **LO.3** A friend tells you that she does not worry about the AMT because she does not itemize deductions and, as a result, she does not generate many AMT adjustments. Evaluate your friend's assertion.

- Decision Making** 13. **LO.3, 4** During the year, Rachel earned \$18,000 of interest income on 2011 private activity bonds. She incurred interest expense of \$7,000 in connection with amounts borrowed to purchase the bonds. What is the effect of these items on Rachel's taxable income? On her AMT? Could there be a related beneficial effect in calculating AMTI? Explain.
- Issue ID** 14. **LO.7** Dart Corporation (a calendar year C corporation) would like to invest some of its excess earnings from retail operations in real estate. Dart is considering a purchase of 10 acres of land in a city whose economic prospects are good and whose population is growing. The company believes that the land will be attractive to a developer in the next five years. Does the AMT adjustment for real estate taxes make this a less attractive investment for Dart? Explain.

Computational Exercises

15. **LO.2** Compute the AMT exemption for the following taxpayers.
- Bristol, who is single, reports AMTI of \$132,800.
 - Marley and Naila are married and file a joint tax return. Their AMTI is \$95,000.
16. **LO.3** In March 2015, Serengeti exercised an ISO that had been granted by his employer, Thunder Corporation, in December 2012. Serengeti acquired 5,000 shares of Thunder stock with a strike price of \$65 per share. The fair market value of the stock at the date of exercise was \$90 per share. Determine Serengeti's AMT adjustment related to these events:
- For 2012.
 - For 2015.
17. **LO.3** This year, Brennen sold a machine used in his business for \$180,000. The machine was put into service eight years ago for \$340,000. Depreciation up to the date of the sale for regular income tax purposes was \$210,000; it was \$190,000 for AMT purposes. What, if any, AMT adjustment arises as a result of the sale of the machine?
18. **LO.4** Dimitri owns a gold mine that qualifies for a 15% depletion rate. The basis of the property at the beginning of the year, prior to any current year depletion deduction, is \$21,000. Gross income from the property for the year is \$200,000; taxable income before depletion is \$65,000. Compute Dimitri's AMT depletion preference for the tax year.
19. **LO.4** Kiki, who incurred intangible drilling costs (IDC) of \$94,000 during the year, deducted that amount. Her net oil and gas income for the year was \$110,000. Compute Kiki's AMT preference for IDC.
20. **LO.5** Yanni, a single individual, reports the following information for the tax year.
- | | |
|---------------------------|----------|
| Salary | \$80,000 |
| State income taxes | 6,800 |
| Mortgage interest expense | 6,200 |
| Charitable contributions | 1,500 |
| Interest income | 1,300 |
| Personal exemption | 4,000 |
- Compute the following for Yanni.
- Regular taxable income.
 - AMT Income.
 - Tentative minimum tax.
21. **LO.6** Elijah, who is single, holds a \$12,000 AMT credit available from year 1. For year 2, Elijah's regular tax liability is \$28,000, and his TMT is \$24,000. Does Elijah owe any AMT for year 2? If so, how much (if any) of the AMT credit can he use for that year?

Problems

22. **LO.2** Use the following data to calculate Chiara's 2015 AMT base. Chiara files as a single taxpayer and itemizes her deductions.

Taxable income	\$148,000
Positive AMT adjustments (does not include personal exemptions)	73,000
Negative AMT adjustments	55,000
AMT preferences	30,000

23. **LO.2** Arthur Wesson, an unmarried individual who is age 68, reports 2015 taxable income of \$160,000 and a regular tax liability of \$38,000. Arthur itemizes his deductions, and he records AMT positive adjustments of \$40,000 and tax preferences of \$35,000.
- What is Arthur's AMT?
 - What is the total amount of Arthur's tax liability?
 - Draft a letter to Arthur explaining why he must pay more than the regular income tax liability. Arthur's address is 100 Colonel's Way, Conway, SC 29526.
24. **LO.2** Calculate the 2015 AMT under the following circumstances. Jenna reports regular taxable income of \$450,000 and does not claim any tax credits.

Communications

Filing Status	Tentative Minimum Tax	
	Case 1	Case 2
Single	\$200,000	\$100,000
Married, filing jointly	200,000	100,000

25. **LO.2** Calculate the 2015 AMT exemption amount for the following cases for a married taxpayer filing jointly, and for a married taxpayer filing separately.

Case	AMTI
1	\$150,000
2	300,000
3	800,000

26. **LO.2** Lisa holds 2015 nonrefundable Federal income tax credits of \$65,000. Her regular income tax liability before credits is \$190,000, and her tentative minimum tax is \$150,000.

- What is the amount of Lisa's AMT?
- What is the amount of Lisa's regular income tax liability after credits?

27. **LO.2, 3, 8** Angela, who is single, incurs circulation expenditures of \$153,000 during 2015. She is deciding whether to deduct the entire \$153,000 or to capitalize it and elect to deduct it over a three-year period. Angela already knows that she will be subject to the AMT for 2015 at both the 26% and 28% rates.

Decision Making

Angela is in the 28% bracket for regular income tax purposes this year; she records regular taxable income of \$153,000 before considering the circulation expenses. Angela expects to be in the 28% bracket in 2016 and 2017.

Advise Angela on how to treat the expenditures in 2015.

28. **LO.2, 3** Vito owns and operates a news agency (as a sole proprietorship). During 2015, he incurred expenses of \$600,000 to increase circulation of newspapers and magazines that his agency distributes. For regular income tax purposes, he deducted the \$600,000 in 2015. In addition, he incurred \$120,000 in circulation expenditures in 2016 and again deducted the full amount. What AMT adjustments are required in 2015 and 2016 for the circulation expenditures?

29. **LO.3** Lorenzo owns two apartment buildings. He acquired Forsythia Acres on February 21, 1998, for \$300,000 (\$90,000 allocated to the land) and Square One on November 12, 2015, for \$800,000 (\$100,000 allocated to the land). Neither apartment complex qualifies as low-income housing. If Lorenzo elects to write off the cost of each building as quickly as possible, what is the effect of depreciation (cost recovery) on his AMTI for:
- 1998?
 - 2015?

**Decision Making
Communications**

30. **LO.3, 8** Helen Carlton acquired used equipment for her business at a cost of \$300,000. The equipment is five-year class property for regular income tax purposes and for AMT purposes. Helen does not claim any additional first-year depreciation.
- If Helen depreciates the equipment using the method that will produce the greatest current deduction for regular income tax purposes, what is the amount of the AMT adjustment? Helen does not elect § 179 limited expensing.
 - How can Helen reduce the AMT adjustment to \$0? What circumstances would motivate her to do so?
 - Draft a letter to Helen regarding the choice of depreciation methods. Helen's address is 500 Monticello Avenue, Glendale, AZ 85306.

Decision Making

31. **LO.3, 8** Geoff incurred \$900,000 of mining and exploration expenditures. He elects to deduct the expenditures as quickly as the tax law allows for regular income tax purposes.
- How will Geoff's treatment of mining and exploration expenditures affect his regular income tax and AMT computations for the year?
 - How can Geoff avoid having AMT adjustments related to the mining and exploration expenditures?
 - What factors should Geoff consider in deciding whether to deduct the expenditures in the year incurred?

32. **LO.3** Rust Company is a real estate construction business with average annual gross receipts of \$3 million. Rust uses the completed contract method on a particular contract that requires 16 months to complete. The contract is for \$500,000, with estimated costs of \$300,000.
- At the end of 2014, \$180,000 of costs had been incurred. The contract is completed in 2015, with the total cost being \$295,000. Determine the amount of any AMT adjustments for 2014 and 2015.

33. **LO.3** Burt, the CFO of Amber, Inc., was granted incentive stock options in 2009. Burt exercised the options in February 2013, when the exercise price was \$75,000 and the fair market value of the stock was \$90,000. Burt sold the stock in September 2016 for \$150,000. What are the regular income tax and AMT consequences for Burt in:
- 2009?
 - 2013?
 - 2016?

34. **LO.3** In 2015, Liza exercised an incentive stock option that had been granted to her in 2013 by her employer, White Corporation. Liza acquired 100 shares of White stock for the option price of \$190 per share. The fair market value of the stock at the date of exercise was \$250 per share. Liza sells the stock for \$340 per share in 2017.
- What is Liza's AMT adjustment in 2015? What is her recognized gain on the sale for regular income tax and for AMT purposes?
 - How would your answers in (a) change if Liza had sold the stock in 2015 rather than 2017?

35. **LO.3** Alicia owns two investment properties that she acquired several years ago. Her adjusted basis in the assets is as follows.

	Regular Income Tax	AMT
Land	\$100,000	\$100,000
Apartment building	450,000	450,000

Alicia sells the land for \$250,000 and the building for \$800,000.

- Calculate Alicia's recognized gain or loss on the sale of each asset for regular income tax and AMT purposes.
 - Determine the AMT adjustment on the sale of each asset.
36. **LO.4** Christopher regularly invests in tech company stocks, hoping to become wealthy by making an early investment in the next high-tech phenomenon. In 2002, Christopher purchased 3,000 shares of FlicksNet, a film rental company, for \$15 per share shortly after the company went public. Because Christopher purchased the shares in their initial offering, the shares are considered qualified small business stock.
- In 2015, Christopher sold 800 of the shares (at \$325 per share) to reserve a seat on Virgin Galactic's first space flight. What regular income tax consequences and AMT consequences arise for Christopher as a result of the sale of these shares?
37. **LO.3** Sammy and Monica, both age 67, incur and pay medical expenses in excess of insurance reimbursements during the year as follows.

For Sammy	\$16,000
For Monica (wife)	4,000
For Chuck (son)	2,500
For Carter (Monica's father)	5,000

Sammy and Monica's AGI is \$130,000. They file a joint return. Chuck and Carter are Sammy and Monica's dependents.

- What is Sammy and Monica's medical expense deduction for regular income tax purposes?
 - What is Sammy and Monica's medical expense deduction for AMT purposes?
 - What is the amount of the AMT adjustment for medical expenses?
38. **LO.3** Wolfgang is age 33. His AGI is \$125,000. He reports the following itemized deductions for the year.

Medical expenses [$\$15,000 - (10\% \times \$125,000)$]	\$ 2,500
State income taxes	4,200
Charitable contributions	5,000
Home mortgage interest on his personal residence	6,000
Casualty loss (after \$100 and 10% reductions)	1,800
Miscellaneous itemized deductions [$\$3,500 - (2\% \times \$125,000)$]	1,000
	<u>\$20,500</u>

- Calculate Wolfgang's itemized deductions for AMT purposes.
 - What is the total amount of the taxpayer's AMT adjustments for these items?
39. **LO.3** Walter, who is single, owns a personal residence in the city. He also owns a cabin near a ski resort in the mountains. He uses the cabin as a vacation home. In August, Walter borrowed \$60,000 on a home equity loan and used the proceeds to reduce credit card obligations and other debt. This year, he paid the following amounts of interest.

On his personal residence	\$16,000
On the cabin	7,000
On the home equity loan	2,500
On credit card obligations	1,500
On the purchase of personal-use SUV	1,350

What amount, if any, must Walter recognize as an AMT adjustment?

40. **LO.3, 4** During the current year, Yoon earned \$10,000 in interest on corporate bonds and incurred \$13,000 of investment interest expense related to the bond holdings. Yoon also earned \$5,000 interest on private activity bonds that were issued in 2007 and incurred interest expense of \$3,500 in connection with the bonds.
- How much investment interest expense can Yoon deduct for regular income tax and AMT purposes for the year?
 - What AMT adjustments and preferences arise as a result of the private activity bond interest income and expense?
41. **LO.3, 4** Gabriel, age 40, and Emma, age 33, are married with two dependents. They reported AGI of \$110,000 for the year, including net investment income of \$10,000 and gambling winnings of \$2,500. They incurred the following expenses during the year, all of which resulted in itemized deductions for regular income tax purposes.
- | | |
|---|----------|
| Medical expenses (before AGI floor) | \$13,000 |
| State income taxes | 2,800 |
| Personal property tax | 900 |
| Real estate tax | 9,100 |
| Interest on personal residence | 8,600 |
| Interest on home equity loan (proceeds were used to buy a new fishing boat) | 1,800 |
| Investment interest expense | 2,600 |
| Charitable contribution (cash) | 4,200 |
| Unreimbursed employee expenses (before 2%-of-AGI floor) | 3,800 |
- What is Gabriel and Emma's AMT adjustment for itemized deductions? Is it positive or negative?
 - Gabriel and Emma also earned interest of \$5,000 on private activity bonds that were issued in 2012. They borrowed money to buy these bonds and paid interest of \$3,900 on the loan. Determine the effects of these amounts on AMTI.
42. **LO.2, 3** Chuck is single and has no dependents. He does not itemize deductions. In 2015, he claims a \$4,000 personal exemption and records taxable income of \$120,000. Chuck's AMT preferences total \$51,000. What is Chuck's AMTI for the year?
43. **LO.2, 3, 4** Jane and Robert Brown are married and have eight children, all of whom are eligible to be claimed as the couple's dependents. Robert earns \$94,000 working as an accountant, and Jane earns \$35,000 as a teaching aide. Given their large family, the Browns live in a frugal manner. The family maintains a large garden and some fruit trees from which they get most of their produce, and the children take family and consumer science classes so that they can help make the family's clothing. The Browns record no gross income other than their salaries (all of their investment income is earned from qualified retirement savings), and their itemized deductions are less than the standard deduction. The Browns report no other AMT adjustments or preferences.
- What is the couple's 2015 regular tax liability?
 - What is the couple's 2015 AMT?

44. **LO.2, 3, 4** Pat, who is age 66 and single with no dependents, received a salary of \$90,000. She reports interest income of \$1,000, dividend income of \$5,000, gambling winnings of \$4,000, and interest income from 2006 private activity bonds of \$40,000. The dividends are *not* qualified dividends. The following additional information may be relevant. Compute Pat's tentative minimum tax.

Medical expenses (before AGI floor)	\$12,000
State income taxes	4,100
Real estate taxes	2,800
Mortgage interest on residence	3,100
Investment interest expense	1,800
Gambling losses	5,100

45. **LO.2, 5** Renee and Sanjeev, who are married, report taxable income of \$273,000. They computed positive AMT adjustments of \$38,000, negative AMT adjustments of \$14,000, and AMT preference items of \$67,500. The couple itemizes their deductions.

- Compute their AMTI.
- Compute their tentative minimum tax.

46. **LO.2, 3, 4, 5** Farr, who is single, has no dependents and does not itemize her deductions. She shows the following items relative to her current-year tax return.

Bargain element from the exercise of an ISO (no restrictions apply to the stock)	\$ 45,000
MACRS depreciation on shopping mall building acquired five years ago	49,000
Percentage depletion in excess of property's adjusted basis	50,000
Taxable income for regular income tax purposes	121,000
Regular tax liability	26,951

- Determine Farr's AMT adjustments and preferences.
- Calculate Farr's AMT (if any).

47. **LO.2, 3, 4, 5** Lynn, age 45, is single and has no dependents. Her income and expenses for the current year are reported as follows.

Income	
Salary	\$33,000
Taxable interest on corporate bonds	3,700
Business income	64,000
Expenditures	
Medical expenses	\$12,000
State income taxes	6,000
Real estate taxes	8,500
Mortgage (qualified housing) interest	9,200
Investment interest	5,500
Cash contributions to various charities	2,900

The \$64,000 business income is from Apex Office Supplies Company, a sole proprietorship that Lynn owns and operates. Apex claimed MACRS depreciation of \$3,175 on real and personal property used in the business. AMT depreciation on the property would have been \$2,500.

Lynn received interest of \$30,000 on 2011 City of Pensacola private activity bonds.

Based on the information presented above, compute Lynn's AMT liability.

48. **LO.5, 6** Bonnie, who is single, reports a zero taxable income in 2015. Bonnie itemizes her deductions and takes the personal exemption. She reports positive AMT timing adjustments of \$200,000 and other AMT positive adjustments of \$100,000 for the year. What is Bonnie's AMT credit that will carry over to 2016?
49. **LO.7** In each of the following independent situations, determine the taxpayer's TMT.

AMTI (Before the Exemption Amount)	
Quincy Corporation	\$150,000
Redland Corporation	160,000
Tanzen Corporation	320,000

50. **LO.7** Brown Inc., a calendar year taxpayer, reported the following transactions. Brown is not a small corporation for AMT purposes.

Taxable income	\$2,600,000
Depreciation for regular income tax purposes on realty (placed in service in 2006)	550,000
Excess amortization of certified pollutions control facilities	450,000
Tax-exempt interest on private activity bonds (issued in 2007)	1,030,000
Percentage depletion in excess of the property's adjusted basis	60,000
ACE adjustment	0

- Calculate Brown's regular income tax liability.
- Calculate Brown's TMT.
- Calculate Brown's AMT.

Cumulative Problems

Tax Return Problem



51. Robert A. Kliesh, age 41, is single and has no dependents. Robert's Social Security number is 111-11-1111. His address is 201 Front Street, Missoula, MT 59812. He does not contribute to the Presidential Election Campaign fund through the Form 1040.

Robert is independently wealthy as a result of having inherited sizable holdings in real estate and corporate stocks and bonds.

Robert is a minister at First Presbyterian Church, but he accepts no salary from the church. However, he does reside in the church's parsonage free of charge. The fair rental value of the parsonage is \$3,000 a month. The church also provides him with a cash grocery allowance of \$200 a week.

Examination of Robert's financial records provides the following information.

- On January 16, 2014, Robert sold 1,000 shares of stock for a loss of \$12,000. The stock was acquired 14 months ago. On February 15, 2014, he sold 400 shares of stock for a gain of \$13,100. That stock was acquired in 2008.
- He received \$30,000 of interest on private activity bonds that he had purchased in 2007. He also received \$40,000 of interest on tax-exempt bonds that are not private activity bonds.
- Robert received gross rent income of \$190,000 from an apartment complex he owns. He qualifies as an active participant.
- Expenses related to the apartment complex, which he acquired in 2007, were \$225,000.
- Robert's interest income (on CDs) totaled \$23,000. Robert invests only in growth stocks, so he earns no dividend income.
- He won \$60,000 from playing the lottery.
- Robert was the beneficiary of an \$800,000 life insurance policy on his Uncle Jake. He received the proceeds in October.

- h. He contributed \$5,500 to his traditional IRA.
- i. Robert reported the following potential itemized deductions.
- \$5,200 fair market value of stock contributed to First Presbyterian (basis \$3,000). He had owned the stock for two years.
 - \$4,200 interest on consumer purchases.
 - \$3,900 state and local income tax.
 - \$15,000 of medical expenses that he paid on behalf of a parishioner who died.
 - \$300 for a safe deposit box that is used to store investments and related legal documents.
 - \$750 contribution to the campaign of a candidate for governor.
 - \$5,000 paid for lottery tickets associated with playing the state lottery. Robert contributed \$5,000 of his net winnings to the church.
 - Robert lives in Montana, so he paid no sales tax.
- j. Robert made \$7,500 of estimated Federal income tax payments for the year.
- k. Robert was covered by health insurance for the entire tax year.

Use Forms 1040 and 6251 and Schedules A, B, D, and E to compute Robert Kliesh's 2014 Federal income tax liability (including AMT, if any). Omit the Form 8949. Suggested software: H&R BLOCK Tax Software.

52. Jacob, age 42, and Jane Brewster, age 37, are married and file a joint return in 2015. The Brewsters have two dependent children, Ellen and Sean, 10-year-old twins. Decision Making

Jacob is a factory supervisor; he earned \$95,000 in 2015. Jane is a computer systems analyst and earned \$103,000. In addition to their salaries, the Brewsters reported the following income items.

Interest income (Carmel Sanitation District Bonds)	\$22,000 (a)
Interest income (Carmel National Bank)	8,500
Qualified dividend income (Able Computer Corporation)	12,000
Gambling winnings	6,500
Gift from Uncle Raymond to Jacob	27,000
"Citizen of the Year" award (Jane)	7,500 (b)
Gain on land sale	14,000 (c)

- a. The Carmel Sanitation District Bonds are private activity bonds that were originally issued in April 2008.
- b. Jane was selected "Citizen of the Year" by the Carmel City Council. She used the award proceeds to pay down the family's credit card debt.
- c. Jacob sold 5 acres of land to a real estate developer on October 12, 2015, for \$100,000. He had acquired the land on May 15, 2009, for \$86,000.

On April 1, 2015, Jacob exercised an incentive stock option granted by his employer. At the date of exercise, the fair market value of the stock was \$18 per share and the exercise price was \$10 per share. Jacob purchased 500 shares with the ISO exercise. As of December 31, 2015, the stock's fair market value had declined to \$13 per share.

The Brewsters incurred the following expenses during 2015.

Medical expenses (doctor and hospital bills)	\$28,000
Charitable contributions (cash)	9,500 (d)
Real property tax on personal residence	8,100
Mortgage interest—personal residence (reported on Form 1098)	8,600
Mortgage interest—home equity loan	1,800 (e)
Investment interest expense	3,500
Gambling losses	6,800

- d. In addition to their cash charitable contributions, the Brewsters contributed stock in Ace Corporation, which they acquired on February 9, 2005, at a cost of \$6,500, to the Carmel Salvation Army, a qualifying charity. The fair market value of the stock was \$11,000 on November 1, 2015, the date of the contribution.
- e. The home equity loan was used to purchase the family's new minivan.

Taking into consideration the above amounts, for 2015, the Brewster's AGI is \$246,500 and taxable income is \$178,150. The following table presents a first draft of the Brewsters' 2015 AMTI calculation.

Regular taxable income	\$178,150
Adjustments and preferences	
Citizen of the Year award	(7,500)
Reduction in medical expenses (10% of AGI for AMT)	6,163
Real property taxes	(8,100)
Mortgage interest	10,400
Charitable contribution of stock (difference between basis and FMV)	4,500
Incentive stock option exercise	1,000
Gambling loss disallowed for regular tax purposes	(300)
AMTI	<u>\$184,313</u>
Exemption amount	<u>(77,047)</u>
AMTI base	<u><u>\$107,266</u></u>

Review the AMTI calculation, and prepare a list, including explanations, of any errors in the calculation. An error could include a missing amount or an amount that should not have been included, an amount that enters the calculation in the wrong direction, or an amount that enters the calculation in the wrong amount. You can presume that the Brewsters' AGI and taxable income amounts for 2015 are calculated correctly.

Research Problems

THOMSON REUTERS

CHECKPOINT
Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Samuel had worked for Pearl, Inc., for 35 years when he was discharged and his position filled by a much younger person. He filed and pursued a suit for age discrimination and received an award of \$1.5 million. Under the contingent fee arrangement with his attorney, one-third of the award was paid directly to the attorney, with the balance going to Samuel. Of the \$1.5 million received, Samuel included his net \$1 million as gross income on his tax return; he neither took as gross income nor deducted the \$500,000 paid to the attorney.

The IRS audited Samuel's return and included the \$500,000 contingency fee in gross income. At the same time, Samuel was allowed a miscellaneous itemized deduction (subject to the 2% floor) for the fee paid to the attorney. The IRS adjustment caused a tax deficiency to be assessed for both the regular income tax and the AMT.

Evaluate the results reached.

Research Problem 2. Jolene receives tax-exempt interest of \$33,000 on bonds that are classified as private activity bonds. She properly excludes the \$33,000 from her gross income for regular income tax purposes. Jolene asks your advice on the treatment of the interest income for AMT purposes. Locate the Code Section that covers this matter, and advise Jolene accordingly.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet Activity

Research Problem 3. The precursor to the Alternative Minimum Tax enacted by the Tax Reform Act of 1986 was the minimum tax, which was first devised in 1969. Find a discussion of the rationale for the original minimum tax and details about its creation. Describe the taxpayer profile that persuaded Congress to enact the 1969 tax. Summarize your findings in no more than five Powerpoint slides to present to your school's accounting club.

Communications

Research Problem 4. Go to a tax blog and post a comment concerning one of the following items relative to individuals who are subject to the AMT.

Communications

- Interest deductions on vacation homes.
- Personal and dependency exemptions.
- Tax preparation fees.
- Adequacy of the exemption amount.
- Indexing of AMT rates.
- Local property tax.
- Medical expenses.

Research Problem 5. Ascertain whether your state's income tax has an AMT component. If your state does not levy an income tax, choose a contiguous state that does. In an e-mail to your instructor, outline how the state AMT formula differs from that of the Federal. When was the state AMT provision adopted?

Communications

Research Problem 6. In no more than four PowerPoint slides, summarize in graphic form the number of individuals who have been subject to the Federal AMT since 1990 and the dollars of AMT that have been collected from them. Present your data in five-year increments. Then extend your graphs to include estimates of the taxpayer coverage and tax collection amounts into the next few tax years:

Communications

- Assuming that Congress does not modify the statutes from how they exist today.
- Assuming that various AMT amounts are indexed for inflation.

Research Problem 7. Use the Tax Stats function at www.irs.gov to determine how many C corporations incurred an AMT liability for the last tax year with complete data. What percentage of total corporate Federal income tax collections came from the AMT?

Roger CPA Review Questions

- Mary, a 65 year-old taxpayer, had an adjusted gross income of \$150,000 in 20X4. In the same year, Mary also incurred \$20,000 in medical expenses. In computing Mary's alternative minimum tax, what will be the adjustment for Mary's medical expenses?
 - \$3,750
 - \$5,000
 - \$8,750
 - \$11,250
- When an entity is responsible for paying the alternative minimum tax (AMT) due to adjustments related to the timing of income, such as including the excess of market value over option price upon the exercise of qualified stock options for AMT purposes, but not until the shares are sold for regular tax purposes, how might that excess tax be recovered?

- a. File a claim for a refund in the year paid.
 - b. Carryforward to offset against a future AMT liability **only**.
 - c. Carryforward to offset against future AMT **or** regular tax liabilities.
 - d. Carryforward to offset against a future regular tax liability **only**.
3. Which of the following will increase a taxpayer's alternative minimum taxable income (AMTI)?

	Personal Exemption	Property Taxes	Medical Expenses over 10% of AGI
a.	Yes	Yes	Yes
b.	Yes	Yes	No
c.	No	Yes	Yes
d.	Yes	No	Yes

Accounting Periods and Methods

LEARNING OBJECTIVES: *After completing Chapter 16, you should be able to:*

- LO.1** State and explain the relevance of the accounting period concept, the different types of accounting periods, and the limitations on their use.
- LO.2** Apply the cash method, accrual method, and hybrid method of accounting.
- LO.3** Utilize the procedure for changing accounting methods.
- LO.4** Determine when the installment method of accounting can be utilized and apply the related calculation techniques.
- LO.5** Review and illustrate the alternative methods of accounting for long-term contracts (the completed contract method and the percentage of completion method), including the limitations on the use of the completed contract method.
- LO.6** Identify tax planning opportunities related to accounting periods and accounting methods.

CHAPTER OUTLINE

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- 16-1b Selecting the Tax Year, 16-7
- 16-1c Changes in the Accounting Period, 16-7
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- 16-2a Permissible Methods, 16-11
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THE BIG PICTURE

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ACCOUNTING PERIOD AND METHOD

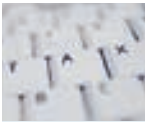
Pearl, Inc. (a C corporation), Tweety, Inc. (an S corporation), and Belinda (an individual) are going to form a partnership (Silver Partnership). The ownership interests and tax years of the partners are as follows:

Partner	Partnership Interest	Tax Year Ends
Belinda	25%	December 31
Pearl, Inc.	35%	November 30
Tweety, Inc.	40%	June 30

The partnership will begin business on April 1, 2015. The partners have several issues they would like you to address.

- A potential conflict exists among the partners regarding when the tax year should end for Silver. Belinda and Pearl would like a year-end close to their own year-ends, while Tweety would like to have a June 30 year-end. Is this a decision Tweety can make because it owns more of the partnership than either of the other two partners? Is this a decision Belinda and Pearl can make because collectively they own more of the partnership than Tweety owns?
- Because Silver will begin business on April 1, 2015, will the first tax year be a “short” tax year or a “long” tax year? Will annualization of the net income of the partnership be required?
- How will the partners know when their share of Silver’s net income or net loss should be reported on their respective income tax returns?
- Belinda is a cash basis taxpayer, and the other partners use the accrual method to report their incomes. What accounting method must be used to compute Belinda’s share of the partnership income?

Read the chapter and formulate your response.



FRAMEWORK 1040 Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income (<i>broadly defined</i>).....	\$ xx,xxx
Less: Exclusions	(x,xxx)
Gross income	\$xx,xxx

FORM 1040 (p. 1)

12 Business income or (loss). Attach Schedule C or C-EZ	
Less: Deductions for adjusted gross income	(x,xxx)
Adjusted gross income	\$xx,xxx
Less: The greater of total itemized deductions or the standard deduction	(x,xxx)
Personal and dependency exemptions	(x,xxx)
Taxable income	\$xx,xxx
Tax on taxable income (<i>see Tax Tables or Tax Rate Schedules</i>).....	\$ x,xxx
Less: Tax credits (including income taxes withheld and prepaid)	(xxx)
Tax due (or refund)	\$ xxx

Tax practitioners must deal with the issue of *when* particular items of income and expense are recognized as well as the basic issue of *whether* the items are includible in taxable income. Earlier chapters discussed the types of income subject to tax (gross income and exclusions) and allowable deductions (the *whether* issue).¹ This chapter focuses on the related issue of the periods in which income and deductions are reported (the *when* issue). Generally, a taxpayer’s income and deductions must be assigned to particular 12-month periods—calendar years or fiscal years.

Income and deductions are placed within particular years through the use of tax accounting methods. The basic accounting methods are the cash method, accrual method, and hybrid method. Other special purpose methods, such as the installment method and the methods used for long-term construction contracts, are available for specific circumstances or types of transactions.

Over the long run, the accounting period used by a taxpayer will not affect the aggregate amount of reported taxable income. However, taxable income for any particular year may vary significantly due to the use of a particular reporting period. Also, through the choice of accounting methods or accounting periods, it is possible to postpone the recognition of taxable income and to enjoy the benefits from deferring the related tax. This chapter discusses the taxpayer’s alternatives for accounting periods and accounting methods.

LO.1

State and explain the relevance of the accounting period concept, the different types of accounting periods, and the limitations on their use.

16-1 ACCOUNTING PERIODS

Generally, an individual or a corporation that keeps adequate books and records may be permitted to elect a **fiscal year**, a 12-month period ending on the *last day* of a month other than December, for the **accounting period**. Otherwise, a *calendar year* must be used.² Frequently, corporations can satisfy the record-keeping requirements and elect to

¹See Chapters 4, 5, and 6.

²§ 441(c) and Reg. § 1.441-1(b)(1)(ii).

use a fiscal year.³ Often the fiscal year conforms to a natural business year (e.g., a summer resort’s fiscal year may end on September 30, after the close of the season). Individuals seldom use a fiscal year because they do not maintain the necessary books and records and because complications can arise as a result of changes in the tax law (e.g., often the transition rules and effective dates differ for fiscal year taxpayers).

Generally, a taxable year may not exceed 12 calendar months. However, if certain requirements are met, a taxpayer may elect to use an annual period that varies from 52 to 53 weeks.⁴ In that case, the year-end must be on the same day of the week (e.g., the Tuesday falling closest to September 30 or the last Tuesday in September). The day of the week selected for ending the year will depend upon business considerations. For example, a retail business that is not open on Sundays may end its tax year on a Sunday so that it can take an inventory without interrupting business operations.

Wade, Inc. is in the business of selling farm supplies. Its natural business year terminates at the end of October with the completion of harvesting. At the end of the fiscal year, Wade must take an inventory, which is most easily accomplished on a Tuesday. Therefore, Wade could adopt a 52- to 53-week tax year ending on the Tuesday closest to October 31. If the company selects this method, the year-end date may fall in the following month if that Tuesday is closer to October 31. The tax year ending in 2015 will contain 52 weeks beginning on Wednesday, October 29, 2014, and ending on Tuesday, November 3, 2015. The tax year ending in 2016 will have 52 weeks beginning on Wednesday, November 4, 2015, and ending on Tuesday, November 1, 2016.

EXAMPLE

1

16-1a Specific Provisions for Partnerships, S Corporations, and Personal Service Corporations

When a partner’s tax year and the partnership’s tax year differ, the partner will enjoy a deferral of income. This results because the partner reports his or her share of the partnership’s income and deductions for the partnership’s tax year ending within or with the partner’s tax year.⁵ For example, if the tax year of the partnership ends on January 31, a calendar year partner will not report partnership profits for the first 11 months of the partnership tax year until the following year. Therefore, partnerships are subject to special tax year requirements.

In general, the partnership tax year must be the same as the tax year of the majority interest partners. The **majority interest partners** are the partners who together own a greater-than-50-percent interest in the partnership capital and profits. If there are no majority interest partners, the partnership must adopt the same tax year as its principal partners. A **principal partner** is a partner with a 5 percent or more interest in the partnership capital or profits.⁶

The RST Partnership is owned equally by Rose Corporation, Steve Corporation, and Tom. The partners have the following tax years:

Partner’s Tax Year Ending	
Rose Corporation	June 30
Steve Corporation	June 30
Tom	December 31

The partnership’s tax year must end on June 30 because Rose Corporation and Steve Corporation together have a greater-than-50% interest in the partnership. If Steve Corporation’s as well as Tom’s year ended on December 31, the partnership would be required to adopt a calendar year.

EXAMPLE

2

³Reg. § 1.441-1(e)(2).

⁴§ 441(f).

⁵Reg. § 1.706-1(a).

⁶§§ 706(b)(1)(B) and 706(b)(3).

If the principal partners do not all have the same tax year and no majority of partners have the same tax year, the partnership must use a year that results in the *least aggregate deferral* of income.⁷ Under the **least aggregate deferral method**, the different tax years of the principal partners are tested to determine which produces the least aggregate deferral. This is calculated by first multiplying the combined percentages of the principal partners with the same tax year by the months of deferral for the test year. Once this is done for each set of principal partners with the same tax year, the resulting products are summed to produce the aggregate deferral. After the aggregate deferral is calculated for each of the test years, the test year with the smallest summation (the least aggregate deferral) is the tax year for the partnership.

The Big Picture

EXAMPLE

3

Return to the facts of *The Big Picture* on p. 16-1. The Code and Regulations eliminate the need for the Silver partners to bargain among themselves over the tax year-end. The partnership's tax year must end on November 30 because using that year-end results in the least aggregate deferral of partnership income as demonstrated below.

Test for Tax Year Ending December 31				
		1	2	1 × 2
	Partner's Year-End	Profit Percentage	Months Income Deferred	Aggregate Months of Deferral
Belinda	12/31	25%	0	0
Pearl, Inc.	11/30	35%	11	3.85
Tweety, Inc.	6/30	40%	6	<u>2.40</u>
				<u>6.25</u>

Test for Tax Year Ending November 30				
	Partner's Year-End	Profit Percentage	Months Income Deferred	Aggregate Months of Deferral
Belinda	12/31	25%	1	0.25
Pearl, Inc.	11/30	35%	0	0
Tweety, Inc.	6/30	40%	7	<u>2.80</u>
				<u>3.05</u>

Test for Tax Year Ending June 30				
	Partner's Year-End	Profit Percentage	Months Income Deferred	Aggregate Months of Deferral
Belinda	12/31	25%	6	1.50
Pearl, Inc.	11/30	35%	5	1.75
Tweety, Inc.	6/30	40%	0	<u>0</u>
				<u>3.25</u>

⁷Reg. § 1.706-1(b)(3).

Generally, S corporations must adopt a calendar year.⁸ However, partnerships and S corporations may *elect* an otherwise *impermissible year* under any of the following conditions:

- A business purpose for the year can be demonstrated.⁹
- The partnership's or S corporation's year results in a deferral of not more than three months' income, and the entity agrees to make required tax payments.¹⁰

Business Purpose

The only business purpose for a fiscal year the IRS has acknowledged is the need to conform the tax year to the natural business year of a company.¹¹ Generally, only seasonal businesses have a natural business year. For example, the natural business year for a department store may end on January 31, after Christmas returns have been processed and clearance sales have been completed.

Required Tax Payments

Under the required payments system, tax payments are due from a fiscal year partnership or S corporation by May 15 of each tax year.¹² The amount due is computed by applying the highest individual tax rate plus 1 percentage point to an estimate of the deferral period income. The deferral period runs from the close of the fiscal year to the end of the required year. Estimated income for this period is based on the average monthly earnings for the previous fiscal year. The amount due is reduced by the amount of required tax payments for the previous year.¹³

Brown, Inc., an S corporation, timely elected a fiscal year ending September 30. Bob is the only shareholder and is a calendar year taxpayer. The "required" tax year ends on December 31, 2015, the major shareholder's year end, and the deferral period is the maximum of three months. For the fiscal year ending September 30, 2015, Brown earned \$100,000. The required tax payment for the previous year was \$5,000. The corporation must pay \$5,150 by May 15, 2016, calculated as follows:

$$(\$100,000 \times \frac{3}{12} \times 40.6\%^*) - \$5,000 = \$5,150$$

*Maximum § 1 rate of 39.6% + 1%.

EXAMPLE

4



ETHICS & EQUITY Who Benefits from the Change in Tax Year?

A public accounting sole practitioner has reached a breaking point. All of his clients use the calendar year to report income. Many of the clients are S corporations and partnerships. His workload the first four months of the year is so heavy that it is putting the quality of his work at risk. He is considering telling his clients that any new partnership or S corporation that is formed must timely elect to use

§ 444 and select a fiscal year ending September 30 (assuming that the required year would otherwise be a calendar year). Although the shareholders and partners would be subject to the "required tax payments" rules, the accountant will sell the plan by promising better service. Evaluate the plan proposed by the accountant.

⁸ §§ 1378(a) and (b).

⁹ §§ 706(b)(1)(C) and 1378(b)(2).

¹⁰ § 444. See Form 8716.

¹¹ Rev. Proc. 2006-46, 2006-2 C.B. 859.

¹² §§ 444(c) and Reg. 1.7519-2T(a)(4)(ii). No payment is required if the calculated amount is \$500 or less. See Form 8752.

¹³ § 7519(b).



TAX IN THE NEWS The “Balanced Approach” to Reducing the Deficit

Some commentators and politicians have been calling for reducing expenditures and increasing taxes—“the balanced approach”—to reduce the nation’s deficit. The tax increases could be in the form of increased tax rates. When tax planners hear calls for increasing tax rates, they immediately think in terms of how to shift

income and deductions between years to mitigate the impact of increases in tax rates on their clients. The period in which the income or deduction is recognized can be altered by the taxpayers changing accounting methods or contract terms. Such reactions are referred to as “behavioral effects of changes in the tax law.”

Personal Service Corporations

A **personal service corporation (PSC)** is a corporation whose shareholder-employees provide personal services (e.g., medical, dental, legal, accounting, engineering, actuarial, consulting, or performing arts). Generally, a PSC must use a calendar year.¹⁴ However, a PSC can *elect* a fiscal year under any of the following conditions:

- A business purpose for the year can be demonstrated.
- The PSC year results in a deferral of not more than three months’ income, the corporation pays the shareholder-employee’s salary during the portion of the calendar year after the close of the fiscal year, and the salary for that period is at least proportionate to the shareholder-employee’s salary received for the preceding fiscal year.¹⁵

EXAMPLE

5

Nancy’s corporation paid Nancy a salary of \$120,000 during its fiscal year ending September 30, 2015. The corporation cannot satisfy the business purpose test for a fiscal year. The corporation can continue to use its fiscal year without any negative tax effects, provided Nancy receives at least \$30,000 $[(3 \text{ months}/12 \text{ months}) \times \$120,000]$ as salary during the period October 1 through December 31, 2015.

If the salary test is not satisfied, the PSC can retain the fiscal year, but the corporation’s deduction for salary for its next fiscal year is limited to the following:

$$A + A(F/N)$$

Where A = Amount paid after the close of the fiscal year.

F = Number of months in the fiscal year minus number of months from the end of the fiscal year to the end of the ongoing calendar year.

N = Number of months from the end of the fiscal year to the end of the ongoing calendar year.

EXAMPLE

6

Assume that the corporation in the previous example paid Nancy \$10,000 of salary during the period October 1 through December 31, 2015. The deduction for Nancy’s salary for the corporation’s fiscal year ending September 30, 2016, is thus limited to \$40,000 calculated as follows:

$$\$10,000 + \left[\$10,000 \left(\frac{12 - 3}{3} \right) \right] = \$10,000 + \$30,000 = \$40,000$$

Salary payments in excess of the limitation are not allowed as an expense of the corporation for the year of the payment, but may be carried to a subsequent year and are subject to the limitation on deductions in the later year.

¹⁴§ 441(i).

¹⁵§§ 444 and 280H.

16-1b Selecting the Tax Year

A taxpayer elects to use a calendar year or, if eligible, a fiscal year by the timely filing of his or her initial tax return. For all subsequent tax years, the taxpayer must use this same period unless approval for change is obtained from the IRS.¹⁶

16-1c Changes in the Accounting Period

A taxpayer must obtain consent from the IRS before changing its tax year.¹⁷ This power to approve or not to approve a change is significant in that it permits the IRS to issue authoritative administrative guidelines that must be met by taxpayers who want to change their accounting period. An application for permission to change tax years must be made on Form 1128, Application for Change in Accounting Period. The application must be filed on or before the fifteenth day of the second calendar month following the close of the short period that results from the change in accounting period.¹⁸

Beginning in 2015, Gold Corporation, a calendar year taxpayer, would like to switch to a fiscal year ending March 31. The corporation must file Form 1128 by May 15, 2015.

EXAMPLE

7

IRS Requirements

The IRS will not grant permission for the change unless the taxpayer can establish a substantial business purpose for the request. One substantial business purpose is to change to a tax year that coincides with the *natural business year* (the completion of an annual business cycle). The IRS applies an objective gross receipts test to determine whether the entity has a natural business year. At least 25 percent of the entity's gross receipts for the 12-month period must be realized in the final two months of the 12-month period for three consecutive years.¹⁹

A Virginia Beach motel had gross receipts as follows:

	2013	2014	2015
July–August receipts	\$ 300,000	\$250,000	\$ 325,000
September 1–August 31 receipts	1,000,000	900,000	1,250,000
Receipts for final 2 months divided by receipts for 12 months	30.0%	27.8%	26.0%

Because it satisfies the natural business year test, the motel will be allowed to use a fiscal year ending August 31.

EXAMPLE

8

The IRS usually establishes certain conditions that the taxpayer must accept if the approval for change is to be granted. In particular, if the taxpayer has a net operating loss (NOL) for the short period, the IRS may require that the loss only be carried forward.²⁰ Recall that NOLs are ordinarily carried back for 2 years and forward for 20 years

¹⁶Reg. §§ 1.441-1(b)(3) and 1.441-1(b)(4).

¹⁷§ 442. Under certain conditions, corporations are allowed to change tax years without obtaining IRS approval. See Reg. § 1.442-1(c)(1); Rev.Proc. 2006-45, 2006 C.B. 851, modified by Rev.Proc. 2007-64, 2007-2 C.B. 818.

¹⁸Reg. § 1.442-1(b)(1). In Example 7, the first period after the change in accounting period (January 1, 2015 through March 31, 2015) is less than a 12-month period and is referred to as a *short period*.

¹⁹Rev.Proc. 2002-38, 2002-1 C.B. 1037; Rev.Rul. 87-57, 1987-2 C.B. 117; and Rev.Proc. 2002-39, 2002-1 C.B. 1046.

²⁰Rev.Proc. 2002-39, 2002-1 C.B. 1046, modified by Rev.Proc. 2003-34, 2003-1 C.B. 856.

(refer to Chapter 7). Denying a carryback is intended to prevent abuse of the change in tax year rules.

EXAMPLE

9

Parrot Corporation, a manufacturer that is not an S corporation, changed from a calendar year to a fiscal year ending September 30. The short-period return for the nine months ending September 30, 2015, reflected a \$60,000 NOL. The corporation had taxable income for 2013 and 2014. As a condition for granting approval, the IRS requires Parrot to carry the loss forward rather than carry the loss back to the two preceding years (the usual order for applying an NOL).

16-1d **Taxable Periods of Less Than One Year**

A **short taxable year** (or **short period**) is a period of less than 12 calendar months. A taxpayer may have a short year for (1) the first income tax return, (2) the final income tax return, or (3) a change in the tax year. If the short period results from a change in the taxpayer's annual accounting period, the taxable income for the period must be annualized. Due to the progressive tax rate structure, taxpayers could reap benefits from a short-period return if some adjustments were not required. Thus, the taxpayer is required to do the following:

1. Annualize the short-period income.

$$\text{Annualized income} = \text{Short-period income} \times \frac{12}{\text{Number of months in the short period}}$$

2. Compute the tax on the annualized income.
3. Convert the tax on the annualized income to a short-period tax.

$$\text{Short-period income} = \text{Tax on annualized income} \times \frac{\text{Number of months in the short period}}{12}$$

EXAMPLE

10

Gray Corporation, a retailer that is not an S corporation, obtained permission to change from a calendar year to a fiscal year ending September 30, beginning in 2015. For the short period January 1 through September 30, 2015, the corporation's taxable income was \$48,000. The relevant tax rates and the resultant short-period tax are as follows:

Amount of Taxable Income	Tax Rates
\$1–\$50,000	15% of taxable income
\$50,001–\$75,000	\$7,500 plus 25% of taxable income in excess of \$50,000

Calculation of Short-Period Tax

Annualized income

$$(\$48,000 \times \frac{12}{9}) = \$64,000$$

Tax on annualized income

$$\begin{aligned} & \$7,500 + .25(\$64,000 - \$50,000) = \\ & \$7,500 + \$3,500 = \$11,000 \end{aligned}$$

$$\text{Short-period tax} = (\$11,000 \times \frac{9}{12}) = \$8,250$$

Annualizing the income increased the tax by \$1,050:

Tax with annualizing	\$ 8,250
Tax without annualizing (.15 × \$48,000)	(7,200)
	<u>\$ 1,050</u>

Rather than annualize the short-period income, the taxpayer can (1) elect to calculate the tax for a 12-month period beginning on the first day of the short period and (2) convert the tax in (1) to a short-period tax as follows:²¹

$$\frac{\text{Taxable income for short period}}{\text{Taxable income for the 12-month period}} \times \text{Tax on the 12 months of income}$$

Assume that Gray Corporation's taxable income for the calendar year 2015 was \$60,000. The tax on the full 12 months of income would have been \$10,000 [\$7,500 + .25(\$60,000 - \$50,000)]. The short-period tax would be \$8,000 [(\$48,000/\$60,000) × \$10,000]. Thus, if the corporation utilized this option, the tax for the short period would be \$8,000 (rather than \$8,250, as calculated in Example 10).

EXAMPLE

11

The short year counts as a full year for purposes of the net operating carryback and carryforward.²²

16-1e Mitigation of the Annual Accounting Period Concept

Several provisions in the Code are designed to give the taxpayer relief from the seemingly harsh results that may be produced by the combined effects of an arbitrary accounting period and a progressive rate structure. For example, except for the change in accounting period restriction explained earlier, under the NOL carryback and carryover rules, a loss in one year can be carried back and offset against taxable income for the preceding two years. Unused NOLs are then carried over for 20 years.²³ In addition, the Code provides special relief provisions for casualty losses pursuant to a disaster and for the reporting of insurance proceeds from destruction of crops.²⁴

Farm Relief

Farmers and fishermen are often subject to wide fluctuations in income between years, some of which are due to the weather. Congress has provided these taxpayers with a special method of computing their tax on income from farming or fishing. In the high-income years, these taxpayers can elect to compute their tax on income from farming or fishing as though it were earned equally in the three previous years.²⁵ Thus, the tax on the farming or fishing income for the year is the sum of the additional tax that would have been due in the three previous years if one-third of the income had been earned in each of those years. This averaging system enables the taxpayer to avoid the higher marginal tax rates associated with a large amount of income received in one year.

The income pattern for farmers can also be disrupted by natural disasters that are covered by insurance. The disaster may occur and the **crop insurance proceeds** may be received in a year before the income from the crop would have been realized. Under these circumstances, the farmer can defer reporting the income until the year following the disaster. Similar relief is available when livestock must be sold on account of drought or other weather-related conditions.²⁶

Restoration of Amounts Received under a Claim of Right

The court-made **claim of right doctrine** applies when the taxpayer receives property as income and treats it as his or her own but a dispute arises over the taxpayer's rights to the income.²⁷ According to the doctrine, the taxpayer must include the amount as income in the year of receipt. The rationale for the doctrine is that the Federal

²¹ §§ 443(b)(1) and (2).

²² Reg. § 1.172-4(a)(2).

²³ § 172. Refer to Chapter 7.

²⁴ §§ 165(i) and 451(d). Refer to Chapter 7.

²⁵ § 1301. The tax is calculated on Schedule J.

²⁶ Sections 451(d) and (e).

²⁷ *North American Consolidated Oil Co. v. Burnet*, 3 USTC ¶943, 11 AFTR 16, 52 S.Ct. 613 (USSC, 1932).



TAX IN THE NEWS Executive Compensation Clawbacks

In recent years, there has been a public outcry over the compensation of executives. With many companies receiving taxpayer-funded bailouts, both taxpayers and shareholders have demanded that executives repay the excessive amounts to the corporation. If executives are required to repay a portion of their salaries and bonuses, an executive's marginal tax rate may be greater in the year the

income was received than in the year of repayment. This appears to be a situation that § 1341 should address. However, when the original amount received was based on an existing contract, the compensation was received under the executive's actual rights and is not income received under a mere claim of right. Therefore, the amount of the "clawback" is not eligible for § 1341 treatment.

government cannot await the resolution of all disputes before exacting a tax. As a corollary to the doctrine, if the taxpayer is later required to repay the funds, generally, a deduction is allowed in the year of repayment.²⁸

EXAMPLE

12

In 2015, Pedro received a \$5,000 bonus computed as a percentage of profits. In 2016, Pedro's employer determined that the 2015 profits had been incorrectly computed, and Pedro had to refund the \$5,000 in 2016. Pedro was required to include the \$5,000 in his 2015 gross income, but he can claim a \$5,000 deduction in 2016.

In Example 12 the transactions were a wash; that is, the income and deduction were the same (\$5,000). Suppose, however, that Pedro was in the 35 percent tax bracket in 2015 but in the 15 percent bracket in 2016. Without some relief provision, the mistake would be costly to Pedro. He paid \$1,750 tax in 2015 ($.35 \times \$5,000$), but the deduction reduced his tax liability in 2016 by only \$750 ($.15 \times \$5,000$). The Code does provide the needed relief in such cases. Under § 1341, when income that has been taxed under the claim of right doctrine must later be repaid, in effect, the taxpayer gets to apply to the deduction the tax rate of the year that will produce the greatest tax benefit. Thus, in Example 12, the repayment in 2016 would reduce Pedro's 2016 tax liability by the higher 2015 rate (.35) applied to the \$5,000. However, relief is provided only in cases where the tax is significantly different—that is, when deduction for the amount previously included in income exceeds \$3,000.



ETHICS & EQUITY Special Tax Relief

A taxpayer who is required to report income in one year but must repay the income in a subsequent year is granted special tax relief. If the taxpayer is in a lower marginal tax bracket in the year the income is repaid than in the year it was received, the deduction reduces the tax for the year of repayment by using the higher tax rate that applied to the income when it was received.

In contrast, if a taxpayer takes a deduction in one year and receives a refund of the amount giving rise to

the deduction in a subsequent year, the refund is taxed at the marginal tax rate in the year of refund. This is true even though the taxpayer's marginal tax rate in the year of receipt is higher than that in the year of the deduction.

Should both adjustments to income and adjustments to deductions receive the same tax relief? Or should neither situation be granted special relief?

LO.2

Apply the cash method, accrual method, and hybrid method of accounting.

16-2 ACCOUNTING METHODS

Accounting methods include overall methods such as cash or accrual. They also include special accounting methods such as for farmers or prepaid income. These topics are explained in this section.

²⁸*U.S. v. Lewis*, 51-1 USTC ¶9211, 40 AFTR 258, 71 S.Ct. 522 (USSC, 1951).

16-2a Permissible Methods

Section 446 requires the taxpayer to compute taxable income using the method of accounting regularly employed in keeping his or her books, provided the method clearly reflects income. The Code recognizes the following as generally permissible **accounting methods**:

- The cash receipts and disbursements method.
- The accrual method.
- A hybrid method (a combination of cash and accrual).

The Regulations refer to these alternatives as *overall methods* and add that the term *method of accounting* includes not only the taxpayer's overall method of accounting but also the accounting treatment of any item.²⁹

Generally, any of the three methods of accounting may be used if the method is consistently employed and clearly reflects income. However, in most cases, the taxpayer is required to use the accrual method for sales and cost of goods sold if inventories are an income-producing factor to the business.³⁰ Other situations in which the accrual method is required are discussed later. Special methods are also permitted for installment sales, long-term construction contracts, and farmers.

A taxpayer who has more than one trade or business may use a different method of accounting for each trade or business activity. Furthermore, a taxpayer may use one method of accounting to determine income from a trade or business and use another method to compute nonbusiness items of income and deductions.³¹

Linda operates a grocery store and owns stock and bonds. The sales and cost of goods sold from the grocery store must be computed by the accrual method because inventories are material. However, Linda can report her dividends and interest from the stocks and bonds under the cash method.

EXAMPLE

13

The Code grants the IRS broad powers to determine whether the taxpayer's accounting method *clearly reflects income*. Thus, if the method employed does not clearly reflect income, the IRS has the power to prescribe the method to be used by the taxpayer.³²

16-2b Cash Receipts and Disbursements Method—Cash Basis

Most individuals and many businesses use the cash basis to report income and deductions. The popularity of this method can largely be attributed to its simplicity and flexibility.

Under the **cash method**, income is not recognized until the taxpayer actually receives, or constructively receives, cash or its equivalent (e.g., the receipt of accounts receivable does not trigger income until collected). Cash is constructively received if it is available to the taxpayer.³³ Generally, a cash equivalent is anything with a fair market value, including any goods or services received in a barter transaction and a note receivable from a customer.

²⁹Reg. § 1.446-1(a)(1).

³⁰Reg. § 1.446-1(a)(4)(i). As discussed subsequently, as a matter of administrative convenience, the IRS will permit taxpayers to use the cash method even though inventory is a material income-producing factor if average annual gross receipts are not more than \$1 million for the most recent three-year period.

³¹§ 446(d) and Reg. § 1.446-1(c)(1)(iv)(b).

³²§ 446(b).

³³Reg. § 1.451-1(a). Refer to Chapter 4 for a discussion of constructive receipt.



TAX IN THE NEWS Rescission Can Overcome Constructive Receipt

In many cases, a cash basis taxpayer has entered into an agreement to accept an amount at a certain date, but then decides it would be beneficial to defer the receipt of the payment until a subsequent year. If the payment is deferred when the funds are available, the taxpayer has a problem in that the payment may have actually or constructively been received when the payments became due.

The doctrine of rescission may be applied to remedy the taxpayer's problem. In a rescission, the original contract is

set aside and the parties are returned to their former position (their position before the original transaction was undertaken). A new contract takes its place. When rescission occurs, the IRS ignores the original agreement and applies the tax law to the second agreement. However, the rescission and the return of any funds received must occur in the same tax year.

Source: Based on "Can Rescission Cure Constructive Receipt?" Robert W. Wood, *Tax Notes*, April 3, 2012.

The Big Picture

EXAMPLE

14

Return to the facts of *The Big Picture* on p. 4-1 in Chapter 4. Recall that Dr. Cliff Payne has opened a dental practice as a sole proprietorship and does not accept credit cards. In the second year of his business, he adopts a new policy of requiring that his patients either pay cash at the time the services are performed or give him a note receivable with interest at the market rate. Generally, the notes can be sold to the local banks for 95% of their face amount. At the end of the second year, Dr. Payne has \$60,000 in notes receivable from patients. The notes receivable are a cash equivalent and have a fair market value of \$57,000 ($\$60,000 \times 95\%$). Therefore, Dr. Payne must include the \$57,000 in his gross income for this year.

Deductions are generally permitted in the year of payment. Thus, year-end accounts payable and accrued expenses are not deducted in the determination of taxable income.

In many cases, a taxpayer using the cash method can choose the year in which a deduction is claimed simply by postponing or accelerating the payment of expenses. For fixed assets, however, the cash basis taxpayer claims deductions through depreciation or amortization, the same as an accrual basis taxpayer does. In addition, prepaid expenses must be capitalized and amortized if the life of the asset extends substantially beyond the end of the tax year.³⁴

The Regulations have established a **one-year rule for prepaid expenses** that permits the taxpayer to deduct expenditures for rights that do not extend beyond the earlier of (1) 12 months after the first date on which the taxpayer realizes the right or (2) the end of the tax year following the year of payment. Both cash basis and accrual basis taxpayers are permitted to use the one-year rule.³⁵

Restrictions on Use of the Cash Method

The cash method can distort income from a merchandising or manufacturing operation because the cost of goods sold is a function of when payments for the goods were made rather than when they were sold. Thus, the Regulations require the accrual method to measure sales and cost of goods sold if inventories are material to the business. This prohibition on the use of the cash method is intended to ensure that annual income is clearly reflected.³⁶

³⁴Reg. § 1.461-1(a)(1).

³⁵Reg. § 1.263(a)-4(f). Refer to Chapter 6 for further discussion of the one-year rule.

³⁶Reg. § 1.446-1(a)(4)(i).



GLOBAL TAX ISSUES Tax Accounting Methods as Well as Tax Rates in Foreign Countries Are Important Considerations

When considering whether to conduct business in a foreign country, corporations must consider the accounting methods used to compute taxable income. Some countries have more generous depreciation and inventory valuation

methods than do others. Also, many countries permit expensing of start-up costs, whereas other countries require capitalization and amortization (such as in the United States).

In addition, the following three types of taxpayers may not use the cash method (and must use the accrual method) for Federal income tax purposes regardless of whether inventories are material: (1) a corporation (other than an S corporation), (2) a partnership with a corporate partner (that is not an S corporation), and (3) a tax shelter. This accrual method requirement has three exceptions:³⁷

- A farming business (other than certain corporations).
- A qualified personal service corporation (a corporation that performs services in health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and whose employees own substantially all of the stock), regardless of gross receipts level.
- A corporation, or a partnership with a corporate partner, that is not a tax shelter, whose average annual gross receipts for all prior three-year periods are \$5 million or less.

As a matter of administrative convenience, the IRS allows any entity with average annual gross receipts of \$1 million or less for the most recent three-year period to use a modified form of the cash method even if the taxpayer is buying and selling inventory. Sales can be reported on the cash method, but the cost of the inventory is deductible only in the year of sale or in the year the taxpayer actually pays for the inventoriable items, whichever is later.

The IRS allows another exception to the required use of the accrual method. Companies whose principal business activity (the activity producing the largest percentage of gross receipts) does not involve sales of goods, manufacturing, mining, and certain publishing activities and whose average annual gross receipts are greater than \$1 million but are not more than \$10 million for the most recent three-year period may use the cash method. However, under this exception, inventory on hand at the end of the tax year cannot be deducted until it is sold. C corporations and partnerships with a C corporation partner, must use the accrual method and, therefore, are not eligible for this exception if their average annual gross receipts for prior three-year periods exceed \$5 million. In addition, tax shelters must always use the accrual method. The major beneficiaries of the \$10 million exception are small construction companies and small service businesses that sell some goods in conjunction with the services provided.³⁸

Special Rules for Small Farmers

The general tax accounting rules contain several exceptions specifically addressed to farmers. Although inventories are material to farming operations and the accrual method would appear to be required, an exception to the general rule allows small farmers to use the cash method of accounting.³⁹ The purpose of the exception is to relieve the small farmer from the bookkeeping burden of accrual accounting. Generally, this exception applies to unincorporated farms and certain closely held farming corporations with gross receipts for the year of \$25 million or less.⁴⁰

³⁷ §§ 448(a) and 448(b). For this purpose, the hybrid method of accounting is considered the same as the cash method. Also see § 447.

³⁹ Reg. § 1.61-4.

⁴⁰ See §§ 447(c) and 464.

³⁸ Rev.Proc. 2001-10, 2001-1 C.B. 272, and Rev.Proc. 2002-28, 2002-1 C.B. 815.

Nevertheless, cash method farmers must capitalize their costs of raising trees that have a preproduction period of more than two years.⁴¹ For example, an apple farmer generally must capitalize the costs of raising the trees until they produce apples in merchantable quantities. However, to simplify the farmer's tax accounting, the cash method farmer is given an option: The preproduction cost of the trees can be expensed if the taxpayer elects to use the alternative depreciation system (refer to Chapter 8) for all of the farming assets.

Farmers who produce crops that take more than a year from planting to harvesting (e.g., pineapples) can elect to use the crop method to report the income. Under the **crop method**, the costs of raising the crop are capitalized as those costs are incurred and then deducted in the year the income from the crop is realized.⁴² This method is analogous to the completed contract method used by contractors (discussed later in this chapter).

Generally, a cash basis farmer must capitalize the purchase price of an animal, whether it is acquired for sale or for breeding. However, the cost of raising the animal can be expensed.⁴³

16-2c Accrual Method

The tax rules governing when an accrual method taxpayer reports income or claims deductions include an "all events test." The timing rules for deductions also include an "economic performance" requirement. These timing rules for income and deductions of accrual method taxpayers are explained below.

All Events Test for Income

Under the **accrual method**, an item is generally included in gross income for the year in which it is earned, regardless of when the income is collected. An item of income is earned when (1) all of the events have occurred to fix the taxpayer's right to receive the income and (2) the amount of income (the amount the taxpayer has a right to receive) can be determined with reasonable accuracy.⁴⁴

EXAMPLE

15

Andre Corporation, a calendar year taxpayer that uses the accrual basis of accounting, was to receive a bonus equal to 6% of Blue Corporation's net income for its fiscal year ending each June 30. For the fiscal year ending June 30, 2015, Blue Corporation had net income of \$240,000, and for the six months ending December 31, 2015, the corporation's net income was \$150,000. Andre Corporation will report \$14,400 ($.06 \times \$240,000$) for 2015 because its right to the amount became fixed when Blue Corporation's year closed. However, Andre Corporation would not accrue income based on the corporation's profits for the last six months of 2015 because its right to the income does not accrue until the close of the corporation's tax year.

An accrual basis taxpayer's amount of income and the tax year the income is recognized are based on its right to receive the income. Thus, unlike the case of a cash basis taxpayer, the fair market value of a receivable is irrelevant.

EXAMPLE

16

Marcey Corporation, an accrual basis taxpayer, has provided services to clients and has the right to receive \$60,000. The clients have signed notes receivable to Marcey that have a fair market value of \$57,000. The corporation must include \$60,000, the amount it has the right to receive, in its gross income, rather than the fair market value of the notes of \$57,000.

⁴¹§ 263A(d).

⁴²Reg. §§ 1.61-4 and 1.162-12(a).

⁴³Reg. § 1.162-12(a).

⁴⁴Reg. § 1.451-1(a). Refer to Chapter 4 for further discussion of the accrual basis.



TAX IN THE NEWS Financial and Tax Accounting under Uncertainty

According to the Financial Accounting Standards Board's Accounting Standards Codification Project, § 605-10-25-4 follows the all events test used in tax accounting to determine when revenue is to be recognized. However, according to the financial accounting rules, when there is uncertainty as to whether the total selling price will be collected, the reporting entity may use the cost recovery method of reporting the income; that is, any amount collected from the sale will first be treated as a recovery of the cost of the item sold, and

gain is not recognized until the seller has recovered its total cost.

The tax accounting rules generally do not permit this cost recovery method. If uncertainty exists as to collectability of the selling price, the total selling price must nevertheless be included in gross income and the cost of the goods reduces the selling price in arriving at the gross profit. Any adjustment for collectability must run the rigors of qualifying for a bad debt deduction, which, in many cases, means that the deduction is recognized in a year subsequent to the year of sale.

If an accrual basis taxpayer receives advance payments for services, goods, or licensing of software, it should consider adopting the special deferral method of Revenue Procedure 2004-34. Under this special accounting method, in the year the advance payment is received, the taxpayer reports on its tax return the same amount reported on its financial statement. In the subsequent year, the balance of the advance payment is reported on the tax return regardless of how much is reported on the financial statement for that year. (See Chapter 4.)

Troy Corporation is an accrual method taxpayer that has properly adopted the deferral method of Revenue Procedure 2004-34. Troy sells computers and two-year service contracts on the computers. On November 1, 2015, Troy Corporation sold a 24-month service contract and received \$240. For financial reporting, Troy reports \$20 of gross income for 2015, \$120 for 2016, and \$100 for 2017. For tax purposes, Troy reports \$20 of income for 2015 (same as for financial reporting) and \$220 for 2016 (the balance of the advance payment).

EXAMPLE

17

Prepaid rental income and prepaid interest income must be recognized in the year of receipt and may not be deferred.⁴⁵

In a situation where the accrual basis taxpayer's right to income is being contested and the income has not yet been collected, generally, no income is recognized until the dispute has been settled.⁴⁶ Before the settlement, "all of the events have not occurred that fix the right to receive the income."

All Events and Economic Performance Tests for Deductions

A three-part test is applied to determine when an accrual basis taxpayer considers an event as either an expense or a capital expenditure. The three parts are (1) **all events test**, (2) amount determinable with reasonable accuracy, and (3) **economic performance test**.⁴⁷

As to when economic performance is met, that depends on the nature of the liability. For example, if an accrual method taxpayer owes money to another company that provided services to it, economic performance is met as the services are provided. Concept Summary 16.1 lists common types of liabilities covered by the economic performance Regulations (Reg. § 1.461-4) and when economic performance is met for each liability.

One common liability illustrated in Example 18 is where a taxpayer has a liability because another party provided services.

⁴⁵Rev.Proc. 2004-34, 2004-1 C.B. 991.

⁴⁷§ 461(h)(4).

⁴⁶*Burnet v. Sanford & Brooks Co.*, 2 USTC ¶636, 9 AFTR 603, 51 S.Ct. 150 (USSC, 1931).

Concept Summary 16.1

Accruals Under the Economic Performance Test

Event	Example	When Economic Performance Is Satisfied
The taxpayer's use of the owner's property	Rent	Ratably over the period used
Specific property provided to the taxpayer	A company's office supplies are purchased	When the taxpayer receives the supplies
Specific services provided to the taxpayer	The taxpayer contracts for repairs to be made to its equipment	When the repairs are made
Services to be provided for a specific time period	The taxpayer purchases a service contract, such as for cleaning services	Ratably over the contract period
Property or services provided by the taxpayer	A manufacturer contracts to customize a customer's van	When the manufacturer incurs costs under the contract
Rebates	Manufacturer rebates based on quantity of purchases	When the rebate is paid
Tort claims	Customers are awarded claims for harm caused by the taxpayer's product	When payment is made to the injured party; not eligible for the recurring item exception
State income tax	Taxes due when filing the return	When payment is made

EXAMPLE

18

An accrual basis calendar year taxpayer, JAB, Inc., promoted a boxing match held in the company's arena on December 31, 2015. CLN, Inc., had contracted to clean the arena for \$5,000, but did not actually perform the work until January 1, 2016. JAB, Inc., did not pay the \$5,000 until 2017. Although financial accounting rules would require JAB, Inc., to accrue the \$5,000 cleaning expense in 2015 to match the revenues from the fight, the economic performance test was not satisfied until 2016, when CLN, Inc., performed the service. Thus, JAB, Inc., must deduct the expense in 2016.

If the taxpayer is obligated to provide property or services, economic performance occurs in the year the taxpayer incurs costs in satisfying its obligation to provide the property or services, as illustrated in Example 19.

EXAMPLE

19

Agmax Corporation farms land owned by an individual. Agmax's contract to use the land is for three years, and at the end of three years, Agmax agreed to apply lime to the farmland. The contract term expired in 2015, and Agmax applied the lime in 2016. The all events test was satisfied at the end of 2015. However, Agmax did not provide the lime until 2016. Agmax was obligated to provide property (lime) and services. The deduction is not permitted until 2016, when Agmax incurs costs in fulfilling its obligation.⁴⁸

TAX IN THE NEWS Payment Is Not Economic Performance

In recent pronouncements, the IRS has reiterated the point that when an accrual basis taxpayer has contracted to receive future services whose cost is deductible, the time for the deduction is when economic performance is satisfied. Moreover, economic performance can occur before or after the taxpayer pays for the services. Generally, economic

performance is satisfied when the other party provides the services. If the taxpayer pays for the services before they are provided, the taxpayer has acquired an asset (prepaid expense). The deduction for the cost of the asset is not allowed until the services are actually received, unless the requirements for the recurring item exception are satisfied.

⁴⁸Reg. § 1.461-4.



FINANCIAL DISCLOSURE INSIGHTS Tax Deferrals from Reserves

The tax law generally applies the economic performance test in determining when an expense is deductible. Accordingly, the use of reserves for financial accounting purposes does not carry over to the tax return. When a business creates a reserve, for example, to account for warranty obligations to customers or vacation pay for employees, book expenses are allowed, but the corresponding tax deduction usually is delayed until an expenditure is actually incurred. The temporary book-tax difference typically creates or adds to a deferred tax asset on the entity's balance sheet.

Deferred tax assets and liabilities are classified as *current* or *noncurrent* for balance sheet purposes. This classification is determined by the following:

- The nature of the underlying asset (e.g., deferral of a bad debt relates to an account receivable, typically a current asset).
- Any knowledge by the entity as to when the required expenditure will occur (e.g., as to the timing and amounts of a legal settlement or award).

For instance, suppose a software developer sells a program to a customer and agrees to provide free annual updates for the next three years. If the revenue from the sale is included in gross income in the year of sale, for financial accounting purposes, a reserve for the anticipated costs of the updates should be deducted and a reserve should be created in the year of the sale. In the simplest case, one-third of the costs associated with the contract are deductible in the year the contract is sold and used by the customer. Of the remaining warranty costs, one-half generates a current deferred tax asset (the costs will actually be incurred within the next tax year), and one-half generates a noncurrent deferred tax asset (for the third contract year).

Current versions of the related IFRS provisions eliminate the classification of deferred tax assets as current or noncurrent. Under IAS 1, all deferred tax assets are deemed to be noncurrent.

The economic performance requirement is accelerated, and thus, year-end accruals can be deducted, if all of the following conditions are met (known as the *recurring item exception*):

- The obligation exists, and the amount of the liability can be reasonably estimated.
- Economic performance occurs on or before the earlier of the date the taxpayer files the return (including extension) or 8½ months after the close of the taxable year.
- The item is recurring in nature and is treated consistently by the taxpayer.
- Either the accrued item is not material or accruing it results in a better matching of revenues and expenses.

Green Corporation often sells goods that are on hand but cannot be shipped for another week. The all events test for the sale are satisfied; therefore, the revenue is recognized although the goods have not been shipped at year-end. Green Corporation is obligated to pay shipping costs. Although the company's obligation for shipping costs can be determined with reasonable accuracy, economic performance is not satisfied until Green (or its agent) actually delivers the goods. However, accruing shipping costs on sold items will better match expenses with revenues for the period. Therefore, the company should be allowed to accrue the shipping costs on items sold but not shipped at year-end.

EXAMPLE

20

The economic performance test as set forth in the Code does not address all possible accrued expenses. That is, in some cases, the taxpayer incurs cost even though no property or services were received. In these instances, according to the Regulations, economic performance generally is not satisfied until the liability is paid. The following liabilities are cases in which payment is the only means of satisfying economic performance:⁴⁹

1. Workers' compensation.
2. Torts.
3. Breach of contract.
4. Violation of law.

⁴⁹Reg. §§ 1.461-4(g)(2)-(6) and 1.461-5(c).

5. Rebates and refunds.
6. Awards, prizes, and jackpots.
7. Insurance, warranty, and service contracts.⁵⁰
8. Taxes.

EXAMPLE

21

Yellow Corporation sold defective merchandise that injured a customer. Yellow admitted liability in 2015, but did not pay the claim until January 2016. The customer's tort claim cannot be deducted until it is paid.

However, items (5) through (8) above are eligible for the aforementioned recurring item exception.

EXAMPLE

22

Pelican Corporation filed its 2015 state income tax return in March 2016 and its Federal return on September 15, 2016. At the time the state return was filed, Pelican was required to pay an additional \$5,000. The state taxes are eligible for the recurring item exception. Thus, the \$5,000 of state income taxes can be deducted on the corporation's 2015 Federal tax return. The deduction is allowed because all of the events had occurred to fix the liability as of the end of 2015, the payment was made within 8½ months after the end of the tax year, the item is recurring in nature, and allowing the deduction in 2015 results in a better matching of revenues and expenses.

Reserves

Generally, the all events and economic performance tests will prevent the use of reserves (e.g., for product warranty expense) frequently used in financial accounting to match expenses with revenues. However, small banks are allowed to use a bad debt reserve.⁵¹ Furthermore, an accrual basis taxpayer in a service business is permitted not to accrue revenue that appears uncollectible based on experience. In effect, this approach indirectly allows a reserve.⁵²

16-2d Hybrid Method

A **hybrid method** of accounting involves the use of more than one method. For example, a taxpayer who uses the accrual basis to report sales and cost of goods sold but uses the cash basis to report other items of income and expense is employing a hybrid method. The Code permits the use of a hybrid method provided the taxpayer's income is clearly reflected.⁵³ A taxpayer who uses the accrual method for business expenses must also use the accrual method for business income.

EXAMPLE

23

The Loyal Pet Clinic boards animals, provides veterinarian services, and sells pet supplies and medicines. The clinic's gross receipts are approximately \$4 million per year, and 40% of the receipts are from sales of pet supplies. Under a hybrid method of accounting, the clinic would use the accrual method for the sales of supplies because inventories are an income-producing factor. However, the services income may be reported using the cash method.

LO.3

Utilize the procedure for changing accounting methods.

16-2e Change of Method

The taxpayer, in effect, makes an election to use a particular accounting method when an initial tax return is filed using that method. If a subsequent change in method is desired, the taxpayer must obtain the permission of the IRS. The request for change is

⁵⁰This item applies to contracts the taxpayer enters into for his or her own protection, rather than the taxpayer's liability as insurer, warrantor, or service provider.

⁵²§ 448(d)(5).

⁵³§ 446(c).

⁵¹§ 585.

made on Form 3115, Application for Change in Accounting Method. Generally, the form must be filed within the taxable year of the desired change.⁵⁴

As previously mentioned, the term *accounting method* encompasses not only the overall accounting method used by the taxpayer (the cash or accrual method) but also the treatment of any material item of income or deduction.⁵⁵ Thus, a change in the method of deducting property taxes from a cash basis to an accrual basis that results in a deduction for taxes in a different year constitutes a change in an accounting method. Another example of an accounting method change is a change involving the method or basis used in the valuation of inventories. However, a change in treatment resulting from a change in the underlying facts does not constitute a change in the taxpayer's method of accounting.⁵⁶ For example, a change in employment contracts so that an employee accrues one day of vacation pay for each month of service rather than 12 days of vacation pay for a full year of service is a change in the underlying facts and is therefore not an accounting method change.

Correction of an Error

A change in accounting method should be distinguished from the *correction of an error*. The taxpayer can correct an error (by filing amended returns) without permission, and the IRS can simply adjust the taxpayer's liability if an error is discovered on audit of the return. Some examples of errors are incorrect postings, errors in the calculation of tax liability or tax credits, deductions of business expense items that are actually personal, and omissions of income and deductions.⁵⁷ Unless the taxpayer or the IRS corrects the error within the statute of limitations, the taxpayer's total lifetime taxable income will be overstated or understated by the amount of the error.

Change from an Incorrect Method

An *incorrect accounting method* is the consistent (for at least two years) use of an incorrect rule to report an item of income or expense. The incorrect accounting method generally will not affect the taxpayer's total lifetime income (unlike the error). That is, an incorrect method has a self-balancing mechanism. For example, deducting freight on inventory in the year the goods are purchased, rather than when the inventory is sold, is an incorrect accounting method. The total cost of goods sold over the life of the business is not affected, but the year-to-year income is incorrect.⁵⁸

If a taxpayer is employing an incorrect method of accounting, permission must be obtained from the IRS to change to a correct method. An incorrect method is not treated as a mechanical error that can be corrected by merely filing an amended tax return.

The tax return preparer as well as the taxpayer will be subject to penalties if the tax return is prepared using an incorrect method of accounting and permission for a change to a correct method has not been requested.⁵⁹

Net Adjustments Due to Change in Accounting Method

In the year of a change in accounting method, an adjustment is generally required in order to prevent the omission or duplication of income or expense items.

⁵⁴See Rev.Proc. 2015-13, 2015-5 I.R.B. 419, for the method change procedures and Rev.Proc. 2015-14, 2015-5 I.R.B. 450, for the list of automatic method changes. Generally, for an automatic method change, the Form 3115 is due when the tax return for the year of change is filed.

⁵⁵Reg. § 1.446-1(a)(1).

⁵⁶Reg. § 1.446-1(e)(2)(ii).

⁵⁷Reg. § 1.446-1(e)(2)(ii)(b).

⁵⁸But see *Korn Industries v. U.S.*, 76-1 USTC ¶9354, 37 AFTR 2d 76-1228, 532 F.2d 1352 (Ct.Cls., 1976).

⁵⁹§ 446(f). See Chapter 26.

EXAMPLE

24

In 2015, White Corporation, with consent from the IRS, switched from the cash to the accrual basis for reporting sales and cost of goods sold. The corporation's accrual basis gross profit for the year was computed as follows:

Sales		\$100,000
Beginning inventory	\$ 15,000	
Purchases	60,000	
Less: Ending inventory	<u>(10,000)</u>	
Cost of goods sold		<u>(65,000)</u>
Gross profit		<u>\$ 35,000</u>

At the end of the previous year, White Corporation had accounts receivable of \$25,000 and accounts payable for merchandise of \$34,000. The accounts receivable from the previous year in the amount of \$25,000 were never included in gross income because White was on the cash basis and did not recognize the uncollected receivables. In the current year, the \$25,000 was not included in the accrual basis sales because the sales are from a prior year. Therefore, a \$25,000 adjustment to income is required to prevent the receivables from being omitted from income.

The corollary of the failure to recognize a prior year's receivables is the failure to recognize a prior year's accounts payable. The beginning of the year's accounts payable were not included in the current or prior year's purchases. Thus, a deduction for the \$34,000 was not taken in either year and is therefore included as an adjustment to income for the period of change.

An adjustment is also required to reflect the \$15,000 beginning inventory that White deducted (due to the use of a cash method of accounting) in the previous year. In this instance, the cost of goods sold during the year of change was increased by the beginning inventory and resulted in a double deduction.

The net adjustment due to the change in accounting method is computed as follows:

Beginning inventory (deducted in prior and current year)	\$ 15,000
Beginning accounts receivable (omitted from income)	25,000
Beginning accounts payable (omitted from deductions)	<u>(34,000)</u>
Net increase in taxable income	<u>\$ 6,000</u>

This adjustment (the \$6,000 increase in taxable income) is referred to as a "net § 481 adjustment" because it is required under § 481. These adjustments are either "positive" (increasing taxable income) or "negative" (decreasing taxable income).

Disposition of the Net § 481(a) Adjustment

Required changes in accounting methods can result from an IRS examination. The IRS usually will examine all years that are open under the statute of limitations. Generally, this means that the three preceding years are examined. Generally, if the IRS auditor finds that a taxpayer is using an incorrect method of accounting, the auditor will impose a change, but on less favorable terms than if the taxpayer had corrected the erroneous method on his or her own. For example, the IRS may require the taxpayer to correct the method for the earliest year open under the statute of limitations and pick up any positive § 481 adjustment all in that year (rather than over four years allowed for a voluntary change in method). Additional tax and interest will be due. However, if the adjustment is greater than \$3,000, the taxpayer can elect to calculate the tax by spreading the adjustment over one or more previous years.⁶⁰ The election is beneficial if the taxpayer's marginal tax rate for the prior years is lower than the marginal tax rate for the year of the change.

To encourage taxpayers to *voluntarily* change (rather than wait for an IRS audit resulting in a required change) from incorrect methods and to facilitate changes from

⁶⁰§ 481(b). Guidance on IRS-initiated method changes can be found in Rev.Proc. 2002-18, 2002-1 C.B. 678.

one correct method to another, the IRS generally allows the taxpayer to spread a positive adjustment into future years. One-fourth of the adjustment is applied to the year of the change, and one-fourth of the adjustment is applied to each of the next three taxable years. A negative adjustment must be deducted in the year of the change.⁶¹

White Corporation in Example 24 voluntarily changed from an incorrect method (the cash basis was incorrect because inventories were material to the business) to a correct method. The company must add \$1,500 ($\frac{1}{4} \times \$6,000$ positive adjustment) to its 2015, 2016, 2017, and 2018 income.

EXAMPLE

25



ETHICS & EQUITY Change in Accounting Method

The IRS faces a difficult choice when it deals with taxpayers who use incorrect accounting methods. On the one hand, the taxpayer who has used an incorrect accounting method may be just as culpable as a person who has omitted income or taken an improper deduction. On the other hand, it is often difficult to discover that a taxpayer is using an incorrect accounting method. Therefore, the IRS

relies to some extent on self-reporting by taxpayers. The Service encourages voluntary changes in incorrect accounting methods by waiving penalties for underpayment of prior years' taxes and permitting the taxpayer, in effect, to pay the related taxes over a four-year period. Is this equitable treatment?

16-3 SPECIAL ACCOUNTING METHODS

Generally, accrual basis taxpayers recognize income when goods are sold. Cash basis taxpayers generally recognize income from a sale on the collection of cash from the customer. The tax law provides special accounting methods for certain installment sales and long-term contracts. These special methods were enacted, in part, to ensure that the tax will be due when the taxpayer is best able to pay the tax.

LO.4

Determine when the installment method of accounting can be utilized and apply the related calculation techniques.

16-3a Installment Method

Under the general rule for computing the gain or loss from the sale of property, the taxpayer recognizes the entire amount of gain or loss upon the sale or other disposition of the property.

Mark sells property to Fran for \$10,000 cash plus Fran's note (fair market value and face amount of \$90,000). Mark's basis for the property was \$15,000. Gain or loss is computed under either the cash or accrual basis as follows:

Selling price	
Cash down payment	\$ 10,000
Note receivable	<u>90,000</u>
	\$100,000
Basis in the property	<u>(15,000)</u>
Realized gain	<u>\$ 85,000</u>

EXAMPLE

26

In Example 26, the general rule for recognizing gain or loss requires Mark to pay a substantial amount of tax on the gain in the year of sale even though he received only

⁶¹Rev.Proc. 2015-13, 2015-5 I.R.B. 419.



TAX IN THE NEWS Seller Financing Is Popular in Troubled Times

As financial institutions are applying stringent loan requirements and real estate investors are anxious to sell, seller financing is becoming more common. In other words, instead of the financing being done by a financial institution, the seller of the property finances the transaction and receives a higher interest rate than could be earned

from a bank. The seller receives a down payment and a mortgage for the balance on the contract. If the buyer turns out to be unable to pay, the seller regains ownership of the property. Thus, even under this worst-case scenario, the seller is still in a better position than if the original sale had not been made.

\$10,000 cash. Congress enacted the installment sales provisions to prevent this sort of hardship by allowing the taxpayer to spread the gain from installment sales over the collection period, when the taxpayer is best able to pay the tax. The installment method is a very important planning tool because of the tax deferral possibilities.

Eligibility and Calculations

The **installment method** applies to *gains* (but not losses) from the sale of property by a taxpayer who will receive at least one payment *after* the year of sale. However, the installment method cannot be used for the following:⁶²

- Gains on property held for sale in the ordinary course of business.
- Depreciation recapture under § 1245 or § 1250.
- Gains on stocks or securities traded on an established market.

As an exception to the first item, the installment method may be used to report gains from sales of the following:⁶³

- Time-share units (e.g., the right to use real property for two weeks each year).
- Residential lots (if the seller is not to make any improvements).
- Any property used or produced in the trade or business of farming.

The Nonelective Aspect

As a general rule, eligible sales *must* be reported by the installment method.⁶⁴ A special election is required to report the gain by any other method of accounting (see the discussion in a subsequent section of this chapter).

Computing the Gain for Each Year Payments Are Received

The gain reported on each sale is computed using the following formula:

$$\frac{\text{Total gain}}{\text{Contract price}} \times \text{Payments received during the tax year} = \text{Gain recognized in the tax year}$$

The taxpayer must compute each variable as follows:

1. *Total gain* is the selling price reduced by selling expenses and the adjusted basis of the property. The selling price is the total consideration received by the seller, including notes receivable from the buyer and the seller's liabilities assumed by the buyer.
2. *Contract price* is the selling price less the seller's liabilities that are assumed by the buyer. Generally, the contract price is the amount, other than interest, the seller will receive from the purchaser.

⁶² §§ 453(b), (i), and (l).

⁶³ § 453(l)(2).

⁶⁴ § 453(a).

3. *Payments received* are the collections on the contract price received in each tax year. This generally is equal to the cash received less the interest income collected for the period. If the buyer pays any of the seller's expenses, the seller regards the amount paid as a payment received.⁶⁵

The seller is not a dealer, and the facts are as follows:

Sales price			
Cash down payment	\$ 1,000		
Seller's mortgage assumed	3,000		
Notes payable to the seller	<u>13,000</u>	\$ 17,000	
Selling expenses		(500)	
Seller's basis		<u>(10,000)</u>	
Total gain		<u>\$ 6,500</u>	

EXAMPLE

27

The contract price is \$14,000 (\$17,000 – \$3,000). Assuming that the \$1,000 is the only payment in the year of sale, the recognized gain in that year is computed as follows:

$$\frac{\$6,500 \text{ (total gain)}}{\$14,000 \text{ (contract price)}} \times \$1,000 = \$464 \text{ (gain recognized in year of sale)}$$

If the sum of the seller's basis and selling expenses is less than the liabilities assumed by the buyer, the difference must be added to the contract price and to the payments (treated as *deemed payments*) received in the year of sale.⁶⁶ This adjustment to the contract price is required so that the ratio of total gain to contract price will not be greater than one. The adjustment also accelerates the reporting of income from the deemed payments.

Assume the same facts as in Example 27, except that the seller's basis in the property is only \$2,000. The total gain, therefore, is \$14,500 [\$17,000 – (\$2,000 + \$500)]. Payments in the year of sale are \$1,500 and are calculated as follows:

Down payment	\$1,000
Excess of mortgage assumed over seller's basis and selling expenses (\$3,000 – \$2,000 – \$500)	<u>500</u>
	<u>\$1,500</u>

EXAMPLE

28

The contract price is \$14,500 [\$17,000 (selling price) – \$3,000 (seller's mortgage assumed) + \$500 (excess of mortgage assumed over seller's basis and selling expenses)]. The gain recognized in the year of sale is computed as follows:

$$\frac{\$14,500 \text{ (total gain)}}{\$14,500 \text{ (contract price)}} \times \$1,500 \text{ deemed payment received} =$$

$$\$1,500 \text{ (gain recognized in year of sale)}$$

In subsequent years, all amounts the seller collects on the note principal (\$13,000) will be recognized gain (\$13,000 × 100%).

As previously discussed, gains attributable to ordinary income recapture under §§ 1245 and 1250 are *ineligible* for installment reporting. Therefore, the § 1245 or § 1250 gain realized must be recognized in the year of sale, and the installment sale gain is the remaining gain.

⁶⁵The gain is reported on Form 6252.

⁶⁶Temp.Reg. § 15a.453-1(b)(3)(i).

EXAMPLE

29

Olaf sold an apartment building for \$50,000 cash and a \$75,000 note due in two years. Olaf's cost of the property was \$90,000, and he had deducted depreciation of \$65,000, \$40,000 of which was in excess of what the straight-line amount would have been. Thus, the basis in the property was \$25,000 (\$90,000 – \$65,000), and he recaptured \$40,000 ordinary income under § 1250.

Olaf's realized gain is \$100,000 (\$125,000 – \$25,000), and the \$40,000 recapture must be recognized in the year of sale. Of the \$60,000 remaining § 1231 gain, \$24,000 must be recognized in the year of sale:

$$\begin{aligned} \frac{\$ 1231 \text{ gain}}{\text{Contract price}} \times \text{Payment received} &= \frac{\$125,000 - \$25,000 - \$40,000}{\$125,000} \times \$50,000 \\ &= \frac{\$60,000}{\$125,000} \times \$50,000 = \$24,000 \end{aligned}$$

The remaining realized gain of \$36,000 (\$60,000 – \$24,000) will be recognized as the \$75,000 note is collected.

Character of the Gain on Depreciable Real Estate

As discussed in Chapter 14, an individual's recognized gain from the sale of depreciable real estate may be subject to a 25 percent tax rate. The gain to the extent of straight-line depreciation taken is subject to the special rate and is referred to as "unrecaptured § 1250 gain." The recognized gain in excess of the depreciation is a § 1231 gain eligible for the 15%/20% rate. Under the installment sale rules, when the sale results in both 25% gain and 15%/20% gain, the 25% gain is reported first and then the 15%/20% gain.

EXAMPLE

30

Continuing with the facts in Example 29, the realized gain was \$100,000, of which \$40,000 was § 1250 ordinary income. The straight-line depreciation would have been \$25,000 (total depreciation of \$65,000 less excess depreciation of \$40,000). Therefore, the unrecaptured § 1250 gain is \$25,000. The recognized installment gain in the year of sale of \$24,000 was less than the unrecaptured § 1250 gain of \$25,000. Therefore, the \$24,000 recognized gain in the year of sale is subject to the 25% tax rate.

Imputed Interest

If a deferred payment contract for the sale of property with a selling price greater than \$3,000 does not contain a reasonable interest rate, a reasonable rate is imputed.⁶⁷ The imputing of interest effectively restates the selling price of the property to equal the sum of the payments at the date of the sale and the discounted present value of the future payments. The difference between the present value of a future payment and the payment's face amount is taxed as interest income, as discussed in the following paragraphs. Thus, the **imputed interest** rules prevent sellers of capital assets from increasing the selling price to reflect the equivalent of unstated interest on deferred payments and thereby converting ordinary (interest) income into long-term capital gains. In addition, the imputed interest rules are important because they affect the timing of income recognition.

Generally, if the contract does not charge at least the Federal rate, interest will be imputed at the Federal rate. The Federal rate is the interest rate the Federal government pays on new borrowing and is published monthly by the IRS.⁶⁸

⁶⁷ §§ 483 and 1274.

⁶⁸ § 1274(d)(1). There are three Federal rates: short-term (not over three years), midterm (over three years but not over nine years), and long-term (over nine years).

As a general rule, the buyer and seller must account for interest on the accrual basis with semiannual compounding.⁶⁹ Requiring the use of the accrual basis ensures that the seller's interest income and the buyer's interest expense are reported in the same tax year. The following example illustrates the calculation and amortization of imputed interest.

Peggy, a cash basis taxpayer, sold land on January 1, 2015, for \$200,000 cash and \$6 million due on December 31, 2016, with 2% interest payable December 31, 2015, and December 31, 2016. At the time of the sale, the Federal rate was 4% (compounded semiannually). Because Peggy did not charge interest at least equal to the Federal rate, interest will be imputed at 4% (compounded semiannually).

EXAMPLE**31**

Date	Payment	Present Value (at 4%) on 1/1/2015	Imputed Interest
12/31/2015	\$ 120,000	\$ 115,384	\$ 4,616
12/31/2016	<u>6,120,000</u>	<u>5,658,284</u>	<u>461,716</u>
	<u>\$6,240,000</u>	<u>\$5,773,668</u>	<u>\$466,332</u>

Thus, the selling price will be restated to \$5,973,668 (\$200,000 + \$5,773,668) rather than \$6,200,000 (\$200,000 + \$6,000,000), and Peggy will recognize interest income in accordance with the following amortization schedule:

	Beginning Balance	Interest (at 4%)*	Received	Ending Balance
2015	\$5,773,668	\$230,947	\$ 120,000	\$5,884,615
2016	5,884,615	235,385	6,120,000	-0-

* Compounded semiannually.

Congress has created several exceptions regarding the rate at which interest is imputed and the method of accounting for the interest income and expense. The general rules and exceptions are summarized in Concept Summary 16.2.

Related-Party Sales of Nondepreciable Property

If the Code did not contain special rules, a taxpayer could make an installment sale of property to a related party (e.g., a family member) who would obtain a basis in the property equal to the purchase price (the fair market value of the property). Then the purchasing family member could immediately sell the property to an unrelated party for cash with no recognized gain or loss (the amount realized would equal the basis). The related-party purchaser would not pay the installment note to the selling family member until a later year or years. The net result would be that the family has the cash, but no taxable gain is recognized until the intrafamily transfer of the cash (when the purchasing family member makes payments on the installment note).

Under special rules designed to combat the scheme described above, the proceeds from the subsequent sale (the second sale) by the purchasing family member are treated as though they were used to pay the installment note due the selling family member (the first sale). As a result, the recognition of gain from the original sale between the related parties is accelerated.⁷⁰

⁶⁹ §§ 1274(a), 1273(a), and 1272(a).

⁷⁰ § 453(e).



Concept Summary 16.2

Interest on Installment Sales

	Imputed Interest Rate	
General rule	Federal rate	
Exceptions:		
• Principal amount not over \$2.8 million. ¹	Lesser of Federal rate or 9%	
• Sale of land (with a calendar year ceiling of \$500,000) between family members (the seller's spouse, brothers, sisters, ancestors, or lineal descendants). ²	Lesser of Federal rate or 6%	
	Method of Accounting for Interest	
	Seller's Interest Income	Buyer's Interest Expense
General rule ³	Accrual	Accrual
Exceptions:		
• Total payments under the contract are \$250,000 or less. ⁴	Taxpayer's overall method	Taxpayer's overall method
• Sale of a farm (sales price of \$1 million or less). ⁵	Taxpayer's overall method	Taxpayer's overall method
• Sale of a principal residence. ⁶	Taxpayer's overall method	Taxpayer's overall method
• Sale for a note with a principal amount of not over \$2 million, the seller is on the cash basis, the property sold is not inventory, and the buyer agrees to report expense by the cash method. ⁷	Cash	Cash

¹§ 1274A(b). This amount is adjusted annually for inflation (see Rev.Rul. 2014–30, 2014–49 I.R.B. 910). For 2015, the amount is \$5,647,300.

²§§ 1274(c)(3)(F) and 483(e).

³§§ 1274(a) and 1272(a)(3).

⁴§§ 1274(c)(3)(C) and 483.

⁵§§ 1274(c)(3)(A) and 483.

⁶§§ 1274(c)(3)(B) and 483.

⁷§ 1274A(c). This amount is adjusted annually for inflation (see Rev.Rul. 2014–30, 2014–49 I.R.B. 910). For 2015, the amount is \$4,033,800.

However, even with these special rules, Congress did not eliminate the benefits of all related-party installment sales.

- Related parties include the first seller's brothers, sisters, ancestors, lineal descendants, controlled corporations, and partnerships, trusts, and estates in which the seller has an interest.⁷¹
- There is no acceleration if the second disposition occurs more than two years after the first sale.⁷²

Thus, if the taxpayer can sell the property to an unrelated party (not a related party) or a patient family member, the intrafamily installment sale is still a powerful tax planning tool. Other exceptions also can be applied in some circumstances.⁷³

Related-Party Sales of Depreciable Property

The installment method cannot be used to report a gain on the sale of depreciable property to a controlled entity. The purpose of this rule is to prevent the seller from deferring

⁷¹§ 453(f)(1), cross-referencing §§ 267(b) and 318(a). Although spouses are related parties, the exemption of gain between spouses (§ 1041) makes the second-disposition rules inapplicable when the first sale was between spouses.

⁷²§ 453(e)(2). But see § 453(e)(2)(B) for extensions of the two-year period.

⁷³See §§ 453(e)(6) and (7).

gain (until collections are received) while the related purchaser is enjoying a stepped-up basis for depreciation purposes.⁷⁴

The prohibition on the use of the installment method applies to sales between the taxpayer and a partnership or corporation in which the taxpayer holds a more-than-50-percent interest. Constructive ownership rules are used in applying the ownership test (e.g., the taxpayer is considered to own stock owned by a spouse and certain other family members).⁷⁵ However, if the taxpayer can establish that tax avoidance was not a principal purpose of the transaction, the installment method can be used to report the gain.

Alan purchased an apartment building from his controlled corporation, Emerald Corporation. Alan was short of cash at the time of the purchase (December 2015), but was to collect a large cash payment in January 2016. The agreement required Alan to pay the entire arm's length price in January 2016. Alan had good business reasons for acquiring the building. Emerald Corporation should be able to convince the IRS that tax avoidance was not a principal purpose for the installment sale because the tax benefits are not overwhelming. The corporation will report all of the gain in the year following the year of sale, and the building must be depreciated over 27.5 years (the cost recovery period).

EXAMPLE**32**

16-3b Disposition of Installment Obligations

Generally, a taxpayer must recognize the deferred profit from an installment sale when the obligation is transferred to another party or otherwise relinquished. The rationale for accelerating the gain is that the deferral should continue for no longer than the taxpayer owns the installment obligation.⁷⁶

The gift or cancellation of an installment note is treated as a taxable disposition by the donor. This discourages attempts to shift income among family members. The amount realized from the cancellation is the face amount of the note if the parties (obligor and obligee) are related to each other.⁷⁷

Liz cancels a note issued by Tina (Liz's daughter) that arose in connection with the sale of property. At the time of the cancellation, the note had a basis to Liz of \$10,000, a face amount of \$25,000, and a fair market value of \$20,000. Presuming that the initial sale by Liz qualified as an installment sale, the cancellation results in gain of \$15,000 (\$25,000 – \$10,000) to Liz.

EXAMPLE**33**

Certain exceptions to the recognition of gain provisions are provided for transfers of installment obligations to the transferor's 80 percent controlled corporation, contributions of capital to a partnership, certain corporate liquidations, transfers due to the taxpayer's death, and transfers between spouses or incident to divorce.⁷⁸ In such situations, the deferred profit is merely shifted to the transferee, who is responsible for the payment of tax on the subsequent collections of the installment obligations. The exception to this rule is that in the case of a transfer of installment obligations to a partnership by a partner, the transferor partner is taxed on the income when the partnership collects on the installment receivables.

The Big Picture

Return to the facts of *The Big Picture* on p. 16-1. Assume that Belinda's capital contribution to the partnership in 2015 was an installment obligation with a basis of \$40,000 and a face amount of \$100,000. In 2016, the partnership collected the \$100,000. The transfer in 2015 was not a taxable disposition, but in 2016 when the receivable is collected, Belinda is required to recognize a gain of \$60,000.

EXAMPLE**34**

⁷⁴§ 453(g).

⁷⁵§§ 1239(b) and (c).

⁷⁶§ 453B(a).

⁷⁷§ 453B(f)(2).

⁷⁸§§ 453B(c), (d), and (g).

16-3c Interest on Deferred Taxes

With the installment method, the seller earns interest on the receivable. The receivable includes the deferred gain. Thus, one could argue that the seller is earning interest on the deferred taxes. Some commentators reason that the government is, in effect, making interest-free loans to taxpayers who report gains by the installment method. Following the argument that the amount of the deferred taxes is a loan, the taxpayer is required to pay interest on the deferred taxes in some situations.⁷⁹

16-3d Electing Out of the Installment Method

A taxpayer can *elect not to use* the installment method. The election is made by reporting on a timely filed return the gain computed by the taxpayer's usual method of accounting (cash or accrual).⁸⁰ However, the Regulations provide that the amount realized by a cash basis taxpayer cannot be less than the fair market value of the property sold. This rule differs from the usual cash basis accounting rules (discussed earlier),⁸¹ which measure the amount realized in terms of the fair market value of the property received. The net effect of the Regulations is to allow the cash basis taxpayer to report his or her gain as an accrual basis taxpayer. The election is frequently applied to year-end sales by taxpayers who expect to be in a higher tax bracket in the following year.

EXAMPLE

35

On December 31, 2015, Kurt sold investment land to Jodie for \$20,000 (fair market value). He had owned the land for seven years. The cash was to be paid on January 4, 2016. Kurt is a cash basis taxpayer, and his basis in the land is \$8,000. Kurt has a large casualty loss that, when combined with his other income in 2015, puts him at a marginal tax rate of 15% in 2015. He expects his tax rate to increase to 35% in 2016.

The transaction constitutes an installment sale because a payment will be received in a tax year after the tax year of disposition. Jodie's promise to pay Kurt is an installment obligation, and under the Regulations, the value of the installment obligation is equal to the value of the property sold (\$20,000). If Kurt elects out of the installment method, he will shift \$12,000 of gain (\$20,000 – \$8,000) from the expected higher rate in 2016 of 15% to the 0% rate for long-term capital gains in 2015. The expected tax savings based on the rate differential may exceed the benefit of the tax deferral available with the installment method.

Permission of the IRS is required to revoke an election not to use the installment method.⁸²

LO.5

Review and illustrate the alternative methods of accounting for long-term contracts (the completed contract method and the percentage of completion method), including the limitations on the use of the completed contract method.

16-3e Long-Term Contracts

A **long-term contract** is a building, installation, construction, or manufacturing contract that is entered into but not completed within the same tax year. However, a *manufacturing* contract is long-term *only* if the contract is to manufacture (1) a unique item not normally carried in finished goods inventory or (2) items that normally require more than 12 calendar months to complete.⁸³ An item is *unique* if it is designed to meet the customer's particular needs and is not suitable for use by others. A contract to perform services (e.g., auditing or legal services) is not considered a contract for this purpose and thus cannot qualify as a long-term contract.

EXAMPLE

36

Rocky, a calendar year taxpayer, entered into two contracts during the year. One contract was to construct a building foundation. Work was to begin in October 2015 and was to be completed by June 2016. The contract is long term because it will not be entered into and completed in the

continued

⁷⁹§ 453A.

⁸⁰§ 453(d) and Reg. § 15a.453-1(d).

⁸¹Refer to Chapter 4, Example 6.

⁸²§ 453(d)(3) and Reg. § 15a.453-1(d)(4).

⁸³§ 460(f) and Reg. § 1.460-2(a).

same tax year. The fact that the contract requires less than 12 calendar months to complete is not relevant because the contract is not for manufacturing. The second contract was for architectural services to be performed over two years. These services will not qualify for long-term contract treatment because the taxpayer will not build, install, construct, or manufacture a product.

Generally, the taxpayer must accumulate all of the direct and indirect costs incurred under a contract. This means that the production costs must be accumulated and allocated to individual contracts. Furthermore, mixed services costs, costs that benefit contracts as well as the general administrative operations of the business, must be allocated to production. Exhibit 16.1 lists the types of costs that must be accumulated and allocated to contracts. The taxpayer must develop reasonable bases for cost allocations.⁸⁴

EXHIBIT 16.1**Contract Costs, Mixed Services Costs, and Current Expense Items for Contracts**

	Contracts Eligible for the Completed Contract Method	Other Contracts
Contract costs:		
Direct materials (a part of the finished product).	Capitalize	Capitalize
Indirect materials [consumed in production but not in the finished product (e.g., grease and oil for equipment)].	Capitalize	Capitalize
Storage, handling, and insurance on materials.	Expense	Capitalize
Direct labor (worked on the product).	Capitalize	Capitalize
Indirect labor [worked in the production process but not directly on the product (e.g., a construction supervisor)].	Capitalize	Capitalize
Fringe benefits for direct and indirect labor (e.g., vacation, sick pay, unemployment, and other insurance).	Capitalize	Capitalize
Pension costs for direct and indirect labor:		
Current cost.	Expense	Capitalize
Past service costs.	Expense	Capitalize
Depreciation on production facilities:		
For financial statements.	Capitalize	Capitalize
Tax depreciation in excess of financial statements.	Expense	Capitalize
Depreciation on idle facilities.	Expense	Expense
Property taxes, insurance, rent, and maintenance on production facilities.	Capitalize	Capitalize
Bidding expenses—successful.	Expense	Capitalize
Bidding expenses—unsuccessful.	Expense	Expense
Interest to finance real estate construction.	Capitalize	Capitalize
Interest to finance personal property:		
Production period of one year or less.	Expense	Expense
Production period exceeds one year and costs exceed \$1 million.	Capitalize	Capitalize
Production period exceeds two years.	Capitalize	Capitalize
Mixed services costs:		
Personnel operations.	Expense	Allocate
Data processing.	Expense	Allocate
Purchasing.	Expense	Allocate
Selling, general, and administrative expenses (including an allocated share of mixed services).	Expense	Expense
Losses.	Expense	Expense

⁸⁴Reg. §§ 1.460-5(b) and 1.263A-1(e).

EXAMPLE

37

Falcon, Inc., uses detailed cost accumulation records to assign labor and materials to its contracts in progress. The total cost of fringe benefits is allocated to a contract on the following basis:

$$\frac{\text{Labor on the contract}}{\text{Total salaries and labor}} \times \text{Total cost of fringe benefits}$$

Similarly, storage and handling costs for materials are allocated to contracts on the following basis:

$$\frac{\text{Contract materials}}{\text{Material purchases}} \times \text{Storage and handling costs}$$

The cost of the personnel operations, a mixed services cost, is allocated between production and general administration based on the number of employees in each function. The personnel cost allocated to production is allocated to individual contracts on the basis of the formula used to allocate fringe benefits.

The accumulated costs are deducted when the revenue from the contract is recognized. Generally, two methods of accounting are used in varying circumstances to determine when the revenue from a contract is recognized:⁸⁵

- The completed contract method.
- The percentage of completion method.

The *completed contract method* may be used for (1) home construction contracts (contracts in which at least 80 percent of the estimated costs are for dwelling units in buildings with four or fewer units) and (2) certain other real estate construction contracts. Other real estate contracts can qualify for the completed contract method if the following requirements are satisfied:

- The contract is expected to be completed within the two-year period beginning on the commencement date of the contract.
- The contract is performed by a taxpayer whose average annual gross receipts for the three taxable years preceding the taxable year in which the contract is entered into do not exceed \$10 million.

All other contractors must use the percentage of completion method.

Completed Contract Method

Under the **completed contract method**, no revenue from the contract is recognized until the contract is completed and accepted. Generally, the contract is completed when it is accepted by the customer or the customer begins using the subject matter of the contract.⁸⁶

In some situations, the original contract price may be disputed, or the buyer may want additional work to be done on a long-term contract. If the disputed amount is substantial (it is not possible to determine whether a profit or loss will ultimately be realized on the contract), the Regulations provide that no amount of income or loss is recognized until the dispute is resolved. In all other cases, the profit or loss (reduced by the amount in dispute) is recognized in the current period upon completion of the contract. However, additional work may need to be performed with respect to the disputed contract. When the amount in dispute is less than the net profit on the contract before the estimated additional cost, the taxpayer must report in the year of completion the profit as reduced by the estimated additional cost.⁸⁷

⁸⁵§ 460.

⁸⁶Reg. § 1.460-1(c)(3).

⁸⁷Reg. §§ 1.451-3(d)(2)(ii)-(vii), Example 2.

Ted, a calendar year taxpayer utilizing the completed contract method of accounting, constructed a building for Brad under a long-term contract. The gross contract price was \$500,000. Ted finished construction in 2015 at a cost of \$475,000. When Brad examined the building, he insisted that the building be repainted or the contract price be reduced. The estimated cost of repainting is \$10,000. Because under the terms of the contract Ted is assured of a profit of at least \$15,000 (\$500,000 – \$475,000 – \$10,000) even if the dispute is ultimately resolved in Brad’s favor, Ted must include \$490,000 (\$500,000 – \$10,000) in gross income and is allowed deductions of \$475,000 for 2015.

In 2016, Ted and Brad resolve the dispute, and Ted repaints certain portions of the building at a cost of \$6,000. Ted must include \$10,000 in 2016 gross income and may deduct the \$6,000 expense in that year.

EXAMPLE

38

If the net profit less the estimated additional cost results in a loss, the loss is deferred until the dispute is resolved.

Assume the same facts as in the previous example, except that the estimated cost of repainting the building is \$50,000. Because the resolution of the dispute completely in Brad’s favor would mean a net loss on the contract for Ted (\$500,000 – \$475,000 – \$50,000 = \$25,000 loss), Ted does not recognize any income or loss until the year the dispute is resolved.

EXAMPLE

39

Frequently, a contractor receives payment at various stages of completion. For example, when the contract is 50 percent complete, the contractor may receive 50 percent of the contract price less a retainage. The taxation of these payments is generally governed by Regulation § 1.451-5, “advance payments for goods and long-term contracts” (discussed in Chapter 4). Generally, contractors are permitted to defer the advance payments until the payments are recognized as income under the taxpayer’s method of accounting.

Percentage of Completion Method

Under the **percentage of completion method**, a portion of the gross contract price is included in income during each period as the work progresses. The revenue accrued each period (except for the final period) is computed as follows:⁸⁸

$$\frac{C}{T} \times P$$

Where C = Contract costs incurred during the period
 T = Estimated total cost of the contract
 P = Contract price

All of the costs allocated to the contract during the period are deductible from the accrued revenue.⁸⁹ The revenue reported in the final period is simply the unreported revenue from the contract. Because T in this formula is an estimate that frequently differs from total actual costs, which are not known until the contract has been completed, the profit on a contract for a particular period may be overstated or understated.

Tan, Inc., entered into a contract that was to take two years to complete, with an estimated cost of \$2,250,000. The contract price was \$3,000,000. Costs of the contract for 2014, the first year, totaled \$1,350,000. The gross profit reported by the percentage of completion method for 2014 was \$450,000 [(\$1,350,000/\$2,250,000 × \$3,000,000) – \$1,350,000]. The contract was completed at the end of 2015 at a total cost of \$2,700,000. In retrospect, 2014 profit should have been \$150,000 [(\$1,350,000/\$2,700,000 × \$3,000,000) – \$1,350,000]. Thus, taxes were overpaid for 2014.

EXAMPLE

40

A *de minimis* rule enables the contractor to delay the recognition of income for a particular contract under the percentage of completion method. If less than 10 percent of the estimated contract costs have been incurred by the end of the taxable year, the

⁸⁸§ 460(b)(1)(A).

⁸⁹Reg. § 1.451-3(c)(3).

taxpayer can elect to defer the recognition of income and the related costs until the taxable year in which cumulative contract costs are at least 10 percent of the estimated contract costs.⁹⁰

Lookback Provisions

In the year a contract is completed, a *lookback* provision requires the recalculation of annual profits reported on the contract under the percentage of completion method. Interest is paid to the taxpayer if taxes were overpaid, and interest is payable by the taxpayer if there was an underpayment.⁹¹ For a corporate taxpayer, the lookback interest paid by the taxpayer is deductible, but for an individual taxpayer, it is nondeductible personal interest associated with a tax liability.

EXAMPLE

41

Assume that Tan, Inc., in Example 40, was in the 35% tax bracket in both years and the relevant interest rate was 10%. For 2014, the company paid excess taxes of \$105,000 [(\$450,000 – \$150,000) × .35]. When the contract is completed at the end of 2015, Tan, Inc., should receive interest of \$10,500 for one year on the tax overpayment (\$105,000 × .10).

LO.6

Identify tax planning opportunities related to accounting periods and accounting methods.

16-4 TAX PLANNING

The tax accounting period and method rules sometimes present opportunities for tax planning.

16-4a Taxable Year

Under the general rules for tax years, partnerships and S corporations frequently will be required to use a calendar year. However, if the partnership or S corporation can demonstrate a business purpose for a fiscal year, the IRS will allow the entity to use the requested year. The advantage to a fiscal year is that the calendar year partners and S corporation shareholders may be able to defer from tax the income earned from the close of the fiscal year until the end of the calendar year. Tax advisers for these entities should apply the IRS's gross receipts test described in Revenue Procedure 87-32 to determine whether permission for the fiscal year will be granted.⁹²

16-4b Cash Method of Accounting

The cash method of accounting gives the taxpayer considerable control over the recognition of expenses and some control over the recognition of income. This method can be used by proprietorships, partnerships, S corporations, and small C corporations (gross receipts of \$5 million or less) that provide services (inventories are not material to the service business). Farmers (except certain farming corporations) can also use the cash method.

16-4c Installment Method

Unlike the cash and accrual methods, the installment method often results in an interest-free loan (of deferred taxes) from the government. The installment method is not available for the sale of inventory and certain other property (e.g., equipment subject to depreciation recapture). But when eligible property is sold, the installment method is an important tax planning technique. That is, the seller may defer gain and attain a higher interest rate than from alternative investments. These benefits must be weighed against the risks of nonpayment by the buyer. If, on the other hand, the taxpayer expects to be

⁹⁰§ 460(b)(5).

⁹¹§§ 460(b)(2) and (6). The taxpayer can elect not to apply the lookback method in situations where the cumulative taxable income as of the close of each prior year is within 10% of the correct income for each prior year.

⁹²See also Rev.Proc. 2002-38, 2002-1 C.B. 1037.

in a higher tax bracket when the payments will be received, he or she can elect not to use the installment method.

Related Parties

Intrafamily installment sales can still be a useful family tax planning tool. If the related party holds the property more than two years, a subsequent sale will not accelerate the gain from the first disposition. Patience and forethought are rewarded.

Disposition of Installment Obligations

A disposition of an installment obligation is also a serious matter. Gifts of the obligations will accelerate income to the seller. The list of taxable and nontaxable dispositions of installment obligations should not be trusted to memory. In each instance where transfers of installment obligations are contemplated, the practitioner should conduct research to make sure he or she knows the consequences.

16-4d Completed Contract Method

Small contractors (average annual gross receipts do not exceed \$10 million) working on contracts that are completed within a two-year period can elect to use the completed contract method and defer profit until the year in which the contract is completed.

REFOCUS ON THE BIG PICTURE

ACCOUNTING PERIOD AND METHOD

Selection of a Tax Year

An entity's tax form will govern the rules for determining the entity's tax year. Because Silver is a partnership, the Code's provisions for partnerships are applicable.

In this case, Tweety's 40 percent ownership interest in Silver is not sufficient to enable it to control the selection of the partnership's tax year. Likewise, Belinda and Pearl's collective controlling interest will not allow them to control the selection of the tax year for the partnership.

The Code and related Regulations have a very precise set of rules regarding the selection of a tax year for a partnership. The partnership applies these rules in the following sequence:

- *Majority interest tax year.* The tax year of the partners who have a common year-end and collectively own a greater-than-50-percent interest in the partnership capital and profits.
- *Principal partners' tax year.* The tax year if all of the principal partners (5 percent or greater interest in capital or profits) have the same tax year.
- *Least aggregate deferral tax year.* The tax year of the principal partners (grouped by a common year-end) that produces the least aggregate deferral of income.

Alternatively, the partnership can select its tax year based on a business purpose for the tax year selected. However, this requires the approval of the IRS, which is unlikely to be granted. The only business purpose the IRS has acknowledged is the need to conform the tax year to the entity's natural business year.

Therefore, from the data provided, it appears that Silver will determine its tax year by using the least aggregate deferral method. Based on this method, Silver's tax year will end on November 30 (see the calculations in Example 3).

continued



Short Tax Year

Silver will have a short tax year that begins on April 1, 2015, and ends on November 30, 2015, as determined by the least aggregate deferral method. Silver will not have to annualize the income reported on its first income tax return. Note, however, that annualization will be required if Silver ever changes its tax year.

Partner's Reporting of Share of Net Income

Each of the partners will receive a Schedule K-1 that reports the partner's share of net income. From a timing perspective, the partner will include the Schedule K-1 items on the partner's income tax return only if a partnership tax year ends within or with the partner's tax year.

Partnership's Accounting Method

Silver Partnership must use the accrual method to compute its income because one of its partners (Pearl, Inc.) is a C corporation within gross receipts of more than \$5 million. Thus, even though Belinda is a cash basis taxpayer, her share of the partnership income will be computed by the accrual method.

Key Terms

Accounting methods, 16-11

Accounting period, 16-2

Accrual method, 16-14

All events test, 16-15

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Claim of right doctrine, 16-9

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Short taxable year, 16-8

Discussion Questions

1. **LO.1** Would a tax year ending December 31 be appropriate for a Ski lodge? Why or why not?
2. **LO.1** Assume that a partnership is profitable and that its tax year ends on December 31 but one of the partners' tax year ends on September 30. Does the partner enjoy a tax benefit or detriment from the partnership's use of a December 31 tax year-end? Explain.

Decision Making

3. **LO.1** A law practice was incorporated on January 1, 2015, and expects to earn \$25,000 per month before deducting the lawyer's salary. The lawyer owns 100% of the stock. The corporation and the lawyer both use the cash method of accounting. The corporation does not need to retain any of the earnings in the business; thus, the salary of the lawyer (a calendar year taxpayer) will equal the corporation's net income before salary expense. If the corporation could choose any tax year and pay the lawyer's salary at the time that would be most tax efficient (but at least once every 12 months), what tax year should the corporation choose? When should the salary be paid each year?

4. **LO.1** Fred, a cash basis taxpayer, received a \$15,000 bonus from his employer in 2015. The bonus was based on the company's profits for 2014. In 2016, the company discovered that its 2014 profits were incorrectly computed. As a result, Fred received an additional \$10,000 with respect to 2014 profits. Fred's marginal tax rate in 2015 was 15%, and it was 35% in 2016. Sue, also a cash basis taxpayer, received a \$35,000 bonus in 2016 that was based on 2015 profits. In 2016, the company discovered that it had overstated its profits in 2015. As a result, Sue was required to repay \$10,000 of her bonus in 2016. Sue was in the 35% marginal tax bracket in 2015 and in the 15% marginal bracket in 2016. What special tax treatment is available to Fred and Sue as a result of their employer's errors? **Issue ID**
5. **LO.2** Under what conditions would the cash method of accounting be advantageous as compared with the accrual basis?
6. **LO.2** In December 2015, Nell, Inc., an accrual basis taxpayer, paid \$12,000 for insurance premiums for her business for the 2016 calendar year. How much of the premiums can Nell, Inc., deduct in 2015?
7. **LO.2** In 2014, the taxpayer became ineligible to use the cash method of accounting. At the beginning of the year, accounts receivable totaled \$240,000, accounts payable for merchandise totaled \$80,000, and the inventory on hand totaled \$320,000. What is the amount of the adjustment due to the change in accounting method?
8. **LO.2** Compare the cash and accrual methods of accounting for the following events:
- Purchased new equipment, paying \$50,000 cash and giving a note payable for \$30,000 due next year.
 - Paid \$3,600 for a three-year service contract on the new equipment.
 - Collected \$1,800 for services to be provided over the current and following years.
 - Received a \$3,000 note from a customer for services provided in the current year. The market value of the note was only \$2,400.
9. **LO.2** Edgar uses the cash method to report the income from his software consulting business. A large publicly held corporation has offered to invest in Edgar's business as a limited partner. What tax accounting complications would be created if Edgar and the corporation became partners? **Decision Making**
10. **LO.2** Samantha, an accrual basis taxpayer, subscribes to a service that updates a database used in her business. In December 2015, Samantha paid the \$120,000 subscription for the period January 2015 through December 2016. What is Samantha's deduction for 2015?
11. **LO.2** Emerald Motors is an automobile dealer. The controller consults with you about the type of accounting used for a special offer to its new car customers. Emerald has offered to provide at no charge to the customer the first four recommended service visits (i.e., at 3,000, 6,000, 9,000, and 12,000 miles). It is a virtual certainty that all customers will exercise their rights to the service, and the cost of the services can be accurately estimated. The controller reasons that the estimated cost should be accrued when the sale of an automobile is made so that all of the costs of the sale can be matched with the revenue. How would you respond to the controller?
12. **LO.4, 6** Irene has made Sara an offer on the purchase of a capital asset. Irene will pay (1) \$200,000 cash or (2) \$50,000 cash and a 6% installment note for \$150,000 guaranteed by City Bank of New York. If Sara sells for \$200,000 cash, she will invest the after-tax proceeds in certificates of deposit yielding 6% interest. Sara's cost of the asset is \$25,000. Why would Sara prefer the installment sale? **Decision Making**

13. **LO.4** Arnold gave land to his son, Bruce. Arnold's basis in the land was \$100,000, and its fair market value at the date of the gift was \$150,000. Bruce borrowed \$130,000 from a bank that he used to improve the property. He sold the property to Della for \$360,000. Della paid Bruce \$90,000 in cash, assumed his \$120,000 mortgage, and agreed to pay \$150,000 in two years. Bruce's selling expenses were \$10,000. Della is going to pay adequate interest. What is Bruce's installment sale gain in the year of sale?
- Decision Making** 14. **LO.4, 6** On June 1, 2013, Father sold land to Son for \$300,000. Father reported the gain by the installment method, with the gain to be spread over five years. In May 2015, Son received an offer of \$400,000 for the land, to be paid over three years. What would be the tax consequences of Son's sale? How could the tax consequences be improved?
- Decision Making** 15. **LO.4, 6** In December 2015, Carl Corporation sold land it held as an investment. The corporation received \$50,000 in 2015 and a note payable (with adequate interest) for \$150,000 to be paid in 2017. Carl Corporation's cost of the land was \$80,000. The corporation has a \$90,000 net capital loss carryover that will expire in 2015. Should Carl Corporation report the sale in 2015 or use the installment method to report the income as payments are received?
16. **LO.2, 5** What are the similarities between the crop method used for farming and the completed contract method used for long-term construction?
17. **LO.5** The Hawk Corporation builds yachts. The vessels it currently produces are practically identical and are completed in approximately 8 months. A customer has approached Hawk about constructing a larger yacht that would take approximately 15 months to complete. What are the tax implications of accepting the contract proposal?

Computational Exercises

18. **LO.1** Delaine is a 90% shareholder in a personal service corporation (PSC). The corporation paid Delaine a salary of \$265,000 during its fiscal year ending September 30, 2015.
- Assume that the corporation cannot satisfy the business purpose test for a fiscal year. How much salary must Delaine receive during the period October 1 through December 31, 2015, in order for the corporation to continue to use its fiscal year?
 - Assume that the corporation cannot satisfy the business purpose test or salary test for a fiscal year. The corporation pays Delaine a salary of \$50,000 for October 1 through December 31, 2015, and salary of \$300,000 from January 1, 2016, through September 30, 2016. How much must the corporation limit its deduction for salary for its fiscal year ending September 30, 2016, in order to retain the fiscal year?
19. **LO.1** Gaffey Corporation obtained permission to change from a calendar year to a fiscal year ending May 31, beginning in 2015. For the short period January 1 through May 31, 2015, the corporation's taxable income was \$140,000. For computing the tax, assume a tax rate of 25%.
- What is Gaffey Corporation's annualized short period income?
 - What is Gaffey Corporation's tax for the short period?
20. **LO.1** In 2015, Aurora received a \$25,000 bonus computed as a percentage of profits. In 2016, Aurora's employer determined that the 2015 profits had been

incorrectly computed, and Aurora had to refund the \$8,000 in 2016. Assume that Aurora was in the 35% tax bracket in 2015 but in the 15% bracket in 2016.

- a. In 2015, how much is Aurora required to include in income?
 - b. In 2016, what is the amount of the deduction Aurora can claim? What is the reduction in taxes for 2016 as a result of the deduction?
21. **LO.2** In 2015, Chaya Corporation, an accrual basis, calendar year taxpayer, provided services to clients and earned \$25,000. The clients signed notes receivable to Chaya that have a fair market value of \$22,000 at year-end. In addition, Chaya sold a 36-month service contract on June 1, 2015, and received payment in full of \$12,000. How much income does Chaya report from these transactions in 2015?
22. **LO.3** For 2015, Essence Company, a calendar year taxpayer, will change from using the cash method for tax purposes to the accrual method. At the end of 2014, Essence had the following items:

Accounts receivable	\$200,000
Accounts payable	135,000
Bank loan	100,000

What is the § 481(a) adjustment for this change in accounting method? Be sure to state whether it is positive or negative.

23. **LO.4** On December 30, 2015, Whitney sold a piece of property for \$85,000. Her basis in the property was \$40,000, and she incurred \$1,200 in selling expenses. The buyer paid \$5,000 down with the balance payable in \$10,000 installments over the next eight years. In addition, the buyer assumed a \$15,000 mortgage on the property. Round any division to four decimal places, and use in subsequent computations. Under the installment sales method, what is the total contract price, the total gain on the sale, and the amount of gain reported in 2015?
24. **LO.4** In 2015, Skylar sold an apartment building for \$20,000 cash and a \$300,000 note due in two years. Skylar's cost of the property was \$250,000, and he had deducted depreciation of \$150,000, \$60,000 of which was in excess of what the straight-line amount would have been.
- a. Under the installment sales method, what is Skylar's total realized gain?
 - b. In 2015, how much § 1250 gain does Skylar recognize? How much § 1231 gain does he recognize?
25. **LO.4** Mason canceled a note issued by Emma (Mason's niece) that arose in connection with the sale of property. At the time of the cancellation, the note had a basis to Mason of \$30,000, a face amount of \$55,000, and a fair market value of \$42,000. Presuming that the initial sale by Mason qualified as an installment sale, how much gain does the cancellation result in for Mason?
26. **LO.5** Jebali Corporation, a calendar year taxpayer utilizing the completed contract method of accounting, constructed a building for Samson, Inc., under a long-term contract. The gross contract price was \$2,300,000. Jebali finished construction in 2015 at a cost of \$2,100,000. However, Samson insisted that Jebali redo the doorway; otherwise, the contract price would be reduced. The estimated cost of redoing the doorway is \$80,000. In 2016, the dispute is settled and Jebali fixed the doorway at a cost of \$65,000.
- a. How much must Jebali include in gross income? What amount of deductions is Jebali allowed for 2015?
 - b. In 2016, how much must Jebali include in gross income? What amount of expenses can Jebali deduct in that year?

27. **LO.5** Shumpert, Inc., entered into a contract that was to take two years to complete, with an estimated cost of \$900,000. The contract price was \$1,300,000. Costs of the contract for 2014, the first year, totaled \$675,000.
- What was the gross profit reported by the percentage of completion method for 2014?
 - After the contract was completed at the end of 2015 at a total cost of \$950,000, what was the gross profit reported by the percentage of completion method for 2015?

Problems

28. **LO.1** Red, White, and Blue are unrelated corporations engaged in real estate development. The three corporations formed a joint venture (treated as a partnership) to develop a tract of land. Assuming that the venture does not have a natural business year, what tax year must the joint venture adopt under the following circumstances?

	Tax Year Ending	Interest in Joint Venture
a. Red	March 31	60%
Blue	June 30	20%
White	October 31	20%
b. Red	October 31	30%
White	September 30	40%
Blue	January 31	30%

- Decision Making** 29. **LO.1** Zorn conducted his professional practice through Zorn, Inc. The corporation uses a fiscal year ending September 30 even though the business purpose test for a fiscal year cannot be satisfied. For the year ending September 30, 2015, the corporation paid Zorn a salary of \$180,000, and during the period January through September 2015, the corporation paid him a salary of \$150,000.
- How much salary should Zorn receive during the period October 1 through December 31, 2015?
 - Assume that Zorn received only \$24,000 salary during the period October 1 through December 31, 2015. What would be the consequences to Zorn, Inc.?
30. **LO.1** Mauve Corporation began operations as a farm supplies business and used a fiscal year ending October 31. The company gradually went out of the farm supplies business and into the mail-order Christmas gifts business. The company has received permission from the IRS to change to a fiscal year ending January 31, effective for the year ending January 31, 2016. For the short period November 1, 2015, through January 31, 2016, Mauve earned \$20,000. Calculate Mauve's tax liability for the short period November 1, 2015, through January 31, 2016.
- Communications** 31. **LO.2** Gold, Inc., is an accrual basis taxpayer. In 2015, an employee accidentally spilled hazardous chemicals on leased property. The chemicals destroyed trees on neighboring property, resulting in \$30,000 of damages. In 2015, the owner of the property sued Gold, Inc., for the \$30,000. Gold's attorney believes that it is liable and that the only issue is whether the neighbor will also seek punitive damages that could be as much as three times the actual damages. In addition, as a result of the spill, Gold was in violation of its lease and was therefore required to pay the landlord \$15,000. However, the amount due for the lease violation is not payable until the termination of the lease in 2018. None of these costs were covered by insurance. Jeff Stuart, the president of Gold, Inc., is generally familiar with the accrual basis tax accounting rules and is concerned about when the company will be

allowed to deduct the amounts the company is required to pay as a result of this environmental disaster. Write Mr. Stuart a letter explaining these issues. Gold's address is 200 Elm Avenue, San Jose, CA 95192.

32. **LO.2** Compute Mary's income or deductions for 2015 using (1) the cash basis and (2) the accrual basis for each of the following:
- In May 2015, Mary paid a license fee of \$1,200 for the period June 1, 2015, through May 31, 2016.
 - In December 2015, Mary collected \$10,000 for January 2016 rents. In January 2016, Mary collected \$2,000 for December 2015 rents.
 - In June 2015, Mary paid \$7,200 for an office equipment service contract for the period July 1, 2015, through December 31, 2016.
 - In June 2015, Mary purchased office furniture for \$273,000. She paid \$131,000 in cash and gave a \$142,000 interest-bearing note for the balance. The office furniture has an MACRS cost recovery period of seven years. Mary did not make the § 179 election and elected not to take additional first-year depreciation.
33. **LO.2, 5** What accounting method (cash or accrual) would you recommend for the following businesses?
- A gift shop with average annual gross receipts of \$900,000.
 - An accounting partnership with annual gross receipts of \$12 million.
 - A drywall subcontractor who works on residences and has annual gross receipts of \$3 million.
 - An incorporated insurance agency with annual gross receipts of \$6 million.
34. **LO.2** How do the all events and economic performance requirements apply to the following transactions by an accrual basis taxpayer?
- The company guarantees its products for six months. At the end of 2015, customers had made valid claims for \$600,000 that were not paid until 2016. Also, the company estimates that another \$400,000 in claims from 2015 sales will be filed and paid in 2016.
 - The accrual basis taxpayer reported \$200,000 in corporate taxable income for 2015. The state income tax rate was 6%. The corporation paid \$7,000 in estimated state income taxes in 2015 and paid \$2,000 on 2014 state income taxes when it filed its 2014 state income tax return in March 2015. The company filed its 2015 state income tax return in March 2016 and paid the remaining \$5,000 of its 2015 state income tax liability.
 - An employee was involved in an accident while making a sales call. The company paid the injured victim \$15,000 in 2015 and agreed to pay the victim \$15,000 a year for the next nine years.
35. **LO.3** Ross Company is a computer consulting firm. The company also sells equipment to its clients. The sales of equipment account for approximately 40% of the company's gross receipts. The company has consistently used the cash method to report its income from services and the accrual method to report its income from the sale of inventory. In June of the current year, Ross's accountant discovered that as a small business, the company qualifies to use the cash method for all of its activities. The company is a calendar year taxpayer. As of the beginning of the current year, the company had \$120,000 of inventory on hand and \$90,000 of accounts receivable from the sales of equipment and \$30,000 of receivables from the consulting services.
- Compute the adjustment due to the change in accounting method.
 - Is the adjustment positive or negative? Explain.
 - When can the adjustment be taken into account in computing taxable income?

Decision Making 36. **LO.4, 6** Floyd, a cash basis taxpayer, has received an offer to purchase his land. The cash basis buyer will pay him either \$100,000 at closing or \$50,000 at closing and \$56,000 two years after the date of closing. If Floyd recognizes the entire gain in the current year, his marginal tax rate will be 25% (combined Federal and state rates). However, if he spreads the gain over the two years, his marginal tax rate on the gain will be only 20%. Floyd does not consider the buyer a credit risk, and he understands that shifting the gain to next year with an installment sale will save taxes. But he realizes that the deferred payment will, in effect, earn only \$6,000 for waiting two years for the other \$50,000. Floyd believes he can earn a 10% before-tax rate of return on his after-tax cash. Floyd's adjusted basis for the land is \$25,000, the buyer is also a cash basis taxpayer, and the short-term Federal rate is 4%. Floyd has asked you to evaluate the two alternatives on an after-tax basis.

37. **LO.4** Kay, who is not a dealer, sold an apartment house to Polly during the current year (2015). The closing statement for the sale is as follows:

Total selling price		\$ 190,000
Add: Polly's share of property taxes (6 months) paid by Kay		3,000
Less: Kay's 8% mortgage assumed by Polly	\$55,000	
Polly's refundable binder ("earnest money") paid in 2015	1,000	
Polly's 8% installment note given to Kay	99,000	
Kay's real estate commissions and attorney's fees	8,000	(163,000)
Cash paid to Kay at closing		<u>\$ 30,000</u>
Cash due from Polly = \$30,000 + \$8,000 expenses		<u><u>\$ 38,000</u></u>

During 2015, Kay collected \$9,000 in principal on the installment note and \$2,000 of interest. Kay's basis in the property was \$110,000 [\$125,000 – \$15,000 (depreciation)]. The Federal rate is 6%.

- Compute the following:
 - Total gain.
 - Contract price.
 - Payments received in the year of sale.
 - Recognized gain in the year of sale and the character of such gain.

(*Hint:* Think carefully about the manner in which the property taxes are handled before you begin your computations.)

- Same as (a)(2) and (3), except that Kay's basis in the property was \$35,000.

Decision Making 38. **LO.4** On June 30, 2015, Kelly sold property for \$240,000 cash and a \$960,000 note due on September 30, 2016. The note will also pay 6% interest, which is slightly higher than the Federal rate. Kelly's cost of the property was \$400,000. She is concerned that Congress may increase the tax rate that will apply when the note is collected. Kelly's after-tax rate of return on investments is 6%.

- What can Kelly do to avoid the expected higher tax rate?
- Assuming that Kelly's marginal combined Federal and state tax rate is 25% in 2015, how much would the tax rates need to increase to make the option identified in (a) advisable?

Decision Making 39. **LO.4** On December 30, 2014, Maud sold land to her son, Charles, for \$50,000 cash and a 7% installment note for \$350,000, payable over 10 years. Maud's cost of the land was \$150,000. In October 2016, after Charles had paid \$60,000 on the principal of the note, he received an offer to sell the land for \$500,000 cash. What advice can you provide Charles that will minimize the present value of the tax liability for Maud and him?

40. **LO.4** George sold land to an unrelated party in 2014. His basis in the land was \$45,000, and the selling price was \$120,000—\$30,000 payable at closing

and \$30,000 (plus 10% interest) due January 1, 2015, 2016, and 2017. What would be the tax consequences of the following? [Treat each part independently, and assume that (1) George did not elect out of the installment method and (2) the installment obligations have values equal to their face amounts. Ignore interest in your calculations.]

- a. In 2015, George borrowed \$40,000 from the bank. The loan was partially secured by the installment notes, but George was personally liable for the loan.
 - b. In 2015, George gave to his daughter the right to collect all future payments on the installment obligations.
 - c. On December 31, 2015, George received the payment due on January 1, 2016. On December 15, 2016, George died, and the remaining installment obligation was transferred to his estate. The estate collected the amount due on January 1, 2017.
41. **LO.5** The Wren Construction Company reports its income by the completed contract method. At the end of 2015, the company completed a contract to construct a building at a total cost of \$800,000. The contract price was \$1.2 million, and the customer paid Wren \$900,000. However, the customer refused to accept the work and would not pay anything else on the contract because he claimed that the roof did not meet specifications. Wren's engineers estimated that it would cost \$140,000 to bring the roof up to the customer's standards. In 2016, the dispute was settled in the customer's favor; the roof was improved at a cost of \$150,000, and the customer accepted the building and paid the remaining \$300,000.
- a. What would be the effects of the above on Wren's taxable income for 2015 and 2016?
 - b. Same as (a), except that Wren had \$1,100,000 of accumulated costs under the contract at the end of 2015.
42. **LO.5** Rust Company is a real estate construction company with average annual gross receipts of \$4 million. Rust uses the completed contract method, and the contracts require 18 months to complete.
- a. Which of the following costs would be allocated to construction in progress by Rust?
 1. The payroll taxes on direct labor.
 2. The current services pension costs for employees whose wages are included in direct labor.
 3. Accelerated depreciation on equipment used on contracts.
 4. Freight charges on materials assigned to contracts.
 5. The past service costs for employees whose wages are included in direct labor.
 6. Bidding expenses for contracts awarded.
 - b. Assume that Rust generally builds commercial buildings under contracts with the owners and reports the income using the completed contract method. The company is considering building a series of similar stores for a retail chain. The gross profit margin would be a low percentage, but the company's gross receipts would triple. Write a letter to your client, Rust Company, explaining the tax accounting implications of entering into these contracts. Rust's mailing address is PO Box 1000, Harrisonburg, VA 22807.
43. **LO.5** On March 31, 2013, Big Boats Company entered into a contract with Vacations Unlimited to produce a state-of-the-art cruise ship, to be completed within three years. Big Boats estimated the total cost of building the ship at \$300 million. The contract price was \$400 million. The ship was completed on February 15, 2016.
- a. What tax accounting method must Big Boats use for the contract? Why?

Communications

- b. Using the financial data provided relating to the contract's performance, complete the following schedule:

Date	Total Costs Incurred to Date	Total Percentage of Contract Completed	Current-Year Revenue Accrued	Current-Year Costs Deductible
12/31/13	\$ 90 million	-----	-----	-----
12/31/14	150 million	-----	-----	-----
12/31/15	270 million	-----	-----	-----
12/31/16	360 million	N/A	-----	-----

- c. What are the consequences of the total cost of \$360 million exceeding the estimated total cost of \$300 million?
44. **LO.5** Ostrich Company makes gasoline storage tanks. Everything produced is under contract (that is, the company does not produce until it gets a contract for a product). Ostrich makes three basic models. However, the tanks must be adapted to each individual customer's location and needs (e.g., the location of the valves and the quality of the materials and insulation). Discuss the following issues relative to Ostrich's operations:
- An examining IRS agent contends that each of the company's contracts is to produce a "unique product." What difference does it make whether the product is unique or a "shelf item"?
 - Producing one of the tanks takes over one year from start to completion, and the total cost is in excess of \$1 million. What costs must be capitalized for this contract that are not subject to capitalization for a contract with a shorter duration and lower cost?
 - What must Ostrich do with the costs of bidding on contracts?
 - Ostrich frequently makes several cost estimates for a contract, using various estimates of materials costs. These costs fluctuate almost daily. Assuming that Ostrich must use the percentage of completion method to report the income from the contract, what will be the consequence if the company uses the highest estimate of a contract's cost and the actual cost is closer to the lowest estimated cost?

- Communications** 45. **LO.5, 6** Swallow Company is a large real estate construction company that has made a Subchapter S election. The company reports its income using the percentage of completion method. In 2016, the company completed a contract at a total cost of \$4.8 million. The contract price was \$7.2 million. At the end of 2015, the year the contract was begun, Swallow estimated that the total cost of the contract would be \$5.4 million. Total accumulated cost on the contract at the end of 2015 was \$1.8 million. The relevant tax rate is 35%, and the relevant Federal interest rate is 5%. Assume that all income tax returns were filed and taxes were paid on March 15 following the end of the calendar tax year.
- Compute the gross profit on the contract for 2015 and 2016.
 - Compute the lookback interest due or receivable with the 2016 tax return.
 - Before bidding on a contract, Swallow generally makes three estimates of total contract costs: (1) optimistic, (2) pessimistic, and (3) most likely (based on a blending of optimistic and pessimistic assumptions). The company has asked you to write a letter explaining which of these estimates should be used for percentage of completion purposes. In writing your letter, you should consider the fact that Swallow is incorporated and has made an S corporation election. Therefore, the income and deductions flow through to the shareholders who are all individuals in the 35% marginal tax bracket. The relevant Federal interest rate is 8%. Swallow's mailing address is 400 Front Avenue, Ashland, OR 97520.

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.



Research Problem 1. Your client is not permitted to deduct a year-end accrual for vacation pay earned but not paid. This result occurs because the tax law considers this to be deferred compensation that is ineligible for the recurring item exception, unless it is paid by March 15 of the year following the accrual [see §§ 404(a)(5) and (6)]. Your client has asked whether the related accrued Social Security taxes on the vacation pay can be accrued under the general recurring item exception because these taxes will be paid by the fifteenth day of the ninth month after the close of the tax year.

Research Problem 2. Your client supplies water to a housing development. The company requires new customers to pay for the extension of the water lines to their homes. The water lines are the company's property. The company has consistently treated the amounts received from its customers as a nontaxable contribution to capital and used the amounts received as a reduction in the cost of the water lines for tax purposes. In recent decisions, the courts have consistently ruled that the payments received from the utility customers in similar circumstances should be treated as income from services, rather than as a contribution to capital. Your client has concluded that it is only a matter of time before the IRS applies the recent court decisions to the company. The client would like you to explain the tax consequences of the IRS's likely adjustments based on these decisions.

Research Problem 3. Your client is a manufacturer. For several years, the company buried empty paint cans on its property. The paint was used in the production process. Recently, a state environmental agency informed the company that it was required to dig up the paint cans and decontaminate the land. The company spent a substantial amount for this environmental cleanup in the current year. An IRS agent contends that the cost must be added to the basis in the land because the cleanup improved the land. The company's CFO has asked you to determine whether any authority exists that would support a current deduction for these costs.

Research Problem 4. In 2015, your client, Clear Corporation, changed from the cash to the accrual method of accounting for its radio station. The company had a positive § 481 adjustment of \$2.4 million as a result of the change and began amortizing the adjustment in 2015. In 2016, Clear received an offer to purchase the assets of the radio station business (this would be considered a sale of a trade or business under § 1060). If the offer is accepted, Clear plans to purchase a satellite television business. Clear has asked you to explain the consequences of the sale of the radio station on the amortization of the § 481 adjustment.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 5. Why did the AICPA object to former Congressman Dave Camp's tax reform proposal introduced in February 2014 (later officially introduced as H.R. 1 of the 113rd Congress) regarding the use of the cash method of accounting?



Internet
Activity

Roger CPA Review Questions

1. Abbott (an S Corporation), Bell, Costello, and Dilbertson form Best Partnership, an equally-shared partnership. Each partner but Abbott has a December 31 tax year-end; Abbott's is June 30. The partners would like to choose a partnership tax year other than one ending December 31, but do not have a valid business purpose for doing so. Which of the following is an acceptable tax year-end they may choose for Best Partnership?

- I. December 31
 - II. September 30
 - III. June 30
- a. I and II only
 - b. I only
 - c. I, II or III
 - d. I and III only

2. LaJoie, Bhatti, and Jenkins are going to form LBJ Partnership. The ownership interests and tax years of the partners are as follows:

Partner	Partnership Interest	Tax Year Ends
LaJoie	20%	January 31
Bhatti	40%	June 30
Jenkins	40%	December 31

According to Reg. § 1.706-1(b) (3), what is LBJ Partnership's required tax year-end? Assume no business purpose for a different taxable year.

- a. January 31
 - b. July 31
 - c. December 31
 - d. June 30
3. Slater Slopes is a newly-formed ski resort partnership with a natural business year ending May 31. The ownership and tax years of its three partners are as follows:

Partner	Partnership Interest	Tax Year Ends
A. Slater	20%	December 31
Excelsior Enterprises	40%	November 30
Pinnacle Productions	40%	November 30

Which of the following is an acceptable year-end for Slater Slopes? Consider both § 706 and § 444.

- I. May 31
 - II. November 30
 - III. September 30
- a. II only
 - b. I and II only
 - c. I only
 - d. I, II and III
4. The cash method of accounting may be used for tax reporting purposes by which of the following taxpayers?
- a. A partnership with a C Corporation—one with annual revenue exceeding \$5 million—as a partner
 - b. A C Corporation with annual revenue of \$2.5 million, which has physical inventory levels that are material in amount
 - c. A farming corporation
 - d. A partnership with a personal service C Corporation—one with annual revenue below \$5 million—as a partner



PART

6

CORPORATIONS

CHAPTER 17

Corporations: Introduction and Operating Rules

CHAPTER 18

Corporations: Organization and Capital Structure

CHAPTER 19

Corporations: Distributions Not in Complete Liquidation

CHAPTER 20

Corporations: Distributions in Complete Liquidation and an Overview of Reorganizations

Corporations are separate entities for Federal income tax purposes. Subchapter C of the Code is devoted to the tax treatment of regular corporations. Part 6 deals mainly with the operating rules contained in Subchapter C that apply to regular corporations and with the effects of various capital transactions on the C corporation and its shareholders.

CHAPTER
17

Corporations: Introduction and Operating Rules

LEARNING OBJECTIVES: *After completing Chapter 17, you should be able to:*

- LO.1** Summarize the tax treatment of various forms of conducting a business.
- LO.2** Compare the taxation of individuals and corporations.
- LO.3** List and apply the tax rules unique to corporations.
- LO.4** Compute the corporate income tax.
- LO.5** Explain the rules unique to computing the tax of related corporations.
- LO.6** Describe the reporting process for corporations.
- LO.7** Determine the impact of tax return positions on corporate financial statements.
- LO.8** Evaluate corporations as an entity form for conducting a business.

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THE BIG PICTURE

A HALF-BAKED IDEA?

Samantha Johnson owns Skylark Bakery. Currently, the bakery is operated as a sole proprietorship and generates an annual operating profit of \$100,000. In addition, the bakery earns annual dividends of \$5,000 from investing excess working capital in the stock of publicly traded corporations. These stock investments typically are held for a minimum of three to four months before funds are required for the business. As a result of income from other business ventures and investments, Samantha is in the 33 percent marginal tax bracket irrespective of the bakery. In the past, Samantha has withdrawn \$50,000 annually from the bakery, which she regards as reasonable payment for her services.

Samantha has asked you about the tax consequences of conducting the business as a regular (C) corporation. Based on the information given, what would be the annual income tax savings (or cost) of operating the bakery as a corporation? For purposes of this analysis, use the 2015 tax rates and ignore any employment tax or state tax considerations.

Read the chapter and formulate your response.

For Federal income tax purposes, the distinctions among the various forms of business organization are very important. The following discussion of the tax treatment of sole proprietorships, partnerships, and regular corporations highlights these distinctions. Limited liability companies, which generally are taxed as one of the three preceding entity forms, are also discussed. S corporations are discussed in Chapter 22 and trusts and estates are covered in Chapter 28.

LO.1

Summarize the tax treatment of various forms of conducting a business.

17-1 TAX TREATMENT OF VARIOUS BUSINESS FORMS

Business operations can be conducted in a number of different forms. Among the various possibilities are the following:

- Sole proprietorships.
- Partnerships.
- Trusts and estates.
- S corporations.
- Regular corporations.
- Limited liability companies.

17-1a Sole Proprietorships

A sole proprietorship is not a taxable entity separate from the individual who owns the proprietorship. The owner of a sole proprietorship reports all business income and expenses of the proprietorship on Schedule C of Form 1040, with the net profit or loss from the proprietorship used by the taxpayer to report taxable income. The proprietor reports all of the net profit from the business, regardless of the amount actually withdrawn during the year.

Income and expenses of the proprietorship retain their character when reported by the proprietor. For example, ordinary income of the proprietorship is treated as ordinary income when reported by the proprietor, and capital gain is treated as capital gain.

The Big Picture

EXAMPLE

1

Return to the facts of *The Big Picture* on p. 17-1. Samantha, the sole proprietor of Skylark Bakery, reports the \$100,000 operating profit from the business on Schedule C of her individual tax return. Even though she withdrew only \$50,000, Samantha reports all of the \$100,000 operating profit from the business on Form 1040, where she computes taxable income for the year. She also reports dividend income of \$5,000 on Schedule B of Form 1040.

17-1b Partnerships

Partnerships are not subject to a Federal income tax. However, a partnership is required to file Form 1065, which reports the results of the partnership's business activities. Most income and expense items are aggregated in computing the ordinary business income (loss) of the partnership on Form 1065. Any income and expense items that are not aggregated in computing the partnership's ordinary business income (loss) are reported separately to the partners. Some examples of separately reported income items are interest income, dividend income, and long-term capital gain. Examples of separately reported expenses include charitable contributions and expenses related to investment income. Partnership reporting is discussed in detail in Chapter 21.

The partnership ordinary business income (loss) and the separately reported items are allocated to the partners according to the partnership's profit and loss sharing agreement. Each partner receives a Schedule K-1 that reports the partner's share of the partnership ordinary business income (loss) and separately reported income and expense items. Each partner reports these items on his or her own tax return.

Jim and Bob are equal partners in Canary Enterprises, a calendar year partnership. During the year, Canary Enterprises had \$500,000 of gross income and \$350,000 of operating expenses. In addition, the partnership sold land that had been held for investment purposes for a long-term capital gain of \$60,000. During the year, Jim withdrew \$40,000 from the partnership and Bob withdrew \$45,000. The partnership's Form 1065 reports ordinary business income of \$150,000 (\$500,000 income – \$350,000 expenses) and long-term capital gain of \$60,000 as a separately stated item. Jim and Bob each receive a Schedule K-1 reporting ordinary business income of \$75,000 and separately stated long-term capital gain of \$30,000. Consequently, each partner reports ordinary business income of \$75,000 and long-term capital gain of \$30,000 on his own return.

EXAMPLE

2

17-1c Corporations

Corporations are governed by Subchapter C or Subchapter S of the Internal Revenue Code. Those governed by Subchapter C are referred to as **C corporations** or **regular corporations**. Corporations governed by Subchapter S are referred to as **S corporations**.

S corporations, which generally do not pay Federal income tax, are similar to partnerships in that ordinary business income (loss) flows through to the shareholders to be reported on their separate returns. Also like partnerships, S corporations do not aggregate all income and expense items in computing ordinary business income (loss). Certain items flow through to the shareholders and retain their separate character when reported on the shareholders' returns. The S corporation ordinary business income (loss) and the separately reported items are allocated to the shareholders according to their stock ownership interests. See Chapter 22 for detailed coverage of S corporations.

Unlike proprietorships, partnerships, and S corporations, C corporations are subject to an entity-level Federal income tax. This results in what is known as a *double taxation effect*. A C corporation reports its income and expenses on Form 1120. The corporation computes tax on the taxable income reported on the Form 1120 using the rate schedule applicable to corporations (see Exhibit 17.1 on the next page). When a corporation distributes its income, the corporation's shareholders report dividend income on their own tax returns. Thus, income that has already been taxed at the corporate level is also taxed at the shareholder level. The effects of double taxation are illustrated in Examples 3 and 4.

Double Taxation Illustrated

Lavender Corporation has taxable income of \$100,000 in 2015. It pays corporate tax of \$22,250 (refer to Exhibit 17.1). This leaves \$77,750, all of which is distributed as a dividend to Mike, a 43-year-old single individual and the corporation's sole shareholder. Mike has no income sources other than Lavender Corporation. Mike has taxable income of \$67,450 (\$77,750 – \$6,300 standard deduction – \$4,000 personal exemption). He pays tax at the preferential rate applicable to qualified dividends received by individuals. His tax is \$4,500 [(\$37,450 × 0%) + (\$30,000 × 15%)]. The combined tax on the corporation's net profit is \$26,750 (\$22,250 paid by the corporation + \$4,500 paid by the shareholder).

EXAMPLE

3

Assume the same facts as in Example 3, except that the business is organized as a sole proprietorship. Mike reports the \$100,000 profit from the business on his tax return. He has taxable income of \$89,700 (\$100,000 – \$6,300 standard deduction – \$4,000 personal exemption) and pays tax of \$18,219. Therefore, operating the business as a sole proprietorship results in a tax *savings* of \$8,531 in 2015 (\$26,750 from Example 3 – \$18,219).

EXAMPLE

4

Taxation of Dividends

As noted earlier, the income of a C corporation is subject to double taxation, which stems, in part, from the fact that dividend distributions are not deductible by the corporation.

Shareholders of closely held corporations frequently attempt to circumvent this disallowance by disguising a dividend distribution as some other purported transaction. One of the more common ways of disguising dividend distributions is to pay excessive compensation to shareholder-employees of a closely held corporation. The IRS scrutinizes compensation and other economic transactions (e.g., loans, leases, and sales) between shareholders and closely held corporations to ensure that payments are reasonable in amount. (See Chapter 19 for more discussion on constructive dividends.)

Double taxation also stems from the fact that dividend distributions are taxable to the shareholders. Historically, dividend income has been taxed at the same rates as ordinary income. However, to alleviate some of the double taxation effect, Congress reduced the tax rate applicable to dividend income of individuals for years after 2002. As a result, the current tax rate applicable to qualified dividend income (and long-term capital gains) is 15 percent or, for taxpayers in the 39.6 percent marginal tax bracket, 20 percent (0 percent for taxpayers in the 10 or 15 percent marginal tax bracket). A 3.8 percent Medicare surtax applies to net investment income in excess of modified adjusted gross income of \$200,000 (\$250,000 if married filing jointly), thus increasing the double taxation of dividend income for high-income taxpayers.

Comparison of Corporations and Other Forms of Doing Business

While a detailed comparison of sole proprietorships, partnerships, S corporations, and C corporations as forms of doing business must be made, it is appropriate at this point to consider some of the tax and nontax factors that favor corporations over proprietorships.

Consideration of tax factors requires an examination of the corporate rate structure. The income tax rate schedule applicable to corporations is reproduced in Exhibit 17.1. As this schedule shows, the marginal rates for corporations range from 15 percent to 39 percent. In comparison, the marginal rates for individuals range from 10 percent to 39.6 percent. In many cases, the tax burden will be greater if a business is operated as a corporation (as in Example 3). However, the corporate form of doing business presents tax savings opportunities when the applicable corporate marginal rate is lower than the applicable individual marginal rate.

EXAMPLE

5

Susanna, an individual taxpayer in the 39.6% marginal tax rate bracket, can generate \$100,000 of additional taxable income in the current year. If the income is taxed to Susanna, the associated tax is \$39,600 ($\$100,000 \times 39.6\%$). If, however, Susanna is able to shift the income to a newly created corporation, the corporate tax is \$22,250 (see Exhibit 17.1). Thus, by taking advantage of the lower corporate marginal tax rates, a tax savings of \$17,350 ($\$39,600 - \$22,250$) is achieved.

EXHIBIT 17.1

Corporate Income Tax Rates

Taxable Income		Tax Is:	
Over—	But Not Over—		Of the Amount Over—
\$ -0-	\$ 50,000	15%	\$ -0-
50,000	75,000	\$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	—	35%	—

Any attempt to take advantage of the difference between the corporate and individual marginal tax rates also must consider the double taxation effect. When the preferential rate for dividend income is considered, however, tax savings opportunities still exist.

Assume in Example 5 that the corporation distributes all of its after-tax earnings to Susanna as a dividend. The dividend results in income tax of \$15,550 $[(\$100,000 - \$22,250) \times 20\%]$ to Susanna. Thus, even when the double taxation effect is considered, the combined tax burden of \$37,800 (\$22,250 paid by the corporation + \$15,550 paid by the shareholder) represents an income tax *savings* of \$1,800 when compared with the \$39,600 of tax that results when the \$100,000 of income is subject to Susanna's 39.6% marginal rate.

EXAMPLE**6**

Examples 5 and 6 ignore other tax issues that also must be considered in selecting the proper form of doing business, but they illustrate the tax savings that can be achieved by taking advantage of rate differentials. In addition to the 3.8 percent Medicare surtax (mentioned previously), some of the other tax considerations that could affect the selection of a business form include the character of business income, the expectation of business losses, employment taxes, and state taxes.

Unlike other forms of business, the tax attributes of income and expense items of a C corporation do not pass through the corporate entity to the shareholders. As a result, if the business is expected to generate tax-favored income (e.g., tax-exempt income or long-term capital gains), one of the other (non-C corporation) forms of business may be desirable.

Losses of a C corporation are treated differently from losses of a proprietorship, a partnership, or an S corporation. A loss incurred by a proprietorship may be deductible by the owner, because all income and expense items are reported by the proprietor. Partnership losses are passed through the partnership entity and may be deductible by the partners, and S corporation losses are passed through to the shareholders. C corporation losses, however, have no effect on the taxable income of the shareholders. Therefore, one of the non-C corporation forms of business may be desirable if business losses are anticipated.

Franco plans to start a business this year. He expects that the business will incur operating losses for the first three years and then become highly profitable. Franco decides to operate as an S corporation during the loss period, because the losses will flow through and be deductible on his personal return. When the business becomes profitable, he intends to switch to C corporation status.

EXAMPLE**7**

The net income of a proprietorship is subject to the self-employment tax, as are some partnership allocations of income to partners. In the alternative, wages paid to a shareholder-employee of a corporation (C or S) are subject to payroll taxes. The combined corporation-employee payroll tax burden should be compared with the self-employment tax associated with the proprietorship and partnership forms of business. This analysis should include the benefit of the deduction available to a corporation for payroll taxes paid, as well as the deduction available to an individual for part of the self-employment taxes paid.

At the entity level, state corporate income taxes and/or franchise taxes are applicable for businesses formed as corporations. Although no entity-level Federal income tax is typically assessed on S corporations, limited liability companies (LLCs), or partnerships, a few states impose a corporate income tax or franchise tax on such business forms. Consideration of state taxation when selecting a business form is particularly relevant for businesses that operate in more than one state. (See Chapter 24 for a discussion of the taxation of multistate corporations.) At the owner level, the income of sole proprietorships, S corporations, and partnerships (including most LLCs) is subject to state individual income taxation. Similarly, dividend income from corporate distributions is subject to state income taxation and without any rate preference for such income.

Nontax Considerations

Nontax considerations will sometimes override tax considerations and lead to the conclusion that a business should be operated as a corporation. The following are some of the more important nontax considerations:

- Sole proprietors and general partners in partnerships face the danger of *unlimited liability*. That is, creditors of the business may file claims not only against the assets of the business but also against the personal assets of proprietors or general partners. State corporate law protects shareholders from claims against their personal assets for corporate debts.
- The corporate form of business can provide a vehicle for raising large amounts of capital through widespread stock ownership. Most major businesses in the United States are operated as corporations.
- Shares of stock in a corporation are freely transferable, whereas a partner's sale of his or her partnership interest is subject to approval by the other partners.
- Shareholders may come and go, but a corporation can continue to exist. Death or withdrawal of a partner, on the other hand, may terminate the existing partnership and cause financial difficulties that result in dissolution of the entity. This *continuity of life* is a distinct advantage of the corporate form of doing business.
- Corporations have *centralized management*. All management responsibility is assigned to a board of directors, which appoints officers to carry out the corporation's business. Partnerships, by contrast, may have decentralized management, in which every partner has a right to participate in the organization's business decisions. **Limited partnerships**, though, may have centralized management. Centralized management is essential for the smooth operation of a widely held business.

17-1d Limited Liability Companies

The use of the **limited liability company (LLC)** form has proliferated greatly in recent years, particularly since 1988 when the IRS first ruled that it would treat qualifying LLCs as partnerships for tax purposes. All 50 states and the District of Columbia have passed laws that allow LLCs, and thousands of companies have chosen LLC status. As with a corporation, operating as an LLC allows its owners ("members") to avoid unlimited liability exposure, which is a primary *nontax* consideration in choosing this form of business organization. The tax advantage of LLCs is that qualifying businesses may be treated as proprietorships or partnerships for tax purposes, thereby avoiding the problem of double taxation associated with regular corporations.

Some states allow an LLC to have centralized management, but not continuity of life or free transferability of interests. Other states allow LLCs to adopt any or all of the corporate characteristics of centralized management, continuity of life, and free transferability of interests.

Entity Classification

Can an organization not qualifying as a corporation under state law still be treated as such for Federal income tax purposes? The tax law defines a corporation as including "associations, joint stock companies, and insurance companies."¹ Unfortunately, the Code contains no definition of what constitutes an *association*, and the issue became the subject of frequent litigation.

It was finally determined that an entity would be treated as a corporation if it had a majority of characteristics common to corporations. For this purpose, relevant characteristics are:

- Continuity of life.
- Centralized management.
- Limited liability.
- Free transferability of interests.

¹§ 7701(a)(3).



GLOBAL TAX ISSUES U.S. Corporate Tax Rate and Global Competitiveness

According to the Organization for Economic Cooperation and Development (OECD), the U.S. combined Federal and state corporate income tax rate of 39.1% is the highest among member states. The effective tax rate that most corporations pay in the United States is substantially less than the top statutory rate, however, as taxpayers reduce their exposure to the corporate tax through the use

of exclusions, deductions, credits, and deferral provisions. Still, the relatively high corporate tax rate puts the United States at a competitive disadvantage in attracting capital investment, and it encourages U.S. corporations to utilize foreign entities to shelter income from U.S. taxation.

Source: www.oecd.org/tax/tax-policy/tax-database.htm.

Considering these criteria did not resolve all of the problems that continued to arise over corporate classification. When this type of business entity—the limited liability company—was developed, the IRS was deluged with inquiries regarding its tax status. As LLCs became increasingly popular with professional groups, all states enacted statutes allowing some form of this entity. Invariably, the statutes permitted the corporate characteristic of limited liability and, often, that of centralized management. Because continuity of life and free transferability of interests are absent, partnership classification was hoped for. This treatment avoided the double taxation inherent in the corporate form.

In 1996, the IRS eased the entity classification problem by issuing the **check-the-box Regulations**.² The Regulations enable taxpayers to choose the tax status of a business entity without regard to its corporate (or noncorporate) characteristics. These rules simplified tax administration considerably and eliminated much of the litigation that arose with regard to the association (i.e., corporation) status.

Under the check-the-box Regulations, an unincorporated entity with *more than one* owner is, by default, classified as a partnership. An unincorporated entity with *only one* owner is, by default, classified as a **disregarded entity** (or DRE). A DRE is treated as a sole proprietorship if it is owned by an individual taxpayer or as a branch or a division of a corporate owner. If the entity wants to use its default status, it simply files the appropriate tax return. If it wants to use a different status or change its status, it does so by “checking a box” on Form 8832. Thus, an LLC (single or multi-member) can choose to be taxed as a C corporation and, if it otherwise qualifies, even elect S corporation status.

The status election is not available to entities that are incorporated under state law or to entities that are required to be taxed as corporations under Federal law (e.g., certain publicly traded partnerships). LLCs are not treated as being incorporated under state law, so they default to either partnership or DRE status. Although an LLC does not typically pay Federal income taxes, LLCs are obligated to report and pay employment and excise taxes.

17-2 AN INTRODUCTION TO THE INCOME TAXATION OF CORPORATIONS

When examining how corporations are treated under the Federal income tax law, a useful approach is to compare their treatment with that applicable to individual taxpayers. In addition, tax provisions that are unique to corporations must be addressed.

17-2a An Overview of Corporate versus Individual Income Tax Treatment

The tax formula for computing the Federal income tax for a corporation is compared with that of an individual taxpayer in Exhibit 17.2, and the following discussion highlights similarities and differences between the two formulas.

LO.2

Compare the taxation of individuals and corporations.

²Reg. §§ 301.7701-1 through -4, and -7.

EXHIBIT 17.2

Tax Formulas

Corporations	Individuals
Income (broadly defined)	Income (broadly defined)
(Exclusions)	(Exclusions)
Gross income	Gross income
(Deductions except for NOL and DRD*)	(Deductions for AGI**)
Taxable income before NOL and DRD	Adjusted gross income
(Net operating loss deduction)	(Greater of itemized or standard deductions)
(Dividends received deduction)	(Personal and dependency exemptions)
Taxable income	Taxable income
Tax on taxable income	Tax on taxable income
(Tax credits)	(Tax credits)
Tax due (or refund)	Tax due (or refund)

*NOL = net operating loss; DRD = dividends received deduction.

**AGI = adjusted gross income.

Similarities

Gross income of a corporation is determined in much the same manner as it is for individuals. Thus, gross income includes compensation for services rendered, income derived from a business, gains from dealings in property, interest, rents, royalties, and dividends—to name only a few items. Both individuals and corporations are entitled to exclusions from gross income. However, corporate taxpayers are allowed fewer exclusions. Interest on municipal bonds and life insurance proceeds are two exclusions that are applicable to both individual and corporate taxpayers.

Gains and losses from property transactions are handled similarly. For example, whether a gain or loss is capital or ordinary depends upon the nature of the asset in the hands of the taxpayer making the taxable disposition. In defining what is not a capital asset, § 1221 makes no distinction between corporate and noncorporate taxpayers.

In the area of nontaxable exchanges, corporations are like individuals in that they do not recognize gain or loss on a like-kind exchange and may defer realized gain on an involuntary conversion of property. The exclusion of gain from the sale of a personal residence does not apply to corporations. The disallowance of losses on sales of property to related parties (e.g., a corporation and a more-than-50 percent shareholder) and on wash sales of securities applies equally to individual and corporate taxpayers.

The business deductions of corporations also parallel those available to individuals. Deductions are allowed for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. Specific provision is made for the deductibility of interest, certain taxes, losses, bad debts, cost recovery, charitable contributions, net operating losses, research and experimental expenditures, and other less common deductions. There is no distinction between business and nonbusiness interest or business and nonbusiness bad debts for corporations. Thus, these amounts are deductible in full as ordinary deductions by corporations. Like individuals, corporations are not allowed a deduction for interest paid or incurred on amounts borrowed to purchase or carry tax-exempt securities. The same holds true for expenses contrary to public policy and certain accrued expenses between related parties.

Some of the tax credits available to individuals, such as the foreign tax credit, can also be claimed by corporations. Not available to corporations are certain credits that are personal in nature, such as the credit for child and dependent care expenses, the credit for elderly or disabled taxpayers, and the earned income credit.

Dissimilarities

The income taxation of corporations and individuals also differs significantly. As noted earlier, different tax rates apply to corporations and to individuals. Corporate tax rates are discussed in more detail later in the chapter (see Examples 26 and 27).

All allowable corporate deductions are treated as business deductions. Thus, the determination of adjusted gross income (AGI), so essential for individual taxpayers, has no relevance to corporations. Taxable income is computed simply by subtracting from gross income all allowable deductions. Itemized deductions, the standard deduction, and the deduction for personal and dependency exemptions do not apply to corporations. The \$100 floor and 10 percent-of-AGI limitations on the deductible portion of personal casualty and theft losses applicable to individuals do not apply to corporations.

17-2b Specific Provisions Compared

A comparison of the income taxation of individuals and corporations appears in Concept Summary 17.1 located following the end of this section. In making this comparison, the following areas warrant special discussion:

- Accounting periods and methods.
- Capital gains and losses.
- Recapture of depreciation.
- Passive losses.
- Charitable contributions.
- Domestic production activities deduction.
- Net operating losses.
- Special deductions available only to corporations.

17-2c Accounting Periods and Methods

Accounting Periods

Corporations generally have the same choices of accounting periods as do individual taxpayers. Like an individual, a corporation may choose a calendar year or a fiscal year for reporting purposes. Corporations usually can have different tax years from those of their shareholders. Also, newly formed corporations (as new taxpayers) usually may choose any approved accounting period without having to obtain the consent of the IRS. **Personal service corporations (PSCs)** and S corporations, however, are subject to severe restrictions in the use of fiscal years. The rules applicable to S corporations are discussed in Chapter 22.

A PSC has as its principal activity the performance of personal services, and such services are substantially performed by shareholder-employees. The performance of services must be in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.³ Barring certain exceptions, PSCs must adopt a calendar year for tax purposes.⁴ The exceptions that permit the use of a fiscal year are discussed in Chapter 16.⁵

Accounting Methods

As a general rule, the cash method of accounting is unavailable to corporations.⁶ However, several important exceptions apply in the case of the following types of corporations:

- S corporations.
- Corporations engaged in the trade or business of farming or timber.
- Qualified PSCs.
- Corporations with average annual gross receipts of \$5 million or less for the most recent three-year period.

³§ 448(d)(2)(A) and Reg. § 1.441-3(d)(1).

⁵§§ 444 and 280H.

⁴§ 441(i). In some cases, a PSC was able to retain the same year as its fiscal year ending 1987. See § 444(b)(3).

⁶§ 448(a).

Regardless of these exceptions, most individuals and corporations that maintain inventory for sale to customers are required to use the accrual method of accounting for determining sales and cost of goods sold. However, as a matter of administrative convenience, the IRS will permit many taxpayers to use the cash method for determining sales and cost of goods sold. This includes any entity with average annual gross receipts of not more than \$1 million for the most recent three-year period, and some entities with average annual gross receipts of not more than \$10 million for the same three-year period.⁷ See Chapter 16 for additional discussion of these exceptions.

A corporation that uses the accrual method of accounting must observe a special rule in dealing with cash basis related parties. If the corporation has an accrual outstanding at the end of any taxable year with respect to such a related party, it cannot claim a deduction until the recipient reports the amount as income.⁸ This rule is most often encountered when a corporation deals with an individual who owns (directly or indirectly) more than 50 percent of the corporation's stock.

The Big Picture

EXAMPLE

8

Return to the facts of *The Big Picture* on p. 17-1. Assume that Samantha incorporates her business as Skylark Bakery, Inc., a calendar year, accrual method C corporation. Samantha, a cash method taxpayer, owns 100% of the corporation's stock at the end of 2015. On December 31, 2015, Skylark Bakery has accrued a \$10,000 bonus to Samantha. Samantha receives the bonus in 2016 and reports it on her 2016 tax return. Skylark Bakery cannot claim a deduction for the \$10,000 until 2016.

17-2d Capital Gains and Losses

Capital gains and losses result from the taxable sales or exchanges of capital assets.⁹ Whether these gains and losses are long-term or short-term depends upon the holding period of the assets sold or exchanged. Each year, a taxpayer's short-term gains and losses are combined, and long-term gains and losses are combined. The result is a net short-term capital gain or loss and a net long-term capital gain or loss. If gains *and* losses result (e.g., net short-term capital gain and net long-term capital loss), such amounts are further netted against each other. If instead the results are *all* gains or *all* losses (e.g., net short-term capital loss and net long-term capital loss), no further combination is necessary.

Capital Gains

Individuals generally pay a preferential tax rate of 15 or 20 percent on net capital gains (i.e., excess of net long-term capital gain over net short-term capital loss).¹⁰ Corporations, however, receive no favorable tax rate on long-term capital gains, and such income is taxed at the normal corporate tax rates.

Capital Losses

Net capital losses of corporate and individual taxpayers receive different income tax treatment. Generally, individual taxpayers can deduct up to \$3,000 of such net losses against other income. Any remaining capital losses are carried forward to future years until absorbed by capital gains or by the \$3,000 deduction. Loss carryovers retain their identity as either long term or short term.¹¹

EXAMPLE

9

Robin, an individual, incurs a net long-term capital loss of \$7,500 for calendar year 2015. Assuming adequate taxable income, Robin may deduct \$3,000 of this loss on his 2015 return. The remaining \$4,500 (\$7,500 – \$3,000) of the loss is carried forward to 2016 and years thereafter until completely deducted. The \$4,500 will be carried forward as a long-term capital loss.

⁷Rev.Proc. 2001-10, 2001-1 C.B. 272, and Rev.Proc. 2002-28, 2002-1 C.B. 815.

⁸§ 267(a)(2).

⁹See Chapter 14 for a detailed discussion of capital gains and losses.

¹⁰A 0% rate applies to individual taxpayers in the 10% and 15% brackets.

¹¹§§ 1211(b) and 1212(b).

Unlike individuals, corporate taxpayers are not permitted to deduct any net capital losses against ordinary income. Capital losses, therefore, can be used only as an offset against capital gains. Corporations, however, carry back net capital losses to three preceding years, applying them first to the earliest year in point of time. Carryforwards are allowed for a period of five years from the year of the loss. When carried back or forward, a long-term capital loss is treated as a short-term capital loss.¹²

Assume the same facts as in Example 9, except that Robin is a corporation. None of the \$7,500 long-term capital loss incurred in 2015 can be deducted that year. Robin Corporation may, however, carry back the loss to 2012, 2013, and 2014 (in this order) and offset it against any capital gains recognized in these years. If the carryback does not exhaust the loss, it may be carried forward to 2016, 2017, 2018, 2019, and 2020 (in this order). The long-term capital loss is treated as short term in any carryover year.

EXAMPLE

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17-2e Recapture of Depreciation

In general, the recapture rules under §§ 1245 and 1250 are equally applicable to both individual and corporate taxpayers (see Chapter 14). However, corporations may have more depreciation recapture (ordinary income) on the disposition of § 1250 property than do individuals. Under § 291, a corporation will have additional ordinary income equal to 20 percent of the excess of the amount of depreciation recapture that would arise if the property was § 1245 property over the amount of depreciation recapture computed under § 1250 (without regard to § 291). As a result, the § 1231 portion of the corporation’s gain on the disposition is correspondingly reduced by the additional recapture.

Under § 1250, recapture is limited to the excess of accelerated depreciation over straight-line depreciation. In general, only straight-line depreciation is allowed for real property placed in service after 1986; thus, there will usually be no depreciation recapture on the disposition of § 1250 property (without regard to § 291). In contrast, all depreciation taken on § 1245 property is subject to recapture under that provision.

Red Corporation purchases nonresidential real property on May 1, 2000, for \$800,000. Straight-line depreciation is taken in the amount of \$316,239 before the property is sold on October 8, 2015, for \$1.2 million.

First, determine the recognized gain:

Sales price		\$1,200,000
Less: Adjusted basis—		
Cost of property	\$ 800,000	
Less: Cost recovery	<u>(316,239)</u>	<u>(483,761)</u>
Recognized gain		<u>\$ 716,239</u>

Second, determine the § 1245 recapture potential. This is the lesser of \$716,239 (recognized gain) or \$316,239 (cost recovery claimed).

Third, determine the normal § 1250 recapture amount:

Cost recovery taken		\$ 316,239
Less: Straight-line cost recovery		<u>(316,239)</u>
§ 1250 ordinary income		<u>\$ -0-</u>

Fourth, because the taxpayer is a corporation, determine the ordinary income recognized under § 291:

§ 1245 recapture potential		\$316,239
Less: § 1250 recapture amount		<u>(-0-)</u>
Excess § 1245 recapture potential		\$316,239
Apply § 291 percentage		<u>× 20%</u>
Additional ordinary income under § 291		<u>\$ 63,248</u>

continued

EXAMPLE

11

¹² §§ 1211(a) and 1212(a).

Red Corporation's recognized gain of \$716,239 is accounted for as follows:

Ordinary income under § 1250	\$ —0—
Ordinary income under § 291	63,248
§ 1231 gain	<u>652,991</u>
Total recognized gain	<u>\$716,239</u>

17-2f Passive Losses

The **passive loss** rules apply to individual taxpayers and to closely held C corporations and personal service corporations (PSCs).¹³ For S corporations and partnerships, passive income or loss flows through to the owners, and the passive loss rules are applied at the owner level. The passive loss rules are applied to closely held C corporations and to PSCs to prevent taxpayers from incorporating to avoid the passive loss limitations (refer to Chapter 11).

A corporation is closely held if, at any time during the last half of the taxable year, more than 50 percent of the value of the corporation's outstanding stock is owned, directly or indirectly, by or for not more than five individuals. A corporation is classified as a PSC if it meets the following requirements:

- The principal activity of the corporation is the performance of personal services.
- The services are substantially performed by shareholder-employees.
- More than 10 percent of the stock (in value) is held by shareholder-employees. *Any* stock held by an employee on *any* one day causes the employee to be a shareholder-employee.

Similar to individual taxpayers, PSCs generally cannot deduct passive losses against either active income or portfolio income. The application of the passive loss rules is not as harsh for closely held C corporations. They may offset passive losses against *net active income*, but not against portfolio income.

EXAMPLE

12

Brown, a closely held C corporation that is not a PSC, has \$300,000 of passive losses from a rental activity, \$200,000 of net active income, and \$100,000 of portfolio income. The corporation may offset \$200,000 of the \$300,000 passive loss against the \$200,000 of net active income, but may not offset the remainder against the \$100,000 of portfolio income. If Brown is a PSC, then none of the \$300,000 of passive losses is deductible in the current year.

17-2g Charitable Contributions

Both corporate and individual taxpayers may deduct charitable contributions if the recipient is a qualified charitable organization. Generally, a deduction will be allowed only for the year in which the payment is made. However, an *accrual basis corporation* may claim the deduction in the year *preceding* payment if two requirements are met. First, the contribution must be authorized by the board of directors by the end of that year. Second, it must be paid on or before the fifteenth day of the third month of the next year.

EXAMPLE

13

On December 29, 2015, Blue Company, a calendar year, accrual basis partnership, authorizes a \$5,000 donation to the Atlanta Symphony Association (a qualified charitable organization). The donation is made on March 11, 2016. Because Blue Company is a partnership, the contribution cannot be deducted until 2016.¹⁴ However, if Blue Company is a corporation and the December 29, 2015 authorization was made by its board of directors, Blue may claim the \$5,000 donation as a deduction for calendar year 2015.

¹³§ 469(a). For definitions, see § 469(j)(1)(closely held) and § 469(j)(2) (PSC).

¹⁴Each partner will report an allocable portion of the charitable contribution deduction as of December 31, 2016 (the end of the partnership's tax year). See Chapter 21.

Property Contributions

Generally, a charitable contribution of property results in a deduction equal to the property's fair market value at the date of the gift. As a result of this rule, a contribution of loss property (fair market value less than basis) should be avoided as the loss inherent in the property (i.e., the excess of basis over fair market value) would never be recognized. A sale of the property to recognize the loss, followed by a charitable contribution of the sale proceeds, would produce a more favorable tax result.

Heron Corporation owns inventory with a basis of \$10,000 and a fair market value of \$8,000. A charitable contribution of the inventory results in a deductible amount of \$8,000, the inventory's fair market value. However, a sale of the inventory, for a recognized loss of \$2,000 (\$8,000 amount realized – \$10,000 basis), and donation of the sale proceeds, for a charitable deduction of \$8,000, results in a total deductible amount of \$10,000.

EXAMPLE

14

Fair market value also is the valuation amount for most charitable contributions of capital gain property. *Capital gain property* is property that, if sold, would result in long-term capital gain or § 1231 gain for the taxpayer.

During the current year, Mallard Corporation donates a parcel of land (a capital asset) to Oakland Community College. Mallard acquired the land five years ago for \$60,000, and the fair market value on the date of the contribution is \$100,000. The corporation's charitable contribution deduction (subject to a percentage limitation discussed later) is measured by the asset's fair market value of \$100,000, even though the \$40,000 appreciation on the land has never been included in Mallard's income.

EXAMPLE

15

In two situations, a charitable contribution of capital gain property is measured by the basis of the property, rather than fair market value. If the corporation contributes *tangible personal property* and the charitable organization puts the property to an unrelated use, the deduction is limited to the basis of the property. Unrelated use is defined as use that is not related to the purpose or function that qualifies the organization for exempt status.

Contributions of Tangible Personal Property

White Corporation donates a painting worth \$200,000 to Western States Art Museum (a qualified organization), which exhibits the painting. White had acquired the painting in 2000 for \$90,000. Because the museum put the painting to a related use, White is allowed to deduct \$200,000, the fair market value of the painting.

EXAMPLE

16

Assume the same facts as in the previous example, except that White Corporation donates the painting to the American Cancer Society, which sells the painting and deposits the \$200,000 proceeds in the organization's general fund. White's deduction is limited to the \$90,000 basis because it contributed tangible personal property that was put to an unrelated use by the charitable organization.

EXAMPLE

17

The deduction for charitable contributions of capital gain property to certain *private nonoperating foundations* is also limited to the basis of the property.

As a general rule, the deduction for a contribution of ordinary income property is limited to the *basis* of the property. *Ordinary income property* is appreciated property that, if sold, would not result in long-term capital gain for the taxpayer. Examples of ordinary income property include inventory and capital assets that have not been held more than 12 months. In addition, § 1231 property (depreciable property used in a trade or business) is treated as ordinary income property to the extent of any depreciation recaptured under § 1245 or § 1250 (as adjusted under § 291). On certain contributions of inventory by *corporations*, however, the amount of the deduction is equal to the lesser

of (1) the sum of the property's basis plus 50 percent of the appreciation on the property or (2) twice the property's basis. The following contributions of inventory qualify for this increased contribution amount.

- A contribution of property to a charitable organization for use that is related to the organization's exempt function and such use is solely for the care of the ill, needy, or infants.
- A contribution of tangible personal research property constructed by the corporation to a qualified educational or scientific organization that uses the property for research or experimentation or for research training. (The property must be contributed within two years from the date of its construction by the donor, and its original use must begin with the donee.)¹⁵

EXAMPLE

18

Lark Corporation, a clothing retailer, donates children's clothing to the Salvation Army to be used to attire homeless children. Lark's basis in the clothes is \$2,000, and the fair market value is \$3,000. Lark's deduction is \$2,500 [$\$2,000 \text{ basis} + 50\%(\$3,000 - \$2,000)$]. If, instead, the fair market value is \$7,000, Lark's deduction is limited to \$4,000 ($2 \times \$2,000 \text{ basis}$).

Limitations Imposed on Charitable Contribution Deductions

Like individuals, corporations are subject to percentage limits on the charitable contribution deduction.¹⁶ For any tax year, a corporate taxpayer's contribution deduction is limited to 10 percent of taxable income. For this purpose, taxable income is computed without regard to the charitable contribution deduction, any net operating loss carryback or capital loss carryback, dividends received deduction, and domestic production activities deduction. Any contributions in excess of the 10 percent limitation may be carried forward to the five succeeding tax years. Any carryforward must be added to subsequent contributions and will be subject to the 10 percent limitation. In applying this limitation, the current year's contributions must be deducted first, with carryover amounts from previous years deducted in order of time.¹⁷

Annual Limitation and Carryover Rules Illustrated**EXAMPLE**

19

During 2015, Orange Corporation (a calendar year taxpayer) had the following income and expenses:

Income from operations	\$140,000
Expenses from operations	110,000
Dividends received	10,000
Charitable contributions made in May 2015	6,000

For purposes of the 10% limitation *only*, Orange Corporation's taxable income is \$40,000 ($\$140,000 - \$110,000 + \$10,000$). Consequently, the allowable charitable contribution deduction for 2015 is \$4,000 ($10\% \times \$40,000$). The \$2,000 unused portion of the contribution can be carried forward to 2016, 2017, 2018, 2019, and 2020 (in that order) until exhausted.

EXAMPLE

20

Assume the same facts as in Example 19. In 2016, Orange Corporation has taxable income (for purposes of the 10% limitation) of \$50,000 and makes a charitable contribution of \$4,500. The maximum deduction allowed for 2016 is \$5,000 ($10\% \times \$50,000$). The first \$4,500 of the allowed deduction must be allocated to the contribution made in 2016, and \$500 of the \$2,000 unused contribution is carried over from 2015. The remaining \$1,500 of the 2015 contribution may be carried over to 2017 (and later years, if necessary).

¹⁵These conditions are set forth in §§ 170(e)(3) and (4).

¹⁷The carryover rules relating to all taxpayers are in § 170(d).

¹⁶The percentage limitations applicable to individuals and corporations are set forth in § 170(b).

17-2h Domestic Production Activities Deduction

One important purpose of the American Jobs Creation Act of 2004 was to replace certain tax provisions that our world trading partners regarded as allowing unfair advantage to U.S. exports. Among other changes, the Act created a deduction based on the income from manufacturing activities (designated as *domestic production activities*). The **domestic production activities deduction (DPAD)** is 9 percent of the lower of:

- Qualified production activities income, or
- Taxable income or alternative minimum taxable income (computed without regard to the DPAD).¹⁸

For individuals, adjusted gross income is substituted for “taxable income.” The DPAD cannot exceed 50 percent of an employer’s W-2 wages related to qualified production activities income.

Elk Corporation, a calendar year taxpayer, manufactures golf equipment. For the current year, Elk had taxable income of \$360,000 (before considering the DPAD) and qualified production activities income of \$380,000. Elk’s deduction is \$32,400 [$9\% \times \$360,000$ (the lesser of \$380,000 or \$360,000)]. Elk’s W-2 wages related to qualified production activities income were \$70,000, so the W-2 wage limitation ($\$70,000 \times 50\% = \$35,000$) does not apply.

EXAMPLE

21

See Chapter 7 for a detailed discussion of the domestic production activities deduction.

17-2i Net Operating Losses

As for individuals, the net operating loss (NOL) of a corporation generally may be carried back 2 years and forward 20 to offset taxable income for those years. Similarly, corporations also may elect to forgo the carryback period and just carry forward an NOL. Unlike individual taxpayers, however, a corporation does not adjust its tax loss for the year for capital losses, because a corporation is not permitted a deduction for net capital losses. Nor does a corporation make adjustments for nonbusiness deductions as individual taxpayers do. Further, a corporation is allowed to include the dividends received deduction (discussed on the next page) in computing its NOL.¹⁹

In 2015, Green Corporation has gross income (including dividends) of \$200,000 and deductions of \$300,000 excluding the dividends received deduction. Green Corporation had received \$100,000 of dividends from Fox, Inc., in which Green holds a 5% stock interest. Green has an NOL computed as follows:

Gross income (including dividends)		\$ 200,000
Less: Business deductions	\$300,000	
Dividends received deduction ($70\% \times \$100,000$)*	<u>70,000</u>	<u>(370,000)</u>
Taxable income (or loss)		<u><u>(\$ 170,000)</u></u>

* See the discussion of the dividends received deduction beginning on the next page.

The NOL is carried back two years to 2013. (Green Corporation may *elect* to forgo the carryback option and instead carry the loss forward.) Assume that Green had taxable income of \$40,000 in 2013. The carryover to 2014 is computed as follows:

Taxable income for 2013	\$ 40,000
Less: NOL carryback	<u>(170,000)</u>
Taxable income for 2013 after NOL carryback (carryover to 2014)	<u><u>(\$ 130,000)</u></u>

EXAMPLE

22

¹⁸§ 199.

¹⁹The modifications required to arrive at the amount of NOL that can be carried back or forward are in § 172(d).

LO.3

List and apply the tax rules unique to corporations.

17-2j Deductions Available Only to Corporations

Certain deductions are specific to corporate taxpayers. Provisions applicable only to corporate taxpayers include the dividends received deduction and the organizational expenditures deduction.

Dividends Received Deduction

The purpose of the **dividends received deduction** is to mitigate multiple taxation of corporate income. Without the deduction, income paid to a corporation in the form of a dividend would be taxed to the recipient corporation with no corresponding deduction to the distributing corporation. Later, when the recipient corporation paid the income to its shareholders, the income would again be subject to taxation with no corresponding deduction to the corporation. The dividends received deduction alleviates this inequity by causing only some or none of the dividend income to be taxable to the recipient corporation.

As the following table illustrates, the amount of the dividends received deduction depends on the percentage of ownership (voting power and value) the recipient corporate shareholder holds in a *domestic corporation* making the dividend distribution.²⁰

Percentage of Ownership by Corporate Shareholder	Deduction Percentage
Less than 20%	70%
20% or more (but less than 80%)	80%
80% or more*	100%

*The payor corporation must be a member of an affiliated group with the recipient corporation.

The dividends received deduction cannot exceed the taxable income limitation. This limitation is equal to the corporation's taxable income multiplied by the percentage that corresponds with the deduction percentage. Thus, if a corporate shareholder owns less than 20 percent of the stock in the distributing corporation, the dividends received deduction is limited to 70 percent of taxable income. For this purpose, taxable income is computed without regard to the NOL deduction, the domestic production activities deduction, the dividends received deduction, and any capital loss carryback. However, the taxable income limitation does not apply if the corporation has an NOL for the current taxable year.²¹

The following steps are useful in applying these rules.

1. Multiply the dividends received by the deduction percentage.
2. Multiply the taxable income by the deduction percentage.
3. Limit the deduction to the lesser of step 1 or step 2, unless deducting the amount derived in step 1 results in an NOL. If so, the amount derived in step 1 is used. This is referred to as the NOL rule.

EXAMPLE

23

Red, White, and Blue Corporations are three unrelated calendar year corporations. During the year, they report the following information:

	Red Corporation	White Corporation	Blue Corporation
Gross income from operations	\$ 400,000	\$ 320,000	\$ 260,000
Expenses from operations	(340,000)	(340,000)	(340,000)
Dividends received from domestic corporations (less than 20% ownership)	<u>200,000</u>	<u>200,000</u>	<u>200,000</u>
Taxable income before the dividends received deduction	<u>\$ 260,000</u>	<u>\$ 180,000</u>	<u>\$ 120,000</u>

continued

²⁰§ 243(a). Dividends from foreign corporations generally do not qualify for a dividends received deduction. But see § 245.

²¹Further, the limitation does not apply in the case of the 100% deduction available to members of an affiliated group. § 246(b).

In determining the dividends received deduction, use the three-step procedure described previously.

Step 1 (70% × \$200,000)	<u>\$140,000</u>	<u>\$140,000</u>	<u>\$140,000</u>
Step 2			
70% × \$260,000 (taxable income)	\$182,000		
70% × \$180,000 (taxable income)		\$126,000	
70% × \$120,000 (taxable income)	<u> </u>	<u> </u>	<u>\$ 84,000</u>
Step 3			
Lesser of step 1 or step 2	\$140,000	\$126,000	
Deduction results in an NOL (use step 1)	<u> </u>	<u> </u>	<u>\$140,000</u>

White Corporation is subject to the 70% of taxable income limitation (step 2). The NOL rule does not apply because subtracting \$140,000 (step 1) from \$180,000 (taxable income before the dividends received deduction) does not yield a negative figure. Blue Corporation qualifies for NOL rule treatment because subtracting \$140,000 (step 1) from \$120,000 (taxable income before the dividends received deduction) yields a negative figure. In summary, each corporation has a dividends received deduction for the year: \$140,000 for Red Corporation, \$126,000 for White Corporation, and \$140,000 for Blue Corporation.

No dividends received deduction is allowed unless the corporation has held the stock for more than 45 days.²² This restriction was enacted to close a tax loophole involving dividends on stock that is held only briefly. When stock is purchased shortly before a dividend record date and soon thereafter sold ex-dividend, a capital loss corresponding to the amount of the dividend often results (ignoring other market valuation changes). If the dividends received deduction was allowed in such cases, the capital loss resulting from the stock sale would exceed the taxable portion of the related dividend income.

On October 1, 2015, Pink Corporation declares a \$1 per share dividend for shareholders of record as of November 1, 2015, and payable on December 1, 2015. Black Corporation purchases 10,000 shares of Pink stock on October 29, 2015, for \$25,000 and sells those 10,000 shares ex-dividend on November 5, 2015, for \$15,000. (It is assumed that there is no fluctuation in the market price of the Pink stock other than the dividend element.) The sale results in a short-term capital loss of \$10,000 (\$15,000 amount realized – \$25,000 basis). On December 1, Black receives a \$10,000 dividend from Pink. Without the holding period restriction, Black Corporation would recognize a \$10,000 capital loss deduction (subject to the capital loss limitation) but only \$3,000 of income [\$10,000 dividend – \$7,000 dividends received deduction (\$10,000 × 70%)], or a \$7,000 net loss. However, because Black did not hold the Pink stock for more than 45 days, no dividends received deduction is allowed.

EXAMPLE

24

Another loophole closing provision applies to the dividends received deduction when the underlying stock is debt financed. A corporation that finances the purchase of dividend-paying stock receives an interest expense deduction from such financing, but would report only a small amount of the related income if the dividends received deduction was allowed unabated. In general, the dividends received deduction is reduced with respect to any dividend-paying stock by the percentage of the investment in the stock that is acquired with “portfolio indebtedness.”²³ For instance, if a stock purchase is financed 50 percent by debt, the dividends received deduction for dividends on such stock is reduced by 50 percent. However, the reduction in the dividends received deduction cannot exceed the amount of the interest deduction allocable to the dividend.

²²The stock must be held more than 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date (or in the case of preferred stock, more than 90 days during the 181-day period beginning on the date that is 90 days before the ex-dividend date). § 246(c).

²³*Portfolio indebtedness* is defined as “any indebtedness directly attributable to investment” in the stock. § 246A.



ETHICS & EQUITY Pushing the Envelope on Year-End Planning

As of December 30, 2015, Lark Corporation (a calendar year taxpayer) has gross income from operations of \$497,000, expenses from operations of \$556,000, and dividends received from domestic corporations (less than 20 percent ownership) of \$200,000. Currently, Lark does not expect any more income or expenses to be

realized by year-end. However, Lark's tax department has suggested that the corporation incur another \$1,001 of deductible expenditures before year-end. What is the motivation behind the tax department's recommendation, and is such year-end planning ethical?

Organizational Expenditures Deduction

Expenses incurred in connection with the organization of a corporation normally are chargeable to a capital account. That they benefit the corporation during its existence seems clear. But how can they be amortized when most corporations possess unlimited life? The lack of a determinable and limited estimated useful life would therefore preclude any tax write-off. Section 248 was enacted to solve this problem.

Under § 248, a corporation may *elect* to amortize **organizational expenditures** over the 180-month period beginning with the month in which the corporation begins business.²⁴ Organizational expenditures include the following:

- Legal services incident to organization (e.g., drafting the corporate charter, bylaws, minutes of organizational meetings, and terms of original stock certificates).
- Necessary accounting services.
- Expenses of temporary directors and of organizational meetings of directors or shareholders and fees paid to the state of incorporation.

Expenditures that *do not qualify* as organizational expenditures include those connected with issuing or selling shares of stock or other securities (e.g., commissions, professional fees, and printing costs) or with transferring assets to a corporation. These expenditures reduce the amount of capital raised and are not deductible at all.

The first \$5,000 of organizational costs is immediately expensed, with any remaining amount of organizational costs amortized over a 180-month period. However, the \$5,000 expensing amount is phased out on a dollar-for-dollar basis when these costs exceed \$50,000. For example, a corporation with \$52,000 of organizational costs could expense \$3,000 [$\$5,000 - (\$52,000 - \$50,000)$] of this amount and amortize the \$49,000 balance ($\$52,000 - \$3,000$) over 180 months.

To qualify for the election, the expenditures must be *incurred* before the end of the tax year in which the corporation begins business. In this regard, the corporation's method of accounting is of no consequence. Thus, an expense incurred by a cash basis corporation in its first tax year qualifies even though it is not paid until a subsequent year.

A corporation is deemed to have made the election to amortize organizational expenditures for the taxable year in which it begins business. No separate statement or specific identification of the deducted amount as organizational expenditures is required. A corporation can elect to forgo the deemed election by clearly electing to capitalize organizational expenditures on a timely filed return for its first taxable year. In that case, the capitalized amount will be deductible by the corporation at such time as it ceases to do business and liquidates.

²⁴The month in which a corporation begins business may not be immediately apparent. Ordinarily, a corporation begins business when it starts the

business operations for which it was organized. Reg. § 1.248-1(d). For a similar problem in the Subchapter S area, see Chapter 22.

Black Corporation, an accrual basis taxpayer, was formed and began operations on April 1, 2015. The following expenses were incurred during its first year of operations (April 1 through December 31, 2015):

Expenses of temporary directors and of organizational meetings	\$15,500
Fee paid to the state of incorporation	2,000
Accounting services incident to organization	18,000
Legal services for drafting the corporate charter and bylaws	32,000
Expenses incident to the printing and sale of stock certificates	48,000

EXAMPLE

25

Black Corporation elects to amortize organizational costs under § 248. Because of the dollar cap (i.e., dollar-for-dollar reduction for amounts in excess of \$50,000), none of the \$5,000 expensing allowance is available. The monthly amortization is \$375 [(\$15,500 + \$2,000 + \$18,000 + \$32,000) ÷ 180 months], and \$3,375 (\$375 × 9 months) is deductible for tax year 2015. Note that the \$48,000 of expenses incident to the printing and sale of stock certificates does not qualify for the election. These expenses cannot be deducted at all, but reduce the amount of the capital realized from the sale of stock.

Organizational expenditures are distinguished from *startup expenditures*.²⁵ Startup expenditures include various investigation expenses involved in entering a new business (e.g., travel, market surveys, financial audits, and legal fees) and operating expenses such as rent and payroll that are incurred by a corporation before it actually begins to produce any gross income. At the election of the taxpayer, such expenditures are deductible in the same manner as organizational expenditures. Thus, up to \$5,000 can be immediately expensed (subject to the phaseout) and any remaining amounts amortized over a period of 180 months. The same rules that apply to the deemed election (and election to forgo the deemed election) for organizational expenditures also apply to startup expenditures.



Concept Summary 17.1

Income Taxation of Individuals and Corporations Compared

	Individuals	Corporations
Computation of gross income	§ 61.	§ 61.
Computation of taxable income	§ 62 and §§ 63(b) through (h).	§ 63(a). Concept of AGI has no relevance.
Deductions	Trade or business (§ 162); nonbusiness (§ 212); some personal and employee expenses (generally deductible as itemized deductions).	Trade or business (§ 162).
Charitable contributions	Limited in any tax year to 50% of AGI; generally limited to 30% of AGI for capital gain property. Excess charitable contributions carried over for five years. Amount of deduction is the fair market value of capital gain property; ordinary income property is limited to adjusted basis; capital gain property is treated as ordinary income property if certain tangible personalty is donated to a nonuse charity or a private nonoperating foundation is the donee.	Limited in any tax year to 10% of taxable income computed without regard to the charitable contribution deduction, NOL carryback, capital loss carryback, dividends received deduction, and domestic production activities deduction. Same as for individuals. Same as for individuals, but exceptions allowed for certain inventory and for research property where one-half of the appreciation also is allowed as a deduction.

continued

²⁵§ 195.

Income Taxation of Individuals and Corporations Compared—(Continued)

	Individuals	Corporations
	Time of deduction is the year in which payment is made.	Time of deduction is the year in which payment is made unless accrual basis taxpayer. Accrual basis corporation can take deduction in year preceding payment if contribution was authorized by board of directors by end of year and contribution is paid by fifteenth day of third month of following year.
Casualty losses	\$100 floor on personal casualty and theft losses; personal casualty losses deductible only to extent losses exceed 10% of AGI.	Deductible in full.
Net operating loss	Adjusted for several items, including nonbusiness deductions over nonbusiness income and personal exemptions. Generally, carryback period is 2 years and carryforward period is 20 years.	Generally no adjustments. Same as for individuals.
Dividends received deduction	None.	70%, 80%, or 100% of dividends received depending on percentage of ownership by corporate shareholder.
Net capital gains	Taxed in full. Tax rate is 0%, 15%, or 20% on net capital gains.	Taxed in full.
Capital losses	Only \$3,000 of capital loss per year can offset ordinary income; unused loss is carried forward indefinitely to offset capital gains or ordinary income up to \$3,000; short-term and long-term carryovers retain their character.	Can offset only capital gains; unused loss is carried back three years and forward five; carryovers and carrybacks are characterized as short-term losses.
Passive losses	In general, passive losses cannot offset either active income or portfolio income.	Passive loss rules apply to closely held C corporations and personal service corporations. For personal service corporations, passive losses cannot offset either active income or portfolio income. For closely held C corporations, passive losses may offset active income but not portfolio income.
Domestic production activities deduction	Based on 9% of the lesser of qualified production activities income (QPAI) or modified AGI or alternative minimum taxable income.	Based on 9% of the lesser of qualified production activities income (QPAI) or taxable income or alternative minimum taxable income.
Tax rates	Progressive with seven rates (10%, 15%, 25%, 28%, 33%, 35%, and 39.6%).	Progressive with four rates (15%, 25%, 34%, and 35%). Two lowest brackets phased out between \$100,000 and \$335,000 of taxable income, and additional tax imposed between \$15,000,000 and \$18,333,333 of taxable income.
Alternative minimum tax	Applied at a graduated rate schedule of 26% and 28%. Exemption allowed depending on filing status (e.g., \$83,400 for married filing jointly in 2015); phaseout begins when AMTI reaches a certain amount (e.g., \$158,900 in 2015 for married filing jointly).	Applied at a 20% rate on AMTI less exemption; \$40,000 exemption allowed but phaseout begins when AMTI reaches \$150,000; adjustments and tax preference items are similar to those applicable to individuals, but also include 75% adjusted current earnings adjustment. Small corporations (gross receipts of \$5 million or less) are not subject to AMT.

17-3 DETERMINING THE CORPORATE INCOME TAX LIABILITY

LO.4

Compute the corporate income tax.

17-3a Corporate Income Tax Rates

Corporate income tax rates have fluctuated over the years, with the current rate structure reflecting a significant reduction that occurred in the Tax Reform Act of 1986. For example, the top statutory corporate income tax rate was reduced from 46 percent to 35 percent. Refer to Exhibit 17.1 for a schedule of the current corporate income tax rates. Unlike the individual income tax rate brackets, the corporate income tax rate brackets are *not* indexed for inflation.

The Big Picture

Return to the facts of *The Big Picture* on p. 17-1. Assume that Samantha incorporates her business as Skylark Bakery, Inc., a calendar year C corporation. The corporation pays Samantha a salary of \$50,000 for the current year. Therefore, Skylark Bakery has taxable income of \$51,500 [\$100,000 operating profit + \$5,000 dividends – \$50,000 salary deduction – \$3,500 dividends received deduction ($\$5,000 \times 70\%$)]. Its 2015 income tax liability is \$7,875, determined as follows:

Tax on \$50,000 at 15%	\$7,500
Tax on \$1,500 at 25%	375
Tax liability	<u>\$7,875</u>

EXAMPLE

26

For taxable income in excess of \$100,000, the amount of the tax is increased by the lesser of (1) 5 percent of the excess or (2) \$11,750. In effect, the additional tax means a 39 percent rate for every dollar of taxable income from \$100,000 to \$335,000.

Silver Corporation, a calendar year taxpayer, has taxable income of \$335,000 for the current year. Its income tax liability is \$113,900, determined as follows:

Tax on \$100,000	\$ 22,250
Tax on \$235,000 \times 39%	91,650
Tax liability	<u>\$113,900</u>

EXAMPLE

27

Note that the tax liability of \$113,900 is 34% of \$335,000. Thus, due to the 39% rate (34% normal rate + 5% additional tax on taxable income between \$100,000 and \$335,000), the benefit of the lower rates on the first \$75,000 of taxable income completely phases out at \$335,000. The tax rate drops back to 34% on taxable income between \$335,000 and \$10 million.

Under § 11(b)(2), personal service corporations are taxed at a flat 35 percent rate on all taxable income. Thus, they do not enjoy the tax savings of the 15 to 34 percent brackets applicable to other corporations.

17-3b Alternative Minimum Tax

Corporations are subject to an alternative minimum tax (AMT) that is structured similarly to the AMT applicable to individuals, both in objective and in application.²⁶ The AMT for corporations, as for individuals, involves a broader tax base than does the regular tax. Like an individual, a corporation is required to apply a minimum tax rate to the expanded base and to pay the greater of the tentative AMT liability and the regular tax. Many of the adjustments and tax preference items necessary to arrive

²⁶Small corporations are not subject to the alternative minimum tax. See § 55.

at alternative minimum taxable income (AMTI) are the same for individuals and corporations. The AMT rate and exemption amount for corporations are different from those applicable to individuals, however. Refer to Chapter 15 for a detailed discussion of the corporate AMT.

17-3c **Restrictions on Corporate Accumulations**

Two provisions of the Code are designed to prevent corporations and their shareholders from avoiding the double tax on dividend distributions. Both provisions impose a penalty tax on undistributed income retained by the corporation. The rules underlying these provisions are complex and beyond the scope of this text. However, a brief description is provided as an introduction.

The *accumulated earnings tax* (described in §§ 531–537) imposes a 20 percent tax on the current year’s corporate earnings that have been accumulated without a reasonable business need. The burden of proving what constitutes a reasonable need is borne by the taxpayer. In determining accumulated income, most businesses are allowed a \$250,000 minimum credit. Thus, most corporations can accumulate \$250,000 in earnings over a series of years without fear of an accumulated earnings tax. Beyond the minimum credit, earnings can be accumulated for:

- Working capital needs (to purchase inventory),
- Retirement of debt incurred in connection with the business,
- Investment or loans to suppliers or customers (if necessary to maintain the corporation’s business), or
- Realistic business contingencies, including lawsuits or self-insurance.

The *personal holding company (PHC) tax* (described in §§ 541–547) was enacted to discourage the sheltering of certain kinds of passive income in corporations owned by individuals with high marginal tax rates. Historically, the tax was aimed at “incorporated pocketbooks” that were frequently found in the entertainment and construction industries. For example, a taxpayer could shelter income from securities in a corporation, which would pay no dividends, and allow the corporation’s stock to increase in value. Like the accumulated earnings tax, the PHC tax employs a 20 percent rate and is designed to force a corporation to distribute earnings to shareholders. However, in any single year, the IRS cannot impose both the PHC tax and the accumulated earnings tax. Generally, a company is considered a PHC and may be subject to the tax if:

- More than 50 percent of the value of the outstanding stock is owned by five or fewer individuals at any time during the last half of the year, and
- A substantial portion (60 percent or more) of the corporation’s income is comprised of passive types of income, including dividends, interest, rents, royalties, or certain personal service income.

LO.5

Explain the rules unique to computing the tax of related corporations.

17-3d **Tax Liability of Related Corporations**

Members of a controlled group of corporations (**related corporations**) are subject to special rules for computing the income tax, deducting the cost of certain depreciable assets under § 179, and using the AMT exemption.²⁷ If these restrictions did not exist, the shareholders of a corporation could gain significant tax advantages by splitting a single corporation into *multiple* corporations. The next two examples illustrate the potential *income tax* advantage of multiple corporations.

²⁷§ 1561(a).

Tax Savings from Multiple Corporations

Gray Corporation annually yields taxable income of \$300,000. The corporate tax on \$300,000 is \$100,250, computed as follows:

Tax on \$100,000	\$ 22,250
Tax on \$200,000 × 39%	78,000
Tax liability	<u>\$100,250</u>

EXAMPLE

28

Assume that Gray Corporation in the previous example is divided equally into four corporations. Each corporation would have taxable income of \$75,000, and the tax for each (absent the special provisions for related corporations) would be computed as follows:

Tax on \$50,000	\$ 7,500
Tax on \$25,000 × 25%	6,250
Tax liability	<u>\$13,750</u>

EXAMPLE

29

The total liability for the four corporations would be \$55,000 ($\$13,750 \times 4$). The savings would be \$45,250 ($\$100,250 - \$55,000$).

A comparison of Examples 28 and 29 reveals that the income tax savings that could be achieved by using multiple corporations result from having more of the total taxable income taxed at lower marginal rates. To close this loophole, the law limits a *controlled group's* taxable income in the tax brackets below 35 percent to the amount the corporations in the group would have if they were one corporation. Thus, in Example 29, under the controlled corporation rules, only \$12,500 (one-fourth of the first \$50,000 of taxable income) for each of the four related corporations would be taxed at the 15 percent rate. The 25 percent rate would apply to the next \$6,250 (one-fourth of the next \$25,000) of taxable income of each corporation. This equal allocation of the \$50,000 and \$25,000 amounts is required unless all members of the controlled group consent to an apportionment plan providing for an unequal allocation.

Similar limitations apply to controlled groups with respect to the election to expense certain depreciable assets under § 179 (see Chapter 8) and to the \$40,000 AMT exemption amount (see Chapter 15). In addition, members of a controlled group must defer the recognition of any realized loss on intercompany sales until a sale is made at a gain to a nongroup member (see Chapter 6).²⁸ Similarly, any gain on the sale of depreciable property between members of a controlled group is recognized as ordinary income (see Chapter 14).²⁹

17-3e Controlled Groups

A **controlled group** of corporations includes parent-subsidary groups, brother-sister groups, combined groups, and certain insurance companies.³⁰ Parent-subsidary controlled groups are discussed in the following section.

Parent-Subsidiary Controlled Group

A **parent-subsidiary controlled group** exists when one corporation owns at least 80 percent of the voting power *or* stock value of another corporation on the last day of the tax year.³¹ Multiple tiers of subsidiaries and chains of ownership are allowed, as long as the group has an identifiable parent corporation.

²⁸ §§ 267(a)(1), (b)(3), and (f).

²⁹ §§ 1239(a) and (c).

³⁰ § 1563(a).

³¹ § 1563(a)(1). For this purpose, stock attribution rules apply. In addition, all stock options are considered to be exercised by their holders. §§ 1563(d)(1) and (e)(1) through (3).

EXAMPLE

30

Aqua Corporation owns 80% of White Corporation. Aqua and White Corporations are members of a parent-subsidary controlled group. Aqua is the parent corporation, and White is the subsidiary.

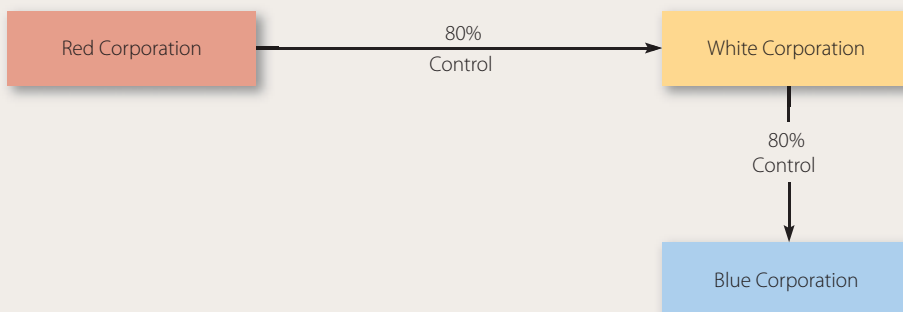
The parent-subsidary relationship described in Example 30 is easy to recognize because Aqua Corporation is the direct owner of White Corporation. Real-world business organizations often are much more complex, sometimes including numerous corporations with chains of ownership connecting them. In these complex corporate structures, determining whether the controlled group classification is appropriate becomes more difficult. The ownership requirements can be met through direct ownership (as in Example 30) or through indirect ownership.

Parent-Subsidiary Relationships Illustrated

EXAMPLE

31

Red Corporation owns 80% of the voting stock of White Corporation, and White Corporation owns 80% of the voting stock of Blue Corporation. Red, White, and Blue Corporations constitute a controlled group in which Red is the common parent and White and Blue are subsidiaries. The same result would occur if Red Corporation, rather than White Corporation, owned the Blue Corporation stock.



EXAMPLE

32

Brown Corporation owns 80% of the stock of Green Corporation, which owns 30% of Blue Corporation. Brown also owns 80% of White Corporation, which owns 50% of Blue Corporation. Brown, Green, Blue, and White Corporations constitute a parent-subsidary controlled group in which Brown is the common parent and Green, Blue, and White are subsidiaries.



17-3f **Consolidated Returns**

The privilege of filing a consolidated return is based on the concept that an affiliated group of corporations constitutes a single taxable entity despite the existence of technically separate businesses. By filing a consolidated return, the corporation can eliminate intercompany profits and losses on the principle that its tax liability should be based on transactions with outsiders rather than on intragroup affairs.

Advantages and Disadvantages of Filing Consolidated Returns

The advantages of a consolidated return are summarized below.

- Losses of one group member can be used to shelter the income of other members. See Example 35.
- Taxation of intercompany dividends may be eliminated.
- Recognition of income from certain intercompany transactions can be deferred. See Example 37.
- Deductions may be optimized due to percentage limitations being modified as a result of the consolidation process. See Example 35.

Consolidation also eliminates any intercompany pricing problems among related corporations that might arise under § 482.³²

Rust Corporation leases a building to Crimson Corporation for \$6,000 a month. If the IRS determines that the market value is really \$9,000 per month, a § 482 allocation would increase Rust Corporation's monthly rent income by \$3,000. If, however, Rust and Crimson are members of an affiliated group that files a consolidated return, the § 482 adjustment would not be made. Increasing Rust Corporation's rent income by \$3,000 is meaningless as it is offset by a \$3,000 increase in Crimson Corporation's deduction for rent expense.

EXAMPLE

33

The disadvantages of filing a consolidated return are as follows:

- An election is binding on subsequent years and can be avoided only if the makeup of the affiliated group changes or the IRS consents to the revocation of consolidated return status.
- Recognition of losses from certain intercompany transactions is deferred.
- The requirement that all group members use the parent's tax year could create short tax years for the subsidiaries. This could cause a bunching of income and use up a full year for carryover purposes.
- Additional administrative compliance costs may be incurred as the consolidated tax return provisions are extensive and complex.

A further negative consideration is that the tax rules for filing a consolidated return may not mesh with those applicable for financial accounting purposes. For example, foreign corporations cannot be included in the consolidated tax return but should be considered when preparing financial statements. This variance in treatment may require explanatory reconciliation and will further add to the administrative burden.

Eligibility and the Election

The election to file a consolidated return is available only to an **affiliated group**.³³ An affiliated group exists when one corporation owns at least 80 percent of the voting power *and* stock value of another corporation. The stock ownership test must be met on every day of the tax year. Multiple tiers and chains of corporations are allowed as long as the group has an identifiable parent corporation (i.e., at least 80 percent of one corporation must be owned by another).

An affiliated group is similar but not identical to a parent-subsidiary controlled group discussed earlier in this chapter. Two major differences are noted below.

- In meeting the 80 percent stock ownership requirement, the affiliated group must satisfy *both* the voting power test and the stock value test. As to a parent-subsidiary controlled group, the satisfaction of either test suffices.
- In the parent-subsidiary controlled group, the stock ownership test is applied only on the last day of the year—not every day as in the case of an affiliated group.

³²§ 482 (Allocation of Income and Deductions Among Taxpayers) is further discussed in Chapter 25 in regard to international situations.

³³§ 1504(a). Most of the tax rules governing consolidated returns are contained in the Regulations. The delegation of this rule-making authority is contained in § 1502.

Members of an affiliated group need not file a consolidated return, and absent an election to consolidate, each corporation files its own Form 1120. If and when an election is made, all of the transactions for the group are combined and reported on one Form 1120. A Form 1122 (Authorization and Consent of Subsidiary Corporation to Be Included in a Consolidated Income Tax Return) should be attached to the first consolidated Form 1120 for every subsidiary included in the group. Each subsequent consolidated Form 1120 must include a Form 851 (Affiliation Schedule) that provides pertinent information as to the members of the group.

Computing Consolidated Taxable Income

Several categories of transactions do not enter into the determination of taxable income.

- Some intercompany transactions are forever disregarded. Examples would be dividends paid by one group member to another. See also the situation presented in Example 33.
- Gains and losses from certain intercompany sales are not recognized until the sold asset leaves the affiliated group (e.g., disposition of the property to an outside party). See Examples 37 and 38.

In computing the taxable income for any consolidated return year, several items are computed on a group basis. These include net capital (and § 1231) gain or loss, casualty gain or loss, charitable contributions, the dividends received deduction, and net operating loss. The importance of this grouping is illustrated below.

Computing Various Items on a Group Basis

EXAMPLE

34

Maize Corporation owns 100% of the stock of E cru Corporation, and both use a calendar year for tax purposes. For 2015, they had the following transactions and filed *separate* returns:

	Maize	E cru
Income from operations	\$300,000	\$170,000
Capital gain	50,000	
Capital loss of \$45,000		(-0-)*
Charitable contribution of \$40,000	(35,000)**	
Taxable income	<u>\$315,000</u>	<u>\$170,000</u>

* No deduction is allowed to a corporation for a net capital loss.

** The charitable deduction is limited to 10% of taxable income, as computed prior to the charitable contribution deduction. Thus, $10\% \times \$350,000$ ($\$300,000 + \$50,000$) = \$35,000.

EXAMPLE

35

Assume the same facts as in Example 34, except that a consolidated return is filed for 2015. The results are:

Income from operations ($\$300,000 + \$170,000$)		\$470,000
Capital transactions—		
Capital gain	\$ 50,000	
Capital loss	(45,000)*	5,000
Charitable contribution		(40,000)**
Taxable income		<u>\$435,000</u>

* A capital loss can be used to offset a capital gain.

** The 10% of taxable income limitation now becomes $10\% \times \$475,000 = \$47,500$. Thus, the full charitable deduction is allowed.

One of the advantages of filing a consolidated return can be seen by comparing the results reached in Examples 34 and 35. Note that in Example 34, the combined taxable income is \$485,000 ($\$315,000 + \$170,000$), while in Example 35, taxable income is \$435,000, or \$50,000 less ($\$485,000 - \$435,000$).



FINANCIAL DISCLOSURE INSIGHTS GAAP and Tax Treatment of Consolidations

Both U.S. financial accounting and tax rules use the term *consolidation*, but there is only a slight resemblance in the content of those rules. Here are some of the key similarities and differences between the book and tax treatment of conglomerates.

- GAAP consolidations for the most part are *mandatory* when specified ownership levels are met. Federal income tax consolidation is an *election* by the affiliates to join the parent's tax return.
- GAAP consolidations can include entities such as partnerships and non-U.S. entities. Federal income tax rules generally limit the consolidated return only to U.S. C corporations.
- Ownership levels required for a U.S. subsidiary to consolidate with a parent differ between the book and tax rules. For example, not only does GAAP set a lower maximum for consolidation (50 percent versus 80 percent) but consolidation may not be elective (see above). Furthermore, the categorization and treatment of minority interests may vary.
- Tax rules treat a merger or an acquisition of a target corporation by a parent as a nontaxable transaction, assuming that the requirements of a § 368 reorganization are met (see Chapter 20). Under GAAP, the transaction usually is reported as a purchase of the target's identifiable assets and liabilities.
- After a takeover occurs, book cost amounts are assigned at fair market value and any excess purchase price is deemed to be goodwill. For Federal income tax purposes, if reorganization treatment is available, the target's basis in its assets carries over to the parent's accounts.
- Goodwill is treated differently under book and tax rules. Financial accounting goodwill cannot be amortized, but impairments to its value are reported as operating losses. Book income results if that impairment of the goodwill is reversed, for example, because the value of the goodwill has increased. For Federal income tax purposes, purchased goodwill is amortized over 15 years.

The consolidated return rules allow the group to make use of the losses of one (or more) of its members. Because this possibility could lead to major tax avoidance (e.g., a profitable corporation acquires a loss corporation to take advantage of its loss carryovers), multiple safeguards have been enacted by Congress to preclude (or curtail) such potential abuse.

One such safeguard protects against the use of losses and deductions that arose in a separate return year.³⁴

For calendar year 2015, Kingfisher Corporation and Starling Corporation first elect to file a consolidated return. As of January 1, 2015, Starling owned land (held as an investment) with a basis of \$300,000 and a fair market value of \$280,000. During 2015, the land is sold for \$270,000. On a consolidated return, only \$10,000 of the loss can be claimed. The other \$20,000 loss comes from a separate return year(s) and relates only to Starling Corporation. It cannot be used by the affiliated group.

EXAMPLE

36

A further safeguard limits the use of losses and deductions when ownership changes within the affiliated group have taken place.³⁵

Deferral Treatment for Intercompany Sales

As noted previously, the deferral of certain intercompany sales can be advantageous (if gains are involved) or disadvantageous (if losses are involved). The realized gain or loss from the intercompany sale is not recognized but is deferred.

³⁴Aside from the Regulations issued by the Treasury Department, the separate return limitation year (SRLY) safeguards can be invoked pursuant to § 269 (Acquisitions Made to Evade or Avoid Income Tax) and § 482 (Allocation of Income and Deductions Among Taxpayers).

³⁵The major statutory weapons available to the IRS are § 381 (Carryovers in Certain Corporate Acquisitions) and § 382 (Limitation on Net Operating Loss Carryforwards and Certain Built-in Losses Following Ownership Change).

EXAMPLE

37

In 2015, Peach Corporation sells land (basis of \$100,000) to Beige Corporation for its fair market value of \$180,000. Both Peach and Beige are members of the same affiliated group that files a consolidated return for 2015. None of the \$80,000 realized gain is recognized on this return.

The deferred gain or loss may be recognized in a later year when the property ultimately is sold to outsiders.

EXAMPLE

38

Assume the same facts as in Example 37. In 2017, Beige Corporation sells the land to a Danish real estate developer for \$210,000. A consolidated return for 2017 should report a recognized gain of \$110,000 (\$80,000 of which was previously deferred).

LO.6

Describe the reporting process for corporations.

17-4 PROCEDURAL MATTERS

This section covers various aspects of the corporate income tax return, including filing requirements, estimated tax payments, and special disclosure schedules on the return.

17-4a Filing Requirements for Corporations

A corporation must file a Federal income tax return whether it has taxable income or not. A corporation that was not in existence throughout an entire annual accounting period is required to file a return for the portion of the year during which it was in existence. In addition, a corporation must file a return even though it has ceased to do business if it has valuable claims for which it will bring suit. A corporation is relieved of filing income tax returns only when it ceases to do business and retains no assets.³⁶

The corporate return is filed on Form 1120. Corporations electing under Subchapter S (see Chapter 22) file on Form 1120S. Forms 1120 and 1120S are reproduced in Appendix B. Corporations with assets of \$10 million or more generally are required to file returns electronically.³⁷

The return must be filed on or before the fifteenth day of the third month following the close of a corporation's tax year. Corporations can receive an automatic extension of six months for filing the corporate return by filing Form 7004 by the due date for the return. However, the IRS may terminate the extension by mailing a 10-day notice to the corporation.³⁸

17-4b Estimated Tax Payments

A corporation must make payments of estimated tax unless its tax liability can reasonably be expected to be less than \$500. The required annual payment (which includes any estimated AMT liability) is the *lesser* of (1) 100 percent of the corporation's tax for the current year or (2) 100 percent of the tax for the preceding year (if that was a 12-month tax year, the return filed showed a tax liability, and the corporation involved is not a *large corporation*). Estimated payments can be made in four installments due on or before the fifteenth day of the fourth month, the sixth month, the ninth month, and the twelfth month of the corporate taxable year.³⁹ The full amount of the unpaid tax is due on the due date of the return.

Failure to make the required estimated tax prepayments results in a nondeductible penalty being imposed on the corporation. The penalty is avoided, however, if any of various exceptions apply.⁴⁰

³⁶§ 6012(a)(2) and Reg. § 1.6012-2(a).

³⁷Reg. §§ 1.6012-2(a)(3) (Form 1120), 1.6012-2(h) (Form 1120S), and 301.6011-5 (electronic filing).

³⁸Reg. § 1.6081-3.

³⁹§ 6655. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. See § 6655(g)(2) for the definition of a *large corporation*.

⁴⁰See § 6655 for the penalty involved and the various exceptions to it.

17-4c Schedule M-1—Reconciliation of Income (Loss) per Books with Income per Return

Schedule M-1 of Form 1120 is used to *reconcile* net income as computed for financial accounting purposes [i.e., using **generally accepted accounting principles (GAAP)**] with taxable income reported on the corporation’s income tax return (commonly referred to as book-tax differences). Schedule M-1 is required of corporations with less than \$10 million of total assets.

The starting point on Schedule M-1 is net income (loss) per books. Additions and subtractions are entered for items that affect financial accounting net income and taxable income differently. The following items are entered as additions (see lines 2 through 5 of Schedule M-1):

- Federal income tax expense per books (deducted in computing net income per books but not deductible in computing taxable income).
- The excess of capital losses over capital gains (deducted for financial accounting purposes but not deductible by corporations for income tax purposes).
- Income that is reported in the current year for tax purposes but is not reported in computing net income per books (e.g., prepaid income).
- Various expenses that are deducted in computing net income per books but are not allowed in computing taxable income (e.g., charitable contributions in excess of the 10 percent ceiling applicable to corporations).

The following subtractions are entered on lines 7 and 8 of Schedule M-1:

- Income reported for financial accounting purposes but not included in taxable income (e.g., tax-exempt interest).
- Deductions taken on the tax return but not expensed in computing net income per books (e.g., domestic production activities deduction).

The result is taxable income (before the NOL deduction and the dividends received deduction).

During the current year, Tern Corporation had the following transactions:

Net income per books (after tax)	\$92,400
Taxable income	50,000
Federal income tax expense per books	7,500
Interest income from tax-exempt bonds	5,000
Interest paid on a loan, the proceeds of which were used to purchase the tax-exempt bonds	500
Life insurance proceeds received as a result of the death of a key employee	50,000
Premiums paid on the key employee life insurance policy	2,600
Excess of capital losses over capital gains	2,000

EXAMPLE

39

For book and tax purposes, Tern determines depreciation under the straight-line method. Tern’s Schedule M-1 for the current year follows.

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return					
Note: The corporation may be required to file Schedule M-3 (see instructions).					
1	Net income (loss) per books	92,400	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	7,500		Tax-exempt interest \$ 5,000	
3	Excess of capital losses over capital gains	2,000		Life insurance proceeds on key employee \$50,000	55,000
4	Income subject to tax not recorded on books this year (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):		a	Depreciation . . . \$	
	a Depreciation \$		b	Charitable contributions \$	
	b Charitable contributions . . . \$				
	c Travel and entertainment . . . \$		9	Add lines 7 and 8	55,000
	Prem.-life ins. \$2,600; Int.-state bonds \$500	3,100	10	Income (page 1, line 28)—line 6 less line 9	50,000
6	Add lines 1 through 5	105,000			

17-4d **Schedule M-2—Analysis of Unappropriated Retained Earnings per Books**

Schedule M-2 reconciles unappropriated retained earnings at the beginning of the year with unappropriated retained earnings at year-end. Beginning balance plus net income per books, as entered on line 1 of Schedule M-1, less dividend distributions during the year equals ending retained earnings. Other sources of increases or decreases in retained earnings are also listed on Schedule M-2.

EXAMPLE

40

Assume the same facts as in Example 39. Tern Corporation's beginning balance in unappropriated retained earnings is \$125,000. During the year, Tern distributed a cash dividend of \$30,000 to its shareholders. Based on these further assumptions, Tern's Schedule M-2 for the current year is as follows:

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)					
1	Balance at beginning of year	125,000	5	Distributions: a Cash	30,000
2	Net income (loss) per books	92,400		b Stock	
3	Other increases (itemize):			c Property	
	-----		6	Other decreases (itemize):	
	-----		7	Add lines 5 and 6	30,000
4	Add lines 1, 2, and 3	217,400	8	Balance at end of year (line 4 less line 7)	187,400

Corporations with less than \$250,000 of gross receipts and less than \$250,000 in assets do not have to complete Schedule L (balance sheet) and Schedules M-1 and M-2 of Form 1120. Similar rules apply to Form 1120S (used by S corporations). These rules are intended to ease the compliance burden on small business.

17-4e **Schedule M-3—Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More**

Corporate taxpayers with total assets of \$10 million or more are required to report much greater detail relative to differences between income (loss) reported for financial purposes and income (loss) reported for tax purposes. This expanded reconciliation of book and taxable income (loss) is reported on **Schedule M-3**. Corporations that are not required to file Schedule M-3 may do so voluntarily. Any corporation that files Schedule M-3 is not allowed to file Schedule M-1. Corporations (and partnerships) with \$10 million to \$50 million of total assets may elect to file Schedule M-1 in lieu of Schedule M-3, Parts II and III. Electing entities must still file Schedule M-3, Part I (lines 1-12). Entities with less than \$10 million of assets that voluntarily file Schedule M-3 also may elect the reduced Schedule M-3 filing requirements. Schedule M-3 is reproduced in Appendix B of this text.

Schedule M-3 is a response, at least in part, to financial reporting scandals such as Enron and WorldCom. One objective of Schedule M-3 is to create greater transparency between corporate financial statements and tax returns. Another objective is to identify corporations that engage in aggressive tax practices by requiring that transactions that create book-tax differences be disclosed on corporate tax returns. The increase in transparency and disclosure comes at a cost, however, as the IRS estimates that, on average, almost 89 hours are needed to comply with the requirements of Schedule M-3.

Part I—Financial Information and Net Income (Loss) Reconciliation

Part I requires the following financial information about the corporation:

- The source of the financial net income (loss) amount used in the reconciliation—SEC Form 10-K, audited financial statements, prepared financial statements, or the corporation's books and records.
- Any restatements of the corporation's income statement for the filing period, as well as any restatements for the past five filing periods.
- Any required adjustments to the net income (loss) amount referred to previously (see Part I, lines 5 through 10).

The adjusted net income (loss) amount must be reconciled with the amount of taxable income reported on the corporation's Form 1120.

Because of Schedule M-3's complexity, the coverage in this chapter will be limited to some of the more important concepts underlying the schedule. A series of examples adapted from the instructions for Schedule M-3 will be used to illustrate these concepts.

Southwest Sportsman's Corporation (SSC) sells hunting and fishing equipment. SSC has several stores in Texas, New Mexico, and Arizona. It also has a subsidiary in Mexico, which is organized as a Mexican corporation. SSC, which does not file a Form 10-K with the SEC, reports income from its Mexican subsidiary on its audited financial statements, which show net income of \$45 million in 2015. The Mexican corporation, which is not consolidated by SSC for tax purposes and is therefore not an includible corporation, had net income of \$7 million. SSC must enter \$7 million on Part I, line 5a of Schedule M-3, resulting in net income per income statement of includible corporations of \$38 million.

EXAMPLE**41**

A situation similar to that described in Example 41 could result in additional entries in Part I of Schedule M-3. For example, if SSC engaged in transactions with its non-includible Mexican subsidiary, an entry would be required on line 8 (adjustment to eliminations of transactions between includible corporations and nonincludible entities).

Part II—Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations with Taxable Income per Return

Part II reconciles income and loss items of includible corporations, while Part III reconciles expenses and deductions. As indicated in Example 41, corporations included in a financial reporting group may differ from corporations in a tax reporting group. Corporations may also be partners in a partnership, which is a flow-through entity. The following example illustrates the adjustments that are required in this situation.

Southwest Sportsman's Corporation also owns an interest in a U.S. partnership, Southwest Hunting Lodges (SHL). On its audited financial statements, SSC reported net income of \$10 million as its distributive share from SHL. (See Chapter 21 for a complete discussion of partnership taxation.) SSC's Schedule K-1 from SHL reports the following amounts:

Ordinary income	\$5,000,000
Long-term capital gain	7,000,000
Charitable contributions	4,000,000
Section 179 expense	100,000

To adjust for the flow-through items from the partnership, SSC must report these items on Schedule M-3, Part II, line 9 [Income (loss) from U.S. partnerships]. The corporation reports \$10 million (book income) on line 9, column (a). SSC reports income per tax return of \$7.9 million ($\$5,000,000 + \$7,000,000 - \$4,000,000 - \$100,000$) in column (d) of line 9 and a permanent difference of \$2.1 million in column (c).

EXAMPLE**42**

Part III—Reconciliation of Expense/Deduction Items

Part III lists 36 reconciling items relating to expenses and deductions. For these items, taxpayers must reconcile differences between income statement amounts (column a) and tax return amounts (column d), then classify these differences as temporary (column b) or permanent (column c) differences. The totals of the reconciling items from Part III are transferred to Part II, line 27 and are included with other items required to reconcile financial statement net income (loss) to tax return net income (loss).

Book-Tax Differences Reconciled

EXAMPLE

43

Southwest Sportsman's Corporation acquired intellectual property in 2015 and deducted amortization of \$20,000 on its financial statements, which were prepared according to GAAP. For Federal income tax purposes, SSC deducted \$30,000. The corporation must report the amortization on line 28, Part III as follows: \$20,000 book amortization in column (a), \$10,000 temporary difference in column (b), and \$30,000 tax return amortization in column (d).

EXAMPLE

44

In January 2015, Southwest Sportsman's Corporation established an allowance for uncollectible accounts (bad debt reserve) of \$35,000 on its books and increased the allowance by \$65,000 during the year. As a result of a client's bankruptcy, SSC decreased the allowance by \$25,000 in November 2015. The corporation expensed the \$100,000 of increases to the allowance on its 2015 income statement but was not allowed to deduct that amount on its tax return. On its 2015 tax return, the corporation was allowed to deduct the \$25,000 actual loss sustained because of its client's bankruptcy. These amounts must be reported on line 32, Part III as follows: \$100,000 book bad debt expense in column (a), \$75,000 temporary difference in column (b), and \$25,000 tax return bad debt deduction in column (d).

Example 43 illustrates the Schedule M-3 reporting when book expenses are less than tax return deductions. Example 44 illustrates reporting procedures when book expenses are greater than tax return deductions. Both examples illustrate the reporting of temporary differences. The amounts from both examples are included in the totals derived in Part III and are carried to Part II, line 27. The reconciliation of book income and taxable income occurs in lines 26 through 30. The reconciled amount on Part II, line 30, column (a) must be equal to the net income per income statement of includible corporations on Part I, line 11. The reconciled amount on Part II, line 30, column (d) must be equal to the taxable income reported on Form 1120.

LO.7

Determine the impact of tax return positions on corporate financial statements.

17-4f **Income Taxes on the Financial Statements**

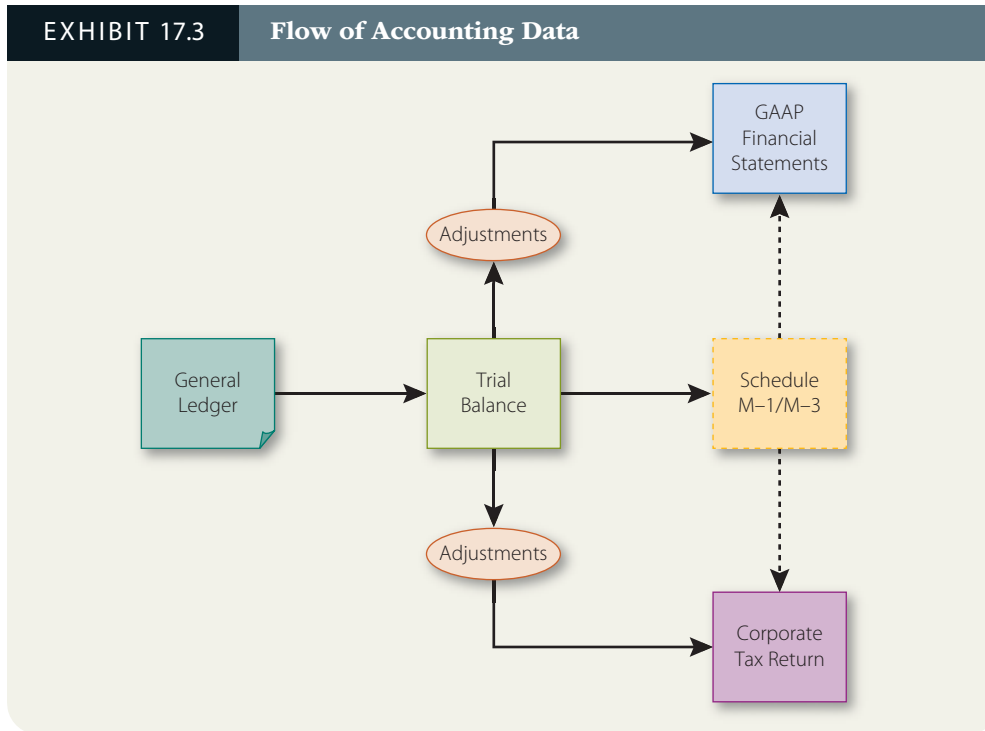
A review of the Schedule M-1 (or Schedule M-3) adjustments to Form 1120 (see prior discussion) reveals considerable differences in the tax and financial accounting treatment of certain transactions. These differences can be *permanent* and appear on the tax return *or* the financial statements but not on both. Permanent differences include interest income on municipal bonds, the dividends received deduction, the domestic production activities deduction, and fines and penalties. Other differences are *temporary* and appear on both the tax return *and* the financial statements but in different periods. Here, the variation is due to timing as to when (or how much of) the transaction is taken into account. Temporary differences include depreciation, depletion, unearned income, reserves for bad debts and product warranties, NOLs, and excess capital losses and charitable contributions. See Exhibit 17.3.

Other differences between the information reported on the tax return and that reflected on the financial statements can arise in parent-subsidary situations. For financial accounting purposes, a corporate group must consolidate all U.S. and foreign subsidiaries within a single financial statement when the parent corporation controls more than 50 percent of the voting power of those subsidiaries.⁴¹ For Federal income tax purposes, however, a consolidated return includes only those *domestic* subsidiaries where the stock ownership is 80 percent or more, while non-U.S. subsidiaries are not eligible for inclusion (refer to previous discussion).⁴²

⁴¹*Consolidation*, ASC Topic 810 (formerly *Consolidation of All Majority Owned Subsidiaries*, Statement of Financial Accounting Standards No. 94). Certain adjustments are made to reduce book income for the after-tax income related to minority shareholders.

⁴²§§ 1504(a) and (b).

EXHIBIT 17.3 Flow of Accounting Data



GAAP Principles

As mentioned earlier, a corporation's financial statements are prepared in accordance with GAAP. The purpose and objectives of these statements are quite different from the objective of the corporation's income tax return.

The **ASC 740 (SFAS 109)** approach produces a total income tax expense (also called the **income tax provision**) for the income currently reported on a corporation's combined financial statement.⁴³ This approach follows the matching principle, where all of the expenses related to earning income are reported in the same period as the income without regard to when the expenses are actually paid.

PanCo, Inc., earns \$100,000 in book income before tax and is subject to a 35% marginal Federal income tax rate. PanCo records a single temporary difference. Tax depreciation exceeds book depreciation by \$20,000. Accordingly, PanCo's taxable income is \$80,000 (\$100,000 – \$20,000 additional tax deduction).

Assuming that the 35 percent corporate rate applies, on its income tax return, PanCo reports total Federal tax expense of \$28,000 ($\$80,000 \times 35\%$). On its financial statement, PanCo reports a total tax expense of \$35,000 ($\$100,000 \times 35\%$). This \$7,000 book-tax difference is the difference between the book and tax basis of the depreciable asset times the current corporate tax rate ($\$7,000 = \$20,000 \times 35\%$).

Although PanCo did not actually pay the \$7,000 tax this year, in future years when the book-tax depreciation difference reverses, the \$7,000 eventually will be paid. Hence, the *future* income tax expense is matched to the related book income and is reported in the current year.

EXAMPLE

45

The total book tax expense under ASC 740 (SFAS 109) is made up of both current and deferred components. The **current tax expense** theoretically represents the taxes actually payable to (or refund receivable from) the governmental authorities for the

⁴³*Income Taxes*, ASC Topic 740 (formerly *Accounting for Income Taxes*, Statement of Financial Accounting Standards No. 109).



TAX IN THE NEWS The Watchdog Is Watching

A recent report by the SEC listed the watchdog agency's areas of focus with respect to the financial statements of publicly traded corporations as they pertain to issues in accounting for income taxes. The most important of the focus areas include the following:

- Realizability of deferred tax assets—how positive and negative evidence supporting the deferrals is assessed by the taxpayer.
- Uncertain tax positions—whether ASC 740-10 (FIN 48) disclosures are comprehensive and complete.
- Foreign earnings—whether sufficient information is provided concerning the reinvestments of overseas earnings and their effects on the effective tax rate.

Income tax matters remain the accounting area most frequently identified as a material weakness for large entities, and income taxes always rank among the ten most frequent restatement issues.

The Edgar database is a good place to follow trends in the agency's information requests and the taxpayer's responses.

current period. One might think of this amount as the actual check the taxpayer writes to the government (or refund received) for the current year. Exhibit 17.4 summarizes the computation of a corporation's current tax expense.

The deferred component of the book tax expense is called the **deferred tax expense** or **deferred tax benefit**. This component represents the future tax cost (or savings) connected with income reported in the current-period financial statement. Deferred tax expense or benefit is created as a result of temporary differences. More technically, ASC 740 (SFAS 109) adopts a **balance sheet approach** to measuring deferred taxes. Under this approach, the deferred tax expense or benefit is the change from one year to the next in the net **deferred tax liability** or **deferred tax asset**.

A deferred tax liability is the expected future tax liability related to current income (measured using enacted tax rates and rules).⁴⁴ A deferred tax liability is created in the following situations:

- An item is deductible for tax in the current period but is not expensed for book until some future period.
- Income is includible currently for book purposes but is not includible in taxable income until a future period.

In essence, a deferred tax liability is created when the book basis of an asset exceeds its tax basis (the opposite condition creates a deferred tax asset).

EXHIBIT 17.4 Current Tax Expense*

	Pretax book income
±	Schedule M-1/M-3 adjustments
	<hr/> Taxable income before NOLs
–	NOL carryforwards
	<hr/> Taxable income
×	Applicable tax rate
	<hr/> Current tax expense (provision) before tax credits
–	Tax credits
	<hr/> <hr/> Current tax expense (tax provision)

*Simplified calculation.

⁴⁴If the tax rate will be different in future years, the *enacted* future tax rate should be used in the computation.

Deferred Tax Expense

EXAMPLE

46

PJ Enterprises earns net income before depreciation of \$500,000 in 2015 and \$600,000 in 2016. PJ uses a single depreciable asset acquired in 2015 for \$80,000. For tax purposes, PJ may deduct \$60,000 in depreciation expense for the first year and \$20,000 in depreciation expense for the second year (i.e., it uses an accelerated method). For book purposes, PJ depreciates the asset on a straight-line basis over two years (\$40,000 in depreciation expense per year).

2015

	Book	Tax
Income before depreciation	\$500,000	\$500,000
Depreciation	(40,000)	(60,000)
Income after depreciation	\$460,000	\$440,000
Corporate tax rate	× 35%	× 35%
Income tax expense/payable	<u>\$161,000</u>	<u>\$154,000</u>
Current tax expense	<u>\$154,000</u>	
Deferred tax expense	<u>\$ 7,000</u>	
Starting adjusted basis in depreciable asset	\$ 80,000	\$ 80,000
Ending adjusted basis in depreciable asset	(40,000)	(20,000)
Change in adjusted basis	<u>\$ 40,000</u>	<u>\$ 60,000</u>
Book-tax balance sheet difference		\$20,000
Corporate tax rate		× 35%
Deferred tax liability		<u>\$ 7,000</u>

In this example, it is easy to “back into” the deferred tax expense amount of \$7,000 by taking the difference between the tax liability per the tax return (\$154,000) and the book tax expense (\$161,000). This method is referred to as the “APB 11” approach, as it applies to the method used before ASC 740 (SFAS 109). Although this method may provide a quick check on the calculation in simple cases, it is not always correct. Be careful to calculate the deferred tax expense using the difference between the book and tax asset basis numbers (\$20,000) at the enacted corporate tax rate (35%).

2016

	Book	Tax
Income before depreciation	\$600,000	\$600,000
Depreciation	(40,000)	(20,000)
Income after depreciation	\$560,000	\$580,000
Corporate tax rate	× 35%	× 35%
Income tax expense/payable	<u>\$196,000</u>	<u>\$203,000</u>
Current tax expense	<u>\$203,000</u>	
Deferred tax expense	<u>(\$ 7,000)</u>	
Starting adjusted basis in depreciable asset	\$ 40,000	\$ 20,000
Ending adjusted basis in depreciable asset	(–0–)	(–0–)
Change in adjusted basis	<u>\$ 40,000</u>	<u>\$ 20,000</u>
Book-tax balance sheet difference		(\$20,000)
Corporate tax rate		× 35%
Deferred tax liability		<u>\$ 7,000</u>

In 2016, the book-tax difference in the asset basis reverses, with a resulting reduction of the deferred tax liability account.

Deferred Tax Expense

EXAMPLE

47

Continue with the facts in Example 46. The following journal entries record the book tax expense (provision) for each year. The book total tax expense combines the current amount (income tax payable) and the future amount (deferred tax liability).

2015 Journal Entry

Income tax expense (provision)	\$161,000	
Income tax payable		\$154,000
Deferred tax liability		7,000

2016 Journal Entry

Income tax expense (provision)	\$196,000	
Deferred tax liability	7,000	
Income tax payable		\$203,000

At the end of 2015, the PJ balance sheet reflects a net deferred tax liability of \$7,000. At the end of 2016, the PJ balance sheet contains a zero deferred tax liability; the temporary difference that created the deferred tax liability has reversed itself.

In contrast to a deferred tax liability, a deferred tax asset is the expected future tax benefit related to current book income (measured using enacted tax rates and rules). A deferred tax asset is created in the following situations:

- An expense is deductible for book in the current period but is not deductible for tax until some future period.
- Income is includible in taxable income currently but is not includible in book income until a future period.

Deferred tax assets and liabilities are reported on the balance sheet just as any other asset or liability would be. However, the interpretation of these assets and liabilities is quite different. Typically, an asset is “good” because it represents a claim on something of value, and a liability is “bad” because it represents a future claim against the corporation’s assets. In the case of deferred tax assets and liabilities, the interpretation is reversed. Deferred tax liabilities are “good” because they represent an amount that may be paid to the government in the future.

In essence, deferred tax liabilities are like an interest-free loan from the government with a due date perhaps many years in the future. Deferred tax assets, on the other hand, are future tax benefits and thus are similar to a receivable from the government that may not be received until many years in the future.⁴⁵

LO.8

Evaluate corporations as an entity form for conducting a business.

17-5 TAX PLANNING

17-5a Corporate versus Noncorporate Forms of Business Organization

The decision to use the corporate form in conducting a trade or business must be weighed carefully. Besides the nontax considerations of the corporate form (limited liability, continuity of life, free transferability of interests, centralized management), tax ramifications will play an important role in any such decision. Close attention should be paid to the following:

1. Operating as a regular corporate entity (C corporation) results in the imposition of the corporate income tax. Corporate taxable income will be taxed twice—once as earned by the corporation and again when distributed to the shareholders. Because dividends are not deductible, a closely held corporation may have a

⁴⁵For a more complete discussion of the impact of taxes on the financial statements, see *South-Western Federal Taxation: Corporations, Partnerships, Estates & Trusts* (2016 edition), Chapter 14.

strong incentive to structure corporate distributions in a deductible form. Before legislation in 2003 lowered the rate on qualified dividends to 15 percent, shareholders had a tax incentive to bail out profits in the form of salaries, interest, or rent.⁴⁶ With the current 15 or 20 percent rate on qualified dividends, shareholders may save taxes by having the corporation pay dividends rather than salaries, rent, or interest, which could be taxed at an individual marginal rate as high as 39.6 percent. The decision should be made only after comparing the tax cost of the two alternatives. The 3.8 percent Medicare surtax on net investment income (including dividend and net capital gain income) also must be considered in this analysis.

2. The differences in Federal tax brackets between an individual and a corporation may not be substantial. Furthermore, several state and local governments impose higher taxes on corporations than on individuals. In these jurisdictions, the combined Federal, state, and local tax rates on the two types of taxpayers are practically identical. Consequently, the tax ramifications of incorporating can be determined *only* on a case-by-case basis.
3. Corporate-source income loses its identity as it passes through the corporation to the shareholders. Thus, preferential tax treatment of certain items by the corporation (e.g., interest on municipal bonds) does not carry over to the shareholders.
4. As noted in Chapter 19, it may be difficult for shareholders to recover some or all of their investment in the corporation without an ordinary income result. Most corporate distributions are treated as dividends to the extent of the corporation's earnings and profits. However, the preferential rate on qualified dividends reduces the impact of such a result.
5. Corporate losses cannot be passed through to the shareholders.⁴⁷
6. The liquidation of a corporation will normally generate tax consequences to both the corporation and its shareholders (see Chapter 20).
7. The corporate form provides shareholders with the opportunity to be treated as employees for tax purposes if the shareholders render services to the corporation. Such status makes a number of attractive tax-sheltered fringe benefits available. They include, but are not limited to, group term life insurance and excludible meals and lodging. One of the most attractive benefits of incorporation is the ability of the business to provide accident and health insurance to its employees, including shareholder-employees. Such benefits are not included in the employee's gross income. Similar rules apply to other medical costs paid by the employer. These benefits are not available to partners, sole proprietors, and more-than-2 percent shareholder-employees of S corporations.

17-5b Operating the Corporation

Tax planning to reduce corporate income taxes should occur before the end of the tax year. Effective planning can cause income to be shifted to the next tax year and can produce large deductions by incurring expenses before year-end. Particular attention should be focused on the following.

Charitable Contributions

Recall that accrual basis corporations may claim a deduction for charitable contributions in the year preceding payment. The contribution must be authorized by the board of directors by the end of the tax year and paid on or before the fifteenth day of the third month of the following year. It might be useful to authorize a contribution even though it may not ultimately be made. A deduction cannot be thrown back to the previous year (even if paid within the two and a half months) if it has not been authorized.

The enhanced deduction amount for contributions of qualified inventory can produce significant tax savings. Gifts of inventory should be designed to take advantage of this provision whenever feasible. Effort should be taken to properly document the type

⁴⁶Such procedures lead to a multitude of problems, one of which, the reclassification of debt as equity, is discussed in Chapter 18. The problems of unreasonable salaries and rents are covered in Chapter 19 in the discussion of constructive dividends.

⁴⁷Points 1, 2, and 5 could be resolved by making a Subchapter S election (see Chapter 22), assuming that the corporation qualifies for the election. In part, the same can be said for point 3.

of inventory donated and each recipient charitable organization, as the statutory provisions that allow for an enhanced deduction have very specific requirements for qualification. Further, a corporation's cost of goods sold must be reduced to reflect any charitable contribution of inventory.

Timing of Capital Gains and Losses

A corporation should consider offsetting gains on the sale of capital assets by selling some of the depreciated securities in the corporate portfolio. In addition, any already realized capital losses should be carefully monitored. Recall that corporate taxpayers are not permitted to claim any net capital losses as deductions against ordinary income. Capital losses can be used only as an offset against capital gains. Further, net capital losses can only be carried back three years and forward five. Gains from the sales of capital assets should be timed to offset any capital losses. The expiration of the carry-over period for any net capital losses should be watched carefully so that sales of appreciated capital assets occur before that date.

Net Operating Losses

In some situations, electing to forgo an NOL carryback and utilizing the carryforward option may generate greater tax savings. When deciding whether to forgo the carryback option, several factors should be considered. First, the present value of the tax refund that is lost by not using the carryback procedure should be calculated. Second, the election to forgo an NOL carryback is irrevocable. Thus, one cannot later choose to change if the predicted high profits do not materialize. Third, consider the future increases (or decreases) in corporate income tax rates that can reasonably be anticipated. This last consideration is the most difficult to work with. The current political environment appears receptive to tax reform legislation that would result in a decrease in the corporate income tax rates.

Dividends Received Deduction

In those cases where the taxable income limitation is applicable to a corporation's dividends received deduction, consideration should be given to the proper timing of income and deductions so as to bring the NOL rule into play. The NOL rule, the exception to the taxable income limitation, can result in a significant increase in the amount of a corporation's dividends received deduction.

EXAMPLE

48

Pearl Corporation, a calendar year C corporation, has the following information for the year:

Gross income from operations	\$ 200,000
Expenses from operations	(225,000)
Dividends received from domestic corporations (less than 20% ownership)	<u>100,000</u>
Taxable income before dividends received deduction	<u>\$ 75,000</u>

Pearl's dividends received deduction is \$52,500 [$70\% \times \$75,000$ (taxable income limitation)]. If, however, Pearl incurs additional expenses of \$5,001 (or defers \$5,001 of income), then the NOL rule applies and Pearl's dividends received deduction is \$70,000 [$70\% \times \$100,000$ (dividends received)].

Organizational Expenditures

To qualify for the 180-month amortization procedure of § 248, only organizational expenditures incurred in the corporation's first tax year can be considered. This rule could prove to be an unfortunate trap for corporations formed late in the year.

EXAMPLE

49

Thrush Corporation is formed in December 2015. Qualified organizational expenditures are incurred as follows: \$62,000 in December 2015 and \$30,000 in January 2016. If Thrush uses the calendar year for tax purposes, only \$62,000 of the organizational expenditures can be written off over a period of 180 months.

The solution to the problem posed by Example 49 is for Thrush Corporation to adopt a fiscal year that ends at or beyond January 31. All organizational expenditures will then have been incurred before the close of the first tax year.

Shareholder-Employee Payment of Corporate Expenses

In a closely held corporate setting, shareholder-employees often pay corporate expenses (e.g., travel and entertainment) for which they are not reimbursed by the corporation. The IRS often disallows the deduction of these expenses by the shareholder-employee because the payments are voluntary on his or her part. If the deduction is more beneficial at the shareholder-employee level, a corporate policy against reimbursement of such expenses should be established. Proper planning in this regard would be to decide before the beginning of each tax year where the deduction would do the most good. Corporate policy on reimbursement of such expenses could be modified on a year-to-year basis depending upon the circumstances.

In deciding whether corporate expenses should be kept at the corporate level or shifted to the shareholder-employee, the treatment of unreimbursed employee expenses must be considered. First, because employee expenses are itemized deductions, they will be of no benefit to the taxpayer who chooses the standard deduction option. Second, these expenses will be subject to the 2 percent-of-AGI floor. No such limitation will be imposed if the corporation claims the expenses.

REFOCUS ON THE BIG PICTURE

COOKED TO PERFECTION

Conducting Skylark Bakery as a C corporation would save Samantha \$9,375 in income taxes annually, computed as follows:

Bakery Operated as Sole Proprietorship	
Operating profit of \$100,000:	
Tax on \$100,000 @ 33%	\$33,000
Dividends of \$5,000:	
Tax on \$5,000 @ 15%	750
Withdrawals of \$50,000:	
No tax	-0-
Total income tax when operated as sole proprietorship	<u>\$33,750</u>

Bakery Operated as Regular (C) Corporation	
Corporate taxable income of \$51,500*:	
Tax on \$50,000 @ 15%	\$ 7,500
Tax on \$1,500 @ 25%	375
Total corporate income tax	<u>\$ 7,875</u>
Samantha's salary of \$50,000:	
Tax on \$50,000 @ 33%	16,500
Total income tax when operated as C corporation	<u>\$24,375</u>

*Computation of corporate taxable income:

Operating profit	\$100,000
Dividend income	5,000
Less: Salary to Samantha	(50,000)
Dividends received deduction (70%)	(3,500)
Taxable income	<u>\$ 51,500</u>



continued

The example illustrates the tax savings available when a high-income individual taxpayer takes advantage of the lower marginal tax rates of C (regular) corporations. However, other issues, such as employment tax considerations and the taxation of dividend distributions (income and Medicare surtax) also should be considered. Further, other potential entity options, such as the LLC and S corporation, also should be evaluated.

What If?

What if the bakery in the first year it becomes a corporation generates a \$10,000 short-term capital loss (STCL) on the disposition of some of its stock investments? Regular corporations can only deduct capital losses against capital gains; thus, the \$10,000 STCL would not be deductible currently by the corporation and, instead, would be carried forward for up to five years. If the bakery is operated as a sole proprietorship, Samantha would report the capital loss on her individual return. She could use the \$10,000 STCL to offset any capital gains she may have and deduct up to \$3,000 of the loss against ordinary income.

Key Terms

Affiliated group, 17-25	Deferred tax liability, 17-34	Organizational expenditures, 17-18
ASC 740 (SFAS 109), 17-33	Disregarded entity, 17-7	Parent-subsidiary controlled group, 17-23
Balance sheet approach, 17-34	Dividends received deduction, 17-16	Passive loss, 17-12
C corporations, 17-3	Domestic production activities deduction (DPAD), 17-15	Personal service corporations (PSCs), 17-9
Check-the-box Regulations, 17-7	Generally accepted accounting principles (GAAP), 17-29	Regular corporations, 17-3
Controlled group, 17-23	Income tax provision, 17-33	Related corporations, 17-22
Current tax expense, 17-33	Limited liability company (LLC), 17-6	S corporations, 17-3
Deferred tax asset, 17-34	Limited partnerships, 17-6	Schedule M-1, 17-29
Deferred tax benefit, 17-34		Schedule M-3, 17-30
Deferred tax expense, 17-34		

Discussion Questions

- LO.1** Jennifer and Jamie are starting a business and have asked you for advice about whether they should form a partnership, a corporation, or some other type of entity. Prepare a list of questions you would ask in helping them decide which type of entity they should choose. Explain your reasons for asking each of the questions.
- LO.1** Barbara owns 40% of the stock of Cassowary Corporation (a C corporation) and 40% of the stock of Emu Corporation (an S corporation). In the current year, each corporation has operating income of \$120,000 and tax-exempt interest income of \$8,000. Neither corporation pays any dividends during the year. Discuss how this information will be reported by the corporations and Barbara for the year.

Decision Making

- LO.1, 8** Art, an executive with Azure Corporation, plans to start a part-time business selling products on the Internet. He will devote about 15 hours each week to running the business. Art's salary from Azure places him in the 35% tax bracket. He projects substantial losses from the new business in each of the first three years and expects sizable profits thereafter. Art plans to leave the profits in the business for several years, sell the business, and retire. Would you advise Art to incorporate the business or operate it as a sole proprietorship? Why?

4. **LO.1, 2** Janice is the sole owner of Catbird Company. In the current year, Catbird had operating income of \$100,000, a long-term capital gain of \$15,000, and a charitable contribution of \$5,000. Janice withdrew \$70,000 of profit from Catbird. How should Janice report this information on her individual tax return if Catbird Company is:
- An LLC?
 - An S Corporation?
 - A C corporation?
5. **LO.1, 2** Joel is the sole shareholder of Manatee Corporation, a C corporation. Because Manatee's sales have increased significantly over the last several years, Joel has determined that the corporation needs a new distribution warehouse. Joel has asked your advice as to whether (1) Manatee should purchase the warehouse or (2) he should purchase the warehouse and lease it to Manatee. What relevant tax issues will you discuss with Joel? **Issue ID**
6. **LO.1** In the current year, Juanita and Joseph form a two-member LLC and do not file Form 8832 (Entity Classification Election). As a result, the LLC will be treated as a partnership for Federal tax purposes. Assess the validity of this statement.
7. **LO.2** In the current year, Jeanette, an individual in the 25% marginal tax bracket, recognized a \$20,000 long-term capital gain. Also in the current year, Parrot Corporation, a C corporation in the 25% marginal tax bracket, recognized a \$20,000 long-term capital gain. Neither taxpayer had any other property transactions in the year. What tax rates are applicable to these capital gains?
8. **LO.2** John (a sole proprietor) and Eagle Corporation (a C corporation) each recognize a long-term capital gain of \$10,000 and a short-term capital loss of \$18,000 on the sale of capital assets. Neither taxpayer had any other property transactions during the year. Describe the tax consequences of these gains and losses for John and for Eagle.
9. **LO.2** A taxpayer sells a warehouse for a recognized gain. Depreciation had been properly claimed on the property, based on the straight-line method over a 39-year recovery period. Will the same amount of depreciation recapture result whether the taxpayer is an individual or a C corporation? Explain.
10. **LO.2** Osprey Corporation, a closely held corporation, has \$100,000 of net active income, \$25,000 of portfolio income, and a \$120,000 loss from a passive activity.
- How much of the passive loss can Osprey deduct in the current year if it is a PSC?
 - If it is not a PSC?
11. **LO.2** On December 24, 2015, the directors of Partridge Corporation, an accrual basis calendar year taxpayer, authorized a cash contribution of \$10,000 to the American Cancer Association. The payment is made on April 14, 2016. Can Partridge deduct the charitable contribution in 2015? Explain.
12. **LO.2, 8** The board of directors of Orange Corporation, a calendar year taxpayer, is holding its year-end meeting on December 30, 2015. One topic on the board's agenda is the approval of a \$25,000 gift to a qualified charitable organization. Orange has a \$20,000 charitable contribution carryover to 2015 from a prior year. Identify the tax issues the board should consider regarding the proposed contribution. **Issue ID**
13. **LO.2, 3, 8** Gold Corporation, a calendar year C corporation, was formed in 2009 and has been profitable until the current year. In 2015, Gold incurs a net operating loss. Identify the issues that Gold Corporation should consider regarding its NOL carryback and carryover options. **Issue ID**

14. **LO.1, 3** Marmot Corporation pays a dividend of \$100,000 in the current year. Otter Corporation, which is in the 25% marginal bracket, owns 15% of Marmot's stock. Gerald, an individual taxpayer in the 25% marginal bracket, also owns 15% of Marmot's stock. Compare and contrast the treatment of the dividend by Otter Corporation and Gerald.
15. **LO.3** Determine whether the following expenditures by Cuckoo Corporation are organizational expenditures, startup expenditures, or neither.
- Legal expenses incurred for drafting the corporate charter and bylaws.
 - Accounting fees incurred in organization.
 - Expenses of temporary board of directors' organizational meetings.
 - Employee salaries incurred during the training period before opening for business.
 - Brokerage fees incurred in initial stock sales.
16. **LO.6** When are C corporations required to make estimated tax payments? How are these payments calculated?
17. **LO.6** Schedule M-1 of Form 1120 is used to reconcile financial accounting net income with taxable income reported on the corporation's income tax return as follows: net income per books + additions – subtractions = taxable income. Classify the following items as additions or subtractions in the Schedule M-1 reconciliation.
- Life insurance proceeds received upon death of covered executive.
 - Tax depreciation in excess of book depreciation.
 - Federal income tax per books.
 - Capital loss in excess of capital gain.
 - Charitable contributions in excess of taxable income limitation.
 - Premiums paid on life insurance policies covering executives (corporation is beneficiary).
 - Domestic production activities deduction.
18. **LO.6** In the current year, Woodpecker, Inc., a C corporation with \$8.5 million in assets, reported amortization of \$40,000 on its financial statements and deducted amortization of \$55,000 on its Federal tax return. Is Woodpecker required to file Schedule M-3? If a Schedule M-3 is filed by Woodpecker, how is the difference in amortization amounts treated on that schedule?

Communications 19. **LO.7** Marcellus Jackson, the CFO of Mac, Inc., notices that the tax liability reported on Mac's tax return is less than the tax expense reported on Mac's financial statements. Provide a letter to Jackson outlining why these two tax expense numbers differ. Mac's address is 482 Linden Road, Paris, KY 40362.

Issue ID 20. **LO.7** Define the terms *temporary difference* and *permanent difference* as they pertain to the financial reporting of income tax expenses. Describe how these two book-tax differences affect the gap between book and taxable income. How are permanent and temporary differences alike? How are they different?

Computational Exercises

21. **LO.2** Goose Corporation, a C corporation, incurs a net capital loss of \$12,000 for 2015. It also has ordinary income of \$10,000 in 2015. Goose had net capital gains of \$2,500 in 2011 and \$5,000 in 2014.
- Determine the amount, if any, of the net capital loss of \$12,000 that is deductible in 2015.
 - Determine the amount, if any, of the net capital loss of \$12,000 that is carried forward to 2016.

22. **LO.2** Aqua Corporation purchases nonresidential real property on May 9, 2012, for \$1 million. Straight-line cost recovery is taken in the amount of \$89,765 before the property is sold on November 30, 2015, for \$1.5 million.
- Compute the amount of Aqua's recognized gain on the sale of the realty.
 - Determine the amount of the recognized gain that is treated as § 1231 gain and the amount that is treated as § 1250 recapture (ordinary income).
23. **LO.2** Hummingbird Corporation, a closely held C corporation that is not a PSC, has \$40,000 of net active income, \$15,000 of portfolio income, and a \$45,000 loss from a passive activity. Compute Hummingbird's taxable income for the year.
24. **LO.2** Compute the charitable contribution deduction (ignoring the percentage limitation) for each of the following C corporations.
- Amber Corporation donated inventory of clothing (basis of \$24,000, fair market value of \$30,000) to a qualified charitable organization that operates homeless shelters.
 - Brass Corporation donated stock held as an investment to Western College (a qualified organization). Brass acquired the stock three years ago for \$18,000, and the fair market value on the date of the contribution is \$32,000. Western College plans on selling the stock.
 - Ruby Corporation donates a sculpture worth \$130,000 to a local museum (a qualified organization), which exhibits the sculpture. Ruby acquired the sculpture four years ago for \$55,000.
25. **LO.3** Crane and Loon Corporations, two unrelated C corporations, have the following transactions for 2015:

	Crane	Loon
Gross income from operations	\$180,000	\$300,000
Expenses from operations	255,000	310,000
Dividends received from domestic corporations (15% ownership)	100,000	230,000

- Compute the dividends received deduction for Crane Corporation.
 - Compute the dividends received deduction for Loon Corporation.
26. **LO.3** Cherry Corporation, a calendar year C corporation, is formed and begins business on April 1, 2015. In connection with its formation, Cherry incurs organizational expenditures of \$54,000. Determine Cherry Corporation's deduction for organizational expenditures for 2015.
27. **LO.4** Compute the income tax liability for each of the following unrelated C corporations.
- Darter Corporation has taxable income of \$68,000.
 - Owl Corporation has taxable income of \$10,800,000.
 - Toucan Corporation, a personal service corporation, has taxable income of \$170,000.

Problems

28. **LO.1, 2** In the current year, Riflebird Company had operating income of \$220,000, operating expenses of \$175,000, and a long-term capital loss of \$10,000. How do Riflebird Company and Roger, the sole owner of Riflebird, report this information on their respective Federal income tax returns for the current year under the following assumptions?
- Riflebird Company is a proprietorship (Roger did not make any withdrawals from the business).
 - Riflebird Company is a C corporation (no dividends were paid during the year).

29. **LO.1, 2** Ellie and Linda are equal owners in Otter Enterprises, a calendar year business. During the current year, Otter Enterprises has \$320,000 of gross income and \$210,000 of operating expenses. In addition, Otter has a long-term capital gain of \$15,000 and makes distributions to Ellie and Linda of \$25,000 each. Discuss the impact of this information on the taxable income of Otter, Ellie, and Linda if Otter is:
- A partnership.
 - An S corporation.
 - A C corporation.
30. **LO.1, 2** In the current year, Azure Company has \$350,000 of net operating income before deducting any compensation or other payment to its sole owner, Sasha. In addition, Azure has interest on municipal bonds of \$25,000. Sasha has significant income from other sources and is in the 39.6% marginal tax bracket. Based on this information, determine the income tax consequences to Azure Company and to Sasha during the year for each of the following independent situations.
- Azure is a C corporation and pays no dividends or salary to Sasha.
 - Azure is a C corporation and distributes \$75,000 of dividends to Sasha.
 - Azure is a C corporation and pays \$75,000 of salary to Sasha.
 - Azure is a sole proprietorship, and Sasha withdraws \$0.
 - Azure is a sole proprietorship, and Sasha withdraws \$75,000.
31. **LO.2** In the current year, Wilson Enterprises, a calendar year taxpayer, suffers a casualty loss of \$90,000. How much of the casualty loss will be deductible by Wilson under the following circumstances?
- Wilson is an individual proprietor and has AGI of \$225,000. The casualty loss was a personal loss, and the insurance recovered was \$50,000.
 - Wilson is a corporation, and the insurance recovered was \$50,000.
32. **LO.1, 4, 8** Benton Company (BC) has one owner, who is in the 33% Federal income tax bracket. BC's gross income is \$395,000, and its ordinary trade or business deductions are \$245,000. Compute the Federal income tax liability on BC's income for the current year under the following assumptions:
- BC is operated as a proprietorship, and the owner withdraws \$100,000 for personal use.
 - BC is operated as a corporation, pays out \$100,000 as salary, and pays no dividends to its shareholder.
 - BC is operated as a corporation and pays out no salary or dividends to its shareholder.
 - BC is operated as a corporation, pays out \$100,000 as salary to its shareholder, and pays out the remainder of its earnings as dividends.
 - Assume that Robert Benton of 1121 Monroe Street, Ironton, OH 45638 is the owner of BC, which was operated as a proprietorship. Robert is thinking about incorporating the business for next year and asks your advice. He expects about the same amounts of income and expenses and plans to take \$100,000 per year out of the company whether he incorporates or not. Write a letter to Robert [based on your analysis in (a) and (b)] containing your recommendations.
33. **LO.2, 4** In the current year, Tanager Corporation (a C corporation) had operating income of \$480,000 and operating expenses of \$390,000. In addition, Tanager had a long-term capital gain of \$55,000 and a short-term capital loss of \$40,000.
- Compute Tanager's taxable income and tax for the year.
 - Assume, instead, that Tanager's long-term capital gain was \$15,000 (not \$55,000). Compute Tanager's taxable income and tax for the year.
34. **LO.2** Virginia owns 100% of Goshawk Company. In the current year, Goshawk Company sells a capital asset (held for three years) at a loss of \$40,000. In addition, Goshawk has a short-term capital gain of \$18,000 and net operating

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income of \$90,000 during the year. Virginia has no recognized capital gain (or loss) before considering her ownership in Goshawk. How much of the capital loss may be deducted for the year and how much is carried back or forward if Goshawk is:

- a. A proprietorship?
 - b. A C corporation?
35. **LO.2** During 2015, Gorilla Corporation has net short-term capital gains of \$15,000, net long-term capital losses of \$105,000, and taxable income from other sources of \$460,000. Prior years' transactions included the following:

2011 net short-term capital gains	\$40,000
2012 net long-term capital gains	18,000
2013 net short-term capital gains	25,000
2014 net long-term capital gains	20,000

- a. How are the capital gains and losses treated on Gorilla's 2015 tax return?
 - b. Determine the amount of the 2015 capital loss that is carried back to each of the previous years.
 - c. Compute the amount of capital loss carryforward, if any, and indicate the years to which the loss may be carried.
 - d. If Gorilla is a sole proprietorship, rather than a corporation, how would the owner report these transactions on her 2015 tax return?
36. **LO.2** Heron Company purchases commercial realty on November 13, 1997, for \$650,000. Straight-line depreciation of \$287,492 is claimed before the property is sold on February 23, 2015, for \$850,000. What are the tax consequences of the sale of realty if Heron is:
- a. A C corporation?
 - b. A sole proprietorship?
37. **LO.2** In the current year, Plum, Inc., a closely held C corporation, has \$410,000 of net active income, \$20,000 of portfolio income, and a \$75,000 passive activity loss. What is Plum's taxable income for the current year under the following circumstances?
- a. Plum is a personal service corporation.
 - b. Plum is not a personal service corporation.
38. **LO.2, 8** Joseph Thompson is president and sole shareholder of Jay Corporation. In December 2015, Joe asks your advice regarding a charitable contribution he plans to have the corporation make to the University of Maine, a qualified public charity. Joe is considering the following alternatives as charitable contributions in December 2015:

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	Fair Market Value
(1) Cash donation	\$200,000
(2) Unimproved land held for six years (\$110,000 basis)	200,000
(3) Maize Corporation stock held for eight months (\$140,000 basis)	200,000
(4) Brown Corporation stock held for nine years (\$360,000 basis)	200,000

Joe has asked you to help him decide which of these potential contributions will be most advantageous taxwise. Jay's taxable income is \$3.5 million before considering the contribution. Rank the four alternatives, and write a letter to Joe communicating your advice. The corporation's address is 1442 Main Street, Freeport, ME 04032.

39. **LO.2, 8** In 2015, Gray Corporation, a calendar year C corporation, has a \$75,000 charitable contribution carryover from a gift made in 2010. Gray is contemplating a gift of land to a qualified charity in either 2015 or 2016. Gray purchased

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the land as an investment five years ago for \$100,000 (current fair market value is \$250,000). Before considering any charitable deduction, Gray projects taxable income of \$1 million for 2015 and \$1.2 million for 2016. Should Gray make the gift of the land to charity in 2015 or in 2016? Provide support for your answer.

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40. **LO.2, 8** Dan Simms is the president and sole shareholder of Simms Corporation, 1121 Madison Street, Seattle, WA 98121. Dan plans for the corporation to make a charitable contribution to the University of Washington, a qualified public charity. He will have the corporation donate Jaybird Corporation stock, held for five years, with a basis of \$11,000 and a fair market value of \$25,000. Dan projects a \$310,000 net profit for Simms Corporation in 2015 and a \$100,000 net profit in 2016. Dan calls you on December 11, 2015, and asks whether he should make the contribution in 2015 or 2016. Write a letter advising Dan about the timing of the contribution.
41. **LO.2** White Corporation, a calendar year C corporation, manufactures plumbing fixtures. For the current year, White has taxable income [before the domestic production activities deduction (DPAD)] of \$900,000, qualified production activities income (QPAI) of \$1.2 million, and W-2 wages attributable to QPAI of \$200,000.
- How much is White Corporation's DPAD?
 - Assume instead that W-2 wages attributable to QPAI are \$150,000. How much is White's DPAD?
42. **LO.2, 3** During the current year, Swallow Corporation, a calendar year C corporation, has the following transactions:

Income from operations	\$660,000
Expenses from operations	720,000
Dividends received from Brown Corporation	240,000

- Swallow Corporation owns 12% of Brown Corporation's stock. How much is Swallow's taxable income or NOL for the year?
 - Assume instead that Swallow Corporation owns 26% of Brown Corporation's stock. How much is Swallow's taxable income or NOL for the year?
43. **LO.3** In each of the following independent situations, determine the dividends received deduction. Assume that none of the corporate shareholders owns 20% or more of the stock in the corporations paying the dividends.

	Almond Corporation	Blond Corporation	Cherry Corporation
Income from operations	\$ 700,000	\$ 800,000	\$ 900,000
Expenses from operations	(600,000)	(850,000)	(910,000)
Qualifying dividends	100,000	100,000	100,000

44. **LO.3** Gull Corporation, a cash method, calendar year C corporation, was formed and began business on November 1, 2015. Gull incurred the following expenses during its first year of operations (November 1, 2015–December 31, 2015):
- | | |
|---|----------|
| Expenses of temporary directors and organizational meetings | \$21,000 |
| Fee paid to state of incorporation | 3,000 |
| Expenses for printing and sale of stock certificates | 11,000 |
| Legal services for drafting the corporate charter and bylaws
(not paid until January 2016) | 19,000 |
- Assuming that Gull Corporation elects under § 248 to expense and amortize organizational expenditures, what amount may be deducted in 2015?
 - Assume the same facts as above, except that the amount paid for the legal services was \$28,000 (instead of \$19,000). What amount may be deducted as organizational expenditures in 2015?

45. **LO.3** Egret Corporation, a calendar year C corporation, was formed on March 6, 2015, and opened for business on July 1, 2015. After its formation but prior to opening for business, Egret incurred the following expenditures:

Accounting	\$ 7,000
Advertising	14,500
Employee payroll	11,000
Rent	8,000
Utilities	1,000

What is the maximum amount of these expenditures that Egret can deduct in 2015?

46. **LO.4** In each of the following *independent* situations, determine the corporation's income tax liability. Assume that all corporations use a calendar year for tax purposes and that the tax year involved is 2015.

	Taxable Income
Purple Corporation	\$ 65,000
Azul Corporation	290,000
Pink Corporation	12,350,000
Turquoise Corporation	19,000,000
Teal Corporation (a personal service corporation)	130,000

47. **LO.5** Red Corporation and White Corporation, both calendar year C corporations, are members of a controlled group of corporations. For the current year, Red has taxable income of \$130,000, and White has taxable income of \$200,000. Assuming that the controlled group does not make an election regarding the apportionment of the marginal tax brackets, what is the income tax liability for each of the corporations?
48. **LO.6** The following information for 2015 relates to Sparrow Corporation, a calendar year, accrual method taxpayer.

Net income per books (after-tax)	\$174,100
Federal income tax expense per books	86,600
Tax-exempt interest income	4,500
MACRS depreciation in excess of straight-line depreciation used for financial statement purposes	7,200
Excess of capital loss over capital gains	9,400
Nondeductible meals and entertainment	5,500
Interest on loan to purchase tax-exempt bonds	1,100

Based on the above information, use Schedule M-1 of Form 1120, which is available on the IRS website, to determine Sparrow's taxable income for 2015.

49. **LO.6** Dove Corporation, a calendar year C corporation, had the following information for 2015:

Net income per books (after-tax)	\$386,250
Taxable income	120,000
Federal income tax per books	30,050
Cash dividend distributions	150,000
Unappropriated retained earnings, as of January 1, 2015	796,010

Based on the above information, use Schedule M-2 of Form 1120 (see Example 40 in the text) to determine Dove's unappropriated retained earnings balance as of December 31, 2015.

50. **LO.6** In the current year, Pelican, Inc., incurs \$10,000 of meals and entertainment expenses that it deducts in computing net income per the corporation's financial statements. All of the meals and entertainment expenditures are subject to the 50% cutback rule applicable to such expenditures. How is this information reported on Schedule M-3?
51. **LO.6** In January 2015, Pelican, Inc., established an allowance for uncollectible accounts (bad debt reserve) of \$70,000 on its books and increased the allowance by \$120,000 during the year. As a result of a client's bankruptcy, Pelican, Inc., decreased the allowance by \$60,000 in November 2015. Pelican, Inc., expensed the \$190,000 of increases to the allowance on its 2015 income statement but was not allowed to deduct that amount on its tax return. On its 2015 tax return, the corporation was allowed to deduct the \$60,000 actual loss sustained because of its client's bankruptcy. On its financial statements, Pelican, Inc., treated the \$190,000 increase in the bad debt reserve as an expense that gave rise to a temporary difference. On its 2015 tax return, Pelican, Inc., took a \$60,000 deduction for bad debt expense. How is this information reported on Schedule M-3?
52. **LO.7** Prance, Inc., earns pretax book net income of \$800,000 in 2015. Prance acquires a depreciable asset in 2015, and first-year tax depreciation exceeds book depreciation by \$80,000. Prance reported no other temporary or permanent book-tax differences. Assuming that the relevant U.S. tax rate is 35%, compute Prance's total income tax expense, current income tax expense, and deferred income tax expense.
53. **LO.7** Using the facts of Problem 52, determine the 2015 end-of-year balance in Prance's deferred tax asset and deferred tax liability balance sheet accounts.

See Appendix E for Comprehensive Tax Return Problems—Form 1120

Research Problems



Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. A personal service corporation (PSC) generally is limited to the calendar year for reporting purposes. One exception to this rule is when the PSC can demonstrate a business purpose for a fiscal year-end. Discuss the business purpose exception, including examples of when the standard is and is not satisfied. Support your research with proper citations of tax authority.

Partial list of research aids:

§ 441(i).

Reg. § 1.441-3.

Communications Research Problem 2. Tern Corporation, a calendar year C corporation, is solely owned by Jessica Ramirez. Tern's only business since its incorporation in 2012 has been land surveying services. In Tern's state of incorporation, land surveying can be performed only by a licensed surveyor. Jessica, Tern's only employee, is a licensed surveyor but is not a licensed engineer. Upon audit of Tern's 2012 and 2013 tax returns, the IRS assessed tax deficiencies stemming from its conclusion that the corporation was a personal service corporation subject to the flat tax rate of 35%. Jessica believes that the IRS's determination is incorrect, and she has asked you for advice

on how to proceed. Evaluate the IRS's position regarding the treatment of Tern Corporation as a personal service corporation, and prepare a memo for the client files describing the results of your research.

Research Problem 3. A new client, John Dobson, recently formed John's Premium Steakhouse, Inc., to operate a new restaurant. The restaurant will be a first-time business venture for John, who recently retired after 30 years of military service. John transferred cash to the corporation in exchange for 100% of its stock, and the corporation is considering leasing a building and restaurant equipment. John has asked you for guidance on the tax treatment of various expenses (e.g., licensing, training, advertising) he expects the corporation to incur during the restaurant's pre-opening period. Research the tax treatment of startup expenditures, including the point at which a business begins for purposes of determining what expenses are included. Prepare a memo for the client files describing the results of your research.

Partial list of research aids:

§ 195.

Reg. § 1.195-1.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. A client has asked you for guidance on selecting the best type of entity for her new business. Using the Internet as your sole research source, prepare an outline detailing the advantages and disadvantages of the entity forms available to a sole owner. Include both tax and nontax issues in your analysis.

Research Problem 5. A significant percentage of U.S. corporations are closely held corporations, with the stock of such corporations often owned predominantly or exclusively by family members. Using the Internet as your sole research source, prepare an outline describing the tax implications and planning opportunities unique to family-owned, closely held corporations.

Communications



Internet
Activity

Communications

Communications

Roger CPA Review Questions

- What is the filing deadline for a C Corporation?
 - March 15
 - April 15
 - The 15th day of the 3rd month after year end
 - The 15th day of the 4th month after year end
- Keckye Co. is a calendar year C Corporation. When is Keckye's tax return due?

a. March 15	c. June 15
b. April 15	d. October 15
- Keckye Co. is a C Corporation with a fiscal year-end of September 30. When is Keckye's tax return due?

a. March 15	c. December 15
b. April 15	d. January 15
- Identify which of the following *cannot* function as a pass-through entity for tax purposes.

a. Sole proprietorship	c. Partnership
b. Limited Liability Company	d. S Corporation

CHAPTER
18

Corporations: Organization and Capital Structure

LEARNING OBJECTIVES: *After completing Chapter 18, you should be able to:*

- LO.1** Identify the tax consequences of incorporating a business.
- LO.2** Describe the special rules that apply when liabilities are assumed by a corporation.
- LO.3** Recognize the basis issues relevant to the shareholder and the corporation.
- LO.4** Explain the tax aspects of the capital structure of a corporation.
- LO.5** Recognize the tax differences between debt and equity investments.
- LO.6** Handle the tax treatment of shareholder debt and stock losses.
- LO.7** Identify tax planning opportunities associated with organizing and financing a corporation.

CHAPTER OUTLINE

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THE BIG PICTURE

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TAX ISSUES ASSOCIATED WITH GROWING INTO THE CORPORATE FORM

Emily has operated her business as a sole proprietorship since it was formed 10 years ago. Now, however, she has decided to incorporate the business as Garden, Inc., because the corporate form offers several important nontax advantages (e.g., limited liability). Also, the incorporation would enable her husband, David, to become a part owner in the business. Emily expects to transfer her business assets in exchange for Garden stock, while David will provide services for his equity interest. Emily's sole proprietorship assets available for transfer to the new corporation are as follows:

	Adjusted Basis	Fair Market Value
Accounts receivable	\$ -0-	\$ 50,000
Building	100,000	400,000
Other assets	300,000	550,000
	<u>\$400,000</u>	<u>\$1,000,000</u>

Aware of the problem of double taxation associated with operating as a regular corporation, Emily is considering receiving some corporate debt at the time of incorporation. The interest expense on the debt will then provide a deduction for Garden, Inc. Emily's main concern, however, is that the incorporation will be a taxable transaction. Can her fears be allayed?

Read the chapter and formulate your response.

Chapter 17 dealt with four principal areas fundamental to working with corporations: (1) understanding the unique treatment that applies to entities treated as corporations for Federal income tax purposes, (2) recognizing specific income tax rules that apply only to corporations, (3) identifying filing and reporting procedures, and (4) considering special situations involving corporations.

Chapter 18 addresses more sophisticated issues involving corporations:

- The tax consequences to the shareholders and the corporation upon the organization of and original transfer of property to the corporation.
- The tax result that ensues when shareholders make transfers of property to a corporation after organization.
- The capital structure of a corporation, including equity and debt financing.
- The tax treatment of investor losses.
- The special treatment given to gain realized from the disposition of qualified small business stock.

LO.1

Identify the tax consequences of incorporating a business.

18-1 ORGANIZATION OF AND TRANSFERS TO CONTROLLED CORPORATIONS

18-1a In General

Property transactions normally produce tax consequences if a gain or loss is realized. As a result, unless an exception in the Code applies, a transfer of property to a corporation in exchange for stock constitutes a taxable sale or exchange of property. The amount of gain or loss is measured by the difference between the value of the stock received and the tax basis of the property transferred.

When a taxpayer's economic status has not changed and the wherewithal to pay is lacking, however, the Code provides special exceptions to the requirement that realized gain or loss be recognized. For example, with both § 1031 (like kind exchanges)¹ and § 351 (transfers of property to controlled corporations), gain or loss is postponed until a substantive change in the taxpayer's investment occurs (e.g., a sale of property or ownership shares to outsiders). When a taxpayer exchanges property for other property of a like kind, § 1031 provides that gain (or loss) on the exchange is not recognized because a substantive change in the taxpayer's investment has not occurred. Section 1031 is merely a deferral mechanism and does not authorize the permanent nonrecognition of gain or loss. The deferral mechanism is accomplished by calculating a substituted basis for the like-kind property received. With this substituted basis, the realized gain or loss associated with the property given up is ultimately recognized when the property received in the exchange is sold.

Another exception to the general rule deals with transfers to controlled corporations. Section 351, which deals with transfers to *controlled corporations* (defined later in the chapter), provides that gain or loss is not recognized upon the transfer of property to a corporation when certain conditions are met. For example, when a business is incorporated, the owner's economic status remains the same; only the *form* of the investment has changed. Example 1 shows how the investment in the business assets carries over to the investment in corporate stock. Further, if only stock in the corporation is received, the taxpayer is hardly in a position to pay a tax on any realized gain. Thus, this approach also is justified under the wherewithal to pay concept discussed in Chapter 1. As noted later, however, if the taxpayer receives property other than stock (i.e., cash or other "boot") from the corporation, realized gain is recognized.

¹For a complete discussion of the rationale and rules pertaining to like-kind exchanges under § 1031, see Chapter 13. Also see Chapter 1 where the *wherewithal to pay concept* is discussed.

GLOBAL TAX ISSUES Choice of Organizational Form When Operating Overseas

When the management of a corporation decides to expand its business by establishing a presence in a foreign market, the new business venture may take one of several organizational forms. As each form comes with its respective advantages and disadvantages, making the best choice can be difficult.

One common approach is to conduct the foreign activity as a *branch* operation of the U.S. corporation. The foreign branch is not a separate legal entity, but a division of the U.S. corporation established overseas. As a result, any gains and losses produced by the foreign unit are included in the corporation's overall financial results.

Another possibility is to organize the foreign operations as a *subsidiary* of the U.S. parent corporation. If this route is

chosen, the subsidiary may be either a *domestic* subsidiary (i.e., organized in the United States) or a *foreign* subsidiary (organized under the laws of a foreign country).

One fundamental tax difference between these two approaches is that the gains and losses of a domestic subsidiary may be consolidated with the operations of the U.S. parent, while the operations of a foreign subsidiary cannot. Thus, the use of a domestic subsidiary to conduct foreign operations generally yields the same final result as the use of a branch. With both approaches, the financial statements of the U.S. parent reflect the results of its worldwide operations.

Finally, § 351 exists because Congress believes that tax rules should not impede the exercise of sound business judgment (e.g., choice of the corporate form of doing business). For example, a taxpayer would think twice about forming a corporation if gain recognition (and the payment of a tax) would always be a consequence.

Ron is considering incorporating his sole proprietorship to obtain the limited liability of the corporate form. Ron realizes that if he incorporates, depending on state law, he will be personally liable only for the debts of the business that he has guaranteed. If Ron incorporates his business, the following assets will be transferred to the corporation:

	Tax Basis	Fair Market Value
Cash	\$ 10,000	\$ 10,000
Furniture and fixtures	20,000	60,000
Land and building	<u>240,000</u>	<u>300,000</u>
	<u>\$270,000</u>	<u>\$370,000</u>

In this change of business form, Ron will receive the corporation's stock worth \$370,000 in exchange for the assets he transfers. Without the nonrecognition provisions of § 351, Ron would recognize a taxable gain of \$100,000 on the transfer (\$370,000 value of the stock received – \$270,000 basis of the assets transferred). Under § 351, however, Ron does not recognize any gain because his economic status has not really changed. Ron's investment in the assets of his sole proprietorship is now represented by his ownership of stock in the corporation. Thus, § 351 provides for tax neutrality on the incorporation decision.

In a like-kind exchange, the recognition of gain is avoided only to the extent the taxpayer receives like-kind property. However, the taxpayer must recognize some or all of the realized gain when receiving "boot" (i.e., property of an unlike kind, such as cash). For example, if a taxpayer exchanges a truck used in a business for another truck to be used in the business and also receives cash, the taxpayer has the withholding to pay an income tax on the cash involved. Further, the taxpayer's economic status has changed to the extent that cash is received. Thus, realized gain on the exchange is recognized to the extent of the cash received. In like manner, if a taxpayer transfers property to a corporation and receives cash or property other than stock, gain (but not loss) is recognized to the extent of the lesser of the gain realized or the

EXAMPLE

1

boot received (i.e., the amount of cash and the fair market value of other property received). Any gain recognized is classified (e.g., ordinary, capital) according to the type of assets transferred.² As discussed later, the nonrecognition of gain or loss is accompanied by a substituted basis in the shareholder's stock.³ The major shareholder consequences of a taxable property transaction versus one that is tax deferred are set out in Concept Summary 18.1.

EXAMPLE

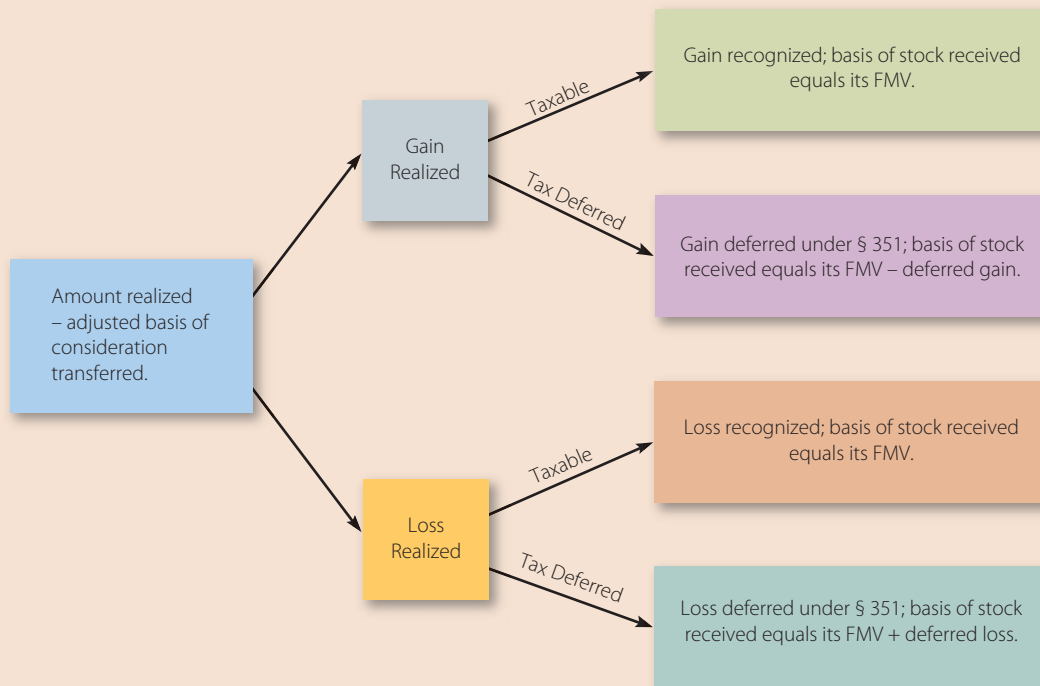
2

Amanda and Calvin form Quail Corporation. Amanda transfers property with an adjusted basis of \$30,000, fair market value of \$60,000, for 50% of the stock, worth \$60,000. Calvin transfers property with an adjusted basis of \$70,000, fair market value of \$60,000, for the remaining 50% of the stock. The transfers qualify under § 351. Amanda has an unrecognized gain of \$30,000, and Calvin has an unrecognized loss of \$10,000. Both have a substituted basis in the stock in Quail Corporation. Amanda has a basis of \$30,000 in her stock, and Calvin has a basis of \$70,000 in his stock. Therefore, if either Amanda or Calvin later disposes of the Quail stock in a taxable transaction (e.g., a sale), this deferred gain/loss will then be fully recognized—a \$30,000 gain to Amanda and a \$10,000 loss to Calvin.

Alternatively, if Amanda and Calvin each had received Quail stock worth \$50,000 and cash of \$10,000, a gain would be recognized by Amanda, but a loss would not be recognized by Calvin. Specifically, Amanda would recognize \$10,000 of the \$30,000 realized gain because she receives boot of \$10,000, while Calvin's receipt of boot would not trigger the recognition of a loss (i.e., recognition of loss never occurs in a § 351 transaction on the receipt of boot). Additional discussion of gain/loss recognition and the basis of stock received appears later in the chapter.

Concept Summary 18.1

Shareholder Consequences: Taxable Corporate Formation Versus Tax-Deferred § 351 Transaction



²§ 351(b) and Rev.Rul. 68-55, 1968-1 C.B. 140.

³§ 358(a). See the discussion preceding Example 21.

Section 351 is *mandatory* if a transaction satisfies the provision’s requirements. As explained in the following sections, the three requirements for nonrecognition of gain or loss under § 351 are that (1) *property* is transferred (2) in exchange for *stock* and (3) the property transferors are in *control* of the corporation after the exchange. Therefore, if recognition of gain or loss is *desired*, the taxpayer must plan to fail to meet at least one of these requirements.

18-1b Property Defined

Questions have arisen concerning what constitutes **property** for purposes of § 351. In general, the definition of property is comprehensive. For example, along with plant and equipment, unrealized receivables of a cash basis taxpayer and installment notes are considered property.⁴ Although the disposition of an installment note receivable normally triggers deferred gain, its transfer under § 351 is not treated as a disposition. Thus, gain is not recognized to the transferor. Proprietary processes and formulas as well as proprietary information in the general nature of a patentable invention also qualify as property under § 351.⁵

The rendition of services to the corporation, however, is excluded from the otherwise comprehensive definition of property. As demonstrated below, a taxpayer must report as income the fair market value of any consideration received as compensation for services because § 351 specifically excludes services from the definition of property.⁶ Consequently, when a taxpayer receives stock as consideration for rendering services to the corporation, taxable income results. In this case, the amount of income recognized by the taxpayer is equal to the fair market value of the stock received. As a consequence, the taxpayer’s basis in the stock received is its fair market value.

Ann and Bob form Olive Corporation with the transfer of the following consideration:

	Consideration Transferred		
	Basis to Transferor	Fair Market Value	Number of Shares Issued
From Ann:			
Personal services rendered to Olive Corporation	\$ -0-	\$20,000	200
From Bob:			
Installment note receivable	5,000	40,000	
Inventory	10,000	30,000	800
Proprietary process	-0-	10,000	

EXAMPLE

3

The value of each share in Olive Corporation is \$100.⁷ Ann has income of \$20,000 on the transfer because services do not qualify as “property.” She has a basis of \$20,000 in her 200 shares of Olive (i.e., Ann is treated as having bought some of the Olive stock by rendering services). Bob has no recognized gain on the receipt of stock because all of the consideration he transfers to Olive qualifies as “property” and he has “control” of Olive after the transfer; see the discussion concerning control that follows. Bob has a substituted basis of \$15,000 in the Olive stock.

18-1c Stock Transferred

Nonrecognition of gain occurs only when the shareholder receives stock. Stock includes common and most preferred. However, it does not include “nonqualified preferred stock,” which possesses many of the attributes of debt. In addition, the Regulations state that the term *stock* does not include stock rights and stock warrants. Otherwise, the term *stock* generally needs no clarification.⁸

⁴*Hempt Brothers, Inc. v. U.S.*, 74-1 USTC ¶9188, 33 AFTR 2d 74-570, 490 F.2d 1172 (CA-3, 1974), and Reg. § 1.453-9(c)(2).

⁵Rev.Rul. 64-56, 1964-1 C.B. 133; Rev.Rul. 71-564, 1971-2 C.B. 179.

⁶§§ 61 and 83.

⁷The value of closely held stock normally is presumed to be equal to the value of the property transferred.

⁸§ 351(g). Examples of nonqualified preferred stock include preferred stock that is redeemable within 20 years of issuance and whose dividend rate is based on factors other than corporate performance. See also Reg. § 1.351-1(a)(1)(ii).

Thus, any corporate debt or **securities** (e.g., long-term debt such as bonds) received are treated as boot because they do not qualify as stock. Therefore, the receipt of debt in exchange for the transfer of appreciated property to a controlled corporation causes recognition of gain.

The Big Picture

EXAMPLE

4

Return to the facts of *The Big Picture* on p. 18-1. Assume that the proposed transaction qualifies under § 351, but Emily decides to receive some corporate debt along with the stock. If she receives Garden stock worth \$900,000 and Garden debt of \$100,000 in exchange for the property transferred, Emily realizes gain of \$600,000 [\$1,000,000 (value of consideration received) – \$400,000 (basis in the transferred property)]. However, because the transaction qualifies under § 351, only \$100,000 of gain is recognized—the \$100,000 of Garden debt is treated as boot. The remaining realized gain of \$500,000 is deferred.

18-1d Control of the Corporation

For the transaction to qualify as nontaxable under § 351, the property transferors must be in **control** of the corporation immediately after the exchange. That is, the person or persons transferring the property must have at least an 80 percent stock ownership in the corporation, resulting in the entity being a controlled corporation. More specifically, the property transferors must own stock possessing at least 80 percent of the total combined *voting power* of all classes of stock entitled to vote *and* at least 80 percent of the total *number of shares* of all other classes of stock.⁹

Control Immediately after the Transfer

Immediately after the exchange, the property transferors must control the corporation. Control can apply to a single person or to several taxpayers if they are all parties to an integrated transaction. When more than one person is involved, the exchange does not necessarily require simultaneous exchanges by those persons. However, the rights of those transferring property to the corporation must be previously set out and determined. Also, the agreement to transfer property should be executed “with an expedition consistent with orderly procedure.”¹⁰ Therefore, if two or more persons transfer property to a corporation for stock and want to defer gain, it is helpful if the transfers occur close together in time and are made in accordance with an agreement among the parties.

The Point at Which Control Is Determined

EXAMPLE

5

Jack exchanges property, basis of \$60,000 and fair market value of \$100,000, for 70% of the stock of Gray Corporation. The other 30% of the stock is owned by Jane, who acquired it several years ago. The fair market value of Jack’s stock is \$100,000. Jack recognizes a taxable gain of \$40,000 on the transfer because he does not have control of the corporation after his transfer and his transaction cannot be integrated with Jane’s for purposes of the control requirement.

EXAMPLE

6

Rebecca, Daryl, and Paige incorporate their businesses by forming Green Corporation. Rebecca exchanges her property for 300 shares in Green on January 7, 2015. Daryl exchanges his property for 400 shares of Green Corporation stock on January 14, 2015, and Paige exchanges her property for 300 shares in Green on March 5, 2015. Because the three exchanges are part of a prearranged plan and the control test is met, the nonrecognition provisions of § 351 apply to all of the exchanges.

Stock need not be issued to the property transferors in the same proportion as the relative value of the property transferred by each. However, when stock received is not

⁹§ 368(c). Nonqualified preferred stock is treated as stock, not boot, for purposes of this control test.

¹⁰Reg. § 1.351-1(a)(1).

proportionate to the value of the property transferred, the actual effect of the transactions must be properly characterized. For example, in such situations, one transferor may actually be making a gift to another transferor.

Ron and Shelia, father and daughter, form Oak Corporation. Ron transfers property worth \$50,000 in exchange for 100 shares of stock, while Shelia transfers property worth \$50,000 for 400 shares of stock. The transfers qualify under § 351 because Ron and Shelia have control of the Oak stock immediately after the transfers of property. However, the implicit gift of 150 shares by Ron to Shelia must be recognized and appropriately characterized. As such, the value of the gift might be subject to the gift tax (see Chapter 27).

EXAMPLE

7

Once control has been achieved, it is not necessarily lost if, shortly after the transaction, stock received by shareholders is sold or given to persons who are not parties to the exchange.¹¹

Naomi and Eric form Eagle Corporation. They transfer appreciated property to the corporation with each receiving 50 shares of Eagle stock. Shortly after the formation, Naomi gives 25 shares to her son. Because Naomi was not committed to making the gift, she is considered to own her original shares of Eagle Corporation stock and, along with Eric, to control Eagle “immediately after the exchange.” Therefore, the requirements of § 351 are met, and neither Naomi nor Eric is taxed on the exchange.

EXAMPLE

8

A different result might materialize if a plan for the ultimate disposition of the stock existed *before* the exchange.

Assume the same facts as in Example 8 except Naomi immediately gives 25 shares to a business associate pursuant to a plan to satisfy an outstanding obligation. In this case, the formation of Eagle would be taxable to Naomi and Eric because of their lack of control (i.e., Naomi and Eric, the property transferors, would have owned only 75% of the stock).

EXAMPLE

9

Transfers for Property and Services

Nonrecognition treatment for the property transferors may be lost if “too much” stock is transferred to persons who did not contribute property.

The Big Picture

Return to the facts of *The Big Picture* on p. 18-1. Assume that Emily transfers her \$1,000,000 of property to Garden, Inc., and receives 50% of its stock. David receives the other 50% of the stock for services rendered (worth \$1,000,000). Both Emily and David have tax consequences from the transfers. David has ordinary income of \$1,000,000 because he does not exchange property for stock. Emily has a taxable gain of \$600,000 [\$1,000,000 (fair market value of the stock in Garden) – \$400,000 (basis in the transferred property)]. As the sole transferor of property, she receives only 50% of Garden’s stock.

EXAMPLE

10

As noted earlier, a person receiving stock in exchange for services and for property transferred is taxed on the stock value related to those services but not on the stock issued for property, assuming the property transferors control the corporation. In addition, such a person can still be treated as a “property transferor” and in this case, all stock received by the person transferring both property and services is counted in determining whether the transferors acquired control of the corporation.¹²

¹¹*Wilgard Realty Co. v. Comm.*, 42-1 USTC ¶9452, 29 AFTR 325, 127 F.2d 514 (CA-2, 1942).

¹²Reg. § 1.351-1(a)(2), Ex. 3.

The Big Picture

EXAMPLE

11

Assume the same facts as in Example 10, except that David transfers property worth \$800,000 (basis of \$260,000) in addition to services rendered to Garden, Inc. (valued at \$200,000). Now David becomes a part of the control group. Emily and David, as property transferors, together receive 100% of the corporation's stock. Consequently, § 351 is applicable to the exchanges. As a result, Emily has no recognized gain. David does not recognize gain on the transfer of the property, but he recognizes ordinary income to the extent of the value of the shares issued for services rendered. Thus, David recognizes \$200,000 of ordinary income currently.

Transfers for Services and Nominal Property

Note that to be part of the group meeting the 80 percent control test, the person contributing services must transfer property having more than a “relatively small value” compared to the services performed. When the primary purpose of the transfer is to qualify the transaction under § 351 for concurrent transferors, the Regulations provide that stock issued for property whose value is relatively small compared to the value of the stock already owned (or to be received for services rendered) will not be treated as issued in return for property.¹³

Exactly when a taxpayer who renders services and transfers property is included in the control group is often subject to question. However, the IRS has stated that such a transferor can be included in the control group if the value of the property transferred is at least 10 percent of the value of the services provided.¹⁴ If the value of the property transferred is less than this amount, the IRS will not issue an advance ruling that the exchange meets the requirements of § 351.

Determining Control Group Membership When Services Are Rendered

EXAMPLE

12

Sara and Rick form Grouse Corporation. Sara transfers land (worth \$100,000, basis of \$20,000) for 50% of the stock in Grouse. Rick transfers equipment (worth \$50,000, adjusted basis of \$10,000) and provides services worth \$50,000 for 50% of the stock. Because the value of the property Rick transfers is not small relative to the value of the services he renders, his stock in Grouse Corporation is counted in determining control for purposes of § 351; thus, the transferors own 100% of the stock in Grouse. In addition, all of Rick's stock, not just the shares received for the equipment, is counted in determining control. As a result, Sara does not recognize gain on the transfer of the land. Rick, however, must recognize income of \$50,000 on the transfer of services. Even though the transfer of the equipment qualifies under § 351, his transfer of services for stock does not.

EXAMPLE

13

Assume the same facts as in Example 12 except the value of Rick's property is \$2,000 and the value of his services is \$98,000. In this situation, the value of the property is small relative to the value of the services (and well below the 10 percent threshold provided by the IRS); therefore, Rick will not be considered a property transferor. Consequently, the transaction will be fully taxable to both Sara and Rick. In this situation, Sara, the sole property transferor, does not have at least 80% control of Grouse Corporation following the transfer. As a result, she will fully recognize her realized gain. Further, because Rick is not treated as having transferred property, the § 351 deferral is not available to him. As a result, he will recognize income of \$98,000 relating to the services provided along with any realized gain or loss on the transfer of the additional \$2,000 of consideration.

Transfers to Existing Corporations

Once a corporation is in operation, § 351 also applies to any later transfers of property for stock by either new or existing shareholders.

¹³Reg. § 1.351-1(a)(1)(ii).

¹⁴Rev.Proc. 77-37, 1977-2 C.B. 568.

Tyrone and Andrew formed Blue Corporation three years ago. Both Tyrone and Andrew transferred appreciated property to Blue in exchange for 50 shares each in the corporation. The original transfers qualified under § 351, and neither Tyrone nor Andrew was taxed on the exchange. In the current year, Tyrone transfers property (worth \$90,000, adjusted basis of \$5,000) for 50 additional Blue shares. Tyrone has a taxable gain of \$85,000 on the transfer. The exchange does not qualify under § 351 because Tyrone does not have 80% control of Blue Corporation immediately after the transfer—he owns 100 shares of the 150 shares outstanding, or a 66⅔% interest.

EXAMPLE

14

See the Tax Planning portion of this chapter for additional discussion of this issue.

18-1e Assumption of Liabilities—§ 357

Without a provision to the contrary, the transfer of mortgaged property to a controlled corporation could trigger gain to the property transferor if the corporation took over the mortgage. This would be consistent with the treatment given in like-kind exchanges under § 1031. Generally, when liabilities are assumed by another party, the party who is relieved of the debt is treated as having received cash or boot. Section 357(a) provides, however, that when the acquiring corporation assumes a liability in a § 351 transaction, the liability is not treated as boot received for gain recognition purposes. Nevertheless, liabilities assumed by the transferee corporation are treated as boot in determining the basis of the stock received by the shareholder. As a result, the basis of the stock received is reduced by the amount of the liabilities assumed by the corporation. See the more complete discussion of basis computations later.

LO2

Describe the special rules that apply when liabilities are assumed by a corporation.

The Big Picture

Return to the facts of *The Big Picture* on p. 18-1. Assume that you learn that Emily's husband, David, becomes disinterested in becoming a stockholder in Garden, Inc., and that Emily's building is subject to a liability of \$70,000 that Garden assumes. Consequently, Emily receives 100% of the Garden stock and is relieved of the \$70,000 liability in exchange for property with an adjusted basis of \$400,000 and fair market value of \$1,000,000. The exchange is tax-free under § 351 because the release of a liability is not treated as boot under § 357(a). However, the basis to Emily of the Garden stock is \$330,000 [\$400,000 (basis of property transferred) – \$70,000 (amount of the liability assumed by Garden)].

EXAMPLE

15

The general rule of § 357(a) has two exceptions: (1) § 357(b) provides that if the principal purpose of the assumption of the liabilities is to avoid tax *or* if there is no bona fide business purpose behind the exchange, the liabilities are treated as boot; (2) § 357(c) provides that if the sum of the liabilities exceeds the adjusted basis of the properties transferred, the excess is taxable gain.

Exception (1): Tax Avoidance or No Bona Fide Business Purpose

Unless liabilities are incurred shortly before incorporation, § 357(b) generally poses few problems. Because the liabilities transferred reduce the basis of the stock received, any realized gain merely is deferred and not completely eliminated. Any postponed gain is recognized when and if the stock is disposed of in a taxable sale or exchange.

Satisfying the bona fide business purpose requirement is not difficult if the liabilities are incurred in connection with the transferor's normal course of conducting a trade or business. But this requirement can cause difficulty if the liability is taken out shortly before the property is transferred and the proceeds are utilized for personal purposes.¹⁵ This type of situation is analogous to a cash distribution by the corporation to the shareholder, which is taxed as boot.

¹⁵See, for example, *Campbell, Jr. v. Wheeler*, 65-1 USTC ¶9294, 15 AFTR 2d 578, 342 F.2d 837 (CA-5, 1965).

EXAMPLE

16

Dan transfers real estate (basis of \$140,000 and fair market value of \$190,000) to a controlled corporation in return for stock in the corporation. However, shortly before the transfer, Dan mortgages the real estate and uses the \$20,000 proceeds to meet personal obligations. Thus, along with the real estate, the mortgage is transferred to the corporation. In this case, the assumption of the mortgage lacks a bona fide business purpose. Consequently, the release of the liability is treated as boot received, and Dan has a taxable gain on the transfer of \$20,000.¹⁶

Amount realized:	
Stock	\$ 170,000
Release of liability—treated as boot	20,000
Total amount realized	<u>\$ 190,000</u>
Less: Basis of real estate	(140,000)
Realized gain	<u>\$ 50,000</u>
Recognized gain	<u>\$ 20,000</u>

The effect of the application of § 357(b) is to taint *all* liabilities transferred even if some are supported by a bona fide business purpose.

EXAMPLE

17

Tim, an accrual basis taxpayer, incorporates his sole proprietorship. Among the liabilities transferred to the new corporation are trade accounts payable of \$100,000 and a credit card bill of \$5,000. Tim had used the credit card to purchase an anniversary gift for his wife. Under these circumstances, *all* of the \$105,000 liabilities are treated as boot and trigger the recognition of gain to the extent gain is realized.

Exception (2): Liabilities in Excess of Basis

The second exception, § 357(c), provides that if the amount of a shareholder's liabilities assumed exceeds the total of the adjusted bases of the properties transferred by that shareholder, the excess is taxable gain. Without this provision, when there are **liabilities in excess of basis** in a property exchange, a taxpayer would have a negative basis in the stock received in the controlled corporation.¹⁷ Section 357(c) precludes the negative basis possibility by treating the excess over basis as gain to the transferor.

EXAMPLE

18

Andre transfers land and equipment with adjusted bases of \$350,000 and \$50,000, respectively, to a newly formed corporation in exchange for 100% of the stock. The corporation assumes the liability on the transferred land in the amount of \$500,000. Without § 357(c), Andre's basis in the stock of the new corporation would be a negative \$100,000 [\$400,000 (bases of properties transferred) + \$0 (gain recognized) – \$0 (boot received) – \$500,000 (liability assumed)]. Section 357(c), however, requires Andre to recognize a gain of \$100,000 (\$500,000 liability assumed – \$400,000 bases of assets transferred). As a result, the stock has a zero basis in Andre's hands, determined as follows:

Bases in the properties transferred (\$350,000 + \$50,000)	\$ 400,000
Plus: Gain recognized	100,000
Less: Boot received	–0–
Less: Liability assumed	<u>(500,000)</u>
Basis in the stock received	<u>\$ –0–</u>

Thus, Andre recognizes \$100,000 of gain, and a negative stock basis is avoided.

The definition of liabilities under § 357(c) excludes obligations that would have been deductible to the transferor had those obligations been paid before the transfer. Therefore, accounts payable of a cash basis taxpayer are not considered liabilities for

¹⁶§ 351(b).

¹⁷*Jack L. Easson*, 33 T.C. 963 (1960), *rev'd* in 61–2 USTC ¶9654, 8 AFTR 2d 5448, 294 F.2d 653 (CA–9, 1961).

purposes of § 357(c). In addition, they are not considered in the computation of the shareholder’s stock basis.

Tina, a cash basis taxpayer, incorporates her sole proprietorship. In return for all of the stock of the new corporation, she transfers the following items:

	Adjusted Basis	Fair Market Value
Cash	\$10,000	\$10,000
Unrealized accounts receivable (amounts due to Tina but not yet received by her)	–0–	40,000
Trade accounts payable	–0–	30,000
Note payable	5,000	5,000

EXAMPLE

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Because the unrealized accounts receivable and trade accounts payable have a zero basis under the cash method of accounting, no income is recognized until the receivables are collected and no deduction materializes until the payables are satisfied. The note payable has a basis because it was issued for consideration received.

In this situation, the trade accounts payable are disregarded for gain recognition purposes and in determining Tina’s stock basis. Thus, for purposes of § 357(c), because the balance of the note payable does not exceed the basis of the assets transferred, Tina does not have a problem of liabilities in excess of basis (i.e., the note payable of \$5,000 does not exceed the aggregate basis in the cash and accounts receivable of \$10,000).

Conceivably, a situation could arise where both §§ 357(b) and (c) apply in the same transfer. In such a situation, § 357(b) predominates.¹⁸ This could be significant because § 357(b) does not create gain on the transfer, as does § 357(c), but merely converts the liability to boot. Thus, the realized gain limitation continues to apply to § 357(b) transactions.

Chris forms Robin Corporation by transferring land with a basis of \$100,000, fair market value of \$1 million. The land is subject to a mortgage of \$300,000. One month prior to incorporating Robin, Chris borrows \$200,000 for personal purposes and gives the lender a second mortgage on the land. Therefore, on the incorporation, Robin issues stock worth \$500,000 to Chris and assumes the two mortgages on the land. Section 357(c) seems to apply to the transfer, given that the mortgages on the property exceed the basis of the property. Thus, Chris would have a gain of \$400,000 under § 357(c). Section 357(b), however, also applies to the transfer because Chris borrowed \$200,000 just prior to the transfer and used the loan proceeds for personal purposes. Thus, under § 357(b), Chris has boot of \$500,000 in the amount of the liabilities, which triggers \$500,000 of recognized gain. Note that *all* of the liabilities are treated as boot, not just the tainted \$200,000 liability.

EXAMPLE

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	§ 357(b) Result	§ 357(c) Result
Amount realized:		
Robin Corporation stock	\$ 500,000	\$ 500,000
Release of mortgage on land	300,000	300,000
Release of second mortgage—personal purposes	<u>200,000</u>	<u>200,000</u>
Total amount realized	\$1,000,000	\$1,000,000
Basis of land	<u>(100,000)</u>	<u>(100,000)</u>
Realized gain	<u>\$ 900,000</u>	<u>\$ 900,000</u>
Gain recognized under § 357(b) (\$300,000 + \$200,000)	<u>\$ 500,000</u>	
Gain recognized under § 357(c) [(\$300,000 + \$200,000) – \$100,000]		<u>\$ 400,000</u>

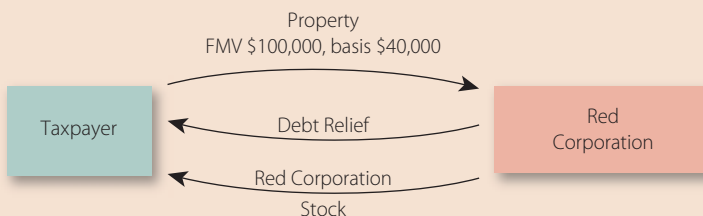
Unfortunately for Chris, the relatively more onerous rule of § 357(b) predominates over § 357(c).

¹⁸§ 357(c)(2)(A).

Concept Summary 18.2 summarizes the tax rules that apply when liabilities are transferred in property transactions, including the special rules that apply in § 351 transactions.

Concept Summary 18.2

Tax Consequences of Liability Assumption



General rule: (§ 1001)

If Red Corporation takes property subject to Taxpayer's liability or assumes Taxpayer's liability, Taxpayer is treated as having received cash. Therefore, if the liability is \$20,000, Taxpayer is treated as receiving Red stock of \$80,000 and cash of \$20,000 in a fully taxable transaction. Gain recognized is \$60,000.

Special rule in a § 351 transaction: [§ 357(a)]

Assuming the same facts as above except the transfer is a § 351 transaction, Taxpayer is not treated as receiving cash of \$20,000 for gain recognition purposes. Therefore, gain recognition is avoided.

Exception to § 351 transaction rule – Tax avoidance or no bona fide business purpose: [§ 357(b)]

Assuming the same facts as above except the transfer is a § 351 transaction and the liability does not have a business purpose, Taxpayer is treated as receiving cash of \$20,000 for gain recognition purposes. Therefore, the realized gain is recognized up to \$20,000.

Exception to § 351 transaction rule – Liabilities in excess of basis: [§ 357(c)]

Assuming the same facts as above except the transfer is a § 351 transaction and the liability is \$45,000 and the Red stock is worth \$55,000. Taxpayer recognizes \$5,000 of gain (excess of \$45,000 liability over \$40,000 property basis).

LO.3

Recognize the basis issues relevant to the shareholder and the corporation.

18-1f Basis Determination and Related Issues

Recall that § 351(a) postpones gain or loss until the transferor-shareholder disposes of the stock in a taxable transaction. The postponement of shareholder gain or loss has a corollary effect on the basis of the stock received by the shareholder and the basis of the property received by the corporation. This procedure ensures that any gain or loss postponed under § 351 ultimately will be recognized when the affected asset is disposed of in a taxable transaction.

Basis of Stock to Shareholder

For a taxpayer transferring property to a corporation in a § 351 transaction, the *stock* received in the transaction is given a *substituted basis*. Essentially, the stock's basis is the same as the basis the taxpayer had in the property transferred, increased by any gain recognized on the exchange of property and decreased by boot received. Recall that for basis purposes, boot received includes liabilities transferred by the shareholder to the corporation. Also note that if the shareholder receives *other property* (i.e., boot) along with the stock, it takes a basis equal to its fair market value.¹⁹ In Exhibit 18.1, the reference to gain recognized does not consider any income resulting from the performance of personal services. See the discussion that follows relating to an elective stock basis reduction that may be made when a shareholder contributes property with a net built-in loss.

¹⁹§ 358(a). Recall from earlier discussions that the basis of stock received for services rendered equals its fair market value.

EXHIBIT 18.1

Shareholder's Basis of Stock Received in Exchange for Property

Adjusted basis of property transferred	\$xx,xxx
Plus: Gain recognized	xxx
Minus: Boot received (including any liabilities transferred)	(xxx)
Minus: Adjustment for loss property (if elected)	(xxx)
Equals: Basis of stock received	<u>\$xx,xxx</u>

Basis of Property to Corporation

The basis of *property* received by the corporation generally is determined under a *carry-over basis* rule. This rule provides that the property's basis to the corporation is equal to the basis in the hands of the transferor increased by the amount of any gain recognized on the transfer by the transferor-shareholder.²⁰

These basis rules are illustrated in Examples 21 and 22.

Calculating Basis: Shareholder Stock and Corporate Property

Kesha and Ned form Brown Corporation. Kesha transfers land (basis of \$30,000 and fair market value of \$70,000); Ned invests cash (\$60,000). They each receive 50 shares in Brown Corporation, worth \$60,000, but Kesha also receives \$10,000 in cash from Brown. The transfers of property, the realized and recognized gain on the transfers, and the basis of the stock in Brown Corporation to Kesha and Ned are as follows:

	A	B	C	D	E	F
	Basis of Property Transferred	FMV of Stock Received	Boot Received	Realized Gain (B + C - A)	Recognized Gain (Lesser of C or D)	Basis of Stock in Brown (A - C + E)
From Kesha:						
Land	\$30,000	\$60,000	\$10,000	\$40,000	\$10,000	\$30,000
From Ned:						
Cash	60,000	60,000	-0-	-0-	-0-	60,000

Brown Corporation has a basis of \$40,000 in the land (Kesha's basis of \$30,000 plus her recognized gain of \$10,000).

EXAMPLE

21

Assume the same facts as in Example 21, except that Kesha's basis in the land is \$68,000 (instead of \$30,000). Because recognized gain cannot exceed realized gain, the transfer generates only \$2,000 of gain to Kesha. The realized and recognized gain and the basis of the stock in Brown Corporation to Kesha are as follows:

	A	B	C	D	E	F
	Basis of Property Transferred	FMV of Stock Received	Boot Received	Realized Gain (B + C - A)	Recognized Gain (Lesser of C or D)	Basis of Stock in Brown (A - C + E)
Land	\$68,000	\$60,000	\$10,000	\$2,000	\$2,000	\$60,000

Brown's basis in the land is \$70,000 (\$68,000 basis to Kesha + \$2,000 gain recognized by Kesha).

EXAMPLE

22

²⁰§ 362(a).

EXHIBIT 18.2 Corporation's Basis in Property Received

Adjusted basis of property transferred	\$xx,xxx
Plus: Gain recognized by transferor-shareholder	xxx
Minus: Adjustment for loss property (if required)	<u>(xxx)</u>
Equals: Basis of property to corporation	<u>\$xx,xxx</u>

Exhibit 18.2 summarizes the basis calculation for property received by a corporation. Concept Summary 18.3 shows the shareholder and corporate consequences of a transfer of property to a corporation for stock, with and without the application of § 351. The facts applicable to shareholder Kesha's transfer in Example 21 are used to illustrate the differences between the transaction being tax-deferred and taxable.

Concept Summary 18.3

Tax Consequences to the Shareholders and Corporation: With and Without the Application of § 351 (Based on the Facts of Example 21)

Shareholder	With § 351			Without § 351		
	Gain/Loss Recognized	Stock Basis	Other Property Basis	Gain/Loss Recognized	Stock Basis	Other Property Basis
Kesha	Realized gain recognized to extent of boot received; loss not recognized. \$10,000	Substituted (see Exhibit 18.1). \$30,000	FMV \$10,000	All realized gain or loss recognized. \$40,000	FMV \$60,000	FMV \$10,000

Corporation	With § 351		Without § 351	
	Gain/Loss Recognized	Property Basis	Gain/Loss Recognized	Property Basis
Brown	No gain or loss recognized on the transfer of corporate stock for property. \$0	Carryover (see Exhibit 18.2). \$40,000	No gain or loss recognized on the transfer of corporate stock for property. \$0	FMV \$70,000

Note that the benefit to Kesha of deferring \$30,000 of gain under § 351 comes with a cost: her stock basis is \$30,000 (rather than \$60,000), and the corporation's basis in the property received is \$40,000 (rather than \$70,000).

Basis Adjustment for Loss Property

A corporation's basis for property received in a § 351 transaction is carried over from the shareholder. As a result, the corporation's basis has no correlation to the property's fair market value. However, in certain situations when **built-in loss property** is contributed to a corporation, the aggregate basis of the assets transferred by a shareholder may exceed their fair market value. When this built-in loss situation exists, an anti-loss duplication rule requires the basis in the loss properties to be stepped down by allocating the built-in loss proportionately among the assets.²¹ This basis adjustment is necessary to prevent the parties from obtaining a double benefit from the losses involved.

²¹§ 362(e)(2). This adjustment is determined separately with respect to each property transferor. This adjustment also is required in the case of a contribution to capital by a shareholder.

In a transaction qualifying under § 351, Charles transfers the following assets to Gold Corporation in exchange for all of its stock:

	Tax Basis	Fair Market Value	Built-In Gain/(Loss)
Equipment	\$100,000	\$ 90,000	(\$10,000)
Land	200,000	230,000	30,000
Building	<u>150,000</u>	<u>100,000</u>	<u>(50,000)</u>
	<u>\$450,000</u>	<u>\$420,000</u>	<u>(\$30,000)</u>

Charles's stock basis is \$450,000 [\$450,000 (basis of the property transferred) + \$0 (gain recognized) – \$0 (boot received)]. However, Gold's basis for the loss assets transferred must be reduced by the amount of the net built-in loss (\$30,000) in proportion to each asset's share of the loss.

	Unadjusted Tax Basis	Adjustment	Adjusted Tax Basis
Equipment	\$100,000	(\$ 5,000)*	\$ 95,000
Land	200,000		200,000
Building	<u>150,000</u>	<u>(25,000)**</u>	<u>125,000</u>
	<u>\$450,000</u>	<u>(\$30,000)</u>	<u>\$420,000</u>

* $\frac{\$10,000 \text{ (loss attributable to equipment)}}{\$60,000 \text{ (total built-in loss)}} \times \$30,000 \text{ (net built-in loss)}$
= \$5,000 (adjustment to basis in equipment).

** $\frac{\$50,000 \text{ (loss attributable to building)}}{\$60,000 \text{ (total built-in loss)}} \times \$30,000 \text{ (net built-in loss)}$
= \$25,000 (adjustment to basis in building).

EXAMPLE

23

Note the end result of Example 23:

- Charles still has a built-in loss in his stock basis. Thus, if he sells the Gold Corporation stock, he will recognize a loss of \$30,000 [\$420,000 (selling price based on presumed value of the stock) – \$450,000 (basis in the stock)].
- Gold Corporation can no longer recognize any loss on the sale of *all* of its assets [\$420,000 (selling price based on value of assets) – \$420,000 (adjusted basis in assets) = \$0 (gain or loss)].

In the event a corporation is subject to the built-in loss adjustment, an alternative approach is available. If both the shareholder and the corporation elect, the basis reduction can be made to the shareholder's stock rather than to the corporation's property.

Assume the same facts as in the previous example. If Charles and Gold elect, Charles can reduce his stock basis to \$420,000 (\$450,000 – \$30,000). As a result, Gold's aggregate basis in the assets it receives is \$450,000. If Charles has no intention of selling his stock, this election could be desirable as it benefits Gold by giving the corporation a higher depreciable basis in the equipment and building.

EXAMPLE

24

Note the end result of Example 24:

- Charles has no built-in loss. Thus, if he sells the Gold Corporation stock, he will recognize no gain or loss [\$420,000 (presumed value of the stock) – \$420,000 (basis in the stock)].
- Gold Corporation has a built-in loss. Thus, if it sells *all* of its assets [\$420,000 (selling price based on value of assets) – \$450,000 (basis in assets)], it recognizes a loss of \$30,000.

Consequently, as shown in the two previous examples, the built-in loss adjustment places the loss with either the shareholder or the corporation but not both.

Stock Issued for Services Rendered

A transfer of stock for services is not a taxable transaction to a corporation.²² But another issue arises: Can a corporation deduct as a business expense the fair market value of the stock it issues in consideration of services? Yes, unless the services are such that the payment is characterized as a capital expenditure.²³

The Big Picture

EXAMPLE

25

Return to the facts of *The Big Picture* on p. 18-1. Emily transfers her \$1,000,000 of property to Garden, Inc., and receives 50% of the stock. In addition, assume that David transfers property worth \$800,000 (basis of \$260,000) and agrees to serve as manager of the corporation for one year (services worth \$200,000) for 50% of the stock. Emily's and David's transfers qualify under § 351. Neither Emily nor David is taxed on the transfer of his or her property. However, David has income of \$200,000, the value of the stock received for the services he will render to Garden, Inc. Garden has a basis of \$260,000 in the property it acquired from David, and it may claim a compensation expense deduction under § 162 for \$200,000. David's stock basis is \$460,000 [\$260,000 (basis of property transferred) + \$200,000 (income recognized for services rendered)].

The Big Picture

EXAMPLE

26

Assume the same facts as in Example 25, except that David provides legal services (instead of management services) in organizing the corporation. The value of David's legal services is \$200,000. David has no gain on the transfer of the property but has income of \$200,000 for the value of the stock received for the services rendered. Garden, Inc., has a basis of \$260,000 in the property it acquired from David and must capitalize the \$200,000 as an organizational expenditure. David's stock basis is \$460,000 [\$260,000 (basis of property transferred) + \$200,000 (income recognized for services rendered)].

Holding Period for Shareholder and Transferee Corporation

In a § 351 transfer, the shareholder's holding period for stock received in exchange for a capital asset or § 1231 property includes the holding period of the property transferred to the corporation. That is, the holding period of the property is "tacked on" to the holding period of the stock. The holding period for stock received for any other property (e.g., inventory) begins on the day after the exchange. The corporation's holding period for property acquired in a § 351 transfer is the holding period of the transferor-shareholder regardless of the character of the property in the transferor's hands. For instance, whether the property transferred is an ordinary asset (e.g., inventory), a § 1231 asset, or a capital asset, the corporation's holding period is the same as the transferor's.²⁴

Recapture Considerations

In a § 351 transfer where no gain is recognized, the depreciation recapture rules do not apply.²⁵ However, any recapture potential associated with the property carries over to the corporation as it steps into the shoes of the transferor-shareholder for purposes of basis determination.

EXAMPLE

27

Paul transfers equipment (adjusted basis of \$30,000, original cost of \$120,000, and fair market value of \$100,000) to a controlled corporation in return for stock. If Paul had sold the equipment, it would have yielded a gain of \$70,000, all of which would have been recaptured as ordinary income under § 1245. Because the transfer comes within § 351, Paul has no recognized gain and no depreciation to recapture. However, if the corporation later disposes of the equipment in a taxable transaction, it must take into account the § 1245 recapture potential originating with Paul. So, for example, if the corporation were to sell the asset shortly after incorporation for \$100,000, gain recognized up to \$70,000 would be given ordinary treatment because of the depreciation recapture rules.

²²Reg. § 1.1032-1(a).

²³Rev.Rul. 62-217, 1962-2 C.B. 59, modified by Rev.Rul. 74-503, 1974-2 C.B. 117.

²⁴§§ 1223(1) and (2).

²⁵§§ 1245(b)(3) and 1250(d)(3).

GLOBAL TAX ISSUES Does § 351 Cover the Incorporation of a Foreign Business?

When a taxpayer wants to incorporate a business overseas by moving assets across U.S. borders, the deferral mechanism of § 351 applies in certain situations, but not in others. In general, § 351 is available to defer gain recognition when starting up a new corporation outside the United States unless so-called tainted assets are involved. Under § 367, tainted assets, which include assets such as inventory and accounts receivable, are treated as having

been sold by the taxpayer prior to the corporate formation; therefore, their transfer results in the current recognition of gain. The presence of tainted assets triggers gain because Congress does not want taxpayers to be able to shift the gain outside the U.S. jurisdiction. The gain recognized is ordinary or capital depending on the nature of the asset involved.

18-2 CAPITAL STRUCTURE OF A CORPORATION

When forming or expanding a corporation, the transaction can be financed with capital contributions or debt proceeds, or a combination of the two. Evaluating the relative advantages and disadvantages of these two basic elements in the capital structure of a corporation can involve various considerations, including the tax aspects of each.

LO.4

Explain the tax aspects of the capital structure of a corporation.

18-2a Capital Contributions

When money or property is received in exchange for capital stock (including treasury stock), the corporation does not recognize any gain or loss.²⁶ Also, it does not include in gross income any shareholders' contributions of money or property to the capital of the corporation or through voluntary pro rata transfers. This is the case even though there is no increase in the outstanding shares of stock of the corporation. The contributions represent an additional price paid for the shares held by the shareholders and are treated as additions to the operating capital of the corporation.²⁷

Contributions by nonshareholders, such as land contributed to a corporation by a civic group or a governmental group to induce the corporation to locate in a particular community, are also excluded from the gross income of a corporation.²⁸ However, if the property is transferred to a corporation by a nonshareholder in exchange for goods or services, the corporation must recognize income.²⁹

A cable television company charges its customers an initial fee to hook up to a new cable system installed in the area. These payments are used to finance the total cost of constructing the cable company's infrastructure. In addition, the customers will make monthly payments for the cable service. The initial payments are used for capital expenditures, but they represent payments for services to be rendered by the cable company. As such, they are taxable income to the cable company and not contributions to capital by nonshareholders.

EXAMPLE

28

The basis of property received by a corporation from a shareholder as a **capital contribution** is equal to the basis of the property in the hands of the shareholder, although the basis is subject to a downward adjustment when loss property is contributed. The basis of property transferred to a corporation by a nonshareholder as a contribution to capital is zero.

If a corporation receives *money* as a contribution to capital from a nonshareholder, a special rule applies. The basis of any property acquired with the money during a 12-month period beginning on the day the contribution was received is reduced by the

²⁶§ 1032.

²⁷§ 118 and Reg. § 1.118-1.

²⁸See *Edwards v. Cuba Railroad Co.*, 1 USTC ¶139, 5 AFTR 5398, 45 S.Ct. 614 (USSC, 1925).

²⁹Reg. § 1.118-1. See also *Teleservice Co. of Wyoming Valley*, 27 T.C. 722 (1957), *aff'd* in 58-1 USTC ¶9383, 1 AFTR 2d 1249, 254 F.2d 105 (CA-3, 1958), *cert. den.* 78 S.Ct. 1360 (USSC, 1958).



TAX IN THE NEWS States Battle Each Other to Lure New Businesses (and Jobs)

More than ever before, states and localities across the country are competing with each other in their efforts to entice businesses to relocate or expand their operations within their borders. These efforts are occurring during a period when many entities are attempting to grow and become more efficient at the same time. The businesses are often looking for locales that can offer proximity to markets, access to an educated workforce, and appropriate infrastructure. But another factor that can make a critical difference in expansion or business realignment decisions is the availability of tax incentives that are offered as inducements by competing state and local governments.

Recently Toyota Motor Corporation announced plans to overhaul and streamline its North American operations and relocate its headquarters from California to Plano, Texas. Officials expect Texas will gain about 4,000 jobs while California will lose close to 3,000 jobs in the process. Arising from the resettlement in Texas, Toyota will receive about \$40 million in incentives from the state. Likewise, when Boeing was developing plans to design and construct a new generation aircraft, Washington State offered Boeing an incentives package valued at \$8.7 billion over 16 years. This incentive package is believed to be the largest corporate incentive package in U.S. history.

amount of the contribution. The excess of money received over the cost of new property reduces the basis of other property held by the corporation and is applied in the following order:

1. Depreciable property.
2. Property subject to amortization.
3. Property subject to depletion.
4. All other remaining properties.

The basis of property within each category is reduced in proportion to the relative bases of the properties.³⁰

EXAMPLE

29

A city donates land worth \$400,000 to Teal Corporation as an inducement for Teal to locate in the city. The receipt of the land produces no taxable income to Teal, and the land's basis to the corporation is zero. If, in addition, the city gives the corporation \$100,000 in cash, the money is not taxable income to the corporation. However, if the corporation purchases property with the \$100,000 cash within the next 12 months, the basis of the acquired property is reduced by \$100,000. Any excess cash retained by Teal is handled according to the ordering rules noted previously. So, for example, if Teal purchases only \$70,000 of property during the following year, the basis of Teal's other depreciable property is reduced by \$30,000.

LO.5

Recognize the tax differences between debt and equity investments.

18-2b Debt in the Capital Structure

Various tax and nontax considerations are relevant when developing the capital structure of a corporation. The relative amounts of debt and equity and their characteristics are of primary importance.

Advantages of Debt

Significant tax differences exist between debt and equity in the capital structure. The advantages of issuing long-term debt instead of stock are numerous. Interest on debt is deductible by the corporation, while dividend payments are not. Further, loan repayments are not taxable to investors unless the repayments exceed basis. A shareholder's receipt of property from a corporation, however, cannot be tax-free as long as the corporation has earnings and profits (see Chapter 19). Such distributions will be taxed as dividends to the extent of earnings and profits of the distributing corporation.

³⁰§ 362(a) and Reg. § 1.362-2(b).



TAX IN THE NEWS A Careful Evaluation May Be Required to Distinguish Debt from Equity

While the tax advantages of debt over equity may be clear (i.e., interest payments on debt are deductible but dividend payments on capital contributions are not), being able to distinguish debt from equity may not be as obvious. In arm’s length, market-based transactions between unrelated parties, the debt versus equity question most likely would never arise. However, the difficulty of distinguishing debt and equity is particularly acute in situations where the parties involved are closely connected or related. To assist taxpayers in distinguishing debt financing and equity financing, the courts have developed a number of factors (noted on the next page) to be considered in such an analysis.

In *NA General Partnership & Subsidiaries* (103 TCM 1916, T.C.Memo. 2012-172), the Tax Court evaluated the nature of

advances made by a parent entity to NA General Partnership & Subsidiaries (treated as a corporation for Federal tax purposes) in light of the court-developed factors. The court noted that the substance of a transaction is controlling, and not merely its form, and that none of the factors is decisive but they should be considered in light of the facts and circumstances of the case. Based on an exhaustive evaluation of 11 factors in the taxpayer’s situation, the court concluded that the advances were debt. Happily for the taxpayer, the court’s decision paved the way for \$932 million of payments to be treated as deductible interest rather than nondeductible dividend payments.

Another distinction between debt and equity relates to the taxation of dividend and interest income. Dividend income on equity holdings is taxed to individual investors at low capital gains rates, while interest income on debt is taxed at higher ordinary income rates.

Wade transfers cash of \$100,000 to a newly formed corporation for 100% of the stock. In its initial year, the corporation has net income of \$40,000. The income is credited to the earnings and profits account of the corporation. If the corporation distributes \$9,500 to Wade, the distribution is a taxable dividend to Wade with no corresponding deduction to the corporation. Assume, instead, that Wade transfers to the corporation cash of \$50,000 for stock and cash of \$50,000 for a note of the same amount. The note is payable in equal annual installments of \$5,000 and bears interest at the rate of 9%. At the end of the year, the corporation pays Wade interest of \$4,500 (\$50,000 × 9%) and a note repayment of \$5,000. The interest payment is a deductible expense to the corporation and taxable to Wade. The \$5,000 principal repayment on the note is neither deducted by the corporation nor taxed to Wade. Based on the tax rates as noted, the after-tax impact to Wade and the corporation under each alternative is illustrated below.

EXAMPLE

30

	If the Distribution Is	
	\$9,500 Dividend	\$5,000 Note Repayment and \$4,500 Interest
<i>After-tax benefit to Wade*</i>		
[\$9,500 × (1 – 15%)]	\$8,075	
[\$5,000 + [\$4,500 × (1 – 35%)]]		\$7,925
<i>After-tax cost to corporation**</i>		
No deduction to corporation	9,500	
[\$5,000 + [\$4,500 × (1 – 35%)]]		7,925

* Assumes that Wade’s dividend income is taxed at the 15% capital gains rate and that his interest income is taxed at the 35% ordinary income rate.

** Assumes that the corporation is in the 35% marginal tax bracket.

Reclassification of Debt as Equity (Thin Capitalization Problem)

In situations where the corporation is said to be thinly capitalized, the IRS contends that debt is an equity interest and denies the corporation the tax advantages of debt financing. **Thin capitalization** occurs when shareholder debt is high relative to shareholder

equity. If the debt instrument has too many features of stock, it may be treated for tax purposes as stock. In that case, the principal and interest payments are considered dividends. In the current environment, however, the IRS may be less inclined to raise the thin capitalization issue because the conversion of interest income to dividend income would produce a tax benefit to individual investors.

Section 385 lists several factors that *may* be used to determine whether a debtor-creditor relationship or a shareholder-corporation relationship exists. The section authorizes the Treasury to prescribe Regulations that provide more definitive guidelines. To date, the Treasury has not drafted acceptable Regulations. Consequently, taxpayers must rely on judicial decisions to determine whether a true debtor-creditor relationship exists.

For the most part, the principles used to classify debt as equity developed in connection with closely held corporations. Here the holders of the debt are also shareholders. Consequently, the rules have often proved inadequate for dealing with such problems in large, publicly traded corporations.

Together, Congress, through § 385, and the courts have identified the following factors to be considered in resolving the thin capitalization issue:

- Whether the debt instrument is in proper form. An open account advance is more easily characterized as a contribution to capital than a loan evidenced by a properly written note.³¹
- Whether the debt instrument bears a reasonable rate of interest and has a definite maturity date. When a shareholder advance does not provide for interest, the return expected may appear to be a share of the profits or an increase in the value of the shares.³² Likewise, a lender unrelated to the corporation will usually be unwilling to commit funds to the corporation without a definite due date.
- Whether the debt is paid on a timely basis. A lender's failure to insist upon timely repayment or satisfactory renegotiation indicates that the return sought does not depend upon interest income and the repayment of principal.
- Whether payment is contingent upon earnings. A lender ordinarily will not advance funds that are likely to be repaid only if the venture is successful.
- Whether the debt is subordinated to other liabilities. Subordination tends to eliminate a significant characteristic of the creditor-debtor relationship. Creditors should have the right to share with other general creditors in the event of the corporation's dissolution or liquidation. Subordination also destroys another basic attribute of creditor status—the power to demand payment at a fixed maturity date.³³
- Whether holdings of debt and stock are proportionate (e.g., each shareholder owns the same percentage of debt as stock). When debt and equity obligations are held in the same proportion, shareholders are, apart from tax considerations, indifferent as to whether corporate distributions are in the form of interest or dividends.
- Whether funds loaned to the corporation are used to finance initial operations or capital asset acquisitions. Funds used to finance initial operations or to acquire capital assets the corporation needs are generally obtained through equity investments.
- Whether the corporation has a high ratio of shareholder debt to shareholder equity. Thin capitalization indicates that the corporation lacks reserves to pay interest and principal on debt when corporate income is insufficient to meet current needs.³⁴ In determining a corporation's debt-equity ratio, courts look at the relation of the debt both to the book value of the corporation's assets and to their actual fair market value.³⁵

³¹*Estate of Mixon, Jr. v. U.S.*, 72-2 USTC ¶9537, 30 AFTR 2d 72-5094, 464 F.2d 394 (CA-5, 1972).

³²*Slappey Drive Industrial Park v. U.S.*, 77-2 USTC ¶9696, 40 AFTR 2d 77-5940, 561 F.2d 572 (CA-5, 1977).

³³*Fin Hay Realty Co. v. U.S.*, 68-2 USTC ¶9438, 22 AFTR 2d 5004, 398 F.2d 694 (CA-3, 1968).

³⁴A court held that a debt-equity ratio of approximately 14.6:1 was not excessive. See *Tomlinson v. 1661 Corp.*, 67-1 USTC ¶9438, 19 AFTR 2d

1413, 377 F.2d 291 (CA-5, 1967). A 26:1 ratio was found acceptable in *Delta Plastics, Inc.*, 85 TCM 940, T.C.Memo. 2003-54.

³⁵In *Bauer v. Comm.*, 84-2 USTC ¶9996, 55 AFTR 2d 85-433, 748 F.2d 1365 (CA-9, 1984), a debt-equity ratio of 92:1 resulted when book value was used. But the ratio ranged from 2:1 to 8:1 when equity included both paid-in capital and accumulated earnings.

Under § 385, the IRS also has the authority to classify an instrument either as *wholly* debt or equity or as *part* debt and *part* equity. This flexible approach is important because some instruments cannot readily be classified either wholly as stock or wholly as debt. It may also provide an avenue for the IRS to address problems in publicly traded corporations.

18-3 INVESTOR LOSSES

The difference between equity and debt financing involves a consideration of the tax treatment of worthless stock and securities versus that applicable to bad debts.

LO.6

Handle the tax treatment of shareholder debt and stock losses.

18-3a Stock and Security Losses

If stocks and bonds are capital assets in their owner's hands, losses from their worthlessness are governed by § 165(g)(1). Under this provision, a capital loss materializes as of the last day of the taxable year in which the stocks or bonds become worthless. No deduction is allowed for a mere decline in value. The burden of proving complete worthlessness is on the taxpayer claiming the loss. One way to recognize partial worthlessness is to dispose of the stocks or bonds in a taxable sale or exchange.³⁶ But even then, the **investor loss** is disallowed if the sale or exchange is to a related party as defined under § 267(b) (e.g., parents and children are related, but aunts, uncles, and cousins are not considered related).



ETHICS & EQUITY Can a Loss Produce a Double Benefit?

In late 2004, Sally invested \$100,000 in TechCo, a startup high-tech venture. Although she had great expectations of financial gain, TechCo's efforts were not well received in the market, and the value of its stock plummeted. Four years ago when TechCo declared bankruptcy, Sally wrote off her \$100,000 stock investment as worthless securities.

To Sally's surprise, this year she receives \$40,000 from the bankruptcy trustee as a final settlement for her TechCo

stock. Sally now realizes that she probably should not have claimed the loss four years ago because the stock was not *completely* worthless. However, as the statute of limitations has passed, she does not plan to amend her tax return from four years ago. She also decides that the \$40,000 is not income but is merely a recovery of some of her original investment. How do you react to Sally's plans?

Stocks and bonds are usually held as investments and, as a result, are capital assets. However, when they are not capital assets, such as when they are held by a broker for resale to customers, worthlessness yields an ordinary loss.³⁷

Under certain circumstances involving stocks and bonds of affiliated corporations, an ordinary loss is allowed upon worthlessness.³⁸ A corporation is an affiliate of another corporation if the corporate shareholder owns at least 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each class of nonvoting stock. Further, to be considered affiliated, the corporation must have derived more than 90 percent of its aggregate gross receipts for all taxable years from sources other than passive income. Passive income for this purpose includes items such as rents, royalties, dividends, and interest.

18-3b Business versus Nonbusiness Bad Debts

In addition to worthlessness of stocks and bonds, the financial demise of a corporation can result in bad debt deductions to those who have extended credit to the corporation.

³⁶Reg. § 1.165-4(a).

³⁷§ 165(a) and Reg. § 1.165-5(b).

³⁸§ 165(g)(3).

These deductions can be either business bad debts or **nonbusiness bad debts**. The distinction between the two types of deductions is important for tax purposes in the following respects:

- Business bad debts are deducted as ordinary losses, while nonbusiness bad debts are treated as short-term capital losses.³⁹ A business bad debt can generate a net operating loss, but a nonbusiness bad debt cannot.⁴⁰
- A deduction is allowed for the partial worthlessness of a business debt, but nonbusiness debts can be written off only when they become entirely worthless.⁴¹
- Nonbusiness bad debt treatment is limited to noncorporate taxpayers. However, all of the bad debts of a corporation qualify as business bad debts and are never given nonbusiness bad debt treatment.⁴²

When is a debt business or nonbusiness? Unfortunately, because the Code sheds little light on the matter, the distinction has been left to the courts.⁴³ In a leading decision, the Supreme Court somewhat clarified the picture when it held that if individual shareholders lend money to a corporation in their capacity as investors, any resulting bad debt is classified as nonbusiness.⁴⁴ Nevertheless, the Court did not preclude the possibility of a shareholder-creditor incurring a business bad debt.

If a loan is made in some capacity that qualifies as a trade or business, nonbusiness bad debt treatment is avoided. For example, if an employee who is also a shareholder makes a loan to preserve employment status, the loan qualifies for business bad debt treatment.⁴⁵ Shareholders also receive business bad debt treatment if they are in the trade or business of lending money or of buying, promoting, and selling corporations. If the shareholder has multiple motives for making the loan, according to the Supreme Court, the “dominant” or “primary” motive for making the loan controls the classification of the loss.⁴⁶

EXAMPLE

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Norman owns 48% of the stock of Lark Corporation, which he acquired several years ago at a cost of \$600,000. Norman is also employed by the corporation at an annual salary of \$240,000. At a time when Lark Corporation is experiencing financial problems, Norman lends it \$300,000. Subsequently, the corporation becomes bankrupt, and both Norman’s stock investment and his loan become worthless.

Norman’s stock investment is treated as a long-term capital loss (assuming that § 1244 does not apply, as discussed below). But how is the bad debt classified? If Norman can prove that his dominant or primary reason for making the loan was to protect his salary, a business bad debt deduction results. If not, it is assumed that Norman was trying to protect his stock investment, and nonbusiness bad debt treatment results.

Factors to be considered in resolving the matter of business versus nonbusiness bad debts include the following:

- A comparison of the amount of the stock investment with the trade or business benefit derived. In Example 31, the stock investment of \$600,000 is compared with the annual salary of \$240,000. In this regard, the salary should be considered as a recurring item and not viewed in isolation. A salary of \$240,000 each year means a great deal to a person who has no other means of support and may have difficulty obtaining similar employment elsewhere.
- A comparison of the amount of the loan with the stock investment and the trade or business benefit derived.

³⁹Compare § 166(a) with § 166(d)(1)(B).

⁴⁰Note the modification required by § 172(d)(2).

⁴¹Compare § 166(a)(2) with § 166(d)(1)(A).

⁴²§ 166(d)(1).

⁴³For definitional purposes, § 166(d)(2) is almost as worthless as the debt it purports to describe.

⁴⁴*Whipple v. Comm.*, 63–1 USTC ¶9466, 11 AFTR 2d 1454, 83 S.Ct. 1168 (USSC, 1963).

⁴⁵*Trent v. Comm.*, 61–2 USTC ¶9506, 7 AFTR 2d 1599, 291 F.2d 669 (CA–2, 1961).

⁴⁶*U.S. v. Generes*, 72–1 USTC ¶9259, 29 AFTR 2d 72–609, 92 S.Ct. 827 (USSC, 1972).

- The percentage of ownership held by the shareholder. A minority shareholder, for example, is under more compulsion to lend the corporation money to protect a job than a person who is in control of corporate policy.

In summary, without additional facts, it is impossible to conclude whether Norman in Example 31 suffered a business or nonbusiness bad debt. Even with such facts, the guidelines are vague. Recall that a taxpayer's intent or motivation is at issue. For this reason, the problem is frequently the subject of litigation.⁴⁷

18-3c Section 1244 Stock

In an exception to the capital treatment that generally results, § 1244 permits ordinary loss treatment for losses on the sale or worthlessness of stock of so-called small business corporations. By placing shareholders on a more nearly equal basis with proprietors and partners in terms of the tax treatment of losses, the provision encourages investment of capital in small corporations. Gain on the sale of § 1244 stock remains capital. Consequently, the shareholder has nothing to lose and everything to gain by complying with § 1244.

Qualification for § 1244

The ordinary loss treatment for **§ 1244 stock** applies to the first \$1 million of capitalized value of the corporation's stock. If more than \$1 million of the corporation's stock is issued, the entity designates which of the shares qualify for § 1244 treatment.⁴⁸ In measuring the capitalization of the newly issued stock, property received in exchange for stock is valued at its adjusted basis, reduced by any liabilities assumed by the corporation or to which the property is subject. The fair market value of the property is not considered. The \$1 million limitation is determined on the date the stock is issued. Consequently, even though a corporation fails to meet these requirements when the stock is disposed of later by the shareholder, the stock can still qualify as § 1244 stock if the requirements were met on the date the stock was issued.

Mechanics of the Loss Deduction

The amount of ordinary loss deductible in any one year from the disposition of § 1244 stock is limited to \$50,000 (or \$100,000 for spouses filing a joint return). If the amount of the loss sustained in the taxable year exceeds these amounts, the remainder is considered a capital loss.

Several years ago, Harvey acquired § 1244 stock at a cost of \$100,000. He sells the stock for \$10,000 in the current year. He has an ordinary loss of \$50,000 and a capital loss of \$40,000. Alternatively, on a joint return, the entire \$90,000 loss is ordinary.

EXAMPLE

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Only the original holder of § 1244 stock, whether an individual or a partnership, qualifies for ordinary loss treatment. If the stock is sold or donated, it loses its § 1244 status.

Special treatment applies if § 1244 stock is issued by a corporation in exchange for property that has an adjusted basis above its fair market value immediately before the exchange. For purposes of determining ordinary loss upon a subsequent sale, the stock basis is reduced to the fair market value of the property on the date of the exchange.

⁴⁷See, for example, *Kelson v. U.S.*, 74-2 USTC ¶9714, 34 AFTR 2d 74-6007, 503 F.2d 1291 (CA-10, 1974), *Kenneth W. Graves*, 87 TCM 1409, T.C.Memo. 2004-140, and *Harry Robert Haurly*, 104 TCM 121, T.C.Memo. 2012-215.

⁴⁸Reg. § 1.1244(c)-2(b)(2).

EXAMPLE

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Dana transfers property with a basis of \$10,000 and a fair market value of \$5,000 to a corporation in exchange for shares of § 1244 stock. Assuming that the transfer qualifies under § 351, the basis of the stock under the general rule is \$10,000, the same as Dana's basis in the property. However, for purposes of § 1244 and measuring the amount of ordinary loss, the stock basis is only \$5,000. If the stock is later sold for \$3,000, the total loss sustained is \$7,000 (\$3,000 – \$10,000); however, only \$2,000 of the loss is ordinary (\$3,000 – \$5,000). The remaining portion of the loss, \$5,000, is a capital loss.

Recall the advantages of issuing some debt to shareholders in exchange for cash contributions to a corporation. A disadvantage of issuing debt is that it does not qualify under § 1244. Should the debt become worthless, the taxpayer generally has a short-term capital loss rather than the ordinary loss for § 1244 stock.

18-4 GAIN FROM QUALIFIED SMALL BUSINESS STOCK

Shareholders are given special tax relief for gains recognized on the sale or exchange of stock acquired in a **qualified small business corporation**. The holder of **qualified small business stock** may exclude 50 percent of any gain from the sale or exchange of such stock. However, for a period during the recent economic downturn, the exclusion increased to 75 percent for qualified small business stock acquired after February 17, 2009, and later, the exclusion increased to 100 percent for qualified stock acquired after September 27, 2010, and before 2015.⁴⁹ To qualify for the exclusion, the taxpayer must have held the stock for more than five years and must have acquired the stock as part of an original issue.⁵⁰ Only noncorporate shareholders qualify for the exclusion.

A qualified small business corporation is a C corporation whose aggregate gross assets did not exceed \$50 million on the date the stock was issued.⁵¹ The corporation must be actively involved in a trade or business. This means that at least 80 percent of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses.

A shareholder can apply the exclusion to the greater of (1) \$10 million or (2) 10 times the shareholder's aggregate adjusted basis in the qualified stock disposed of during a taxable year.⁵²

LO.7

Identify tax planning opportunities associated with organizing and financing a corporation.

18-5 TAX PLANNING

With any provision in the tax law where special treatment is provided, consideration must be given to whether a taxpayer qualifies or could qualify for the special treatment and whether the taxpayer should take advantage of the treatment. Section 351 provides one such area where careful planning is advised.

18-5a Working with § 351

Effective tax planning with transfers of property to corporations requires a clear understanding of § 351 and its related Code provisions. The most important question in planning is simply this: Does the desired tax result come from complying with § 351 or from avoiding it?

⁴⁹§ 1202. The 0%, 15%, and 20% capital gains rates do not apply. Instead, the 28% capital gains rate applies. Thus, the maximum effective tax rate on the sale of qualified small business stock is 14% (28% × 50%), 7% (28% × 25%), or 0% (28% × 0%). At the time of this writing, Congress has not extended the 100% exclusion beyond 2014.

⁵⁰The stock must have been issued after August 10, 1993, which is the effective date of § 1202 as originally enacted.

⁵¹§ 1202(d). Its aggregate assets may not exceed this amount at any time between August 10, 1993, and the date the stock was issued.

⁵²§ 1202(b). The amount is \$5 million for married taxpayers filing separately.

Utilizing § 351

If the tax-free treatment of § 351 is desired, ensure that the parties transferring property (which includes cash) receive control of the corporation. Simultaneous transfers are not necessary, but a long period of time between transfers can be disastrous if the transfers are not properly documented as part of a single plan. The parties should document and preserve evidence of their intentions. Also, it is helpful to have some reasonable explanation for any delay in the transfers.

To meet the requirements of § 351, mere momentary control on the part of the transferor may not suffice if loss of control is compelled by a prearranged agreement.⁵³

For many years, Paula operated a business as a sole proprietor employing Brooke as manager. To dissuade Brooke from quitting and going out on her own, Paula promised her a 30% interest in the business. To fulfill this promise, Paula transfers the business to newly formed Green Corporation in return for all of its stock. Immediately thereafter, Paula transfers 30% of the stock to Brooke. Section 351 probably does not apply to Paula's transfer to Green Corporation because it appears that Paula was under an obligation to relinquish control. If this preexisting obligation exists, § 351 will not be available to Paula because, as the sole property transferor, she does not have control of Green Corporation. However, if there is no obligation and the loss of control was voluntary on Paula's part, momentary control would suffice.⁵⁴

EXAMPLE

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Make sure that later transfers of property to an existing corporation satisfy the control requirement if recognition of gain is to be avoided. In this connection, another transferor's interest cannot be counted if the value of stock received is relatively small compared with the value of stock already owned and the primary purpose of the transfer is to qualify other transferors for § 351 treatment.⁵⁵

For contributions of property by a partner to a partnership, at formation or subsequent to formation, § 721 is available to provide nonrecognition treatment. This partnership provision generally resembles § 351. However, in such situations, any partner can make a tax-deferred contribution without regard to a control test. Thus, the 80 percent control requirement, which serves as a high threshold to be met if tax-deferred treatment is desired in a corporate setting, contrasts to the treatment given in partnership taxation where no such control test applies. See Chapter 21 for additional discussion.

Avoiding § 351

Because § 351 provides for the nonrecognition of gain on transfers to controlled corporations, it is often regarded as a favorable relief provision. In some situations, however, avoiding § 351 may produce a more advantageous tax result. The transferors might prefer to recognize gain on the transfer of property if they cannot be particularly harmed by the gain. For example, they may be in low tax brackets, or the gain may be a capital gain that could be neutralized by available capital losses. The corporation will then have a stepped-up basis in the transferred property.

A transferor might also prefer to avoid § 351 to allow for immediate recognition of a loss. Recall that § 351 provides for the nonrecognition of both gains and losses. A transferor who wants to recognize loss has several alternatives:

- Sell the property to the corporation for its stock. The IRS could attempt to collapse the "sale," however, by taking the approach that the transfer really falls under § 351.⁵⁶ If the sale is disregarded, the transferor ends up with a realized but unrecognized loss.
- Sell the property to the corporation for other property or boot. Because the transferor receives no stock, § 351 is inapplicable.

⁵³Rev.Rul. 54-96, 1954-1 C.B. 111.

⁵⁴Compare *Fabs v. Florida Machine and Foundry Co.*, 48-2 USTC ¶9329, 36 AFTR 1161, 168 F.2d 957 (CA-5, 1948), with *John C. O'Connor*, 16 TCM 213, T.C.Memo. 1957-50, *aff'd* in 58-2 USTC ¶9913, 2 AFTR 2d 6011, 260 F.2d 358 (CA-6, 1958).

⁵⁵Reg. § 1.351-1(a)(1)(ii).

⁵⁶*U.S. v. Hertwig*, 68-2 USTC ¶9495, 22 AFTR 2d 5249, 398 F.2d 452 (CA-5, 1968).

- Transfer the property to the corporation in return for securities or nonqualified preferred stock. Recall that § 351 does not apply to a transferor who receives securities or nonqualified preferred stock. In both this and the previous alternatives, watch for the possible disallowance of the loss under the related-party rules.

Suppose the loss property is to be transferred to the corporation and no loss is recognized by the transferor due to § 351. This could present an interesting problem in terms of assessing the economic realities involved.

EXAMPLE

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Iris and Lamont form Wren Corporation with the following investments: property by Iris (basis of \$40,000 and fair market value of \$50,000) and property by Lamont (basis of \$60,000 and fair market value of \$50,000). Each receives 50% of the Wren stock. Has Lamont acted wisely in settling for only 50% of the stock? At first, it would appear so because Iris and Lamont each invested property of the same value (\$50,000). But what about tax considerations? By applying the general carryover basis rules, the corporation now has a basis of \$40,000 in Iris's property and \$60,000 in Lamont's property. In essence, Iris has shifted a possible \$10,000 gain to the corporation while Lamont has transferred a \$10,000 potential loss. Thus, an equitable allocation of the Wren stock would call for Lamont to receive a greater percentage interest than Iris would receive. This issue is further complicated by the special basis adjustment required when a shareholder such as Lamont contributes property with a built-in loss to a corporation. In this situation, if Wren is to take a carryover basis in Lamont's property, Lamont must reduce his stock basis by the \$10,000 built-in loss. This reduced stock basis, of course, could lead to a greater tax burden on Lamont when he sells the Wren stock. This may suggest additional support for Lamont having a greater percentage interest than Iris has.

18-5b Selecting Assets to Transfer

When a business is incorporated, the organizers must determine which assets and liabilities should be transferred to the corporation. Leasing property to the corporation may be a more attractive alternative than transferring ownership. Leasing provides the taxpayer with the opportunity to withdraw money from the corporation in a deductible form without the payment being characterized as a nondeductible dividend. If the property is given to a family member in a lower tax bracket, the lease income can be shifted as well. If the depreciation and other deductions available in connection with the property are larger than the lease income, the taxpayer would retain the property until the income exceeds the deductions.

When an existing cash basis business is incorporated, an important issue to consider is whether the business's accounts receivable and accounts payable will be transferred to the new corporation or be retained by the owner of the unincorporated business. Depending on the approach taken, either the new corporation or the owner of the old unincorporated business will recognize the income associated with the cash basis receivables when they are collected. The cash basis accounts payable raise the corresponding issue of who will claim the deduction.

The Big Picture**EXAMPLE**

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Return to the facts of *The Big Picture* on p. 18-1. If Emily decides to retain the \$50,000 of cash basis accounts receivable rather than transfer them to the newly formed Garden, Inc., she will recognize \$50,000 of ordinary income upon their collection. Alternatively, if the receivables are transferred to Garden as the facts suggest, the corporation will recognize the ordinary income. However, a subsequent corporate distribution to Emily of the cash collected could be subject to double taxation as a dividend (see Chapter 19 for further discussion). Given the alternatives available, Emily needs to evaluate which approach is better for the parties involved.

Another way to shift income to other taxpayers is by the use of corporate debt. Shareholder debt in a corporation can be given to family members in a lower tax bracket. This technique also causes income to be shifted without a loss of control by the corporation.

18-5c Debt in the Capital Structure

The advantages and disadvantages of debt as opposed to equity have previously been noted. To increase debt without incurring the thin capitalization problem, consider the following:

- Preserve the formalities of the debt. This includes providing for written instruments, realistic interest rates, and specified due dates.
- If possible, have the corporation repay the debt when it comes due. If this is not possible, have the parties renegotiate the arrangement. Try to proceed as a non-shareholder creditor would. It is not unusual, for example, for bondholders of publicly held corporations to extend due dates when default occurs. The alternative is to foreclose and perhaps seriously impair the amount the creditors will recover.
- Avoid provisions in the debt instrument that make the debt convertible to equity in the event of default. These provisions are standard practice when nonshareholder creditors are involved. They serve no purpose if the shareholders are also the creditors and hold debt in proportion to ownership shares.

Gail, Cliff, and Ruth are equal shareholders in Magenta Corporation. Each transfers cash of \$100,000 to Magenta in return for its bonds. The bond agreement provides that the holders will receive additional voting rights in the event Magenta Corporation defaults on its bonds. The voting rights provision is worthless and merely raises the issue of thin capitalization. Gail, Cliff, and Ruth already control Magenta Corporation, so what purpose is served by increasing their voting rights? The parties probably used a boilerplate bond agreement that was designed for third-party lenders (e.g., banks and other financial institutions).

EXAMPLE

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- Pro rata holding of debt is difficult to avoid. For example, if each of the shareholders owns one-third of the stock, each will want one-third of the debt. Nevertheless, some variation is possible.

Assume the same facts as Example 37, except that only Gail and Cliff acquire the bonds. Ruth leases property to Magenta Corporation at an annual rent that approximates the yield on the bonds. Presuming the rent passes the arm's length test (i.e., what unrelated parties would charge), all parties reach the desired result. Gail and Cliff withdraw corporate profits in the form of interest income, and Ruth is provided for with rent income. Magenta Corporation can deduct both the interest and the rent payments.

EXAMPLE

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- Try to keep the debt-equity ratio within reasonable proportions. A problem frequently arises when the parties form the corporation. Often, the amount invested in capital stock is the minimum required by state law. For example, if the state of incorporation permits a minimum of \$1,000, limiting the investment to this amount does not provide much safety for later debt financing by the shareholders.
- Stressing the fair market value of the assets rather than their tax basis to the corporation can be helpful in preparing to defend debt-equity ratios.

Emily, Josh, and Miles form Black Corporation with the following capital investments: cash of \$200,000 from Emily; land worth \$200,000 (basis of \$20,000) from Josh; and a patent worth \$200,000 (basis of \$0) from Miles. To state that the equity of Black Corporation is \$220,000 (the tax basis to the corporation) does not reflect reality. The equity account is more properly stated at \$600,000 (\$200,000 + \$200,000 + \$200,000).

EXAMPLE

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- The nature of the business can have an effect on what is an acceptable debt-equity ratio. Capital-intensive industries (e.g., manufacturing and transportation) characteristically rely heavily on debt financing. Consequently, larger debt should be tolerated.

What if a corporation's efforts to avoid the thin capitalization problem fail and the IRS raises the issue on audit? What steps should the shareholders take? They should hedge their position by filing a protective claim for refund, claiming dividend treatment on the previously reported interest income. In such an event, ordinary income would be converted to preferential dividend income treatment. Otherwise, the IRS could ultimately invoke the statute of limitations and achieve the best of all possible worlds—the shareholders would have been taxed on the interest income at the ordinary income rates while the corporation would receive no deduction for what is now reclassified as a dividend. By filing the claim for refund, the shareholders have kept the statute of limitations from running until the thin capitalization issue is resolved at the corporate level.

18-5d Investor Losses

Be aware of the danger of losing § 1244 attributes. Only the original holder of § 1244 stock is entitled to ordinary loss treatment. If after a corporation is formed the owner transfers shares of stock to family members to shift income within the family group, the benefits of § 1244 are lost.

EXAMPLE

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Norm incorporates his business by transferring property with a basis of \$100,000 for 100 shares of stock. The stock qualifies as § 1244 stock. Norm later gives 50 shares each to his children, Susan and Paul. Eventually, the business fails, and the shares of stock become worthless. If Norm had retained the stock, he would have had an ordinary loss deduction of \$100,000 (assuming that he filed a joint return). Susan and Paul, however, have a capital loss of \$50,000 each because the § 1244 attributes are lost as a result of the gift (i.e., neither Susan nor Paul was an original holder of the stock).

REFOCUS ON THE BIG PICTURE

TAX ISSUES CAN BE NEUTRALIZED WHEN GROWING INTO THE CORPORATE FORM



Emily, the sole property transferor, must acquire at least 80 percent of the stock issued by Garden, Inc., for the transaction to receive tax-deferred treatment under § 351. Otherwise, a tremendous amount of gain (up to \$600,000) will be recognized. As a corollary, David must not receive more than 20 percent of Garden's stock in exchange for his services (see Example 10). However, even if § 351 is available, any debt issued by the corporation will be treated as boot and will trigger gain recognition to Emily (see Example 4). Therefore, she must evaluate the cost of recognizing gain now versus the benefit of Garden obtaining an interest deduction later.

What If?

Can the § 351 transaction be modified to further reduce personal and business tax costs, both at the time of formation and in future years? Several strategies may be worth considering.

- Instead of having Garden issue debt on formation, Emily might withhold certain assets. If the building is not transferred, for example, it can be leased to the corporation. The resulting rent payment would mitigate the double tax problem by producing a tax deduction for Garden.

continued

- An additional benefit results if Emily does not transfer the cash basis receivables to Garden. This approach avoids a tax at the corporate level and a further tax when the receipts are distributed to Emily in the form of a dividend. If the receivables are withheld, their collection is taxed only to Emily (see Example 36).
- No mention is made as to the existence (or nonexistence) of any accounts payable outstanding at the time of corporate formation. If they do exist, which is likely, it might be wise for Emily to transfer them to Garden. The subsequent corporate payment of the liability produces a corporate deduction that will reduce any corporate tax.

Double taxation can be mitigated in certain situations with a modest amount of foresight!

Key Terms

Built-in loss property, 18-14

Capital contribution, 18-17

Control, 18-6

Investor loss, 18-21

Liabilities in excess of basis, 18-10

Nonbusiness bad debts, 18-22

Property, 18-5

Qualified small business corporation, 18-24

Qualified small business stock, 18-24

Section 1244 stock, 18-23

Securities, 18-6

Thin capitalization, 18-19

Discussion Questions

1. **LO.1** In terms of justification and effect, § 351 (transfers to a controlled corporation) and § 1031 (like-kind exchanges) are much alike. Explain.
2. **LO.1** Under what circumstances will gain and/or loss be recognized on a § 351 transfer?
3. **LO.1** What does “property” include for purposes of § 351?
4. **LO.1** Can the receipt of boot ever be taxable in a § 351 transfer in the absence of realized gain? Explain.
5. **LO.1** Does the receipt of securities in exchange for the transfer of appreciated property to a controlled corporation cause recognition of gain? Explain.
6. **LO.1** What is the control requirement of § 351? Describe the effect of the following in satisfying this requirement:
 - a. A shareholder renders only services to the corporation for stock.
 - b. A shareholder renders services and transfers property to the corporation for stock.
 - c. A shareholder has only momentary control after the transfer.
 - d. A long period of time elapses between the transfers of property by different shareholders.
7. **LO.1** Nancy and her daughter, Kathleen, have been working together in a cattery called “The Perfect Cat.” Nancy formed the business in 2000 as a sole proprietorship, and it has been very successful. Assets have a fair market value of \$450,000 and a basis of \$180,000. On the advice of their tax accountant, Nancy decides to incorporate “The Perfect Cat.” Because of Kathleen’s participation, Nancy would like her to receive shares in the corporation. What are the relevant tax issues?

Issue ID

- Issue ID** 8. **LO.1, 2, 7** Four friends plan to form a corporation for purposes of constructing a shopping center. Charlie will be contributing the land for the project and wants more security than shareholder status provides. He is contemplating two possibilities: receive corporate bonds for his land or take out a mortgage on the land before transferring it to the corporation. Comment on the choices Charlie is considering. What alternatives can you suggest?
- Decision Making**
- Issue ID** 9. **LO.1** At a point when Robin Corporation has been in existence for six years, shareholder Ted transfers real estate (adjusted basis of \$20,000 and fair market value of \$100,000) to the corporation for additional stock. At the same time, Peggy, the other shareholder, acquires one share of stock for cash. After the two transfers, the percentages of stock ownership are as follows: 79% by Ted and 21% by Peggy.
- What were the parties trying to accomplish?
 - Will it work? Explain.
10. **LO.2** How does the transfer of mortgaged property to a controlled corporation affect the transferor-shareholder's basis in stock received? Assume that no gain is recognized on the transfer.
11. **LO.3** Discuss how each of the following affects the calculation of the basis of stock received by a shareholder in a § 351 transfer:
- The transfer of a liability to the corporation along with property.
 - Property that has been transferred has built-in losses.
 - The basis in the property transferred to the corporation.
 - The receipt of "other property" (i.e., boot) in addition to stock.
12. **LO.3** In a § 351 transfer, Grebe Corporation receives property in exchange for stock. Will Grebe's holding period for the property be the same as the shareholder's holding period for the stock? Explain.
13. **LO.4** A corporation acquires property as a contribution to capital from a shareholder and from a nonshareholder. Are the rules pertaining to the property's basis the same? Explain.
14. **LO.5** In structuring the capitalization of a corporation, what are the advantages and disadvantages of utilizing debt rather than equity?
15. **LO.6** Katie, a single taxpayer, invested \$75,000 in the stock of Penguin Corporation, which recently declared bankruptcy. Although distressed over the loss of her investment, Katie is relieved that she can claim a \$75,000 ordinary (rather than capital) loss deduction. Comment on Katie's expectations.
16. **LO.6** Under what circumstances, if any, may a shareholder deduct a business bad debt on a loan made to the corporation?
- Issue ID** 17. **LO.1, 7** Keith's sole proprietorship holds assets that, if sold, would yield a gain of \$100,000. It also owns assets that would yield a loss of \$30,000. Keith incorporates his business using only the gain assets. Two days later, Keith sells the loss assets to the newly formed corporation. What is Keith trying to accomplish? Will he be successful? Explain.
- Issue ID** 18. **LO.7** Sarah incorporates her small business but does not transfer the machinery and equipment the business uses to the corporation. Subsequently, the machinery and equipment are leased to the corporation for an annual rent. What tax reasons might Sarah have for not transferring the machinery and equipment to the corporation when the business was incorporated?

Computational Exercises

19. **LO.1** Marie and Ethan form Roundtree Corporation with the transfer of the following. Marie performs personal services for the corporation with a fair market value of \$80,000 in exchange for 400 shares of stock. Ethan contributes an installment note receivable (basis \$25,000; fair market value \$30,000), land (basis \$50,000; fair market value \$170,000), and inventory (basis \$100,000; fair market value \$120,000) in exchange for 1,600 shares. Determine Marie and Ethan's current income, gain, or loss; calculate the basis that each takes in the Roundtree stock.
20. **LO.1** Grady exchanges qualified property, basis of \$12,000 and fair market value of \$18,000, for 60% of the stock of Eadie Corporation. The other 40% of the stock is owned by Pedro, who acquired it five years ago. Calculate Grady's current income, gain, or loss and the basis he takes in his shares of Eadie stock as a result of this transaction.
21. **LO.2** Jocelyn contributes land with a basis of \$60,000 and fair market value of \$90,000 and inventory with a basis of \$5,000 and fair market value of \$8,000 in exchange for 100% of Zion Corporation stock. The land is subject to a \$15,000 mortgage. Determine Jocelyn's recognized gain or loss and the basis in the Zion stock received.
22. **LO.2** Martin transfers real estate with an adjusted basis of \$260,000 and fair market value of \$350,000 to a newly formed corporation in exchange for 100% of the stock. The corporation assumes the liability on the transferred real estate in the amount of \$300,000. Determine Martin's recognized gain on the transfer and the basis for his stock.
23. **LO.3** Yvonne and Simon form Ion Corporation. Yvonne transfers equipment (basis of \$110,000 and fair market value of \$165,000). Simon invests \$130,000 of cash. They each receive 100 shares in Ion Corporation, worth \$130,000, but Yvonne also receives \$35,000 in cash from Ion. Calculate Ion Corporation's basis in the equipment. In addition, determine Yvonne and Simon's basis in the Ion stock.
24. **LO.5** Chaz transfers cash of \$60,000 to a newly formed corporation for 100% of the stock. In its initial year, the corporation has net income of \$15,000. The income is credited to its earnings and profits account. The corporation distributes \$5,000 to Chaz.
- How do Chaz and the corporation treat the \$5,000 distribution?
 - Assume, instead, that Chaz transfers to the corporation cash of \$30,000 for stock and cash of \$30,000 for a note of the same amount. The note is payable in equal annual installments of \$3,000 each (beginning at the end of the corporation's initial year of operations) and bears interest at the rate of 6%. At the end of the year, the corporation pays an amount to meet this obligation. Determine the total amount of the payment and its tax treatment to Chaz and the corporation.
25. **LO.6** Several years ago, Lowell, who is single, acquired § 1244 stock in Blue Corporation at a cost of \$60,000. He sells the Blue stock for \$5,000 in the current year. Determine the amount and nature of Lowell's gain or loss recognized this year.

Problems

26. **LO.1, 3** Seth, Pete, Cara, and Jen form Kingfisher Corporation with the following consideration:

	Consideration Transferred		
	Basis to Transferor	Fair Market Value	Number of Shares Issued
From Seth—			
Inventory	\$30,000	\$96,000	30*
From Pete—			
Equipment (\$30,000 of depreciation taken by Pete in prior years)	45,000	99,000	30**
From Cara—			
Proprietary process	15,000	90,000	30
From Jen—			
Cash	30,000	30,000	10

*Seth receives \$6,000 in cash in addition to the 30 shares.

**Pete receives \$9,000 in cash in addition to the 30 shares.

Assume that the value of each share of Kingfisher stock is \$3,000. As to these transactions, provide the following information:

- Seth's recognized gain or loss. Identify the nature of any such gain or loss.
 - Seth's basis in the Kingfisher Corporation stock.
 - Kingfisher Corporation's basis in the inventory.
 - Pete's recognized gain or loss. Identify the nature of any such gain or loss.
 - Pete's basis in the Kingfisher Corporation stock.
 - Kingfisher Corporation's basis in the equipment.
 - Cara's recognized gain or loss.
 - Cara's basis in the Kingfisher Corporation stock.
 - Kingfisher Corporation's basis in the proprietary process.
 - Jen's recognized gain or loss.
 - Jen's basis in the Kingfisher stock.
27. **LO.1, 3** Tom and Gail form Owl Corporation with the following consideration:

	Consideration Transferred		
	Basis to Transferor	Fair Market Value	Number of Shares Issued
From Tom—			
Cash	\$ 50,000	\$ 50,000	
Installment note	240,000	350,000	40
From Gail—			
Inventory	60,000	50,000	
Equipment	125,000	250,000	
Patentable invention	15,000	300,000	60

The installment note has a face amount of \$350,000 and was acquired last year from the sale of land held for investment purposes (adjusted basis of \$240,000). As to these transactions, provide the following information:

- Tom's recognized gain or loss.
- Tom's basis in the Owl Corporation stock.
- Owl Corporation's basis in the installment note.
- Gail's recognized gain or loss.
- Gail's basis in the Owl Corporation stock.

- f. Owl Corporation's basis in the inventory, equipment, and the patentable invention.
- g. How would your answers to the preceding questions change if Tom received common stock and Gail received preferred stock?
- h. How would your answers change if Gail was a partnership?
28. **LO.1, 7** Jane, Jon, and Clyde incorporate their respective businesses and form Starling Corporation. On March 1 of the current year, Jane exchanges her property (basis of \$50,000 and value of \$150,000) for 150 shares in Starling Corporation. On April 15, Jon exchanges his property (basis of \$70,000 and value of \$500,000) for 500 shares in Starling. On May 10, Clyde transfers his property (basis of \$90,000 and value of \$350,000) for 350 shares in Starling. **Decision Making**
- a. If the three exchanges are part of a prearranged plan, what gain will each of the parties recognize on the exchanges?
- b. Assume that Jane and Jon exchanged their property for stock four years ago, while Clyde transfers his property for 350 shares in the current year. Clyde's transfer is not part of a prearranged plan with Jane and Jon to incorporate their businesses. What gain will Clyde recognize on the transfer?
- c. Returning to the original facts, if the property that Clyde contributes has a basis of \$490,000 (instead of \$90,000), how might the parties otherwise structure the transaction?
29. **LO.1** Michael Kennedy (1635 Maple Street, Syracuse, NY 13201) exchanges property (basis of \$200,000 and fair market value of \$850,000) for 75% of the stock of Red Corporation. The other 25% is owned by Sarah Mitchell, who acquired her stock several years ago. You represent Michael, who asks whether he must report gain on the transfer. Prepare a letter to Michael and a memorandum for the tax files documenting your response. **Communications**
30. **LO.1** John organized Toucan Corporation 10 years ago. He contributed property worth \$1 million (basis of \$200,000) for 2,000 shares of stock in Toucan (representing 100% ownership). John later gave each of his children, Julie and Rachel, 500 shares of the stock. In the current year, John transfers property worth \$350,000 (basis of \$170,000) to Toucan for 1,000 more of its shares. What gain, if any, will John recognize on the transfer?
31. **LO.1, 3** Ann and Bob form Robin Corporation. Ann transfers property worth \$420,000 (basis of \$150,000) for 70 shares in Robin Corporation. Bob receives 30 shares for property worth \$165,000 (basis of \$30,000) and for legal services (worth \$15,000) in organizing the corporation.
- a. What gain or income, if any, will the parties recognize on the transfer?
- b. What basis do Ann and Bob have in the stock in Robin Corporation?
- c. What is Robin Corporation's basis in the property and services it received from Ann and Bob?
32. **LO.1, 7** Rhonda owns 50% of the stock of Peach Corporation. She and the other 50% shareholder, Rachel, have decided that additional contributions of capital are needed if Peach is to remain successful in its competitive industry. The two shareholders have agreed that Rhonda will contribute assets having a value of \$200,000 (adjusted basis of \$15,000) in exchange for additional shares of stock. After the transaction, Rhonda will hold 75% of Peach Corporation and Rachel's interest will fall to 25%. **Decision Making**
- a. What gain is realized on the transaction? How much of the gain will be recognized?
- b. Rhonda is not satisfied with the transaction as proposed. How will the consequences change if Rachel agrees to transfer \$1,000 of cash in exchange for additional stock? In this case, Rhonda will own slightly less than 75% of Peach and Rachel's interest will be slightly more than 25%.
- c. If Rhonda still is not satisfied with the result, what should be done to avoid any gain recognition?

33. **LO.1, 2, 3** Cynthia, a sole proprietor, was engaged in a service business and reported her income on the cash basis. On February 2, 2015, she incorporates her business as Dove Corporation and transfers the assets of the business to the corporation in return for all of the stock in addition to the corporation's assumption of her proprietorship's liabilities. All of the receivables and the unpaid trade payables are transferred to the newly formed corporation. The balance sheet of the corporation immediately after its formation is as follows:

Assets		
	Basis to Dove	Fair Market Value
Cash	\$ 80,000	\$ 80,000
Accounts receivable	–0–	240,000
Equipment (cost \$180,000; depreciation previously claimed \$60,000)	120,000	320,000
Building (straight-line depreciation)	160,000	400,000
Land	40,000	160,000
Total	<u>\$400,000</u>	<u>\$1,200,000</u>
Liabilities and Stockholder's Equity		
Liabilities:		
Accounts payable—trade		\$ 120,000
Notes payable—bank		360,000
Stockholder's equity:		
Common stock		720,000
Total		<u>\$1,200,000</u>

Discuss the tax consequences of the incorporation of the business to Cynthia and to Dove Corporation.

34. **LO.1, 2, 3** Allie forms Broadbill Corporation by transferring land (basis of \$125,000, fair market value of \$775,000), which is subject to a mortgage of \$375,000. One month prior to incorporating Broadbill, Allie borrows \$100,000 for personal reasons and gives the lender a second mortgage on the land. Broadbill Corporation issues stock worth \$300,000 to Allie and assumes the mortgages on the land.
- What are the tax consequences to Allie and to Broadbill Corporation?
 - How would the tax consequences to Allie differ if she had not borrowed the \$100,000?

- Decision Making** 35. **LO.1, 3** Rafael transfers the following assets to Crane Corporation in exchange for all of its stock. (Assume that neither Rafael nor Crane plans to make any special tax elections at the time of incorporation.)

Assets	Rafael's Adjusted Basis	Fair Market Value
Inventory	\$ 60,000	\$100,000
Equipment	150,000	105,000
Shelving	80,000	65,000

- What is Rafael's recognized gain or loss?
- What is Rafael's basis in the stock?
- What is Crane's basis in the inventory, equipment, and shelving?
- If Rafael has no intentions of selling his Crane stock for at least 15 years, what action would you recommend that Rafael and Crane Corporation consider? How does this change the previous answers?

36. **LO.1, 3** Alice and Jane form Osprey Corporation. Alice transfers property, basis of \$25,000 and value of \$200,000, for 50 shares in Osprey Corporation. Jane transfers property, basis of \$50,000 and value of \$165,000, and agrees to serve as manager of Osprey for one year; in return, Jane receives 50 shares in Osprey. The value of Jane's services to Osprey is \$35,000.
- What gain or income do Alice and Jane recognize on the exchange?
 - What is Osprey Corporation's basis in the property transferred by Alice and Jane? How does Osprey treat the value of the services that Jane renders?
37. **LO.1, 3** Assume in Problem 36 that Jane receives the 50 shares of Osprey Corporation stock in consideration for the appreciated property and for the provision of accounting services in organizing the corporation. The value of Jane's services is \$35,000.
- What gain or income does Jane recognize?
 - What is Osprey Corporation's basis in the property transferred by Jane? How does Osprey treat the value of the services that Jane renders?
38. **LO.4** Red Corporation wants to set up a manufacturing facility in a midwestern state. After considerable negotiations with a small town in Ohio, Red accepts the following offer: land (fair market value of \$3 million) and cash of \$1 million.
- How much gain or income, if any, must Red Corporation recognize?
 - What basis will Red Corporation have in the land?
 - Within one year of the contribution, Red constructs a building for \$800,000 and purchases inventory for \$200,000. What basis will Red Corporation have in each of those assets?
39. **LO.5, 6** Emily Patrick (36 Paradise Road, Northampton, MA 01060) formed Teal Corporation a number of years ago with an investment of \$200,000 cash, for which she received \$20,000 in stock and \$180,000 in bonds bearing interest of 8% and maturing in nine years. Several years later Emily lent the corporation an additional \$50,000 on open account. In the current year, Teal Corporation becomes insolvent and is declared bankrupt. During the corporation's existence, Emily was paid an annual salary of \$60,000. Write a letter to Emily in which you explain how she would treat her losses for tax purposes. **Communications**
40. **LO.5, 6** Stock in Jaybird Corporation (555 Industry Lane, Pueblo, CO 81001) is held equally by Vera, Wade, and Wes. Jaybird seeks additional capital in the amount of \$900,000 to construct a building. Vera, Wade, and Wes each propose to lend Jaybird Corporation \$300,000, taking from Jaybird a \$300,000 four-year note with interest payable annually at two points below the prime rate. Jaybird Corporation has current taxable income of \$2 million. You represent Jaybird Corporation. Jaybird's president, Steve Ferguson, asks you how the payments on the notes might be treated for tax purposes. Prepare a letter to Ferguson and a memo for your tax files in which you document your conclusions. **Communications**
41. **LO.6** Sam, a single taxpayer, acquired stock in a corporation that qualified as a small business corporation under § 1244 at a cost of \$100,000 three years ago. He sells the stock for \$10,000 in the current tax year.
- How will the loss be treated for tax purposes?
 - Assume instead that Sam sold the stock to his sister, Kara, a few months after it was acquired for \$100,000 (its fair market value). If Kara sells the stock for \$60,000 in the current year, how should she treat the loss for tax purposes?
42. **LO.6** Three years ago and at a cost of \$40,000, Paul Sanders acquired stock in a corporation that qualified as a small business corporation under § 1244. A few months after he acquired the stock, when it was still worth \$40,000, he gave it to his brother, Mike Sanders. Mike, who is married and files a joint return, sells the stock **Communications**

for \$25,000 in the current tax year. Mike asks you, his tax adviser, how the sale will be treated for tax purposes. Prepare a letter to your client and a memo for the file. Mike's address is 10 Hunt Wood Drive, Hadley, PA 16130.

43. **LO.6** Gigi transfers real estate (basis of \$60,000 and fair market value of \$40,000) to Monarch Corporation in exchange for shares of § 1244 stock. (Assume that the transfer qualifies under § 351.)
- What is the basis of the stock to Gigi? (Gigi and Monarch do not make an election to reduce her stock basis.)
 - What is the basis of the stock to Gigi for purposes of § 1244?
 - If Gigi sells the stock for \$38,000 two years later, how will the loss be treated for tax purposes?

Decision Making

44. **LO.5, 7** Frank, Cora, and Mitch are equal shareholders in Purple Corporation. The corporation's assets have a tax basis of \$50,000 and a fair market value of \$600,000. In the current year, Frank and Cora each loan Purple Corporation \$150,000. The notes to Frank and Cora bear interest of 8% per annum. Mitch leases equipment to Purple Corporation for an annual rental of \$12,000. Discuss whether the shareholder loans from Frank and Cora might be reclassified as equity. Consider in your discussion whether Purple Corporation has an acceptable debt-equity ratio.

Research Problems

THOMSON REUTERS

CHECKPOINT[®]
Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint[®] Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Decision Making Communications

Research Problem 1. Lynn Jones, Shawn, Walt, and Donna are trying to decide whether they should organize a corporation and transfer their shares of stock in several corporations to this new corporation. All of their shares are listed on the New York Stock Exchange and are readily marketable. Lynn would transfer shares in Brown Corporation, Shawn would transfer stock in Rust Corporation, Walt would transfer stock in White Corporation, and Donna would transfer stock in several corporations. The stock would be held by the newly formed corporation for investment purposes. Lynn asks you, her tax adviser, whether she would have gain on the transfer of her substantially appreciated shares in Brown Corporation if she transfers the shares to a newly formed corporation. Your input will be critical as they make their decision. Prepare a letter to your client, Lynn Jones, and a memo for the firm's files. Lynn's address is 1540 Maxwell Avenue, Highland, KY 41099.

Research Problem 2. Tim is a real estate broker who specializes in commercial real estate. Although he usually buys and sells on behalf of others, he also maintains a portfolio of property of his own. He holds this property, mainly unimproved land, either as an investment or for sale to others.

In early 2013, Irene and Al contact Tim regarding a tract of land located just outside the city limits. Tim bought the property, which is known as the Moore farm, several years ago for \$600,000. At that time, no one knew that it was located on a geological fault line. Irene, a well-known architect, and Al, a building contractor, want Tim to join them in developing the property for residential use. They are aware of the fault line but believe that they can circumvent the problem by using newly developed design and construction technology. Because of the geological flaw, however, they regard the Moore farm as being worth only \$450,000. Their intent is to organize a corporation to build the housing project, and each party will receive stock commensurate to the property or services contributed.

After consulting his tax adviser, Tim agrees to join the venture if certain modifications to the proposed arrangement are made. The transfer of the land would be structured as a sale to the corporation. Instead of receiving stock, Tim would receive a note from the corporation. The note would be interest-bearing and be due in five years. The maturity value of the note would be \$450,000—the amount that even Tim concedes is the fair market value of the Moore farm.

What income tax consequences ensue from Tim's suggested approach? Compare this result with what would happen if Tim merely transferred the Moore farm in return for stock in the new corporation.

Research Problem 3. Sarah is the sole owner of Bluegrass Corporation. The basis and value of her stock investment in Bluegrass are approximately \$100,000. In addition, she manages Bluegrass's operations on a full-time basis and pays herself an annual salary of \$40,000. Because of a recent downturn in business, she needs to put an additional \$80,000 into her corporation to help meet short-term cash-flow needs (e.g., inventory costs, salaries, and administrative expenses). Sarah believes that the \$80,000 transfer can be structured in one of three ways: as a capital contribution, as a loan made to protect her stock investment, or as a loan intended to protect her job. From a tax perspective, which alternative would be preferable in the event that Bluegrass's economic slide worsens and bankruptcy results? Explain your answer.

Partial list of research aids:

Kenneth W. Graves, 87 TCM 1409, T.C.Memo. 2004-140.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet
Activity

Research Problem 4. Identify two publicly traded corporations that have issued more than one class of stock to their shareholders. Was the issuance of the additional classes of stock part of the original incorporation, or did it occur later? Determine the rationale for the corporations' actions.

Research Problem 5. Limited liability company (LLC) status has become a popular form of operating a business in the United States. Investigate how the growth of LLC status has affected the relative number of new businesses that have chosen to operate as corporations.

Roger CPA Review Questions

- Kellye and Becky formed Whoop! Shutz Corporation by contributing property with a fair market value of \$50,000 and \$70,000 cash, respectively, each for a 50% ownership in the newly formed company. What is Kellye's taxable gain in this situation if the adjusted basis in the property is \$25,000 and the company is valued at \$120,000?

a. \$0	c. \$25,000
b. \$10,000	d. \$35,000
- Kellye, Becky, and Emily formed Whoop! Shutz Corporation on 1/1/20X4 with the following contributions:

Kellye	\$50,000 cash
Becky	\$50,000 cash
Emily	Legal services

Each was given a one-third ownership in Whoop! Shotz. What amount of income will Emily recognize if the company is valued at \$150,000 after formation?

- a. \$50,000
 b. \$33,333
 c. \$0
 d. \$40,000

3. Emily, Becky, and Kellye form Whoop! Shotz with the following contributions:

Emily	\$25,000
Becky	\$25,000
Kellye	Legal services

After the formation, each has a one-third stake in the company. What amount of gain or income will they each record if the company is valued at \$100,000?

	Emily	Becky	Kellye
a.	\$ 0	\$ 0	\$25,000
b.	8,333	8,333	33,333
c.	0	0	33,333
d.	25,000	25,000	25,000

4. Kellye and Becky create Whoop! Shotz Corporation by contributing property with a fair market value of \$50,000 and cash of \$70,000, respectively. Each receives a 50% share in the company, which is valued at \$150,000 immediately after the formation. The property has an adjusted basis of \$25,000 and is subject to a \$10,000 mortgage, which is assumed by the company. What gain will Kellye recognize in this situation?

- a. \$0
 b. \$10,000
 c. \$15,000
 d. \$25,000

5. Herman, a single individual, formed a corporation in Year 1 by way of a qualifying § 351 tax-free asset transfer, in which he transferred property having an adjusted basis of \$250,000 and a fair market value of \$220,000 and received § 1244 small business corporation stock in exchange. In Year 3 Herman sold all of the stock for \$210,000. What is the amount and character of loss that Herman must recognize as a result of selling the stock in Year 3?

	Ordinary Loss	Capital Loss
a.	\$ 0	\$40,000
b.	10,000	30,000
c.	40,000	0
d.	10,000	0

Corporations: Distributions Not in Complete Liquidation

LEARNING OBJECTIVES: *After completing Chapter 19, you should be able to:*

- LO.1** Explain the role that earnings and profits play in determining the tax treatment of distributions.
- LO.2** Compute a corporation's earnings and profits (E & P).
- LO.3** Determine taxable dividends paid during the year by correctly allocating current and accumulated E & P to corporate distributions.
- LO.4** Describe the tax treatment of dividends for individual shareholders.
- LO.5** Evaluate the tax impact of property dividends by computing the shareholder's dividend income, basis in the property received, and the effect on the distributing corporation's E & P and taxable income.
- LO.6** Recognize situations when constructive dividends exist and compute the tax resulting from such dividends.
- LO.7** Compute the tax arising from receipt of stock dividends and stock rights and the shareholder's basis in the stock and stock rights received.
- LO.8** Identify various stock redemptions that qualify for sale or exchange treatment.
- LO.9** Determine the tax impact of stock redemptions on the distributing corporation.
- LO.10** Identify planning opportunities available to minimize the tax impacts of corporate distributions, constructive dividends, and stock redemptions.

CHAPTER OUTLINE

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THE BIG PICTURE

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TAXING CORPORATE DISTRIBUTIONS

Lime Corporation, an ice cream manufacturer, has had a very profitable year. To share its profits with its two equal shareholders, Orange Corporation and Gustavo, it distributes cash of \$200,000 to Orange and real estate worth \$300,000 (adjusted basis of \$20,000) to Gustavo. The real estate is subject to a mortgage of \$100,000, which Gustavo assumes. The distribution is made on December 31, Lime's year-end.

Lime Corporation has had both good and bad years in the past. More often than not, however, it has lost money. Despite this year's banner profits, the GAAP-based balance sheet for Lime indicates a year-end deficit in retained earnings. Consequently, the distribution of cash and land is treated as a liquidating distribution for financial reporting purposes, resulting in a reduction of Lime's paid-in capital account.

The tax consequences of the distributions to Lime Corporation and its shareholders depend on a variety of factors that are not directly related to the financial reporting treatment. Identify these factors, and explain the tax effects of the distributions to both Lime Corporation and its two shareholders.

Read the chapter and formulate your response.

Chapter 18 examined the tax consequences of corporate formation. In Chapters 19 and 20, the focus shifts to the tax treatment of corporate distributions, a topic that plays a leading role in tax planning. The importance of corporate distributions derives from the variety of tax treatments that may apply. From the shareholder's perspective, distributions received from the corporation may be treated as ordinary income, preferentially taxed dividend income, capital gain, or a nontaxable recovery of capital. From the corporation's perspective, distributions made to shareholders are generally not deductible. However, a corporation may recognize losses in liquidating distributions (see Chapter 20), and gains may be recognized at the corporate level on distributions of appreciated property.

In the most common scenario, a distribution triggers dividend income to the shareholder and provides no deduction to the paying corporation, resulting in a double tax (i.e., a tax is levied at both the corporate and shareholder levels). This double tax may be mitigated by a variety of factors, including the corporate dividends received deduction and preferential tax rates on qualified dividends paid to individuals.

As will become apparent in the subsequent discussion, the tax treatment of corporate distributions can be affected by a number of considerations:

- The availability of earnings to be distributed.
- Whether the distribution is a “qualified dividend.”
- Whether the shareholder is an individual or another kind of taxpaying entity.
- The basis of the shareholder's stock.
- The character of the property being distributed.
- Whether the shareholder gives up ownership in return for the distribution.
- Whether the distribution is liquidating or nonliquidating.

This chapter discusses the tax rules related to nonliquidating distributions of cash and other property. Distributions of stock and stock rights are also addressed along with the tax treatment of stock redemptions. Corporate liquidations are discussed in Chapter 20.

LO.1

Explain the role that earnings and profits play in determining the tax treatment of distributions.

19-1 CORPORATE DISTRIBUTIONS—OVERVIEW

To the extent that a distribution is made from corporate earnings and profits (E & P), the shareholder is deemed to receive a dividend, which is taxed either as ordinary income or as preferentially taxed dividend income.¹ Generally, corporate distributions are presumed to be paid out of E & P (defined later in this chapter) and are treated as dividends *unless* the parties to the transaction can show otherwise. Distributions not treated as dividends (because of insufficient E & P) are nontaxable to the extent of the shareholder's stock basis, which is reduced accordingly. The excess of the distribution over the shareholder's basis is treated as a gain from the sale or exchange of the stock.²

EXAMPLE

1

At the beginning of the year, Amber Corporation (a calendar year taxpayer) has E & P of \$15,000. The corporation generates no additional E & P during the year. On July 1, the corporation distributes \$20,000 to its sole shareholder, Bonnie, whose stock basis is \$4,000. In this situation, Bonnie recognizes dividend income of \$15,000 (the amount of E & P distributed). Of the remaining \$5,000 distributed, \$4,000 reduces her stock basis to zero, and Bonnie recognizes a taxable gain of \$1,000.

¹§§ 301(c)(1), 316, and 1(h)(11).

²§§ 301(c)(2) and (3).

19-2 EARNINGS AND PROFITS (E & P)

The notion of **earnings and profits (E & P)** is similar in many respects to the accounting concept of retained earnings. Both are measures of the firm's accumulated capital (E & P includes both the accumulated E & P of the corporation since the latter of its incorporation date or February 28, 1913, and the current year's E & P). A difference exists, however, in the way these figures are calculated. The computation of retained earnings is based on financial accounting rules, while E & P is determined using rules specified in the tax law.

E & P fixes the upper limit on the amount of dividend income that shareholders must recognize as a result of a distribution by the corporation. In this sense, E & P represents the corporation's economic ability to pay a dividend without impairing its capital. Thus, the effect of a specific transaction on E & P may often be determined by assessing whether the transaction increases or decreases the corporation's capacity to pay a dividend.

19-2a Computation of E & P

The Code does not explicitly define the term *earnings and profits*. Instead, a series of adjustments to taxable income are identified to provide a measure of the corporation's economic income. Both cash basis and accrual basis corporations use the same approach when determining E & P.³

Additions to Taxable Income

To determine current E & P, it is necessary to add *all* previously excluded income items back to taxable income. Included among these positive adjustments are interest on municipal bonds, excluded life insurance proceeds (in excess of cash surrender value), and Federal income tax refunds from tax paid in prior years.

Eagle Corporation collects \$100,000 on a key employee life insurance policy (the corporation is the owner and beneficiary of the policy). At the time the policy matured on the death of the insured employee, it had a cash surrender value of \$30,000. None of the \$100,000 is included in Eagle's taxable income, but \$70,000 is added to its taxable income when computing current E & P (i.e., amount collected on the policy net of its cash surrender value). The collection of the \$30,000 cash surrender value does not increase E & P because it does not reflect an increase in its dividend-paying capacity. Instead, it represents a shift in Eagle's assets from life insurance to cash.

LO.2

Compute a corporation's earnings and profits (E & P).

EXAMPLE

2

In addition to excluded income items, the dividends received deduction (see Chapter 17) and the domestic production activities deduction (see Chapter 7), which do not decrease the corporation's assets, are added back to taxable income to determine E & P. Neither of these deductions impairs a corporation's ability to pay dividends. Instead, they are partial exclusions for specific types of income (dividend income and income from domestic production activities).

Subtractions from Taxable Income

When calculating E & P, it is also necessary to subtract certain nondeductible expenses from taxable income. These negative adjustments include the nondeductible portion of meal and entertainment expenses; related-party losses; expenses incurred to produce tax-exempt income; Federal income taxes paid; nondeductible key employee life insurance premiums (net of increases in cash surrender value); and nondeductible fines, penalties, and lobbying expenses.

Herron Corporation sells property with a basis of \$10,000 to its sole shareholder for \$8,000. Because of § 267 (disallowance of losses on sales between related parties), Herron cannot deduct the \$2,000 loss when calculating its taxable income. However, because the overall economic effect of the transaction is a decrease in its assets by \$2,000, the loss reduces the current E & P for the year of sale.

EXAMPLE

3

³Section 312 describes many of the adjustments to taxable income necessary to determine E & P. Regulation § 1.312-6 addresses the effect of accounting methods on E & P.

EXAMPLE

4

Crane Corporation pays a \$10,000 premium on a key employee life insurance policy covering the life of its president. As a result of the payment, the cash surrender value of the policy is increased by \$7,000. Although none of the \$10,000 premium is deductible for tax purposes, current E & P is reduced by \$3,000 (i.e., amount of the premium payment net of the increase in the cash surrender value). The \$7,000 increase in cash surrender value is not subtracted because it does not represent a decrease in its ability to pay a dividend. Instead, it represents a shift in Crane's assets from cash to life insurance.

Timing Adjustments

Some E & P adjustments shift the effect of a transaction from the year of its inclusion in or deduction from taxable income to the year in which it has an economic effect on the corporation. Charitable contributions, net operating losses, and capital losses all necessitate this kind of adjustment.

EXAMPLE

5

During 2015, Hawk Corporation makes charitable contributions, \$12,000 of which cannot be deducted when calculating its taxable income for the year because of the 10% taxable income limitation. Consequently, the \$12,000 is carried forward to 2016 and fully deducted in that year. The excess charitable contribution reduces Hawk's current E & P for 2015 by \$12,000 and increases its current E & P for 2016 (when the deduction is allowed) by the same amount. The increase in E & P in 2016 is necessary because the charitable contribution carryover reduces the taxable income for that year (the starting point for computing E & P) but already has been taken into account in determining its E & P for 2015.

Gains and losses from property transactions generally affect the determination of E & P only to the extent they are recognized for tax purposes. Thus, gains and losses deferred under the like-kind exchange provision and deferred involuntary conversion gains do not affect E & P until recognized. Accordingly, no timing adjustment is required for these items.

Accounting Method Adjustments

In addition to the above adjustments, accounting methods used for determining E & P are generally more conservative than those allowed for calculating taxable income. For example, the installment method is not permitted for E & P purposes.⁴ Thus, an adjustment is required for the deferred gain from property sales made during the year under the installment method. All principal payments are treated as having been received in the year of sale.

EXAMPLE

6

In 2015, Cardinal Corporation, a cash basis calendar year taxpayer, sells unimproved real estate with a basis of \$20,000 for \$100,000. Under the terms of the sale, Cardinal will receive two annual payments of \$50,000, beginning in 2016, each with interest of 9%. Cardinal Corporation does not elect out of the installment method. Because Cardinal's taxable income for 2015 will not reflect any of the gain from the sale, the corporation must make an \$80,000 positive adjustment for 2015 (the deferred gain from the sale). Similarly, \$40,000 negative adjustments will be required in 2016 and 2017 when the deferred gain is recognized under the installment method.

The alternative depreciation system (ADS) must be used for purposes of computing E & P.⁵ This method requires straight-line depreciation with a half-year convention over a recovery period equal to the Asset Depreciation Range (ADR) midpoint life of an asset.⁶ Also, ADS prohibits additional first-year depreciation.⁷ If MACRS cost recovery is used for income tax purposes, a positive or negative adjustment equal to the difference between MACRS and ADS must be made each year. Likewise, when assets are disposed

⁴§ 312(n)(5).

⁵§ 312(k)(3)(A).

⁶See § 168(g)(2). The ADR midpoint lives for most assets are set out in Rev.Proc. 87-56, 1987-2 C.B. 674. The recovery period is 5 years for automobiles and light-duty trucks and 40 years for real property. For assets with no class life, the recovery period is 12 years.

⁷§ 168(k)(2). This provision allowing additional first-year cost recovery applied to certain assets placed in service before January 1, 2005. In addition, it was available for certain assets placed in service from 2008 through 2014. This provision may be extended by Congress in 2015.

of, an additional adjustment to taxable income is required to allow for the difference in gain or loss caused by the gap between income tax basis and the E & P basis.⁸ The adjustments arising from depreciation are illustrated in the following example.

On January 2, 2013, White Corporation paid \$30,000 to purchase equipment with an ADR midpoint life of 10 years and a MACRS class life of 7 years. The equipment was depreciated under MACRS. The asset was sold on July 2, 2015, for \$27,000. For purposes of determining taxable income and E & P, cost recovery claimed on the equipment is summarized below. Assume that White elected not to claim § 179 expense or additional first-year depreciation on the property.

EXAMPLE

7

Year	Cost Recovery Computation	MACRS	ADS	Adjustment Amount
2013	\$30,000 × 14.29%	\$ 4,287		
	\$30,000 ÷ 10-year ADR recovery period × 1/2 (half-year for first year of service)		\$1,500	\$2,787
2014	\$30,000 × 24.49%	7,347		
	\$30,000 ÷ 10-year ADR recovery period		3,000	4,347
2015	\$30,000 × 17.49% × 1/2 (half-year for year of disposal)	2,624		
	\$30,000 ÷ 10-year ADR recovery period × 1/2 (half-year for year of disposal)		1,500	1,124
	Total cost recovery	<u>\$14,258</u>	<u>\$6,000</u>	<u>\$8,258</u>

Each year, White Corporation will increase taxable income by the adjustment amount indicated previously to determine E & P. In addition, when computing E & P for 2015, White will reduce taxable income by \$8,258 to account for the excess gain recognized for income tax purposes, as shown below.

	Income Tax	E & P
Amount realized	\$ 27,000	\$ 27,000
Adjusted basis for income tax (\$30,000 cost – \$14,258 MACRS)	(15,742)	
Adjusted basis for E & P (\$30,000 cost – \$6,000 ADS)		(24,000)
Gain on sale	<u>\$ 11,258</u>	<u>\$ 3,000</u>
Adjustment amount (\$3,000 – \$11,258)	<u>(\$ 8,258)</u>	

In addition to more conservative depreciation methods, the E & P rules impose limitations on the deductibility of § 179 expense. In particular, this expense must be deducted over a period of five years.⁹ Thus, in any year that § 179 is elected, 80 percent of the resulting expense must be added back to taxable income to determine current E & P. In each of the following four years, a subtraction from taxable income equal to 20 percent of the § 179 expense must be made.

The E & P rules also require specific accounting methods in various situations, making adjustments necessary when certain methods are used for income tax purposes. For example, E & P requires cost depletion rather than percentage depletion.¹⁰ When accounting for long-term contracts, E & P rules specify the percentage of completion method rather than the completed contract method.¹¹ As the E & P determination does not allow for the amortization of organizational expenses, any such expense deducted when computing taxable income must be added back to determine E & P.¹² To account for income deferral under the LIFO inventory method, the E & P computation requires an adjustment for changes in the LIFO recapture amount (the excess of FIFO over LIFO inventory value) during the year. Increases in LIFO recapture are added to taxable income, and decreases are subtracted.¹³

⁸§ 312(f)(1).

⁹§ 312(k)(3)(B).

¹⁰Reg. § 1.316-2(e).

¹¹§ 312(n)(6).

¹²§ 312(n)(3).

¹³§ 312(n)(4).

E & P rules also specify that intangible drilling costs and mine exploration and development costs be amortized over a period of 60 months and 120 months, respectively.¹⁴ For income tax purposes, however, these costs can be deducted in the current year.

19-2b Summary of E & P Adjustments

Recall that E & P serves as a measure of a corporation's earnings that are available for distribution as taxable dividends to the shareholders. Current E & P is determined by making a series of adjustments to the corporation's taxable income that are outlined in Concept Summary 19.1. Other items that affect E & P, such as property dividends and stock redemptions, are covered later in the chapter.

Concept Summary 19.1

E & P Adjustments

Nature of the Transaction	Adjustment to Taxable Income to Determine Current E & P	
	Addition	Subtraction
Tax-exempt income	X	
Dividends received deduction	X	
Domestic production activities deduction	X	
Collection of proceeds from insurance policy on life of corporate officer (in excess of cash surrender value)	X	
Deferred gain on installment sale (all gain is added to E & P in year of sale)	X	
Future recognition of installment sale gross profit		X
Excess charitable contribution (over 10% limitation) and excess capital loss in year incurred		X
Deduction of charitable contribution, NOL, or capital loss carryovers in succeeding taxable years (increases E & P because deduction reduces taxable income while E & P was reduced in a prior year)	X	
Federal income taxes paid		X
Federal income tax refund	X	
Loss on sale between related parties		X
Nondeductible fines, penalties, and lobbying expenses		X
Nondeductible meal and entertainment expenses		X
Payment of premiums on insurance policy on life of corporate officer (in excess of increase in cash surrender value of policy)		X
Realized gain (not recognized) on an involuntary conversion	No effect	
Realized gain or loss (not recognized) on a like-kind exchange	No effect	
Excess percentage depletion (only cost depletion can reduce E & P)	X	
Accelerated depreciation (E & P is reduced only by straight-line, units-of-production, or machine hours depreciation)	X	X
Additional first-year depreciation	X	
Section 179 expense in year elected (80%)	X	
Section 179 expense in four years following election (20% each year)		X
Increase (decrease) in LIFO recapture amount	X	X
Intangible drilling costs deducted currently (reduce E & P in future years by amortizing costs over 60 months)	X	
Mine exploration and development costs (reduce E & P in future years by amortizing costs over 120 months)	X	

¹⁴§ 312(n)(2).

19-2c **Current versus Accumulated E & P**

Accumulated E & P is the total of all previous years' current E & P (since February 28, 1913) reduced by distributions made from E & P in previous years. It is important to distinguish between **current E & P** and **accumulated E & P** because the taxability of corporate distributions depends upon how these two accounts are allocated to each distribution made during the year. A complex set of rules governs the allocation process.¹⁵ These rules are described in the following section and summarized in Concept Summary 19.2.



Concept Summary 19.2

Allocating E & P to Distributions

1. Current E & P is applied first to distributions on a pro rata basis; then accumulated E & P is applied (as necessary) in chronological order beginning with the earliest distribution. See Example 8.
2. Until the parties can show otherwise, it is presumed that current E & P covers all distributions. See Example 9.
3. When a deficit exists in accumulated E & P and a positive balance exists in current E & P, distributions are regarded as dividends to the extent of current E & P. See Example 10.
4. When a deficit exists in current E & P and a positive balance exists in accumulated E & P, the two accounts are netted at the date of distribution. If the resulting balance is zero or negative, the distribution is treated as a return of capital, first reducing the basis of the stock to zero, then generating taxable gain. If a positive balance results, the distribution is a dividend to the extent of the balance. Any current E & P deficit is deemed to accrue ratably throughout the year unless the corporation can show otherwise. See Example 11.

19-2d **Allocating E & P to Distributions**

When a positive balance exists in both the current and accumulated E & P accounts, corporate distributions are deemed to be made first from current E & P and then from accumulated E & P. When distributions exceed the amount of current E & P, it becomes necessary to allocate current and accumulated E & P to each distribution made during the year. Current E & P is applied first on a pro rata basis to each distribution (using the distribution dollar amounts). Then accumulated E & P is applied in chronological order beginning with the earliest distribution. As shown in the following example, this allocation is important if any shareholder sells stock during the year.

LO3

Determine taxable dividends paid during the year by correctly allocating current and accumulated E & P to corporate distributions.

On January 1 of the current year, Black Corporation has accumulated E & P of \$10,000. Current E & P for the year amounts to \$30,000, earned evenly throughout the year. Megan and Matt are sole *equal* shareholders of Black from January 1 to July 31. On August 1, Megan sells all of her stock to Helen. Black makes two distributions to the shareholders during the year: \$40,000 to Megan and Matt (\$20,000 each) on July 1 and \$40,000 to Matt and Helen (\$20,000 each) on December 1. Current and accumulated E & P are applied to the two distributions as follows:

EXAMPLE

8

	Source of Distribution		
	Current E & P	Accumulated E & P	Return of Capital
July 1 distribution (\$40,000)	\$15,000	\$10,000	\$15,000
December 1 distribution (\$40,000)	15,000	-0-	25,000

continued

¹⁵Regulations relating to the source of a distribution are at Reg. § 1.316-2.

Because 50% of the total distributions are made on July 1 and December 1, respectively, one-half of current E & P is applied to each of the two distributions. Accumulated E & P is applied in chronological order, so the entire amount attaches to the July 1 distribution. The tax consequences to the shareholders are presented below.

	Shareholder		
	Megan	Matt	Helen
July distribution (\$40,000)			
Dividend income—			
From current E & P (\$15,000)	\$ 7,500	\$ 7,500	\$ -0-
From accumulated E & P (\$10,000)	5,000	5,000	-0-
Return of capital (\$15,000)	7,500	7,500	-0-
December distribution (\$40,000)			
Dividend income—			
From current E & P (\$15,000)	-0-	7,500	7,500
From accumulated E & P (\$0)	-0-	-0-	-0-
Return of capital (\$25,000)	-0-	12,500	12,500
Total distribution	<u>\$20,000</u>	<u>\$40,000</u>	<u>\$20,000</u>
Total dividend income	<u>\$12,500</u>	<u>\$20,000</u>	<u>\$ 7,500</u>
Nontaxable return of capital (assuming sufficient basis in the stock investment)	<u>\$ 7,500</u>	<u>\$20,000</u>	<u>\$12,500</u>

Because the balance in the accumulated E & P account is exhausted when it is applied to the July 1 distribution, Megan has more dividend income than Helen, even though both receive equal distributions during the year. In addition, each shareholder's basis is reduced by the nontaxable return of capital; any excess over basis results in taxable gain.

When the tax years of the corporation and its shareholders are not the same, it may be impossible to determine the amount of current E & P on a timely basis. For example, if shareholders use a calendar year and the corporation uses a fiscal year, then current E & P may not be ascertainable until after the shareholders' returns have been filed. To address this timing issue, the allocation rules presume that current E & P is sufficient to cover every distribution made during the year until the parties can show otherwise.

EXAMPLE

9

Green Corporation uses a June 30 fiscal year for tax purposes. Carol, Green's only shareholder, uses a calendar year. On July 1, 2015, Green Corporation has a zero balance in its accumulated E & P account. For fiscal year 2015–2016, the corporation suffers a \$5,000 deficit in current E & P. On August 1, 2015, Green distributes \$10,000 to Carol. The distribution is dividend income to Carol and is reported when she files her income tax return for the 2015 calendar year on or before April 15, 2016. Because Carol cannot prove until June 30, 2016, that the corporation has a deficit for the 2015–2016 fiscal year, she must assume that the \$10,000 distribution is fully covered by current E & P. When Carol learns of the deficit, she should file an amended return for 2015 showing the \$10,000 as a return of capital.

Additional difficulties arise when either the current or the accumulated E & P account has a deficit balance. In particular, when current E & P is positive and accumulated E & P has a deficit balance, accumulated E & P is *not* netted against current E & P. Instead, the distribution is deemed to be a taxable dividend to the extent of the positive current E & P balance.

The Big Picture

Return to the facts of *The Big Picture* on p. 19-1. Recall that Lime Corporation had a deficit in GAAP-based retained earnings at the start of the year and banner profits during the year. Assume that these financial results translate into an \$800,000 deficit in accumulated E & P at the start of the year and current E & P of \$600,000. In addition, for purposes of this example, assume that there is no mortgage on the real estate. In this case, current E & P would exceed the total cash and property distributed to the shareholders. The distributions are treated as taxable dividends; they are deemed to be paid from current E & P even though Lime still has a deficit in accumulated E & P at the end of the year.

EXAMPLE

10

In contrast to the previous rule, when a deficit exists in current E & P and a positive balance exists in accumulated E & P, the accounts are netted at the date of distribution. If the resulting balance is zero or negative, the distribution is a return of capital. If a positive balance results, the distribution is a dividend to the extent of the balance. Any loss in current E & P is deemed to accrue ratably throughout the year unless the parties can show otherwise.

At the beginning of the current year, Gray Corporation (a calendar year taxpayer) has accumulated E & P of \$10,000. During the year, the corporation incurs a \$15,000 deficit in current E & P that accrues ratably. On July 1, Gray distributes \$6,000 in cash to Hal, its sole shareholder. To determine how much of the \$6,000 cash distribution represents dividend income to Hal, the balances of both accumulated and current E & P as of July 1 are determined and netted. This is necessary because of the deficit in current E & P.

EXAMPLE

11

	Source of Distribution	
	Current E & P	Accumulated E & P
January 1		\$10,000
July 1 (1/2 of \$15,000 current E & P deficit)	(\$7,500)	2,500
July 1 distribution of \$6,000:		
Dividend income:		\$2,500
Return of capital:		\$3,500

The balance in E & P just before the July 1 distribution is \$2,500. Thus, of the \$6,000 distribution, \$2,500 is taxed as a dividend, and \$3,500 represents a return of capital.



ETHICS & EQUITY Shifting E & P

Ten years ago, Spencer began a new business venture with Robert. Spencer owns 70 percent of the outstanding stock, and Robert owns 30 percent. The business has had some difficult times, but current prospects are favorable.

On November 15, Robert decides to quit the venture and plans to sell all of his stock to Spencer's sister, Heidi, a longtime employee of the business. Robert will sell his stock to Heidi after the company pays out the current-year shareholder distribution of about \$100,000. Spencer is looking forward to working with his sister, but he now faces a terrible dilemma.

The corporation has a \$300,000 deficit in accumulated E & P and only about \$20,000 of current E & P to date.

Within the next two months, however, Spencer expects to sign a major deal with a large client. If Spencer signs the contract before the end of the year, the corporation will have a large increase in current E & P, causing the upcoming distribution to be fully taxable to Robert as a dividend.

As a similar contract is not expected next year, most of next year's distribution will be treated as a tax-free return of capital for Heidi. Alternatively, if Spencer waits until January, both he and Robert will receive a nontaxable distribution this year. However, next year's annual distribution will be fully taxable to his sister as a dividend. What should Spencer do?

LO.4

Describe the tax treatment of dividends for individual shareholders.

19-3 DIVIDENDS

As noted earlier, distributions by a corporation from its E & P are treated as dividends. The tax treatment of dividends varies, depending on whether the shareholder receiving them is a corporation or another kind of taxpaying entity. All corporations treat dividends as ordinary income and are permitted a dividends received deduction (see Chapter 17). In contrast, individuals apply reduced tax rates on qualified dividend income while nonqualified dividends are taxed as ordinary income.

19-3a Rationale for Reduced Tax Rates on Dividends

The double tax on corporate income has always been controversial. Arguably, taxing dividends twice creates several undesirable economic distortions, including:

- An incentive to invest in noncorporate rather than corporate entities.
- An incentive for corporations to finance operations with debt rather than with equity because interest payments are deductible. Notably, this behavior increases the vulnerability of corporations in economic downturns because of higher leverage.
- An incentive for corporations to retain earnings and structure distributions of profits to avoid the double tax.

Collectively, these distortions raise the cost of capital for corporate investments. Estimates are that eliminating the double tax would increase capital stock in the corporate sector by as much as \$500 billion.¹⁶ In addition, some argue that elimination of the double tax would make the United States more competitive globally. Bear in mind that a majority of our trading partners assess only one tax on corporate income.

While many support a reduced or no tax rate on dividends, others contend that the double tax should remain in place because of the concentration of economic power held by publicly traded corporations. Furthermore, many of the distortions noted previously can be avoided through the use of deductible payments by C corporations and by utilizing other forms of doing business (e.g., partnerships, limited liability companies, and S corporations). Those favoring retention of the double tax also note that the benefits of reduced tax rates on dividends flow disproportionately to the wealthy.¹⁷

The United States continues to struggle to find the appropriate course to follow on the taxation of dividends. The reduced tax rate on **qualified dividends** for individuals reflects a compromise between the complete elimination of tax on dividends and the treatment of dividends as ordinary income.

19-3b Qualified Dividends

Qualified Dividends—Application and Effect

Under current law, dividends that meet certain requirements are subject to a 15 percent tax rate for most individual taxpayers (a 20 percent rate applies to taxpayers in the 39.6 percent tax bracket). Dividends received by individuals in the 10 or 15 percent rate brackets are exempt from tax.¹⁸

Qualified Dividends—Requirements

To be taxed at the lower rates, dividends must be paid by either domestic or certain qualified foreign corporations. Qualified foreign corporations include those traded on a U.S. stock exchange or any corporation located in a country that (1) has a

¹⁶Integration of Individual and Corporate Tax Systems, Report of the Department of the Treasury (January 1992).

¹⁷The Urban Institute–Brookings Institution Tax Policy Center estimates that more than one-half of the benefits from the reduced tax rate on dividends go to the .2% of households with incomes over \$1 million.

¹⁸See §§ 1(h)(1) and (11).



GLOBAL TAX ISSUES Corporate Integration

From an international perspective, the double taxation of dividends is unusual. Most countries have adopted a policy of corporate integration, which imposes a single tax on corporate profits. Corporate integration takes several forms. One popular approach is to impose a tax at the corporate level, but allow shareholders to claim a credit for corporate-level taxes paid when dividends are received.

A second alternative is to allow a corporate-level deduction for dividends paid to shareholders. A third approach is to allow shareholders to exclude corporate dividends from income. A fourth alternative suggested in the past by the U.S. Treasury is the “comprehensive business income tax,” which excludes both dividend and interest income while disallowing deductions for interest expense.

comprehensive income tax treaty with the United States, (2) has an information-sharing agreement with the United States, and (3) is approved by the Treasury.¹⁹

Two other requirements must be met for dividends to qualify for the favorable rates. First, dividends paid to shareholders who hold both long and short positions in the stock do not qualify. Second, the stock on which the dividend is paid must be held for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date.²⁰ To allow for settlement delays, the ex-dividend date is typically two days before the date of record on a dividend. This holding period rule parallels the rule applied to corporations that claim the dividends received deduction.²¹

In June of the current year, Green Corporation announces that a dividend of \$1.50 will be paid on each share of its common stock to shareholders of record on July 15. Amy and Corey, two unrelated shareholders, own 1,000 shares of the stock on the record date (July 15). Consequently, each receives \$1,500 (1,000 shares × \$1.50). Assume that Amy purchased her stock on January 15 of this year, while Corey purchased her stock on July 1. Both shareholders sell their stock on July 20. To qualify for the lower dividend rate, stock must be held for more than 60 days during the 121-day period beginning 60 days prior to July 13 (the ex-dividend date). In this case, the 121-day period runs from May 14 to September 11. The \$1,500 Amy receives is subject to preferential tax treatment as she held the stock for more than 60 days during this 121-day period. The \$1,500 Corey receives, however, is not. Corey did not meet the 60-day holding requirement, so her dividend will be taxed as ordinary income.

EXAMPLE

12

19-3c Property Dividends

Although most corporate distributions are cash, a corporation may distribute a **property dividend** for various reasons. For example, the shareholders could want a particular property that is held by the corporation. Similarly, a corporation with low cash reserves may still want to distribute a dividend to its shareholders.

Property distributions have the same impact as distributions of cash except for effects attributable to any difference between the basis and the fair market value of the distributed property. In most situations, distributed property is appreciated, so its sale would result in a gain to the corporation. Distributions of property with a basis that differs from fair market value raise several tax questions.

- For the shareholder:
 - What is the amount of the distribution?
 - What is the basis of the property in the shareholder's hands?
- For the corporation:
 - Is a gain or loss recognized as a result of the distribution?
 - What is the effect of the distribution on E & P?

LO.5

Evaluate the tax impact of property dividends by computing the shareholder's dividend income, basis in the property received, and the effect on the distributing corporation's E & P and taxable income.

¹⁹In Notice 2011-64, 2011-37 I.R.B. 231, the Treasury identified 57 qualifying countries (among those included on the list are the members of the European Union, the Russian Federation, Canada, and Mexico). Nonqualifying countries not on the list include most of the former Soviet republics (except Kazakhstan), Bermuda, and the Netherlands Antilles.

²⁰§ 1(h)(11)(B)(iii)(I).

²¹See § 246(c) and the relevant discussion in Chapter 17.

Property Dividends—Effect on the Shareholder

When a corporation distributes property rather than cash to a shareholder, the amount distributed is measured by the fair market value of the property on the date of distribution.²² As with a cash distribution, the portion of a property distribution covered by existing E & P is a dividend, and any excess is treated as a return of capital until stock basis is recovered. If the fair market value of the property distributed exceeds the corporation's E & P and the shareholder's basis in the stock investment, a capital gain usually results.

The amount distributed is reduced by any liabilities to which the distributed property is subject immediately before and immediately after the distribution and by any liabilities of the corporation assumed by the shareholder. The basis of the distributed property for the shareholder is the fair market value of the property on the date of the distribution.

The Big Picture

EXAMPLE

13

Return to the facts of *The Big Picture* on p. 19-1. Lime Corporation distributed property with a \$300,000 fair market value and \$20,000 adjusted basis to one of its shareholders, Gustavo. The property was subject to a \$100,000 mortgage, which Gustavo assumed. As a result, Gustavo has a distribution of \$200,000 [\$300,000 (fair market value) – \$100,000 (liability)] that is treated as a taxable dividend. The basis of the property to Gustavo is \$300,000.

EXAMPLE

14

Red Corporation owns 10% of Tan Corporation. Tan has ample E & P to cover any distributions made during the year. One distribution made to Red Corporation consists of a vacant lot with an adjusted basis of \$80,000 and a fair market value of \$50,000. Red has a taxable dividend of \$50,000 (before the dividends received deduction), and its basis in the lot is \$50,000.

As discussed in the following section, distributing property that has depreciated in value as a property dividend may reflect poor planning.

Property Dividends—Effect on the Corporation

All distributions of appreciated property generate gain recognition to the distributing corporation.²³ In effect, a corporation that distributes appreciated property is treated as if it had sold the property to the shareholder for its fair market value. However, the distributing corporation does *not* recognize loss on distributions of property.

EXAMPLE

15

Refer back to the facts of Example 14. Tan Corporation is not allowed to recognize the \$30,000 loss on the property distribution. The \$30,000 basis disappears (\$50,000 fair market value less \$80,000 adjusted basis). As an alternative, Tan Corporation could sell the vacant lot and use the related \$30,000 loss to reduce its taxes. Then Tan could distribute the \$50,000 of proceeds to its shareholders. Either way, the shareholders end up with property worth \$50,000. But by selling the vacant lot and distributing the cash, Tan Corporation benefits by being able to use the \$30,000 loss.

The Big Picture

EXAMPLE

16

Return to the facts of *The Big Picture* on p. 19-1. Lime Corporation distributed property with a fair market value of \$300,000 and an adjusted basis of \$20,000 to Gustavo, one of its shareholders. As a result, Lime recognizes a \$280,000 gain on the distribution.

If the distributed property is subject to a liability in excess of its basis or the shareholder assumes such a liability, a special rule applies. For purposes of determining gain

²²Section 301 describes the tax treatment of corporate distributions to shareholders.

²³Section 311 describes how corporations are taxed on distributions.

on the distribution, the fair market value of the property is treated as not being less than the amount of the liability.²⁴

Assume that the land in Example 14 is subject to a liability of \$85,000. Tan Corporation recognizes a gain of \$5,000 on the distribution (\$85,000 liability – \$80,000 basis of land). Red Corporation has no dividend income (the liability assumed exceeds the fair market value of the land), and its basis in the land is \$85,000 (the land's deemed fair market value based on the liability assumed).

EXAMPLE**17**

Corporate distributions reduce E & P by the amount of money distributed or by the *greater* of the fair market value or the adjusted basis of property distributed, less the amount of any liability on the property.²⁵ E & P is increased by gain recognized on appreciated property distributed as a property dividend.

Property Distributions—E & P Impacts

Crimson Corporation distributes property (basis of \$10,000 and fair market value of \$20,000) to Brenda, its shareholder. Crimson recognizes a \$10,000 gain. Crimson's E & P is increased by the \$10,000 gain and decreased by the \$20,000 fair market value of the distribution. Brenda has dividend income of \$20,000 (presuming sufficient E & P).

EXAMPLE**18**

Assume the same facts as in Example 18, except that the adjusted basis of the property in the hands of Crimson Corporation is \$25,000. Because the loss is not recognized and the adjusted basis is greater than fair market value, E & P is reduced by \$25,000. Brenda reports dividend income of \$20,000.

EXAMPLE**19**

Assume the same facts as in Example 19, except that the property is subject to a liability of \$6,000, which Brenda assumes. E & P is now reduced by \$19,000 (\$25,000 adjusted basis – \$6,000 liability). Brenda has a dividend of \$14,000 (\$20,000 amount of the distribution – \$6,000 liability), and her basis in the property is \$20,000.

EXAMPLE**20**

Under no circumstances can a distribution, whether cash or property, either generate a deficit in E & P or add to a deficit in E & P. Deficits can arise only through corporate losses.

Teal Corporation has accumulated E & P of \$10,000 at the beginning of the current tax year. During the year, it has current E & P of \$15,000. At the end of the year, it distributes cash of \$30,000 to its sole shareholder, Walter. Teal's E & P at the end of the year is zero. The accumulated E & P of \$10,000 is increased by current E & P of \$15,000 and reduced by \$25,000 because of the dividend distribution. The remaining \$5,000 of the distribution to Walter does not reduce E & P because a distribution cannot generate a deficit in E & P. Instead, the remaining \$5,000 reduces Walter's stock basis and/or produces a capital gain to Walter.

EXAMPLE**21**

The non-cash property distribution rules are summarized in Concept Summary 19.3.

19-3d **Constructive Dividends**

Any measurable economic benefit conveyed by a corporation to its shareholders can be treated as a dividend for Federal income tax purposes even though it is not formally declared or designated as a dividend. Also, it need not be issued pro rata to all shareholders nor satisfy the legal requirements of a dividend.²⁶ Such a benefit, often described as a **constructive dividend**, is distinguishable from actual corporate distributions of cash and property in form only.

LO.6

Recognize situations when constructive dividends exist and compute the tax resulting from such dividends.

²⁴§ 311(b)(2).

²⁵§§ 312(a), (b), and (c).

²⁶See *Lengsfeld v. Comm.*, 57-1 USTC ¶9437, 50 AFTR 1683, 241 F.2d 508 (CA-5, 1957).



Concept Summary 19.3

Non-Cash Property Distributions

Appreciated Property	Depreciated Property
<ol style="list-style-type: none"> Regular Tax: Increase regular taxable income by regular tax gain (difference between FMV and regular tax adjusted basis). Current E & P: Increase current earnings and profits by E & P gain (difference between FMV and E & P adjusted basis). Shareholder(s): Determine impact of distribution on the shareholder(s). End of Year E & P: Decrease earnings and profits by the <i>fair market value</i> of property (net of liabilities assumed by the shareholder). As with cash distributions, property distributions cannot create an E & P deficit. <p>Note: The Internal Revenue Code puts the corporation in the same position as if it had sold the property and distributed the cash.</p>	<ol style="list-style-type: none"> Regular Tax: No impact on regular taxable income (regular tax loss not recognized). Current E & P: Generally, no change in current earnings and profits. Shareholder(s): Determine impact of distribution on the shareholder(s). End of Year E & P: Decrease earnings and profits by the <i>E & P adjusted basis</i> of property (net of liabilities assumed by the shareholder). As with cash distributions, property distributions cannot create an E & P deficit. <p>Note: Earnings and profits will reflect the “loss” on the distribution of depreciated property (via the adjusted basis decrease to E & P), but the regular tax loss vanishes.</p>

For tax purposes, constructive distributions are treated the same as actual distributions.²⁷ Thus, corporate shareholders are entitled to the dividends received deduction (see Chapter 17), and other shareholders can apply the preferential tax rates (0, 15, or 20 percent) on qualified constructive dividends. The constructive distribution is taxable as a dividend only to the extent of the corporation’s current and accumulated E & P. The burden of proving that the distribution constitutes a return of capital because of inadequate E & P rests with the taxpayer.²⁸

Constructive dividend situations usually arise in closely held corporations. Here, the dealings between the parties are less structured, and frequently, formalities are not preserved. The constructive dividend serves as a substitute for actual distributions and is usually intended to accomplish some tax objective not available through the use of direct dividends. The shareholders may be attempting to distribute corporate profits in a form deductible to the corporation.²⁹ Alternatively, the shareholders may be seeking benefits for themselves while avoiding the recognition of income. Although some constructive dividends are disguised dividends, not all are deliberate attempts to avoid actual and formal dividends; many are inadvertent. Thus, an awareness of the various constructive dividend situations is essential to protect the parties from unanticipated, undesirable tax consequences. The most frequently encountered types of constructive dividends are summarized next.

Shareholder Use of Corporate-Owned Property

A constructive dividend can occur when a shareholder uses a corporation’s property for personal purposes at no cost. Personal use of corporate-owned automobiles, airplanes, yachts, fishing camps, hunting lodges, and other entertainment facilities is commonplace in some closely held corporations. In these situations, the shareholder has dividend income equal to the fair rental value of the property for the period of its personal use.³⁰

Bargain Sale of Corporate Property to a Shareholder

Shareholders often purchase property from a corporation at a cost below the fair market value. These bargain sales produce dividend income equal to the difference between

²⁷*Simon v. Comm.*, 57–2 USTC ¶9989, 52 AFTR 698, 248 F.2d 869 (CA-8, 1957).

²⁸*DiZenzo v. Comm.*, 65–2 USTC ¶9518, 16 AFTR 2d 5107, 348 F.2d 122 (CA-2, 1965).

²⁹Recall that dividend distributions do not provide the distributing corporation with an income tax deduction, although they do reduce E & P.

³⁰See *Daniel L. Reeves*, 94 TCM 287, T.C.Memo. 2007–273.

the property's fair market value on the date of sale and the amount the shareholder paid for the property.³¹ These situations might be avoided by appraising the property on or about the date of the sale. The appraised value should become the price paid by the shareholder.

Bargain Rental of Corporate Property

A bargain rental of corporate property by a shareholder also produces dividend income. Here, the measure of the constructive dividend is the excess of the property's fair rental value over the rent actually paid. Again, appraisal data should be used to avoid any questionable situations.

Payments for the Benefit of a Shareholder

If a corporation pays an obligation of a shareholder, the payment is treated as a constructive dividend. The obligation in question need not be legally binding on the shareholder; it may, in fact, be a moral obligation.³² Forgiveness of shareholder indebtedness by the corporation creates an identical problem.³³ Also, excessive rentals paid by a corporation for the use of shareholder property are treated as constructive dividends.



ETHICS & EQUITY A Contribution to Alma Mater

Eagle Corporation pays its president and sole shareholder, Kristin, an annual salary of \$400,000. As the sole shareholder, Kristin is always looking for ways to receive additional benefits from the corporation. However, Kristin wants to avoid dividends (because of the effects of double taxation) and has no desire to increase her compensation. Kristin recently made a pledge of \$150,000 to her favorite

charity—Southern State College—her alma mater. The funds will be used to establish an endowed scholarship in Kristin's name. Rather than fulfilling this pledge with her personal funds, she is thinking about having Eagle make the contribution on her behalf. How do you advise Kristin? Could this contribution be considered a constructive dividend? Why or why not?

Unreasonable Compensation

A salary payment to a shareholder-employee that is deemed to be **unreasonable compensation** is frequently treated as a constructive dividend and therefore is not deductible by the corporation. In determining the reasonableness of salary payments, the following factors are considered:³⁴

- The employee's qualifications.
- A comparison of salaries with dividend distributions.
- The prevailing rates of compensation for comparable positions in comparable business concerns.
- The nature and scope of the employee's work.
- The size and complexity of the business.
- A comparison of salaries paid with both gross and net income.
- The taxpayer's salary policy toward all employees.
- For small corporations with a limited number of officers, the amount of compensation paid to the employee in question in previous years.
- Whether a reasonable shareholder would have agreed to the level of compensation paid.

³¹Reg. § 1.301-1(j).

³²*Montgomery Engineering Co. v. U.S.*, 64-2 USTC ¶9618, 13 AFTR 2d 1747, 230 F.Supp. 838 (D.Ct. N.J., 1964), *aff'd* in 65-1 USTC ¶9368, 15 AFTR 2d 746, 344 F.2d 996 (CA-3, 1965).

³³Reg. § 1.301-1(m).

³⁴All but the final factor in this list are identified in *Mayson Manufacturing Co. v. Comm.*, 49-2 USTC ¶9467, 38 AFTR 1028, 178 F.2d 115 (CA-6, 1949).



TAX IN THE NEWS Win Some—Lose Some

Compensation paid by an employer is deductible as a business expense, provided the amount is reasonable. What is “reasonable” depends on the relevant facts and circumstances. In a recent case, the Tax Court determined that a portion of the amounts paid to a corporation’s owner and his wife was unreasonable.

Although the payments were largely intended to compensate the couple for prior years in which they received little to no salary, the payments essentially depleted the corporation’s assets. Compensation for prior years’ services can be deductible in the current year as long as the employee was actually undercompensated in prior years and the current payments are intended as compensation for past services.

In this case, the compensation—about \$1.6 million over three years—included both *salary* and *pension contributions* to a defined benefit pension plan. On audit, the IRS determined that all the compensation paid to the husband and wife was unreasonable, disallowed the deductions to the corporation, and treated the entire amount as a dividend to the husband and wife.

After reviewing a number of factors—including the low salary payments in prior years—the Tax Court held that most of the compensation (about \$1.3 million) was reasonable. The balance (about \$300,000) was deemed to be dividends.

However, there was another twist to this case. Remember that the compensation payments included both salary and *pension contributions*. When the Tax Court found that a portion of the taxpayer’s compensation was unreasonable, it concluded that the taxpayers received a nondeductible pension contribution. Therefore, a 10% excise tax (§ 4975) on nondeductible contributions to qualified employer plans applied.

The Court did not impose a penalty for failure to file tax returns related to the § 4975 excise tax or a failure to pay a penalty on the tax that would have been due on those returns as it found that the taxpayers had reasonably relied on the advice of their CPA.

Source: *Thousand Oaks Residential Care Home, Inc.*, 105 TCM 1056, T.C.Memo. 2013-10.

The last factor above, known as the “reasonable investor test,” is a relatively new development in the law on reasonable compensation.³⁵ Its use by the courts has been inconsistent. In some cases, the Seventh Circuit Court of Appeals has relied solely on the reasonable investor test in determining reasonableness, whereas the Tenth Circuit Court of Appeals has largely ignored this factor. Other Federal circuits have used an approach that considers all of the factors in the list.³⁶

Loans to Shareholders

Advances to shareholders that are not bona fide loans are constructive dividends. Whether an advance qualifies as a bona fide loan is a question of fact to be determined in light of the particular circumstances. Factors considered in determining whether the advance is a bona fide loan include the following:³⁷

- Whether the advance is on open account or is evidenced by a written instrument.
- Whether the shareholder furnished collateral or other security for the advance.
- How long the advance has been outstanding.
- Whether any repayments have been made, excluding dividend sources.
- The shareholder’s ability to repay the advance.
- The shareholder’s use of the funds (e.g., payment of routine bills versus nonrecurring, extraordinary expenses).
- The regularity of the advances.
- The dividend-paying history of the corporation.

³⁵For example, see *Alpha Medical, Inc. v. Comm.*, 99-1 USTC ¶150,461, 83 AFTR 2d 99-697, 172 F.3d 942 (CA-6, 1999).

³⁶See *Vitamin Village, Inc.*, 94 TCM 277, T.C.Memo. 2007-272, for an example of a case that uses the reasonable investor test and other factors.

³⁷*Fin Hay Realty Co. v. U.S.*, 68-2 USTC ¶9438, 22 AFTR 2d 5004, 398 F.2d 694 (CA-3, 1968). But see *Nariman Teymourian*, 90 TCM 352, T.C.Memo. 2005-302, for an example of how good planning can avoid constructive dividends in the shareholder loan context.

Even when a corporation makes a bona fide loan to a shareholder, a constructive dividend may be triggered, equal to the amount of imputed (forgone) interest on the loan.³⁸ Imputed interest is the interest on the loan (calculated using the interest rate the Federal government applies to new borrowings, compounded semiannually), in excess of the interest actually charged on the loan. When the imputed interest provision applies, the shareholder is deemed to have made an interest payment to the corporation equal to the amount of imputed interest and the corporation is deemed to have repaid the imputed interest to the shareholder through a constructive dividend. As a result, the corporation receives interest income and makes a nondeductible dividend payment, and the shareholder has taxable dividend income that might be offset with an interest deduction.

Mallard Corporation lends its principal shareholder, Henry, \$100,000 on January 2 of the current year. The loan is interest-free and payable on demand. On December 31, the imputed interest rules are applied. Assuming that the Federal rate is 6%, compounded semiannually, the amount of imputed interest is \$6,090. This amount is deemed paid by Henry to Mallard in the form of interest. Mallard is then deemed to return the amount to Henry as a constructive dividend. Thus, Henry has dividend income of \$6,090, which might be offset with a deduction for the interest deemed paid to Mallard. Mallard has interest income of \$6,090 for the interest received, with no offsetting deduction for the dividend payment.

EXAMPLE

22

Loans to a Corporation by Shareholders

Shareholder loans to a corporation may be reclassified as equity if the debt has too many features of stock. Any interest and principal payments made by the corporation to the shareholder are then treated as constructive dividends. This topic was covered more thoroughly in the discussion of thin capitalization in Chapter 18.

19-3e Stock Dividends and Stock Rights

Stock Dividends

Historically, **stock dividends** were excluded from income on the theory that the ownership interest of the shareholder was unchanged as a result of the distribution.³⁹ Recognizing that some distributions of stock could affect ownership interests, the 1954 Code included a provision (§ 305) taxing stock dividends where (1) the stockholder could elect to receive either stock or property or (2) the stock dividends were in discharge of preference dividends. However, because this provision applied to a narrow range of transactions, corporations were able to develop an assortment of alternative methods that circumvented taxation and still affected shareholders' proportionate interests in the corporation.⁴⁰ In response, the scope of § 305 was expanded.

In its current state, the provisions of § 305 are based on the proportionate interest concept. As a general rule, stock dividends are excluded from income if they are pro rata distributions of stock or stock rights, paid on common stock. Five exceptions to this general rule exist. These exceptions deal with various disproportionate distribution situations. If stock dividends are not taxable, the corporation's E & P is not reduced.⁴¹ If the stock dividends are taxable, the distributing corporation treats the distribution in the same manner as any other taxable property dividend.

If a stock dividend is taxable, the shareholder's basis for the newly received shares is fair market value and the holding period starts on the date of receipt. If a stock dividend is not taxable, the basis of the stock on which the dividend is distributed is reallocated.⁴² If the dividend shares are identical to these formerly held shares, basis for the old stock is reallocated by dividing the taxpayer's basis in the old stock by the total number of shares. If the dividend stock is not identical to the underlying shares (e.g., a stock dividend of preferred on

LO.7

Compute the tax arising from receipt of stock dividends and stock rights and the shareholder's basis in the stock and stock rights received.

³⁸See § 7872.

³⁹See *Eisner v. Macomber*, 1 USTC ¶32, 3 AFTR 3020, 40 S.Ct. 189 (USSC, 1920).

⁴⁰See "Stock Dividends," S.Rept. 91-552, 1969-3 C.B. 519.

⁴¹§ 312(d)(1).

⁴²§ 307(a).

common), basis is determined by allocating the basis of the formerly held shares between the old and new stock according to the fair market value of each. The holding period includes the holding period of the formerly held stock.⁴³

Stock Dividends

EXAMPLE

23

Gail bought 1,000 shares of common stock two years ago for \$10,000. In the current tax year, she receives 10 shares of common stock as a nontaxable stock dividend. Gail's basis of \$10,000 is divided by 1,010. Each share of stock has a basis of \$9.90 instead of the pre-dividend \$10 basis.

EXAMPLE

24

Assume that Gail received, instead, a nontaxable preferred stock dividend of 100 shares. The preferred stock has a fair market value of \$1,000, and the common stock, on which the preferred is distributed, has a fair market value of \$19,000. After the receipt of the stock dividend, the basis of the common stock is \$9,500, and the basis of the preferred is \$500, computed as follows:

Fair market value of common	\$19,000
Fair market value of preferred	1,000
	<u>\$20,000</u>
Basis of common: $19/20 \times \$10,000$	\$ 9,500
Basis of preferred: $1/20 \times \$10,000$	\$ 500

Stock Rights

The rules for determining taxability of **stock rights** are identical to those for determining taxability of stock dividends. If the rights are taxable, the recipient has income equal to the fair market value of the rights. The fair market value then becomes the shareholder-distributee's basis in the rights.⁴⁴ If the rights are exercised, the holding period for the new stock begins on the date the rights (whether taxable or nontaxable) are exercised. The basis of the new stock is the basis of the rights plus the amount of any other consideration given.

If stock rights are not taxable and the value of the rights is less than 15 percent of the value of the old stock, the basis of the rights is zero. However, the shareholder may elect to have some of the basis in the formerly held stock allocated to the rights.⁴⁵ The election is made by attaching a statement to the shareholder's return for the year in which the rights are received.⁴⁶ If the fair market value of the rights is 15 percent or more of the value of the old stock and the rights are exercised or sold, the shareholder *must* allocate some of the basis in the formerly held stock to the rights.

EXAMPLE

25

A corporation with common stock outstanding declares a nontaxable dividend payable in rights to subscribe to common stock. Each right entitles the holder to purchase one share of stock for \$90. One right is issued for every two shares of stock owned. Fred owns 400 shares of stock purchased two years ago for \$15,000. At the time of the distribution of the rights, the market value of the common stock is \$100 per share, and the market value of the rights is \$8 per right. Fred receives 200 rights. He exercises 100 rights and sells the remaining 100 rights three months later for \$9 per right.

Fred need not allocate the cost of the original stock to the rights because the value of the rights is less than 15% of the value of the stock ($\$1,600 \div \$40,000 = 4\%$). If Fred does not allocate his original stock basis to the rights, the tax consequences are as follows:

- Basis of the new stock is \$9,000 [$\90 (exercise price) \times 100 (shares)]. The holding period of the new stock begins on the date the stock was purchased.
- Sale of the rights produces long-term capital gain of \$900 [$\9 (sales price) \times 100 (rights)]. The holding period of the rights starts with the date the original 400 shares of stock were acquired.

continued

⁴³§ 1223(5).

⁴⁴Reg. § 1.305-1(b).

⁴⁵§ 307(b)(1).

⁴⁶Reg. § 1.307-2.

If Fred elects to allocate basis to the rights, the tax consequences are as follows:

- Basis of the stock is \$14,423 [$\$40,000$ (value of stock) \div $\$41,600$ (value of rights and stock) \times $\$15,000$ (cost of stock)].
- Basis of the rights is \$577 [$\$1,600$ (value of rights) \div $\$41,600$ (value of rights and stock) \times $\$15,000$ (cost of stock)].
- When Fred exercises the rights, his basis for the new stock will be \$9,288.50 [$\$9,000$ (cost) + $\$288.50$ (basis for 100 rights)].
- Sale of the rights would produce a long-term capital gain of \$611.50 [$\900 (sales price) – $\$288.50$ (basis for the remaining 100 rights)].

19-4 STOCK REDEMPTIONS

19-4a Overview

When a shareholder sells stock to an unrelated third party, the transaction typically is treated as a sale or exchange whereby the amount realized is offset by the shareholder's stock basis and a capital gain (or loss) results. In such cases, the Code treats the proceeds as a return *of* the shareholder's investment.

LO.8

Identify various stock redemptions that qualify for sale or exchange treatment.

The Big Picture

Return to the facts of *The Big Picture* on p. 19-1. Assume that Gustavo sells some of his shares of Lime Corporation stock (stock basis, \$80,000) to a third party for \$1.2 million. If the transaction is treated as a sale or exchange (return *of* the owner's investment), Gustavo has a long-term capital gain of \$1,120,000 [$\1.2 million (amount realized) – $\$80,000$ (stock basis)].

EXAMPLE

26

In a **stock redemption**, where a shareholder sells stock back to the *issuing corporation* for cash or other property, the transaction can have the *effect* of a dividend distribution rather than a sale or exchange. This is particularly the case when the stock of the corporation is closely held. For instance, consider a redemption of stock from a sole shareholder. In such a case, the shareholder's ownership interest remains unaffected by the stock redemption, as the shareholder continues to own 100 percent of the corporation's outstanding shares after the transaction. If such redemptions were granted sale or exchange treatment, dividend income could be avoided entirely by never formally distributing dividends and, instead, effecting stock redemptions whenever corporate funds were desired by shareholders. Nontaxable stock dividends then could be used to replenish shares as needed.

The key distinction between a sale of stock to an unrelated third party and some stock redemptions is the effect of the transaction on the shareholder's ownership interest in the corporation. In a sale of stock to an unrelated third party, the shareholder's ownership interest in the corporation is diminished. In the case of many stock redemptions, however, there is little or no change to the shareholder's ownership interest. In general, if a shareholder's ownership interest is *not* diminished as a result of a stock redemption, the Code will treat the transaction as a dividend distribution (return *from* the shareholder's investment).

However, the Code does allow sale or exchange treatment for *certain* kinds of stock redemptions. In these transactions, as a general rule, the shareholder's ownership interest is diminished as a result of the redemption. (The requirements for qualifying stock redemptions are provided later in this chapter.)

GLOBAL TAX ISSUES Foreign Shareholders Prefer Sale or Exchange Treatment in Stock Redemptions

As a general rule, foreign shareholders are subject to U.S. tax on dividend income from U.S. corporations but not on capital gains from the sale of U.S. stock. In some situations, a nonresident alien is taxed on a capital gain from the disposition of stock in a U.S. corporation, but only if the stock was effectively connected with the conduct of a U.S. trade or business of the individual. Foreign corporations are similarly taxed on gains from the sale of U.S. stock

investments. Whether a stock redemption qualifies for sale or exchange treatment therefore takes on added significance for foreign shareholders. If one of the qualifying stock redemption rules can be satisfied, the foreign shareholder typically will avoid U.S. tax on the transaction. If, instead, dividend income is the result, a 30 percent withholding tax typically applies. For further details, see Chapter 25.

The Big Picture

EXAMPLE

27

Return to the facts of *The Big Picture* on p. 19-1 and the previous example. Assume that Lime Corporation redeems some of its shares from Gustavo (stock basis, \$80,000) for \$1.2 million. If the redemption is treated as a sale or exchange (return of the owner's investment), Gustavo has a long-term capital gain of \$1,120,000 [\$1.2 million (amount realized) – \$80,000 (stock basis)]. However, if the redemption is treated as a dividend distribution (return from the owner's investment), Gustavo has \$1.2 million of dividend income (assuming adequate E & P).

Stock redemptions occur for a variety of reasons. Publicly traded corporations often reacquire their shares with the goal of increasing shareholder value. For corporations where the stock is closely held, redemptions frequently occur to achieve shareholder objectives. For instance, a redemption might be used to acquire the stock of a deceased shareholder of a closely held corporation. Using corporate funds to purchase the stock from the decedent's estate relieves the remaining shareholders of the need to use their own money to acquire the stock. Stock redemptions also occur as a result of property settlements in divorce actions. When spouses jointly own 100 percent of a corporation's shares, a divorce decree may require that the stock interest of one spouse be bought out. A redemption of the departing spouse's shares relieves the other spouse from having to use his or her funds for the transaction. Stock redemptions are also frequently incorporated into buy-sell agreements between shareholders so that corporate funds can be used to buy the stock of a shareholder terminating his or her ownership interest.

Noncorporate shareholders generally prefer to have a stock redemption treated as a sale or exchange rather than as a dividend distribution. For individual taxpayers, the tax rate for long-term capital gains and qualified dividend income is 0, 15, or 20 percent, depending on the taxpayer's marginal tax bracket. Also, the 3.8 percent Medicare surtax on net investment income of certain high-income taxpayers applies to capital gains and dividend income. As Examples 28 and 29 illustrate, qualifying stock redemption treatment is preferred because it results in both the tax-free recovery of the redeemed stock's basis and the offset of capital gains by capital losses. In a nonqualified stock redemption, the *entire* distribution (assuming adequate E & P) is taxed as dividend income and cannot be offset by capital losses.

Qualifying and Nonqualified Redemptions Compared

EXAMPLE

28

Abby, an individual in the 33% tax bracket, acquired stock in Quail Corporation four years ago for \$80,000. In the current year, Quail Corporation (E & P of \$1 million) redeems her shares for \$170,000. If the redemption qualifies for sale or exchange treatment, Abby has a long-term capital gain of \$90,000 [\$170,000 (redemption amount) – \$80,000 (basis)]. Her income tax liability on the \$90,000 gain is \$13,500 (\$90,000 × 15%). If the stock redemption does not qualify as a sale or exchange, the entire distribution is treated as a dividend and Abby's income tax liability is \$25,500 (\$170,000 × 15%). Thus, Abby saves \$12,000 (\$25,500 – \$13,500) in income taxes if the transaction is a qualifying stock redemption.

Qualifying and Nonqualified Redemptions Compared

Assume in Example 28 that Abby has a capital loss carryover of \$60,000 in the current tax year. If the transaction is a qualifying stock redemption, Abby can offset the entire \$60,000 capital loss carryover against her \$90,000 long-term capital gain. As a result, only \$30,000 of the gain is taxed and her income tax liability is only \$4,500 ($\$30,000 \times 15\%$). On the other hand, if the transaction does not qualify for sale or exchange treatment, the entire \$170,000 is taxed as a dividend at 15%. In addition, assuming that she has no capital gains in the current year, Abby is able to deduct only \$3,000 of the \$60,000 capital loss carryover to offset her other ordinary income.

EXAMPLE

29

In contrast, *corporate* shareholders normally receive more favorable tax treatment from a dividend distribution than would result from a qualifying stock redemption. Corporate taxpayers typically report only a small portion of a dividend distribution as taxable income because of the dividends received deduction (see Chapter 17). Further, the preferential tax rate applicable to dividend and long-term capital gain income is not available to corporations. Consequently, tax planning for stock redemptions must consider the different preferences of corporate and noncorporate shareholders.

Assume in Example 28 that Abby is a corporation, that the stock represents a 40% ownership interest in Quail Corporation, and that Abby has corporate taxable income of \$850,000 before the redemption transaction. If the transaction is a qualifying stock redemption, Abby has a long-term capital gain of \$90,000 that is subject to tax at 34%, or \$30,600. On the other hand, if the \$170,000 distribution is treated as a dividend, Abby has a dividends received deduction of \$136,000 ($\$170,000 \times 80\%$); so only \$34,000 of the payment is taxed. Consequently, Abby's tax liability on the transaction is only \$11,560 ($\$34,000 \times 34\%$).

EXAMPLE

30

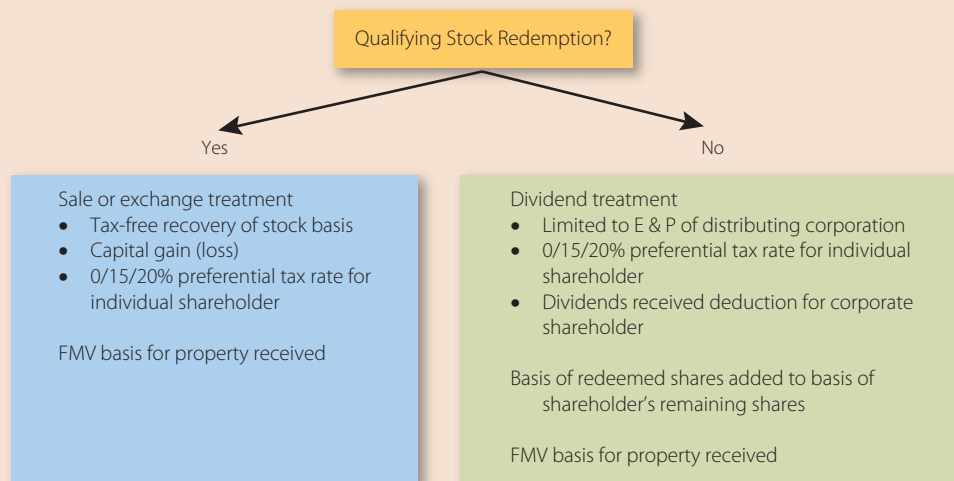
When a qualifying stock redemption results in a *loss* to a shareholder rather than a gain, § 267 disallows loss recognition if the shareholder owns (directly or indirectly) more than 50 percent of the corporation's stock.

A shareholder's basis in property received in a stock redemption, qualifying or nonqualifying, generally will be the property's fair market value, determined as of the date of the redemption. Further, the holding period of the property begins on that date. Concept Summary 19.4 sets out the major tax consequences of stock redemptions to shareholders.



Concept Summary 19.4

Tax Consequences of Stock Redemptions to Shareholders



The Code establishes the criteria for determining whether a transaction is a qualifying stock redemption for tax purposes and thus receives sale or exchange treatment. The terminology in an agreement between the parties is not controlling, nor is state law. Section 302(b) provides several types of qualifying stock redemptions. In addition, certain distributions of property to an estate in exchange for a deceased shareholder's stock are treated as qualifying stock redemptions under § 303. Each of these types of qualifying redemptions is discussed later in this section.

19-4b Historical Background

Under prior law, the *dividend equivalency rule* was used to determine which stock redemptions qualified for sale or exchange treatment. Under that rule, if the facts and circumstances of a redemption indicated that it was essentially equivalent to a dividend, the redemption did not qualify for sale or exchange treatment. Instead, the entire amount received by the shareholder was taxed as dividend income to the extent of the corporation's E & P.

The uncertainty and subjectivity surrounding the dividend equivalency rule led Congress to enact several objective tests for determining the status of a redemption. Currently, the following types of stock redemptions qualify for sale or exchange treatment:

- Distributions not essentially equivalent to a dividend (“not essentially equivalent redemptions”).
- Distributions substantially disproportionate in terms of shareholder effect (“disproportionate redemptions”).
- Distributions in complete termination of a shareholder's interest (“complete termination redemptions”).
- Distributions to pay a shareholder's death taxes (“redemptions to pay death taxes”).

Concept Summary 19.5 later in this chapter summarizes the requirements for each of these qualifying stock redemptions.

19-4c Stock Attribution Rules

As explained earlier, to qualify for sale or exchange treatment, a stock redemption generally must result in the substantial reduction of the shareholder's ownership interest in the corporation. In determining whether a stock redemption has sufficiently reduced a shareholder's interest, the stock owned by certain related parties is attributed to the redeeming shareholder.⁴⁷ Thus, the stock **attribution** rules must be considered in applying the stock redemption provisions. Under these rules, related parties are defined to include the following family members: spouses, children, grandchildren, and parents. Attribution also takes place *from* and *to* partnerships, estates, trusts, and corporations (50 percent or more ownership required in the case of regular corporations). Exhibit 19.1 summarizes the stock attribution rules.

The Big Picture

EXAMPLE

31

Return to the facts of *The Big Picture* on p. 19-1. Assume instead that Gustavo owns 30% (rather than 50%) of the stock in Lime Corporation and his two children own 20% of the Lime stock. For purposes of the stock attribution rules, Gustavo is treated as owning 50% of the stock in Lime Corporation. He owns 30% directly and, because of the family attribution rules, 20% indirectly through his children.

EXAMPLE

32

Chris owns 40% of the stock in Gray Corporation. The other 60% is owned by a partnership in which Chris has a 20% interest. Chris is deemed to own 52% of Gray Corporation: 40% directly and, because of the partnership interest, 12% indirectly (20% × 60%).

⁴⁷§ 318.

EXHIBIT 19.1

Stock Attribution Rules

Deemed or Constructive Ownership	
Family	An individual is deemed to own the stock owned by his or her spouse, children, grandchildren, and parents (not siblings or grandparents).
Partnership	A partner is deemed to own the stock owned by a partnership to the extent of the partner's proportionate interest in the partnership. Stock owned by a partner is deemed to be owned in full by a partnership.
Estate or trust	A beneficiary or an heir is deemed to own the stock owned by an estate or a trust to the extent of the beneficiary's or heir's proportionate interest in the estate or trust. Stock owned by a beneficiary or an heir is deemed to be owned in full by an estate or a trust.
Corporation	Stock owned by a corporation is deemed to be owned proportionately by any shareholder owning 50% or more of the corporation's stock. Stock owned by a shareholder who owns 50% or more of a corporation is deemed to be owned in full by the corporation.

As discussed later, the *family* attribution rules (refer to Example 31) can be waived in the case of some complete termination redemptions. In addition, the stock attribution rules do not apply to stock redemptions to pay death taxes.

19-4d Not Essentially Equivalent Redemptions

Under § 302(b)(1), a redemption qualifies for sale or exchange treatment if it is “not essentially equivalent to a dividend.” This provision represents a continuation of the dividend equivalency rule applicable under prior law. The earlier redemption language was retained principally for redemptions of preferred stock because shareholders often have no control over when corporations call in such stock.⁴⁸ Like its predecessor, the **not essentially equivalent redemption** lacks an objective test. Instead, each case must be resolved on a facts and circumstances basis.⁴⁹

Based upon the Supreme Court's decision in *U.S. v. Davis*,⁵⁰ a redemption will qualify as a not essentially equivalent redemption only when the shareholder's interest in the redeeming corporation has been meaningfully reduced. In determining whether the **meaningful reduction test** has been met, the stock attribution rules apply. A decrease in the redeeming shareholder's voting control appears to be the most significant indicator of a meaningful reduction,⁵¹ but reductions in the rights of the shareholders to share in corporate earnings or to receive corporate assets upon liquidation are also considered.⁵²

Application of the Meaningful Reduction Test

Pat owns 58% of the common stock of Falcon Corporation. As a result of a redemption of some of his stock, Pat's ownership interest in Falcon is reduced to 51%. Because Pat continues to have dominant voting rights in Falcon after the redemption, the distribution is treated as essentially equivalent to a dividend. The entire amount of the distribution, therefore, is taxed as dividend income (assuming adequate E & P).

EXAMPLE

33

Maroon Corporation redeems 2% of its stock from Maria. Before the redemption, Maria owned 10% of Maroon Corporation. In this case, the redemption *may* qualify as a not essentially equivalent redemption. Maria experiences a reduction in her voting rights, her right to participate in current earnings and accumulated surplus, and her right to share in net assets upon liquidation.

EXAMPLE

34

⁴⁸See S.Rept. No. 1622, 83d Cong., 2d Sess., 44 (1954).

⁴⁹Reg. § 1.302-2(b)(1).

⁵⁰70-1 USTC ¶9289, 25 AFTR 2d 70-827, 90 S.Ct. 1041 (USSC, 1970).

⁵¹See, for example, *Jack Paparo*, 71 T.C. 692 (1979).

⁵²See, for example, *Grabowski Trust*, 58 T.C. 650 (1972).



TAX IN THE NEWS Appellate Courts Rule OPIS Losses Lack Economic Substance

In the case of any nonqualified stock redemption, the basis of the stock redeemed attaches to the basis of the shareholder's remaining stock *or to stock the shareholder owns constructively*. (See Example 35.) For more than a decade, the IRS has been aggressively attacking tax shelters designed solely to shift basis in a nonqualified stock redemption from one shareholder (the redeeming shareholder) to another shareholder (the related shareholder). (See, for example, Notice 2001-45, 2001-2 C.B. 129.) OPIS (Offshore Portfolio Investment Strategy) was one of the basis-shifting tax strategies targeted by the IRS. The IRS offered a settlement program to taxpayers who participated in OPIS and other basis-shifting shelters. (See Announcement

2002-97, 2002-2 C.B. 757.) Not all taxpayers chose to settle, however, as evidenced by two recent appellate court cases [*Blur v. Comm.*, 2014-1 USTC ¶50,107, 112 AFTR 2d 2013-7429, 737 F.3d 1303 (CA-10, 2013), and *Reddam v. Comm.*, 2014-1 USTC ¶50,322, 113 AFTR 2d 2014-2549, 755 F.3d 1051 (CA-9, 2014)]. In these two cases, each taxpayer had claimed a capital loss of more than \$45 million stemming from the OPIS transaction. (Both taxpayers had sufficient capital gains from other transactions to offset against the OPIS-related losses.) However, the appellate court in each case ruled against the taxpayer, holding that the OPIS transaction lacked economic substance and, as a result, was disregarded for tax purposes.

When a redemption *fails* to satisfy any of the qualifying stock redemption rules, the basis of the redeemed shares does not disappear. Typically, the basis will attach to the basis of the redeeming shareholder's remaining shares in the corporation. If, however, the redeeming shareholder has terminated his or her direct stock ownership and the redemption is nonqualified due to the attribution rules, the basis of the redeemed shares will attach to the basis of the constructively owned stock.⁵³ In this manner, a nonqualified stock redemption can result in stock basis being shifted from one taxpayer (the redeeming shareholder) to another taxpayer (the shareholder related under the attribution rules).

EXAMPLE

35

Fran and Floyd, wife and husband, each own 50 shares in Grouse Corporation, representing 100% of the corporation's stock. All of the stock was purchased for \$50,000. Both Fran and Floyd serve as directors of the corporation. The corporation redeems Floyd's 50 shares, but he continues to serve as director of the corporation. The redemption is treated as a dividend distribution (assuming adequate E & P) because Floyd constructively owns Fran's stock, or 100% of the Grouse stock outstanding. Floyd's \$25,000 basis in the 50 shares redeemed attaches to Fran's stock; thus, Fran now has a basis of \$50,000 in the 50 shares she owns in Grouse.

19-4e Disproportionate Redemptions

A redemption qualifies for sale or exchange treatment under § 302(b)(2) as a **disproportionate redemption** if both of the following conditions are met:

- After the distribution, the shareholder owns *less than* 80 percent of the interest owned in the corporation before the redemption.
- After the distribution, the shareholder owns *less than* 50 percent of the total combined voting power of all classes of stock entitled to vote.

In determining a shareholder's ownership interest before and after a redemption, the attribution rules apply. Compare Examples 36 and 37.

Disproportionate Redemption Tests

EXAMPLE

36

Bob, Carl, and Dan, unrelated individuals, own 30 shares, 30 shares, and 40 shares, respectively, in Wren Corporation. Wren has 100 shares outstanding and E & P of \$200,000. The corporation redeems 20 shares of Dan's stock for \$30,000. Dan paid \$200 a share for the stock two years ago. Dan's ownership in Wren Corporation before and after the redemption is as follows:

continued

⁵³Reg. § 1.302-2(c). But see Prop.Reg. § 1.302-5.

	Total Shares	Dan's Ownership	Ownership Percentage	80% of Original Ownership
Before redemption	100	40	40% (40 ÷ 100)	32% (80% × 40%)
After redemption	80	20	25% (20 ÷ 80)*	

*Note that the denominator of the fraction is reduced after the redemption (from 100 to 80).

Dan's 25% ownership after the redemption meets both tests of § 302(b)(2). It is less than 80% of his original ownership and less than 50% of the total voting power. The distribution therefore qualifies as a disproportionate redemption and receives sale or exchange treatment. As a result, Dan has a long-term capital gain of \$26,000 [\$30,000 – \$4,000 (20 shares × \$200)].

Given the situation in Example 36, assume instead that Carl and Dan are father and son. The redemption described previously would not qualify for sale or exchange treatment because of the effect of the attribution rules. Dan is deemed to own Carl's stock before and after the redemption. Dan's ownership in Wren Corporation before and after the redemption is as follows:

EXAMPLE

37

	Total Shares	Dan's Direct Ownership	Carl's Ownership	Dan's Direct and Indirect Ownership	Ownership Percentage	80% of Original Ownership
Before redemption	100	40	30	70	70% (70 ÷ 100)	56% (80% × 70%)
After redemption	80	20	30	50	62.5% (50 ÷ 80)	

Dan's direct and indirect ownership of 62.5% fails to meet either of the tests of § 302(b)(2). After the redemption, Dan owns more than 80% of his original ownership and more than 50% of the voting stock. Thus, the redemption does not qualify for sale or exchange treatment and results in a dividend distribution of \$30,000 to Dan. The basis in the 20 shares redeemed is added to Dan's basis in his remaining 20 shares.

A redemption that does not qualify as a disproportionate redemption may still qualify as a not essentially equivalent redemption if it meets the meaningful reduction test (see Example 34).

19-4f Complete Termination Redemptions

A redemption that terminates a shareholder's *entire* stock ownership in a corporation qualifies for sale or exchange treatment. The attribution rules generally apply in determining whether the shareholder's stock ownership has been terminated. However, the *family* attribution rules do not apply to a **complete termination redemption** if both of the following conditions are met:

- The former shareholder does not hold or acquire any interest, other than that of a creditor, in the corporation for at least 10 years after the redemption (including an interest as an officer, a director, or an employee).
- The former shareholder files an agreement to notify the IRS of any prohibited interest acquired within the 10-year postredemption period and to retain all necessary records pertaining to the redemption during this time period.

Acquisition of stock in the corporation by bequest or inheritance will not constitute a prohibited interest. The required agreement should be in the form of a separate statement signed by the former shareholder and attached to the return for the year in which the redemption occurs. The agreement should state that the former shareholder agrees to notify the IRS within 30 days of acquiring a prohibited interest in the corporation during the 10-year postredemption period.⁵⁴

⁵⁴Reg. § 1.302-4(a).

Family Attribution Waiver

EXAMPLE

38

Kevin owns 50% of the stock in Green Corporation, while the remaining interest in Green is held as follows: 40% by Wilma (Kevin's wife) and 10% by Carmen (a key employee). Green redeems all of Kevin's stock for its fair market value. As a result, Wilma and Carmen are the only remaining shareholders, now owning 80% and 20%, respectively. If the two requirements for the family attribution waiver are met, the transaction will qualify as a complete termination redemption and result in sale or exchange treatment. If the waiver requirements are not satisfied, Kevin will be deemed to own Wilma's (his wife's) stock and the entire distribution will be taxed as a dividend (assuming adequate E & P).

EXAMPLE

39

Assume in Example 38 that Kevin qualifies for the family attribution waiver for the redemption. In the year of the redemption, Kevin treats the transaction as a sale or exchange. However, if he purchases Carmen's stock seven years after the redemption, he has acquired a prohibited interest and the redemption distribution is reclassified as a dividend. Kevin must notify the IRS and will owe additional taxes due to this revised treatment.

19-4g **Redemptions to Pay Death Taxes**

Section 303 provides sale or exchange treatment to a redemption of stock included in, and representing a substantial part of, a decedent's gross estate. The purpose of this provision is to provide an estate with liquidity to pay death-related expenses when a significant portion of the estate consists of stock in a closely held corporation. Often such stock is not easily marketable, and a stock redemption represents the only viable option for its disposition. The redemption might not satisfy any of the other qualifying stock redemption provisions because of the attribution rules (e.g., attribution to estate from beneficiaries). A **redemption to pay death taxes** provides sale or exchange treatment without regard to the attribution rules, but the provision limits this treatment to the sum of the death taxes and funeral and administration expenses. A redemption in excess of these expenses may qualify for sale or exchange treatment under one of the § 302 provisions.

An estate's basis in property acquired from a decedent is generally the property's fair market value on the date of death.⁵⁵ Typically, there is little change in the fair market value of stock from the date of a decedent's death to the date of a redemption to pay death taxes. When the redemption price in a redemption to pay death taxes is the same as the estate's basis in the stock, the estate will recognize no gain (or loss) on the transaction.

Section 303 applies only to a distribution made with respect to stock of a corporation that is included in the gross estate of a decedent and whose value *exceeds* 35 percent of the value of the adjusted gross estate.⁵⁶ (For definitions of *gross estate* and *adjusted gross estate*, see the Glossary in Appendix C.)

EXAMPLE

40

Juan's adjusted gross estate is \$7 million. The death taxes and funeral and administration expenses of the estate total \$720,000. Included in the gross estate is stock of Yellow Corporation, valued at \$2.8 million. Juan had acquired the stock nine years ago at a cost of \$300,000. Yellow redeems \$720,000 of the stock from Juan's estate. Because the value of the Yellow stock in Juan's estate exceeds the 35% threshold (\$2.8 million ÷ \$7 million = 40%), the redemption qualifies under § 303 as a sale or exchange to Juan's estate. Assuming that the value of the stock has remained unchanged since the date of Juan's death, there is no recognized gain (or loss) on the redemption [\$720,000 (amount realized) – \$720,000 (estate's stock basis)].

⁵⁵If available and elected, an alternate valuation date would apply. § 1014(a).

⁵⁶§ 303(b)(2)(A). For purposes of this test, the stock of two or more corporations in which the decedent held a 20 percent or more interest is treated as the stock of one corporation. § 303(b)(2)(B).

Concept Summary 19.5

Summary of the Qualifying Stock Redemption Rules

Type of Redemption	Requirements to Qualify
Not essentially equivalent to a dividend [§ 302(b)(1)]	Meaningful reduction in shareholder's voting interest. Reduction in shareholder's right to share in earnings or assets upon liquidation also considered. Stock attribution rules apply.
Substantially disproportionate [§ 302(b)(2)]	Shareholder's interest in the corporation, after the redemption, must be less than 80% of interest before the redemption and less than 50% of total combined voting power of all classes of stock entitled to vote. Stock attribution rules apply.
Complete termination [§ 302(b)(3)]	Entire stock ownership terminated. In general, stock attribution rules apply. However, <i>family</i> attribution rules are waived when former shareholder has no interest, other than as a creditor, in the corporation for at least 10 years and files an agreement to notify the IRS of any prohibited interest acquired during 10-year period. Shareholder must retain all necessary records during 10-year period.
Redemption to pay death taxes [§ 303]	Value of stock of one corporation in gross estate exceeds 35% of value of adjusted gross estate. Redemption limited to sum of death taxes and funeral and administration expenses. Generally tax-free because tax basis of stock is FMV on date of decedent's death and value is unchanged at redemption. Stock attribution rules do not apply.

19-5 STOCK REDEMPTIONS—EFFECT ON THE CORPORATION

Thus far, the discussion has focused on the tax consequences of stock redemptions to the *shareholder*. There are also several tax issues surrounding the redeeming *corporation* that must be addressed, including the recognition of gain or loss on property distributed pursuant to a redemption, the effect on a corporation's E & P from a distribution that is a qualifying stock redemption, and the deductibility of expenditures incurred in connection with a redemption. These issues are discussed in the following paragraphs.

19-5a Recognition of Gain or Loss

Distributions in redemption of stock, qualifying or not, are nonliquidating distributions. Section 311 provides that corporations recognize *gain* on all nonliquidating distributions of appreciated property as if the property had been sold for its fair market value. When distributed property is subject to a corporate liability that is greater than the fair market value, the liability amount is used to determine the recognized gain.

Losses are not recognized on nonliquidating distributions of property. Therefore, a corporation should avoid distributing loss property (fair market value less than basis) as consideration in the redemption of a shareholder's stock. However, the corporation could sell the property in a taxable transaction in which it can recognize a loss and then distribute the proceeds.

To carry out a redemption, Blackbird Corporation distributes land (basis of \$80,000, fair market value of \$300,000) to a shareholder's estate. Blackbird has a recognized gain of \$220,000 (\$300,000 – \$80,000). If the land is subject to a liability of \$330,000, Blackbird has a recognized gain of \$250,000 (\$330,000 – \$80,000). If the value of the property distributed was less than its adjusted basis, the realized loss would not be recognized.

LO.9

Determine the tax impact of stock redemptions on the distributing corporation.

EXAMPLE

41

19-5b Effect on Earnings and Profits

In a qualifying stock redemption, the E & P of the distributing corporation is reduced by an amount not in excess of the ratable share of the corporation's E & P attributable to the stock redeemed.⁵⁷

EXAMPLE

42

Navy Corporation has 100 shares of stock outstanding. In a qualifying stock redemption, Navy distributes \$200,000 in exchange for 30 of its shares. At the time of the redemption, Navy has paid-in capital of \$120,000 and E & P of \$450,000. The charge to E & P is limited to 30% of the corporation's E & P (\$135,000), and the remainder of the redemption price (\$65,000) is a reduction of the Navy paid-in capital account. If, instead, the 30 shares were redeemed for \$80,000, the charge to E & P would be limited to \$80,000, the amount Navy paid to carry out the stock redemption.

19-5c Redemption Expenditures

In redeeming its shares, a corporation may incur certain expenses such as accounting, brokerage, legal, and loan fees. Section 162(k) specifically denies a deduction for redemption expenditures incurred in connection with a stock redemption. The disallowance does not apply to amounts otherwise deducted under § 163, such as interest from debt-financed redemptions.

19-6 OTHER CORPORATE DISTRIBUTIONS

Partial liquidations of a corporation, if in compliance with the statutory requirements of § 302(e), will result in sale or exchange treatment to noncorporate shareholders. Distributions of stock and securities of a controlled corporation to the shareholders of the parent corporation will be free of any tax consequences if they fall under § 355. Both of these types of corporate distributions are similar to stock redemptions and dividend distributions in some respects but are not discussed here because of their limited applicability.

See Concept Summary 19.6 for a listing of key points to consider when working with corporate distributions.

19-7 TAX PLANNING

19-7a Corporate Distributions

The following points are especially important when planning for corporate distributions.

- Because E & P is the pool of funds from which dividends may be distributed, its periodic determination is essential to corporate planning. Thus, an E & P account should be established and maintained, particularly if the possibility exists that a corporate distribution might be a return of capital.
- Accumulated E & P is the sum of all past years' current E & P. Because there is no statute of limitations on the computation of E & P, the IRS can redetermine a corporation's current E & P for a tax year long since passed. Such a change affects accumulated E & P and has a direct impact on the taxability of current distributions to shareholders.
- Distributions can be planned to avoid or minimize dividend exposure.

LO.10

Identify planning opportunities available to minimize the tax impacts of corporate distributions, constructive dividends, and stock redemptions.

⁵⁷§ 312(n)(7).

EXAMPLE

43

After several unprofitable years, Darter Corporation has a deficit in accumulated E & P of \$100,000 as of January 1, 2015. Starting in 2015, Darter expects to generate annual E & P of \$50,000 for the next four years and would like to distribute this amount to its shareholders. The corporation's cash position (for dividend purposes) will correspond to the current E & P generated. Consider the following two distribution schedules:

1. On December 31 of 2015, 2016, 2017, and 2018, Darter Corporation distributes cash of \$50,000.
2. On December 31 of 2016 and 2018, Darter Corporation distributes cash of \$100,000.

The two alternatives are illustrated as follows.

Year	Accumulated E & P (First of Year)	Current E & P	Distribution	Amount of Dividend
Alternative 1				
2015	(\$100,000)	\$50,000	\$50,000	\$50,000
2016	(100,000)	50,000	50,000	50,000
2017	(100,000)	50,000	50,000	50,000
2018	(100,000)	50,000	50,000	50,000
Alternative 2				
2015	(\$100,000)	\$50,000	\$ -0-	\$ -0-
2016	(50,000)	50,000	100,000	50,000
2017	(50,000)	50,000	-0-	-0-
2018	-0-	50,000	100,000	50,000

Alternative 1 produces \$200,000 of dividend income because each \$50,000 distribution is fully covered by current E & P. Alternative 2, however, produces only \$100,000 of dividend income for the shareholders. The remaining \$100,000 is a return of capital. Why? At the time Darter Corporation made its first distribution of \$100,000 on December 31, 2016, it had a deficit of \$50,000 in accumulated E & P (the original deficit of \$100,000 is reduced by the \$50,000 of current E & P from 2015). Consequently, the \$100,000 distribution yields a \$50,000 dividend (the current E & P for 2016), and \$50,000 is treated as a return of capital. As of January 1, 2017, Darter's accumulated E & P has a deficit balance of \$50,000 because a distribution cannot increase a deficit in E & P. After adding the remaining \$50,000 of current E & P from 2017, the balance on January 1, 2018, is zero. Thus, the second distribution of \$100,000 made on December 31, 2018, also yields \$50,000 of dividends (the current E & P for 2018) and a \$50,000 return of capital.

19-7b Planning for Qualified Dividends

Retirement Plans

The reduced tax rates available to individual taxpayers on net capital gain and qualified dividend income are not available when stock is held in retirement accounts. Because income in § 401(k) plans and IRAs is not taxed when earned, the benefits of the lower tax rates on these forms of income are lost. Instead, distributions from these plans (other than Roth IRAs) are taxed at ordinary income tax rates.

Closely Held Corporations

Closely held corporations have considerable discretion regarding their dividend policies. In the past, the double tax result provided strong motivation to avoid the payment of dividends. Instead, the incentive was to bail out corporate profits in a manner that provided tax benefits to the corporation. Hence, liberal use was made

Concept Summary 19.6

Corporate Distributions

- Without a special provision, corporate distributions are taxed as dividend income to the recipient shareholders to the extent of the distributing corporation's E & P accumulated since February 28, 1913, or to the extent of current E & P. Any excess is treated as a return of capital to the extent of the shareholder's basis in the stock and, thereafter, as capital gain.
- Property distributions are considered dividends (taxed as noted in item 1) in the amount of their fair market value. The amount distributed is reduced by any liabilities on the property distributed. The shareholder's basis in the property is its fair market value.
- Earnings and profits of a corporation are increased by corporate earnings for the taxable year computed in the same manner as the corporation computes its taxable income. As a general rule, the account is increased for all items of income, whether taxed or not, and reduced by all items of expense, whether deductible or not. Refer to Concept Summary 19.1 for a summary of the effect of certain transactions on taxable income in arriving at current E & P.
- A corporation recognizes gain, but not loss, on distributions of property to its shareholders. E & P of the distributing corporation is reduced by the amount of money distributed or by the greater of the fair market value or the adjusted basis of property distributed less the amount of any liability applicable to the distributed property.
- As a general rule, stock dividends or stock rights (representing stock in the distributing corporation) are not taxed, with certain exceptions.
- Stock redemptions that qualify under § 302(b) are given sale or exchange treatment. This provision requires that such distributions be substantially disproportionate, complete terminations, or not essentially equivalent to a dividend. In determining whether a transaction is a not essentially equivalent redemption or a disproportionate redemption, the attribution rules apply. However, in a complete termination redemption, the family attribution rules may be waived if certain conditions are met.
- If stock included in a decedent's estate represents more than 35% of the adjusted gross estate, § 303 provides automatic sale or exchange treatment on its redemption.
- A corporation is taxed on the appreciation of property distributed in redemption of its stock.
- In a qualifying stock redemption, the E & P account of the distributing corporation is reduced by an amount not in excess of the ratable share of its E & P that is attributable to the stock redeemed.

of compensation, loan, and lease arrangements because salaries, interest, and rent are deductible. Under current law, however, shareholders prefer dividends because salaries, interest, and rent are fully taxed while dividends receive preferential treatment. Thus, the question becomes this: Should the *corporation* or the *shareholders* benefit? In general, the best strategy considers the tax consequences to both parties.

EXAMPLE

44

Consider a corporation paying tax at the 34% rate and an individual shareholder in the 35% tax bracket. A deductible \$10,000 payment to the shareholder will save the corporation \$3,400 in tax, resulting in an after-tax cost of \$6,600. The shareholder will pay \$3,500 in tax, resulting in after-tax income of \$6,500. This creates a joint tax burden of \$100 (\$3,500 tax paid by the shareholder – \$3,400 tax saved by the corporation). If, instead, the corporation paid a \$10,000 qualified dividend (subject to a 15% tax rate) to the shareholder, no tax savings would be realized by the corporation, resulting in an after-tax cost of \$10,000. The shareholder would owe \$1,500 in taxes, leaving \$8,500 of income. Considering both the corporation and the shareholder, a dividend creates \$1,400 more tax liability than a deductible payment; so the deductible payment is more tax-efficient.

In Example 44, when the deductible payment is made, the shareholder bears an increased tax burden of \$2,000 (\$3,500 tax due from the deductible payment – \$1,500 tax due from the dividend) while the corporation saves \$3,400 (\$3,400 tax saved because of the deductible payment – \$0 tax saved because of the dividend). Both parties can actually benefit if the corporation transfers part of its benefit to the shareholder through a larger deductible payment.

Assume the same facts as in Example 44, except that the corporation pays a \$14,000 deductible payment. In this case, the corporation will save \$4,760 ($\$14,000 \times 34\%$) in tax, resulting in an after-tax cost of \$9,240. From the corporation's perspective, this is preferable to a \$10,000 dividend because it costs \$760 less after tax ($\$10,000$ dividend cost $-$ $\$9,240$ after-tax cost of a \$14,000 deductible payment). The shareholder will pay taxes of \$4,900 on the deductible payment, resulting in after-tax income of \$9,100. The shareholder will also prefer this payment to a \$10,000 dividend because it generates \$600 more after-tax income ($\$9,100 - \$8,500$ from a dividend).

EXAMPLE

45

Thus, if properly structured, deductible payments by the corporation to the shareholder still appear to be preferable to dividends in most situations (unless the corporation faces a low tax rate).

19-7c Constructive Dividends

Tax planning can be particularly effective in avoiding constructive dividend situations. Shareholders should try to structure their dealings with the corporation on an arm's length basis. For example, reasonable rent should be paid for the use of corporate property, and a fair price should be paid for its purchase. The parties should make every effort to support the amount involved with appraisal data or market information obtained from reliable sources at or near the time of the transaction. Dealings between shareholders and a closely held corporation should be as formal as possible. In the case of loans to shareholders, for example, the parties should provide for an adequate rate of interest and written evidence of the debt. Shareholders should also establish and follow a realistic repayment schedule.

If shareholders want to bail out corporate profits in a form deductible to the corporation, a balanced mix of the possible alternatives lessens the risk of constructive dividend treatment. Rent for the use of shareholder property, interest on amounts borrowed from shareholders, or salaries for services rendered by shareholders are all feasible substitutes for dividend distributions. Overdoing any one approach, however, may attract the attention of the IRS. Too much interest, for example, may mean that the corporation is thinly capitalized, and some of the debt may be reclassified as an equity investment.

Much can be done to protect against the disallowance of unreasonable compensation. Example 46 is an illustration, all too common in a family corporation, of what *not* to do.

Bob Cole wholly owns Eagle Corporation. Corporate employees and their annual salaries include Rebecca, Bob's wife (\$120,000); Sam, Bob's son (\$80,000); Bob (\$640,000); and Ed, Bob's longtime friend who is unrelated to the Cole family (\$320,000). The operation of Eagle Corporation is shared about equally between Bob Cole and Ed. Rebecca performed significant services for Eagle during its formative years, but now merely attends the annual meeting of the board of directors. Sam is a full-time student and occasionally signs papers for the corporation in his capacity as treasurer. Eagle Corporation has not distributed a dividend for 10 years although it has accumulated substantial E & P. Rebecca, Sam, and Bob run the risk of a finding of unreasonable compensation, based on the following factors:

- Rebecca's salary is vulnerable unless proof is available that some or all of her \$120,000 annual salary is payment for services rendered to the corporation in prior years and that she was underpaid for those years.⁵⁸
- Sam's salary is also vulnerable; he does not appear to earn the \$80,000 paid to him by the corporation. Neither Sam nor Rebecca is a shareholder, but each one's relationship to Bob is enough of a tie-in to raise the unreasonable compensation issue.
- Bob's salary appears susceptible to challenge. Why is he receiving \$320,000 more than Ed when it appears they share equally in the operation of the corporation?
- The fact that Eagle Corporation has not distributed dividends over the past 10 years, even though it is capable of doing so, increases the likelihood of a constructive dividend.

EXAMPLE

46

⁵⁸See, for example, *R. J. Nicoll Co.*, 59 T.C. 37 (1972).

19-7d **Stock Redemptions**

Stock redemptions offer several possibilities for tax planning:

- The alternative to a qualifying stock redemption is dividend treatment. The 20/15/0 percent preferential tax rate on dividend income reduces some of the adverse consequences of a nonqualified stock redemption.
- A nonqualified redemption may be preferable to a redemption that produces sale or exchange treatment if the distributing corporation has little or no E & P or the distributee-shareholder is another corporation. In the latter situation, dividend treatment may be preferred because of the availability of the dividends received deduction.
- A not essentially equivalent redemption provides minimal utility and generally should be relied upon only as a last resort. Instead, a redemption should be structured to satisfy the objective tests required of one of the other qualifying redemptions.
- The timing and sequence of a redemption should be considered carefully, as a series of redemptions may have the effect of a dividend distribution. The following example illustrates this point.

EXAMPLE

47

Sparrow Corporation's stock is held by three unrelated shareholders: Alma (60 shares), Antonio (20 shares), and Ali (20 shares). The corporation redeems 24 of Alma's shares. Shortly thereafter, it redeems 5 of Antonio's shares. Does Alma's redemption qualify as a disproportionate redemption? Taken in isolation, it satisfies the 80% and 50% tests. Yet, if the IRS takes into account the later redemption of Antonio's shares, Alma has not satisfied the 50% test; she still owns 36/71 of the corporation after the two redemptions. A greater time lag between the redemptions places Alma in a better position to argue against collapsing the two redemptions as parts of one integrated plan.

- For a family corporation in which all of the shareholders are related to each other, the only hope of achieving sale or exchange treatment may lie in the use of a redemption that completely terminates a shareholder's interest or that follows a shareholder's death. In a complete termination redemption, it is important that the family stock attribution rules be avoided. Here, strict compliance with the requirements for the family attribution waiver (e.g., the withdrawing shareholder does not acquire a prohibited interest in the corporation within 10 years) is crucial.
- In a redemption to pay death taxes, the amount to be sheltered from dividend treatment is limited to the sum of death taxes and funeral and administration expenses. However, a redemption in excess of the limitation does not destroy the applicability of § 303.

REFOCUS ON THE BIG PICTURE

TAXING CORPORATE DISTRIBUTIONS



A number of factors affect the tax treatment of Lime Corporation's distributions. The amount of current and accumulated E & P (which differ from the financial reporting concept of retained earnings) partially determines the tax effect on the shareholders. Given that Lime Corporation has had a highly profitable year (see Example 10), it is likely that there is sufficient current E & P to cover the distributions. If so, they are dividends to the shareholders rather than a return of capital. Orange Corporation receives \$200,000 of dividend income that is mostly offset by the dividends received deduction. The amount of the offsetting deduction depends on the ownership percentage that Orange has in Lime. In this situation, Orange would likely qualify for a dividends

received deduction of \$160,000 ($\$200,000 \times 80\%$). Gustavo has \$200,000 of dividend income (i.e., \$300,000 value of the land less the \$100,000 mortgage). Assuming that Lime is a domestic corporation and that Gustavo has held his stock for the entire year, the land is a qualified dividend. As a result, the dividend is subject to a 0 percent, 15 percent, or 20 percent tax rate (depending on Gustavo's marginal tax rate). Gustavo's basis in the land is its fair market value at distribution, or \$300,000 (see Example 13).

From Lime Corporation's perspective, the distribution of appreciated property creates a deemed gain (see Example 16). Thus, a \$280,000 gain results (\$300,000 fair market value of the land less its adjusted basis of \$20,000). While the gain increases Lime's E & P, the distributions to the shareholders reduce it by \$200,000 for the cash and \$200,000 for the land (\$300,000 fair market value reduced by the \$100,000 mortgage).

What If?

What if current E & P is less than the cash and land distributed to the shareholders? Current E & P is applied pro rata to the cash and the land. Because the amounts received by the two shareholders are equal (\$200,000 each), the current E & P applied is taxed as a dividend and is treated as previously described. To the extent the distributions are not covered by current E & P, accumulated E & P is then applied in a pro rata fashion (because both distributions were made on December 31). However, Lime probably has a deficit in accumulated E & P. As a result, the remaining amounts distributed to the two shareholders are first a tax-free recovery of stock basis, and any excess is taxed as a sale of the stock (probably classified as capital gain).

Key Terms

Accumulated E & P, 19-7

Attribution, 19-22

Complete termination redemption, 19-25

Constructive dividend, 19-13

Current E & P, 19-7

Disproportionate redemption, 19-24

Earnings and profits (E & P), 19-3

Meaningful reduction test, 19-23

Not essentially equivalent redemption, 19-23

Property dividend, 19-11

Qualified dividends, 19-10

Redemption to pay death taxes, 19-26

Stock dividends, 19-17

Stock redemption, 19-19

Stock rights, 19-18

Unreasonable compensation, 19-15

Discussion Questions

- LO.2** In determining Blue Corporation's current E & P for 2015, how should taxable income be adjusted as a result of the following transactions?
 - A capital loss carryover from 2014, fully used in 2015.
 - Nondeductible meal expenses in 2015.
 - Interest on municipal bonds received in 2015.
 - Nondeductible lobbying expenses in 2015.
 - Loss on a sale between related parties in 2015.
 - Federal income tax refund received in 2015.
- LO.3** Describe the effect of a distribution in a year when the distributing corporation has any of the following:
 - A deficit in accumulated E & P and a positive amount in current E & P.
 - A positive amount in accumulated E & P and a deficit in current E & P.
 - A deficit in both current and accumulated E & P.
 - A positive amount in both current and accumulated E & P.

3. **LO.3** A calendar year corporation has substantial accumulated E & P, but it expects to incur a deficit in current E & P for the year due to significant losses in the last half of the year. A cash distribution to its shareholders on January 1 should result in a return of capital. Comment on the validity of this statement.
4. **LO.4** Discuss the rationale for the reduced tax rates on dividends paid to individuals.
- Issue ID** 5. **LO.1, 2, 3, 4, 5** Orange Corporation distributes \$200,000 in cash to each of its three shareholders: Sandy, Byron, and Fuchsia Corporation. What factors must be considered when determining how the distribution is treated for tax purposes by the shareholders?
- Issue ID** 6. **LO.5** Assume the same facts as in Question 5, except that noncash property is distributed. What factors must be considered when determining how the distribution is treated for tax purposes by Orange Corporation?
7. **LO.5** Ochre Corporation's board of directors decides to distribute property to its shareholders rather than pay a cash dividend. Why might Ochre's board make this decision?
- Decision Making** 8. **LO.5** Raven Corporation owns three machines that it uses in its business. It no longer needs two of these machines and is considering distributing them to its two shareholders as a property dividend. All three machines have a fair market value of \$20,000 each. The basis of each machine is as follows: Machine A, \$27,000; Machine B, \$20,000; and Machine C, \$12,000. The corporation has asked you for advice. What do you recommend?
- Issue ID** 9. **LO.5** Tangerine Corporation is considering a property distribution to its shareholders. If appreciated property is to be used, does it matter to Tangerine whether the property distributed is a long-term capital asset or property subject to depreciation recapture? Would your answer differ if the property distributed has a fair market value less than the adjusted basis? Explain.
- Issue ID** 10. **LO.6** Samantha is the president and sole shareholder of Toucan Corporation. She is paid an annual salary of \$500,000, while her son, Aaron, the company's chief financial officer, is paid a salary of \$290,000. Aaron works for Toucan on a part-time basis and spends most of his time training for triathlons. Toucan advances \$85,000 to Samantha as an interest-free loan. What are the tax issues?
11. **LO.6** Whether compensation paid to a corporate employee is reasonable is a question of fact to be determined from the surrounding circumstances. How would the resolution of this problem be affected by each of the following factors?
- The employee owns no stock but is the mother-in-law of the sole shareholder.
 - The shareholder-employee does not have a college degree.
 - The shareholder-employee works 40 hours per week for another unrelated employer.
 - The shareholder-employee was underpaid for services during the formative period of the corporation.
 - The corporation has never paid a dividend.
 - Year-end bonuses are paid to all employees, but officer-shareholders receive disproportionately larger bonuses.
12. **LO.6, 10** Pink Corporation has several employees. Their names and salaries are listed below.

Judy	\$470,000
Holly (Judy's daughter)	100,000
Terry (Judy's son)	100,000
John (an unrelated third party)	320,000

Holly and Terry are the only shareholders of Pink Corporation. Judy and John share equally in the management of the company's operations. Holly and Terry are both full-time college students at a university 200 miles away. Pink has substantial E & P and has never distributed a dividend. Discuss any problems related to Pink's salary arrangement.

13. **LO.8, 9, 10** Chao, Louis, and Mari, unrelated individuals, own all of the shares of Cerise Corporation. All three shareholders have been active in the management of Cerise since its inception. In the current year, Chao wants to retire and sell all of her shares in the corporation. What issues should be considered in determining whether Chao should sell her stock to one of the other shareholders, to Cerise Corporation, or to a third party? Issue ID
14. **LO.8** Corporate shareholders typically prefer dividend treatment on a stock redemption. Why?
15. **LO.8** Do the stock attribution rules apply to all stock redemptions? Explain.
16. **LO.8** Briefly discuss the requirements for a redemption to qualify as a not essentially equivalent redemption.
17. **LO.8** If a redemption is treated as a dividend ("nonqualified stock redemption"), what happens to the basis of the stock redeemed?
18. **LO.8, 9** Tammy and Barry formed Pheasant Corporation several years ago in a transaction that qualified under § 351. Both shareholders serve as officers and on the board of directors of Pheasant. In the current year, Pheasant Corporation redeemed all of Barry's shares in the corporation with a property distribution. What are the tax issues for Barry and Pheasant? Issue ID
19. **LO.8** Explain the requirements for a redemption to pay death taxes. What are the tax consequences of a redemption to pay death taxes for the shareholder and the corporation?
20. **LO.8, 9** Angie and her daughter, Ann, who are the only shareholders of Bluebird Corporation, each paid \$100,000 four years ago for their shares in Bluebird. Angie also owns 20% of the stock in Redbird Corporation. The Redbird stock is worth \$500,000, and Angie's basis in the stock is \$50,000. Angie dies in the current year leaving all of her property to her husband, Gary, but Ann wants to be the sole shareholder of Bluebird Corporation. Bluebird has assets worth \$4 million (basis of \$700,000) and E & P of \$1 million. Angie's estate is worth approximately \$6 million. Angie had made gifts during her lifetime to Ann. What are the tax issues for Angie's estate, Ann, and Bluebird? Issue ID

Computational Exercises

21. **LO.1** At the beginning of the year, Myrna Corporation (a calendar year taxpayer) has E & P of \$32,000. The corporation generates no additional E & P during the year. On December 31, the corporation distributes \$50,000 to its sole shareholder, Abby, whose stock basis is \$10,000. How is the distribution treated for tax purposes?
22. **LO.3** On January 1 of the current year, Rhondell Corporation has accumulated E & P of \$13,000. Current E & P for the year is \$84,000, earned evenly throughout the year. Elizabeth and Jonathan are sole equal shareholders of Rhondell from January 1 to April 30. On May 1, Elizabeth sells all of her stock to Marshall. Rhondell makes two distributions to shareholders during the year: A total of \$42,000 (\$21,000

to Elizabeth and \$21,000 to Jonathan) on April 30 and a total of \$58,000 (\$29,000 to Jonathan and \$29,000 to Marshall) on December 31.

Determine the allocation of the distributions by completing the table below. Assume the shareholders have sufficient basis in their stock for any amount that is treated as return of capital.

	From Current E & P	From Accumulated E & P	Treated as Return of Capital
April 30 distribution of \$42,000	\$ _____	\$ _____	\$ _____
December 31 distribution of \$58,000	\$ _____	\$ _____	\$ _____

- Decision Making**
23. **LO.4, 10** Robin Corporation would like to transfer excess cash to its sole shareholder, Adam, who is also an employee. Adam is in the 28% tax bracket, and Robin is in the 34% bracket. Because Adam's contribution to the business is substantial, Robin believes that a \$25,000 bonus in the current year is reasonable compensation and should be deductible by the corporation. However, Robin is considering paying Adam a \$25,000 dividend because the tax rate on dividends is lower than the tax rate on compensation. Is Robin correct in believing that a dividend is the better choice? Why or why not?
24. **LO.5** Global Corporation distributed property with an \$850,000 fair market value and a \$415,000 adjusted basis to one of its shareholders. The property was subject to a \$230,000 mortgage, which the shareholder assumed. Global has ample E & P to cover any distribution made during the year. What is the amount of the shareholder's dividend income on the distribution? What is the shareholder's basis in the property received?
25. **LO.5** Quinlan has ample E & P to cover any distributions made during the year. One distribution made to a shareholder consists of a property with an adjusted basis of \$150,000 and a fair market value of \$90,000. What are the tax consequences of this distribution to Quinlan?
26. **LO.6** Deerwood Corporation lends its principal shareholder, Lafayette, \$500,000 on July 1 of the current year. The loan is interest-free and payable on demand. On December 31, the imputed interest rules are applied. Assume that the Federal rate is 6%, compounded semiannually. What are the tax consequences of this loan to Lafayette?
27. **LO.7** What are the tax consequences to Euclid from the following independent events?
- Euclid bought 500 shares of common stock five years ago for \$50,000. This year, Euclid receives 20 shares of common stock as a nontaxable stock dividend. What is Euclid's basis per share after this event?
 - Assume instead that Euclid received a nontaxable preferred stock dividend of 20 shares. The preferred stock has a fair market value of \$5,000, and the common stock, on which the preferred is distributed, has a fair market value of \$75,000.
28. **LO.8** During the current year, Gnatcatcher, Inc., (E & P of \$1 million) distributed \$200,000 each to Brandi and Yuen in redemption of some of their Gnatcatcher stock. The two shareholders acquired their shares five years ago. Each shareholder is in the 33% tax bracket, and each had a \$45,000 basis in her redeemed stock.
- Assume the distribution to Brandi is a qualifying stock redemption. Determine Brandi's tax liability on the distribution.
 - Assume the distribution to Yuen is a nonqualified stock redemption. Determine Yuen's tax liability on the distribution.

29. **LO.8** Rosalie owns 50% of the outstanding stock of Salmon Corporation. In a qualifying stock redemption, Salmon distributes \$80,000 to Rosalie in exchange for one-half of her shares, which have a basis of \$100,000. Compute Rosalie's recognized loss, if any, on the redemption.
30. **LO.8** Derk owns 250 shares of stock in Rose Corporation. The remaining 750 shares of Rose are owned as follows: 150 by Derk's daughter, 200 by Derk's aunt, and 400 by a partnership in which Derk has an 80% interest. Determine the number of shares Derk owns (directly and indirectly) in Rose Corporation.
31. **LO.9** Caramel Corporation has 5,000 shares of stock outstanding. In a qualifying stock redemption, Caramel distributes \$145,000 in exchange for 1,000 of its shares. At the time of the redemption, Caramel has paid-in capital of \$800,000 and E & P of \$300,000. Calculate the reduction to Caramel's E & P as a result of the distribution.

Problems

32. **LO.1, 4** At the start of the current year, Blue Corporation (a calendar year taxpayer) has accumulated E & P of \$100,000. Blue's current E & P is \$60,000, and at the end of the year, it distributes \$200,000 (\$100,000 each) to its equal shareholders, Pam and Jon. Pam's stock basis is \$11,000; Jon's stock basis is \$26,000. How is the distribution treated for tax purposes?
33. **LO.1, 2** Cardinal Corporation, a calendar year taxpayer, receives dividend income of \$250,000 from a corporation in which it holds a 10% interest. Cardinal also receives interest income of \$35,000 from municipal bonds. (The municipality used the proceeds from the bond issue to construct a library.) Cardinal borrowed funds to purchase the municipal bonds and pays \$20,000 of interest on the loan. Excluding these items, Cardinal's taxable income is \$500,000.
- What is Cardinal Corporation's taxable income after these items are taken into account?
 - What is Cardinal Corporation's accumulated E & P at the start of next year if its beginning balance this year is \$150,000?
34. **LO.1, 2, 3** On September 30, Silver Corporation, a calendar year taxpayer, sold a parcel of land (basis of \$400,000) for a \$1 million note. The note is payable in five installments, with the first payment due next year. Because Silver did not elect out of the installment method, none of the \$600,000 gain is taxed this year. Silver Corporation had a \$300,000 deficit in accumulated E & P at the beginning of the year. Before considering the effect of the land sale, Silver had a deficit in current E & P of \$50,000.
- Sam, the sole shareholder of Silver, has a basis of \$200,000 in his stock. If Silver distributes \$900,000 to Sam on December 31, how much income must he report for tax purposes?
35. **LO.2** Sparrow Corporation (a calendar year, accrual basis taxpayer) had the following transactions in 2015, its second year of operation.

Taxable income	\$330,000
Federal income tax liability paid	112,000
Tax-exempt interest income	5,000
Meals and entertainment expenses (total)	3,000
Premiums paid on key employee life insurance	3,500

Increase in cash surrender value attributable to life insurance premiums	\$ 700
Proceeds from key employee life insurance policy	130,000
Cash surrender value of life insurance policy at distribution	20,000
Excess of capital losses over capital gains	13,000
MACRS deduction	26,000
Straight-line depreciation using ADS lives	16,000
Section 179 expense elected during 2014	25,000
Dividends received from domestic corporations (less than 20% owned)	25,000

Sparrow uses the LIFO inventory method, and its LIFO recapture amount increased by \$10,000 during 2015. In addition, Sparrow sold property on installment during 2014. The property was sold for \$40,000 and had an adjusted basis at sale of \$32,000. During 2015, Sparrow received a \$15,000 payment on the installment sale. Finally, assume that no additional first-year depreciation was claimed. Compute Sparrow's current E & P.

36. **LO.1, 2** In each of the following independent situations, indicate the effect on taxable income and E & P, stating the amount of any increase (or decrease) in each as a result of the transaction. Assume that E & P has already been increased by taxable income.

Transaction	Taxable Income Increase (Decrease)	E & P Increase (Decrease)
a. Realized gain of \$80,000 on involuntary conversion of building (\$10,000 of gain is recognized).	_____	_____
b. Mining exploration costs incurred on May 1 of current year; \$24,000 is deductible from current-year taxable income.	_____	_____
c. Sale of equipment to unrelated third party for \$240,000; basis is \$120,000 (no election out of installment method; no payments are received in current year).	_____	_____
d. Dividends of \$20,000 received from 5% owned corporation, together with dividends received deduction (assume that taxable income limit does not apply).	_____	_____
e. Domestic production activities deduction of \$45,000 claimed in current year.	_____	_____
f. Section 179 expense deduction of \$25,000 in current year.	_____	_____
g. Impact of current-year § 179 expense deduction in succeeding year.	_____	_____
h. MACRS depreciation of \$80,000. ADS depreciation would have been \$90,000.	_____	_____
i. Federal income taxes of \$80,000 paid in current year.	_____	_____

37. **LO.1, 3** Black Corporation and Tom each own 50% of Tan Corporation's common stock. On January 1, Tan has a deficit in accumulated E & P of \$200,000. Its current E & P is \$90,000. During the year, Tan makes cash distributions of \$40,000 each to Black and Tom.
- How are the two shareholders taxed on the distribution?
 - What is Tan Corporation's accumulated E & P at the end of the year?

38. **LO.1, 3** Complete the following schedule for each case. Unless otherwise indicated, assume that the shareholders have ample basis in the stock investment.

	Accumulated E & P Beginning of Year	Current E & P	Cash Distributions (All on Last Day of Year)	Dividend Income	Return of Capital
a.	(\$200,000)	\$ 70,000	\$130,000	\$ _____	\$ _____
b.	150,000	(120,000)	210,000	_____	_____
c.	90,000	70,000	150,000	_____	_____
d.	120,000	(60,000)	130,000	_____	_____
e.	Same as (d), except that the distribution of \$130,000 is made on June 30 and the corporation uses the calendar year for tax purposes.			_____	_____

39. **LO.1, 3** Larry, the sole shareholder of Brown Corporation, sold his Brown stock to Ed on July 30 for \$270,000. Larry's basis in the stock was \$200,000 at the beginning of the year. Brown had accumulated E & P of \$120,000 on January 1 and has current E & P of \$240,000. During the year, Brown made the following distributions: \$450,000 of cash to Larry on July 1 and \$150,000 of cash to Ed on December 30. How will Larry and Ed be taxed on the distributions? How much gain will Larry recognize on the sale of his stock to Ed?
40. **LO.4** In November of the current year, Emerald Corporation declared a dividend of \$2 per share (the shareholder record date is December 15). Assume that Emerald has sufficient current E & P to cover the dividend payment. If Judy purchases 500 shares of Emerald stock on December 5 and sells the stock on December 25, how is she taxed on the \$1,000 dividend?
41. **LO.1, 5** Heather, an individual, owns all of the outstanding stock in Silver Corporation. Heather purchased her stock in Silver nine years ago, and her basis is \$56,000. At the beginning of this year, the corporation has \$76,000 of accumulated E & P and no current E & P (before considering the effect of the distributions as noted below). What are the tax consequences to Heather (amount and type of income and basis in property received) and Silver Corporation (gain or loss and effect on E & P) in each of the following situations?
- Silver distributes land to Heather. The land was held as an investment and has a fair market value of \$54,000 and an adjusted basis of \$42,000.
 - Assume that Silver Corporation has no current or accumulated E & P prior to the distribution. How would your answer to (a) change?
 - Assume that the land distributed in (a) is subject to a \$46,000 mortgage (which Heather assumes). How would your answer change?
 - Assume that the land has a fair market value of \$54,000 and an adjusted basis of \$62,000 on the date of the distribution. How would your answer to (a) change?
 - Instead of distributing land in (a), assume that Silver decides to distribute equipment used in its business. The equipment has a \$14,000 market value, a \$1,200 adjusted basis for income tax purposes, and a \$5,200 adjusted basis for E & P purposes. When the equipment was purchased four years ago, its original fair market value was \$18,000.
42. **LO.1, 5** Lime Corporation, with E & P of \$500,000, distributes land (worth \$300,000, adjusted basis of \$350,000) to Harry, its sole shareholder. The land is subject to a liability of \$120,000, which Harry assumes. What are the tax consequences to Lime and to Harry?

43. **LO.1, 3** At the beginning of the year, Penguin Corporation (a calendar year taxpayer) has accumulated E & P of \$55,000. During the year, Penguin incurs a \$36,000 loss from operations that accrues ratably. On October 1, Penguin distributes \$40,000 in cash to Holly, its sole shareholder. How is Holly taxed on the distribution?
- Issue ID** 44. **LO.1, 2, 3, 4, 5** Cerulean Corporation has two equal shareholders, Eloise and Olivia. Eloise acquired her Cerulean stock three years ago by transferring property worth \$700,000, basis of \$300,000, for 70 shares of the stock. Olivia acquired 70 shares in Cerulean Corporation two years ago by transferring property worth \$660,000, basis of \$110,000. Cerulean Corporation's accumulated E & P as of January 1 of the current year is \$350,000. On March 1 of the current year, the corporation distributed to Eloise property worth \$120,000, basis to Cerulean of \$50,000. It distributed cash of \$220,000 to Olivia. On July 1 of the current year, Olivia sold her stock to Magnus for \$820,000. On December 1 of the current year, Cerulean distributed cash of \$90,000 each to Magnus and Eloise. What are the tax issues?
45. **LO.5** Iris Corporation owns 30% of Fresia Corporation's stock. On November 15, Fresia Corporation, with current E & P of \$320,000, distributes land (fair market value of \$100,000; basis of \$160,000) to Iris. The land is subject to a liability of \$80,000, which Iris assumes.
- How is Iris Corporation taxed on the distribution?
 - What is Fresia Corporation's E & P after the distribution?
46. **LO.2, 6** Parrot Corporation is a closely held company with accumulated E & P of \$300,000 and current E & P of \$350,000. Tom and Jerry are brothers; each owns a 50% share in Parrot, and they share management responsibilities equally. What are the tax consequences of each of the following independent transactions involving Parrot, Tom, and Jerry? How does each transaction affect Parrot's E & P?
- Parrot sells an office building (adjusted basis of \$350,000; fair market value of \$300,000) to Tom for \$275,000.
 - Parrot lends Jerry \$250,000 on March 31 of this year. The loan is evidenced by a note and is payable on demand. No interest is charged on the loan (the current applicable Federal interest rate is 7%).
 - Parrot owns an airplane that it leases to others for a specified rental rate. Tom and Jerry also use the airplane for personal use and pay no rent. During the year, Tom used the airplane for 120 hours, and Jerry used it for 160 hours. The rental value of the airplane is \$350 per hour, and its maintenance costs average \$80 per hour.
 - Tom leases equipment to Parrot for \$20,000 per year. The same equipment can be leased from another company for \$9,000 per year.
- Communications** 47. **LO.7** Jacob Corcoran bought 10,000 shares of Grebe Corporation stock two years ago for \$24,000. Last year, Jacob received a nontaxable stock dividend of 2,000 shares in Grebe Corporation. In the current tax year, Jacob sold all of the stock received as a dividend for \$18,000. Prepare a letter to Jacob and a memo for the file describing the tax consequences of the stock sale. Jacob's address is 925 Arapahoe Street, Boulder, CO 80304.
- Decision Making** 48. **LO.4** Kristen, the president and sole shareholder of Egret Corporation, has earned a salary bonus of \$30,000 for the current year. Because of the lower tax rates on qualifying dividends, Kristen is considering substituting a dividend for the bonus. Assume that the tax rates are 28% for Kristen and 34% for Egret Corporation.
- How much better off would Kristen be if she were paid a dividend rather than salary?
 - How much better off would Egret Corporation be if it paid Kristen a salary rather than a dividend?

- c. If Egret Corporation pays Kristen a salary bonus of \$40,000 instead of a \$30,000 dividend, how would your answers to (a) and (b) change?
- d. What should Kristen do?
49. **LO.8** Silver Corporation has 2,000 shares of common stock outstanding. Howard owns 600 shares, Howard's grandfather owns 300 shares, Howard's mother owns 300 shares, and Howard's son owns 100 shares. In addition, Maroon Corporation owns 500 shares. Howard owns 70% of the stock in Maroon Corporation.
- Applying the § 318 stock attribution rules, how many shares does Howard own in Silver Corporation?
 - Assume that Howard owns only 40% of the stock in Maroon Corporation. How many shares does Howard own, directly and indirectly, in Silver Corporation?
 - Assume the same facts as in (a) above, but in addition, Howard owns a 25% interest in Yellow Partnership. Yellow owns 200 shares in Silver Corporation. How many shares does Howard own, directly and indirectly, in Silver Corporation?
50. **LO.8** Shonda owns 1,000 of the 1,500 shares outstanding in Rook Corporation (E & P of \$1 million). Shonda paid \$50 per share for the stock seven years ago. The remaining stock in Rook is owned by unrelated individuals. What are the tax consequences to Shonda in the following independent situations?
- Rook Corporation redeems 450 shares of Shonda's stock for \$225,000.
 - Rook Corporation redeems 600 shares of Shonda's stock for \$300,000.
51. **LO.8, 9** Stork Corporation (E & P of \$850,000) has 1,000 shares of common stock outstanding. The shares are owned by the following individuals: Lana Johnson, 400 shares; Lori Jones (Lana's mother), 200 shares; and Leo Jones (Lana's brother), 400 shares. Lana paid \$200 per share for the Stork stock eight years ago. Lana is interested in reducing her stock ownership in Stork via a stock redemption for \$1,000 per share, the fair market value of the stock. Stork Corporation would distribute cash for the entire redemption transaction. Lana has inquired as to the minimum number of shares she would have to redeem to obtain favorable long-term capital gain treatment and the overall tax consequences of such a redemption to both her and Stork Corporation. Prepare a letter to Lana (1000 Main Street, St. Paul, MN 55166) and a memo for the file in which you explain your conclusions.
52. **LO.8** Cyan Corporation (E & P of \$700,000) has 4,000 shares of common stock outstanding. The shares are owned as follows: Angelica, 2,000 shares; Dean (Angelica's son), 1,500 shares; and Walter (Angelica's uncle), 500 shares. In the current year, Cyan redeems all of Angelica's shares. Determine whether the redemption can qualify for sale or exchange treatment under the complete termination redemption rules in each of the following independent circumstances.
- Angelica remains as a director of Cyan Corporation.
 - Three years after the redemption, Angelica loans \$100,000 to Cyan Corporation and receives in return a two-year note receivable.
 - Dean replaces Angelica as president of Cyan Corporation.
 - Six years after the redemption, Angelica receives 250 shares in Cyan as a gift from Walter.
53. **LO.8, 9** Robert and Lori (Robert's sister) own all of the stock in Swan Corporation (E & P of \$1 million). Each owns 500 shares and has a basis of \$85,000 in the shares. Robert wants to sell his stock for \$600,000, the fair market value, but he will continue to be employed as an officer of Swan Corporation after the sale. Lori would like to purchase Robert's shares and, thus, become the sole shareholder in Swan, but Lori is short of funds. What are the tax consequences to Robert, Lori, and Swan Corporation under the following circumstances?

Communications

- a. Swan Corporation distributes cash of \$600,000 to Lori, and she uses the cash to purchase Robert's shares.
 - b. Swan Corporation redeems all of Robert's shares for \$600,000.
54. **LO.8, 9** The gross estate of Raul, decedent, includes stock in Iris Corporation (E & P of \$3 million) valued at \$2.5 million. At the time of his death, Raul owned 60% of the Iris stock outstanding, and he had a basis of \$420,000 in the stock. The death taxes and funeral and administration expenses related to Raul's estate amount to \$1 million, and the adjusted gross estate is \$7 million. The remainder of the Iris stock is owned by Monica, Raul's daughter and sole heir of his estate. What are the tax consequences to Raul's estate if Iris Corporation distributes \$2.5 million to the estate in redemption of all of its stock in the corporation?
55. **LO.8, 9** Broadbill Corporation (E & P of \$650,000) has 1,000 shares of common stock outstanding. The shares are owned by the following individuals: Tammy, 300 shares; Yvette, 400 shares; and Jeremy, 300 shares. Each of the shareholders paid \$50 per share for the Broadbill stock four years ago. In the current year, Broadbill Corporation distributes \$75,000 to Tammy in redemption of 150 of her shares. Determine the tax consequences of the redemption to Tammy and to Broadbill under the following independent circumstances.
- a. Tammy and Jeremy are grandmother and grandson.
 - b. The three shareholders are siblings.
- Communications** 56. **LO.9** Crane Corporation has 2,000 shares of stock outstanding. It redeems 500 shares for \$370,000 when it has paid-in capital of \$300,000 and E & P of \$1.2 million. The redemption qualifies for sale or exchange treatment for the shareholder. Crane incurred \$13,000 of accounting and legal fees in connection with the redemption transaction and \$18,500 of interest expense on debt incurred to finance the redemption. What is the effect of the distribution on Crane Corporation's E & P? Also, what is the proper tax treatment of the redemption expenditures? Prepare a letter to the president of Crane Corporation (506 Wall Street, Winona, MN 55987) and a memo for the file in which you explain your conclusions.

Research Problems



Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

- Communications** **Research Problem 1.** Kenny Merinoff and his son, John, own all of the outstanding stock of Flamingo Corporation. Both John and Kenny are officers in the corporation and, together with John's uncle, Ira, comprise the entire board of directors. Flamingo uses the cash method of accounting and has a calendar year-end. In late 2008, the board of directors adopted the following legally enforceable resolution (agreed to in writing by each of the officers):

Salary payments made to an officer of the corporation that shall be disallowed in whole or in part as a deductible expense for Federal income tax purposes shall be reimbursed by such officer to the corporation to the full extent of the disallowance. It shall be the duty of the board of directors to enforce payment of each such amount.

In 2013, Flamingo paid Kenny \$800,000 in compensation. John received \$650,000. On an audit in late 2014, the IRS found the compensation of both officers to be excessive. It disallowed deductions for \$400,000 of the payment to Kenny and \$350,000 of the payment to John. The IRS recharacterized the disallowed payments as constructive dividends. Complying with the resolution by the board of directors, both Kenny and John repaid the disallowed compensation to Flamingo Corporation in 2015. John and Kenny

have asked you to determine how their repayments should be treated for tax purposes. John is still working as a highly compensated executive for Flamingo, while Kenny is retired and living off his savings. Prepare a memo for your firm's client files describing the results of your research.

Partial list of research aids:

§ 1341.

Vincent E. Oswald, 49 T.C. 645 (1968).

Research Problem 2. Emerald Corporation is required to change its method of accounting for Federal income tax purposes. The change will require an adjustment to income to be made over three tax periods. Jonas, the sole shareholder of Emerald Corporation, wants to better understand the implications of this adjustment for E & P purposes, as he anticipates a distribution from Emerald in the current year. Prepare a memo for your firm's client files describing the results of your research.

Partial list of research aids:

§ 481(a).

Rev.Proc. 97-27, 1997-1 C.B. 680.

Research Problem 3. Your firm has a new individual client, Carla Navarro, who has been assigned to you for preparation of the current year's tax return. Upon review of Carla's tax returns from prior years, you notice that she reported a large capital gain from a stock redemption in 2013. Upon further investigation, you determine that stock in the corporation was owned by some of Carla's family members at the time of the redemption and that the only way the redemption would have qualified for sale or exchange treatment would have been if Carla had availed herself of the family attribution waiver for a complete termination redemption. You establish that the redemption terminated Carla's direct stock ownership in the corporation, that she had no interest in the corporation since the redemption, and that she retained all records pertaining to the redemption. However, you cannot find any evidence that the notification agreement required of a family attribution waiver was properly filed. When asked about the missing agreement, Carla indicated that she knew nothing about any required agreement and that if such an agreement was required, her previous CPA should have taken care of it. Your partner has asked you to research whether it is still possible to file an effective family attribution waiver agreement for Carla. In a memo for the tax file, summarize the results of your research.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. In July 2013, Windstream Corp. (Nasdaq: WIN), a Fortune 500 and S&P 500 company, made an announcement regarding the taxation of a recent distribution. It also made a projection regarding the anticipated tax consequences of future distributions. Locate articles or press releases regarding Windstream's announcement and related distribution. What might have led Windstream to make the announcement? What implications might the information contained in the announcement have for investors' expectations regarding the company's future earnings? On what might the predictions regarding the taxation of future distributions be based?

Research Problem 5. Stock buy-back (redemption) programs are a frequent occurrence among publicly traded corporations. Using the Internet as your sole research source, find at least six publicly traded corporations that announced stock buy-back programs in 2014. What are some of the reasons noted by these corporations for the buy-back programs?

Communications

Communications



Internet
Activity

Roger CPA Review Questions

1. Candy Corp. is a C Corporation that began operations in Year 1. Candy Corp.'s Year 1 through Year 3 taxable earnings and profits (E & P) are as follows:

Year	E & P
1	(\$25,000)
2	5,000
3	10,000

On the last day of Year 3, Candy Corp. makes a \$12,500 cash shareholder distribution, distributed equally among its two shareholders, Goode and Plenteau. How much of Goode's distribution is a nontaxable return of capital? Assume sufficient basis in Goode's stock investment.

- a. \$5,000
b. \$0
- c. \$1,250
d. \$6,250
2. As of December 31, 20X14, Eliot Corp. has net income per books of \$100,000, which includes municipal bond interest of \$4,000, a deduction for business meals of \$5,000, a deduction for a net capital loss of \$5,000, and a deduction for Federal income taxes of \$22,000. What is Eliot Corp.'s current earnings and profits (E & P) for 20X14?
- a. \$98,500
b. \$107,500
- c. \$125,500
d. \$102,500
3. As of December 31, 20X15, Hardy Corp. has net income per books of \$120,000, which includes straight-line depreciation expense of \$5,000. Hardy Corp. claimed accelerated depreciation of \$15,000 for tax purposes. Also included in book income were lobbying expenses of \$4,000 and a Federal income tax refund of \$5,000. What is Hardy Corp.'s current earnings and profits (E & P) for 20X15?
- a. \$119,000
b. \$109,000
- c. \$124,000
d. \$114,000
4. As of December 31, 20X15, Caledonia Corp. has taxable income of \$150,000, which includes a \$20,000 accelerated depreciation deduction; had straight-line depreciation been used, the deduction would have been \$6,000. Also included in taxable income is an operating loss carryforward from a prior year of \$3,000. Additionally, Caledonia earned \$4,000 in municipal bond interest during the year. What is Caledonia Corp.'s current earnings and profits (E & P) for 20X15?
- a. \$164,000
b. \$171,000
- c. \$157,000
d. \$168,000
5. At the beginning of the year, Crispin, a C corporation, had a deficit of \$35,000 in accumulated earnings and profits (E & P). For the current year, Crispin reported E & P of \$12,000. Crispin distributed \$10,000 during the year. What was the amount of Crispin's accumulated E & P deficit at year-end?
- a. \$23,000
b. \$33,000
- c. \$27,000
d. \$37,000
6. On January 1 of the current year, Quail Corp., an accrual-basis, calendar-year C corporation, had accumulated earnings and profits (E & P) of \$20,000. On December 31 of the current year, Quail Corp. has current E & P of \$24,000, earned evenly throughout the year. Ray and Devi were sole equal shareholders of Quail throughout the year.

Quail made two distributions to shareholders during the year: \$30,000 on July 1 and \$30,000 on December 31. How much of the December 31 distribution is taxable dividend income for Devi?

- a. \$7,000
 - b. \$11,000
 - c. \$6,000
 - d. \$1,000
7. Compendium Corp. distributed cash and personal property to its sole shareholder. Considering the following facts, what is the amount of gain that would be recognized by Compendium as the result of making this distribution to its shareholder?

Item	Amount
Cash	\$25,000
Personal property	
Fair market value	10,000
Adjusted basis	4,000
Liability on property assumed by shareholder	12,000

- a. \$4,000
 - b. \$6,000
 - c. \$8,000
 - d. \$29,000
8. How does a shareholder treat the gain on a redemption of stock that qualifies as a redemption to pay death taxes under § 303?
- a. As a tax-free transaction
 - b. Partly as capital gain and partly as a dividend
 - c. Entirely as capital gain
 - d. Entirely as a dividend
9. Calvin owns 40% of the outstanding shares of Copernicus Corp., which has accumulated earnings and profits of \$100,000 as of December 31, Year 1. The outstanding shares not owned by Calvin are owned by parties unrelated to Calvin. On January 1 of Year 2, Calvin, wishing to pursue another business opportunity, sells his stock back to Copernicus Corp. Copernicus distributes cash of \$250,000 in redemption of all of Calvin's stock. If Calvin's adjusted basis for the stock on the date of redemption is \$125,000, what will be the tax effect of the redemption to Calvin?
- a. \$125,000 capital gain
 - b. \$25,000 dividend
 - c. \$125,000 dividend
 - d. \$150,000 dividend
10. Calliope Corp. has outstanding 400 shares of common stock of which Yak, So, Day, and Ren each own 100 shares or 25 percent. No stock is considered constructively owned by any of the shareholders under § 318. Calliope redeems 34 shares from Yak, 24 shares from So, and 42 shares from Day. Which shareholder(s) qualify for exchange treatment on this redemption?
- I. Yak
 - II. So
 - III. Day
- a. None
 - b. II only
 - c. III only
 - d. I and II only

11. Close Corp. distributed cash and a parcel of land in a nonliquidating distribution to its sole shareholder. The following facts apply to this distribution:

Item	Amount
Cash	\$50,000
Land	
Fair market value	30,000
Adjusted basis	40,000

Based on these facts, what amount of gain or loss should be recognized by Close Corp. as a result of this distribution?

- \$60,000 loss
 - No gain or loss should be recognized
 - \$10,000 loss
 - \$40,000 gain
12. Callow Corp. has 400 shares of stock outstanding. Callow exchanges \$150,000 cash for 100 of the shares in a qualifying stock redemption. Just prior to the redemption, Callow had earnings and profits (E & P) of \$300,000. By what amount will Callow Corp.'s E & P be reduced as a result of this redemption? Assume a sufficiently large additional paid-in capital account balance.
- \$150,000
 - E & P will not be reduced
 - \$75,000
 - Depends on balance in Additional Paid-In Capital

Corporations: Distributions in Complete Liquidation and an Overview of Reorganizations

LEARNING OBJECTIVES: *After completing Chapter 20, you should be able to:*

LO.1

Determine the tax consequences of complete liquidations for both the corporation and its shareholders.

LO.2

Determine the tax consequences of subsidiary liquidations for both the parent and the subsidiary corporations.

LO.3

Explain the general requirements and tax consequences of corporate reorganizations.

LO.4

Identify tax planning opportunities available to minimize the tax impact in complete liquidations and corporate reorganizations.

CHAPTER OUTLINE

20-1 Liquidations—In General, 20-2

- 20-1a The Liquidation Process, 20-2
- 20-1b Liquidating and Nonliquidating Distributions Compared, 20-2

20-2 Liquidations—Effect on the Distributing Corporation, 20-4

- 20-2a The General Rule, 20-4
- 20-2b Antistuffing Rules, 20-4

20-3 Liquidations—Effect on the Shareholder, 20-9

20-4 Liquidations—Parent-Subsidiary Situations, 20-10

- 20-4a Minority Shareholder Interests, 20-10
- 20-4b Indebtedness of the Subsidiary to the Parent, 20-11
- 20-4c Basis of Property Received by the Parent Corporation—The General Rule, 20-11
- 20-4d Basis of Property Received by the Parent Corporation—§ 338 Election, 20-12

20-5 Corporate Reorganizations, 20-15

- 20-5a In General, 20-15
- 20-5b Summary of the Different Types of Reorganizations, 20-16
- 20-5c Summary of the Tax Consequences in a Tax-Free Reorganization, 20-17

20-6 Tax Planning, 20-20

- 20-6a Effect of a Liquidating Distribution on the Corporation, 20-20
- 20-6b Effect of a Liquidating Distribution on the Shareholder, 20-21
- 20-6c Parent-Subsidiary Liquidations, 20-21
- 20-6d Asset Purchase versus Stock Purchase, 20-22



THE BIG PICTURE

THE OPTIONS FOR TRANSITIONING TO RETIREMENT

Mr. and Mrs. Albert Smithson have experienced great pride in Orange Corporation, the successful business that they built over their careers, but they believe the time has come for them to think seriously about retirement. They own all of the stock in Orange, a C corporation, and their stock investment has a basis of \$200,000. The business, which is in the 34 percent income tax bracket, owns net assets that are worth \$4 million and have a basis of \$1.5 million.

Unfortunately, the Smithsons have no family members who are interested in carrying on the business, so they must resort to liquidating Orange Corporation. Their strategy, in general, is to convert the value of their business into a diversified portfolio of marketable securities and to live off the earnings generated by the portfolio during their retirement years. The Smithsons realize that such a plan will be taxable, so they would like to know the amount that will be available after all Federal taxes are paid. It is important that they have a realistic idea of the amount of the after-tax proceeds so that they can determine whether retiring at this point is even feasible. After working for their entire lives, they are eager to live comfortably off their retirement nest egg.

Read the chapter and formulate your response.

Like individuals, corporations sometimes can be personified as being in a particular stage of life. It may be early in a corporation's life, struggling for direction, or it could be later in life, thriving and enjoying continually higher levels of success. Alternatively, the corporation could be at a stage where its viability as a going concern does not seem feasible any longer, or the shareholders may believe the entity's future could be brighter if it were to reshape itself. This chapter discusses the tax implications if the shareholders decide to terminate the existence of the corporation by complete liquidation. In addition, corporate reorganizations are discussed, which essentially are business realignments where the business of the entity operates in a new form. In the case of a complete liquidation, both the shareholders and the corporation face tax consequences, unless a subsidiary corporation is liquidated by its parent. In contrast, a reorganization can produce tax-deferred treatment to both the shareholders and the corporations if the transaction takes one of several forms specified in the Code.

LO.1

Determine the tax consequences of complete liquidations for both the corporation and its shareholders.

20-1 LIQUIDATIONS—IN GENERAL

When a corporation makes a nonliquidating distribution (e.g., stock redemption), the entity typically will continue as a going concern. With a complete liquidation, however, corporate existence terminates, as does each shareholder's ownership interest. A complete liquidation, like a qualifying stock redemption, produces sale or exchange treatment to the *shareholder*. However, the tax effects of a liquidation to the *corporation* vary somewhat from those of a redemption. Sale or exchange treatment is also the general rule for the liquidating corporation, although some losses are disallowed.

20-1a The Liquidation Process

A **corporate liquidation** exists when a corporation ceases to be a going concern. The corporation continues solely to wind up affairs, pay debts, and distribute any remaining assets to its shareholders. Legal dissolution under state law is not required for a liquidation to be complete for tax purposes. A liquidation can exist even if the corporation retains a nominal amount of assets to pay remaining debts and preserve its legal status.¹

Shareholders may decide to liquidate a corporation for one or more reasons, including the following:

- The corporate business has been unsuccessful.
- The shareholders want to acquire the corporation's assets.
- Another person or entity wants to purchase the corporation's assets. The purchaser may buy the shareholders' stock and then liquidate the corporation to acquire the assets. Alternatively, the purchaser may buy the assets directly from the corporation. After the assets are sold, the corporation distributes the sales proceeds to its shareholders and liquidates.

As one might expect, the different means used to liquidate a corporation produce varying tax results.

20-1b Liquidating and Nonliquidating Distributions Compared

As discussed in Chapter 19, a *nonliquidating* property distribution of noncash property produces gain (but not loss) to the distributing corporation. For the shareholder, the receipt of cash or other property produces dividend income to the extent of the corporation's E & P or, in the case of a qualifying stock redemption, results in sale or exchange treatment.

¹Reg. § 1.332-2(c).



TAX IN THE NEWS Interest Accruals on Transferee Liabilities

Under § 6901 and the theory of transferee liability, the IRS has the authority to assess a deficiency for unpaid corporate taxes (including penalties and interest on such tax deficiencies) against a shareholder who received a transfer of assets from the corporation. This transferee liability is limited to the value of the assets received by the shareholder. In addition, interest can be assessed on the amount of the transferee liability.

Recently, an appellate court [*Schussel v. Werfel*, 2014–2 USTC ¶50,348, 114 AFTR 2d 2014–5114, 758 F.3d 82 (CA–1, 2014)] addressed the effect of state law on the date interest begins to accrue on a transferee liability. The taxpayer had received a notice of transferee liability related to the unpaid taxes of an insolvent U.S. corporation from which he had funneled approximately \$9 million to a controlled Bermuda

tax shelter. The notice included an assessment for interest calculated on the transferee liability as of the due date of the unpaid corporate taxes.

The taxpayer argued that state law controlled the interest accrual and that under applicable Massachusetts law, interest begins to accrue on the date the notice of liability was issued. The IRS argued that interest begins to accrue on the date the corporate taxes were due.

The notice of liability was issued in 2010, for deficiencies related to tax years 1993–1995; thus, over 15 years of interest accruals were in dispute. The appellate court concurred with the taxpayer’s argument and held that under Massachusetts law, interest on a transferee liability begins to accrue on the date of the notice of liability.

Similar to a qualifying stock redemption, a *liquidation* produces sale or exchange treatment for the shareholders. E & P has no impact on the gain or loss to be recognized by the shareholder in either type of distribution.² However, in a liquidation, a corporation generally recognizes gain *and* loss upon the distribution of its assets.

Goose Corporation, with E & P of \$40,000, makes a cash distribution of \$50,000 to a shareholder. The shareholder’s basis in the Goose stock is \$20,000. If the distribution is not a qualifying stock redemption or in complete liquidation, the shareholder recognizes dividend income of \$40,000 (the amount of Goose’s E & P) and treats the remaining \$10,000 of the distribution as a return of capital (i.e., stock basis is reduced to \$10,000).

If the distribution is a qualifying stock redemption or is pursuant to a complete liquidation, the shareholder has a capital gain of \$30,000 (\$50,000 distribution – \$20,000 stock basis). In the case of these distributions, Goose’s E & P is of no consequence to the shareholder’s tax result.

EXAMPLE

1

In the event a corporate distribution results in a *loss* to the shareholder, another distinction exists between nonliquidating distributions and liquidations. Section 267 disallows recognition of losses between related parties in nonliquidating distributions but not in complete liquidations.

The stock of Tern Corporation is owned equally by three brothers, Rex, Sam, and Ted. When Ted’s basis in his stock is \$40,000, the corporation distributes \$30,000 to him in cancellation of all of his shares. If the distribution is a qualifying stock redemption, the \$10,000 realized loss is not recognized because Ted and Tern Corporation are related parties. Under § 267, Ted is deemed to own more than 50% in value of the corporation’s outstanding stock. Ted’s direct ownership is limited to 33 $\frac{1}{3}$ %, but through his brothers, he owns indirectly another 66 $\frac{2}{3}$ % for a total of 100%. On the other hand, if the distribution is pursuant to a complete liquidation, Ted’s \$10,000 realized loss is recognized.

EXAMPLE

2

The rules governing the basis of property received from a corporation are identical for both nonliquidating and liquidating distributions. Section 301(d) specifies that the basis of property received in a nonliquidating distribution is its fair market value on the date of distribution, while § 334(a) provides the same treatment for property received in a liquidating distribution.

²§ 331.

In the following pages, the tax consequences of a complete liquidation are examined first from the view of the distributing corporation and then in terms of the shareholder. Because the tax rules differ when a subsidiary corporation is liquidated, the rules relating to the liquidation of a subsidiary corporation are discussed separately.

20-2 LIQUIDATIONS—EFFECT ON THE DISTRIBUTING CORPORATION

A corporation generally recognizes gain or loss on the distribution of property in a complete liquidation, but there are several exceptions to this rule.

20-2a The General Rule

Under § 336(a), a corporation recognizes *gain or loss* on the distribution of property in a complete liquidation as if the property were sold at its fair market value. This treatment is consistent with the notion of double taxation that is inherent in operating a business as a C corporation—once at the corporate level and again at the shareholder level.

As in the case of a nonliquidating distribution, when property distributed in a complete liquidation is subject to a liability of the corporation, the deemed fair market value used to calculate gain or loss may not be less than the amount of the liability.

EXAMPLE

3

Pursuant to a complete liquidation, Warbler Corporation distributes to its shareholders land held as an investment (basis of \$200,000, fair market value of \$300,000). If no liability is involved, Warbler has a gain of \$100,000 on the distribution (\$300,000 – \$200,000). Likewise, if the land is subject to a liability of \$250,000, Warbler Corporation has a gain of \$100,000. If, instead, the liability were \$350,000, Warbler's gain on the distribution would be \$150,000 (\$350,000 – \$200,000).

Liquidation expenses incurred by a corporation are deductible as trade or business expenses under § 162. Examples include accounting and legal costs of drafting and implementing a plan of liquidation and the cost of revoking the corporation's charter. However, expenditures incurred in the sale of property, such as brokerage commissions and legal costs incurred in title transfers, reduce the amount realized on the disposition.

There are four exceptions to the general rule of gain and loss recognition by a liquidating corporation:

- *Losses* are not recognized on certain liquidating distributions to related-party shareholders.
- *Losses* are not recognized on certain sales and liquidating distributions of property that was contributed to the corporation with a built-in loss shortly before the adoption of a plan of liquidation.
- A subsidiary corporation does not recognize *gains or losses* on liquidating distributions to its parent corporation.
- A subsidiary corporation does not recognize *losses* on liquidating distributions to its minority shareholders.

The first two exceptions, referred to as the “antistuffing rules,” are discussed in detail in the next section and are summarized in Concept Summary 20.1. The last two exceptions, dealing with the liquidation of a subsidiary corporation, are discussed later in this chapter.

20-2b Antistuffing Rules

When property is transferred to a corporation in a § 351 transaction or as a contribution to capital, carryover basis rules generally apply (see Chapter 18). Usually, the transferee corporation takes a basis in the property equal to that of the transferor-shareholder, and the shareholder takes an equal basis in the stock received in the exchange (or adds such

amount to existing stock basis in the case of a capital contribution). Without special limitations, a transfer of loss property (fair market value less than basis) in a carryover basis transaction would present opportunities for the duplication of losses.

The Big Picture

Return to the facts of *The Big Picture* on p. 20-1. Assume that Mr. and Mrs. Smithson transfer property (basis of \$100,000, fair market value of \$55,000) to Orange Corporation in exchange for additional stock. The exchange qualifies under § 351. Absent any exceptions to the contrary, the general rule of carryover basis would apply and Orange would take a carryover basis of \$100,000 in the property while the Smithsons would take a \$100,000 basis in the additional stock. A sale or liquidating distribution of the property by Orange Corporation would result in a \$45,000 loss [\$55,000 (fair market value of property) – \$100,000 (property basis)]. Similarly, a sale by the Smithsons of the stock acquired in the § 351 exchange would also result in a \$45,000 loss [\$55,000 (fair market value of stock) – \$100,000 (stock basis)].

EXAMPLE

4

Congress addressed this loss duplication issue in the Tax Reform Act of 1986 by enacting two loss limitation (“antistuffing”) rules under § 336(d) that apply to corporations upon liquidation. The effect of these rules is to disallow some or all of a loss realized by a corporation in liquidating distributions (and, in some cases, sales) of certain property.

The antistuffing rules limited the duplication of losses realized upon a corporation’s liquidation, but loss duplication was still possible if the corporation sold high-basis property in the normal course of business instead of upon or pursuant to liquidation. In 2004, Congress revisited the loss duplication issue and enacted § 362(e)(2), which requires a corporation to step down the basis of property acquired in a § 351 or contribution to capital transaction by the amount of any net built-in loss embodied in such property. The basis step-down is required when a shareholder transfers properties having an aggregate basis in excess of their aggregate fair market value (“net built-in loss”), and it is allocated proportionately among the properties having built-in losses. Alternatively, the transferor-shareholder can elect to reduce his or her stock basis by the amount of net built-in loss. (See Chapter 18 for a complete discussion of the basis adjustment rules.) The antistuffing rules of § 336(d) continue to apply in the case of liquidating distributions (and certain sales) of loss property, but their bite has been lessened somewhat by the § 362(e)(2) basis step-down rules.

Related-Party Loss Limitation

Losses are disallowed on distributions to *related parties* in either of the following cases:

- The distribution is *not* pro rata, or
- The property distributed is *disqualified property*.³

A corporation and a shareholder are considered related if the shareholder owns (directly or indirectly) more than 50 percent in value of the corporation’s stock.⁴

A *pro rata distribution* is a distribution where *each* shareholder receives his or her proportionate share of the corporate asset distributed. Examples 5 and 6 illustrate a non pro rata distribution. *Disqualified property* is property that is acquired by the liquidating corporation in a § 351 or contribution to capital transaction during the five-year period ending on the date of the distribution. The related-party loss limitation can apply even if the property was appreciated (fair market value greater than basis) when it was transferred to the corporation. See Examples 7 and 8.

³§ 336(d)(1).

⁴Section 267 provides the definition of a related party for purposes of this provision. The rules are similar to the stock attribution rules discussed in

Chapter 19; one exception, however, is that stock owned by a sibling is treated as owned by the taxpayer under § 267.

Related-Party Loss Limitation Tests

EXAMPLE

5

Bluebird Corporation stock is owned by Ana and Sanjay, who are unrelated. Ana owns 80% and Sanjay owns 20% of the stock in the corporation. Bluebird has the following assets (none of which was acquired in a § 351 or contribution to capital transaction) that are distributed in complete liquidation of the corporation:

	Adjusted Basis	Fair Market Value
Cash	\$600,000	\$600,000
Equipment	150,000	200,000
Building	400,000	200,000

Assume that Bluebird Corporation distributes the equipment to Sanjay and the cash and the building to Ana. Bluebird recognizes a gain of \$50,000 on the distribution of the equipment. The loss of \$200,000 on the building is disallowed because the property is distributed to a related party and the distribution is not pro rata (i.e., the building is not distributed 80% to Ana and 20% to Sanjay).

EXAMPLE

6

Assume in Example 5 that Bluebird Corporation distributes the cash and equipment to Ana and the building to Sanjay. Again, Bluebird recognizes the \$50,000 gain on the equipment. However, it now recognizes the \$200,000 loss on the building because the property is not distributed to a related party (i.e., Sanjay does not own more than 50% of the stock in Bluebird Corporation).

EXAMPLE

7

Wren Corporation's stock is held equally by three brothers. Four years before Wren's liquidation, the shareholders transfer jointly owned property (basis of \$150,000, fair market value of \$200,000) to the corporation in return for stock in a § 351 transaction. When the property is worth \$100,000, it is transferred pro rata to the brothers in a liquidating distribution. Because each brother owns directly and indirectly more than 50% (i.e., 100% in this situation) of the stock and disqualified property is involved, Wren recognizes none of the \$50,000 realized loss [\$100,000 (fair market value) – \$150,000 (basis)].

EXAMPLE

8

Assume in Example 7 that the property's fair market value is \$100,000 at the time of the § 351 transfer and \$75,000 at the time of the liquidating distribution to the brothers. As a result of the § 362(e)(2) basis step-down rules, Wren Corporation's basis in the property is \$100,000 [\$150,000 (basis to brothers) – \$50,000 (net built-in loss of property transferred)]. In a liquidating distribution of the property to the brothers, Wren would realize a loss of \$25,000 [\$75,000 (fair market value of property at distribution) – \$100,000 (Wren's stepped-down basis in property)]. Because this is a distribution of disqualified property to related parties, none of the \$25,000 loss is recognized by Wren.

Built-In Loss Limitation

A second loss limitation applies to sales, exchanges, or distributions of built-in loss property (fair market value less than basis) that is transferred to a corporation shortly before the corporation is liquidated. The built-in loss limitation applies when both of the following conditions are met:

- The property was acquired by the corporation in a § 351 or contribution to capital transaction.
- Such acquisition was part of a plan whose principal purpose was to recognize a loss on that property by the liquidating corporation. A tax avoidance purpose is presumed in the case of transfers occurring within two years of the adoption of a plan of liquidation.

This disallowance rule applies only to the extent that a property's built-in loss at transfer is not eliminated by a § 362(e)(2) stepped-down basis. Some built-in losses on property transfers will avoid the basis step-down either because built-in gain properties were also transferred by the shareholder (see Example 9) or because the shareholder elected to step down the basis of his or her stock instead. Any loss attributable to a decline in a property's value after its transfer to the corporation is not subject to the built-in loss limitation.⁵

On January 2, 2015, Brown Corporation acquires two properties from a shareholder in a transaction that qualifies under § 351.

	Shareholder's Basis	Fair Market Value	Built-In Gain/(Loss)
Land	\$100,000	\$50,000	(\$50,000)
Securities	10,000	35,000	25,000
			<u>(\$25,000)</u>

The net built-in loss of \$25,000 results in a stepped-down basis of \$75,000 in the land for Brown Corporation [\$100,000 (shareholder's basis) – \$25,000 (step-down equal to net built-in loss)]. Brown adopts a plan of liquidation on July 9, 2015, and distributes the land to an unrelated shareholder on November 12, 2015, when the land is worth \$30,000. Of the \$45,000 loss realized [\$30,000 (value of land on date of distribution) – \$75,000 (basis in land)] by Brown on the distribution, \$25,000 is disallowed by the built-in loss limitation [\$50,000 (value of land when acquired by Brown) – \$75,000 (stepped-down basis in land)], and \$20,000 is recognized (equal to the decline in value occurring after acquisition by Brown).

The built-in loss limitation applies to a broader range of transactions than the related-party exception, which disallows losses only on certain *distributions* to related parties (i.e., more-than-50 percent shareholders). The built-in loss limitation can apply to distributions of property to any shareholder, including an unrelated party, and to a *sale or exchange* of property by a liquidating corporation. However, the limitation is narrower than the related-party exception in that it applies only to property that had a built-in loss upon its acquisition by the corporation and only as to the amount of the built-in loss (as adjusted by the basis step-down rules).

Assume in Example 9 that the land had a fair market value of \$120,000 on the date Brown Corporation acquired it. As there is no net built-in loss on the transfer, Brown will have a basis of \$100,000 in the land. If the distribution is to an unrelated shareholder, Brown will recognize the entire \$70,000 loss [\$30,000 (fair market value on date of distribution) – \$100,000 (basis)]. However, if the distribution is to a related party, Brown cannot recognize any of the loss under the related-party loss limitation because the property is disqualified property. When the distribution is to a related party, the loss is disallowed even though the entire decline in value occurred during the period the corporation held the property.

The built-in loss limitation will apply only in rare cases if the corporation has held the property more than two years prior to liquidation. The presumption of a tax avoidance purpose for property transferred to a corporation in the two years preceding the liquidation can be rebutted if there is a clear and substantial relationship between the contributed property and the (current or future) business of the corporation. When there is a business reason for the transfer, the built-in loss limitation will not apply. Compare Examples 11 and 12.

⁵§ 336(d)(2).

EXAMPLE

9

EXAMPLE

10

Presumption of Tax Avoidance Purpose

EXAMPLE

11

Cardinal Corporation's stock is held by two unrelated individuals: 60% by Manuel and 40% by Jack. One year before Cardinal's liquidation, Manuel transfers land (basis of \$150,000, fair market value of \$100,000) and equipment (basis of \$10,000, fair market value of \$70,000) to the corporation as a contribution to capital. As there is no net built-in loss on the transfer, Cardinal will have a basis of \$150,000 in the land. There is no business reason for the transfer. In liquidation, Cardinal distributes the land (now with a fair market value of \$90,000) to Jack. Even though the distribution is to an unrelated party, the built-in loss of \$50,000 is not recognized. However, Cardinal Corporation can recognize the loss of \$10,000 (\$90,000 – \$100,000) that occurred while it held the land. If, instead, the land is distributed to Manuel, a related party, the entire \$60,000 loss is disallowed under the related-party loss limitation.

EXAMPLE

12

Assume in Example 11 that the land and equipment are transferred to Cardinal Corporation because a bank required the additional capital investment as a condition to making a loan to the corporation. Because there is a business purpose for the transfer, all of the \$60,000 loss is recognized if the land is distributed to Jack in liquidation. If, instead, the land is distributed to Manuel, a related party, the entire loss is still disallowed under the related-party loss limitation.

Concept Summary 20.1

Summary of Antistuffing Loss Disallowance Rules

Related-Party Loss Limitation

Distribution of loss property to a related party *and* distribution is not pro rata or property is disqualified property.

- Related party if shareholder owns directly or indirectly *more than 50%* in value of stock.
 - Section 267 attribution rules apply. Similar to § 318 attribution rules but includes stock owned by siblings.
- Distribution is pro rata if each shareholder receives proportional interest in property.
- Disqualified property is property acquired by a corporation within five years of distribution date in a § 351 or contribution to capital transaction.

Limitation can apply even if a corporation acquired property by purchase or in a carryover basis transaction with no built-in loss (i.e., fair market greater than basis).

Limitation does not apply to *sales* of loss property.

Built-In Loss Limitation

Distribution, sale, or exchange of certain built-in loss property (fair market value less than basis).

- Property was acquired in a § 351 or contribution to capital transaction.
- Acquisition was part of a plan whose principal purpose was to recognize a loss on the property by the corporation upon liquidation.
 - Presumption of tax avoidance purpose if property was acquired within two years of the date of the plan of liquidation.
 - Clear and substantial business purpose for a transfer of property to a corporation can rebut the presumption.
 - Transfers occurring more than two years before liquidation are rarely subject to the loss limitation.

Loss limitation applies only to amount of the built-in loss at the time of transfer to a corporation (excess of corporation's basis in property over fair market value of property).

- Basis step-down rules will eliminate many built-in losses. However, loss limitation remains applicable where built-in loss is not entirely eliminated by basis step-down (i.e., built-in gain property transferred with built-in loss property) or where shareholder elected to step-down basis of stock.

20-3 LIQUIDATIONS—EFFECT ON THE SHAREHOLDER

The tax consequences to the shareholders of a corporation in the process of liquidation are generally governed by § 331. The exception to this rule, § 332, applies in the liquidation of a subsidiary (discussed in the next section).

Section 331(a) provides for sale or exchange treatment for the shareholders. Thus, the difference between the fair market value of the assets received from the corporation and the adjusted basis of the stock surrendered is the gain or loss recognized by the shareholder. The fair market value of property received subject to a corporate liability is reduced by the amount of such liability. Typically, the stock is a capital asset in the hands of the shareholder, and capital gain or loss results. The burden of proof is on the taxpayer to furnish evidence as to the adjusted basis of the stock. In the absence of such evidence, the stock is deemed to have a zero basis.⁶ The basis of property received in a liquidation is the property's fair market value on the date of distribution.⁷ If installment notes are distributed in liquidation, shareholders can use the installment method to defer to the point of collection the portion of their gain that is attributable to the notes.⁸

To the extent that a corporation pays tax on the net amount of gain recognized as a result of its liquidation, the proceeds available to be distributed to the shareholders are likewise reduced. This reduction for the payment of taxes will reduce the amount realized by the shareholders, which will then reduce their gain (or increase the loss) recognized.

The Big Picture

Return to the facts of *The Big Picture* on p. 20-1. At the point when the Smithsons are contemplating retirement, their business, Orange Corporation, has net assets worth \$4 million. This valuation is after the payment of all of Orange's corporate debts except for taxes it would pay on net gains recognized if it liquidates. Assuming that the Smithsons decide to liquidate the corporation and the taxes the corporation pays total \$850,000, the amount realized by the Smithsons is \$3,150,000 (\$4,000,000 – \$850,000).

EXAMPLE

13

The Big Picture

Return to the facts of *The Big Picture* on p. 20-1. Continuing with the preceding example, if Orange Corporation liquidates and the Smithsons receive a liquidating distribution of \$3,150,000, they will recognize a capital gain of \$2,950,000 (\$3,150,000 amount realized – \$200,000 stock basis). The basis of any property the Smithsons receive will be its fair market value.

EXAMPLE

14



ETHICS & EQUITY Transferee Liability for Tax Deficiency of Liquidated Corporation

In 2013, Loon Corporation distributed all of its remaining assets to two equal shareholders in a complete liquidation. The two shareholders, Gloria Martinez and Roger Stinson, each received a distribution of \$250,000 for their stock in Loon.

In 2015, the IRS audited Loon Corporation and assessed additional tax of \$175,000 (plus penalties and interest)

against the corporation. Since Loon was defunct and without assets, the IRS then assessed the entire deficiency against Gloria Martinez, based on transferee liability. The IRS did not attempt to collect any of the deficiency from Roger Stinson. Is this an equitable solution to the collection of Loon's tax liability?

⁶See *John Calderazzo*, 34 TCM 1, T.C.Memo. 1975-1, and *Coloman v. Comm.*, 76-2 USTC ¶9581, 38 AFTR 2d 5523, 540 F.2d 427 (CA-9, 1976).

⁷§ 334(a).

⁸§ 453(h). Shareholders must allocate their stock basis between the notes and the other assets received in the liquidation. Upon distribution, the

corporation generally recognizes gain (or loss) equal to the difference between the fair market value of the notes and the corporation's basis in the notes. § 453B(a).

LO.2

Determine the tax consequences of subsidiary liquidations for both the parent and the subsidiary corporations.

20-4 LIQUIDATIONS—PARENT-SUBSIDIARY SITUATIONS

Section 332, an exception to the general rule of § 331, provides that a parent corporation does *not* recognize gain or loss on a liquidation of a subsidiary. In addition, the subsidiary corporation recognizes *neither gain nor loss* on distributions of property to its parent.⁹

The requirements for applying § 332 are as follows:

- The parent must possess at least 80 percent of the total voting power of the subsidiary's stock and at least 80 percent of the total value of the subsidiary's stock.
- The subsidiary must distribute all of its property in complete cancellation of all of its stock within the taxable year or within three years from the close of the tax year in which the first distribution occurred.
- The subsidiary must be solvent.¹⁰

If these requirements are met, nonrecognition of gains and losses becomes mandatory. However, if the subsidiary is insolvent, the parent corporation will have an ordinary loss deduction under § 165(g).

When a series of distributions occurs in the liquidation of a subsidiary corporation, the parent corporation must own the required amount of stock (at least 80 percent) on the date the plan of liquidation is adopted and at all times until all property has been distributed.¹¹ If the parent fails the control requirement at any time, the provisions for nonrecognition of gain or loss do not apply to any distribution.¹²

The parent-subsidiary rules are set out in Concept Summary 20.2.

20-4a Minority Shareholder Interests

In a § 332 parent-subsidiary liquidation, up to 20 percent of the subsidiary's stock can be owned by minority shareholders. In such liquidations, a distribution of property to a minority shareholder is treated in the same manner as a *nonliquidating* distribution. That is, the subsidiary corporation recognizes gain (but not loss) on the property distributed to the minority shareholder.¹³

EXAMPLE

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The stock of Tan Corporation is held as follows: 80% by Mustard Corporation and 20% by Arethia. Tan Corporation is liquidated on December 10, 2015, pursuant to a plan adopted on January 20, 2015. At the time of its liquidation, Tan has assets with a basis of \$100,000 and fair market value of \$500,000. Tan Corporation distributes the property pro rata to Mustard Corporation and to Arethia. Tan must recognize gain of \$80,000 [(\$500,000 fair market value – \$100,000 basis) × 20% minority interest]. Because the corporate tax due in this liquidation relates entirely to the minority shareholder distribution, that amount will most likely be deducted from the \$100,000 distribution (\$500,000 × 20%) going to Arethia. The remaining gain of \$320,000 is not recognized because it is attributable to property being distributed to Mustard, the parent corporation.

A minority shareholder is subject to the general rule requiring the recognition of gain or loss in a liquidation. Accordingly, the difference between the fair market value of the assets received and the basis of the minority shareholder's stock is the amount of gain or loss recognized. Further, the basis of property received by the minority shareholder is the property's fair market value on the date of distribution.¹⁴

⁹§ 337(a). This is an exception to the general rule of § 336.

¹⁰§ 332(b) and Reg. §§ 1.332-2(a) and (b).

¹¹Establishing the date of the adoption of a plan of complete liquidation could be crucial in determining whether § 332 applies. See, for example, *George L. Riggs, Inc.*, 64 T.C. 474 (1975).

¹²§ 332(b)(3) and Reg. § 1.332-2(a).

¹³§§ 336(a) and (d)(3).

¹⁴§ 334(a).

GLOBAL TAX ISSUES Basis Rules for Liquidations of Foreign Subsidiaries

The basis of property acquired by a parent corporation in the liquidation of a subsidiary corporation is generally equal to the basis the subsidiary had in such property. However, legislation in 2004 modified the basis rules regarding property acquired by a U.S. parent in some § 332 liquidations of foreign subsidiaries. In general, if the aggregate basis in a

foreign subsidiary's assets exceeds their aggregate fair market value, the U.S. parent will take a fair market value basis in the property acquired. The purpose of this amendment is to deny the importation of built-in losses (excess of basis over fair market value). [See §§ 334(b)(1)(B) and 362(e)(1)(B).]

20-4b Indebtedness of the Subsidiary to the Parent

If a subsidiary transfers appreciated property to its parent to satisfy a debt, it must recognize gain on the transaction unless the subsidiary is liquidating and the conditions of § 332 (discussed in the previous section) apply. When § 332 applies, the subsidiary does not recognize gain or loss upon the transfer of properties to the parent in satisfaction of indebtedness.¹⁵

Eagle Corporation owes \$20,000 to its parent, Finch Corporation. It satisfies the obligation by transferring land (basis of \$8,000, fair market value of \$20,000) to Finch. Normally, Eagle would recognize a gain of \$12,000 on the transaction. However, if the transfer is made pursuant to a liquidation under § 332, Eagle does not recognize a gain.

EXAMPLE

16

This nonrecognition provision does not apply to the parent corporation. The parent corporation recognizes gain or loss on the transfer of property in satisfaction of indebtedness, even if the property is received during liquidation of the subsidiary.

Pelican Corporation owns bonds (basis of \$95,000) of its subsidiary, Crow Corporation, that were acquired at a discount. Upon liquidation of Crow pursuant to § 332, Pelican receives a distribution of \$100,000, the face amount of the bonds. The transaction has no tax effect on Crow. However, Pelican Corporation recognizes gain of \$5,000 [\$100,000 (amount realized) – \$95,000 (basis in bonds)].

EXAMPLE

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20-4c Basis of Property Received by the Parent Corporation—The General Rule

Property received in the complete liquidation of a subsidiary has the same basis it had in the hands of the subsidiary.¹⁶ Unless the parent corporation makes a § 338 election (discussed in the next section), this carryover basis in the assets generally will differ significantly from the parent's basis in the stock of the subsidiary. Because the liquidation is a nontaxable exchange, the parent's gain or loss on the difference in basis is not recognized. Further, the parent's basis in the stock of the subsidiary disappears.

Basis Issues in Subsidiary Liquidations

Lark Corporation has a basis of \$200,000 in the stock of Heron Corporation, a subsidiary in which it owns 85% of all classes of stock. Lark purchased the Heron stock 10 years ago. In the current year, Lark liquidates Heron Corporation and acquires assets with a fair market value of \$800,000 and a tax basis to Heron of \$500,000. Lark Corporation takes a basis of \$500,000 in the assets, with a potential gain upon their sale of \$300,000. Lark's \$200,000 basis in Heron's stock disappears.

EXAMPLE

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¹⁵§ 337(b)(1).

¹⁶§ 334(b)(1) and Reg. § 1.334-1(b). But see § 334(b)(1)(B) (exception for property acquired in some liquidations of foreign subsidiaries).

Basis Issues in Subsidiary Liquidations

EXAMPLE

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Indigo Corporation has a basis of \$600,000 in the stock of Kackie Corporation, a wholly owned subsidiary acquired 10 years ago. It liquidates Kackie Corporation and receives assets with a fair market value of \$400,000 and a tax basis to Kackie of \$300,000. Indigo Corporation takes a basis of \$300,000 in the assets it acquires from Kackie. If it sells the assets for \$400,000, it has a gain of \$100,000 in spite of the fact that its basis in the Kackie stock was \$600,000. Indigo's loss on its stock investment in Kackie will never be recognized.

In addition to the parent corporation taking the subsidiary's basis in its assets, the parent's holding period for the assets includes that of the subsidiary.¹⁷ Further, the carryover rules of § 381 apply. Under that provision, the parent acquires other tax attributes of the subsidiary, including the subsidiary's net operating loss carryover, business credit carryover, capital loss carryover, and E & P.

20-4d Basis of Property Received by the Parent Corporation—§ 338 Election

As discussed previously, the liquidation of a subsidiary generally is a nontaxable transaction resulting in the nonrecognition of gain or loss for both the parent and the subsidiary corporations and the carryover of the subsidiary's asset bases (and other tax attributes). This treatment reflects the fact that such a liquidation often is merely a change in corporate structure and not a change in substance. This is particularly the case when the parent has owned the stock of the subsidiary since the subsidiary's inception. In such cases, the carried-over bases are comparable to what the parent would have in the subsidiary's assets if the parent, and not the subsidiary, had originally acquired the assets.

The carryover basis rule for § 332 liquidations can result in some inequities when the subsidiary has been in existence for some time prior to the parent's acquisition of the subsidiary's stock. The parent's basis in the stock of the subsidiary will reflect the fair market value of the subsidiary's assets (and goodwill) at the time of the stock purchase. As a result, the parent's basis in the stock of the subsidiary will usually be greater than the subsidiary's basis in its assets. In such cases, a liquidation of the subsidiary under the carryover basis rule would result in the parent taking a basis in the subsidiary's assets that is less than the parent's basis in the stock of the subsidiary. This is the case even if the parent acquired the subsidiary stock solely to obtain the subsidiary's assets.

If the parent could treat the purchase of the subsidiary stock as a purchase of its assets, the parent could take a basis in the assets equal to the acquisition cost of the stock. In most cases, this would mean a higher asset basis and, as a result, larger depreciation deductions and lower gains upon disposition for the parent. To obtain this stock-basis-for-asset-basis result, taxpayers successfully devised stock purchase/subsidiary liquidation transactions that fell outside the purview of § 332.¹⁸ Congress codified this treatment by enacting § 338, which permits the purchase of a controlling interest of stock to be treated as a purchase of the subsidiary's assets.

Requirements for Application

A corporation (the "parent") may *elect* the provisions of § 338 if it acquires stock representing at least 80 percent of the voting power and at least 80 percent of the value of

¹⁷§ 1223(2).

¹⁸See, for example, *U.S. v. M.O.J. Corp.*, 60-1 USTC ¶9209, 5 AFTR 2d 535, 274 F.2d 713 (CA-5, 1960). See also *Kimbell-Diamond Milling Co.*, 14 T.C.

74 (1950), *aff'd* 51-1 USTC ¶9201, 40 AFTR 328, 187 F.2d 718 (CA-5, 1951), *cert. den.* 72 S.Ct. 50 (USSC, 1951) (IRS argued stock-for-asset basis).

another corporation (the “subsidiary”) within a 12-month period (“*qualified stock purchase*”). The stock must be acquired in a taxable transaction (i.e., § 351 and other non-recognition provisions do not apply). An acquisition of stock by any member of an affiliated group that includes the parent corporation is considered to be an acquisition by the parent. The **§ 338 election** must be made by the fifteenth day of the ninth month beginning after the month in which a qualified stock purchase occurs. If made, the election is irrevocable.

Tax Consequences

Upon making a qualified § 338 election, the subsidiary is treated as having sold its assets on the qualified stock purchase date for a value that is determined with reference to the parent’s basis in the subsidiary stock plus any liabilities of the subsidiary (“aggregate deemed sales price”).¹⁹ The subsidiary is then treated as a new corporation that purchased those assets for a similarly computed amount (“adjusted grossed-up basis”) on the day following the qualified stock purchase date.²⁰ The deemed sale results in gain (or loss) recognition to the subsidiary, and the deemed purchase results in a stepped-up (or -down) basis for the subsidiary’s assets.²¹ The subsidiary may, but need not, be liquidated. If the subsidiary is liquidated, the parent will obtain a carryover of the stepped-up (or -down) basis of the subsidiary’s assets.

A Comparison of the General Rule and the § 338 Election

Under the general rule of nonrecognition, the liquidation of a subsidiary is tax-free to both the subsidiary (except for any minority interest) and the parent corporation. Under § 338, the subsidiary recognizes gain (or loss) on the deemed disposition of its assets. A liquidation of the subsidiary remains tax-free to the parent. While a carryover basis rule applies in both cases, the subsidiary’s assets generally will have a stepped-up basis as a result of the § 338 election and a liquidation of the subsidiary will result in a carryover of the stepped-up basis to the parent. Further, a liquidation of the subsidiary results in a carryover of its other tax attributes (e.g., E & P) to the parent regardless of whether a § 338 election is made. However, when the election is made, the subsidiary is treated as a new corporation as of the day following the qualified stock purchase date; as a result, any tax attributes acquired by the parent are likely to be nominal (or zero) in amount.

The holding period of the subsidiary’s assets is determined with reference to the substance of the transaction. When the subsidiary is liquidated and there is no § 338 election, the subsidiary’s historical holding period in its assets carries over to the parent. This is the typical carryover rule found in other nonrecognition provisions. A § 338 election, however, assumes a sale and repurchase of the subsidiary’s assets. As a result of these deemed transactions, the holding period starts anew. If there is a § 338 election and the subsidiary is liquidated, the holding period of the property received by the parent begins on the date of the qualified stock purchase. On the other hand, if there is a § 338 election and the subsidiary is not liquidated, the holding period of the assets begins on the day *after* the qualified stock acquisition date. Exhibit 20.1 illustrates the consequences of a § 338 election to both the parent and subsidiary corporations.

¹⁹See §§ 338(a)(1) and (b) and Reg. § 1.338-4.

²⁰See §§ 338(a)(2) and (b) and Reg. § 1.338-5.

²¹For the rules governing the allocation of the purchase price to the assets, see § 338(b)(5) and Reg. § 1.338-6.

EXHIBIT 20.1 Consequences of a Section 338 Election
Assume the following:

- Parent acquires 100% of subsidiary's stock for \$750,000 on August 3, 2015.
- Subsidiary (E & P of \$400,000) has only one asset, land (fair market value of \$1 million, basis of \$504,000), no liabilities, and no loss or tax credit carryovers. Subsidiary's tax rate is 34%.
- Parent files a timely § 338 election, and both aggregate deemed sale price (ADSP) and adjusted grossed-up basis (AGUB) are \$876,727.

Subsidiary is liquidated
Consequences to Subsidiary:

Deemed to have sold the land for ADSP of \$876,727, which results in a recognized gain of \$372,727 [$\$876,727$ (ADSP) – \$504,000 (basis)], and tax of \$126,727 ($\$372,727 \times 34\%$). The land's new basis is \$876,727 (AGUB). No gain or loss recognized on distribution of land to parent.

Consequences to Parent:

No gain or loss recognized on receipt of land from subsidiary. Basis in land is \$876,727; holding period for the land begins on August 3, 2015; and basis in subsidiary stock disappears. Acquires subsidiary's E & P, but that amount is \$0 as a result of the § 338 election.

Subsidiary is not liquidated
Consequences to Subsidiary:

Deemed to have sold the land for ADSP of \$876,727, which results in a recognized gain of \$372,727 [$\$876,727$ (ADSP) – \$504,000 (basis)], and tax of \$126,727 ($\$372,727 \times 34\%$). Treated as a new corporation (e.g., E & P of \$0) as of August 4, 2015; land's new basis is \$876,727 (AGUB); and holding period for the land begins on August 4, 2015.

Consequences to Parent:

No tax consequences. Basis in subsidiary stock remains unchanged at \$750,000.



Concept Summary 20.2

Summary of Liquidation Rules

Effect on the Shareholder	Basis of Property Received	Effect on the Corporation
§ 331—The general rule provides for gain or loss treatment on the difference between the FMV of property received and the basis of the stock in the corporation. Gain allocable to installment notes received can be deferred to point of collection.	§ 334(a)—Basis of assets received by the shareholder will be the FMV on the date of distribution (except for installment obligations in which gain is deferred to the point of collection).	§ 336—Gain or loss is recognized for distributions in kind and for sales by the liquidating corporation. Losses are not recognized for distributions to related parties if the distribution is not pro rata or if disqualified property is distributed. Losses may be disallowed on sales and distributions of certain other property even if made to unrelated parties.
§ 332—In liquidation of a subsidiary, no gain or loss is recognized to the parent. Subsidiary must distribute all of its property within the taxable year or within three years from the close of the taxable year in which the first distribution occurs. Minority shareholders taxed under general rule of § 331.	§ 334(b)(1)—Property has the same basis as it had in the hands of the subsidiary. Parent's basis in the stock disappears. Carryover rules of § 381 apply. Minority shareholders get FMV basis under § 334(a).	§ 337—No gain or loss is recognized to the subsidiary on distributions to the parent. Gain (but not loss) is recognized on distributions to minority shareholders.
	§ 338—Subsidiary need not be liquidated. If subsidiary is liquidated, parent's basis in assets is new stepped-up (or -down) basis. Parent's basis in the stock disappears. Carryover rules of § 381 apply, but such amounts are likely to be nominal.	§ 338—Gain or loss is recognized to the subsidiary. Subsidiary is treated as a new corporation, and its basis in assets is stepped up (or down) to reflect parent's basis in subsidiary stock plus subsidiary's liabilities. New basis is allocated among various asset classes.

20-5 CORPORATE REORGANIZATIONS

LO.3

Explain the general requirements and tax consequences of corporate reorganizations.

One tenet of U.S. tax policy is to encourage business development. Accordingly, the tax laws allow entities to form without taxation, assuming that certain requirements are met. As an extension of this policy, corporate restructurings are also favored with tax-free treatment. Corporations may engage in a variety of acquisitions, combinations, consolidations, and divisions tax free, as long as the “reorganization” requirements in the Code are met.

Because the dollar value of most reorganizations is substantial, the tax implications are significant; thus, the tax law often dictates the form of the restructuring. The taxable gain for the shareholder is likely to be treated as either a dividend or a capital gain. For individual shareholders, qualified dividend income and long-term capital gains are subject to lower tax rates than ordinary income. Corporate shareholders are allowed the dividends received deduction if the reorganization gains are categorized as a dividend. However, because corporations receive no tax rate reduction for capital gains, corporate shareholders and the corporations involved in the restructuring would be taxed at their highest marginal rate on any restructuring gains classified as capital.

Careful reorganization planning can reduce or totally eliminate the possible current taxes for both the corporations and their shareholders. Consequently, when feasible, parties contemplating a corporate reorganization should obtain a letter ruling from the IRS determining the income tax effect of the transactions. Assuming that the parties proceed with the transactions as proposed in the ruling request, a favorable ruling provides, in effect, an insurance policy as to the tax treatment of the restructuring.²²

Courts originally concluded that even minor changes in a corporation’s structure would produce taxable gains for the shareholders involved.²³ Congress, however, determined that businesses should be allowed to make necessary capital adjustments without being subject to taxation.²⁴ The theory for nonrecognition in certain corporate reorganizations is similar to that underlying § 351 treatment and like-kind exchanges. As the Regulations state:

the new property is substantially a continuation of the old investment ... and, in the case of reorganizations, ... the new enterprise, the new corporate structure, and the new property are substantially continuations of the old.²⁵

20-5a In General

Although the term **reorganization** is commonly associated with a corporation in financial difficulty, for tax purposes, the term refers to any corporate restructuring that may be tax-free under § 368. To qualify as a tax-free reorganization, a corporate restructuring must meet not only the specific requirements of § 368 but also several general requirements. These requirements include the following:

1. There must be a *plan of reorganization*.
2. The reorganization must meet the *continuity of interest* and the *continuity of business enterprise* tests provided in the Regulations.
3. The restructuring must meet the judicial doctrine of having a *sound business purpose*.
4. The court-imposed *step transaction* doctrine should not apply to the reorganization.

²²To expedite the letter ruling process, the IRS attempts to issue rulings within 10 weeks from the date of request. Rev.Proc. 2005–68, 2005–2 C.B. 694.

²³*U.S. v. Phellis*, 1 USTC ¶154, 3 AFTR 3123, 42 S.Ct. 63 (USSC, 1921).

²⁴Reg. § 1.368–1(b). See S.Rept. No. 275, 67th Cong., 1st Sess. (1921), at 1939–1 C.B. 181.

²⁵Reg. § 1.1002–1(c).



FINANCIAL DISCLOSURE INSIGHTS When an Acquisition Fails

What happens when an acquisition of another company does not turn out to be as great of a deal as expected? Ask Hewlett-Packard (HP), which recently recorded an \$8.8 billion book write-down due to its botched acquisition of Autonomy Corporation. Given that the total package for the acquisition was \$11 billion, most of the purchase price provided no lasting value to HP.

When a corporation acquires another business, a value is determined for its net assets. To the extent the amount exchanged for the company exceeds the value of the net assets, goodwill is created and is recorded in the accounting records. Thus, goodwill is the intangible value derived from the acquisition beyond the net assets. Among other things, goodwill may represent the intangible value of a brand to create profits. When the acquiring entity writes down the

goodwill from the acquisition, it means that the expected value did not materialize; the acquirer overpaid for the target. This clearly was the position of HP in its acquisition of Autonomy.

At least annually, firms are required to assess the value of their goodwill. If the existing book value cannot be supported, it must be written down through an impairment charge. Since this write-down is a noncash charge, the financial markets may discount its effects. However, as with HP, a huge write-down can indicate that management botched its valuation of the target (Autonomy) and substantially overpaid for its acquisition. This can lead to shareholder lawsuits, which can result in true negative cash flows that ultimately hurt the company and the shareholders alike.

While all of these concepts are important, the initial and most important consideration is whether the reorganization qualifies for nonrecognition status under § 368, which is described next.

20-5b Summary of the Different Types of Reorganizations

Section 368(a) specifies seven corporate restructurings or reorganizations that will qualify as nontaxable exchanges. If the transaction fails to qualify as a reorganization, it will not receive the special tax-favored treatment. Therefore, a corporation considering a business reorganization must determine in advance whether the proposed transaction specifically falls within one of these seven types.

The Code states, in § 368(a)(1), that the term *reorganization* applies to any of the following:

- A. A statutory merger or consolidation.
- B. The acquisition by a corporation of another using solely stock of each corporation (voting stock-for-stock exchange).
- C. The acquisition by a corporation of substantially all of the property of another corporation in exchange for voting stock (voting stock-for-asset exchange).
- D. The transfer of all or part of a corporation's assets to another corporation when the original corporation's shareholders are in control of the new corporation immediately after the transfer (acquisitive or divisive exchange: spin-off, split-off, or split-up).
- E. A recapitalization.
- F. A mere change in identity, form, or place of organization.
- G. A transfer by a corporation of all or a part of its assets to another corporation in a bankruptcy or receivership proceeding.

These seven types of tax-free reorganizations typically are designated by their identifying letters: "Type A," "Type B," "Type C," etc. For the most part, excepting the recapitalization (E), the change in form (F), and the insolvent corporation (G) provisions, a tax-free reorganization is (1) a statutory merger or consolidation, (2) an exchange of stock for voting stock, (3) an exchange of assets for voting stock, or (4) a divisive reorganization (a so-called spin-off, split-off, or split-up).

20-5c Summary of the Tax Consequences in a Tax-Free Reorganization

The tax treatment for the parties involved in a tax-free reorganization almost parallels the treatment under the like-kind exchange provisions of § 1031 (see Chapter 13). Unfortunately, the like-kind exchange provisions do not apply to the exchange of stock or securities.²⁶

Therefore, the general rule is that when an investor exchanges stock in one corporation for stock in another, the exchange is a taxable transaction. If the transaction qualifies as a reorganization under § 368, however, the exchange receives tax-deferred treatment. Thus, a § 368 reorganization, in substance, is similar to a nontaxable exchange of like-kind property. The four-column template of Concept Summary 20.3 is useful in computing the amount of gain or loss recognized and the adjusted basis in the new stock received in a corporate reorganization.

John holds 1,000 shares of Lotus stock that he purchased for \$6,000 several years ago. In a merger of Lotus into Blossom, Inc., John exchanges his 1,000 Lotus shares for 500 Blossom shares. The Lotus stock and the Blossom stock both are valued at \$10,000. Assuming that this exchange qualifies for tax-free treatment under § 368, John's recognized gain and basis in his Blossom stock are computed as follows.

EXAMPLE

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Realized Gain	Recognized Gain	Postponed Gain	Basis in Blossom Stock
\$10,000	\$-0-	\$4,000	\$10,000
<u>-6,000</u>			<u>-4,000</u>
<u>\$ 4,000</u>			<u>\$ 6,000</u>

The exchange of John's stock has no tax consequences for Lotus or Blossom.



Concept Summary 20.3

Gain and Basis Rules for Nontaxable Exchanges

(1) Realized Gain/Loss	(2) Recognized Gain (Not Loss)	(3) Postponed Gain/Loss	(4) Basis of New Asset
Amount realized	Lesser of boot received or gain realized	Realized gain/loss (column 1)	FMV of asset (stock) received
<u>- Adjusted basis of asset(s) surrendered</u>		<u>- Recognized gain (column 2)</u>	<u>- Postponed gain (column 3) or + Postponed loss (column 3)</u>
<u>Realized gain/loss</u>	<u>Recognized gain</u>	<u>Postponed gain/loss</u>	<u>Adjusted basis in new asset (stock)</u>

Gain or Loss

Corporations meeting the requirements of § 368 do not recognize gains or losses on restructurings. However, an exception to the nonrecognition rule occurs when other property is transferred by the acquiring corporation in the reorganization. **Other property**, also called **boot**, is any asset other than stock or securities exchanged in the reorganization.²⁷ If boot is transferred, gain but not loss may be recognized.

²⁶§ 1031(a)(2)(B).

²⁷§§ 361(a) and (b). In a Type A or Type C reorganization, gain will not be recognized due to the retention of other property because the target is

liquidated under the reorganization rules (i.e., no property is retained by the target).

EXAMPLE

21

In a qualifying reorganization, Acquiring exchanges \$800,000 of stock and land valued at \$200,000 (basis of \$150,000) for all of Target’s assets, which have a value of \$1 million and a basis of \$600,000. Due to the boot (land) it used in the transfer, Acquiring recognizes a gain of \$50,000 (\$200,000 – \$150,000) on the reorganization. If Target distributes the land to its shareholders, it does not recognize gain. If Target retains the land, however, it recognizes a gain to the extent of the *other property* received, \$200,000.

Generally, the shareholders of corporations involved in a tax-free reorganization do not recognize gain or loss when exchanging their stock unless they receive boot in addition to stock. As demonstrated in Concept Summary 20.3, the gain recognized by the shareholder is the lesser of the boot received or the realized gain. This is analogous to the treatment of boot in a like-kind exchange. The only instance when shareholders may recognize losses in reorganizations is when they receive solely boot and no stock.

EXAMPLE

22

Kalla, the sole shareholder of Target in Example 21, has a basis of \$700,000 in her stock. She exchanges her Target stock for the \$800,000 of Acquiring stock plus the land (\$200,000) transferred by Acquiring to Target. The recognized gain for Kalla is the lesser of boot received (land, \$200,000) or realized gain (\$300,000). Thus, Kalla has a recognized gain on the reorganization of \$200,000. The computations are as follows.

Realized Gain	Recognized Gain	Postponed Gain	Basis in Acquiring Stock
\$1,000,000*	\$200,000	\$300,000	\$800,000
<u>–700,000</u>		<u>–200,000</u>	<u>–100,000</u>
<u>\$ 300,000</u>		<u>\$100,000</u>	<u>\$700,000</u>

*\$800,000 stock + \$200,000 land.

Once the recognized gain is computed, its character must be determined. The following are the possibilities for gain characterization.

- Dividend to the extent of the shareholder’s proportionate share of the corporation’s earnings and profits (E & P). The remaining gain is generally capital gain.
- If the requirements of § 302(b) can be met, the transaction is treated similar to a qualifying stock redemption, receiving capital gain treatment (see Chapter 19).



ETHICS & EQUITY Possible Sour Notes

Navarro is a closely held family corporation in the recording industry. It has signed contracts with several acts, and a few of its artists are beginning to hit the top of the Billboard charts. These artists have the potential of making Navarro extremely profitable. At present, however, Navarro is barely able to cover its costs. Several of its artists are “high-maintenance” and constitute a substantial financial drain on the corporation.

Unbeknownst to Navarro, Velvet Records, a large publicly held corporation, has tried to persuade several of Navarro’s artists to sign with it when their contracts expire. Velvet throws lavish parties for these artists and allows them to use company limousines and jets. Nevertheless, the artists feel a sense of loyalty to Navarro. They know that Navarro tries to look out for their best interests in their personal lives as well as in business dealings. Consequently, Velvet has been unsuccessful in luring any artists from Navarro.

Since its signing efforts have failed, Velvet approaches Navarro’s president, Mark Bryson, regarding the purchase of

some artists’ contracts. Mark discusses the offer with his family members. There is a real concern that Velvet is too big to provide individualized service for its clients’ needs. But most of the family members agree that a takeover of Navarro by Velvet, rather than a sale of the contracts, would be a sound business move for Navarro. That way, Velvet would acquire all of Navarro’s contracts, not just the most profitable ones. Velvet would also inherit the high-maintenance clients who are so costly to service.

Ultimately, Navarro and Velvet Records agree to a “Type C” reorganization, and Velvet transfers 10 percent of its stock for all of Navarro’s assets. A few days before the takeover is finalized, Mark learns that Navarro’s most successful singer has been diagnosed with throat cancer. The prognosis appears to be good, but the singer is unlikely to be able to record any new material for at least two years. It is possible that this artist never will be able to record again.

What ethical issues, if any, do Mark, Navarro, and Velvet face in their business dealings?

Sam acquired a 5% interest in Target 15 years ago for \$55,000. He exchanges his Target stock for \$50,000 of cash and 2% of Acquiring's outstanding stock worth \$100,000. At the time of the reorganization, Target's E & P is \$60,000. Sam's realized and recognized gains are computed as follows.

EXAMPLE

23

Realized Gain	Recognized Gain	Postponed Gain	Basis in Acquiring Stock
\$150,000*	\$50,000	\$95,000	\$100,000
<u>-55,000</u>	Boot	<u>-50,000</u>	<u>-45,000</u>
<u>\$ 95,000</u>		<u>\$45,000</u>	<u>\$ 55,000</u>

* \$100,000 stock + \$50,000 cash

The first \$3,000 (\$60,000 Target E & P × 5% ownership) of the \$50,000 gain recognized by Sam is taxed as a dividend, and the remaining \$47,000 is treated as a long-term capital gain.

Debt security holders receive treatment similar to shareholders. They recognize gain only when the principal (face) amount of the securities received is greater than the principal (face) amount of the securities surrendered. If securities are received and none are relinquished, the gain will be recognized.

The term *security* is not defined in the Code or the Regulations. Generally, however, debt instruments with terms longer than 10 years (e.g., bonds) are treated as securities, and those with terms of 5 years or less (e.g., notes) are not. An exception to this general rule occurs when the debt instrument issued by the acquiring corporation is exchanged for target securities having the same term and/or maturity date.²⁸

Alejandra holds a security issued by Hibiscus. The principal value of the security is \$10,000, and its maturity date is December 31, 2018. In connection with the merger of Hibiscus and Tea, Alejandra exchanges her Hibiscus security for a \$10,000 Tea note that also matures on December 31, 2018. Even though these notes do not have a term remaining of more than five years, they qualify for tax-free reorganization treatment because they have the same term.

EXAMPLE

24

Assume, instead, that in exchange for her \$10,000 security, Alejandra receives a note from Tea with a \$15,000 principal value. Alejandra recognizes a \$5,000 capital gain on the exchange. Her basis in the Tea bond is \$15,000 (\$10,000 original basis + \$5,000 gain recognized).

Basis

The assets transferred from the target corporation to the acquiring corporation retain their basis (called carryover basis). However, the acquiring corporation's carryover basis is increased by any gain recognized by the target corporation on the reorganization, as shown in Concept Summary 20.4.

Target exchanges its assets with a value of \$5 million and a basis of \$3 million for \$4.5 million of Acquiring stock and \$500,000 of land. Assume that Target does not distribute the land to its shareholders. Target recognizes a \$500,000 gain on the reorganization due to the boot (land) not being distributed. Acquiring's basis in the assets received from Target is \$3.5 million [\$3,000,000 (Target's basis) + \$500,000 (Target's gain recognized)].

EXAMPLE

25

In a tax-free reorganization, the shareholder/bondholder generally starts with a tax basis in the stock and securities received that is the same as the basis of the stock and securities surrendered (called substituted basis). As Concept Summary 20.4 shows, this basis is decreased by the fair market value of boot received and increased by the gain and/or dividend income recognized on the transaction.

Basis also may be computed using the Concept Summary 20.3 template. Using the template approach, the fair market value of the stock and securities received is reduced by the gain (or increased by the loss) postponed. This basis computation ensures that

²⁸Rev.Rul. 2004-78, 2004-2 C.B. 108.



Concept Summary 20.4

Basis Rules for a Tax-Free Reorganization

Basis to Acquiring Corporation of Property Received

Target's basis in property transferred	\$xx,xxx
Plus: Gain recognized by target on the transaction	<u>x,xxx</u>
Equals: Basis of property to acquiring corporation	<u><u>\$xx,xxx</u></u>

Basis to Target Shareholders of Stock and Securities Received

Basis of stock and securities transferred	\$xx,xxx
Plus: Gain and dividend income recognized	x,xxx
Less: Money and fair market value of other property received	<u>(x,xxx)</u>
Equals: Basis of stock and securities received	<u><u>\$xx,xxx</u></u>

the postponed gain or loss will be recognized when the new stock or securities are disposed of in a future taxable transaction.

Basis Computations

EXAMPLE

26

Quinn exchanges all of his stock in Target for stock in Acquiring plus \$3,000 of cash. The exchange is pursuant to a tax-free reorganization. Quinn paid \$10,000 for the stock in Target two years ago. The Acquiring stock received by Quinn has a fair market value of \$12,000. Quinn has a realized gain of \$5,000, which is recognized to the extent of the boot received, \$3,000. Quinn's basis in the Acquiring stock is \$10,000. This can be computed as follows.

Realized Gain	Recognized Gain	Postponed Gain	Basis in Acquiring Stock
\$15,000*	\$3,000	\$5,000	\$12,000
<u>-10,000</u>		<u>-3,000</u>	<u>-2,000</u>
<u>\$ 5,000</u>		<u>\$2,000</u>	<u>\$10,000</u>

* \$12,000 stock + \$3,000 cash.

EXAMPLE

27

Assume the same facts as in Example 26, except that Quinn's basis in the Target stock was \$16,000. Quinn realizes a loss of \$1,000 on the exchange, none of which is recognized. His basis in the Acquiring stock is \$13,000, computed as follows.

Realized Gain	Recognized Loss	Postponed Loss	Basis in Acquiring Stock
\$15,000*	\$-0-	(\$1,000)	\$12,000
<u>-16,000</u>		<u>-0-</u>	<u>+1,000</u>
<u>(\$ 1,000)</u>		<u>(\$1,000)</u>	<u>\$13,000</u>

* \$12,000 stock + \$3,000 cash.

LQ.4

Identify tax planning opportunities available to minimize the tax impact in complete liquidations and corporate reorganizations.

20-6 TAX PLANNING

20-6a Effect of a Liquidating Distribution on the Corporation

With the exception of parent-subsidiary liquidations, distributions in liquidation are taxed at both the corporate level and the shareholder level. When a corporation

liquidates, it generally can claim losses on assets that have declined in value. These assets should not be distributed in the form of a property dividend or stock redemption because losses are not recognized on nonliquidating distributions.

20-6b **Effect of a Liquidating Distribution on the Shareholder**

Shareholders faced with large prospective gains in a liquidation may consider shifting part or all of that gain to other taxpayers. One approach is to donate stock to charity. A charitable contribution of the stock produces a deduction equal to the stock's fair market value (see Chapter 10). Alternatively, the stock may be given to family members. If the family member is in the 10 or 15 percent marginal tax bracket, some or all of the gain on liquidation could be taxed at the 0 percent preferential rate on long-term capital gains. Whether these procedures will be successful in shifting the liquidation-related gain from the taxpayer depends on the timing of the transfer. If the donee of the stock is not in a position to prevent the liquidation of the corporation, the donor may be deemed to have made an anticipatory assignment of income. In such a case, the gain is still taxed to the donor. In addition, possible gift tax issues on the stock transfer must be considered (see Chapter 27). Advance planning of stock transfers, therefore, is crucial in arriving at the desired tax result.

The installment sale provisions provide some relief from the general rule that a shareholder recognizes all gain upon receiving a liquidating distribution. If the assets of the liquidating corporation are not to be distributed in kind, a sale of the assets in exchange for installment notes should be considered. Shareholders receiving the notes in a liquidation can then report their gain on the installment method as the notes are collected. Gain deferred under the installment method is subject to the tax rates applicable in each year of collection. The differential in the maximum tax rate on net capital gains (i.e., 0/15/20 percent) presents a planning opportunity for taxpayers whose income fluctuates from year to year. These taxpayers may be able to reduce the tax consequences of an installment sale by directing collections to a year in which a lower rate applies to the capital gain.

20-6c **Parent-Subsidiary Liquidations**

The nonrecognition provision applicable to the liquidation of a subsidiary, § 332, is not elective. Nevertheless, some flexibility may be available:

- Whether § 332 applies depends on the 80 percent stock ownership test. A parent corporation may be able to avoid § 332 by reducing its stock ownership in the subsidiary below this percentage to allow for recognition of a loss. On the other hand, the opposite approach may be desirable to avoid gain recognition. A corporate shareholder possessing less than the required 80 percent ownership may want to acquire additional stock to qualify for § 332 treatment.
- Once § 332 becomes effective, less latitude is allowed in determining the parent's basis in the subsidiary's assets. Generally, the subsidiary's existing basis in its assets carries over to the parent. If a timely § 338 election is made, the subsidiary's basis in its assets is stepped up to reflect, in part, the parent's basis in the subsidiary stock. If the subsidiary also is liquidated, the parent obtains assets with the stepped-up basis.
- An election to have the § 338 rules apply should be carefully weighed as the election can be detrimental. The income tax liability on the subsidiary's recognized gain that results from the deemed sale of its assets is the cost under § 338 for obtaining the stepped-up basis. As a result, a § 338 election may be a viable option only when the subsidiary possesses loss and/or credit carryovers that can be used to offset the associated tax.

20-6d Asset Purchase versus Stock Purchase

The acquisition of a corporation's assets generally takes one of two forms. In one form, the acquiring corporation purchases the stock of the target corporation, and then the target (subsidiary) is liquidated. In the other form, the acquiring corporation purchases the assets of the target corporation, and then the target distributes the proceeds to its shareholders in liquidation. Nontax considerations may affect the form of acquisition, with each form having both favorable and unfavorable aspects.

An asset purchase requires that title be transferred and that creditors be notified. Further, an asset purchase may not be feasible if valuable nontransferable trademarks, contracts, or licenses are involved. Alternatively, an asset purchase may be preferable to a stock purchase if the target's shareholders refuse to sell their stock. In addition, an asset purchase avoids the transfer of liabilities (including unknown liabilities) generally inherent in stock acquisitions. An asset purchase also has the advantage of allowing the purchaser to avoid the acquisition of unwanted assets, whereas a stock purchase would involve all of a target's assets.

REFOCUS ON THE BIG PICTURE

THE TRANSITION TO RETIREMENT IS SUBJECT TO DOUBLE TAXATION



The Smithsons are wise to evaluate the affordability of their retirement plan *before* they sell or liquidate their business. Nonetheless, after payment of income tax at both the corporate and shareholder levels, they will net only \$2,560,000 from the sale of their \$4 million business.

Specifically, in the event the corporation is able to sell the business assets for \$4 million, the realized gain of \$2.5 million will give rise to Federal income tax of \$850,000 ($\$2,500,000 \times 34\%$). Following the payment of the corporate income tax, the net proceeds to the Smithsons will be \$3,150,000. After offsetting the amount realized from the liquidation by their stock basis of \$200,000, their capital gain of \$2,950,000 will be subject to capital gains tax of \$590,000 ($\$2,950,000 \times 20\%$). Therefore, the net after-tax cash available for investment will be \$2,560,000 ($\$3,150,000$ proceeds – capital gains tax of \$590,000). (To simplify this analysis, the 3.8 percent Medicare surtax is not considered.) Now the question for the Smithsons is whether this amount will likely be sufficient to fund the type of retirement they desire.

What If?

Instead of the complete liquidation transaction just described, the Smithsons should consider alternatives that could produce a better tax result such as the following:

- If the Smithsons are able to find a buyer who is interested in maintaining the business in the current corporate form, they should try to sell their *stock* in the business rather than selling the business assets in liquidation. If the buyer is willing to pay \$4 million for the corporation's stock, the Smithsons would recognize a capital gain of \$3.8 million and net \$3,240,000 after tax ($\$4$ million proceeds – capital gains tax of \$760,000). This approach would increase the net after-tax amount available to fund their retirement portfolio by \$680,000 due to the fact that the corporate-level tax is avoided. Again, the 3.8 percent Medicare surtax is not considered in this analysis.
- Another approach would be to attempt to market the corporation as a potential takeover target in a tax-free reorganization. With this approach, the Smithsons would receive stock in the acquiring corporation without having to recognize *any* gain from the transaction. This strategy could enable the Smithsons to live off the

continued

subsequent dividend distributions made by the acquiring corporation. Further, if they needed additional cash flow to meet living expenses, they could sell shares of stock in the acquiring corporation as needed, and any resulting gain would be subject to the capital gains rates at that time. An obvious advantage of this approach is that gain from the disposition of their stock would be deferred until the stock in the acquiring corporation is sold in a taxable transaction. However, a disadvantage the Smithsons would need to evaluate is that they would not be able to build a diversified portfolio, given that their investment holdings would largely, if not completely, consist of the stock of the acquiring corporation.

Key Terms

Boot, 20-17

Other property, 20-17

Section 338 election, 20-13

Corporate liquidation, 20-2

Reorganization, 20-15

Discussion Questions

- LO.1** Under what circumstances are losses disallowed to a corporation in liquidation?
- LO.1** For purposes of the related-party loss limitation within the context of a complete liquidation, what is the definition of *disqualified property*?
- LO.1** For the built-in loss limitation to apply, the property must have been acquired by the corporation as part of a plan whose principal purpose was to recognize a loss on the property by the liquidating corporation. Explain.
- LO.1** Explain the tax consequences to a shareholder of a corporation in the process of liquidation under the general rule of § 331.
- LO.2** Discuss the tax consequences to the parent corporation in a § 332 liquidation of a subsidiary.
- LO.2** In terms of the rules applying to a § 332 parent-subsidiary liquidation, comment on each of the following:
 - The parent corporation's ownership interest in the subsidiary.
 - The period of time in which the subsidiary must liquidate.
 - The solvency of the subsidiary.
- LO.2** A subsidiary corporation is liquidated under § 332. Pursuant to its liquidation, the subsidiary transferred property to a minority shareholder. With respect to this distribution, what are the tax consequences to the subsidiary corporation and to the minority shareholder?
- LO.2** In general, what are the tax consequences of a § 338 election?
- LO.2** From the perspective of the parent corporation, contrast the tax consequences of a subsidiary liquidation under the general nonrecognition rules with a subsidiary liquidation that follows a § 338 election.
- LO.3** Explain why a private letter ruling from the IRS is like an insurance policy for a corporate reorganization.
- LO.3** How is the four-column template in Concept Summary 20.3 used to determine a shareholder's basis in the stock received in a corporate restructuring?

Computational Exercises

12. **LO.1** Sunset Corporation, with E & P of \$400,000, makes a cash distribution of \$120,000 to a shareholder. The shareholder's basis in the Sunset stock is \$50,000.
- Determine the tax consequences to the shareholder if the distribution is a non-qualified stock redemption.
 - Determine the tax consequences to the shareholder if the distribution is a qualifying stock redemption.
 - Determine the tax consequences to the shareholder if the distribution is pursuant to a complete liquidation of Sunset.
13. **LO.1** Pursuant to a complete liquidation, Carrot Corporation distributes to its shareholders real estate held as an investment (basis of \$650,000, fair market value of \$880,000).
- Determine the gain or loss recognized by Carrot on the distribution if no liability is involved.
 - Determine the gain or loss recognized by Carrot on the distribution if the real estate is subject to a liability of \$690,000.
 - Determine the gain or loss recognized by Carrot on the distribution if the real estate is subject to a liability of \$885,000.
14. **LO.1** Osprey Corporation stock is owned by Pedro and Pittro, who are unrelated. Pedro owns 50% and Pittro owns 50% of the stock in the corporation. Osprey has the following assets (none of which were acquired in a § 351 or contribution to capital transaction) that are distributed in complete liquidation of the corporation.

	Adjusted Basis	Fair Market Value
Cash	\$300,000	\$300,000
Land	200,000	440,000
Equipment	250,000	140,000

Assume that Osprey Corporation distributes the land to Pedro and the cash and equipment to Pittro.

- Determine Osprey's recognized gain or loss on the distribution of land.
 - Determine Osprey's recognized gain or loss on the distribution of the equipment.
15. **LO.1** On January 2, 2015, Martin Corporation acquires two properties from a shareholder in a transaction that qualifies under § 351. The shareholder's basis, the fair market value, and the built-in gain (loss) of each property are:

	Shareholder's Basis	Fair Market Value	Built-In Gain (Loss)
Property 1	\$300,000	\$375,000	\$ 75,000
Property 2	525,000	400,000	(125,000)
Net built-in loss			<u>(\$ 50,000)</u>

Martin adopts a plan of liquidation later in the year and distributes Property 2 to a 30% shareholder when the property is worth \$350,000.

- Compute Martin's basis in Property 1 and in Property 2 as of January 2, 2015.
- Compute Martin's realized and recognized loss on the liquidating distribution of Property 2.

16. **LO.1** Green Corporation's assets are valued at \$920,000 after payment of all corporate debts, except for \$134,000 of taxes payable on net gains it recognized on the liquidation. Bruno, an individual and the sole shareholder of Green, has a basis of \$280,000 in his stock. Compute the gain or loss recognized by Bruno on the liquidation of Green Corporation.
17. **LO.2** The stock of Quail Corporation is held as follows: 85% by Pheasant Corporation and 15% by Gisela, an individual. Quail Corporation is liquidated in December of the current year pursuant to a plan adopted earlier in the year. At the time of its liquidation, Quail Corporation has assets with a basis of \$730,000 and fair market value of \$1 million. Quail Corporation distributes the property pro rata to Pheasant Corporation and to Gisela.
- Compute Quail's recognized gain or loss on the distribution of property to Pheasant.
 - Compute Quail's recognized gain or loss on the distribution of property to Gisela.
18. **LO.2** Goose Corporation has a basis of \$2.4 million in the stock of Swift Corporation, a wholly owned subsidiary acquired 30 years ago. Goose liquidates Swift Corporation and receives assets that are worth \$2 million and have a basis to Swift of \$1.7 million.
- Determine Goose Corporation's recognized gain or loss on the liquidation.
 - Determine Goose Corporation's basis in the assets received in liquidation.
19. **LO.3** Rebecca holds 100 shares of Gotchas stock that she purchased for \$1,000 several years ago. In a merger of Gotchas into Solis, Inc., Rebecca exchanges her 100 Gotchas shares for 1,000 Solis shares and \$500. Gotchas is valued at \$40 per share and Solis at \$3.50 per share.
- What is Rebecca's realized and recognized gain/loss from the reorganization?
 - What is Rebecca's basis in her Solis stock?
20. **LO.3** In a qualifying reorganization, Cato exchanges \$1.2 million worth of stock and property valued at \$500,000 (\$245,000 basis) for all of Firestar's assets, which have a value of \$1.7 million and a \$350,000 basis. Firestar distributes the property received from Cato. The exchange meets the § 368 requirements.
- What is Cato's recognized gain/loss from the reorganization?
 - What is Firestar's recognized gain/loss from the reorganization?
21. **LO.3** Townsend, the sole shareholder of Pruett Corporation, has a \$480,000 basis in his stock. He exchanges his Pruett stock for \$600,000 of Rogers Corporation voting common stock plus land with a fair market value of \$100,000 and basis of \$25,000 that is transferred by Rogers to Pruett. This exchange qualifies under § 368.
- What is Townsend's recognized gain/loss from the reorganization?
 - What is the gain/loss recognized by Pruett Corporation and Rogers Corporation on the reorganization?
 - What is Townsend's basis in the Rogers stock and the land received?
22. **LO.3** Hosha exchanges all of her Leaf stock for Petal stock plus \$5,000 cash. The exchange is pursuant to a tax-free reorganization. Hosha paid \$25,000 for the Leaf stock five years ago. The Petal stock received by Hosha has an \$18,000 fair market value.
- What is Hosha's realized and recognized gain/loss from the reorganization?
 - What is Hosha's basis in the Petal stock she received?

Problems

23. **LO.1, 4** Dove Corporation (E & P of \$800,000) has 1,000 shares of stock outstanding. The shares are owned as follows: Julia, 600 shares; Maxine (Julia's sister), 300 shares; and Janine (Julia's daughter), 100 shares. Dove Corporation owns land (basis of \$300,000, fair market value of \$260,000) that it purchased as an investment seven years ago. Dove distributes the land to Julia in exchange for all of her shares in the corporation. Julia had a basis of \$275,000 in the shares. What are the tax consequences for both Dove Corporation and Julia if the distribution is:
- A qualifying stock redemption?
 - A liquidating distribution?
24. **LO.1** Pursuant to a complete liquidation, Oriole Corporation distributes to its shareholders land held for three years as an investment (adjusted basis of \$250,000, fair market value of \$490,000). The land is subject to a liability of \$520,000.
- What are the tax consequences to Oriole Corporation on the distribution of the land?
 - If the land is, instead, subject to a liability of \$400,000, what are the tax consequences to Oriole on the distribution?
25. **LO.1** The stock of Mulberry Corporation is owned by Archana (60%) and Anar (40%), who are mother and daughter. Pursuant to a plan of complete liquidation adopted earlier in the current year, Mulberry distributes land worth \$575,000 to Anar (basis of \$100,000 in Mulberry stock). The land was purchased by Mulberry Corporation three years ago for \$650,000, and it is distributed subject to a liability of \$425,000. What amount of gain or loss is recognized by Mulberry Corporation and by Anar with respect to the distribution of the land?
26. **LO.1** Last year, Lory Corporation, a land development company, acquired land and construction equipment from its sole shareholder in a § 351 transaction. At the time, the land had a basis of \$790,000 and a fair market value of \$650,000, and the equipment had a basis of \$130,000 and a fair market value of \$300,000. The assets were transferred to Lory Corporation for the purpose of developing the land and constructing a residential home community. However, the residential housing market suffered a steep decline in the current year, and as a result of financial difficulties, Lory Corporation was forced to sell its assets and liquidate. Pursuant to a plan of liquidation adopted during the year, Lory sold the land to an unrelated party for its current fair market value of \$500,000. What amount of loss, if any, is recognized by Lory Corporation on the sale of the land?
27. **LO.1** Last year, a shareholder transferred land (basis of \$650,000, fair market value of \$575,000) to Roadrunner Corporation in a § 351 transaction. This was the only property transferred to Roadrunner at that time. During the current year, Roadrunner Corporation adopted a plan of liquidation and distributed the land to Rhonda, a 15% shareholder. On the date of the distribution, the land had a fair market value of \$400,000. Roadrunner Corporation never used the land for business purposes during the time it owned the property. What amount of loss may Roadrunner recognize on the distribution of the land?
- Decision Making** 28. **LO.1, 4** Last year, Pink Corporation acquired land and securities in a § 351 tax-free exchange. On the date of the transfer, the land had a basis of \$720,000 and a fair market value of \$1 million, and the securities had a basis of \$110,000 and a fair market value of \$250,000. Pink Corporation has two shareholders, Maria and Paul, who are unrelated. Maria owns 85% of the stock in the corporation, and Paul owns 15%. Pink adopts a plan of liquidation in the current year. On this date, the value of

the land has decreased to \$500,000. What is the effect of each of the following on Pink Corporation? Which option should be selected?

- a. Distribute all of the land to Maria.
 - b. Distribute all of the land to Paul.
 - c. Distribute 85% of the land to Maria and 15% to Paul.
 - d. Distribute 50% of the land to Maria and 50% to Paul.
 - e. Sell the land and distribute the proceeds of \$500,000 proportionately to Maria and to Paul.
29. **LO.1, 4** Assume in Problem 28 that the land had a fair market value of \$630,000 on the date of its transfer to the corporation. On the date of the liquidation, the land's fair market value has decreased to \$500,000. How would your answer to Problem 28 change if:
- a. All of the land is distributed to Maria?
 - b. All of the land is distributed to Paul?
 - c. The land is distributed 85% to Maria and 15% to Paul?
 - d. The land is distributed 50% to Maria and 50% to Paul?
 - e. The land is sold and the proceeds of \$500,000 are distributed proportionately to Maria and to Paul?
30. **LO.1** Pursuant to a complete liquidation in the current year, Scarlet Corporation distributes to Jake land (basis of \$425,000, fair market value of \$390,000) that was purchased three years ago and held as an investment. The land is subject to a liability of \$250,000. Jake, who owned 35% of the Scarlet shares outstanding, had a basis of \$60,000 in the stock. What are the tax consequences of the liquidating distribution to Scarlet Corporation and to Jake?
31. **LO.2** The stock of Magenta Corporation is owned by Fuchsia Corporation (95%) and Marta (5%). Magenta is liquidated in the current year, pursuant to a plan of liquidation adopted earlier in the year. In the liquidation, Magenta distributes various assets worth \$950,000 (basis of \$620,000) to Fuchsia (basis of \$700,000 in Magenta stock) and a parcel of land worth \$50,000 (basis of \$75,000) to Marta (basis of \$30,000 in Magenta stock). Assuming that the § 338 election is not made, what are the tax consequences of the liquidation to Magenta, Fuchsia, and Marta?
32. **LO.2** The stock in Ivory Corporation is owned by Gold Corporation (80%) and Imelda (20%). Gold Corporation purchased its shares in Ivory nine years ago at a cost of \$650,000, and Imelda purchased her shares in Ivory four years ago at a cost of \$175,000. Ivory Corporation has the following assets that are distributed in complete liquidation:

Decision Making

	Adjusted Basis	Fair Market Value
Cash	\$600,000	\$600,000
Inventory	80,000	200,000
Equipment	350,000	200,000

- a. Assume that Ivory Corporation distributes the cash and inventory to Gold Corporation and the equipment to Imelda. What are the tax consequences of the distributions to Ivory Corporation, to Gold Corporation, and to Imelda?
 - b. Assume that Ivory Corporation distributes the cash and equipment to Gold Corporation and the inventory to Imelda. What are the tax consequences of the distributions to Ivory Corporation, to Gold Corporation, and to Imelda?
33. **LO.2** Orange Corporation purchased bonds (basis of \$350,000) of its wholly owned subsidiary, Green Corporation, at a discount. Upon liquidation of Green

pursuant to § 332, Orange receives payment in the form of land worth \$400,000, the face amount of the bonds. Green had a basis of \$320,000 in the land. What are the tax consequences of this land transfer to Green Corporation and to Orange Corporation?

34. **LO.2** On July 22, 2014, Lilac Corporation purchased 25% of the Coffee Corporation stock outstanding. Lilac Corporation purchased an additional 40% of the stock in Coffee on March 25, 2015, and an additional 20% on May 1, 2015. On September 23, 2015, Lilac Corporation purchased the remaining 15% of Coffee Corporation stock outstanding. For purposes of the § 338 election, on what date does a qualified stock purchase occur? What is the due date for making the § 338 election?
35. **LO.2** On April 29, 2015, Auk Corporation acquires 100% of the outstanding stock of Amazon Corporation (E & P of \$750,000) for \$1.2 million. Amazon has assets with a fair market value of \$1.4 million (basis of \$800,000), no liabilities, and no loss or tax credit carryovers. Amazon Corporation's tax rate is 34%. Auk Corporation files a timely § 338 election. Assume that both the aggregate deemed sale price (ADSP) and adjusted grossed-up basis (AGUB) are \$1.4 million.
- What are the tax consequences of the § 338 election to Amazon Corporation and to Auk Corporation?
 - Assume that Amazon Corporation is liquidated immediately following the § 338 election. What are the tax consequences of the liquidation to Amazon Corporation and to Auk Corporation?
36. **LO.3** Quail Corporation was created in 2005 through contributions from Kasha (\$900,000) and Frank (\$100,000). In a transaction qualifying as a reorganization, Quail exchanges all of its assets currently valued at \$1.8 million (basis of \$1.2 million) for 12,000 shares of Covey Corporation stock valued at \$1.7 million plus \$100,000 in Covey bonds. Quail distributes the Covey stock and bonds proportionately to Frank and Kasha in exchange for their stock in Quail. Quail's current and accumulated E & P before the reorganization amounts to \$70,000.
- How do Kasha and Frank treat this transaction for income tax purposes? What is Kasha's and Frank's basis in their Covey stock?
 - How do Quail and Covey treat this transaction for income tax purposes? What is Covey's basis in the assets it receives from Quail?
37. **LO.3** Jed acquired 25% of the stock of Alpha (basis of \$100,000) 12 years ago, and the other 75% was purchased by Zia (basis of \$400,000) three years ago. Alpha enters into a tax-free consolidation with Beta, in which Jed will receive an 8% interest in the new AlphaBeta (value \$90,000) plus \$36,000 cash, and Zia will receive a 28% interest (value \$315,000) plus land worth \$63,000. Alpha's basis in the land is \$35,000.
- Before the reorganization or distributions to its shareholders, Alpha's value is \$504,000, and Beta's value is \$720,000.
- What is Jed's and Zia's recognized gain or loss on the reorganization? What is each shareholder's basis in his or her AlphaBeta stock?
 - What is Alpha's and Beta's recognized gain or loss on the reorganization?
 - Diagram the consolidation of Alpha and Beta Corporation.
38. **LO.3** Target Corporation holds assets with a fair market value of \$4 million (adjusted basis of \$2.2 million) and liabilities of \$1.5 million. It transfers assets worth \$3.7 million to Acquiring Corporation in a "Type C" reorganization, in exchange for Acquiring voting stock and the assumption of \$1.4 million of Target's liabilities.
- Target retained a building worth \$300,000 (adjusted basis of \$225,000). Target distributes the Acquiring voting stock and the building with an associated \$100,000

mortgage to Wei, its sole shareholder, for all of her stock in Target. Wei's basis in her stock is \$2.1 million.

- What is the value of the stock transferred from Acquiring to Target?
- What is the amount of gain (loss) recognized by Wei, Target, and Acquiring on the reorganization?
- What is Wei's basis in the stock and building she received?

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Shelly Zumaya (2220 East Hennepin Avenue, Minneapolis, MN 55413) is the president and sole shareholder of Kiwi Corporation (stock basis of \$400,000). Incorporated in 2004, Kiwi Corporation's sole business has consisted of the purchase and resale of used farming equipment. In December 2013, Kiwi transferred its entire inventory (basis of \$1.2 million) to Shelly in a transaction described by the parties as a sale. According to Shelly and collaborated by the minutes of the board of directors, the inventory was sold to her for the sum of \$2 million, the fair market value of the inventory. The terms of the sale provided that Shelly would pay Kiwi Corporation the \$2 million at some future date. This debt obligation was not evidenced by a promissory note, and to date, Shelly has made no payments (principal or interest) on the obligation. The inventory transfer was not reported on Kiwi's 2013 tax return, either as a sale or a distribution. After the transfer of the inventory to Shelly, Kiwi Corporation had no remaining assets and ceased to conduct any business. Kiwi did not formally liquidate under state law. Upon an audit of Kiwi Corporation's 2013 tax return, the IRS asserted that the transfer of inventory constituted a liquidation of Kiwi and, as such, that the corporation recognized a gain on the liquidating distribution in the amount of \$800,000 [\$2 million (fair market value) – \$1.2 million (inventory basis)]. Further, because Kiwi Corporation is devoid of assets, the IRS assessed the entire tax liability against Shelly, based on transferee liability. Finally, the IRS assessed a tax due from Shelly for her gain recognized in the purported liquidating distribution. Shelly has contacted you regarding the IRS's determination. Prepare a letter to Shelly Zumaya and a memo for the file, documenting your research.

Communications

Research Problem 2. Paloma purchased all of the outstanding Dove stock in 2001. Dove has prospered under Paloma's direction, and now Hawk Corporation is interested in acquiring Dove, but not directly. Hawk forms a new subsidiary, called Starling, whose purpose is to merge with Dove. Starling (the target) transfers its asset, Hawk stock, to Dove (acquiring) in exchange for all of the Dove stock. Dove distributes the Hawk stock to Paloma in exchange for her Dove stock. Starling distributes the Dove stock to its shareholder, Hawk, and then ceases to exist. Dove is now a wholly owned subsidiary of Hawk, and Paloma is a Hawk shareholder. Hawk immediately liquidates Dove to acquire all of Dove's assets and liabilities. Hawk continues Dove's previous line of business. The end result is that Hawk has all of Dove's assets and liabilities and Paloma is a shareholder of Hawk. Explain whether this reverse triangular restructuring qualifies as a reorganization under § 368 or whether the step transaction doctrine causes it to be disqualified.

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

- Communications** **Research Problem 3.** The requirements for effectively liquidating a corporate entity under state law vary from state to state. Using the Internet as your sole research source, prepare an outline discussing how an entity incorporated in your home state is liquidated, including any reporting requirements associated with such liquidation.
- Communications** **Research Problem 4.** While the requirements for a § 332 parent-subsidary liquidation are fairly straightforward, some planning and reporting issues must be addressed to ensure the proper outcome. Using the Internet as your sole research source, prepare an outline discussing the general requirements for a § 332 parent-subsidary liquidation, including any associated planning and reporting considerations.
- Communications** **Research Problem 5.** Find a current article (not more than two years old) discussing the financial accounting treatment of mergers and acquisitions. The article can discuss current trends in merger and acquisition financial accounting. Provide a written one-page summary of the article to your professor.

Roger CPA Review Questions

- Katsu Corp. distributes property to its shareholders as part of a complete liquidation. The fair market value of the property is \$500,000, Katsu's adjusted basis in the property is \$150,000, and the property is subject to a liability of \$200,000. What amount of gain will Katsu recognize as a result of the transaction?
 - \$150,000
 - \$550,000
 - \$300,000
 - \$350,000
- Calamity Corp. distributes five unimproved parcels of swampland to its shareholders as part of a complete liquidation. The fair market value of each parcel is \$25,000 and Calamity's adjusted basis in each parcel is \$40,000. What amount of gain or loss will Calamity Corp. recognize as a result of distributing the parcels?
 - \$15,000 gain
 - No gain or loss will be recognized
 - \$75,000 loss
 - \$60,000 loss
- Senior Corp. completely liquidates its 80%-owned subsidiary, Junior Corp. The liquidation results in a distribution to Senior of property with a fair market value of \$1,000,000 and an adjusted basis to Junior of \$400,000. How much gain will Senior and Junior each recognize on the transaction?
 - Senior, \$0; Junior, \$600,000
 - Senior, \$0; Junior, \$0
 - Senior, \$600,000; Junior, \$0
 - Senior, \$0; Junior, \$120,000



PART

7

FLOW-THROUGH ENTITIES

CHAPTER **21**

Partnerships

CHAPTER **22**

S Corporations

Unlike C corporations, some business entities are taxed under the conduit principle. Generally, this means the tax attributes of various transactions are retained as they flow through the entity to the owners. With limited exceptions, no tax is imposed at the entity level. Part 7 discusses two types of flow-through entities—partnerships and corporations that make the Subchapter S election. Part 7 also integrates the material on corporations (Part 6) with flow-through entities in regard to the decision-making process. By comparing the tax attributes of C corporations, S corporations, and partnerships, the owners are provided with the tools needed to choose the appropriate form for conducting a business.

Partnerships

LEARNING OBJECTIVES: *After completing Chapter 21, you should be able to:*

- LO.1** Distinguish among the various types of entities treated as partnerships for tax purposes.
- LO.2** Describe the conceptual basis for partnership taxation and how partnership income is reported and taxed.
- LO.3** Determine the tax effects of forming a partnership with cash and property contributions.
- LO.4** Identify elections available to a partnership and specify the tax treatment of expenditures of a newly formed partnership.
- LO.5** Specify the accounting methods available to a partnership.
- LO.6** List and explain the methods of determining a partnership's tax year.
- LO.7** Calculate a partnership's taxable income and separately stated items and describe how the partnership's income is reported.
- LO.8** Outline and discuss the requirements for allocating income, gains, losses, deductions, and credits among the partners and describe how that income is reported.
- LO.9** Determine a partner's basis in the partnership interest.
- LO.10** Explain how liabilities affect a partner's basis.
- LO.11** Illustrate a partner's capital account rollforward and explain why the year-end balance might differ from the partner's year-end basis in the partnership interest.
- LO.12** List and review the limitations on deducting partnership losses.
- LO.13** List and explain the special rules that govern the treatment of transactions between a partner and the partnership.
- LO.14** Define terms related to distributions from a partnership and determine the tax treatment of proportionate nonliquidating distributions from a partnership to a partner and the tax treatment of proportionate distributions that liquidate a partnership.
- LO.15** Calculate the selling partner's amount and character of gain or loss on the sale or exchange of a partnership interest.
- LO.16** Describe the application of partnership provisions to limited liability companies (LLCs) and limited liability partnerships (LLPs).
- LO.17** Identify tax planning opportunities related to partnerships and their partners.

CHAPTER OUTLINE

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 - 21-1b Key Concepts in Taxation of Partnership Income, 21-4
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THE BIG PICTURE

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WHY USE A PARTNERSHIP, ANYWAY?

For 15 years, Maria has owned and operated a seaside bakery and café called The Beachsider. Each morning, customers line up on the boardwalk in front of the building and enjoy fresh coffee and croissants while waiting for a table. “The building is too small,” Maria commented to her landlord, Kyle. “Is there any way we can expand?” The Beachsider is one of several older buildings on 3 acres of a 10-acre parcel that Kyle inherited 30 years ago. The remaining 7 acres are undeveloped.

Kyle and Maria talked to Josh, a real estate developer, and he proposed an expansion to The Beachsider and upgrades to the other buildings. The improvements would preserve the character of the original retail center, and the remaining acreage would be available for future expansion. Kyle and Maria were impressed with Josh’s vision and excited about the plans to upgrade the property and expand Maria’s business.

The parties agreed to form a partnership to own and operate The Beachsider and to improve and lease the other buildings. Josh summarized the plan as follows: “Kyle and Maria will each contribute one-half of the capital we need. Kyle’s real estate is valued at about \$2 million. Maria’s bakery equipment and the café furnishings are valued at about \$500,000. The improvements will cost about \$1.5 million, which Maria has agreed to contribute to the partnership.”

Josh continued, “You have agreed that I do not need to contribute any capital to the partnership. I will oversee the construction, and when it is complete, I will vest in a 5 percent interest in the partnership’s capital. On an ongoing basis, I will oversee the partnership’s operations in exchange for a fixed salary and 20 percent of the partnership’s ongoing profits. The construction is estimated to be completed in June of this year, and my capital interest is estimated to be valued at \$200,000 at that time.”

What are the tax consequences if the trio forms Beachside Properties as a partnership to own and operate the retail center? What issues might arise later in the life of the entity?

Read the chapter and formulate your response.

This chapter and the next chapter analyze two types of entities that may offer advantages over Subchapter C corporations. These entities are partnerships and S corporations, which are called *flow-through* or *pass-through* entities because the owners of the trade or business choose to avoid treating the enterprise as a completely separate taxable entity. Instead, the owners are taxed on a proportionate share of the entity's taxable income at the end of each of its taxable years.

This chapter addresses partnership formations, operations, and nonliquidating distributions and, in addition, sales of partnership interests and partnership liquidating distributions. Chapter 22 discusses the taxation of S corporations.

21-1 OVERVIEW OF PARTNERSHIP TAXATION

There are several types of partnerships, each suited for different situations. As described in the “Tax in the News” feature on the next page, partnerships are used in almost every imaginable industry and use of these entities is on the rise.

LO.1

Distinguish among the various types of entities treated as partnerships for tax purposes.

21-1a What Is a Partnership?

Partnerships are governed by Subchapter K of the Internal Revenue Code. According to Subchapter K, a partnership is an association formed by two or more persons to carry on a trade or business, with each contributing money, property, labor, or skill, and with all expecting to share in profits and losses. For Federal income tax purposes, a partnership includes a syndicate, a group, a pool, a joint venture, or other unincorporated organization through which any business, financial operation, or venture is carried on. The entity must not be otherwise classified as a corporation, trust, or estate.¹

Types of Partnerships

The types of entities that may be treated as partnerships include general partnerships, limited partnerships, limited liability partnerships, limited liability limited partnerships, and limited liability companies. These entities are typically distinguished based on the types of business permitted to be conducted by the entity, the extent to which the partners may participate in management, and the extent to which the partners are personally liable for the entity's debts.

- A **general partnership (GP)** consists of two or more partners who are **general partners** and who may participate in management of the entity; there are no **limited partners**. Creditors of a general partnership can collect from both the partnership's assets and the personal assets of the owner-partners. A general partner can be subject to a malpractice judgment brought against the partnership, even though the partner was not personally involved in the malpractice. General partnerships are sometimes used for operating activities (e.g., product manufacturing or sales) and corporate joint ventures.
- A **limited liability company (LLC)** combines the corporate benefit of limited liability for the owners with the benefits of partnership taxation, including the single level of tax and special allocations of income, losses, and cash flows. Owners are technically considered to be “members” rather than partners and are generally permitted to participate in management of the entity. A properly structured multi-owner LLC is generally treated as a partnership for all Federal tax purposes. Almost all states permit capital-intensive companies, nonprofessional service-oriented businesses, and some professional service-providing companies to operate as LLCs. Most of the entities in the examples in this chapter are structured as LLCs for state law purposes and are treated as partnerships for Federal tax purposes.

¹A “person” can be an individual, trust, estate, corporation, association, or another partnership. §§ 7701(a)(1) and (2).



TAX IN THE NEWS Who Uses Partnerships?

Partnerships come in all flavors and sizes! In about a decade, the number of U.S. partnerships increased by over 50 percent—from about 2.2 million entities in 2002 to about 3.4 million entities in 2012 (the most recent information available at this writing).

Partnerships are used in almost every type of industry—from agriculture to health care to waste management. Almost half of all partnerships are engaged in some sort of real estate business, but over one-half of assets are owned by partnerships in the finance and insurance sector. Certain elements of the tax

law make partnerships especially appealing for activities such as research and development and oil and gas exploration and extraction. All kinds of service activities are operated through some sort of partnership (especially limited liability partnerships): partnerships are common in the accounting, finance, law, education, and transportation services industries.

Source: IRS, *Statistics of Income Bulletin*, Winter 2015 and Fall 2004 reports based on 2012 and 2002 filing years.

- A **limited partnership (LP)** is a partnership with at least one general partner and one or more limited partners. These partnerships often have numerous limited partners and are used to raise capital for real estate development, oil and gas exploration, research and development, and various financial product investment vehicles. Typically, only the general partners are liable to creditors; each limited partner's risk of loss is restricted to that partner's equity investment in the entity. To reduce exposure to the entity's liabilities, the general partners are often corporations or LLCs. Limited partners, by definition, may not participate in management of the entity.
- A **limited liability partnership (LLP)** is treated similarly to a general partnership in most states. The primary difference between an LLP and a general partnership is that an LLP partner is not personally liable for any malpractice committed by other partners. The LLP is currently the organizational form of choice for the large accounting firms.
- A **limited liability limited partnership (LLLP)** is an extension of the limited partnership form in which all partners, whether general or limited, are accorded limited liability. At this writing, about half of U.S. states permit formation of LLLPs or recognize LLLPs formed in another state. Existing limited partnerships can acquire LLLP status by filing a proper request with the appropriate state jurisdiction.

A partnership is governed by a **partnership agreement**, which should explain the rights and obligations of the partners; the allocation of income, deductions, and cash flows; initial and future capital contribution requirements; conditions for terminating the partnership; and other matters. The governing agreement of an LLC has a similar structure and is known as an **operating agreement**.

The Big Picture

Return to the facts of *The Big Picture* on p. 21-1. When Beachside Properties is formed, Kyle, Maria, and Josh must decide which type of partnership to utilize.

With a general partnership, Kyle, Maria, and Josh would each be jointly and severally liable for all entity debts. With a limited partnership, one of the partners would be designated as a general partner and would be liable for all entity debts. Because all three partners want to have limited liability, they decide not to use a general or limited partnership.

They do not consider a limited liability partnership because that form is typically reserved for service-providing entities, such as accounting firms.

With a limited liability company (or, if their state permits, a limited liability limited partnership), each partner's losses will be limited to the partner's contributed capital. Therefore, Kyle, Maria, and Josh decide to form Beachside Properties as an LLC.

EXAMPLE

1

The “Check-the-Box” Regulations

The IRS’s “check-the-box” Regulations allow most unincorporated business entities—such as general partnerships, limited partnerships, LLPs, LLLPs, and LLCs—to select their Federal tax status.² As discussed in Chapter 17, if an unincorporated entity has two or more owners, it generally can choose to be taxed as either a partnership or a C corporation.

Election Out of Subchapter K

A partnership may elect out of the partnership taxation rules if it is involved in certain activities.³ If a proper election is made, the partnership is disregarded for Federal tax purposes and its operations are reported directly on the owners’ tax returns. Such elections “out” of partnership status are not common and are beyond the scope of this chapter.

LO.2

Describe the conceptual basis for partnership taxation and how partnership income is reported and taxed.

21-1b Key Concepts in Taxation of Partnership Income

A partnership is not a taxable entity.⁴ Rather, the taxable income or loss of the partnership flows through to the partners at the end of the partnership’s tax year.⁵ The partners report their allocable share of the partnership’s income or loss on their tax returns. The partnership itself pays no Federal income tax on its income; instead, the partners’ individual tax liabilities are affected by the activities of the entity.

EXAMPLE

2

Adam contributes land with a basis and value of \$60,000 in exchange for a 40% interest in the calendar year ABC LLC, which is taxed as a partnership. In 2015, the LLC generates \$200,000 of ordinary taxable income. Because the LLC needs capital for expansion and debt reduction, ABC makes no cash distributions during 2015. Adam is taxed on his \$80,000 allocable share of the LLC’s 2015 income ($\$200,000 \times 40\%$), even though he received no distributions from the entity during 2015.

The same result would occur if the LLC reported a loss: the LLC would allocate 40% of the loss to Adam, and he would deduct the loss, subject to the loss limitation rules discussed later in this chapter.

Conceptual Basis for Partnership Taxation

The unique tax treatment of partners and partnerships can be traced to two legal concepts: the **aggregate (or conduit) concept** and the **entity concept**. These theories influence practically every partnership tax rule.

Aggregate (or Conduit) Concept The aggregate concept treats the partnership as a channel through which income, credits, deductions, and other items flow to the partners. The partnership is regarded as a collection of taxpayers joined in an agency relationship. For example, the income tax is imposed on the partners rather than the partnership.

Entity Concept The entity concept treats partners and partnerships as separate units and gives the partnership its own tax “personality” by (1) requiring a partnership to file an information tax return and (2) treating partners as separate and distinct from the partnership in certain transactions between a partner and the entity.

Combined Concepts Some rules governing the formation, operation, and liquidation of a partnership contain a blend of the entity and aggregate concepts.

Separately Stated Items

In keeping with the aggregate theory, many items of partnership income, expense, gain, or loss retain their identity as they flow through to the partners. This separate

²Reg. §§ 301.7701-1 to -3.

³§ 761(a) outlines three types of business arrangements for which an election out of Subchapter K is permitted.

⁴§ 701.

⁵§ 702.

flow-through of certain items is required because such **separately stated items** *might* affect any two partners' tax liabilities in different ways.⁶ For example, charitable contributions are separately stated because partners need to compute their own deduction limitations for charitable contributions.

Typically, a partnership combines income and expenses related to the partnership's trade or business activities into a single income or loss amount that is passed through to the partners. As shown in Example 19, most other partnership items, such as investment income, gains, and losses, are separately stated.

Partners' Ownership and Allocation of Partnership Items

Another "aggregate" concept is that each partner typically owns both a **capital interest** and a **profits (loss) interest** in the partnership. A capital interest is measured by a partner's **capital sharing ratio**, which is the partner's percentage ownership of the capital of the partnership.

A profits (loss) interest is simply the partner's percentage allocation of the partnership's current operating results. **Profit and loss sharing ratios** are usually specified in the partnership agreement and are used to determine each partner's allocation of the partnership's ordinary taxable income (loss) and separately stated items.⁷

The partnership agreement may provide for a **special allocation** of various items to specified partners. It may also allocate items in a different proportion from the general profit and loss sharing ratios. As discussed later in the chapter, for a special allocation to be recognized for tax purposes, it must produce nontax economic consequences to the partners receiving the allocation.⁸

Inside and Outside Basis

In this chapter, there are numerous references to inside and outside basis. **Inside basis** refers to the partnership's adjusted tax basis for each asset it owns. **Outside basis** represents each partner's basis in the partnership interest. In many cases—especially upon formation of the partnership—the sum of the partnership's inside bases in its assets equals the sum of the partners' outside bases in their partnership interests.

When income or gain flows through to a partner from the partnership, the partner's outside basis in the partnership interest is increased. When a deduction or loss flows through to a partner, basis is reduced. The justification for these increases and decreases in the partner's basis is to ensure that these items are taxed only once.

In Example 2, Adam's outside basis in the LLC interest is \$60,000 after his contribution of land in exchange for the LLC interest. The LLC's inside basis in the land is also \$60,000. When Adam reports his \$80,000 share of the LLC's income, his outside basis is increased to \$140,000.

If Adam sold his interest at the beginning of 2016 for \$140,000, he would have no gain or loss. Instead, if there were no adjustments to basis, Adam's basis would be only \$60,000 and he would be taxed on an \$80,000 gain in addition to paying tax on his \$80,000 share of ABC's income. Without the basis adjustment, the LLC's income would be subject to double taxation.

EXAMPLE

3

Partnership Reporting

In keeping with the entity concept, a partnership must file an information return, Form 1065. This return accumulates information related to the partnership's operations and separately stated items. On this return, the partnership makes most elections regarding the treatment of partnership items, but no tax is calculated or paid with the return.

This return is due by the fifteenth day of the fourth month following the end of the tax year. For a calendar year partnership, this deadline is April 15. The partnership may request (by the original due date) an automatic five-month extension of time for filing

⁶§ 703(a)(1).

⁸§ 704(b).

⁷§ 704(a).

(to September 15 for a calendar-year partnership). Note that this extended due date is one month earlier than the extended deadline for individual taxpayers.

In addition to Form 1065, the partnership return includes a **Schedule K-1** for each partner that shows that partner's share of partnership items. Each partner receives a copy of Schedule K-1 for use in preparing the respective partner's tax return.

Anti-Abuse Provisions

Largely because of the interplay between the entity and aggregate concepts and their implementation in the tax law, partnership taxation is often very flexible. For example, partnership operating income or losses can sometimes be shifted among partners, and partnership capital gains and losses can sometimes be shifted from one partner to another. The Code contains many provisions designed to thwart unwarranted allocations, but the IRS believes opportunities for tax avoidance still abound. The IRS has adopted Regulations that allow it to recharacterize transactions that it considers to be "abusive."⁹

LO.3

Determine the tax effects of forming a partnership with cash and property contributions.

21-2 FORMATION OF A PARTNERSHIP: TAX EFFECTS

When a partnership is formed, the partners contribute cash and other property in exchange for the partnership interest. This transaction has implications for both the partners and the partnership. Are any gains or losses recognized? What is the basis for each property and the basis of each partnership interest? How does the partnership recover (depreciate, deduct, amortize) the basis of contributed property? What issues must the partnership address in its initial year?

21-2a Contributions to the Partnership

Congress intended the partnership formation transaction to be tax-neutral so that the partners could readily form a partnership without, in most cases, facing prohibitive tax consequences.

Gain or Loss Recognition

As a general rule, § 721 provides that neither the partner nor the partnership recognizes any realized gain or loss that arises when a partner contributes property to a partnership. This applies when the property is contributed in exchange for a partnership interest upon formation of the entity or if the contribution occurs at some later date. The realized gain or loss is deferred.¹⁰

There are two reasons for this treatment. First, forming a partnership allows investors to combine their assets toward greater economic goals than could be achieved separately. Only the form of ownership, rather than the amount owned by each investor, has changed. Second, because the partnership interest received is typically a nonliquid asset, the partner may not have sufficient cash with which to pay the tax.

Tax Results of Partnership Formation

EXAMPLE

4

Alicia transfers two assets to the Wren LLC on the day the entity is created, in exchange for a 60% profit and loss interest worth \$60,000. She contributes cash of \$40,000 and retail display fixtures (basis to her as a sole proprietor, \$8,000; fair market value, \$20,000). Alicia *realizes* a \$12,000 gain [\$60,000 fair market value of LLC interest – \$48,000 basis (\$40,000 cash + \$8,000 basis in fixtures)].

Under § 721, Alicia *does not recognize* the \$12,000 realized gain in the year of contribution. She received only a nonliquid LLC interest; she received no cash with which to pay any resulting tax liability.

⁹Reg. § 1.701-2.

¹⁰§ 721.

Tax Results of Partnership Formation

Assume the same facts as in Example 4, except that the fixtures Alicia contributes to the LLC have an adjusted basis of \$25,000. She has a \$5,000 *realized* loss [$\$60,000 - (\$40,000 + \$25,000)$], which she cannot deduct. Section 721 applies to losses as well as gains.

Alicia could achieve the same economic result, with the added benefit of a loss deduction, if she sold the fixtures at fair market value and contributed \$60,000 of cash to the LLC. The LLC could then use the contribution to buy similar fixtures.

EXAMPLE

5

Basis Issues

When a partner makes a tax-deferred contribution of an asset to the capital of a partnership, any potential gain or loss recognition is postponed rather than excluded.¹¹ The contributed assets held by the partnership and the partnership interest held by the partner are both assigned a basis that is derived from the partner's basis in the contributed property.

Partnership's Basis in Assets The partnership's basis in the contributed assets (inside basis) equals the partner's basis in the property prior to its transfer to the partnership. This is called a *carryover basis*: the partner's basis "carries over" to the partnership.

Partner's Basis in the Partnership Interest The partner's outside basis in the new partnership interest is the same as the partner's basis in the contributed assets. This is called a *substituted basis*: the basis in assets is "substituted" for the basis in the partnership interest.

Holding Period

Partnership's Holding Period in Assets The holding period for the contributed asset carries over to the partnership. Thus, the partnership's holding period for the contributed assets includes the period during which the partner owned the asset.

Partner's Holding Period in the Partnership Interest The partner's holding period in the partnership interest depends on the type of assets contributed to the entity. If a partner contributes only capital and § 1231 assets, the partner's holding period in the partnership interest is the same as that partner's holding period for these assets. If only cash or assets that are not capital or § 1231 assets are contributed, the holding period in the partnership interest begins on the date the partnership interest is acquired. If both categories of assets are contributed, the partnership interest is apportioned and a separate holding period applies to each portion.

Luis transfers a capital asset in exchange for a one-third interest in JKL LLC. The asset has an adjusted basis to Luis of \$10,000 and a fair market value of \$30,000. Luis has a \$20,000 realized gain on the exchange ($\$30,000 - \$10,000$), but under § 721, he does not recognize any of the gain.

Luis's basis for his LLC interest is the amount necessary to recognize the \$20,000 deferred gain if his LLC interest is subsequently sold for its \$30,000 fair market value. This amount, \$10,000, is the substituted basis. Luis's holding period for the capital asset "tacks" and becomes his holding period for the partnership interest.

The LLC's basis for the contributed property is the amount necessary to allow for the recognition of the \$20,000 deferred gain if the property is subsequently sold for its \$30,000 fair market value. This amount, also \$10,000, is the carryover basis. Luis's holding period for the capital asset becomes the partnership's holding period for the asset.

Note that if Luis had contributed cash for the interest, both his and the partnership's holding periods would begin on the date the cash was contributed.

EXAMPLE

6

¹¹§ 723.

21-2b Exceptions to the General Rule of § 721

In certain situations, the nonrecognition provisions of § 721 do not apply. The most widely applicable situations are when:

- Appreciated stocks and securities are contributed to an investment partnership.
- The transaction is essentially a taxable exchange of properties.
- The transaction is a disguised sale of properties.
- The partnership interest is received in exchange for services rendered to the partnership by the partner.

Investment Partnership

If the transfer consists of appreciated stocks and securities and the partnership is an investment partnership, it is possible that the realized gain on the stocks and securities will be recognized by the contributing partner at the time of contribution.¹² This provision prevents multiple investors from using the partnership form to diversify their investment portfolios on a tax-free basis. A similar provision, § 351(e), applies to corporations (see Chapter 18).

Exchange

If a transaction is essentially a taxable exchange of properties, tax on the gain is not deferred under the nonrecognition provisions of § 721.¹³

EXAMPLE

7

Sara owns land, and Brandon owns stock. Sara would like to have Brandon's stock, and Brandon wants Sara's land. If Sara and Brandon both contribute their property to newly formed SB Partnership in exchange for interests in the partnership, the tax on the transaction appears to be deferred under § 721. If the partnership then distributes the land to Brandon and the stock to Sara, the tax on this transaction also appears to be deferred under § 731 (discussed later in the chapter). Not so! The IRS will disregard the passage of the properties through the partnership and will hold, instead, that Sara and Brandon exchanged the land and stock directly. Thus, the transactions will be treated as any other taxable exchange.

Disguised Sale

A similar result occurs in a **disguised sale** of property or of a partnership interest. A disguised sale may occur when a partner contributes appreciated property to a partnership and soon thereafter receives a distribution from the partnership. This distribution may be viewed as a payment by the partnership for purchase of the property.¹⁴

EXAMPLE

8

Kim transfers property to the existing KLM Partnership. The property has an adjusted basis of \$10,000 and a fair market value of \$30,000. Two weeks later, the partnership distributes \$30,000 of cash to Kim. Under § 731, the distribution would not be taxable to Kim if the basis of her partnership interest prior to the distribution was greater than the \$30,000 of cash distributed. However, the transaction appears to be a disguised purchase-sale transaction. Therefore, Kim must recognize gain of \$20,000 on transfer of the property, and the partnership is deemed to have purchased the property for \$30,000.

Services

A partner may receive an interest in partnership capital or profits in exchange for services rendered to the partnership. In certain circumstances, receipt of such an interest does not qualify for nonrecognition treatment under § 721.

¹²§ 721(b).

¹³Reg. § 1.731-1(c)(3).

¹⁴§ 707(a)(2)(B) and related Regulations and Proposed Regulations.

Capital Interest Received in Exchange for Services When a partner receives a fully vested interest in partnership capital (i.e., unrestricted liquidation rights) in exchange for services, the value of the interest is generally taxable to the partner as ordinary compensation income. Services are not treated as “property” that can be transferred to a partnership on a tax-free basis. Generally, the partner’s ordinary income equals the amount the partner would receive if the partnership was liquidated immediately following the contribution of services, less any amount the partner paid for the interest. However, if the interest is subject to a “substantial risk of forfeiture” (as defined under § 83), the liquidation value would be \$0; so the partner would not recognize any income.¹⁵

Profits Interest Received in Exchange for Services When a partner receives an interest in the partnership’s future profits in exchange for services, the partner is not typically required to recognize any income at the time the interest is received, even if the partner is fully vested in the partnership interest. The amount of the partnership’s future profits cannot typically be determined, and no liquidation rights exist; so there is no current value to the interest. However, receipt of the profits interest might be currently taxable to the partner if (1) the future income of the partnership is assured, (2) the partnership interest is sold within two years of its receipt, or (3) the interest relates to a limited partnership interest in a publicly traded partnership.¹⁶

Effect on the Partnership and Other Partners In the case of a transfer of either an interest in partnership profits or capital, the partnership may deduct any amount included in the service partner’s income if the services are of a deductible nature.¹⁷ If the services are not deductible by the partnership, they must be capitalized. For example, the cost of architectural plans created by a partner are capitalized and included in the basis of the structure built with those plans. Alternatively, day-to-day management services performed by a partner for the partnership are usually deductible by the partnership. Any deduction related to the service partners’ interest is generally allocated to the other partners in the partnership.

Bill, Carlos, and Dave form BCD LLC, with each receiving a one-third interest in the capital and profits of the LLC. Dave receives his one-third interest as compensation for tax planning services he rendered prior to the formation of the LLC. The value of a one-third capital interest in the LLC (for each of the parties) is \$20,000. Dave recognizes \$20,000 of compensation income, and he has a \$20,000 basis in his LLC interest. The same result would occur if the LLC had paid Dave \$20,000 for his services and he immediately contributed that amount to the entity for a one-third ownership interest. The LLC will probably treat the \$20,000 as a startup expense under § 195, and amortization of that amount would be allocated to Bill and Carlos. Startup expenses are discussed later in the chapter.

EXAMPLE

9

21-2c Other Issues Relative to Property Contributed under § 721

When property is contributed to a partnership under the general rule of § 721, other issues arise, including depreciation and cost recovery of the assets, character of any subsequent gain or loss on disposition of the assets, and allocations related to the pre-contribution gain or loss inherent in the property.

Depreciation Method and Period

If depreciable property is contributed to the partnership, the partnership is usually required to use the same cost recovery method and life used by the partner. The

¹⁵§ 83(a); Reg. § 1.83-3 and the related Prop.Reg. § 1.83-3; Notice 2005-43, 2005-1 C.B. 1221.

¹⁶Rev.Proc. 93-27, 1993-2 C.B. 343, as clarified by Rev.Proc. 2001-43, 2001-2 C.B. 191.

¹⁷§ 83(h).

partnership merely “steps into the shoes” of the partner and continues the same cost recovery calculations. The partnership may not elect under § 179 to immediately expense any part of the basis of depreciable property it receives from the transferor partner.

Intangible Assets

If a partner contributes an existing “§ 197” intangible asset to the partnership, the partnership generally will “step into the shoes” of the partner in determining future amortization deductions. Section 197 intangible assets include goodwill, going-concern value, information systems, customer- or supplier-related intangible assets, patents, licenses obtained from a governmental unit, franchises, trademarks, covenants not to compete, and other items.

EXAMPLE

10

On September 1, 2013, at a cost of \$120,000, James obtained a license to operate a television station from the Federal Communications Commission. The license is effective for 20 years. On January 1, 2015, he contributes the license to the JS LLC in exchange for a 60% interest. The value of the license is still \$120,000 at that time.

The license is a § 197 asset because it is a license with a term greater than 15 years. The cost is amortized over 15 years. James claims amortization for 4 months in 2013 and 12 months in 2014. Thereafter, the LLC steps into James’s shoes in claiming amortization deductions over the remaining 13 years and 8 months.

Intangible assets that do not fall under the § 197 rules are amortized over their useful life, if any.¹⁸

Gain or Loss on Disposition of Receivables, Inventory, and Built-In Loss Properties

Under general tax accounting rules, the character of a gain or loss is determined based on the use of the property by the partnership. However, to prevent the conversion of ordinary income into capital gain, a partnership’s gain or loss is treated as ordinary when the partnership disposes of either of the following:¹⁹

- Contributed receivables that were unrealized in the contributing partner’s hands at the contribution date. Such receivables include the right to receive payment for goods or services delivered or to be delivered.
- Contributed property that was inventory in the contributor’s hands on the contribution date if the partnership disposes of the property within *five years of the contribution*. For this purpose, inventory includes all tangible property except capital assets and real or depreciable business assets.

EXAMPLE

11

Deon operates a cash basis retail electronics store as a sole proprietor. Raul is an enterprising individual who likes to invest in small businesses. On January 2 of the current year, Deon and Raul form the DR LLC. Their contributions to the LLC are as follows:

	Adjusted Basis	Fair Market Value
From Deon:		
Receivables	\$ -0-	\$ 20,000
Land used as parking lot*	12,000	50,000
Inventory	25,000	50,000
From Raul:		
Cash	120,000	120,000

*The parking lot had been held for nine months at the contribution date.

continued

¹⁸Reg § 1.167(a)-3.

¹⁹§ 724. For this purpose, § 724(d)(2) waives the holding period requirement in defining § 1231 property.

Within 30 days of formation, DR collects the receivables and sells the inventory for \$50,000 of cash. It uses the land for the next 10 months as a parking lot, then sells it for \$35,000 of cash. DR realizes the following income in the current year from these transactions:

- Ordinary income of \$20,000 from collecting the receivables.
- Ordinary income of \$25,000 from the sale of inventory.
- Section 1231 gain of \$23,000 from the sale of land.

Because the land takes a carryover holding period, it is treated as having been held 19 months at the sale date, thus meeting the one-year holding period requirement for receiving § 1231 classification.

A similar rule is designed to prevent a capital loss from being converted into an ordinary loss. Under the rule, if contributed property is disposed of at a loss and the property had a “built-in” capital loss on the contribution date, the loss is treated as a capital loss if the partnership disposes of the property *within five years of the contribution*. The capital loss is limited to the amount of the “built-in” loss on the date of contribution.

Assume the same facts as Example 11, except for the following:

- Deon held the land for investment purposes. It had a fair market value of \$8,000 at the contribution date.
- DR used the land as a parking lot for 10 months and sold it for \$6,500.

DR realizes the following income and loss from the land contribution and sale transactions:

- Capital loss of \$4,000 from the sale of the land (\$8,000 – \$12,000).
- Section 1231 loss of \$1,500 from the sale of the land (\$6,500 – \$8,000).

Because the land was sold within five years of the contribution date, the \$4,000 built-in loss is a capital loss. The post-contribution loss of \$1,500 is a § 1231 loss because DR used the property in its business.

EXAMPLE

12

Allocations Related to Contributed Property

As discussed later in the chapter, special allocations must be made relative to contributed property that is appreciated or depreciated. The partnership’s income and losses must be allocated under § 704(c) to ensure that the inherent gain or loss is not shifted away from the contributing partner. So, in Examples 11 and 12, the pre-contribution portion of the income, gains, and losses would be allocated to Deon.

The Big Picture

Return to the facts of *The Big Picture* on p. 21-1. Assume that Kyle’s \$2 million of contributed real estate consists of land with a \$600,000 basis and a fully depreciated building and fixtures (\$0 basis). Maria has fully depreciated the \$500,000 of bakery equipment and café furnishings that she contributed and so has a \$0 basis in those assets.

When Beachside Properties LLC is formed, no tax results for the LLC or for Kyle or Maria. Kyle does not recognize his \$1.4 million realized gain, nor does Maria recognize her \$500,000 realized gain.

Kyle takes a substituted basis of \$600,000 for his interest, and Maria takes a substituted basis of \$1.5 million (\$1.5 million of contributed cash + \$0 basis in contributed property). Beachside Properties assumes a carryover basis of \$600,000 for the real estate contributed by Kyle and \$0 for the property contributed by Maria. If there had been a remaining depreciable basis for any of the contributed property, the LLC would have “stepped into the member’s shoes” in calculating depreciation deductions. Any future income related to the pre-contribution gains would be allocated to the contributing member.

When Josh vests in his 5% *capital interest* in the LLC, the \$200,000 value of the interest is taxable to him because it is a capital interest received in exchange for services. Beachside Properties will capitalize this amount and allocate it to the building expansion and new fixtures. Josh’s 20% interest in the *future profits* of the LLC will be taxed to him as profits are earned by Beachside.

EXAMPLE

13

Concept Summary 21.1 reviews the rules that apply to partnership asset contributions and basis adjustments.



Concept Summary 21.1

Partnership Formation and Initial Basis Computations

- Under the general rule of § 721, partners or partnerships do not recognize gain or loss when property is contributed in exchange for capital interests.
 - Partners contributing property in exchange for partnership interests take the contributed property's adjusted basis for their *outside basis* in their partnership interest. The partners are said to take a substituted basis in their partnership interest.
 - The partnership will continue to use the contributing partner's basis as the *inside basis* in property it receives.
 - The holding period of a partner's interest includes that of contributed property when the property was a § 1231 asset or capital asset in the partner's hands. Otherwise, the holding period starts on the day the interest is acquired.
- The holding period of an interest acquired by a cash contribution starts at acquisition.
- The partnership's holding period for contributed property includes the contributing partner's holding period.
 - The partnership "steps into the partner's shoes" in calculating depreciation and amortization of contributed property.
 - Certain provisions prevent the recharacterization of ordinary income to capital gains for inventory and accounts receivable and prevent capital losses from being converted to ordinary losses.
 - The general rule of § 721 does not apply to partnership interests received in certain transactions, including formation of certain investment partnerships, disguised property exchanges, disguised sales, and receipt of a fully vested capital interest in exchange for services.

LO4

Identify elections available to a partnership and specify the tax treatment of expenditures of a newly formed partnership.

21-2d Tax Accounting Elections

A newly formed partnership must make numerous tax accounting elections. These elections are formal decisions on how a particular transaction or tax attribute should be handled. In general, these elections must be made by the partnership rather than by the partners individually.²⁰ For example, as discussed later in the chapter, the partnership selects its taxable year and accounting method, elects the treatment of organizational and startup expenditures, and determines the partnership's "qualified production activities income" (QPAI) and production-related wages for purposes of the § 199 deduction.

The partnership, rather than the partners, makes other elections under general tax accounting rules, including:

- Cost recovery methods and assumptions.
- Section 179 deductions for certain tangible personal property.
- Inventory method.
- Cost or percentage depletion method, excluding oil and gas wells.
- Treatment of research and experimental expenditures.

Each partner is bound by the decisions made by the partnership relative to these elections. If the partnership fails to make an election, a partner cannot make the election individually.

There are three rather narrow exceptions to this general rule. Each *partner* is separately required to make a specific election for the following tax issues:

- Whether to reduce the basis of depreciable property when first excluding income from discharge of indebtedness.
- Whether to claim cost or percentage depletion for oil and gas wells.
- Whether to take a deduction or credit for taxes paid to foreign countries and U.S. possessions.

²⁰§ 703(b).

21-2e Initial Costs of a Partnership

In its initial stages, a partnership incurs expenses related to some or all of the following activities: forming the partnership (organizational costs), starting business operations (startup costs), admitting partners to the partnership, marketing and selling partnership units to prospective partners (syndication costs), and acquiring assets.

Organizational and Startup Costs

Organizational costs include expenditures that are (1) incident to the creation of the partnership; (2) chargeable to a capital account; and (3) of a character that, if incident to the creation of a partnership with an ascertainable life, would be amortized over that life. Organizational costs include accounting fees and legal fees incident to the partnership's formation. The expenditures must be incurred within a period that starts a reasonable time before the partnership begins business. The period ends with the due date (without extensions) of the tax return for the initial tax year.

Startup costs include operating costs that are incurred after the entity is formed but before it begins business. Such costs include marketing surveys prior to conducting business, pre-operating advertising expenses, costs of establishing an accounting system, costs incurred to train employees before business begins, and salaries paid to executives and employees before the start of business.

For tax purposes, organizational costs and startup costs follow the same rules, although each type of cost is considered separately. As Examples 14 and 15 illustrate, for each type of expenditure, the partnership may elect to deduct up to \$5,000 of such expenditures in the year in which it begins business. This amount must be reduced, however, by expenditures in that category that exceed \$50,000. Any expenditures that cannot be deducted under this provision are amortizable over 180 months, beginning with the month in which the partnership begins business.²¹ The partnership is deemed to have elected the \$5,000 deduction and 180-month amortization treatment for each of these expenditures simply by deducting the proper amounts on the tax return.²²

Organizational and Startup Costs

Bluejay LLC was formed on June 1, 2015, and started business on July 1. Bluejay adopts a calendar year. During 2015, Bluejay incurred \$4,000 in legal fees for drafting the LLC's operating agreement and \$2,200 in accounting fees for tax advice of an organizational nature, for a total of \$6,200 of organizational costs.

The LLC may deduct \$5,040 of these costs on its 2015 tax return. This deduction is the sum of the \$5,000 permitted deduction and the \$40 ($\$1,200 \times 6/180$) amortization deduction for the \$1,200 of organizational costs that exceed the \$5,000 base amount.

EXAMPLE

14

Return to the facts of Example 14. In June 2015, Bluejay also incurred \$20,000 of pre-opening advertising expenses and \$34,000 of salaries and training costs for new employees before opening for business, for a total of \$54,000 of startup costs.

The LLC may deduct \$2,767 of these costs on its tax return for 2015. This deduction is the sum of the following:

- \$1,000, which is the \$5,000 permitted deduction reduced by the \$4,000 ($\$54,000 - \$50,000$) amount by which the startup costs exceed \$50,000.
- \$1,767 ($\$53,000 \times 6/180$) amortization of the remaining \$53,000 ($\$54,000 - \$1,000$) of startup costs for six months.

Thus, Bluejay can deduct \$5,040 of organizational costs and \$2,767 of startup costs on its 2015 tax return.

EXAMPLE

15

²¹§§ 709(b) and 195(b)(1).

²²Reg. §§ 1.709-1 and 1.195-1.

Syndication Costs

Syndication costs are capitalized, but no amortization election is available.²³ Syndication costs include the following expenditures incurred for promoting and marketing partnership interests:

- Brokerage fees.
- Registration fees.
- Legal fees paid for security advice or advice on the adequacy of tax disclosures in the prospectus or placement memo for securities law purposes.
- Accounting fees related to offering materials.
- Printing costs of prospectus, placement memos, and other selling materials.

Acquisition Costs of Depreciable Assets

As mentioned earlier, the partnership typically determines its depreciation deductions by “stepping into the shoes” of the contributing partner. If additional costs are incurred, though, the additional basis is treated as a new MACRS asset, placed in service on the date the cost is incurred (e.g., the date the asset is transferred to the partnership). For example, legal fees and transfer taxes incurred in transferring assets to a partnership must be capitalized. Cost recovery for these amounts commences when the underlying property is placed in service.

LO.5

Specify the accounting methods available to a partnership.

21-2f Method of Accounting

A newly formed partnership may adopt either the cash or accrual method of accounting or a hybrid of these two methods.

However, two exceptions limit use of the cash method of accounting by partnerships.²⁴ The cash method may *not* be adopted by a partnership that:

- Has one or more C corporation partners or
- Is a tax shelter.

As an “exception to the exception,” a partnership with a C corporation partner may still elect to use the cash method if:

- The partnership meets the \$5 million gross receipts test described below;
- The C corporation partner(s) is a qualified personal service corporation, such as an incorporated attorney; or
- The partnership is engaged in the business of farming.

A partnership meets the \$5 million gross receipts test if it has not received average annual gross receipts of more than \$5 million for all tax years. “Average annual gross receipts” is the average of gross receipts for the three tax years ending with the tax period *prior to* the tax year in question. For new partnerships, the period of existence is used. Gross receipts are annualized for short taxable periods. A partnership must change to the accrual method the first year *after* the year in which its average annual gross receipts exceed \$5 million. It must use the accrual method thereafter.

A tax shelter is a partnership whose interests have been sold in a registered offering or a partnership in which more than 35 percent of the losses are allocated to limited partners.

LO.6

List and explain the methods of determining a partnership’s tax year.

21-2g Taxable Year of the Partnership

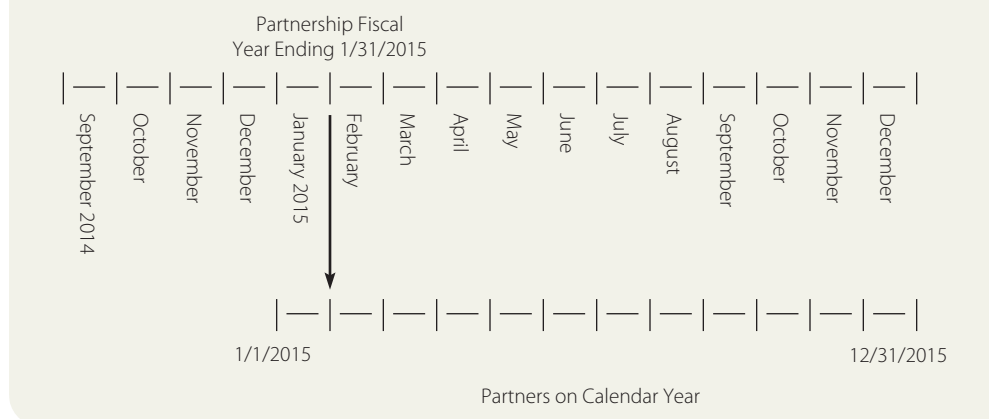
A partnership must use either the **required taxable year** or one of three alternate taxable years. Partnership taxable income (and any separately stated items) flows through to each partner at the end of the *partnership’s* taxable year. A *partner’s* taxable income,

²³§ 709(a).

²⁴§ 448.

EXHIBIT 21.1

Deferral Benefit If Partnership Could Use a Fiscal Year and All Partners Used the Calendar Year



then, includes the distributive share of partnership income for any *partnership* taxable year that ends during the partner's tax year.

Deferral of Partnership Income

The required taxable year rules prevent excessive deferral of taxation of partnership income. How might deferral arise? In the hypothetical example of Exhibit 21.1, the partners have a calendar tax year. If the partnership's adopted year ended on January 31, the reporting of income from the partnership and payment of related taxes would be deferred for up to 11 months. For instance, income earned by the partnership in February 2014 would not be taxable to the partners until the partnership's tax year closes on January 31, 2015. It would be reported in the partners' tax returns for the year ended December 31, 2015, which is not due until April 15, 2016. Even though each partner would be required to make quarterly estimated tax payments, some deferral might still be possible.

Required Taxable Year

The partnership's required taxable year is determined under the first of three rules that applies.²⁵ The partnership must consider each rule in order. First, the partnership uses the tax year of the "majority partners" if partners owning more than 50 percent of partnership capital and profits have the same tax year. If there are no "majority partners," the partnership uses the tax year of the "principal partners" if all partners who own 5 percent or more of capital or profits have the same tax year.

If no year-end is determined under either of these tests, the partnership determines a year under the **least aggregate deferral rule**. Under this rule, the partnership tests the year-ends that are used by the various partners to determine the weighted-average deferral of partnership income. The year-end that offers the least amount of deferral is the *required tax year* under this rule.

Crimson, Inc., and Indigo, Inc., are equal partners in the CI Partnership. Crimson uses the calendar year, and Indigo uses a fiscal year ending August 31. Neither Crimson nor Indigo is a majority partner as neither owns more than 50%. Although Crimson and Indigo are both principal partners, they do not have the same tax year. Therefore, the general rules indicate that the partnership's required tax year must be determined by the "least aggregate deferral rule." The following computations support August 31 as CI's tax year, because the 2.0 product using that year-end is less than the 4.0 product when December 31 is used.

EXAMPLE

16

continued

²⁵§ 706(b).

Test for Partnership 12/31 Year-End					
Partner	Year Ends	Profits Interest		Months of Deferral*	Product
Crimson, Inc.	12/31	50%	×	-0-	= 0.0
Indigo, Inc.	8/31	50%	×	8	= <u>4.0</u>
Aggregate number of deferral months					<u><u>4.0</u></u>

Test for Partnership 8/31 Year-End					
Partner	Year Ends	Profits Interest		Months of Deferral*	Product
Crimson, Inc.	12/31	50%	×	4	= 2.0
Indigo, Inc.	8/31	50%	×	-0-	= <u>0.0</u>
Aggregate number of deferral months					<u><u>2.0</u></u>

* Months from partnership's test year-end to partner's year-end.

Alternative Tax Years

If the required tax year is undesirable to the entity, three alternative tax years may be available:

- Establish to the IRS's satisfaction that a *business purpose* exists for a different tax year. This will typically be a "natural business year" (as defined)²⁶ that ends following a peak season or shortly thereafter.
- Elect a tax year so that taxes on partnership income are deferred for not more than *three months* from the *required* tax year.²⁷ This election is highly restrictive, can be expensive, and is not often made.
- Elect a 52- to 53-week taxable year that ends the same week as the required taxable year (or the taxable year elected under the three-month deferral rule) would end.

Concept Summary 21.2 summarizes the taxable years that are available to a partnership.

Concept Summary 21.2

Permitted Taxable Year-Ends for a Partnership

1. **Required taxable year.** A partnership will generally use the taxable year prescribed under § 706(b), which is the first of the following years that applies to the partnership:
 - Majority partners' tax year—More than 50% of capital and profits is owned by partners who have the same taxable year.
 - Principal partners' tax year—All partners who own 5% or more of capital or profits are principal partners; all principal partners have the same tax year.
 - Year with smallest amount of income deferral—"Least aggregate deferral rule" (see Example 16).
2. **Natural business year.** The partnership may, instead, try to establish that a business purpose exists for selecting a natural business year (i.e., a year that ends following a peak season).
3. **Section 444 taxable year.** The partnership may elect a taxable year that results in less than a three-month deferral of income from the required taxable year. The taxpayer must pay "interest" on any deemed deferred tax.
4. **52–53 week year.** For the selected taxable year (which must meet one of the above criteria), the taxpayer may choose a 52–53 week tax period under § 441(f).

²⁶Rev.Proc. 2006–46, 2006–2 C.B. 859, § 5.07.

²⁷§ 444.

21-3 OPERATIONS OF THE PARTNERSHIP

An individual, a corporation, a trust, an estate, or another partnership can become a partner in a partnership. Because a partnership is a tax-reporting, rather than a taxpaying, entity for purposes of its Federal (and state) income tax computations, the partnership's income, deductions, credits, and alternative minimum tax (AMT) preferences and adjustments can ultimately be reported and taxed on any of a number of income tax forms [e.g., Forms 1040 (individuals), 1041 (fiduciaries), 1120 (C corporations), and 1120S (S corporations)].

A partnership is subject to all other taxes in the same manner as any other business. Thus, the partnership files returns and pays the outstanding amount of appropriate sales taxes and property taxes. For employees (not partners), the partnership files returns and pays Social Security, unemployment, and other payroll taxes.

LO.7

Calculate a partnership's taxable income and separately stated items and describe how the partnership's income is reported.

21-3a Measuring and Reporting Partnership Income

The partnership's Form 1065 organizes and reports the transactions of the entity for the tax year. Each of the partnership's tax items is reported on Schedule K of that return. Each partner receives a Schedule K-1 that reports the partner's allocable share of the partnership's income, gains, losses, deductions, tax credits, adjustments, preferences, and other necessary tax reporting information.

Income Measurement

A partnership measures and reports two kinds of income: separately stated items and nonseparately stated ordinary (operating) income. A separately stated item is any item with tax attributes that could affect partners differently. Separately stated items are segregated and reported separately on the partnership's Schedule K and each partner's Schedule K-1. All other (nonseparately stated) income and expenses are reported as income from operations on page 1 of the partnership's Form 1065, and then the net amount is shown on Schedule K and allocated to the partners on their Schedules K-1. To get a full picture of a partnership's activities, review its Schedule K.

Among the many income and deduction items passed through separately are the following:

- Net short-term and net long-term capital gains or losses.
- Section 1231 gains and losses.
- Charitable contributions.
- Portfolio income items (qualified and ordinary dividends, interest, and royalties).
- Expenses related to portfolio income.
- Immediately expensed tangible personal property (§ 179).
- Guaranteed payments, discussed later in this section.
- Passive activity items such as rental real estate income or loss.
- Intangible drilling and development costs.
- Taxes paid to foreign countries and U.S. possessions.²⁸

The reason for separately reporting the preceding items is rooted in the aggregate or conduit concept. These items affect various exclusions, deductions, and credits at the partner level and must pass through without loss of identity so that the proper tax for each partner may be determined.²⁹

A partnership is not allowed to claim the following deductions:

- Net operating losses (NOLs).
- Depletion of oil and gas interests.
- Dividends received deduction.

²⁸§ 702(a).

²⁹§ 702(b).

Items that are only allowed by legislative grace to individuals, such as standard deductions or personal exemptions, are not allowed to the partnership. If a partnership makes a payment on behalf of a partner, such as for alimony, medical expenses, or other items that constitute deductions to individuals, the partnership treats the payment as a distribution or guaranteed payment to the partner, and the partner then determines whether a deduction may be claimed.

The Big Picture

EXAMPLE

17

Return to the facts of *The Big Picture* on p. 21-1. In its second year of operations, Beachside Properties LLC reports income and expenses from operating the café as well as rent income and expenses from leasing the other buildings. Beachside's activities are summarized as follows:

Sales revenue	\$2,000,000
Cost of sales	800,000
Salaries to employees	500,000
Cost recovery deductions	91,984
Utilities, supplies, and other expenses	128,016
Taxes and licenses (including payroll taxes)	60,000
Guaranteed payments to LLC members	240,000
Charitable contributions	6,000
Short-term capital gain	12,000
Net income from rental real estate	300,000
Qualified dividends received	4,000
Tax-exempt income (bond interest)	2,100
AMT adjustment (cost recovery)	18,224
Payment of medical expenses on behalf of Kyle	4,000
Distribution of cash to Josh	20,000

The LLC experienced a \$250,000 net loss from operations last year, its first year of business.

Beachside will determine its ordinary income or loss for the year, along with its separately stated items. As discussed next, the guaranteed payments are reported as income by the members and are either deducted or capitalized by the LLC. In addition, Beachside will report additional information the members might need to prepare their individual income tax returns.

Beachside cannot deduct last year's net \$250,000 loss—this loss was passed through to the LLC members in the previous year. The LLC is not allowed to deduct the payment for Kyle's medical expenses. This payment is probably handled as a distribution to Kyle, who may report it as a medical expense on his Schedule A in determining his itemized deductions. Similarly, the LLC cannot deduct the distribution to Josh (distributions are discussed later in this chapter). The AMT adjustment is not a separate component of the LLC's income. However, it must be reported to Beachside's members so that they can properly calculate any AMT liability.

Guaranteed Payments Paid by the Partnership

A **guaranteed payment** is a payment to a partner for services performed by the partner or for the use of the partner's capital. The partnership either deducts or capitalizes the payment, depending on its nature. As discussed later, regardless of the partnership's treatment, the partner reports the payment as ordinary income.

A guaranteed payment may not be determined by reference to partnership income. Guaranteed payments are usually expressed as a fixed-dollar amount or as a percentage of capital the partner has invested in the partnership.

The Big Picture

EXAMPLE

18

Return to the facts of *The Big Picture* as revised in Example 17. Assume that Josh was elected as managing member of Beachside Properties LLC; he has the sole authority to contract for the LLC and works 1,000 hours per year in the business. Maria works 1,000 hours per year in the café. After

continued

transferring his land to Beachside, Kyle has generally not been involved in the LLC's operations. In addition, recall that the LLC uses capital contributed by Maria and Kyle of \$2 million each.

Josh and Maria both receive guaranteed payments of \$5,000 per month for services to the LLC. In addition, Maria and Kyle both receive guaranteed payments of \$5,000 per month for the LLC's use of their capital. The guaranteed payments total \$240,000 for the year (12 months \times \$5,000 \times 4 payments). Beachside may deduct these payments.

Guaranteed payments resemble the salary or interest payments of other businesses.³⁰ Deductible guaranteed payments, like other deductible expenses of a partnership, can create an ordinary loss for the entity. If the partnership distributes appreciated property to pay the guaranteed payment, the partnership must recognize gain on the transfer.³¹

Partnership Reporting

Form 1065 Ordinary Income and Separately Stated Items The partnership's income is reported on Form 1065. Form 1065 contains five pages. Pages 1, 4, and 5 of the Beachside Form 1065 for its second tax year are found on subsequent pages. The entire Form 1065 and related tax forms are available at www.irs.gov. Page 1 summarizes the partnership's ordinary income and loss from the partnership's trade or business activities. Cost of goods sold is calculated on Form 1125-A and reported on page 1. Pages 2 and 3 provide information about the partnership's activities and general information about the partners. Page 4 (Schedule K) accumulates information related to separately stated items and other information the partners need to prepare their returns. Reported on the first line of Schedule K is the partnership's ordinary trade or business income from Form 1065, page 1.

Page 5 provides several schedules, including a balance sheet (Schedule L), a reconciliation of book and "taxable" income [Schedules M-1 and the Analysis of Net Income (Loss)], and a reconciliation of partners' beginning and ending capital (Schedule M-2).

The Big Picture

Continue with the facts of Examples 17 and 18 and refer to pages 1, 4, and 5 of Beachside's Form 1065 on subsequent pages. Beachside's ordinary income on Form 1065, page 1 is \$180,000 after considering the sales revenue, cost of sales, guaranteed payments, and other operating expenses.

On Schedule K (Form 1065, page 4), Beachside's separately stated income and deduction items (lines 1 to 13a) include net income from rental real estate, guaranteed payments to partners (to be reported as income by the partners), qualified dividends received, short-term capital gain, and charitable contributions.

Beachside's real estate rental operations are reported separately from the income from the bakery and will be shown on a Form 8825 included with Beachside's tax return. Beachside's *deduction* for guaranteed payments is shown on Form 1065, page 1, and the amount the LLC members must report as *income* is shown on Schedule K, line 4.

EXAMPLE

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Other Items Reported on Schedule K Starting on Schedule K, line 13d, the partnership must also report any additional information the partners need to prepare a complete and accurate income tax return. This information includes the partners' shares of the following:

- Line 13d. Information necessary to calculate the domestic production activities deduction (DPAD) described in Chapter 7.
- Line 14a. Self-employment income, for use in calculating the partner's self-employment tax and any additional Medicare tax.
- Line 15. Tax credits calculated and allocated at the partnership level.
- Line 16. Foreign-source income and other information the partners need to calculate any foreign tax credit or deduction.

³⁰§ 707(c).

³¹Rev.Rul. 2007-40, 2007-1 C.B. 1426.

- Line 17. AMT preferences and adjustments, for use in calculating the partner's alternative minimum tax.
- Line 18. Tax-exempt/nondeductible items that must be reflected in the partner's basis.
- Line 19. Distributions of cash and property.
- Line 20, Code A. Investment income, used to determine the partner's investment interest expense deduction limitation. Amounts on this line should generally only include amounts not taxed at favorable tax rates (e.g., interest income and non-qualified dividend income).
- Line 20, Code Y. Net investment income. On this line, report any amounts that might be subject to the net investment income tax (discussed later in this chapter) that are not readily identifiable as investment income on the Schedule K-1. For example, guaranteed payments for use of the partner's capital should be reported on this line, as they are subject to the net investment income tax. However, interest and dividends are not separately reported on this line because they are readily identifiable as investment income.

Most of the items listed above are determined based on general tax accounting rules discussed elsewhere in this text. Special rules apply in calculating the DPAD for a pass-through entity, as follows:³²

- Whether an activity qualifies for the DPAD is determined at the entity level.
- The actual DPAD is calculated at the partner (or S corporation shareholder) level.
- For many types of partnerships, QPAI and W-2 wages related to production can be calculated at the entity level.³³ Details of this calculation are beyond the scope of this chapter.
- For purposes of the DPAD, guaranteed payments to partners do not qualify as W-2 wages.
- On Schedule K-1, each partner is allocated a share of the amounts needed to calculate the DPAD, such as QPAI and W-2 wages related to domestic production activities.

The Big Picture

EXAMPLE

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Continue with the information in Examples 17 to 19. In addition to the business income and separately stated items described in Example 19, the LLC also reports the following information that the members will utilize in preparing their tax returns:

Additional Information (Schedule K)

Net earnings (loss) from self-employment (line 14a)	\$150,000
AMT adjustment—cost recovery (line 17a)	18,224
Tax-exempt income—bond interest (line 18a)	2,100
Distributions (line 19a)	24,000
Investment income (line 20a)	12,000
Net investment income (line 20c)	120,000

Investment income on line 20a (used to calculate any allowable investment interest expense deduction) includes Beachside's short-term capital gains but does not include favorably taxed qualified dividends.

Net investment income on line 20c (reported in a supporting schedule) includes guaranteed payments of \$60,000 paid to both Maria and Kyle for the LLC's use of their capital, but it does not include short-term capital gains or qualified dividends.

Beachside does not report any information to the members related to the § 199 deduction, because income from food and beverage sales is not considered to be a "domestic production" activity. The LLC members' self-employment tax and net investment income tax are discussed later.

³²See § 199(d)(1) and Reg. § 1.199-5.

³³Rev.Proc. 2007-34, 2007-1 C.B. 1345.

Form **1065**
 Department of the Treasury
 Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2014, or tax year beginning _____, 2014, ending _____, 20____.
 ▶ Information about Form 1065 and its separate instructions is at www.irs.gov/form1065.

OMB No. 1545-0123

2014

A Principal business activity <i>Restaurant/Commercial Rental</i>	Type or Print	Name of partnership <i>Beachside Properties LLC</i>	D Employer identification number <i>11-1111111</i>
B Principal product or service <i>Food service</i>		Number, street, and room or suite no. If a P.O. box, see the instructions. <i>1600 Ocean Vista Way</i>	E Date business started <i>1/1/2013</i>
C Business code number <i>722110</i>		City or town, state or province, country, and ZIP or foreign postal code <i>Surfside</i>	F Total assets (see the instructions) \$ <i>3,218,100</i>

- G** Check applicable boxes: (1) Initial return (2) Final return (3) Name change (4) Address change (5) Amended return (6) Technical termination - also check (1) or (2)
- H** Check accounting method: (1) Cash (2) Accrual (3) Other (specify) ▶ _____
- I** Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ _____ **3**
- J** Check if Schedules C and M-3 are attached

Caution. Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a Gross receipts or sales	1a	<i>2,000,000</i>		
	b Returns and allowances	1b			
	c Balance. Subtract line 1b from line 1a	1c		<i>2,000,000</i>	
	2 Cost of goods sold (attach Form 1125-A)	2		<i>800,000</i>	
	3 Gross profit. Subtract line 2 from line 1c	3		<i>1,200,000</i>	
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)	4			
	5 Net farm profit (loss) (attach Schedule F (Form 1040))	5			
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)	6			
7 Other income (loss) (attach statement)	7				
8 Total income (loss). Combine lines 3 through 7	8		<i>1,200,000</i>		
Deductions <small>(see the instructions for limitations)</small>	9 Salaries and wages (other than to partners) (less employment credits)	9		<i>500,000</i>	
	10 Guaranteed payments to partners	10		<i>240,000</i>	
	11 Repairs and maintenance	11			
	12 Bad debts	12			
	13 Rent	13			
	14 Taxes and licenses	14		<i>60,000</i>	
	15 Interest	15			
	16a Depreciation (if required, attach Form 4562)	16a	<i>91,984</i>		
	b Less depreciation reported on Form 1125-A and elsewhere on return	16b			
	16c		<i>91,984</i>		
	17 Depletion (Do not deduct oil and gas depletion.)	17			
18 Retirement plans, etc.	18				
19 Employee benefit programs	19				
20 Other deductions (attach statement)	20		<i>128,016</i>		
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21		<i>1,020,000</i>		
22 Ordinary business income (loss). Subtract line 21 from line 8	22		<i>180,000</i>		

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ _____ ▶ _____
 Signature of general partner or limited liability company member manager Date

May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ▶				Firm's EIN ▶
	Firm's address ▶				Phone no.

Schedule K		Partners' Distributive Share Items	Total amount	
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)	1	180,000
	2	Net rental real estate income (loss) (attach Form 8825)	2	300,000
	3a	Other gross rental income (loss)	3a	
	b	Expenses from other rental activities (attach statement)	3b	
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	0
	4	Guaranteed payments	4	240,000
	5	Interest income	5	
	6	Dividends: a Ordinary dividends	6a	4,000
		b Qualified dividends	6b	4,000
	7	Royalties	7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	8	12,000
9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))	9a		
	b Collectibles (28%) gain (loss)	9b		
	c Unrecaptured section 1250 gain (attach statement)	9c		
10	Net section 1231 gain (loss) (attach Form 4797)	10		
11	Other income (loss) (see instructions) Type ▶	11		
Deductions	12	Section 179 deduction (attach Form 4562)	12	
	13a	Contributions	13a	6,000
	b	Investment interest expense	13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶	13c(2)	
d	Other deductions (see instructions) Type ▶	13d		
Self-Employment	14a	Net earnings (loss) from self-employment	14a	150,000
	b	Gross farming or fishing income	14b	
	c	Gross nonfarm income	14c	720,000
Credits	15a	Low-income housing credit (section 42(j)(5))	15a	
	b	Low-income housing credit (other)	15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	15c	
	d	Other rental real estate credits (see instructions) Type ▶	15d	
	e	Other rental credits (see instructions) Type ▶	15e	
	f	Other credits (see instructions) Type ▶	15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	16b	
	c	Gross income sourced at partner level	16c	
		Foreign gross income sourced at partnership level		
	d	Passive category ▶ e General category ▶ f Other ▶	16f	
		Deductions allocated and apportioned at partner level		
	g	Interest expense ▶ h Other ▶	16h	
		Deductions allocated and apportioned at partnership level to foreign source income		
	i	Passive category ▶ j General category ▶ k Other ▶	16k	
l	Total foreign taxes (check one): ▶ Paid <input type="checkbox"/> Accrued <input type="checkbox"/>	16l		
m	Reduction in taxes available for credit (attach statement)	16m		
n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment	17a	18,224
	b	Adjusted gain or loss	17b	
	c	Depletion (other than oil and gas)	17c	
	d	Oil, gas, and geothermal properties—gross income	17d	
	e	Oil, gas, and geothermal properties—deductions	17e	
	f	Other AMT items (attach statement)	17f	
Other Information	18a	Tax-exempt interest income	18a	2,100
	b	Other tax-exempt income	18b	
	c	Nondeductible expenses	18c	
	19a	Distributions of cash and marketable securities	19a	24,000
	b	Distributions of other property	19b	
	20a	Investment income	20a	12,000
b	Investment expenses	20b		
c	Other items and amounts (attach statement) <i>\$120,000 guaranteed payments for capital</i>			

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l	1	730,000
2	Analysis by partner type:	(i) Corporate	(ii) Individual (active)
a	General partners		
b	Limited partners	486,000	244,000

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
Assets		(a)	(b)	(c)	(d)
1	Cash		97,503		123,740
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts		0		0
3	Inventories		60,000		80,000
4	U.S. government obligations				
5	Tax-exempt securities		40,000		40,000
6	Other current assets (attach statement)				
7a	Loans to partners (or persons related to partners)				
b	Mortgage and real estate loans				
8	Other investments (attach statement)		120,000		860,000
9a	Buildings and other depreciable assets	3,400,000		3,400,000	
b	Less accumulated depreciation	1,767,503	1,632,497	1,885,640	1,514,360
10a	Depletable assets				
b	Less accumulated depletion		0		0
11	Land (net of any amortization)		600,000		600,000
12a	Intangible assets (amortizable only)	10,000		10,000	
b	Less accumulated amortization	10,000	0	10,000	0
13	Other assets (attach statement)				
14	Total assets		2,550,000		3,218,100
Liabilities and Capital					
15	Accounts payable				
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (attach statement)				
18	All nonrecourse loans		500,000		600,000
19a	Loans from partners (or persons related to partners)				
b	Mortgages, notes, bonds payable in 1 year or more				
20	Other liabilities (attach statement)				
21	Partners' capital accounts		2,050,000		2,618,100
22	Total liabilities and capital		2,550,000		3,218,100

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return		Note. The partnership may be required to file Schedule M-3 (see instructions).	
1	Net income (loss) per books	492,100	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):	0	
3	Guaranteed payments (other than health insurance)	240,000	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):		
a	Depreciation \$		
b	Travel and entertainment \$	0	
5	Add lines 1 through 4	732,100	
6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):		
a	Tax-exempt interest \$	2,100	2,100
7	Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):		
a	Depreciation \$		0
8	Add lines 6 and 7		2,100
9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5		730,000

Schedule M-2 Analysis of Partners' Capital Accounts			
1	Balance at beginning of year	2,050,000	
2	Capital contributed: a Cash	100,000	
	b Property		
3	Net income (loss) per books	492,100	
4	Other increases (itemize):	0	
5	Add lines 1 through 4	2,642,100	
6	Distributions: a Cash		24,000
	b Property		
7	Other decreases (itemize):		
8	Add lines 6 and 7		24,000
9	Balance at end of year. Subtract line 8 from line 5		2,618,100

GLOBAL TAX ISSUES Withholding Requirements for Foreign Partners

A U.S. partnership may have foreign partners, and these partners will be taxed on their U.S. income. Because it might be difficult for the IRS to collect the tax owed by such foreign partners, several Code sections provide for various withholding procedures. The procedures differ depending on whether the income is “effectively connected with a U.S. trade or business,” derived from investment property, or related to real estate transactions.

If the partnership purchases real property from a foreign seller, for example, the partnership is generally required to withhold 10 percent of the purchase price. If a partnership sells a U.S. real property interest, it must typically withhold 20 percent of the gain allocated to a foreign partner. Further, if the partnership receives “fixed and determinable

annual or periodic payments” (FDAP), such as dividends, interest, or rents, it is typically required to withhold 30 percent of the foreign partner’s distributive share of such income.

Finally, if the partnership has U.S. business income, it must generally withhold and pay an amount equal to the highest U.S. tax rate applicable to the foreign taxpayer’s allocable share of partnership income. Note that many of these withholding requirements are reduced or eliminated through tax treaties between the United States and the foreign jurisdiction.

Source: See §§ 1441(b), 1445(a) and (e), and 1446(a) and related Regulations.

Reconciling Taxable Income The partnership reconciles “book” income with income reported on the return. Refer to pages 4 and 5 of Beachsider’s Form 1065 on previous pages.

The partnership calculates the net of the partnership’s income and expense amounts on Schedule K (lines 1 to 13) and reports that amount on line 1 of the Analysis of Net Income (Loss) (page 5 of Form 1065) to determine the partnership’s equivalent of “taxable income.” This is the amount to which book income must be reconciled on either Schedule M-1 or Schedule M-3.

Schedule M-1 is found on page 5 of Form 1065. Schedule M-3 is a separate three-page form. In general, Schedule M-3 is required in lieu of Schedule M-1 if certain conditions are met, such as if the partnership has \$10 million or more in assets or \$35 million or more in receipts (or if the partnership has a partner who meets those conditions). Beginning with calendar year 2014 partnership returns, some mid-sized partnerships (e.g., those with between \$10 million and \$50 million of assets) may be able to file Schedule M-1 and a portion of Schedule M-3 rather than complete the entire Schedule M-3. If a partnership is required to file Schedule M-3, it usually must also answer various questions on Schedule C.

The net taxable income calculated on the Analysis of Net Income (Loss) schedule should agree with the reconciled taxable income on Schedule M-1 (line 9) or the reconciled amount from Schedule M-3, Part II.

The Big Picture

EXAMPLE

21

Continue with the facts in Examples 17 to 20. Beachside Properties LLC must prepare the Analysis of Net Income (Loss) and Schedule M-1 on Form 1065, page 5. In preparing these schedules, the LLC combines the ordinary income of \$180,000, the guaranteed payments of \$240,000, and the four separately stated income and deduction amounts [lines 2, 6a, 8, and 13a (negative)] to arrive at “net income” of \$730,000. This amount is shown on line 1 of the Analysis of Net Income (Loss) and is the amount to which the \$492,100 of book income is reconciled on Schedule M-1, line 9.

Reconciling Partners’ Capital Schedule M-2 reconciles partners’ beginning and ending capital accounts. The analysis of capital accounts on Schedule M-2 reflects contributions to and distributions from the partnership as well as the partnership’s income, gains, losses, and deductions. Schedule M-2 can be prepared using any of several methods, including the tax basis, generally accepted accounting principles (GAAP), or the

“§ 704(b) book” method. The method used on Schedule M-2 should also be used in preparing the capital account reconciliation on the partners’ Schedules K-1.

Schedule L (on page 5 of Form 1065) generally shows an accounting-basis balance sheet. If the capital reconciliation method used in Schedule M-2 differs from the method used for Schedule L, a reconciling schedule should be provided.

The Big Picture

Continue with Examples 17 to 21 and the Beachside Properties Form 1065 excerpts. Beachside prepares its Schedule L and Schedule M-2 using the same method, so Beachside’s beginning and ending capital accounts have the same balances on both Schedule L and Schedule M-2.

In addition to Beachside’s book income, Schedule M-2 also reflects the \$20,000 cash distribution to Josh, payment of medical expenses of \$4,000 to Kyle, and (as discussed later) a contribution of cash of \$100,000 from Maria.

EXAMPLE

22

Withdrawals

Capital withdrawals by partners during the year do not affect the partnership’s income measuring and reporting process. These items are usually treated as distributions made on the last day of the partnership’s tax year. When withdrawals exceed the partners’ shares of partnership income, the excess is taxed under the distribution rules (discussed later in the chapter).³⁴

Penalties

A partner’s share of each partnership item should be reported on the partner’s respective tax return in the same manner as presented on the Form 1065. If a partner treats an item differently, the IRS must be notified of the inconsistent treatment.³⁵ If a partner fails to notify the IRS, a negligence penalty may be added to the tax due.

To encourage the filing of a partnership return, a penalty is imposed on the partnership of \$195 per partner per month (or fraction thereof, but not to exceed 12 months) for failure to file a complete and timely information return without reasonable cause.³⁶ A “small partnership” with 10 or fewer partners who are individuals (other than nonresident aliens), corporations, or an estate of a partner is exempt from these penalties.³⁷

21-3b Partner Allocations and Reporting

After ordinary income, separately stated items, and other related information are determined at the partnership level, those amounts must be allocated among the partners and reported on their tax returns. These allocations must have economic effect and substantiality, and they must take into account any precontribution gains and losses.

Economic Effect

As shown by the example of Beachside Properties in *The Big Picture*, a partnership agreement or an LLC’s operating agreement can provide that any partner may share capital, profits, and losses in the same ratios or in different ratios. For example, a partner could have a 25 percent capital sharing ratio, yet be allocated 30 percent of the profits and 20 percent of the losses of the partnership. Such special allocations have, at times, been used to manipulate the allocation of tax benefits among

LO.8

Outline and discuss the requirements for allocating income, gains, losses, deductions, and credits among the partners and describe how that income is reported.

³⁴ §§ 731(a)(1) and 733.

³⁵ § 6222.

³⁶ § 6698.

³⁷ § 6231(a)(1)(B).

partners. The Regulations³⁸ are designed to prevent unfair use of such allocations. Although these rules are too complex to discuss in detail, the general outline of one of these rules—the **economic effect test**—can be easily understood.

In general, the economic effect test requires the following:

- An allocation of income or gain to a partner must increase the partner's capital account, and an allocation of deduction or loss must decrease the partner's capital account. These “§ 704(b) book capital accounts” reflect the fair market values of the contributed property and must be maintained according to rules outlined in the Regulations.
- When the partner's interest is liquidated, the partner must receive net assets that have a fair market value equal to the positive balance in the capital account.
- A partner with a negative capital account must restore that account upon liquidation of the interest. Restoration of a negative capital account can best be envisioned as a contribution of cash to the partnership equal to the negative balance. Alternative tests (beyond the scope of this text) may also be used to meet this requirement.

These capital account maintenance requirements are designed to ensure that a partner bears the economic burden of a loss or deduction allocation and receives the economic benefit of an income or gain allocation.

The Big Picture

EXAMPLE

23

Continue with Examples 17 and 19 and the Beachside Properties Form 1065 excerpts. Maria arrives at the bakery at 4 A.M. (or earlier) six days a week to make sure her cinnamon rolls and croissants are ready when the bakery opens at 6. Consequently, the other LLC members have agreed with Maria that she should be allocated the first \$30,000 of profits from bakery operations each year, starting in year 2.

Beachside's Form 1065, page 1 for the LLC's second year of operations includes only the bakery's retail operations. Although the § 704(b) book income may differ from the \$180,000 ordinary income, to simplify this illustration, assume they are the same amount. Maria is entitled to the first \$30,000 shown on that page. The remaining \$150,000 of ordinary income and all other items of partnership income, gain, loss, or deduction are allocated based on the members' profit-sharing percentages.

Assume *for this example only* that the bakery operations are the only item impacting the § 704(b) book capital accounts this year and that the initial § 704(b) book capital amounts are as follows:

	Maria	Kyle	Josh
Beginning § 704(b) book capital	\$1,800,000	\$1,800,000	\$150,000
Special allocation	30,000	–0–	–0–
Allocation of remaining income	<u>60,000</u>	<u>60,000</u>	<u>30,000</u>
Ending § 704(b) book capital	<u>\$1,890,000</u>	<u>\$1,860,000</u>	<u>\$180,000</u>

This allocation will be respected as long as the members will eventually (i.e., currently or upon liquidation) receive cash and property that reflects these ending capital account values.

Substantiality

Partnership allocations must also have “substantial” effect. In general, an allocation does not meet the “substantial” test unless it has economic consequences in addition to tax consequences that might benefit a subset of the partners. Allocations are not generally permitted if they are for tax reasons only or if an allocation in one tax year is required to be offset by an equal allocation in a future tax year.

³⁸Reg. § 1.704–1(b).

The Big Picture

In Example 23, assume instead that the \$30,000 special allocation of net income was awarded to Maria in year 2 simply to allow Maria to utilize her personal expiring net operating loss carryover and that an offsetting \$30,000 special allocation of deductions would be made to Maria the following tax year.

Even though the LLC's allocations meet the "economic effect" tests, they would not be permitted because there is no substantial nontax economic reason for the allocations. The allocations over the two-year period serve only to reduce the LLC members' combined income tax liability.

EXAMPLE

24

Precontribution Gain or Loss

Certain income, gain, loss, and deductions relative to contributed property may not be allocated under the rules described above. Instead, **precontribution gain or loss** must be allocated among the partners to take into account the variation between the basis of the property and its fair market value on the date of contribution.³⁹ The partnership keeps track of these differences in its § 704(b) book accounting records. For nondepreciable property, *built-in* gain or loss on the date of contribution must be allocated to the contributing partner when the property is eventually disposed of by the partnership in a taxable transaction. If the property is depreciable, Regulations describe allowable methods of allocating depreciation deductions.⁴⁰

The Big Picture

Return to the facts of *The Big Picture* on p. 21-1. When Beachside Properties LLC was formed, Kyle contributed land (value of \$800,000 and basis of \$600,000) and buildings (value of \$1.2 million and basis of \$0). Maria contributed \$1.5 million of cash, plus equipment and furnishings (value of \$500,000 and basis of \$0). For § 704(b) book capital account purposes, Beachside records the land and other properties at their fair market values. For tax purposes, the LLC takes carryover bases in the properties. The LLC must keep track of the differences between the basis in each property and the value at the contribution date. If any of this property is sold, the gain must be allocated to the contributing partner to the extent of any previously unrecognized built-in gain.

For example, if Beachside sells the land contributed by Kyle for \$1.1 million, the gain would be calculated and allocated as follows:

	§ 704(b) Book	Tax
Amount realized	\$1,100,000	\$1,100,000
Less: Adjusted basis	(800,000)	(600,000)
Gain realized	\$ 300,000	\$ 500,000
Built-in gain to Kyle	(-0-)	(200,000)
Remaining gain (allocated proportionately)	\$ 300,000	\$ 300,000

For tax purposes, Kyle would recognize \$320,000 of the gain $[(\$300,000 \times 40\%) + \$200,000]$, Maria would recognize \$120,000 $(\$300,000 \times 40\%)$, and Josh would recognize \$60,000 $(\$300,000 \times 20\%)$.

If nondepreciable property has built-in losses at the contribution date, allocations related to the built-in loss can be made only to the contributing partner. For purposes of allocations to other partners, the partnership's basis in the loss property is treated as being the fair market value of the property at the contribution date.⁴¹

³⁹§ 704(c)(1)(A).

⁴⁰Reg. § 1.704-3.

⁴¹§ 704(c)(1)(C).

Schedule K-1

Once the partnership's items are calculated on Schedule K, they are allocated among the partners and reported on their Schedules K-1. Schedule K summarizes the tax-related items for the entire partnership. Schedule K-1 summarizes the tax-related items for each partner after considering the allocation conventions outlined in the partnership agreement or required under the Code. For each partnership item, the sum of the amounts allocated to all of the partners should equal the partnership's total amount per Schedule K. If an amount is specially allocated, that allocation will be reflected in the amounts reported on Schedule K-1.

Refer to Maria's Schedule K-1 from Beachside Properties on the following page. Part I includes information about the partnership. Part II includes information about the partner, including the partner's profit-, loss-, and capital-sharing percentages; share of partnership liabilities at the beginning and end of the year; and changes in the partner's capital account during the year.

Part III includes the information the partners use in completing their tax return. Lines 1 to 13 reflect the partner's distributive share of the partnership's income and deductions, including any amounts specially allocated to that partner. Lines 14 to 17 are used in determining other taxes or credits the partner should (or must) consider, such as self-employment tax, alternative minimum tax, foreign taxes, and various tax credits. The remaining lines are used in determining the partner's outside basis in the partnership interest. Schedule K-1 may be issued electronically if the partner so agrees.

The Big Picture

EXAMPLE

26

Continue with the examples on Beachside Properties and the Form 1065 excerpts. Also refer to Maria's Schedule K-1 on the following page. Maria, a 40% owner, will receive a Schedule K-1 from Beachside Properties. On her Schedule K-1, Maria receives a special allocation of the first \$30,000 of ordinary income from operations, plus a normal allocation of her 40% share of the remaining ordinary income. She is also allocated 40% of all separately stated items. On her Form 1040, Maria includes \$90,000 of ordinary income $\{\$30,000 + [40\% \times (\$180,000 - \$30,000)]\}$, a \$2,400 charitable contribution, a \$4,800 short-term capital gain, \$120,000 of passive rental income, and \$1,600 of qualified dividend income. On the first page of Form 1040, Maria lists her \$840 share of tax-exempt interest income. As shown in the next example, she must also consider the \$120,000 guaranteed payment she received. In determining her AMT liability (if any), Maria takes into account a \$7,290 positive adjustment.

Note that the specially allocated income simply increases Maria's amount on line 1 and decreases the amounts allocated to the other members. Kyle's and Josh's allocations on line 1 will be \$60,000 and \$30,000, respectively.

In her personal tax return, Maria combines the partnership's amounts with similar items from sources other than Beachside. For example, if Maria has a \$3,000 long-term capital loss from a stock transaction, the overall net short-term capital gain calculated on Schedule D of her 1040 is \$1,800 $(\$4,800 - \$3,000)$.

For each LLC item, the sum of the allocated amounts on Josh's, Kyle's, and Maria's K-1s will equal the totals on Beachside Properties' Schedule K. Thus, the three amounts on Schedule K-1, line 1, after the special allocation $(\$90,000 + \$60,000 + \$30,000)$, equal the total \$180,000 of ordinary income shown on Beachside's Form 1065, page 1.

A partner who receives guaranteed payments during a partnership year must include the payments in income as if they were received on the last day of the partnership year. Guaranteed payments are always taxable as ordinary income to the recipient partner. The partner's guaranteed payment is reported on Schedule K-1, line 4. The partner uses this information (in lieu of a Form W-2 or 1099) to report the income on the partner's tax return. Note that a guaranteed payment will often be subject to self-employment tax and, potentially, other additional taxes, as discussed later in the chapter.

651113

**Schedule K-1
(Form 1065)**

Department of the Treasury
Internal Revenue Service

2014

For calendar year 2014, or tax
year beginning _____, 2014
ending _____, 20_____

Final K-1 Amended K-1

OMB No. 1545-0123

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
11-111111

B Partnership's name, address, city, state, and ZIP code
*Beachside Properties LLC
1600 Ocean Vista Way
Surfside*

C IRS Center where partnership filed return
P.O. Box 409101, Ogden, UT 84409

D Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
111-11-1111

F Partner's name, address, city, state, and ZIP code
*Maria LeClerc
1600 Ocean Vista Way
Surfside*

G General partner or LLC member-manager Limited partner or other LLC member

H Domestic partner Foreign partner

I1 What type of entity is this partner? *Active Individual*

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	<i>40.000000 %</i>	<i>40.000000 %</i>
Loss	<i>40.000000 %</i>	<i>40.000000 %</i>
Capital	<i>47.500000 %</i>	<i>47.500000 %</i>

K Partner's share of liabilities at year end:

Nonrecourse \$ *240,000*

Qualified nonrecourse financing \$ _____

Recourse \$ _____

L Partner's capital account analysis:

Beginning capital account \$ *1,400,000*

Capital contributed during the year \$ *100,000*

Current year increase (decrease) \$ *214,840*

Withdrawals & distributions \$ *()*

Ending capital account \$ *1,714,840*

Tax basis GAAP Section 704(b) book
 Other (explain)

M Did the partner contribute property with a built-in gain or loss?
 Yes No
If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	<i>90,000</i>	15	Credits
2	Net rental real estate income (loss)	<i>120,000</i>		
3	Other net rental income (loss)		16	Foreign transactions
4	Guaranteed payments	<i>120,000</i>		
5	Interest income			
6a	Ordinary dividends	<i>1,600</i>		
6b	Qualified dividends	<i>1,600</i>		
7	Royalties			
8	Net short-term capital gain (loss)	<i>4,800</i>		
9a	Net long-term capital gain (loss)		17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		<i>A</i>	<i>7,290</i>
9c	Unrecaptured section 1250 gain			
10	Net section 1231 gain (loss)		18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		<i>A</i>	<i>840</i>
12	Section 179 deduction			
13	Other deductions			
<i>A</i>		<i>2,400</i>	19	Distributions
			<i>A</i>	<i>4,800</i>
			<i>Y</i>	<i>60,000</i>
14	Self-employment earnings (loss)	<i>60,000</i>		
<i>A</i>				
<i>C</i>		<i>480,000</i>		

*See attached statement for additional information.

For IRS Use Only

The Big Picture

EXAMPLE

27

Continue with the facts of Example 26. In addition to their allocations of ordinary income and separately stated items, Kyle and Josh will report as ordinary income their guaranteed payments of \$60,000, and Maria will report her \$120,000 guaranteed payment.

Concept Summary 21.3 reviews the tax reporting rules for partnership items at both the partnership and partner levels.

Concept Summary 21.3

Tax Reporting of Partnership Items

Item	Partnership Level (Form 1065)	Partner Level (Schedule K-1)
1. Partnership ordinary income or loss.	Page 1 line 22. Schedule K, line 1. The partnership deducts or capitalizes, as appropriate, guaranteed payments paid to the partners.	Line 1. Each partner's share is passed through for separate reporting. Special allocations, basis effects, and loss limitations may apply. Each partner reports as ordinary income any guaranteed payments received, per Schedule K-1, line 4. Some amounts may be specially allocated to specific partners.
2. Separately reported income and deduction items such as portfolio income, capital gain and loss, and § 179 deductions.	Schedule K, various lines.	Various lines. Each partner's share of each item is passed through for separate reporting. Special allocations, basis effects, and loss limitations may apply.
3. Additional calculations that partner is required to make (e.g., AMT and foreign tax credits).	Schedule K, various lines.	Various lines. Each partner's share of each item is passed through and considered in various calculations.
4. Net earnings from self-employment and net investment income.	Schedule K, line 14, Code A; and line 20, Code Y.	Line 14, Code A; and line 20, Code Y.

LO.9

Determine a partner's basis in the partnership interest.

21-3c Partner's Basis

Each partner has an initial outside basis. Outside basis is increased and decreased for the partner's share of each partnership operating item, whether taxable or tax-exempt. It is increased for property contributions and decreased for property distributions. In addition, all partnership liabilities are allocated among the partners and included in their outside bases. [In contrast, the liabilities of an S corporation are *not* included in the shareholders' bases (see Chapter 22).] Generally, the total of the partners' outside bases equals the partnership's inside basis in its assets.

Initial Basis in the Partnership Interest

A partner's basis in the partnership interest is important for determining the treatment of distributions from the partnership to the partner, establishing the deductibility of partnership losses, and calculating gain or loss on the partner's disposition of the partnership interest.

A partner's basis is not reflected anywhere on the Schedule K-1. Instead, each partner should maintain a personal record of the basis in the partnership interest. A partner's basis in a newly formed partnership usually equals (1) the adjusted basis in any property (or cash) the partner contributed to the partnership plus (2) the fair market value of

any services the partner performed for the partnership (i.e., the amount of ordinary income reported by the partner for services rendered to the partnership).

If a partnership interest is acquired after the partnership is formed, the method of acquisition controls how the partner's initial basis is computed. If the partnership interest is purchased from another partner, the purchasing partner's basis is the amount paid (cost basis) for the partnership interest. The basis of a partnership interest acquired by gift is the donor's basis for the interest plus, in certain cases, some or all of the transfer (gift) tax paid by the donor. The basis of a partnership interest acquired through inheritance generally is the fair market value of the interest on the date the partner dies.

Basis—Effect of Partnership Operations

After the partner is admitted to the partnership, the partner's basis is adjusted for numerous items. The following operating results *increase* a partner's adjusted basis:

- The partner's proportionate share of partnership income (including capital gains and tax-exempt income).
- The partner's proportionate share of any increase in partnership liabilities (as discussed in the next section).

The following operating results *decrease* the partner's adjusted basis in the partnership:

- The partner's proportionate share of partnership deductions and losses (including capital losses).
- The partner's proportionate share of nondeductible expenses.
- The partner's proportionate share of any reduction in partnership liabilities.⁴²

Under no circumstances can the partner's adjusted basis for the partnership interest be reduced below zero.

Increasing the adjusted basis for the partner's share of partnership taxable income is logical because the partner has already been taxed on the income. By increasing the partner's basis, the partner is not taxed again on the income when the interest is sold or a distribution is received from the partnership.

It is also logical that the tax-exempt income (or noncapitalizable, nondeductible expenditures) should increase (decrease) the partner's basis. If the income is exempt in the current period, it should not contribute to the recognition of gain when the partner either sells the interest or receives a distribution from the partnership.

Tyler is a one-third partner in the TUV LLP. His proportionate share of the partnership income during the current year consists of \$10,000 of tax-exempt income that is not distributed to Tyler. Tyler's adjusted basis and fair market value for the interest were \$35,000 and \$50,000, respectively, before considering this income. This translates to \$15,000 of unrealized appreciation for the partnership interest.

By increasing the adjusted basis of Tyler's partnership interest to \$45,000 (\$35,000 + \$10,000), the unrealized gain inherent in Tyler's partnership investment remains at \$15,000, and the \$10,000 of tax-exempt income will not be taxed upon a later sale of the partnership interest.

EXAMPLE

28

Basis—Effect of Partnership Liabilities

A partner's outside basis includes the partner's share of partnership debt.⁴³ Partnership debt includes any partnership obligation that creates an asset; results in an expense to the partnership; or results in a nondeductible, noncapitalizable item at the partnership level. This definition includes certain contingent liabilities.⁴⁴ The definition also includes most debt that is considered a liability under financial accounting rules. However, partnership debt does not include accounts payable of a *cash basis* partnership.

LO.10

Explain how liabilities affect a partner's basis.

⁴² §§ 705 and 752.

⁴³ § 752.

⁴⁴ Reg. § 1.752-1(a)(4)(ii).

Under § 752, an increase in a partner's share of partnership debt is treated as a cash contribution by the partner to the partnership and increases the partner's basis. A decrease in a partner's share of partnership debt is treated as a cash distribution from the partnership to the partner and decreases the partner's basis.

EXAMPLE

29

Jim and Becky contribute property to form the JB Partnership. Jim contributes cash of \$30,000. Becky contributes land with an adjusted basis and fair market value of \$45,000, subject to a liability of \$15,000. The partnership borrows \$50,000 to finance construction of a building on the contributed land. At the end of the first year, the accrual basis partnership owes \$3,500 in trade accounts payable to various vendors. Assume that no other operating activities occurred. If Jim and Becky share equally in liabilities, the partners' bases in their partnership interests are determined as follows:

Jim's Basis		Becky's Basis	
Contributed cash	\$30,000	Basis in contributed land	\$ 45,000
Share of debt on land (assumed by partnership)	<u>7,500</u>	Less: Debt assumed by partnership	(15,000)
		Share of debt on land (assumed by partnership)	<u>7,500</u>
Initial basis	\$37,500	Initial basis	\$ 37,500
Share of construction loan	25,000	Share of construction loan	25,000
Share of trade accounts payable (accrual basis)	<u>1,750</u>	Share of trade accounts payable (accrual basis)	<u>1,750</u>
Basis, end of first year	<u>\$64,250</u>	Basis, end of first year	<u>\$ 64,250</u>

If in the following year the partnership pays off its accounts payable, debt on land, or construction loan, the partners' bases are correspondingly decreased.

Partnership debt is classified as either recourse or nonrecourse. **Recourse debt** is partnership debt for which the partnership or at least one of the partners is personally liable. This personal liability can exist, for example, through the operation of state law or through personal guarantees that a partner makes to the creditor. **Nonrecourse debt** is debt for which no partner is personally liable. Lenders of nonrecourse debt generally require that collateral be pledged against the loan. Upon default, the lender can claim only the collateral, not the partners' personal assets. Note that for an LLC, most debt will be treated as nonrecourse debt because the LLC members typically are not personally liable for the debt.

Recourse Debt Rules Recourse debt is generally allocated among the partners and is included in their basis in accordance with a **constructive liquidation scenario**.⁴⁵ As illustrated in Example 30, under this scenario, the following events are *deemed* to occur at the end of each taxable year of the partnership:

1. Most partnership assets (including cash) become worthless.
2. The worthless assets are sold at fair market value (\$0), and losses on the deemed sales are determined.
3. These losses are allocated to the partners according to their loss sharing ratios. These losses reduce the partners' capital accounts.
4. Any partner with a (deemed) negative capital account balance is treated as contributing cash to the partnership to restore that negative balance to zero.
5. The cash deemed contributed by the partners with negative capital balances is used to pay the liabilities of the partnership.
6. The partnership is deemed to be liquidated immediately, and any remaining cash is distributed to partners with positive capital account balances.

⁴⁵See Reg. § 1.752-2 and related Regulations and Proposed Regulations.

A partner's share of partnership recourse liabilities equals the amount of the partner's cash contribution that would be used (in step 5 above) in payment of partnership recourse liabilities. This approach allocates debt based on each partner's "economic risk of loss." For a partnership in which all contributions and allocations have been proportionate to the capital contributions, recourse debt is essentially allocated in accordance with the partners' loss-sharing ratios.

On January 1 of the current year, Hill, Inc., and Dart, Inc., each contribute \$20,000 of cash to the newly created HD Partnership. Each partner has a 50% interest in partnership capital and profits. Losses are allocated 60% to Hill and 40% to Dart. The partnership's balance sheet was as follows on December 31:

	Basis	FMV		Basis	FMV
Cash	\$12,000	\$12,000	Recourse debt	\$30,000	\$30,000
Receivables	7,000	7,000	Hill, Inc. capital	19,500	19,500
Land and buildings	<u>50,000</u>	<u>50,000</u>	Dart, Inc. capital	<u>19,500</u>	<u>19,500</u>
	<u>\$69,000</u>	<u>\$69,000</u>		<u>\$69,000</u>	<u>\$69,000</u>

The recourse debt is shared in accordance with the constructive liquidation scenario. All of the partnership assets (including cash) are deemed to be worthless and sold for \$0. This creates a loss of \$69,000 (\$12,000 + \$7,000 + \$50,000).

The constructive liquidation scenario results in the \$69,000 loss being allocated \$41,400 to Hill (60%) and \$27,600 to Dart (40%). As a consequence, Hill's capital account has a negative balance of \$21,900, and Dart's account has a negative balance of \$8,100. Each partner is deemed to contribute cash equal to these negative capital accounts, which would be used to pay the recourse liabilities under the constructive liquidation scenario. Accordingly, Hill and Dart share \$21,900 and \$8,100, respectively, in the recourse debt. The debt allocation percentages (73% to Hill and 27% to Dart) are different from the partners' 60%/40% loss sharing ratios.

Note that if the partners shared losses equally, the intuitive result would arise. The \$69,000 constructive liquidation loss would be allocated equally (\$34,500 each) to Hill and Dart. As a result, each partner would have a \$15,000 negative capital account that would correspond to that partner's share of the partnership's recourse debt.

EXAMPLE

30

Nonrecourse Debt Rules As previously noted, debt of an LLC will fall into the nonrecourse category unless it has been personally guaranteed by one or more of the LLC's members. Nonrecourse debt is allocated to the partners' bases in three stages.

First, an amount of debt equal to the amount of *minimum gain* is allocated to partners who share in minimum gain as provided by the partnership agreement. In general, minimum gain approximates the amount of nonrecourse (mortgage) liability on a property in excess of the "book" basis of the property. The "book" basis for nondepreciable contributed property is its fair market value on the contribution date. Further details of the minimum gain calculation are beyond the scope of this text.

Second, the amount of nonrecourse debt equal to the remaining *precontribution gain* under § 704(c) is allocated to the partner who contributed the property and debt to the partnership. For this purpose, the remaining precontribution gain is the excess of the current nonrecourse debt balance on the contributed property over the current tax basis of the contributed property.⁴⁶ Note that this calculation is only relevant when the "book" and "tax" bases of the contributed property are different.

Third, any remaining nonrecourse debt is allocated to the partners in accordance with their profit sharing ratios.

⁴⁶Reg. § 1.704-3.

EXAMPLE

31

Ted contributes a nondepreciable asset to the TK LLC in exchange for a one-third interest in the capital, profits, and losses of the LLC. The asset has an adjusted tax basis to Ted and the LLC of \$24,000 and a fair market value and "book" basis on the contribution date of \$50,000. The asset is encumbered by a nonrecourse note of \$35,000 that has not been guaranteed by any of the LLC members.

- Step 1. Because the "book" basis exceeds the nonrecourse debt, there is no minimum gain.
 Step 2. Under § 704(c) principles, the first \$11,000 of the nonrecourse debt (\$35,000 debt – \$24,000 tax basis) is allocated to Ted.
 Step 3. The remaining \$24,000 of nonrecourse debt is allocated according to the members' profit sharing ratios, and Ted's share is \$8,000.

Summary. Ted shares in \$19,000 (\$11,000 + \$8,000) of the nonrecourse debt.

Ted's basis in his LLC interest is determined as follows:

Basis of contributed property	\$ 24,000
Less: Liability assumed by LLC	(35,000)
Plus: Allocation of § 704(c) debt	<u>11,000</u>
Basis before remaining allocation	\$ -0-
Plus: Allocation of remaining nonrecourse debt	<u>8,000</u>
Basis in LLC interest	<u>\$ 8,000</u>

The § 704(c) allocation of nonrecourse debt prevents Ted from receiving a deemed distribution (\$35,000) in excess of his basis in property he contributed (\$24,000). Without this required allocation of nonrecourse debt, in some cases, a contributing partner or an LLC member would be required to recognize gain on a contribution of property encumbered by nonrecourse debt.

Other Factors Affecting Basis Calculations

The partner's basis is also affected by (1) postacquisition contributions of cash or property to the partnership, (2) postacquisition distributions of cash or property from the partnership, and (3) special calculations that are designed to allow the full deduction of percentage depletion for oil and gas wells (beyond the scope of this text). Postacquisition contributions of cash or property affect basis in the same manner as contributions made upon the creation of the partnership. Postacquisition distributions of cash or property reduce basis.

The Big Picture

EXAMPLE

32

Return to the facts of *The Big Picture*. Example 26 described how the income and deduction items of Beachside Properties LLC are allocated to Maria on her Schedule K-1. But how is Maria's basis affected by those items?

Assume that at the beginning of that tax year (Beachside's second year of operations), Maria's basis in her LLC interest was \$1.6 million, including a \$200,000 share of the LLC's \$500,000 of nonrecourse debt. At the end of the year, Beachside had \$600,000 of debt, which was again treated as nonrecourse to all of the LLC members.

During the year, Maria contributes to the LLC cash of \$100,000 and additional property (basis of \$0 and fair market value of \$50,000). Maria's share of Beachside's income, gain, and deductions is described in Example 26 and on her Schedule K-1.

Maria's basis can be calculated using the ordering rules shown in Exhibit 21.2. At the end of the year, Maria's basis is as follows:

Beginning basis	\$1,600,000
Contributions, including increase in share of liabilities:	
Share of net increase in LLC liabilities [40% × (\$600,000 – \$500,000)]	40,000
Cash contribution to LLC capital	100,000
Maria's basis in noncash capital contribution	-0-

continued

Share of LLC income items:	
Ordinary LLC income	\$ 90,000
LLC's net passive income from rental real estate	120,000
Tax-exempt income	840
Short-term capital gain	4,800
Qualified dividend income	1,600
Distributions and withdrawals:	
Capital withdrawal	-0-
Share of LLC deduction items:	
Charitable contribution	(2,400)
Ending basis	<u>\$1,954,840</u>

As will be explained later in this chapter, Maria could withdraw cash from the LLC up to the amount of her basis without paying tax on the distribution.

Maria's basis does not appear on the LLC's tax return or on her Schedule K-1. All members are responsible for maintaining their own basis calculations.

When a partnership interest is sold, exchanged, or retired, the partner must compute the adjusted basis as of the date the transaction occurs. Computation of gain or loss requires an accurate calculation of the partner's adjusted basis on the transaction date.

Exhibit 21.2 summarizes the rules for computing a partner's basis in a partnership interest.

21-3d Partner's Capital Account

As mentioned earlier in the chapter, the partner's basis is not the same as the partner's capital account. Think of the capital account as an accounting calculation of the partner's ownership in the entity.

The capital account analysis (sometimes called a "rollforward" or "reconciliation") is shown on the partner's Schedule K-1 (see p. 21-29). This calculation shows the change in the partner's capital account from the beginning to the end of the tax year.

LO.11

Illustrate a partner's capital account rollforward and explain why the year-end balance might differ from the partner's year-end basis in the partnership interest.

EXHIBIT 21.2

Partner's Basis in Partnership Interest

Basis is generally adjusted in the following order:

Initial basis. Amount paid for partnership interest or gift or inherited basis (including share of partnership debt). Amount paid can be amount contributed to the partnership or amount paid to another partner or former partner.

- + Partner's subsequent contributions, including increases in the partner's share of partnership debt.
- + Since interest acquired, partner's share of the partnership's:
 - Taxable income items.
 - Tax-exempt income items.
 - Excess of depletion deductions over adjusted basis of property subject to depletion.
- Partner's distributions and withdrawals, including decreases in the partner's share of partnership debt.
- Since interest acquired, partner's share of the partnership's:
 - Separately stated deductions.
 - Nondeductible items not chargeable to a capital account.
 - Special depletion deduction for oil and gas wells.
 - Loss items.

The basis of a partner's interest can never be negative.

This capital account analysis can be prepared using any of several methods, including the tax basis, GAAP, or the § 704(b) book method. The method selected is indicated on the Schedule K-1 and should be the same method that was used in preparing the partnership's Schedule M-2. The partnership might need to keep track of partners' capital using more than one method—for example, using both GAAP and the § 704(b) book method.

The total of the partners' beginning and ending capital account balances of all Schedules K-1 should equal the beginning and ending balances shown on the partnership's Schedule M-2 (Analysis of Partners' Capital Accounts). These beginning and ending amounts should also generally equal the partners' capital accounts shown on the partnership's balance sheet (Schedule L) (or an explanation of the differences should be attached).

The partner's ending capital account balance is rarely the same amount as the partner's tax basis. For example, a partner's tax basis includes the partner's share of partnership liabilities; these liabilities are not included in a partner's capital. The partner's share of partnership liabilities is shown separately in Part II of the Schedule K-1.

Sometimes, the partner's ending basis in the partnership interest can be estimated by adding the partner's ending capital and the partner's share of liabilities. This would be accurate, for example, when the partner has been in the partnership since its inception and the capital account analysis is prepared on a tax basis.

The Big Picture

EXAMPLE

33

Maria's Schedule K-1 shows her capital account rollforward from the prior year to the current year. Her capital account was calculated on a tax basis, and the beginning capital account balance was \$1.4 million. The reconciliation shows the \$100,000 of cash Maria contributed and the \$0 basis of other contributed property.

The current-year increase (decrease) of \$214,840 is the combination (additions and subtractions) of Maria's amounts shown on Schedule K-1, Part III, on lines 1 to 13, plus the tax-exempt income shown on line 18. (Note that the ordinary/qualified dividends are only included one time and the guaranteed payments are not included.)

Maria's ending tax-basis capital account on Schedule K-1 is \$1,714,840. Her Schedule K-1 shows a \$240,000 share of nonrecourse liabilities. While this will not always be the case, the sum of these amounts equals her ending tax basis of \$1,954,840 as calculated in Example 32.

LO.12

List and review the limitations on deducting partnership losses.

21-3e Loss Limitations

Partnership losses flow through to the partners for use on their income tax returns. However, the amount and nature of the partner's deductible losses may be limited. When limitations apply, all or a portion of the losses are suspended until a triggering event occurs. Only then can the losses be used to determine the partner's tax liability. No time limit is imposed on such carryforwards of losses.

Three different limitations may apply to partnership losses that are passed through to a partner:

1. The first is the overall limitation contained in § 704(d). This limitation allows a loss deduction only to the extent of the partner's adjusted basis.
2. Losses that are deductible under the overall limitation may then be subject to the at-risk limitation of § 465. Losses are deductible under this provision only to the extent the partner is at risk for the partnership interest.
3. Any losses that survive this second limitation may be subject to a third limitation, the passive loss rules of § 469.

Only losses that make it through all three hurdles may be deducted on the partner's tax return. Special rules apply to losses from real estate activities.

EXAMPLE

34

Megan is a 50% member in Green LLC, which does not invest in real estate. On January 1, 2015, Megan's adjusted basis for her LLC interest is \$50,000, and her at-risk amount is \$35,000. Her share of losses from Green for 2015 is \$60,000, all of which is passive. She owns another investment that produced \$25,000 of passive income during 2015.

Megan will be able to deduct \$25,000 of Green's losses on her Form 1040 for 2015. Her deductible loss is calculated as follows:

Applicable Provision	Deductible Loss	Suspended Loss
§ 704(d) overall limitation	\$50,000	\$10,000
§ 465 at-risk limitation	35,000	15,000
§ 469 passive loss limitation	25,000	10,000

Megan can deduct only \$50,000 under the overall limitation. Of this \$50,000, only \$35,000 is deductible under the at-risk limitation. Under the passive loss limitation, passive losses can be deducted only against passive income. Thus, Megan can deduct only \$25,000 on her return in 2015.

Overall Limitation

As indicated above, a partner may deduct loss items and deductions flowing through from the partnership only to the extent of the partner's adjusted basis in the partnership. The basis is determined at the end of the partnership's taxable year. It is adjusted for any partnership income and gain items and contributions and distributions made during the year, but it is determined before considering any loss or deduction items for the year. (In Exhibit 21.2, basis would be calculated through "Partner's distributions and withdrawals.")

Losses that cannot be deducted because of this rule are suspended and carried forward (never back) for use against future increases in the partner's adjusted basis. Such increases might result from additional capital contributions, from sharing in additional partnership debt, or from future partnership income.

At-Risk Limitation

Under the at-risk rules, certain loss deductions are limited to amounts that are economically invested in the partnership. Limited losses are from business and income-producing activities allocated to individual partners and closely held C corporation partners [as defined in § 542(a)(2)]. Suspended losses are carried forward until a partner has a sufficient amount at risk in the activity to absorb them.⁴⁷

Invested amounts include cash, the adjusted basis of property contributed by the partner, and the partner's share of partnership earnings that have not been withdrawn.⁴⁸

When some or all of the partners are personally liable for partnership recourse debt, that debt is included in the adjusted basis of those partners. Usually, those partners also include the debt in their amount at risk.

As a general rule, partners cannot include nonrecourse debt in their amount at risk even though that debt is included in the adjusted basis of their partnership interest. In many cases, however, an exception to this general rule applies. Real estate nonrecourse financing provided by a bank, retirement plan, or similar party or by a Federal, state, or local government generally is deemed to be at risk.⁴⁹ Such debt is termed **qualified nonrecourse debt**.

⁴⁷§ 465(a)(2).

⁴⁸§ 465(a).

⁴⁹§ 465(b)(6).

EXAMPLE

35

In Example 34, Megan's amount at risk was \$35,000, and \$15,000 was suspended under the at-risk limitation. Assume this situation arose because Megan's basis in her LLC interest included a \$15,000 nonrecourse debt that could not be included in her amount at risk.

If, instead, the activity was a real estate activity and the debt was qualified nonrecourse financing, Megan's basis and at-risk amounts would have been the same (\$50,000) and no amount would have been suspended under § 465.

Passive Activity Rules

The third loss limitation is that passive activity losses can generally only be deducted to the extent they offset passive activity income.⁵⁰ These rules apply to partners who are individuals, estates, trusts, closely held C corporations, or personal service corporations. As discussed in Chapter 11, the rules require the partners to separate their activities into three groups:

- *Active.* Earned income, such as salary and wages; income or loss from a trade or business in which the partner materially participates; and guaranteed payments received by the partner for services.
- *Portfolio.* Annuity income, interest, dividends, guaranteed payments from a partnership for interest on capital, royalties not derived in the ordinary course of a trade or business, and gains and losses from disposal of investment assets.
- *Passive.* Income from a trade or business activity in which the partner does not materially participate on a regular, continuous, and substantial basis, or income from many rental activities.⁵¹

Material participation in an activity is determined annually. The IRS has provided a number of objective tests for determining material participation. These tests require the partner to have substantial involvement in daily operations of the activity. By definition, a partner treated as a limited partner is typically considered *not* to materially participate in partnership activities.⁵²

Rent income from real or personal property generally is passive income, regardless of the partner's level of participation. Exceptions are made for rent income from activities where substantial services are provided (e.g., certain developers and resorts); from hotels, motels, and other transient lodging; from short-term equipment rentals; and from certain developed real estate. In addition, rental real estate is not treated as a passive activity for a person who qualifies as a real estate professional.

In any one year, individuals can offset up to \$25,000 of passive losses from rental real estate against active and portfolio income.⁵³ The \$25,000 maximum is reduced by 50 percent of the difference between the taxpayer's modified AGI and \$100,000. Thus, when the taxpayer's modified AGI reaches \$150,000, the offset is eliminated. The offset is available to those who actively (rather than materially) participate in rental real estate activities.

For additional information regarding loss limitations, the passive loss rules, and the rental real estate exception, refer to Chapter 11.

LO.13

List and explain the special rules that govern the treatment of transactions between a partner and the partnership.

21-4 TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

Many types of transactions occur between a partnership and one of its partners. The partner may contribute property to the partnership, perform services for the partnership, or receive distributions from the partnership. The partner may borrow money from or lend money to the partnership. Property may be bought and sold between the partner

⁵⁰§ 469(a)(1).

⁵¹§§ 469(c)(1) and (2).

⁵²§ 469(h)(2).

⁵³§ 469(i).

and the partnership. Guaranteed payments and some of these other transactions were discussed earlier in the chapter. The remaining types of partner-partnership transactions are the focus of this section.

21-4a **Self-Employment Tax and § 1411 Tax of Partners**

A partner is not treated as an employee for tax purposes. Thus, a partner is not subject to withholding on any guaranteed payments, and the partnership cannot generally deduct its payments for any fringe benefits paid to the partners.

Certain types of partnership income allocated to a partner who is an individual taxpayer may be considered “net earnings from self-employment” [subject to self-employment (SE) tax] or “net investment income” (subject to tax under § 1411).

Self-Employment Income

Section 1402 provides for an SE tax consisting of a 12.4 percent tax for old-age, survivors, and disability insurance and a 2.9 percent tax for hospital insurance. In 2013 and later years, an additional Medicare tax of .9 percent applies to SE income in excess of \$250,000 for married taxpayers filing joint tax returns (or half that amount if a separate return is filed) or \$200,000 for other taxpayers. The taxpayer calculates the SE tax on Schedule SE and the additional Medicare tax on Form 8959.

SE Treatment of Distributive Shares SE income includes a general partner’s distributive share of income from a partnership’s trade or business, whether or not that income is distributed (e.g., income reported on line 1 of Schedule K-1). It also includes the distributive share allocated to a “limited partner” that is in the nature of compensation for services performed for or on behalf of the partnership.⁵⁴ However, SE income does not include the distributive share allocated to a limited partner who merely is an investor in the entity.

SE Treatment of Guaranteed Payments For both general and limited partners, any guaranteed payments for *services* are subject to the SE tax. Guaranteed payments for use of the partner’s capital are not subject to the SE tax.

Treatment as a General versus a Limited Partner For SE tax purposes, a taxpayer could save up to 15.3 percent of any distributive share by being treated as a limited, rather than general, partner. (Recall that an LLC member is often treated similarly to a limited partner.) As a result, this has been a contentious area for the IRS.

Proposed Regulations provide guidance regarding whether a partner or an LLC member should be treated as a general partner or a limited partner. These Regulations provide that a partner or an LLC member will be treated as a general partner if:

- The partner has personal liability for partnership debts by virtue of status as a partner,
- The partner can enter into contractual relationships on behalf of the partnership, or
- The partner works more than 500 hours in the partnership’s trade or business during the tax year.

If the partner is treated as a general partner solely because of the “hours worked” limitation, the interest can still be treated as a limited interest (for purposes of classifying the partner’s distributive share of income) if there is at least one other limited partner with identical rights.

In any event, under these Regulations, a “service partner” in any of the following service industries is always considered to be a general partner: health, law, engineering, architecture, accounting, actuarial science, or consulting.

⁵⁴ §§ 1402(a) and (a)(13). See also Prop.Reg. § 1.1402(a)-2(h).

Because of the proposed status of these Regulations, taxpayers are not required to comply with them or disclose any noncompliance. These Regulations are highly controversial and have existed since 1997 without being finalized.

The Big Picture

EXAMPLE

36

Return to the facts of *The Big Picture* in Examples 18 and 27. Beachside's Schedule K and Schedules K-1 were prepared in accordance with these Proposed Regulations, with the members' distributive shares and guaranteed payments being treated as follow:

	Distributive Share (Proposed Regulations)	Guaranteed Payments [§ 1402(a)(13)]
Kyle	\$60,000—not SE income	\$60,000—not SE income (capital)
Maria	\$90,000—not SE income*	\$60,000—SE income (services) and \$60,000—not SE income (capital)
Josh	\$30,000—SE income	\$60,000—SE income (services)

*Under the Proposed Regulations, Maria's distributive share is not SE income. She is not personally liable for the LLC's debt, and she is not authorized to contract on behalf of the LLC. Even though she works for the LLC more than 500 hours per year, another LLC member (Kyle) has the same rights as Maria; because Kyle would be classified as a limited partner, Maria is also classified as such. See Prop.Reg. § 1.1402(a)-2(i), Example (iii).

Section 1411 Tax

Under § 1411, an individual taxpayer's "net investment income" (NII) is subject to an additional tax of 3.8 percent to the extent the taxpayer's modified adjusted gross income exceeds \$250,000 for married taxpayers filing joint returns (or half that amount if a separate return is filed) or \$200,000 for other taxpayers. Modified adjusted gross income equals the taxpayer's adjusted gross income increased by any net foreign-earned income excluded from taxation under § 911. This tax is calculated on Form 8960.

Certain types of income allocated from a partnership are also treated as NII, including dividends, interest, passive income, and gains from property not used in a trade or business. In addition, the partner's distributive share is considered NII if the partner is a "passive" investor, as defined under § 469. The tax also applies to "income on investment of working capital," which includes guaranteed payments for use of a partner's capital. Tax-exempt income is not subject to this tax. As shown in Example 20 for Schedule K, the partner's Schedule K-1 also shows the partner's share of any net investment income that is not clearly indicated as such elsewhere on the Schedule K-1.

The Big Picture

EXAMPLE

37

Refer to the discussion of Schedule K on p. 21-19 and Maria's Schedule K-1 on p. 21-29. On line 20, Code Y, Beachside has reported Maria's NII of \$60,000 for the year. According to the IRS's instructions to Form 1065, this line includes only NII that is not evident from other Schedule K-1 information. In Maria's case, this amount consists of the guaranteed payment she received in exchange for capital. In addition, Maria's net investment income includes her distributive share of the partnership's qualified dividends (\$1,600) and net short-term capital gains (\$4,800). It does not include the \$840 of tax-exempt interest income reported to her on line 18.

Maria will prepare Form 8960 to calculate her net investment income tax. Assuming Maria has no net investment income from other sources and files as a single taxpayer, she will pay a tax of 3.8% on the lesser of \$66,400 (\$60,000 + \$1,600 + \$4,800) or the excess of her modified AGI over \$200,000.

21-4b Other Transactions between Partners and Partnerships

Certain transactions between a partner and the partnership are treated as if the partner were an outsider, dealing with the partnership at arm's length.⁵⁵ Loan transactions, rental payments, and sales of property between the partner and the partnership are treated in this manner. In addition, payments for services are generally treated this way when the services are short-term technical services the partner also provides for parties other than the partnership.

Sales of Property

Certain sales of property are subject to special rules. No loss is recognized on a sale of property between a person and a partnership when the person owns, directly or indirectly, more than 50 percent of partnership capital or profits.⁵⁶ The disallowed loss might not vanish entirely, however. If the transferee eventually sells the property at a gain, the disallowed loss reduces the gain the transferee would otherwise recognize.

Blake sells land (adjusted basis, \$30,000; fair market value, \$45,000) to a partnership in which he controls a 60% capital interest. The partnership pays him only \$20,000 for the land. Blake cannot deduct his \$10,000 realized loss. Blake and the partnership are related parties, and the loss is disallowed.

When the partnership sells the land to an outsider at a later date, it receives a sales price of \$44,000. The partnership can offset the recognition of its \$24,000 realized gain on the subsequent sale (\$44,000 sales proceeds – \$20,000 adjusted basis) by the amount of Blake's \$10,000 prior disallowed loss (\$20,000 – \$30,000). Thus, the partnership recognizes a \$14,000 gain on its sale of the land.

EXAMPLE

38

Using a similar rationale, any gain that is realized on a sale or exchange between a partner and a partnership in which the partner controls a capital or profits interest of more than 50 percent must be recognized as ordinary income, unless the asset is a capital asset to both the seller and the purchaser.⁵⁷ Note that this provision recharacterizes the gain from capital gain to ordinary income, whereas the above provision disallows a realized loss.

21-5 DISTRIBUTIONS FROM THE PARTNERSHIP

Distributions from a partnership generally reflect the aggregate theory, which holds that the partner essentially owns a share of the partnership's underlying assets. A routine cash withdrawal (or "draw") paid by a continuing partnership to a continuing partner reduces the partner's outside basis by the amount of the cash received. The partnership's inside basis in assets is similarly reduced.

21-5a Distributions in General

First consider a few definitions. A *distribution* is a payment from a partnership to a partner with respect to the partner's ownership interest in the partnership.

Not all payments from a partnership to a partner are treated as distributions. For example, as discussed earlier in the chapter, a partnership may pay rent to a partner for use of the partner's property, make a guaranteed payment to a partner for services or for use of the partner's capital, or purchase property from a partner.

LO.14

Define terms related to distributions from a partnership and determine the tax treatment of proportionate nonliquidating distributions from a partnership to a partner and the tax treatment of proportionate distributions that liquidate a partnership.

⁵⁵§ 707(a).

⁵⁶§ 707(b).

⁵⁷§ 707(b)(2).

Liquidating versus Nonliquidating Distributions

If a payment is treated as a distribution from the partnership to the partner, it will fall into one of two categories:

- Liquidating distributions.
- Nonliquidating distributions.

These distributions may consist of cash or partnership property. Whether a distribution is a **liquidating** or **nonliquidating distribution** depends solely on whether the partner remains a partner in the partnership after the distribution is made.

Liquidating Distributions A *liquidating distribution* occurs either (1) when a partnership itself liquidates and distributes all of its property to its partners or (2) when an ongoing partnership redeems the interest of one of its partners.

Nonliquidating Distributions A *nonliquidating distribution* (often called a “current distribution”) is any distribution from a continuing partnership to a continuing partner—that is, any distribution that is not a liquidating distribution.

EXAMPLE

39

Kate joins the calendar year KLM LLC on January 1, 2015, by contributing \$40,000 of cash in exchange for a one-third interest in the LLC’s capital, profits, and losses. Her distributive share of the LLC’s income for the year is \$25,000. If the LLC distributes \$65,000 (\$25,000 share of its profits + \$40,000 initial capital contribution) to Kate on December 31, 2015, the distribution is a nonliquidating distribution as long as Kate continues to be a member of the LLC. If, instead, the LLC is liquidated or Kate ceases to be a member of the ongoing LLC, the \$65,000 distribution is a liquidating distribution.

Proportionate versus Disproportionate Distributions

Each distribution is also classified based on whether it is proportionate or disproportionate. In a **proportionate distribution**, a partner receives the appropriate share of certain ordinary income-producing assets of the partnership. A **disproportionate distribution** occurs when the distribution increases or decreases the distributee partner’s interest in certain ordinary income-producing assets. The tax treatment of disproportionate distributions is complex and is beyond the scope of this discussion.

21-5b Proportionate Nonliquidating Distributions

In general, neither the partner nor the partnership recognizes gain or loss when a nonliquidating distribution occurs.⁵⁸ The partner usually takes a carryover basis in the assets distributed.⁵⁹ The distributee partner’s outside basis is reduced (but not below zero) by the amount of cash and the adjusted basis of property distributed.⁶⁰ As the following example illustrates, a distribution does not change a partner’s overall economic position.

Nonliquidating Distributions—The Basics

EXAMPLE

40

Steven owns a 25% interest in the SP LLC. On December 31 of the current year, his basis in the LLC interest is \$40,000. The fair market value of the interest is \$70,000. The LLC distributes \$25,000 of cash to him on that date. The distribution is not taxable to Steven or the LLC. The distribution reduces Steven’s adjusted basis in the LLC to \$15,000 (\$40,000 – \$25,000), and the fair market value of his LLC interest is, arguably, reduced to \$45,000 (\$70,000 – \$25,000).

⁵⁸ §§ 731(a) and (b).

⁵⁹ § 732(a)(1).

⁶⁰ § 733.

Nonliquidating Distributions—The Basics

Assume the same facts as in Example 40, except that the LLC distributes both the \$25,000 cash and land with an adjusted basis to the LLC of \$13,000 and a fair market value of \$30,000 on the date of distribution. The distribution is not taxable to Steven or the LLC. Steven reduces his basis in the LLC to \$2,000 [$\$40,000 - (\$25,000 + \$13,000)$] and takes a carryover basis of \$13,000 in the land. The fair market value of Steven's remaining interest in the LLC is, arguably, reduced to \$15,000 [$\$70,000 - (\$25,000 + \$30,000)$].

If Steven had sold his LLC interest for \$70,000 rather than receiving the distribution, he would have realized and recognized gain of \$30,000 ($\$70,000$ selling price $-$ $\$40,000$ outside basis). Because he has not recognized any gain or loss on the distribution of cash and land, he should still have the \$30,000 of deferred gain to recognize at some point in the future. This is exactly what will happen. If Steven sells the land and remaining LLC interest on January 1 of the next year (the day after the distribution), he realizes and recognizes gains of \$17,000 ($\$30,000 - \$13,000$) on the land and \$13,000 ($\$15,000 - \$2,000$) on the LLC interest. These gains total \$30,000, which is the amount of the original deferred gain.

EXAMPLE

41

Note the difference between the tax theory governing distributions from C corporations and partnerships. In a C corporation, a distribution from current or accumulated income (earnings and profits) is taxable as a dividend to the shareholder, and the corporation does not receive a deduction for the amount distributed. This is an example of corporate income being subject to double taxation. In a partnership, a distribution from current or accumulated profits is not taxable because Congress has decided that partnership income should be subject to only a single level of taxation. Because a partner pays taxes when the share of income is earned by the partnership, this income is not taxed again when distributed.

These results make sense under the entity and aggregate concepts. The entity concept applies to corporate dividends, so any amount paid as a dividend is treated as a transfer by the corporate entity to the shareholder and is taxed accordingly. Under the aggregate theory, though, a partner receiving a distribution of partnership income is treated as merely receiving something already owned. Whether the partner chooses to leave the income in the partnership or receive it in a distribution makes no difference.

Cash Distributions

Gain and Loss Recognition A proportionate nonliquidating distribution of cash is taxable to the partner if the distributed cash exceeds the outside basis of his or her interest in the partnership.⁶¹ In a nonliquidating distribution, losses are not recognized by the partner.

Samantha owns a one-third interest in the SMP LLC. Her basis in this ownership interest is \$50,000 on December 31, 2015, after accounting for the calendar year LLC's 2015 operations. On December 31, 2015, the LLC distributes \$60,000 of cash to Samantha. She recognizes a \$10,000 gain from this distribution ($\$60,000$ cash received $-$ $\$50,000$ basis in her LLC interest). Most likely, this gain is taxed as a capital gain.⁶²

EXAMPLE

42

While distributions *from* current and accumulated earnings are taxed differently to shareholders and partners, cash distributions *in excess* of accumulated profits are taxed similarly. Both shareholders and partners are allowed to recover the cumulative capital invested in the entity tax free.

Liability Reduction Treated as Cash Distribution Recall from earlier in the chapter that the reduction of a partner's share of partnership debt is treated as a distribution

⁶¹§ 731(a)(1).

⁶²§ 731(a). If the partnership holds any "hot assets," however, Samantha will probably recognize some ordinary income. See § 751(b) and the related discussion of ordinary income ("hot") assets later in this chapter.

of cash from the partnership to the partner. A reduction of a partner's share of partnership debt, then, first reduces the partner's basis in the partnership. Any reduction of a share of debt in excess of a partner's basis in the partnership is taxable to the partner as a gain.

EXAMPLE

43

Returning to the facts of Example 42, assume that Samantha's \$50,000 basis in her LLC interest included a \$60,000 share of the LLC's liabilities. If the LLC repays all of its liabilities, Samantha is treated as receiving a \$60,000 distribution from the LLC. The first \$50,000 of this distribution reduces her basis to \$0. The last \$10,000 distributed creates a taxable gain to her of \$10,000.

Marketable Security Distributions Treated as Cash A distribution of marketable securities can also be treated as a distribution of cash. Discussion of such distributions is beyond the scope of this chapter.

Property Distributions

In general, a distributee partner does not recognize gain from a property distribution. If the basis of property distributed by a partnership exceeds the partner's basis in the partnership interest, the distributed asset takes a substituted basis. This ensures that the partner does not receive asset basis that is not "paid for."

EXAMPLE

44

Amanda has a \$50,000 basis in her LLC interest. The LLC distributes land it owns with a basis and a fair market value of \$60,000. Amanda does not recognize any gain on this distribution because it is a distribution of property other than cash. Amanda takes a substituted basis of \$50,000 in the land. Her basis in her LLC interest is reduced by the basis she takes in the asset received, or \$50,000. Therefore, Amanda has a \$50,000 basis in the land and a \$0 basis in her LLC interest, and she recognizes no gain on this distribution.

Ordering Rules

When the inside basis of the distributed assets exceeds the distributee partner's outside basis, the assets are deemed distributed in the following order:

- Cash is distributed first.
- Unrealized receivables and inventory are distributed second.
- All other assets are distributed last.

Unrealized Receivables and Inventory Defined **Unrealized receivables** are receivables that have not yet been reported as income under the partnership's method of accounting and will ultimately be realized and recognized as ordinary income. For example, accounts receivable from services or sales of property will be unrealized receivables if the taxpayer uses the cash method, but not if the taxpayer uses the accrual method. In addition, for purposes of the distribution rules, unrealized receivables also include depreciation recapture income that will arise if the partnership sells its depreciable assets (regardless of whether the taxpayer uses the cash or accrual method).

Inventory, for purposes of these ordering rules, includes any partnership assets except cash, capital, or § 1231 assets. "Inventory" is so broadly defined that all accounts receivable are considered to be inventory, although only cash basis receivables are "unrealized receivables."

Basis in Distributed Property and Partnership Interest Because the partner typically does not recognize a gain from a *property* distribution, the partner's basis for property received cannot exceed the partner's basis in the partnership interest immediately before the distribution. For each level of asset distribution, the relevant adjustments are made to the partner's basis in the interest. For example, after a cash distribution, the

partner's basis in the interest is recomputed before determining the effect of a distribution of unrealized receivables or inventory. If the remaining outside basis at the end of any step is insufficient to cover the entire inside basis of the assets in the next step, that remaining outside basis is allocated among the assets within that class.⁶³

Effect of Ordering Rules

Lindsey has a \$48,000 basis in her partnership interest. On October 10 of the current tax year, the partnership distributes to her cash of \$12,000, cash basis receivables with an inside basis of \$0 and a fair market value of \$10,000, and a parcel of land with a basis and fair market value to the partnership of \$60,000. Lindsey has realized gain on the distribution of \$34,000 ($\$12,000 + \$10,000 + \$60,000 - \$48,000$). None of that gain is recognized, however, because the \$12,000 cash distribution does not exceed her \$48,000 adjusted basis for her partnership interest. In determining the basis effects of the distribution, the cash is treated as being distributed first, reducing Lindsey's adjusted basis to \$36,000 ($\$48,000 - \$12,000$). The receivables are distributed next, taking a \$0 carry-over basis to Lindsey. Her adjusted basis remains at \$36,000. The land is distributed last, taking a substituted basis of \$36,000 and reducing her adjusted basis for her partnership interest to \$0.

EXAMPLE

45

Assume the same facts as in Example 45 and that Lindsey sells the parcel of land early the following year for its fair market value of \$60,000. She also collects \$10,000 from the cash basis receivables. Now she recognizes all of the \$34,000 gain she deferred upon receiving the property from the partnership [$(\$60,000 \text{ amount realized} - \$36,000 \text{ basis for the land}) + (\$10,000 \text{ collected} - \$0 \text{ basis for the receivables})$].

EXAMPLE

46

In Examples 45 and 46, although Lindsey does not recognize any of the gain from the distribution, she has a zero outside basis for her partnership interest. If the partnership generates net losses in the following year, she will not be able to deduct them.

When more than one asset in a particular class is distributed, special rules may apply, as discussed under Proportionate Liquidating Distributions. Concept Summary 21.4 reviews the general rules that apply to proportionate nonliquidating partnership distributions.

21-5c Proportionate Liquidating Distributions

Proportionate liquidating distributions consist of a single distribution or a series of distributions that result in the termination of the partner's entire interest in the partnership. This section examines situations when a partner's interest is liquidated because the partnership is liquidating.

The partnership itself typically does not recognize either gain or loss on a proportionate liquidating distribution. The following discussion outlines rules for allocation of basis and possible gain or loss recognition by partners.

Gain Recognition and Ordering Rules

When a partnership liquidates, the liquidating distributions to a partner usually consist of an interest in several or all of the partnership's assets. As with a nonliquidating distribution, gain is recognized if distributed cash exceeds the partner's basis before the distribution. The ordering rules also parallel those for nonliquidating distributions, except that the partner's *entire* basis in the partnership interest is allocated to the assets received in the liquidating distribution, unless the partner is required to recognize a loss (see next section). As a result of the ordering rules, the basis of some assets may be adjusted upward or downward to absorb the partner's remaining outside basis. Unrealized receivables or inventory are never "stepped up," although they may be "stepped down."

⁶³§ 732.

Concept Summary 21.4

Proportionate Nonliquidating Distributions (General Rules)

- In general, neither the distributee partner nor the partnership recognizes any gain or loss on a proportionate nonliquidating distribution. If cash distributed exceeds the distributee partner's outside basis, however, gain is recognized. Property distributions generally do not result in gain recognition.
- The distributee partner usually takes the same basis in the distributed property that the property had to the partnership (carryover basis). However, where the inside basis of distributed property exceeds the partner's outside basis, the basis assigned to the distributed property cannot exceed that outside basis (substituted basis).
- Gain recognized by the distributee partner on a proportionate nonliquidating distribution is capital in nature.
- Loss is never recognized on a proportionate nonliquidating distribution.

Calculations

1. Partner's outside basis. _____
2. Less: Cash distributed to partner. _____
3. Gain recognized by partner (excess of line 2 over line 1). _____
4. Partner's remaining outside basis (line 1 – line 2). If less than \$0, enter \$0. _____
5. Partnership's inside basis of unrealized receivables and inventory distributed. _____
6. Partner's basis in unrealized receivables and inventory distributed (enter lesser of line 4 or line 5). _____
7. Partner's basis available to allocate to other property distributed (line 4 – line 6). _____
8. Partnership's inside basis of other property distributed. _____
9. Partner's basis in other property distributed (enter lesser of line 7 or line 8). _____
10. Partner's remaining outside basis (line 7 – line 9). _____

The general ordering and gain recognition rules for a proportionate liquidating distribution are summarized as follows:

- Cash is distributed first and results in a capital gain if the amount distributed exceeds the partner's basis in the partnership interest. The cash distributed reduces the liquidated partner's outside basis dollar for dollar. The partner's basis cannot be reduced below zero.
- Unrealized receivables and inventory are distributed next, and they take a basis equal to the lesser of the partnership's inside basis in those assets or the partner's remaining outside basis. The partner's outside basis is reduced by the amount of basis assigned to these ordinary income-producing assets.
- Finally, if the liquidating partner has any remaining outside basis, that basis is allocated to the other assets received.⁶⁴

EXAMPLE

47

When Tara's basis in her LLC interest is \$70,000, she receives cash of \$15,000, a proportionate share of inventory, and land in a distribution that liquidates both the LLC and her entire LLC interest. The inventory has a basis to the LLC of \$20,000 and a fair market value of \$30,000. The land's basis is \$8,000, and the fair market value is \$12,000. Under these circumstances, Tara recognizes no gain or loss. After Tara's \$70,000 basis is reduced by the \$15,000 cash received, the remaining \$55,000 is allocated first to the inventory and then to the land. The basis of the inventory in Tara's hands is \$20,000. The land absorbs Tara's remaining basis of \$35,000 (\$70,000 – \$15,000 – \$20,000).

⁶⁴ §§ 731 and 732.

Multiple Properties

When more than one asset in a particular class is distributed in either a proportionate nonliquidating distribution or a proportionate liquidating distribution, special rules may apply. If the partner's remaining basis for the partnership interest is *less than* the partnership's basis for the distributed assets in the particular class, the partner's remaining basis for each distributed asset is proportionately reduced, with an eye toward reducing the differences between each asset's basis and its fair market value.

If, however, in a liquidating distribution the partner's remaining basis for the partnership interest is *greater than* the partnership's basis for the distributed assets in the "other assets" class, the partner's basis for each remaining distributed asset is computed by following three steps:

- Step 1.* Each distributed asset within the "other asset" class initially takes a carryover basis.
- Step 2.* Then this carryover basis for each of these assets is increased in proportion to their respective amounts of unrealized appreciation (amount that fair market value is greater than carryover basis). Under no circumstances, however, can the basis of any asset be increased above its fair market value in step 2.
- Step 3.* Any remaining increase in basis is allocated among all of the distributed assets in the "other assets" class in proportion to their respective fair market values.

Assume the same facts as in Example 47, except that Tara receives two parcels of land instead of one. The LLC's basis for the parcels is \$2,000 for Parcel 1 and \$6,000 for Parcel 2. Each parcel has a fair market value of \$6,000.

Tara takes a \$15,000 basis for the cash and a \$20,000 carryover basis for the inventory. She has a \$35,000 basis for her LLC interest after these two items are distributed. Because two parcels of land are distributed and because Tara's remaining \$35,000 basis for her LLC interest exceeds the LLC's \$8,000 basis for the two parcels of land, Tara's basis for each parcel of land is computed by following these steps:

- Step 1.* She initially takes a carryover basis of \$2,000 for Parcel 1 and \$6,000 for Parcel 2.
- Step 2.* She increases the basis of Parcel 1 by \$4,000 to its fair market value of \$6,000. The basis for Parcel 2 is not affected in this step because Parcel 2 has a fair market value equal to its basis.
- Step 3.* Tara's \$23,000 (\$35,000 – \$6,000 – \$6,000) remaining basis is allocated to each land parcel in proportion to the parcels' respective \$6,000 fair market values after the step 2 allocation. Therefore, the amount of the step 3 basis increase allocated to each parcel is:

$$\$23,000 \text{ (remaining basis)} \times \frac{\$6,000 \text{ (step 2 basis)}}{\$12,000 \text{ (total step 2 basis)}} = \$11,500$$

Therefore, \$11,500 is allocated to each parcel. Tara's basis in Parcel 1 is \$17,500 [\$2,000 (initial basis) + \$4,000 (step 2 increase) + \$11,500 (step 3 increase)]. Her basis in Parcel 2 is also \$17,500 [\$6,000 (initial basis) + \$11,500 (step 3 increase)].

EXAMPLE

48

Loss Recognition

The distributee partner recognizes a *loss* on a liquidating distribution if both of the following are true:

- The partner receives *only* cash, unrealized receivables, or inventory.
- The partner's outside basis in the partnership interest exceeds the partnership's inside basis for the assets distributed in these categories. This excess is the amount of the loss recognized by the distributee partner.⁶⁵

⁶⁵§ 731(a)(2).

The word *only* is important. A distribution of any other property precludes recognition of the loss.

Liquidating Distributions with Potential Losses

EXAMPLE

49

When Ramon's outside basis is \$40,000, he receives a liquidating distribution of \$7,000 cash and a proportionate share of inventory having a partnership basis of \$3,000 and a fair market value of \$10,000. Ramon is not allowed to "step up" the basis in the inventory, so it is allocated a \$3,000 carryover basis. Ramon's unutilized outside basis is \$30,000 (\$40,000 – \$7,000 – \$3,000). Because he receives a liquidating distribution of *only* cash and inventory, he recognizes a capital loss of \$30,000 on the liquidation.

EXAMPLE

50

Assume the same facts as in Example 49, except that in addition to the cash and inventory, Ramon receives the desk he used in the partnership. (Assume that the distribution is proportionate to the partners, and disregard potential depreciation recapture.) The desk has an adjusted basis of \$100 to the partnership. Applying the rules outlined previously to this revised fact situation produces the following results:

- Step 1. Cash of \$7,000 is distributed to Ramon, and it reduces his outside basis to \$33,000.
- Step 2. Inventory is distributed to Ramon. He takes a \$3,000 carryover basis in the inventory and reduces his outside basis in the partnership to \$30,000.
- Step 3. The desk is distributed to Ramon. Because the desk is not cash, an unrealized receivable, or inventory, he cannot recognize a loss. Therefore, Ramon's remaining basis in his partnership interest is allocated to the desk. He takes a \$30,000 basis for the desk.

What can Ramon do with a \$30,000 desk? If he continues to use it in a trade or business, he can depreciate it. Once he has established his business use of the desk, he can sell it and recognize a large § 1231 loss. If the loss is isolated in the year of the sale, it is an ordinary loss. Thus, with proper planning, no liquidated partner should be forced to recognize a capital loss instead of an ordinary loss.

Gain recognized by the withdrawing partner on the subsequent disposition of inventory is ordinary income unless the disposition occurs more than five years after the distribution.⁶⁶ The withdrawing partner's holding period for all other property received in a liquidating distribution includes the partnership's related holding period.

LO.15

Calculate the selling partner's amount and character of gain or loss on the sale or exchange of a partnership interest.

21-6 SALE OF A PARTNERSHIP INTEREST

A partner can sell or exchange all or part of a partnership interest. The transaction can be between the partner and a third party; if so, it is similar in concept to a sale of corporate stock. However, in either type of transaction (sale or redemption), the results will differ for a partnership interest because both the entity and aggregate concepts apply. The result is that the gain or loss from disposition of a partnership interest may be divided into capital gain or loss and ordinary income or loss.

21-6a General Rules

Generally, the sale or exchange of a partnership interest results in gain or loss, measured by the difference between the amount realized and the selling partner's adjusted basis in the partnership interest.⁶⁷

Liabilities

In computing the amount realized and the adjusted basis of the interest sold, the selling partner's share of partnership liabilities must be determined. The purchasing partner includes any assumed indebtedness as a part of the consideration paid for the partnership interest.⁶⁸

⁶⁶§ 735(a)(2).

⁶⁷§ 741.

⁶⁸§ 742.

Cole originally contributed \$50,000 in cash for a one-third interest in the CDE LLC. During the time Cole was a member of the LLC, his share of the LLC's income was \$90,000 and he withdrew \$60,000 cash. Cole's capital account balance is now \$80,000, and the LLC's liabilities are \$45,000, of which Cole's share is \$15,000. Cole's outside basis is \$95,000 (\$80,000 capital account + \$15,000 share of the LLC's debts).

Cole sells his LLC interest to Stephanie for \$110,000 of cash, with Stephanie assuming Cole's share of the LLC's liabilities. The total amount realized by Cole is \$125,000 (\$110,000 cash received + \$15,000 of the LLC's debts transferred to Stephanie). Cole's gain on the sale is \$30,000 (\$125,000 amount realized – outside basis of \$95,000).

Stephanie's adjusted basis for her LLC interest is the purchase price of \$125,000 (\$110,000 cash paid + \$15,000 assumed LLC debt).

EXAMPLE

51

Income Allocation

When a partner sells an entire interest in the partnership:

- Income for the partnership interest for the tax year is allocated between the buying partner and the selling partner, and
- The partnership's tax year "closes" with respect to the selling partner.

The closing of the tax year causes the selling partner to report the share of income on the sale date rather than at the end of the partnership's tax year. There are several acceptable methods of determining the partner's share of income.⁶⁹

The selling partner's basis is adjusted for the allocated income or loss before the partner calculates the gain or loss on the sale of the interest.

On September 30, 2015, Erica sells her 20% interest in Evergreen LLC to Jason for \$25,000. Erica is a calendar year taxpayer. Evergreen owns no hot assets (see discussion below), and its tax year ends on June 30.

On July 1, 2015, Erica's basis in the LLC interest was \$8,000. Her share of current LLC income is \$10,000 for the period she owned the LLC interest (July 1 to September 30). Because the LLC's tax year closes with respect to Erica, she must report \$10,000 of income on her 2015 tax return. Her basis in the LLC interest is increased to \$18,000, and she recognizes a \$7,000 capital gain on the sale (\$25,000 – \$18,000).

Note that Erica will also report income from Evergreen's tax year ending on June 30, 2015, on her 2015 tax return.

EXAMPLE

52

21-6b Effect of Hot Assets

A major exception to capital gain or loss treatment on the sale or exchange of a partnership interest arises when a partnership has **hot assets**. In general, *hot assets* are *unrealized receivables* and *inventory*, which when collected or disposed of by the partnership, would cause it to recognize ordinary income or loss. When a partner sells the interest in a partnership, it is as if the partnership had sold its hot assets and allocated to the selling partner the partner's proportionate share of the ordinary income or loss created by the sale. The primary purpose of this rule is to prevent a partner from converting ordinary income into capital gain through the sale of a partnership interest.⁷⁰

Unrealized Receivables

As previously noted, unrealized receivables generally include the accounts receivable of a cash basis partnership and, for sale or exchange purposes, depreciation recapture potential.⁷¹

⁶⁹§ 706 (d)(1) and related Regulations and 2009 Proposed Regulations.

⁷⁰§ 751(a).

⁷¹§ 751(a)(1).

EXAMPLE

53

The cash basis Canary LLP owns only a \$10,000 receivable for rendering health care advice. Its basis in the receivable is zero because no income has been recognized. This item is a hot asset because ordinary income is not generated until Canary collects on the account.

Jacob, a 50% partner, sells his interest to Mark for \$5,000. If Jacob's basis in his partnership interest is \$0, his total gain is \$5,000. The entire gain is attributable to Jacob's share of the unrealized receivable, so his gain is taxed as ordinary income.

Inventory

For a sale or exchange of a partnership interest, the term *inventory* includes all partnership property except money, capital assets, and § 1231 assets. Receivables of an accrual basis partnership are included in the definition of inventory, as they are not cash, capital assets, or § 1231 assets.⁷² This definition also is broad enough to include all items considered to be unrealized receivables.

EXAMPLE

54

Jan sells her one-third interest in the JKL LLC to Matt for \$20,000 cash. The interest has an outside basis of \$15,000. On the sale date, the LLC's balance sheet reflects the following:

	Adjusted Basis	FMV		Adjusted Basis	FMV
Cash	\$10,000	\$10,000	Jan, capital	\$15,000	\$20,000
Inventory	21,000	30,000	Kelly, capital	15,000	20,000
Capital assets	14,000	20,000	Luis, capital	15,000	20,000
Total	<u>\$45,000</u>	<u>\$60,000</u>	Total	<u>\$45,000</u>	<u>\$60,000</u>

The overall gain on the sale is \$5,000 (\$20,000 – \$15,000). Jan's share of the appreciation in the inventory is \$3,000 [$(\$30,000 - \$21,000) \times 1/3$]. Therefore, she recognizes \$3,000 of ordinary income because of the inventory and \$2,000 of capital gain from the rest of the sale.

LO.16

Describe the application of partnership provisions to limited liability companies (LLCs) and limited liability partnerships (LLPs).

21-7 LIMITED LIABILITY ENTITIES

21-7a Limited Liability Companies

Owners of small businesses often want to combine the limited liability of a corporation with the pass-through provisions of a partnership. S corporations, described in Chapter 22, provide some of these advantages. The limited liability company is a form of entity that goes further in combining partnership taxation with limited personal liability for all owners of the entity.

Taxation of LLCs

A properly structured LLC with two or more owners is generally taxed as a partnership under the "check-the-box" rules. Because none of the LLC members are personally liable for any debts of the entity, the LLC is effectively treated as a limited partnership with no general partners. As described earlier in this chapter, this results in unusual application of partnership taxation rules in areas such as allocation of liabilities to the LLC members, inclusion or exclusion of debt for at-risk purposes, passive or active status of a member for passive loss purposes, and determination of a member's liability for self-employment tax.

Converting to an LLC

A partnership can convert to an LLC with few, if any, tax ramifications: the old elections of the partnership continue, and the partners retain their bases and ownership interests in the new entity. However, a C or S corporation that reorganizes as an LLC is treated as

⁷²§ 751(d).

having liquidated prior to forming the new entity. The transaction is taxable to both the corporation and the shareholders.

Advantages of an LLC

An LLC offers certain advantages over a limited partnership, including the following:

- Generally, none of the owners of an LLC are personally liable for the entity's debts. General partners in a limited partnership have personal liability for partnership recourse debts.
- Limited partners cannot participate in the management of the partnership. All owners of an LLC have the legal right to participate in the entity's management.

Disadvantages of an LLC

The disadvantages of an LLC stem primarily from the entity's relative newness and the lack of final Regulations in certain areas. There is only a limited body of case law interpreting the various state statutes, so the application of some provisions is uncertain. An additional uncertainty for LLCs that operate in more than one jurisdiction is which state's law will prevail and how it will be applied.

Among other factors, statutes differ from state to state as to the type of business an LLC can conduct—particularly as to the extent to which certain service-providing firms can operate as LLCs. A service entity may find that it can operate as an LLC in one state but not in another.

21-7b Limited Liability Partnerships

All states permit LLPs to be formed. Also, about half of the states have adopted legislation authorizing a variation known as a limited liability limited partnership (LLLP). The difference between a general partnership and an LLP is small, but very significant. Recall that general partners are jointly and severally liable for all partnership debts. In some states, partners in a registered LLP are jointly and severally liable for contractual liability (i.e., they are treated as general partners for commercial debt). They are also always personally liable for their own malpractice or other torts. They are not, however, personally liable for the malpractice and torts of their partners. As a result, the exposure of their personal assets to lawsuits filed against other partners and the partnership is considerably reduced.

An LLP must have formal documents of organization and register with the state. Because the LLP is a general partnership in other respects, it does not have to pay any state franchise taxes on its operations—an important difference between LLPs and LLCs in states that impose franchise taxes on LLCs. LLPs are taxed as partnerships under Federal tax statutes.

See Concept Summary 22.4 in Chapter 22 for a review of the various tax implications of LLCs and LLPs.

21-8 TAX PLANNING

Partnerships offer a single level of taxation and flexibility in structuring transactions that is not found in other entity forms. In addition, many types of partnerships can be structured to limit the partners' personal liability for entity debts. Proper planning should be used at all stages of entity formation and operations to ensure the results match the partners' expectations.

21-8a Choosing Partnership Taxation

A partnership often provides tax advantages over a C or S corporation. A partnership is subject to only a single level of taxation. Corporate income, however, is taxed at the entity level and upon distribution to corporate owners as dividends. Partnership income may be subject to high tax rates at the partner level, but this tax will generally be lower than the combined layers of tax on corporate income.

LO.17

Identify tax planning opportunities related to partnerships and their partners.

For both C and S corporations, income or loss allocations or distributions are required to be proportionate to the ownership interest of each shareholder. A partnership, though, may adjust its allocations of income and cash flow among the partners each year according to their needs, as long as the allocation meets the substantial economic effect and capital account maintenance rules discussed in the chapter.

Upon liquidation of a C or S corporation, any previously unrealized income, such as appreciation of corporate assets, is recognized at the entity level. As discussed in this chapter, a partnership generally may liquidate tax free.

Many states impose reporting and licensing requirements on corporate entities, including S corporations. These include franchise or capital stock tax returns that may require annual assessments and costly professional preparation assistance. Partnerships, on the other hand, often have no reporting requirements beyond Federal and state informational tax returns. (Note, however, that some states impose franchise taxes and additional filing requirements on LLCs.)

For smaller business operations, a partnership enables several owners to combine their resources at low cost. It also offers simple filing requirements, the taxation of income only once, and the ability to discontinue operations relatively inexpensively.

For larger business operations, a partnership offers a unique ability to raise capital with low filing and reporting costs compared to, for example, corporate bond issuances. Special allocations of income and cash-flow items may be used by partnerships to meet the objectives of the owners.

Concept Summary 21.5 lists various factors that the owners of a business should consider in deciding whether to use a C corporation, an S corporation, or a partnership as a means of doing business

21-8b **Formation and Operation of a Partnership**

Potential partners should be cautious in transferring assets to a partnership to ensure that they are not required to recognize any gain upon the creation of the entity. The nonrecognition provisions of § 721 are relatively straightforward and resemble the provisions under § 351, which permit certain tax-free property transfers to corporations. However, any partner can make a tax-deferred contribution of assets to the entity either at the inception of the partnership or later. This possibility is not available to less-than-controlling shareholders in a corporation.

The partners should anticipate the tax benefits and pitfalls that are presented in the Code and should take appropriate actions to resolve any potential problems before they arise. Typically, all that is needed is an appropriate provision in the partnership agreement (e.g., with respect to differing allocation percentages for gains and losses). Recall, however, that a special allocation of income, expense, or credit items in the partnership agreement must satisfy certain requirements before it is acceptable to the IRS.

21-8c **Basis Considerations and Loss Deduction Limitations**

If a partnership incurs a loss for the taxable year, careful planning will help ensure that the partners can claim the deduction.

A partner can contribute capital to the partnership before the end of the tax year. If economic conditions warrant, the partnership could incur additional debt. The partner's cash contribution or share of debt increases the partner's basis in the partnership interest. If the loss also meets the "at-risk" and "passive" hurdles, the loss can be deducted.

In the following year, if the partnership is expected to report taxable income, the partner could withdraw cash or pay off debt equal to the income. The partner's cash contribution would have to be invested in the partnership for only a short time. Similarly, the partnership's additional debt would not have to be maintained for a long period of time.

21-8d **Transactions between Partners and Partnerships**

Partners should be careful when engaging in transactions with the partnership to ensure that no negative tax results occur. A partner who owns a majority of the partnership



Concept Summary 21.5

Advantages and Disadvantages of the Partnership Form

The partnership form may be attractive when one or more of the following factors is present:

- The entity is generating net taxable losses and/or valuable tax credits, which will be of use to the owners.
- The owners want to avoid complex corporate administrative and filing requirements.
- The owners want to make special allocations of certain income or deduction items that are not possible under the C or S corporation forms.
- Other means by which to reduce the effects of the double taxation of corporate business income (e.g., compensation to owners, interest, and rental payments) have been exhausted. [Double taxation of a corporate entity can result in total Federal tax at rates up to 58.8% (35% corporate + 20% individual rate on dividends + 3.8% net investment income tax).]
- The entity does not generate material amounts of tax preference and adjustment items, which increase the alternative minimum tax liabilities of its owners.
- The entity is generating net passive income, which its owners can use to claim immediate deductions for net passive losses they have generated from other sources.
- The owners anticipate liquidation of the entity within a short period of time. Liquidation of a C or S corporation would generate entity-level recognized gains on appreciated property distributed.
- The owners have adequate bases in their ownership interests to facilitate the deduction of flow-through losses and the assignment of an adequate basis to assets distributed in kind to the owners.

The partnership form may be less attractive when one or more of the following factors is present:

- The tax paid by the individual owners on the entity's income is greater than the tax the entity would pay if it were a C corporation, and the income is not expected to be distributed soon. [If distributed by a C corporation, double taxation would likely occur at combined Federal rates of up to 58.8% (as shown left).]
- The entity is generating net taxable income without distributing any cash to the owners. The owners may not have sufficient cash with which to pay the tax on the entity's earnings.
- The type of income the entity is generating (e.g., business and portfolio income) is not as attractive to its owners as net passive income would be because the owners could use net passive income to absorb the net passive losses they have generated on their own.
- The entity is in a high-exposure business, and the owners want protection from personal liability. An LLC, LLP, or LLLP structure may be available, however, to limit personal liability.
- The owners want to minimize Federal self-employment and § 1411 tax.
- The entity has already been formed as a corporation, and conversion to partnership status could result in significant taxes in the course of liquidation.
- Partnership operations are complex (indicating that Form 1065 might not be filed until near the due date for the return), but partners with the same tax year need to file their returns as early as possible for personal reasons (e.g., to meet debt requirements or to receive a tax refund).

generally should not sell property at a loss to the partnership because the loss is disallowed. Similarly, a majority partner should not sell a capital asset to the partnership at a gain if the asset is to be used by the partnership as other than a capital asset. The gain on this transaction is taxed as ordinary income to the selling partner rather than as capital gain.

As an alternative to selling property to a partnership, the partner should consider a lease arrangement. The partner recognizes rent income, and the partnership has a rent expense. If the partner needs more cash immediately, the partner can sell the property to an outside third party who leases the property to the partnership for a fair rental.

21-8e Drafting the Partnership Agreement

Although a written partnership agreement (or an LLC operating agreement) is not always required, many rules governing the tax consequences to partners and their partnership refer to such an agreement. Remember that a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partnership agreement. In addition, the partner's status as a limited or general partner is often determined by reference to the rights the partner has in managing the entity.

Consequently, if taxpayers operating a business in partnership form want a measure of certainty as to the tax consequences of their activities, a carefully drafted partnership agreement is crucial. An agreement that sets forth the obligations, rights, and powers of the partners should prove invaluable in settling controversies among them and provide some degree of certainty as to the tax consequences of the partners' actions.

REFOCUS ON THE BIG PICTURE

WHY USE A PARTNERSHIP, ANYWAY?



After considering the various types of partnerships, Kyle, Maria, and Josh decided to form Beachside Properties as an LLC (see Example 1). On formation of the entity, there was no tax to the LLC or to any of its members (see Example 13). Beachside Properties computes its income as shown in Examples 17 and 19. Beachside determines additional information the three members will need (Example 20) and reconciles book and tax income and members' capital (Examples 21 and 22). Payments to the members for services or for the use of their capital are treated as guaranteed payments; the amounts are deducted by the LLC and reported as income by the LLC member (see Examples 18 and 27). A portion of ordinary income was specially allocated to Maria under the substantial economic effect rules; precontribution gains will eventually be specially allocated under § 704(c); the remaining income is allocated according to profit-sharing ratios (Examples 23 to 26). The LLC's income affects the members' bases and capital accounts as shown in Examples 32 and 33. An important consideration for the LLC members is whether their distributive shares and guaranteed payments will be treated as self-employment income or subject to net investment income tax (Examples 36 and 37).

What If?

What happens in the future when the LLC members decide to expand or renovate Beachside's facilities? At that time, the existing members can contribute additional funds, the LLC can obtain new members, or the entity can solicit third-party financing. An LLC is not subject to the 80 percent control requirement applicable to the formation of and subsequent transfers of property to a corporation. Therefore, new investors can contribute cash or other property in exchange for interests in the LLC—and the transaction will qualify for tax-deferred treatment under § 721.

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Key Terms

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Discussion Questions

1. **LO.1** What is a partnership agreement? What types of provisions does it include?
2. **LO.1** What is the difference between a general partnership and a limited liability company? When might each type of entity be used? Why?
3. **LO.2** Describe how a partnership reports its income for tax purposes. Who makes most elections related to partnership income and deductions? What theory underlies this treatment?
4. **LO.3** Compare the provision for the nonrecognition of gain or loss on contributions to a partnership (i.e., § 721) with the similar provision related to corporate formation (i.e., § 351). What are the major differences and similarities?
5. **LO.3, 4** How does a partnership calculate depreciation on property that is contributed by a partner? If the partnership incurs additional costs that must be capitalized (i.e., transfer taxes related to changing the title), how are those costs treated?
6. **LO.4** What types of expenditures might a new partnership incur? How are those costs treated for Federal tax purposes? Create a chart describing the expenditure, the treatment, and the Code section requiring this treatment.
7. **LO.5** When can a partnership use the cash method of accounting?
8. **LO.7, 8** What is a guaranteed payment? How is it reported on Form 1065 and its various schedules? How is it reported to and by the partner?
9. **LO.8** What is the purpose of the three rules that implement the economic effect test?
10. **LO.9, 10** Discuss the adjustments that must be made to a partner's basis in the partnership interest. When are such adjustments made?
11. **LO.11** What is a partner's capital account? Describe how a partner's ending capital account balance is determined.
12. **LO.13** When is partnership income subject to self-employment tax or the net investment income tax by an individual partner?
13. **LO.10, 12, 17** Discuss situations in which the partnership entity form might be more advantageous (or disadvantageous) than operating as a Subchapter C or S corporation.
14. **LO.14** What is the difference between the definition of a proportionate nonliquidating distribution and a proportionate liquidating distribution? What is the significance of the word *proportionate*?
15. **LO.14** How does a proportionate nonliquidating distribution of cash from a partnership to a partner compare with one from a Subchapter C corporation to a shareholder?

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16. **LO.2** Enercio contributes \$100,000 in exchange for a 40% interest in the calendar year ABC LLC, which is taxed as a partnership. In 2015, the LLC generates \$80,000 of ordinary taxable income. Enercio withdrew \$10,000 from the partnership during 2015. Enercio is taxed on what amount of the LLC's 2015 income? On how much of the \$10,000 distribution will Enercio be taxed?

17. **LO.3** Henrietta transfers cash of \$75,000 and equipment with a fair market value of \$25,000 (basis to her as a sole proprietor, \$10,000) in exchange for a 40% profit and loss interest worth \$100,000 in a partnership.
- How much are Henrietta's realized and recognized gains?
 - What is the amount of Henrietta's basis in her partnership interest?
 - What is the partnership's basis in the contributed equipment?
18. **LO.3** On January 2 of the current year, Fenton and Myers form the FM LLC. Their contributions to the LLC are as follows:

	Adjusted Basis	Fair Market Value
From Fenton:		
Cash	\$ 50,000	\$ 50,000
Accounts receivable	-0-	90,000
Inventory	25,000	60,000
From Myers:		
Cash	200,000	200,000

Within 30 days of formation, FM collects the receivables and sells the inventory for \$60,000 cash. How much income does FM recognize from these transactions, and what is its character?

19. **LO.7** During 2016, the Taste Partnership reported income before guaranteed payments of \$92,000. Stella owns a 90% profits interest and works 1,600 hours per year in the business. Euclid owns a 10% profits interest and performs no services for the partnership during the year. For services performed in 2016, Stella receives a "salary" of \$6,000 per month. Euclid withdrew \$10,000 from the partnership during the year.
- What is the amount of guaranteed payments made by the partnership during 2016?
 - How much is the partnership's ordinary income after any deduction for guaranteed payments?
 - How much income will Stella report? Euclid?
20. **LO.8** When Padgett Properties LLC was formed, Nova contributed land (value of \$200,000 and basis of \$50,000) and \$100,000 cash, and Oscar contributed cash of \$300,000. Both members received a 50% interest in LLC profits and capital.
- How is the land recorded for § 704(b) book capital account purposes?
 - What is Padgett's tax basis in the land?
 - If Padgett sells the land several years later for \$300,000, how much tax gain will Nova and Oscar report?
21. **LO.10** On June 1, 2015, Elisha and Ezra (who are equal partners) contribute property to form the Double E Partnership. Elisha contributes cash of \$200,000. Ezra contributes a building and land with an adjusted basis and fair market value of \$340,000, subject to a liability of \$140,000. The partnership borrows \$20,000 to finance construction of a parking lot in front of the building. At the end of the first year (December 31), the accrual basis partnership owes \$8,200 in trade accounts payable to various creditors. The partnership reported net income of \$30,000 for the year, which they share equally. Assume that Elisha and Ezra share equally in partnership liabilities. How much is Elisha's basis in the partnership interest on December 31? Ezra's?
22. **LO.12** Tobias is a 50% member in Solomon LLC, which does not invest in real estate. On January 1, 2015, Tobias's adjusted basis for his LLC interest is \$130,000, and his at-risk amount is \$105,000. His share of losses from Solomon for 2015 is \$150,000, all of which is passive. He has another investment that produced

\$90,000 of passive income during 2015. (Assume there were no distributions or changes in liabilities during the year.)

How much of Solomon's losses may Tobias deduct in 2015 on his Form 1040? How much of the loss is suspended, and what Code provisions cause the suspensions?

23. **LO.13** Heather sells land (adjusted basis \$75,000; fair market value, \$95,000) to a partnership in which she controls an 80% capital interest. The partnership pays her only \$50,000 for the land.
 - a. How much loss does Heather realize and recognize?
 - b. If the partnership later sells the land to a third party for \$80,000, how much gain does that partnership realize and recognize?
24. **LO.14** Pablo has a \$63,000 basis in his partnership interest. On May 9 of the current tax year, the partnership distributes to him, in a proportionate nonliquidating distribution, cash of \$25,000, cash basis receivables with an inside basis of \$0 and a fair market value of \$16,000, and land with a basis and fair market value to the partnership of \$80,000.
 - a. How much is Pablo's realized and recognized gain on the distribution?
 - b. What is Pablo's basis in the receivables, land, and partnership interest following the distribution?
25. **LO.14** When Bruno's basis in his LLC interest is \$150,000, he receives cash of \$55,000, a proportionate share of inventory, and land in a distribution that liquidates both the LLC and his entire LLC interest. The inventory has a basis to the LLC of \$45,000 and a fair market value of \$48,000. The land's basis is \$70,000, and the fair market value is \$60,000. How much gain or loss does Bruno recognize, and what is his basis in the inventory and land received in the distribution?
26. **LO.15** Sweeney originally contributed \$175,000 in cash for a one-fourth interest in the Gilbert LLC. During the time Sweeney was a member of the LLC, his share of the LLC's income was \$90,000 and he withdrew \$75,000 cash. The LLC's liabilities are \$80,000, of which Sweeney's share is \$20,000. Sweeney sells his LLC interest to Jana for \$225,000 cash, with Jana assuming Sweeney's share of the LLC's liabilities. How much is Sweeney's gain on the sale, and how much is Jana's adjusted basis for her LLC interest?

Problems

27. **LO.3** Emma and Laine form the equal EL Partnership. Emma contributes cash of \$100,000. Laine contributes property with an adjusted basis of \$40,000 and a fair market value of \$100,000.
 - a. How much gain, if any, must Emma recognize on the transfer? Must Laine recognize any gain? If so, how much?
 - b. What is Emma's basis in her partnership interest?
 - c. What is Laine's basis in her partnership interest?
 - d. What basis does the partnership take in the property transferred by Laine?
28. **LO.3, 17** Kenisha and Shawna form the equal KS LLC with a cash contribution of \$360,000 from Kenisha and a property contribution (adjusted basis of \$380,000, fair market value of \$360,000) from Shawna.
 - a. How much gain or loss, if any, does Shawna realize on the transfer? Does Shawna recognize any gain or loss? If so, how much?
 - b. What is Kenisha's basis in her LLC interest?
 - c. What is Shawna's basis in her LLC interest?

Decision Making

- d. What basis does the LLC take in the property transferred by Shawna?
- e. Are there more effective ways to structure the formation? Explain.
29. **LO.3** Liz and John formed the equal LJ Partnership on January 1 of the current year. Liz contributed \$80,000 of cash and land with a fair market value of \$90,000 and an adjusted basis of \$75,000. John contributed equipment with a fair market value of \$170,000 and an adjusted basis of \$20,000. John had previously used the equipment in his sole proprietorship.
- How much gain or loss will Liz, John, and the partnership realize?
 - How much gain or loss will Liz, John, and the partnership recognize?
 - What bases will Liz and John take in their partnership interests?
 - What bases will LJ take in the assets it receives?
 - Are there any differences between inside and outside basis? Explain.
 - How will the partnership depreciate any assets it receives from the partners?
- Issue ID** 30. **LO.3** Mike and Melissa form the equal MM Partnership. Mike contributes cash of \$40,000 and land (fair market value of \$100,000, adjusted basis of \$120,000), and Melissa contributes the assets of her sole proprietorship (value of \$140,000, adjusted basis of \$115,000). What are the tax consequences of the partnership formation to Mike, Melissa, and MM Partnership?
- Issue ID** 31. **LO.3** Assume the same facts as in Problem 30, except that Mike sells his land to a third party for \$100,000 and then contributes that cash to the partnership in addition to the original \$40,000 contribution. The partnership locates equivalent land that it purchases for \$110,000. How do these changes affect the tax and economic result for Mike and the partnership?
- Decision Making** 32. **LO.3, 9, 17** Sam and Drew are equal partners in SD LLC formed on June 1 of the current year. Sam contributed land that he inherited from his uncle in 2007. Sam's uncle purchased the land in 1982 for \$30,000. The land was worth \$100,000 when Sam's uncle died. The fair market value of the land was \$200,000 at the date it was contributed to the LLC.
- Drew has significant experience developing real estate. After the LLC is formed, he will prepare a plan for developing the property and secure zoning approvals for the LLC. Drew would normally bill a third party \$50,000 for these efforts. Drew will also contribute \$150,000 of cash in exchange for his 50% interest in the LLC. The value of his 50% interest is \$200,000.
- How much gain or income will Sam recognize on his contribution of the land to the LLC? What is the character of any gain or income recognized?
 - What basis will Sam take in his LLC interest?
 - How much gain or income will Drew recognize on the formation of the LLC? What is the character of any gain or income recognized?
 - What basis will Drew take in his LLC interest?
- Decision Making** 33. **LO.3, 17** Continue with the facts presented in Problem 32.
- Construct a balance sheet for SD LLC assuming that Drew's services are completed immediately after forming SD. The balance sheet should reflect the LLC's basis in the assets and the fair market value of these assets.
 - Outline any planning opportunities that may minimize current taxation to any of the parties.
- Decision Making** 34. **LO.3, 17** Continue with the facts presented in Problem 32. At the end of the first year, the LLC distributes \$100,000 of cash to Sam. No distribution is made to Drew.
- Under general tax rules, how would the payment to Sam be treated?
 - How much income or gain would Sam recognize as a result of the payment?

- c. Under general tax rules, what basis would the LLC take in the land Sam contributed?
- d. What alternative treatment might the IRS try to impose?
- e. Under the alternative treatment, how much income or gain would Sam recognize?
- f. Under the alternative treatment, what basis would the LLC take in the land contributed by Sam?
35. **LO.3** The JM Partnership was formed to acquire land and subdivide it as residential housing lots. On March 1, 2015, Jessica contributed land valued at \$600,000 to the partnership, in exchange for a 50% interest in JM. She had purchased the land in 2007 for \$420,000 and held it for investment purposes (capital asset). The partnership holds the land as inventory.
- On the same date, Matt contributed land valued at \$600,000 that he had purchased in 2005 for \$720,000. He became a 50% owner. Matt is a real estate developer, but this land was held personally for investment purposes. The partnership holds this land as inventory.
- In 2016, the partnership sells the land contributed by Jessica for \$620,000. In 2017, the partnership sells the real estate contributed by Matt for \$580,000.
- a. What is each partner's initial basis in his or her partnership interest?
- b. What is the amount of gain or loss recognized on the sale of the land contributed by Jessica? What is the character of this gain or loss?
- c. What is the amount of gain or loss recognized on the sale of the land contributed by Matt? What is the character of this gain or loss?
- d. How would your answer in (c) change if the property was sold in 2022?
36. **LO.4** In 2015, Tom and Missy form TM Partnership, Ltd. (an LLLP), to own and operate certain real estate. Tom contributed land, and Missy contributed cash to be used for setting up the entity and creating a plan for developing the property. Once a development plan was in place, the partnership sold interests in the partnership to investors to raise funds for constructing a shopping center. The partnership incurred expenses of \$30,000 for forming the entity and \$60,000 for starting the business (e.g., setting up the accounting systems, locating tenants, and negotiating leases). It also paid \$5,000 in transfer taxes for changing the ownership of the property to the partnership's name. The brokerage firm that sold the interests to the limited partners charged a 6% commission, which totaled \$600,000. The calendar year partnership started business in November 2015. Describe how all of these initial expenses are treated by the partnership.
37. **LO.4** On July 1 of the current year, the R & R Partnership (an LLLP) was formed to operate a bed-and-breakfast. The partnership paid \$3,000 in legal fees for drafting the partnership agreement and \$5,000 for accounting fees related to organizing the entity. It also paid \$10,000 in syndication costs to locate and secure investments from limited partners. In addition, before opening the inn for business, the entity paid \$15,500 for advertising and \$36,000 in costs related to an open house just before the grand opening of the property. The partnership opened the inn for business on October 1.
- a. How are these expenses classified?
- b. How much may the partnership deduct in its initial year of operations?
- c. How are costs treated that are not deducted currently?
38. **LO.5** Browne and Red, both C corporations, formed the BR Partnership on January 1, 2013. Neither Browne nor Red is a personal service corporation, and BR is not a tax shelter. BR's gross receipts were \$4.6 million, \$5 million, \$6 million, and \$7 million, respectively, for the four tax years ending in 2013, 2014, 2015, and 2016. Describe the methods of accounting available to BR in each tax year.

Issue ID

Issue ID

39. **LO.6** Cerulean, Inc., Coral, Inc., and Crimson, Inc. form the Three Cs Partnership on January 1 of the current year. Cerulean is a 50% partner, and Crimson and Coral are 25% partners. For reporting purposes, Crimson uses a fiscal year with an October 31 year-end, Coral uses the calendar year, and Cerulean uses a fiscal year with a February 28/29 year-end. What is the required tax year for Three Cs under the least aggregate deferral method?
40. **LO.3, 7, 8** Phoebe and Parker are equal members in Phoenix Investors, LLC. They are real estate investors who formed the LLC several years ago with equal cash contributions. Phoenix then purchased a parcel of land.

On January 1 of the current year, to acquire a one-third interest in the entity, Reece contributed to the LLC some land she had held for investment. Reece purchased the land five years ago for \$75,000; its fair market value at the contribution date was \$90,000. No special allocation agreements were in effect before or after Reece was admitted to the LLC. Phoenix holds all land for investment.

Immediately before Reece's property contribution, the balance sheet of Phoenix Investors LLC was as follows:

	Basis	FMV		Basis	FMV
Land	\$30,000	\$180,000	Phoebe, capital	\$15,000	\$ 90,000
			Parker, capital	15,000	90,000
	<u>\$30,000</u>	<u>\$180,000</u>		<u>\$30,000</u>	<u>\$180,000</u>

- a. At the contribution date, what is Reece's basis in her interest in the LLC?
- b. When does the LLC's holding period begin for the contributed land?
- c. On June 30 of the current year, the LLC sold the land contributed by Reece for \$90,000. How much is the recognized gain or loss? How is it allocated among the LLC members?
- d. Prepare a balance sheet reflecting basis and fair market value for the LLC immediately after the land sale described in (c). Assume that no other transactions occurred during the year.
41. **LO.7, 8** Assume the same facts as in Problem 40, with the following exceptions:
- Reece purchased the land five years ago for \$120,000. Its fair market value was \$90,000 when it was contributed to the LLC.
 - A few years later, Phoenix sold the land contributed by Reece for \$84,000.
- a. How much is the recognized gain or loss? How is it allocated among the LLC members?
- b. Prepare a balance sheet reflecting basis and fair market value for the LLC immediately after the land sale. Also prepare schedules that support the basis and fair market value of each LLC member's capital account.
42. **LO.7, 9, 10** Amy and Mitchell are equal partners in the accrual basis AM Partnership. At the beginning of the current year, Amy's capital account has a balance of \$300,000, and the partnership has recourse debts of \$200,000 payable to unrelated parties. Assume that all partnership recourse debt is shared equally between the partners. The following information about AM's operations for the current year is obtained from the partnership's records.

Ordinary income	\$400,000
Interest income	4,000
Long-term capital loss	6,000
Short-term capital gain	12,000
Charitable contribution	4,000
Cash distribution to Amy	20,000

Assume that year-end partnership debt payable to unrelated parties is \$140,000. If all transactions are reflected in her beginning capital and basis in the same manner, what is Amy's basis in the partnership interest:

- a. At the beginning of the year?
 - b. At the end of the year?
43. **LO.7, 8** Assume the same facts as in Problem 42. What income, gains, losses, and deductions does Amy report on her income tax return? Based on the information provided, what other calculations is she required to make?
44. **LO.11** Assume the same facts as in Problem 42. Prepare Amy's tax-basis capital account rollforward from the beginning to the end of the tax year. How does her capital account differ from her basis as calculated in Problem 42?
45. **LO.7, 8, 9** The KL Partnership is owned equally by Kayla and Lisa. Kayla's basis is \$20,000 at the beginning of the tax year. Lisa's basis is \$16,000 at the beginning of the year. Assume partnership debt did not change from the beginning to the end of the tax year. KL reported the following income and expenses for the current tax year:

Sales revenue	\$150,000
Cost of sales	80,000
Distribution to Lisa	15,000
Depreciation expense	20,000
Utilities	14,000
Rent expense	18,000
Long-term capital gain	6,000
Payment to Mercy Hospital for Kayla's medical expenses	12,000

- a. Determine the ordinary partnership income and separately stated items for the partnership.
 - b. Calculate Kayla's basis in her partnership interest at the end of the tax year. What items should Kayla report on her Federal income tax return?
 - c. Calculate Lisa's basis in her partnership interest at the end of the tax year. What items should Lisa report on her Federal income tax return?
46. **LO.7, 8, 9, 12** How would your answers in Problem 45 change if partnership revenues were \$100,000 instead of \$150,000?
47. **LO.3, 7, 9, 10** Suzy contributed assets valued at \$360,000 (basis of \$200,000) in exchange for her 40% interest in Suz-Anna GP (a general partnership). Anna contributed land and a building valued at \$640,000 (basis of \$380,000) in exchange for the remaining 60% interest. Anna's property was encumbered by a qualified nonrecourse debt of \$100,000, which was assumed by the partnership. The partnership reports the following income and expenses for the current tax year:

Sales	\$560,000
Utilities, salaries, and other operating expenses	360,000
Short-term capital gain	10,000
Tax-exempt interest income	4,000
Charitable contributions	8,000
Distribution to Suzy	10,000
Distribution to Anna	20,000

During the current tax year, Suz-Anna refinanced the land and building. At the end of the year, Suz-Anna had recourse debt of \$100,000 for partnership accounts payable and qualified nonrecourse debt of \$200,000.

- a. What is Suzy's basis after formation of the partnership? Anna's basis?
 - b. What income and separately stated items does the partnership report on Suzy's Schedule K-1? What items does Suzy report on her tax return?
 - c. Assume that all partnership debts are shared proportionately. At the end of the tax year, what are Suzy's basis and amount at risk in her partnership interest?
48. **LO.11** Assume the same facts as in Problem 47, and assume that Suz-Anna prepares the capital account rollforward on the partners' Schedules K-1 on a tax basis.
- a. What is Suzy's capital account balance at the beginning of the tax year?
 - b. What is Suzy's capital account balance at the end of the tax year?
 - c. What accounts for the difference between Suzy's ending capital account and her ending tax basis in the partnership interest?
- Issue ID** 49. **LO.3, 7, 9, 10** Assume the same facts as in Problem 47, except that Suz-Anna was formed as an LLC instead of a general partnership.
- a. How would Suz-Anna's ending liabilities be treated?
 - b. How would Suzy's basis and amount at risk be different?
50. **LO.7** Burgundy, Inc., and Violet are equal partners in the calendar year BV LLC. Burgundy uses a fiscal year ending April 30, and Violet uses a calendar year. Burgundy receives an annual guaranteed payment of \$100,000 for use of capital contributed by Burgundy. BV's taxable income (after deducting the payment to Burgundy, Inc.) is \$80,000 for 2015 and \$90,000 for 2016.
- a. What is the amount of income from the LLC that Burgundy must report for its tax year ending April 30, 2016?
 - b. What is the amount of income from the LLC that Violet must report for her tax year ending December 31, 2016?
51. **LO.7** Assume the same facts as in Problem 50. Assume that Burgundy, Inc.'s annual guaranteed payment is increased to \$120,000 starting on January 1, 2016, and the LLC's taxable income for 2015 and 2016 (after deducting Burgundy's guaranteed payment) is the same (i.e., \$80,000 and \$90,000, respectively). What is the amount of income from the LLC that Burgundy, Inc., must report for its tax year ending April 30, 2016?
- Issue ID** 52. **LO.3, 7, 9, 12** Bryan and Cody each contributed \$120,000 to the newly formed BC Partnership in exchange for a 50% interest. The partnership used the available funds to acquire equipment costing \$200,000 and to fund current operating expenses. The partnership agreement provides that depreciation will be allocated 80% to Bryan and 20% to Cody. All other items of income and loss will be allocated equally between the partners. Upon liquidation of the partnership, property will be distributed to the partners in accordance with their capital account balances. Any partner with a negative capital account must contribute cash in the amount of the negative balance to restore the capital account to \$0.
- In its first year, the partnership reported an ordinary loss (before depreciation) of \$80,000 and depreciation expense of \$36,000. In its second year, the partnership reported \$40,000 of income from operations (before depreciation), and it reported depreciation expense of \$57,600.
- a. Calculate the partners' bases in their partnership interests at the end of the first and second tax years. Are any losses suspended? Explain.
 - b. Does the allocation provided in the partnership agreement have economic effect? Explain.
- Issue ID** 53. **LO.7, 9, 12** Assume the same facts as in Problem 52. On the first day of the third tax year, the partnership sold the equipment for \$150,000. The gain on the sale is allocated equally to the partners. The partnership distributes all cash in accordance with the partners' capital account balances, and the partnership liquidates.

- a. Calculate the partners' bases in their partnership interests after reflecting any gain or loss on disposal of the equipment. Disregard any depreciation in year 3.
 - b. How will partnership cash balances be distributed to the partners upon liquidation?
 - c. What observations can you make regarding the value of a deduction to each partner?
54. **LO.10** The MGP General Partnership was created on January 1 of the current year by having Melinda, Gabe, and Pat each contribute \$10,000 cash to the partnership in exchange for a one-third interest in partnership income, gains, losses, deductions, and credits. On December 31 of the current year, the partnership balance sheet reads as follows:

	Basis	FMV		Basis	FMV
Assets	<u>\$60,000</u>	<u>\$75,000</u>	Recourse debt	\$30,000	\$30,000
			Melinda, capital	14,000	19,000
			Gabe, capital	14,000	19,000
			Pat, capital	<u>2,000</u>	<u>7,000</u>
				<u>\$60,000</u>	<u>\$75,000</u>

Pat's capital account is less than Melinda's and Gabe's capital accounts because Pat has withdrawn more cash than the other partners have.

How do the partners share the recourse debt as of December 31 of the current year?

55. **LO.3, 9, 10** Paul and Anna plan to form the PA LLC by the end of the current year. The members will each contribute \$80,000 of cash, and in addition, the LLC will borrow \$240,000 from First State Bank. The \$400,000 will be used to buy an investment property. The property will serve as collateral, and both members will be required to personally guarantee the debt.

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The tentative agreement provides that 65% of operating income, gains, losses, deductions, and credits will be allocated to Paul for the first five years the LLC is in existence. The remaining 35% is allocated to Anna. Thereafter, all LLC items will be allocated equally. Assume that the agreement also provides that capital accounts will be properly maintained and that each member must restore any deficit in the capital account upon the LLC's liquidation.

The LLC members would like to know, before the end of the tax year, how the \$240,000 liability will be allocated for basis purposes. Using the format (1) facts, (2) issues, (3) conclusion, and (4) law and analysis, draft a memo for the tax planning file for PA LLC that describes how the debt will be shared between Paul and Anna for purposes of computing the adjusted basis of each LLC interest.

56. **LO.9, 10, 12, 17** The BCD Partnership plans to distribute cash of \$20,000 to partner Brad at the end of the tax year. The partnership reported a loss for the year, and Brad's share of the loss is \$10,000. At the beginning of the tax year, Brad's basis in his partnership interest, including his share of partnership liabilities, was \$15,000. The partnership expects to report substantial income in future years.
- a. What rules are used to calculate Brad's ending basis in his partnership interest?
 - b. How much gain or loss will Brad report for the tax year?
 - c. Will the deduction for the \$10,000 loss be suspended? Why or why not?
 - d. Could any planning opportunities be used to minimize any negative tax ramifications of the distribution? Explain.

Issue ID

Decision Making

57. **LO.10, 12** Jasmine Gregory is a 20% member in Sparrow Properties LLC, which is a lessor of residential rental property. Her share of the LLC's losses for the current year is \$100,000. Immediately before considering the deductibility of this

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loss, Jasmine's capital account (which, in this case, corresponds to her basis excluding liabilities) reflected a balance of \$50,000. Jasmine has personally guaranteed a \$10,000 debt of the LLC that is allocated to her as a recourse debt. Her share of the LLC's nonrecourse debt is \$30,000. This debt cannot be treated as qualified nonrecourse debt. Jasmine spends several hundred hours a year working for Sparrow Properties.

Jasmine is also a managing member of Starling Rentals LLC, which is engaged in long-term (more than 30 days) equipment rental activities. (This is considered a passive activity.) Jasmine's share of Starling's income is \$36,000.

Jasmine's modified adjusted gross income before considering the LLCs' activities is \$300,000. The "active participation" rental real estate deduction is not available to Jasmine. Determine how much of Sparrow's \$100,000 loss Jasmine can deduct on her current calendar year return. Using the format (1) facts, (2) issues, (3) conclusion, and (4) law and analysis, draft an internal office memo for the client's tax file describing the loss limitations. Identify the Code sections under which losses are suspended.

58. **LO.13** Four GRRLs Partnership is owned by four girlfriends. Lacy holds a 40% interest; each of the others owns 20%. Lacy sells investment property to the partnership for its fair market value of \$200,000 (Lacy's basis is \$250,000).
- How much loss, if any, may Lacy recognize?
 - If the partnership later sells the property for \$260,000, how much gain must it recognize?
 - How would your answers in (a) and (b) change if Lacy owned a 60% interest in the partnership?
 - If Lacy owned a 60% interest and her basis in the investment property was \$120,000 (instead of \$250,000), how much, if any, gain would she recognize on the sale? How would the gain be characterized?
59. **LO.14** Gil's outside basis in his interest in the GO Partnership is \$100,000. In a proportionate nonliquidating distribution, the partnership distributes to him cash of \$30,000, inventory (fair market value of \$40,000, basis to the partnership of \$20,000), and land (fair market value of \$90,000, basis to the partnership of \$40,000). The partnership continues in existence.
- Does the partnership recognize any gain or loss as a result of this distribution? Explain.
 - Does Gil recognize any gain or loss as a result of this distribution? Explain.
 - Calculate Gil's basis in the land, in the inventory, and in his partnership interest immediately following the distribution.
60. **LO.14** When Teri's outside basis in the TMF Partnership is \$80,000, the partnership distributes to her \$30,000 of cash, an account receivable (fair market value of \$60,000, inside basis to the partnership of \$0), and a parcel of land (fair market value of \$60,000, inside basis to the partnership of \$80,000). Teri remains a partner in the partnership, and the distribution is proportionate to the partners.
- Determine the recognized gain or loss to the partnership as a result of this distribution.
 - Determine the recognized gain or loss to Teri as a result of the distribution.
 - Determine Teri's basis in the land, account receivable, and TMF Partnership after the distribution.
61. **LO.14** In each of the following independent cases in which the partnership owns no hot assets, indicate:
- Whether the partner recognizes gain or loss.
 - Whether the partnership recognizes gain or loss.
 - The partner's adjusted basis for the property distributed.
 - The partner's outside basis in the partnership after the distribution.
- All partners receive proportionate distributions.

- a. Kim receives \$20,000 of cash in partial liquidation of her interest in the partnership. Kim's outside basis for her partnership interest immediately before the distribution is \$3,000.
- b. Kourtni receives \$40,000 of cash and land with an inside basis to the partnership of \$30,000 (value of \$50,000) in partial liquidation of her interest. Kourtni's outside basis for her partnership interest immediately before the distribution is \$80,000.
- c. Assume the same facts as in (b), except that Kourtni's outside basis for her partnership interest immediately before the distribution is \$60,000.
- d. Klois receives \$50,000 of cash and inventory with a basis of \$30,000 and a fair market value of \$50,000 in partial liquidation of her partnership interest. Her basis was \$90,000 before the distribution.
62. **LO.14** At the beginning of the tax year, Melodie's basis in the MIP LLC was \$60,000, including her \$40,000 share of the LLC's liabilities. At the end of the year, MIP distributed to Melodie cash of \$10,000 and inventory (basis of \$6,000, fair market value of \$10,000). In addition, MIP repaid all of its liabilities by the end of the year.
- a. If this is a proportionate nonliquidating distribution, what is the tax effect of the distribution to Melodie and MIP? After the distribution, what is Melodie's basis in the inventory and in her MIP interest?
- b. Would your answers to (a) change if this had been a proportionate liquidating distribution? Explain.
63. **LO.14** In each of the following independent liquidating distributions in which the partnership also liquidates, determine the amount and character of any gain or loss to be recognized by each partner and the basis of each asset (other than cash) received. In each case, assume that distributions of hot assets are proportionate to the partners.
- a. Landon has a partnership basis of \$40,000 and receives a distribution of \$50,000 in cash.
- b. Mark has a partnership basis of \$50,000 and receives \$20,000 of cash and a capital asset with a basis to the partnership of \$25,000 and a fair market value of \$40,000.
- c. Neil has a partnership basis of \$100,000 and receives \$40,000 of cash, inventory with a basis to the partnership of \$30,000, and a capital asset with a partnership basis of \$20,000. The inventory and capital asset have fair market values of \$20,000 and \$30,000, respectively.
- d. Oscar has a partnership basis of \$40,000 and receives a distribution of \$10,000 of cash and an account receivable with a basis of \$0 to the partnership (value is \$15,000).
64. **LO.15** BDD Partnership is a service-oriented partnership that has three equal general partners. One of them, Barry, sells his interest to another partner, Dale, for \$90,000 of cash and the assumption of Barry's share of partnership liabilities. Immediately before the sale, the partnership's cash basis balance sheet is as shown below. Assume that the capital accounts *before* the sale reflect the partners' bases in their partnership interests, excluding liabilities. The payment exceeds the stated fair market value of the assets because of goodwill that is not recorded on the books.

	Basis	FMV		Basis	FMV
Cash	\$120,000	\$120,000	Note payable	\$ 30,000	\$ 30,000
Accounts receivable	-0-	90,000	Capital accounts		
Capital assets	30,000	75,000	Barry	40,000	85,000
			David	40,000	85,000
			Dale	40,000	85,000
Total	<u>\$150,000</u>	<u>\$285,000</u>	Total	<u>\$150,000</u>	<u>\$285,000</u>

- a. What is the total amount realized by Barry on the sale?
- b. How much, if any, ordinary income must Barry recognize on the sale?
- c. How much capital gain must Barry report?
- d. What is Dale's basis in the partnership interest acquired?

See Appendix E for Comprehensive Tax Return Problem—Form 1065

Research Problems



Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Fredstone Consolidated, Inc. and Gradison Enterprises, Inc. are both real estate developers. Each entity owns a 50% general partner interest in Realty Partners, GP, a general partnership. Fredstone and Gradison each contributed \$15,000 to form the partnership. The partnership uses the \$30,000 contributed by the partners and a recourse loan of \$100,000 obtained from an unrelated third-party lender to acquire \$130,000 of rental properties. (All amounts are in thousands.)

The partners believe they will have extensive losses in the first year due to depreciation expense and initial cash-flow requirements. Fredstone and Gradison agreed to share losses equally. To make sure the losses can be allocated as intended, they included a provision in the partnership agreement requiring each partner to restore any deficit balance in their partnership capital account upon liquidation of the partnership.

Fredstone was also willing to include a provision that requires it to make up any deficit balance within 90 days of liquidation of the partnership. This provision does not apply to Gradison; instead, Gradison is required to restore any deficit balance in its capital account within two years of liquidation of the partnership. No interest will be owed on the deferred restoration payment.

- a. Can Realty allocate the \$100,000 recourse debt equally to the two partners so that they can deduct their respective shares of partnership losses? Explain.
- b. Assume, instead, that Realty is an LLC, but that the lender has required that Fredstone must guarantee 100% (all \$100,000) of the debt and Gradison must guarantee 50% (\$50,000) of the debt. Assume, also, that Fredstone and Gradison agree to waive their rights of contribution against each other. Under Proposed Regulations, how is the debt now allocated between Fredstone and Gradison under § 752?

Research Problem 2. Barney, an individual, and Aldrin, Inc., a domestic C corporation, have decided to form BA LLC. The new LLC will produce a product that Barney recently developed and patented. Barney and Aldrin, Inc., will each own a 50% capital and profits interest in the LLC. Barney is a calendar year taxpayer, while Aldrin, Inc. uses a July 1–June 30 fiscal year. The LLC does not have a “natural business year” and elects to be taxed as a partnership.

- a. Determine the taxable year of the LLC under the Code and Regulations.
- b. Two years after formation of the LLC, Barney sells half of his interest (25%) to Aldrin, Inc. Can the LLC retain the taxable year determined in part (a)? Why or why not?

Research Problem 3. Andy has operated his moving company, MoveOn, as a sole proprietorship for several years. In 2015, MoveOn placed into service \$20,000 of

property qualifying for immediate expensing under § 179. In 2015, Andy also joined with another local mover to form and operate a storage company, The Attic LLC. Andy holds a 90% capital and profits interest in The Attic. In 2015, The Attic purchased and placed into service \$215,000 of property qualifying for expensing under § 179. Andy has \$150,000 of taxable income from MoveOn and a \$75,000 share of ordinary income from his 90% ownership of The Attic, both before considering any § 179 expense. Assuming Andy wants to maximize his current deductions (without sacrificing future deductions), how much can he elect to deduct under § 179? [NOTE: Assume that the limitation in § 179(b) is \$25,000 and the limitation in § 179(c) begins at \$200,000 (whether or not an extenders bill has been passed). Assume also that other provisions of § 179 and the related Regulations apply as written.]

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet Activity

Research Problem 4. Use the search feature on your favorite business news site on the Web (e.g., CNN, Bloomberg, or Fox News) and search for news on partnerships, LLCs, or limited partnerships. What entities did you find that are taking advantage of the partnership entity form? (Make sure these entities are truly legal partnerships. Some entities called “partnerships” by the news media actually involve transfers of stock or formation of a corporation to manage the joint venture.)

Research Problem 5. Download a copy of the legislation with which your state began to allow the formation of limited liability companies. What types of business activities can an LLC conduct in your state?

Roger CPA Review Questions

1. Which of the following is (are) correct about the holding period of the property acquired by a partnership as a contribution to the contributing partner's capital account?
 - I. The holding period begins on the date the partner's holding period of the contributed asset began
 - II. The holding period depends on the character of the property transferred
 - III. The holding period excludes the period during which the property was held by the contributing partner
 - a. I and II
 - b. II and III
 - c. I only
 - d. None of the above
2. Guaranteed payments made by a partnership to partners for services rendered to the partnership include which of the following?
 - a. Sales of partners' assets to the partnership at guaranteed amounts regardless of market values
 - b. A salary of \$170,000 annually without regard to partnership income
 - c. Payments of principal on secured notes honored at maturity
 - d. Net long-term capital gains earned by the partnership
3. Properly reported guaranteed payments have the following effect(s):
 - I. The guaranteed payment increases receiving partner's ordinary income by the entire amount paid during the tax year
 - II. The guaranteed payment decreases every partner's tax basis in the partnership by the entire amount paid during the tax year

III. The guaranteed payment is deductible by the partnership in computing its ordinary income or loss for the tax year

- a. All of the above
 b. I and III, but not II
 c. I and II, but not III
 d. None of the above
4. On March 17, 20X4, Packer became a partner in Cats & Dogs Co., an already formed partnership. Packer does not have property to contribute and thus contributes services in exchange for his 5% interest in Cats & Dogs. Cats & Dogs' net assets are as follows:

	Basis	Fair Market Value
January 1, 20X4	\$150,000	\$150,000
March 17, 20X4	150,000	170,000
December 31, 20X4	150,000	175,000

On Packer's 20X4 tax return, what amount must Packer include as ordinary income from the receipt of the partnership interest?

- a. \$0
 b. \$7,500
 c. \$8,500
 d. \$8,750
5. On a partnership tax return, all of the following are subject to special limitations and must be separately passed through to the partners, except:
- a. Charitable contributions
 b. Guaranteed payments
 c. Long-term capital gains
 d. Dividend income
6. Prairee partnership has four equal partners, Dodd, Crank, Pick, and Mack. Each of the partners had a tax basis of \$320,000 as of January 1, 20X5. Prairee's 20X5 net business income was \$152,000. During 20X5, Prairee paid Mack guaranteed payments of \$4,000 for deductible services rendered, which were not included in determining Prairee's net business income. During 20X5, each of the four partners took a distribution of \$50,000. What amount from Prairee should be included on Dodd's 20X5 tax return?
- a. \$152,000
 b. \$42,000
 c. \$38,000
 d. \$37,000
7. Prairee partnership has four equal partners, Dodd, Crank, Pick, and Mack. Each of the partners had a tax basis of \$320,000 as of January 1, 20X5. Prairee's 20X5 net business income was \$152,000. During 20X5, Prairee paid Mack guaranteed payments of \$4,000 for deductible services rendered. During 20X5, each of the four partners took a distribution of \$50,000. What is Mack's tax basis in Prairee on December 31, 20X5?
- a. \$307,000
 b. \$358,000
 c. \$422,000
 d. \$472,000
8. Osha, a cash basis calendar-year partnership, began business on April 1, 20X5. Osha incurred and paid the following during 20X5:

Legal work associated with formation of the partnership	\$15,260
Accounting work associated with raising additional capital	10,000

What is the maximum amount of deductible organizational costs on Osha's 20X5 partnership return?

- a. \$5,000
 b. \$5,513
 c. \$5,684
 d. \$6,013

9. During formation of Beecky partnership, Sam contributed property with an adjusted basis of \$130,000 in exchange for a 25% interest in Beecky. The fair market value of the contributed property was \$170,000, and the property was encumbered by a mortgage with a balance of \$120,000. What amount of gain should Sam recognize from contributing the property into Beecky partnership?
- a. \$50,000
b. \$40,000
c. \$10,000
d. \$0
10. Catherine has a \$100,000 basis in her partnership interest. On April 28 of the current tax year, the partnership distributes to her cash of \$32,000, cash basis receivables with an inside basis of \$0 and a fair market value of \$12,000, and a parcel of land with a fair market value of \$75,000 and a basis to the partnership of \$65,000. After accounting for this distribution, what is Catherine's basis in the land?
- a. \$65,000
b. \$53,000
c. \$63,000
d. \$56,000
11. Which of the following lists of distributed assets shows the proper order in which these assets should be accounted for in a partnership distribution having a total inside basis exceeding the outside basis of the distributee partner?
- a. Cash, unrealized depreciation recapture income, unimproved land
b. Improved land, cash, inventory
c. Cash, inventory, marketable securities
d. Unrealized depreciation recapture income, cash, unimproved land
12. Preakness Partnership makes a current distribution to Prasad, consisting of \$30,000 in cash, land with a fair market value of \$50,000 (partnership basis \$55,000), and inventory with a fair market value of \$8,000 (\$3,000 partnership basis). Immediately prior to the distribution, Prasad's outside basis in the partnership was \$35,000. What amount of gain will Prasad recognize on the distribution, and what is Prasad's resulting basis in the land?

	Recognized Gain	Basis in Land
a.	\$3,000	\$5,000
b.	\$0	\$0
c.	\$0	\$2,000
d.	\$3,000	\$0

13. Pelican Partnership makes a current distribution to Prabakhar, consisting of \$30,000 in cash and capital assets worth \$10,000 (partnership basis \$8,000). Immediately prior to the distribution, Prabhakar's outside basis in the partnership was \$35,000. What amount of gain will Prabhakar recognize on the distribution, and what is Prabhakar's resulting outside basis in the partnership?

	Recognized Gain	Outside Basis in Partnership
a.	\$5,000	\$0
b.	\$0	\$0
c.	\$0	(\$3,000)
d.	\$3,000	\$0

14. Brooke and Bulstrode are equal partners in the B&B Partnership, a cash basis tax entity with the following balance sheet:

	Tax Basis	Fair Market Value
Cash	\$100	\$100
Accounts Receivable	-	250
Goodwill	-	500
Total Assets	<u>\$100</u>	<u>\$850</u>
Liabilities	\$150	\$150
Brooke, capital	50	350
Bulstrode, capital	50	350
Total liabilities & capital	<u>\$250</u>	<u>\$850</u>

On the balance sheet date, Brooke purchases Bulstrode's 50% interest in the partnership, paying Bulstrode \$350 cash and assuming Bulstrode's share of the partnership liabilities. As a result of this buyout of her partnership interest, what is the total gain on sale that Bulstrode should report on her individual tax return?

- a. \$200
b. No gain or loss will be reported
- c. \$375
d. \$300
15. Cadwallader has had a 30% interest in C&C Associates, a partnership, since 20X9. In 20X14, the partnership is liquidated. The partnership's only assets at the time of liquidation are \$50,000 in cash and land with a fair market value of \$60,000 and a basis of \$65,000. C&C Associates has no liabilities. Cadwallader's adjusted basis for her partnership interest is \$34,500 and she receives \$30,000 cash in liquidation of her entire interest. What amount and type of loss should Cadwallader recognize on her 20X14 tax return?
- a. \$4,500 ordinary loss
b. \$4,500 long-term capital loss
- c. \$4,500 short-term capital loss
d. \$0
16. Perry Partnership distributed cash of \$15,000 and a parcel of land in a liquidating distribution to Gupta, a partner. The land had a fair market value of \$50,000 and an inside basis of \$52,000 at the time of the distribution. Gupta's outside basis in Perry just prior to the distribution was \$70,000. What is Gupta's resulting basis in the land?
- a. \$50,000
b. \$55,000
- c. \$53,000
d. \$52,000
17. Pettifog Partnership distributes cash of \$20,000, hot assets worth \$5,000, and a parcel of land in a liquidating distribution to Gupta, a partner. The hot assets have a basis of \$0 to the partnership. The land has a fair market value of \$80,000 and an inside basis of \$55,000. Gupta's outside basis in Pettifog just prior to the distribution is \$85,000. Identify the amount of gain or loss Gupta must recognize and Gupta's resulting basis in the land.

	Gain or Loss	Basis in Land
a.	\$0	\$60,000
b.	\$10,000 loss	\$0
c.	\$0	\$65,000
d.	\$5,000 loss	\$0

S Corporations

LEARNING OBJECTIVES: After completing Chapter 22, you should be able to:

- | | |
|---|--|
| <p>LO.1 Explain the tax effects that S corporation status has on shareholders.</p> <p>LO.2 Identify corporations that qualify for the S election.</p> <p>LO.3 Explain how to make an S election.</p> <p>LO.4 Explain how an S election can be terminated.</p> <p>LO.5 Compute nonseparately stated income and identify separately stated items.</p> <p>LO.6 Allocate income, deductions, and credits to shareholders.</p> | <p>LO.7 Determine how distributions to S corporation shareholders are taxed.</p> <p>LO.8 Calculate a shareholder's basis in S corporation stock.</p> <p>LO.9 Explain the tax effects that losses have on shareholders.</p> <p>LO.10 Compute the built-in gains and passive investment income penalty taxes.</p> <p>LO.11 Engage in tax planning for S corporations.</p> |
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CHAPTER OUTLINE

- | | |
|---|---|
| <p>22-1 Choice of Business Entity, 22-2
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THE BIG PICTURE

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DEDUCTIBILITY OF LOSSES AND THE CHOICE OF BUSINESS ENTITY

Cane, Inc., has been a C corporation for a number of years, earning taxable income of less than \$100,000 per year. Thus, the business has been subject to the lower C corporation tax rates, but due to cheap imports from China, Cane's two owners, Smith and Jones, expect operating losses for the next two or three years. They hope to outsource some of the manufacturing to Vietnam and turn the company around. How can they deduct these anticipated future losses?

The corporation receives some tax-exempt income, generates a small domestic production activities deduction (DPAD), and holds some C corporation earnings and profits. Each owner draws a salary of \$92,000. Cane has issued two classes of stock, voting and nonvoting common. Cane is located in Texarkana, Texas. Smith lives in Texas, and Jones lives in Arkansas. Both are married to nonresident aliens.

Should Smith and Jones elect so that Cane is taxed as an S corporation? Does Cane need to liquidate or go through some type of reorganization before it makes an S election?

Read the chapter and formulate your response.

An individual establishing a business has a number of choices as to the form of business entity under which to operate. Chapters 17 through 20 outline many of the rules, advantages, and disadvantages of operating as a regular corporation. Chapter 21 discusses the partnership entity and the limited liability company (LLC) and limited liability partnership (LLP) forms.

Another alternative, the **S corporation**, provides many of the benefits of partnership taxation and at the same time gives the owners limited liability protection from creditors. The S corporation rules, which are contained in **Subchapter S** of the Internal Revenue Code (§§ 1361–1379), were enacted to allow flexibility in the entity choice that businesspeople face. Thus, S status combines the legal environment of C corporations with taxation similar to that applying to partnerships. S corporation status is obtained through an election by a *qualifying* corporation with the consent of its shareholders.

LO.1

Explain the tax effects that S corporation status has on shareholders.

22-1 CHOICE OF BUSINESS ENTITY

S corporations (like C corporations) are organized under state law. Other than for income tax purposes, they are recognized as separate legal entities and generally provide shareholders with the same liability protection afforded by C corporations. For Federal income tax purposes, however, taxation of S corporations resembles that of partnerships. As with partnerships, the income, deductions, and tax credits of an S corporation flow through to shareholders annually, regardless of whether distributions of wealth (like cash) are made to the shareholders. Thus, income is taxed at the shareholder level and not at the corporate level. Payments to S shareholders by the corporation are distributed tax-free to the extent the distributed earnings were previously taxed. Further, C corporation penalty taxes such as the accumulated earnings tax, personal holding company tax, and alternative minimum tax do not apply to an S corporation.

Although the Federal tax treatment of S corporations and partnerships is similar, it is not identical. For instance, liabilities affect an owner's basis differently, and S corporations may incur a tax liability at the corporate level. Furthermore, an S corporation may not make a special allocation of tax items like a partnership can, and distributions of appreciated property are taxable in an S corporation situation (see Concept Summary 22.3 later in this chapter). In addition, a variety of C corporation provisions apply to S corporations. For example, the liquidation of C and S corporations is taxed in the same way. As a rule, where the S corporation provisions are silent, C corporation rules apply.

Today, the choice of a flow-through entity for a closely held business often is between an S corporation and an LLC; both are flow-through entities for Federal income tax purposes and provide limited liability for the owners under nontax state law. In the typical year, over 4 million S corporations file Federal income tax returns, and filings are received from over 2 million LLCs. Concept Summary 22.1 lists several major factors to be considered when making this entity choice.

Concept Summary 22.1

Making an S Election

A number of considerations will affect a decision to make an S election.

- Avoid the S election if shareholders have high marginal income tax rates relative to C corporation rates.
- If corporate losses are anticipated and there is unlikely to be corporate taxable income soon, S corporation status is advisable.
- If a C corporation holds an NOL carryover from prior years, the losses cannot be used in an S corporation year.
- There may be tax advantages to the S shareholder who receives a flow-through of passive income or domestic production activities deduction.
- Some states treat S corporations as C corporations and apply a corporate income tax to them.
- Tax-exempt income at the S level does not lose its special tax treatment for shareholders.
- An S corporation avoids the corporate ACE adjustment, personal holding company tax, and accumulated earnings tax.

22-1a An Overview of S Corporations

As the following examples illustrate, S corporations can be advantageous even when the individual tax rate exceeds the corporate tax rate.

S Corporation Advantages

An S corporation earns \$300,000 for the tax year. The marginal individual tax rate applicable to the entity's shareholders is 39.6% on ordinary income and 20% on dividends. The applicable marginal corporate tax rate is 34%. All after-tax income is distributed currently.

EXAMPLE

1

	C Corporation	S Corporation
Earnings	\$ 300,000	\$ 300,000
Less: Corporate tax	(102,000)	–0–
Available for distribution	\$ 198,000	\$ 300,000
Less: Tax at owner level	(39,600)	(118,800)
Available after-tax earnings	<u>\$ 158,400</u>	<u>\$ 181,200</u>

The S corporation generates an extra \$22,800 of after-tax earnings (\$181,200 – \$158,400) when compared with a similar C corporation. The C corporation might be able to reduce this disadvantage, however, by paying out its earnings as compensation, rents, or interest expense. Tax at the owner level can also be deferred or avoided by not distributing after-tax earnings.

A new corporation elects S status and incurs a net operating loss (NOL) of \$300,000. The shareholders may use their proportionate shares of the NOL to offset other taxable income in the current year, providing an immediate tax savings. In contrast, a newly formed C corporation is required to carry the NOL forward for up to 20 years and does not receive any tax benefit in the current year. Hence, an S corporation can accelerate NOL deductions and thereby provide a greater present value for tax savings generated by the loss.

EXAMPLE

2

22-2 QUALIFYING FOR S CORPORATION STATUS

There are certain conditions that a corporation must meet before S corporation status is available.

LO.2

Identify corporations that qualify for the S election.

22-2a Definition of a Small Business Corporation

To achieve S corporation status, a corporation *first* must qualify as a **small business corporation**. If each of the following requirements is met, then the entity can elect S corporation status.

- Is a domestic corporation (incorporated and organized in the United States).
- Is an eligible corporation (see the following section for ineligible types).
- Issues only one class of stock.
- Is limited to a theoretical maximum of 100 shareholders.
- Has only individuals, estates, and certain trusts and exempt organizations as shareholders.
- Has no nonresident alien shareholders.

No maximum or minimum dollar sales or capitalization restrictions apply to small business corporations.

Ineligible Corporations

Small business corporation status is not permitted for non-U.S. corporations, nor for certain banks and insurance companies.

Any domestic corporation that is not an ineligible corporation can be a qualified Subchapter S corporation subsidiary (QSSS) if the S corporation holds 100 percent of its stock and elects to treat the subsidiary as a QSSS.¹ QSSSs are separate entities for legal purposes, but they are treated merely as a division of the parent for Federal income tax purposes.

One Class of Stock

A small business corporation may have only one class of stock issued and outstanding.² This restriction permits differences in voting rights, but not differences in distribution or liquidation rights.³ Thus, two classes of common stock that are identical except that one class is voting and the other is nonvoting would be treated as a single class of stock for small business corporation purposes. In contrast, voting common stock and voting preferred stock (with a preference on dividends) are treated as two classes of stock. Authorized and unissued stock or treasury stock of another class does not disqualify the corporation. Likewise, unexercised stock options, phantom stock, stock appreciation rights, warrants, and convertible debentures usually do not constitute a second class of stock.⁴

The Big Picture

EXAMPLE

3

Return to the facts of *The Big Picture* on p. 22-1. Cane, Inc., could elect to be an S corporation as long as the two classes of common stock are identical except that one class is voting and the other class is nonvoting.

You learn that both shareholders have binding employment contracts with Cane, Inc. The amount of compensation paid by the corporation to Jones under her employment contract is reasonable, but the amount paid to Smith under his employment contract is excessive, resulting in a constructive dividend. Smith's employment contract was not prepared to circumvent the one-class-of-stock requirement.

Because employment contracts are not considered governing provisions, Cane still is treated as though it has only one class of stock if an S election is made.

Although the one-class-of-stock requirement seems straightforward, it is possible for debt to be reclassified as stock, resulting in an unexpected loss of S corporation status.⁵ To mitigate concern over possible reclassification of debt as a second class of stock, the law provides a set of *safe harbor provisions*.

First, straight debt *issued in an S corporation year* will not be treated as a second class of stock and will not disqualify the S election.⁶ The characteristics of straight debt include the following.

- The debtor is subject to a written, unconditional promise to pay on demand or on a specified date a sum certain in money.
- The interest rate and payment date are not contingent on corporate profits, management discretion, or similar factors.
- The debt is not convertible to stock.

In addition to straight debt under the safe harbor rules, short-term unwritten debt that is held by stockholders in the same proportion as their stock is not treated as a second class of stock, even if it otherwise would be reclassified as equity.⁷

Number of Shareholders

A small business corporation theoretically is limited to 100 shareholders. If shares of stock are owned jointly by two individuals, they generally are treated as separate shareholders.

¹§ 1361(b)(3)(B).

²§ 1361(b)(1)(D).

³§ 1361(c)(4).

⁴Reg. § 1.1361-1(f)(1).

⁵Refer to the discussion of debt-versus-equity classification in Chapter 18.

⁶§ 1361(c)(5)(A).

⁷Reg. § 1.1361-1(f)(1).

Family members may be treated as one shareholder for purposes of determining the number of shareholders. The term *members of the family* includes a “common ancestor, the lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestor.”⁸

Fred and Wilma (husband and wife) jointly own 10 shares in Marlins, Inc., an S corporation, with the remaining 290 shares outstanding owned by 99 other unrelated shareholders. Fred and Wilma are divorced; pursuant to the property settlement approved by the court, the 10 shares held by Fred and Wilma are divided between them—5 to each.

Before the divorce settlement, Marlins had 100 shareholders under the small business corporation rules. After the settlement, it still has 100 shareholders and continues to qualify as a small business corporation. A former spouse is treated as being in the same family as the individual to whom he or she was married.

EXAMPLE

4

Type of Shareholder Limitation

Small business corporation shareholders may be resident individuals, estates, certain trusts, and certain tax-exempt organizations.⁹ Charitable organizations, employee benefit trusts exempt from taxation, and a one-person LLC also can qualify as shareholders of an S corporation. This limitation prevents partnerships, corporations, limited liability partnerships, most LLCs, and most IRAs and Roth IRAs from owning S corporation stock. Partnerships and corporate shareholders could easily circumvent the 100-shareholder limitation as illustrated in the following example.

Saul and 105 of his friends want to form an S corporation. Saul reasons that if he and his friends form a partnership, the partnership can then form an S corporation and act as a single shareholder, thereby avoiding the 100-shareholder rule. Saul’s plan will not work because partnerships cannot own stock in a small business corporation.

EXAMPLE

5

Although partnerships and corporations cannot own small business corporation stock, small business corporations can be partners in a partnership or shareholders in a corporation. This allows the 100-shareholder requirement to be bypassed in a limited sense. For example, if two small business corporations, each with 100 shareholders, form a partnership, then the shareholders of both corporations can enjoy the limited liability conferred by S corporation status and a single level of tax on partnership profits.

Nonresident Aliens

Nonresident aliens cannot own stock in a small business corporation.¹⁰ That is, individuals who are not U.S. citizens *must live in the United States* to own S corporation stock. Therefore, shareholders with nonresident alien spouses in community property states¹¹ cannot own S corporation stock because the nonresident alien spouse would be treated as owning half of the community property.¹² Similarly, if a resident alien shareholder moves outside the United States, the S election is terminated.

⁸ §§ 1361(c)(1)(A)(ii) and (B)(i). TD 9422, 2008–42 IRB 898 provides insight into the determination of who is a family member.

⁹ § 1361(b)(1)(B). Foreign trusts, charitable remainder trusts, and charitable lead trusts cannot be shareholders.

¹⁰ § 1362(b)(1)(C).

¹¹ Assets acquired by a married couple are generally considered community property in these states: Arizona, California, Idaho, Louisiana, Nevada,

New Mexico, Texas, Washington, Wisconsin, and (if elected by the spouses) Alaska.

¹² See *Ward v. U.S.*, 81–2 USTC ¶9674, 48 AFTR 2d 81–5942, 661 F.2d 226 (Ct.Cls., 1981), where the court found that the stock was owned as community property. Because the taxpayer-shareholder (a U.S. citizen) was married to a citizen and resident of Mexico, the nonresident alien prohibition was violated. If the taxpayer-shareholder had held the stock as separate property, the S election would have been valid.

The Big Picture

EXAMPLE

6

Return to the facts of *The Big Picture* on p. 22-1. Because Jones lives in Arkansas, a common law property state, the fact that she is married to a nonresident alien spouse would not affect an S election. However, because Smith lives in Texas, a community property state, as it stands, his nonresident alien spouse would be treated as owning half of his community property stock, and an S election would not be allowed. To qualify for S status, Smith could move to Arkansas or his wife could move to Texas (becoming a resident alien).

LO.3

Explain how to make an S election.

22-2b Making the Election

To become an S corporation, a *small business corporation* (defined previously) must file a valid election with the IRS. The election is made on Form 2553. For the election to be valid, it should be filed on a timely basis and all shareholders must consent.

For S corporation status to apply in the current tax year, the election must be filed either in the previous year or on or before the fifteenth day of the third month of the current year.

The Big Picture

EXAMPLE

7

Return to the facts of *The Big Picture* on p. 22-1. Suppose that in 2015, shareholders Smith and Jones decide to become an S corporation beginning January 1, 2016. Because the C corporation uses a calendar tax year, the S election can be made at any time in 2015 or by March 15, 2016. An election after March 15, 2016, will not be effective until the 2017 calendar tax year.

There is a simplified method of requesting relief for late S elections that were intended to be effective as of the date of the election. The entity must file a properly completed Form 2553 with a Form 1120S no later than six months after the due date of the tax return (excluding extensions) of the entity for the first tax year in which the S election was intended. The Form 2553 must explain the reason for the failure to timely file the election. Sufficient reasonable cause might occur, for example, where both the corporation's accountant and its attorney failed to file the election because each believed the other had done so or because there was miscommunication as to who was responsible for filing.

Even if the 2¹/₂-month deadline is met, an S election is not valid unless the corporation qualifies as a small business corporation for the *entire* tax year. Otherwise, the election is not effective until the following tax year.

A corporation that does not yet exist cannot make an S corporation election.¹³ Thus, for new corporations, a premature election may not be effective. A new corporation's 2¹/₂-month election period begins at the earliest occurrence of any of the following events.

- When the corporation has shareholders.
- When it acquires assets.
- When it begins doing business.¹⁴

EXAMPLE

8

Several individuals acquire assets on behalf of Rock Corporation on June 29, 2015, and begin doing business on July 3, 2015. They subscribe to shares of stock, file articles of incorporation for Rock, and become shareholders on July 7, 2015. The S election must be filed no later than 2¹/₂ months after June 29, 2015 (i.e., on or before September 12) to be effective for 2015.

¹³See, for example, *T.H. Campbell & Bros., Inc.*, 34 TCM 695, T.C.Memo. 1975-149; Ltr.Rul. 8807070.

¹⁴Reg. § 1.1372-2(b)(1). Also see, for example, *Nick A. Artukovich*, 61 T.C. 100 (1973).

22-2c Shareholder Consent

A qualifying election requires the consent of all of the corporation's shareholders.¹⁵ Consent must be in writing, and it generally must be filed by the election deadline. A consent extension is available only if Form 2553 is filed on a timely basis, reasonable cause is given, and the interests of the government are not jeopardized.¹⁶

Vern and Yvonne decide to convert their C corporation into a calendar year S corporation for 2015. At the end of February 2015 (before the election is filed), Yvonne travels to Ukraine and forgets to sign a consent to the election. Yvonne will not return to the United States until June and cannot be reached by fax or e-mail.

Vern files the S election on Form 2553 and requests an extension of time to file Yvonne's consent to the election. Vern indicates that there is a reasonable cause for the extension: a shareholder is out of the country. Because the government's interest is not jeopardized, the IRS probably will grant Yvonne an extension of time to file the consent. Vern must file the election on Form 2553 on or before March 15, 2015, for the election to be effective for the 2015 calendar year.

EXAMPLE

9

Both husband and wife must consent if they own their stock jointly (as joint tenants, tenants in common, tenants by the entirety, or community property). This requirement has led to considerable taxpayer grief—particularly in community property states where the spouses may not realize that their stock is jointly owned as a community asset.

Three shareholders, Amy, Monty, and Dianne, incorporate in January and file Form 2553. Amy is married and lives in California. Monty is single, and Dianne is married; both live in South Carolina. Because Amy is married and lives in a community property state, her husband also must consent to the S election. South Carolina is not a community property state, so Dianne's husband need not consent.

EXAMPLE

10

Finally, for current-year S elections, persons who were shareholders during any part of the taxable year before the election date but were not shareholders when the election was made must also consent to the election.¹⁷

On January 15, 2015, the stock of Columbus Corporation (a calendar year C corporation) was held equally by three individual shareholders: Jim, Sally, and LuEllen. On that date, LuEllen sells her interest to Jim and Sally. On March 14, 2015, Columbus Corporation files Form 2553. Jim and Sally indicate their consent by signing the form. Columbus cannot become an S corporation until 2016 because LuEllen did not indicate consent. Had all three shareholders consented by signing Form 2553, S status would have taken effect as of January 1, 2015.

EXAMPLE

11

22-2d Loss of the Election

An S election remains in force until it is revoked or lost. Election or consent forms are not required for future years. However, an S election can terminate if any of the following occurs.

- Shareholders owning a majority of shares (voting and nonvoting) voluntarily revoke the election.
- A new shareholder owning more than one-half of the stock affirmatively refuses to consent to the election.
- The corporation no longer qualifies as a small business corporation.
- The corporation does not meet the passive investment income limitation.

LO.4

Explain how an S election can be terminated.

¹⁵§ 1362(a)(2).

¹⁷§ 1362(b)(2)(B)(ii).

¹⁶Rev.Rul. 60-183, 1960-1 C.B. 625; *William Pestcoe*, 40 T.C. 195 (1963); Reg. § 1.1362-6(b)(3)(iii).

Voluntary Revocation

A **voluntary revocation** of the S election requires the consent of shareholders owning a majority of shares on the day the revocation is to be made.¹⁸ A revocation filed up to and including the fifteenth day of the third month of the tax year is effective for the entire tax year, unless a later date is specified. Similarly, unless an effective date is specified, revocation made after the first 2¹/₂ months of the current tax year is effective for the following tax year.

EXAMPLE

12

The shareholders of Petunia Corporation, a calendar year S corporation, voluntarily revoke the S election on January 5, 2015. They do not specify a future effective date in the revocation. If the revocation is properly executed and timely filed, Petunia will be a C corporation for the entire 2015 calendar year. If the election is not made until June 2015, Petunia will remain an S corporation in 2015 and will become a C corporation at the beginning of 2016.

A corporation can revoke its S status *prospectively* by specifying a future date when the revocation is to be effective. A revocation that designates a future effective date splits the corporation's tax year into a short S corporation year and a short C corporation year. The day on which the revocation occurs is treated as the first day of the C corporation year. The corporation allocates income or loss for the entire year on a pro rata basis, using the number of days in each short year.

EXAMPLE

13

Assume the same facts as in the preceding example, except that Petunia designates July 1, 2015, as the revocation date. Accordingly, June 30, 2015, is the last day of the S corporation's tax year. The C corporation's tax year runs from July 1, 2015, to December 31, 2015. Income or loss for the 12-month period is allocated between the two short years (i.e., 184/365 to the C corporation year).

Rather than allocating on a pro rata basis, the corporation can elect to compute actual income or loss attributable to the two short years. This election requires the consent of everyone who was a shareholder at any time during the S corporation's short year and everyone who owns stock on the first day of the C corporation's year.¹⁹

EXAMPLE

14

Assume the same facts as in the preceding example, except that all of Petunia's shareholders consent to allocate the income or loss to the two short tax years based on its actual realization. Assume further that Petunia experiences a total loss of \$102,000, of which \$72,000 is incurred in the first half of the year. Because \$72,000 of the loss occurs before July 1, this amount is allocated to the S corporation short year, and only \$30,000 is allocated to the C corporation year.

Loss of Small Business Corporation Status

If an S corporation fails to qualify as a small business corporation at any time after the election has become effective, its status as an S corporation ends. The termination occurs on the day the corporation ceases to be a small business corporation.²⁰ Thus, if the corporation ever has more than 100 shareholders, a second class of stock, or a non-qualifying shareholder or otherwise fails to meet the definition of a small business corporation, the S election is immediately terminated.

EXAMPLE

15

Peony Corporation has been a calendar year S corporation for three years. On August 13, 2015, one of its 100 shareholders sells *some* of her stock to an outsider. Peony now has 101 shareholders, and it ceases to be a small business corporation. For 2015, Peony is an S corporation through August 12, 2015, and a C corporation from August 13 to December 31, 2015.

¹⁸§ 1362(d)(1).

¹⁹§ 1362(e)(3).

²⁰§ 1362(d)(2)(B).

Passive Investment Income Limitation

The Code provides a **passive investment income (PII)** limitation for S corporations that were previously C corporations or for S corporations that have merged with C corporations. If an S corporation holds C corporation E & P and it generates passive investment income in excess of 25 percent of its gross receipts for three consecutive tax years, the S election is terminated as of the beginning of the fourth year.²¹

For 2012, 2013, and 2014, Diapason Corporation, a calendar year S corporation, received passive income in excess of 25% of its gross receipts. If Diapason holds accumulated E & P from years in which it was a C corporation, its S election is terminated as of January 1, 2015.

EXAMPLE

16

PII includes dividends, interest, rents, gains and losses from sales of capital assets, and royalties net of investment deductions. Rents are not considered PII if the corporation renders significant personal services to the occupant.

Violet Corporation owns and operates an apartment building. The corporation provides utilities for the building, maintains the lobby, and furnishes trash collection for tenants. These activities are not considered significant personal services, so any rent income earned by the corporation will be considered PII.

Alternatively, if Violet also furnishes maid services to its tenants (personal services beyond what normally would be expected from a landlord in an apartment building), the rent income would no longer be PII.

EXAMPLE

17

Reelection after Termination

After an S election has been terminated, the corporation must wait five years before reelecting S corporation status. The five-year waiting period is waived if:

- There is a more-than-50-percent change in ownership of the corporation after the first year for which the termination is applicable, or
- The event causing the termination was not reasonably within the control of the S corporation or its majority shareholders.

22-3 OPERATIONAL RULES

S corporations are treated much like partnerships for tax purposes. With a few exceptions,²² S corporations generally make tax accounting and other elections at the corporate level. Each year, the S corporation determines nonseparately stated income or loss and separately stated income, deductions, and credits. These items are taxed only once, at the shareholder level. All items are allocated to each shareholder based on average ownership of stock throughout the year. The *flow-through* of each item of income, deduction, and credit from the corporation to the shareholder is illustrated in Exhibit 22.1.

22-3a Computation of Taxable Income

An S corporation's taxable income or loss is determined in a manner similar to the tax rules that apply to partnerships, except that S corporations amortize organizational expenditures under the C corporation rules²³ and must recognize gains, *but not losses*, on distributions of appreciated property to shareholders.²⁴ Other special provisions affecting only the computation of C corporation income, such as the dividends received deduction, do not extend to S corporations.²⁵ Finally, as with partnerships, certain deductions of

LO.5

Compute nonseparately stated income and identify separately stated items.

²¹§ 1362(d)(3)(A)(ii).

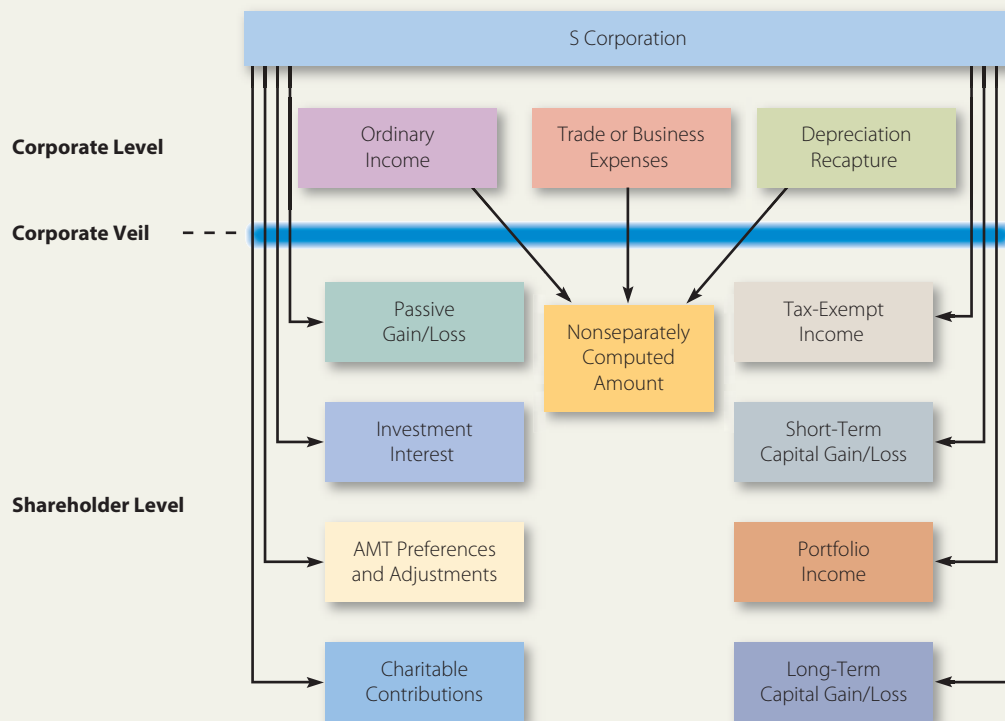
²⁴§ 1363(b).

²²A few elections can be made at the shareholder level (e.g., the choice between a foreign tax deduction or credit).

²⁵§ 703(a)(2).

²³§§ 248 and 1363(b).

EXHIBIT 22.1 Flow-Through of Separate Items of Income and Loss to S Corporation Shareholders



individuals are not permitted, including alimony payments, personal moving expenses, certain dependent care expenses, the personal exemption, and the standard deduction.

In general, S corporation items are divided into (1) nonseparately stated income or loss and (2) separately stated income, losses, deductions, and credits that could affect the tax liability of any shareholder in a different manner, depending on other factors in the shareholder's tax situation. In essence, nonseparate items are aggregated into an undifferentiated amount that constitutes Subchapter S ordinary income or loss. An S corporation's separately stated items are identical to those separately stated by partnerships. These items retain their tax attributes on the shareholder's return. Separately stated items are listed on Schedule K of the 1120S. They include the following.

- Tax-exempt income.
- Long-term and short-term capital gains and losses.
- Section 1231 gains and losses.
- Charitable contributions (no grace period).
- Passive gains, losses, and credits.
- Certain portfolio income.
- Section 179 expense deduction.
- Domestic production gross receipts and deductions.
- Tax preferences and adjustments for the alternative minimum tax.
- Depletion.
- Foreign income or loss.
- Recoveries of tax benefit items.
- Intangible drilling costs.
- Investment interest, income, and expenses.

The following is the income statement for Jersey, Inc., an S corporation.

Sales		\$ 40,000
Less cost of sales		<u>(23,000)</u>
Gross profit on sales		\$ 17,000
Less: Interest expense	\$1,200	
Charitable contributions	400	
Advertising expenses	1,500	
Other operating expenses	<u>2,000</u>	<u>(5,100)</u>
Book income from operations		\$ 11,900
Add: Tax-exempt interest	\$ 300	
Dividend income	200	
Long-term capital gain	<u>500</u>	1,000
Less: Short-term capital loss		<u>(150)</u>
Net income per books		<u><u>\$ 12,750</u></u>

EXAMPLE

18

Jersey's ordinary income is calculated as follows, using net income for book purposes as the starting point.

Net income per books		\$ 12,750
<i>Separately stated items</i>		
Deduct: Tax-exempt interest	\$ 300	
Dividend income	200	
Long-term capital gain	<u>500</u>	<u>(1,000)</u>
Add: Charitable contributions	\$ 400	
Short-term capital loss	<u>150</u>	<u>550</u>
Ordinary income		<u><u>\$ 12,300</u></u>

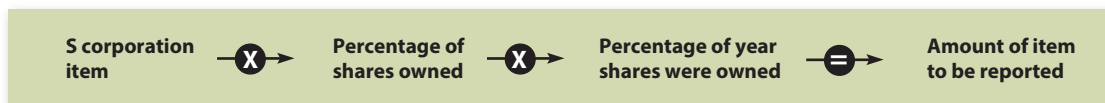
The \$12,300 of Jersey's ordinary income, as well as each of the five separately stated items, are divided among the shareholders based upon their stock ownership.

22-3b Allocation of Income and Loss

Each shareholder is allocated a pro rata portion of nonseparately stated income or loss and all separately stated items. The pro rata allocation method assigns an equal amount of each of the S items to each day of the year. If a shareholder's stock holding changes during the year, this allocation assigns the shareholder a pro rata share of each item for *each* day the stock is owned. On the date of transfer, the transferor (and not the transferee) is considered to own the stock.²⁶

LO.6

Allocate income, deductions, and credits to shareholders.



The per-day allocation must be used, unless the shareholder disposes of his or her entire interest in the entity.²⁷

²⁶Reg. § 1.1377-1(a)(2)(ii).

²⁷§§ 1366(a)(1) and 1377(a)(1).

S Corporation Per-Day Allocation

EXAMPLE

19

Assume in the previous example that Pat, a shareholder, owned 10% of Jersey's stock for 100 days and 12% for the remaining 265 days. Using the required per-day allocation method, Pat's share of the S corporation items is as follows.

	Schedule K Totals	Pat's Share		Pat's Schedule K-1 Totals
		10%	12%	
Ordinary income	\$12,300	\$337	\$1,072	\$1,409
Tax-exempt interest	300	8	26	34
Dividend income	200	5	17	22
Long-term capital gain	500	14	44	58
Charitable contributions	400	11	35	46
Short-term capital loss	150	4	13	17

Pat's share of the Subchapter S ordinary income is the total of $\$12,300 \times [.10 \times (100/365)]$ plus $\$12,300 \times [.12 \times (265/365)]$, or \$1,409. Each of the Schedule K-1 totals from the right-hand column flows through to the appropriate lines on Pat's individual income tax return (Form 1040).

EXAMPLE

20

If Pat in the previous example dies after owning the stock 100 days, his share of the S corporation items is reported on his final individual income tax return (Form 1040). Thus, only the items in the column labeled 10% in Example 19 are reported on Pat's final tax return. S corporation items that occur after Pat's death most likely would flow through to the income tax return of Pat's estate (Form 1041).

The Short-Year Election

If a shareholder's interest is completely terminated by a sale or by a disposition following death during the tax year, all shareholders holding stock during the year and the corporation may elect to treat the S taxable year as two taxable years. The first year ends on the date of the termination. Under this election, an interim closing of the books is undertaken, and the shareholders report their shares of the S corporation items as they occurred during the short tax year.²⁸

The short-year election provides an opportunity to shift income, losses, and credits among shareholders. The election is desirable in circumstances where more loss can be allocated to taxpayers with higher marginal rates.

EXAMPLE

21

Alicia, the owner of all of the shares of an S corporation, transfers her stock to Cindy halfway through the tax year. There is a \$100,000 NOL for the entire tax year, but \$30,000 of the loss occurs during the first half of the year. Without a short-year election, \$50,000 of the loss is allocated to Alicia, and \$50,000 is allocated to Cindy. If the corporation makes the short-year election, Cindy is allocated \$70,000 of the loss. Of course, the sales price of the stock would probably be increased to recognize the tax benefits being transferred from Alicia to Cindy.

In the case of the death of a shareholder, a short-year election prevents the income and loss allocation to a deceased shareholder from being affected by postdeath events.

EXAMPLE

22

Joey and Karl equally own Rose, Inc., a calendar year S corporation. Joey dies on June 29 of a year that is not a leap year. Rose has income of \$250,000 for January 1 through June 29 and \$750,000 for the remainder of the year. Without a short-year election, the income is allocated by assigning an equal portion of the annual income of \$1 million to each day (or \$2,739.73 per day) and allocating

continued

²⁸ § 1377(a)(2).

the daily portion between the shareholders. Joey is allocated 50% of the daily income for the 180 days from January 1 to June 29, or \$246,575.70 $[(\$2,739.73/2) \times 180]$. Joey's estate is allocated 50% of the income for the 185 days from June 30 to December 31, or \$253,425.02 $[(\$2,739.73/2) \times 185]$.

If the short-year election is made, the income of \$250,000 from January 1 to June 29 is divided equally between Joey and Karl, so that each is taxed on \$125,000. The income of \$750,000 from June 30 to December 31 is divided equally between Joey's estate and Karl, or \$375,000 to each.

Under either alternative, Karl reports income of \$500,000. However, with the short-year election, \$375,000 is allocated to Joey's estate versus only \$253,425.02 without the election. Because the estate income tax rates are more progressive than the income tax rates on individuals, Joey's heirs would prefer that the election not be made.

22-3c Tax Treatment of Distributions to Shareholders

The amount of any actual distribution of wealth (like cash) to an S corporation shareholder is equal to the cash plus the fair market value of any other property distributed. How the distribution is taxed depends upon whether the S corporation has C corporation **accumulated earnings and profits (AEP)** (described in Chapter 19).

No C Corporation AEP

If the S corporation has never been a C corporation or if it has no C corporation AEP, the distribution is a tax-free recovery of capital to the extent that it does not exceed the shareholder's basis in the stock of the S corporation. When the amount of the distribution exceeds the basis of the stock, the excess is treated as a gain from the sale or exchange of property (capital gain in most cases). The vast majority of S corporations fall into this favorable category.

Twirl, Inc., a calendar year S corporation, has no AEP. During the year, Juan, an individual shareholder of the corporation, receives a cash distribution of \$12,200 from Twirl. Juan's basis in his stock is \$9,700. Juan recognizes a capital gain of \$2,500, the excess of the distribution over the stock basis ($\$12,200 - \$9,700$). The remaining \$9,700 is tax-free, but it reduces Juan's basis in his stock to zero.

EXAMPLE

23

C Corporation AEP

S corporations that hold C corporation AEP treat distributions of pre-election (C corporation) and postelection (S corporation) earnings differently. Distributions of AEP are taxed as dividends, while distributions of previously taxed S corporation earnings are tax-free to the extent of the shareholder's basis in the stock.

Concept Summary 22.2 outlines the taxation of distributions. These rules are intended to prevent two problems that result when a C corporation has been converted to an S corporation.

- Tax manipulation could result in AEP from the C corporation years being withdrawn without taxation, because S corporation shareholders are taxed on income, not on distributions.
- On the other hand, double taxation could occur. Earnings from the S corporation years might flow to the shareholders' tax returns as income and be taxed as dividends as if the corporation were a C corporation.

A special account is required to track undistributed earnings of an S corporation that have been taxed to shareholders previously. Distributions from this account, known as the **accumulated adjustments account (AAA)**, are tax-free. The AAA begins with a zero balance on the first day of an S corporation's first tax year. Essentially, the AAA is the cumulative total of undistributed nonseparately and separately stated items for S corporation taxable years beginning after 1982. Thus, the account parallels the calculation of C corporation AEP. Calculation of the AAA applies to all S corporations, but the AAA is most important to those that have been C corporations. The AAA provides a mechanism to ensure that the earnings of an S corporation are taxed to shareholders only once.



Concept Summary 22.2

Classification Procedures for Distributions from an S Corporation

Where No Earnings and Profits Exist	Where Earnings and Profits Exist
1. Distributions are nontaxable to the extent of shareholder's basis of stock.*	1. Distributions are tax-free to the extent of the AAA.
2. Excess is treated as gain from a sale or exchange of stock (capital gain in virtually all cases).	2. Distributions from AEP constitute dividend income. [†]
	3. Distributions are tax-free to the extent of the other adjustments account (OAA).
	4. Any residual distribution amount is nontaxable to the extent of shareholder's basis of stock.*
	5. Excess is treated as gain from a sale or exchange of stock (capital gain in virtually all cases).

*The distribution reduces the stock basis. Once stock basis reaches zero, any distribution from the AAA is treated as a gain from the sale or exchange of stock. Thus, the shareholder's stock basis is an upper limit on what a shareholder may receive tax-free.

[†]The AAA bypass election is available to pay out AEP before reducing the AAA [§ 1368(e)(3)].

The AAA is computed by making adjustments in the order specified in Exhibit 22.2. Its balance is determined at the end of each year rather than at the time distributions are made. When more than one distribution occurs in the same year, a pro rata portion of each distribution is treated as having been made out of the AAA.

In calculating the amount in the AAA for purposes of determining the tax treatment of current-year distributions, the net negative adjustments (e.g., the excess of losses and deductions over income) for that tax year are ignored. Tax-exempt income and related expenses (e.g., insurance proceeds and premiums paid for life insurance) do not affect the AAA.

A shareholder has a proportionate interest in the AAA, regardless of the size of his or her stock basis.²⁹ However, because the AAA is a corporate account, no connection exists between the prior accumulated S corporation income and any specific shareholder.³⁰ Thus, the benefits of the AAA can be shifted from one shareholder to another shareholder. For example, when one S shareholder transfers stock to another shareholder, any AAA balance on the purchase date may be distributed tax-free to the purchaser. Similarly, issuing additional stock to a new shareholder in an S corporation with a positive balance in the AAA dilutes the account relative to the existing shareholders.

The AAA can have a negative balance. All losses decrease the AAA balance, even those in excess of the shareholder's stock basis. However, *distributions* may not make the AAA negative or increase a negative balance.

EXHIBIT 22.2 Adjustments to the Corporate AAA

Increase by:

1. Schedule K income items other than tax-exempt income.
2. Nonseparately computed income.
3. Depletion in excess of basis in the property.

Decrease by:

4. Negative Schedule K adjustments other than distributions (e.g., losses and deductions).
5. Any portion of a distribution that is considered to be tax-free from the AAA (but not below zero).

Note: When the combination of items 1 through 4 results in a negative number, the AAA is adjusted first for the distribution and then for the adjustments in items 1 through 4.

²⁹§ 1368(c).

³⁰§ 1368(e)(1)(A).

Distribution Ordering Rules

A cash distribution from an S corporation with AEP comes first from the AAA (limited to stock basis).³¹ Distributions from the AAA are tax-free. The remaining distribution is taxed as a dividend to the extent of AEP. After AEP is fully distributed, any residual amount is applied against the other adjustments account (OAA, discussed in the next section) and then the shareholder's remaining stock basis. The reduction in the shareholder's stock basis is a tax-free recovery of capital.³² Any distributions once the stock basis reaches zero typically are taxed as capital gains.

Ordering Rules for Distributions

Short, a calendar year S corporation, distributes \$1,300 cash to its only shareholder, Otis, on December 31. Otis's basis in his stock is \$1,400, Short's AAA balance is \$500, and Short holds \$750 AEP before the distribution.

According to the distribution ordering rules, the first \$500 is a tax-free recovery of basis from the AAA. The next \$750 is a taxable dividend distribution from AEP. The remaining \$50 of cash is a tax-free recovery of basis. Immediately after the distribution, Short holds a zero balance in its AAA and AEP. Otis's stock basis now is \$850.

	Corporate AAA	Corporate AEP	Otis's Stock Basis*
Balance before the distribution	\$ 500	\$ 750	\$1,400
Distribution (\$1,300)			
From AAA	(500)		(500)
From AEP		(750)	
From stock basis			(50)
Balance after the distribution	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ 850</u>

*Details of basis adjustments are discussed later in the chapter.

EXAMPLE

24

Assume the same facts as in the preceding example. During the following year, Short reports zero ordinary income and distributes \$1,000 to Otis. Of the distribution, \$850 is a tax-free recovery of basis, and \$150 is taxed to Otis as a capital gain.

EXAMPLE

25

With the consent of all of its shareholders, an S corporation can elect to have a distribution treated as if it were made from AEP rather than from the AAA. This mechanism is known as an AAA **bypass election**. This election may be desirable as a simple means by which to eliminate a small AEP balance. See Exhibit 22.3.

EXHIBIT 22.3

Special Complications of Conversion of C Corporation to S Corporation

- Positive accumulated earnings and profits (AEP) may cause distributions to be taxed as dividends.
- Positive AEP may trigger one or more corporate level taxes.
- Positive AEP with passive investment income exceeding 25 percent of gross income for three consecutive years causes loss of S status.
- Net operating loss from C years can only be used to reduce built-in gains.
- C corporation operating loss carryover period continues to run.
- S corporation may make a bypass election to distribute AEP before AAA.

³¹§§ 1368(c)(1) and (e)(1). Before 1983, an account similar to the AAA was in place, namely, **previously taxed income (PTI)**. An S corporation in existence before 1983 might still hold some PTI.

³²§ 1368(c).

EXAMPLE

26

Collett, a calendar year S corporation, has AEP of \$12,000 and a balance of \$20,000 in the AAA. Collett Corporation may elect to distribute the AEP first, creating a \$12,000 dividend for its shareholders, before using the AAA.

Schedule M-2

S corporations report changes in the AAA on Schedule M-2 of Form 1120S. Schedule M-2 contains a column labeled **other adjustments account (OAA)**. This account includes items that affect basis but not the AAA, such as tax-exempt income and any related nondeductible expenses. For example, life insurance proceeds received and insurance premiums paid are traced through the OAA. Distributions are made from the OAA after AEP and the AAA are depleted to zero. Distributions from the OAA generally are tax-free.

EXAMPLE

27

Sparrow, an S corporation, records the following items.

AAA, beginning of the year	\$ 8,500
Ordinary income	25,000
Tax-exempt interest	4,000
Key employee life insurance proceeds received	5,000
Payroll penalty expense	2,000
Charitable contributions	3,000
Unreasonable compensation	5,000
Premiums on key employee life insurance	2,100
Distributions to shareholders	16,000

Sparrow's Schedule M-2 for the current year appears as follows.

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)			
	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year	8,500		
2 Ordinary income from page 1, line 21	25,000		
3 Other additions		9,000**	
4 Loss from page 1, line 21	()		
5 Other reductions	(10,000*	(2,100)	
6 Combine lines 1 through 5	23,500	6,900	
7 Distributions other than dividend distributions	16,000		
8 Balance at end of tax year. Subtract line 7 from line 6	7,500	6,900	

*\$2,000 (payroll penalty) + \$3,000 (charitable contributions) + \$5,000 (unreasonable compensation).

**\$4,000 (tax-exempt interest) + \$5,000 (life insurance proceeds).

Schedule M-3: Net Income or Loss Reconciliation

S corporations that have total assets on Schedule L at the end of the tax year that equal or exceed \$50 million must file Schedule M-3 in lieu of Schedule M-1. For purposes of measuring total assets at the end of the year, assets are not reduced by liabilities. Total assets are determined using the accrual method of accounting unless both (1) the tax return of the corporation is prepared using an overall cash method of accounting and (2) no entity includible in the Federal tax return prepares or is included in financial statements prepared on an accrual basis. A \$10 million threshold applied before 2014.

ETHICS & EQUITY Avoiding Schedule M-3

Your S corporation client has read that a Schedule M-3 is required for all S corporations with at least \$50 million of assets. He says that the new schedule will reveal between 75 to 90 percent of the company's book-tax differences. Although this new schedule will help IRS agents find abusive transactions, your client is concerned that it will

impose additional compliance burdens. The client's S corporation is approaching \$50 million of assets, and he is thinking of either distributing some of the entity's business assets to himself or engaging in a spin-off. Is it ethical to consider these actions?

Effect of Terminating the S Election

Normally, distributions to shareholders from a C corporation are taxed as dividends to the extent of E & P. However, any distribution of *cash* by a corporation to shareholders during a one-year period³³ following S election termination receives special treatment. Such a distribution is treated as a tax-free recovery of stock basis to the extent that it does not exceed the AAA.³⁴ To take advantage of post-termination benefits, an S corporation must know the amount of both the AAA and the OAA as of the date the election terminates.

Quinn, the sole shareholder of Roman, Inc., a calendar year S corporation, elects during 2015 to terminate the S election, effective January 1, 2016. As of the end of 2015, Roman has an AAA of \$1,300. Quinn can receive a nontaxable distribution of cash during a post-termination period of approximately one year to the extent of Roman's AAA. Although a cash distribution of \$1,300 during 2016 would be nontaxable to Quinn, it would reduce the basis of his stock.

EXAMPLE

28

22-3d Tax Treatment of Noncash Property Distributions by the Corporation

An S corporation recognizes a gain on any distribution of appreciated property in the same manner as if the asset were sold to the shareholder at its fair market value.³⁵ The corporate gain is passed through to the shareholders. The character of the gain—capital gain or ordinary income—depends upon the type of asset being distributed. There is an important reason for this gain recognition rule. Without it, property might be distributed tax-free (other than for certain recapture items) and later sold without income recognition to the shareholder because the shareholder's basis in the property equals its fair market value.

The S corporation does not recognize a loss when distributing assets that are worth less than their basis. As with gain property, the shareholder's basis is equal to the asset's fair market value. Thus, the potential loss is postponed until the shareholder sells the stock of the S corporation. Because loss property receives a step-down in basis without any loss recognition by the S corporation, distributions of loss property should be avoided. See Concept Summary 22.3.

LO.7

Determine how distributions to S corporation shareholders are taxed.



Concept Summary 22.3

Consequences of Noncash Distributions

	Appreciated Property	Depreciated Property
S corporation	Realized gain is recognized by the corporation, which passes it through to the shareholders. Such gain increases a shareholder's stock basis, generating a basis in the property equal to FMV. On the distribution, the shareholder's stock basis is reduced by the FMV of the property (but not below zero).	Realized loss is not recognized. The shareholder takes an FMV basis in the property.
C corporation	Realized gain is recognized under § 311(b) and increases E & P (net of tax). The shareholder reports a taxable dividend to the extent of corporate E & P equal to the property's FMV. The shareholder takes an asset basis equal its FMV.	Realized loss is not recognized. The shareholder takes an FMV basis in the property.
Partnership	No gain to the partnership or partner. The partner takes a carryover basis in the asset, but the asset basis is limited to the partner's basis in the partnership.	Realized loss is not recognized. The partner takes a carryover basis in the asset, but the asset basis is limited to the partner's basis in the partnership.

³³The period is approximately one year in length. The post-termination transition period is discussed later in the chapter.

³⁵§ 311(b).

³⁴§§ 1371(e) and 1377(b).

Noncash Distributions

EXAMPLE

29

Turnip, Inc., an S corporation for 10 years, distributes a tract of land held as an investment to Chang, its majority shareholder. The land was purchased for \$22,000 many years ago and is currently worth \$82,000. Turnip recognizes a capital gain of \$60,000, which increases the AAA by \$60,000. The gain appears on Turnip's Schedule K, and a proportionate share of it passes through to the shareholders' tax returns. Then the property distribution reduces the AAA by \$82,000 (the fair market value). The tax consequences are the same for appreciated property, whether it is distributed to the shareholders and they dispose of it or the corporation sells the property and distributes the proceeds to the shareholders.

If the land had been purchased for \$82,000 and was currently worth \$22,000, Chang would take a \$22,000 basis in the land. The \$60,000 realized loss is not recognized at the corporate level. The loss does not reduce Turnip's AAA. Only when the S corporation sells the asset does it recognize the loss and reduce AAA.

EXAMPLE

30

Assume the same facts as in the previous example, except that Turnip is a C corporation (\$1 million E & P balance) or a partnership. The partner's basis in the partnership interest is \$100,000.

	Appreciated Property		
	S Corporation	C Corporation	Partnership
Entity gain/loss	\$60,000	\$60,000	\$ -0-
Owner's gain/loss/dividend	60,000	82,000	-0-
Owner's basis in land	82,000	82,000	22,000
	Property That Has Declined in Value		
	S Corporation	C Corporation	Partnership
Entity gain/loss	\$ -0-	\$ -0-	\$ -0-
Owner's gain/loss/dividend	-0-	22,000	-0-
Owner's basis in land	22,000	22,000	82,000

LO.8

Calculate a shareholder's basis in S corporation stock.

22-3e Shareholder's Basis in S Stock

The calculation of the initial tax basis of stock in an S corporation is similar to that for the basis of stock in a C corporation and depends upon the manner in which the shares are acquired (e.g., gift, inheritance, purchase, or exchange under § 351). Once the initial tax basis is determined, various transactions during the life of the corporation affect the shareholder's basis in the stock. Although each shareholder is required to compute his or her own basis in the S shares, neither Form 1120S nor Schedule K-1 provides a place for deriving this amount.

A shareholder's basis is increased by stock purchases and capital contributions. Operations during the year cause the following upward adjustments to basis.³⁶

- Nonseparately computed income.
- Separately stated income items (e.g., nontaxable income).
- Depletion in excess of basis in the property.

Basis then is reduced by distributions not reported as income by the shareholder (e.g., an AAA distribution). Next, the following items reduce basis (*but not below zero*).

- Nondeductible expenses of the corporation (e.g., fines, penalties, and illegal kickbacks).
- Nonseparately computed loss.
- Separately stated loss and deduction items.

³⁶§ 1367(a).

As under the partnership rule, basis first is increased by income items; then it is decreased by distributions and finally by losses.³⁷ In most cases, this *losses last* rule is advantageous to the S shareholder.

In its first year of operation, Iris, Inc., a calendar year S corporation in Clemson, South Carolina, earns income of \$2,000. On February 2 in its second year of operation, Iris distributes \$2,000 to Marty, its sole shareholder. During the remainder of the second year, the corporation incurs a \$2,000 loss.

Before accounting for the entity's operating results, Marty's stock basis is zero. Under the S corporation ordering rules, the \$2,000 distribution is tax-free AAA to Marty, and the \$2,000 loss is suspended until Marty generates additional stock basis (e.g., from capital contributions or future entity profits).

EXAMPLE**31**

A shareholder's basis in the stock can never be reduced below zero. Once stock basis reaches zero, any additional basis reductions from losses or deductions, but *not* distributions, decrease (but not below zero) the shareholder's basis in loans made to the S corporation. Any excess of losses or deductions over both bases is *suspended* until there are subsequent bases.

Once the basis of any debt is reduced, it is later increased (up to the original amount) by the subsequent *net* increase resulting from *all* positive and negative basis adjustments. The debt basis is adjusted back to the original amount by any "net increase" before any increase is made in the stock basis.³⁸ "Net increase" for a year is computed after taking distributions (other than those from AEP) into consideration.

A distribution in excess of stock basis does not reduce any debt basis. If a loss and a distribution occur in the same year, the loss reduces the stock basis last, *after* the distribution.

Stacey, a sole shareholder, has a \$7,000 stock basis and a \$2,000 basis in a loan that she made to Romulus, a calendar year S corporation with no AEP. At the beginning of the tax year, the corporation's AAA and OAA balances are zero. Ordinary income for the year is \$8,200, during which Romulus received \$2,000 of tax-exempt interest income.

Cash of \$17,300 is distributed to Stacey on November 15. Stacey recognizes only a \$100 capital gain.

EXAMPLE**32**

	Corporate AAA	Corporate OAA	Stacey's Stock Basis	Stacey's Loan Basis
Beginning balance	\$ -0-	\$ -0-	\$ 7,000	\$2,000
Ordinary income	8,200		8,200	
Tax-exempt income		2,000	2,000	
Subtotal	\$ 8,200	\$ 2,000	\$17,200	\$2,000
Distribution (\$17,300):				
From AAA	(8,200)		(8,200)	
From OAA		(2,000)	(2,000)	
From stock basis			(7,000)	
Ending balance	\$ -0-	\$ -0-	\$ -0-	\$2,000
Distribution in excess of basis = Capital gain			\$ 100	

Pass-through losses can reduce loan basis, but distributions do not. Stock basis cannot be reduced below zero, but the \$100 excess distribution does not reduce Stacey's loan basis.

The basis rules for an S corporation are similar to the rules for determining a partner's interest basis in a partnership. However, a partner's basis in the partnership interest

³⁷Reg. § 1.1367-1(f).

³⁸§ 1367(b)(2); Reg. § 1.1367-2(e).

includes the partner's direct investment plus a *ratable share* of any partnership liabilities.³⁹ If a partnership borrows from a partner, the partner receives a basis increase as if the partnership had borrowed from an unrelated third party.⁴⁰ In contrast, except for loans from the shareholder to the corporation, corporate borrowing has no effect on S corporation shareholder basis.

The fact that a shareholder has guaranteed a loan made to the corporation by a third party has no effect on the shareholder's loan basis, unless payments actually have been made as a result of that guarantee.⁴¹

If a loan's basis has been reduced and is not restored, income is recognized when the S corporation repays the shareholder. If the corporation issued a note as evidence of the debt, repayment constitutes an amount received in exchange for a capital asset and the amount that exceeds the shareholder's basis is entitled to capital gain treatment.⁴² However, if the loan is made on open account, the repayment constitutes ordinary income to the extent that it exceeds the shareholder's basis in the loan.⁴³ Each repayment is prorated between the gain portion and the repayment of the debt.⁴⁴ Thus, a written note should be given to ensure capital gain treatment for the income that results from a loan's repayment.

Effects of Debt

EXAMPLE

33

Sammy is a 57% owner of Falcon, an S corporation in Brooklyn, New York. At the beginning of the year, his stock basis is zero. Sammy's basis in a \$12,000 loan made to Falcon and evidenced by Falcon's note has been reduced to \$0 by prior losses. At the end of the year, he receives a \$13,000 distribution. During the year, his net share of corporate taxable income is \$11,000. Because there is no "net increase" (i.e., his share of income is less than the amount of the distribution), Sammy's debt basis is not restored. Instead, his share of income increases his stock basis to \$11,000. Therefore, on receipt of the \$13,000 distribution, \$11,000 is a tax-free recovery of his stock basis, and \$2,000 is a capital gain.⁴⁵

EXAMPLE

34

Assume in the previous example that the distribution that Sammy receives is only \$8,000. Because the "net increase" is \$3,000 (\$11,000 income share in excess of \$8,000 distribution), the debt basis is restored by \$3,000. Accordingly, the remaining income share not used to increase debt basis (\$8,000) is used to increase Sammy's stock basis to \$8,000. Therefore, on receipt of the \$8,000 distribution, all \$8,000 is tax-free, reducing the stock basis back to zero.

LO.9

Explain the tax effects that losses have on shareholders.

22-3f Treatment of Losses

Net Operating Loss

One major advantage of an S election is the ability to pass through any net operating loss of the corporation directly to the shareholders. A shareholder can deduct an NOL for the year in which the S corporation's tax year ends. The corporation does not deduct the NOL. A shareholder's basis in the stock is reduced to the extent of any pass-through of the NOL, and the entity's AAA is reduced by the same deductible amount.⁴⁶

³⁹§ 752(a).

⁴⁰Reg. § 1.752-1(e).

⁴¹See, for example, *Estate of Leavitt*, 90 T.C. 206 (1988), *aff'd* 89-1 USTC ¶9332, 63 AFTR 2d 89-1437, 875 F.2d 420 (CA-4, 1989); *Selfe v. U.S.*, 86-1 USTC ¶9115, 57 AFTR 2d 86-464, 778 F.2d 769 (CA-11, 1985); *James K. Calcutt*, 91 T.C. 14 (1988).

⁴²*Joe M. Smith*, 48 T.C. 872 (1967), *aff'd* and *rev'd* in 70-1 USTC ¶9327, 25 AFTR 2d 70-936, 424 F.2d 219 (CA-9, 1970); Rev.Rul. 64-162, 1964-1 C.B. 304.

⁴³Reg. § 1.1367-2. Open account debt is treated as if it were evidenced by a note if the shareholder's principal balance exceeds \$25,000 at the end of the tax year.

⁴⁴Rev.Rul. 68-537, 1968-2 C.B. 372.

⁴⁵§ 1367(b)(2)(B); Reg. § 1.1367-2(e).

⁴⁶§§ 1368(a)(1)(A) and (e)(1)(A).

The Big Picture

Return to the facts of *The Big Picture* on p. 22-1. If Smith and Jones make the S election for Cane, Inc., they each can pass through any NOLs to the extent of the current stock basis. If the new S corporation incurs an NOL of \$84,000 during 2015, both shareholders are entitled to deduct \$42,000 against other income for the tax year in which Cane's tax year ends. Any NOL incurred before the S election is in effect does not flow through to the two shareholders as long as the S election is maintained.

EXAMPLE

35

Deductions for an S corporation's loss pass-throughs (e.g., NOL, capital loss, and charitable contributions) cannot exceed a shareholder's adjusted basis in the stock *plus* the basis of any loans made by the shareholder to the corporation. If a taxpayer is unable to prove the tax basis, the loss pass-through can be denied. As noted previously, once a shareholder's stock basis has been eliminated by a loss pass-through, any excess loss reduces the shareholder's basis for any loans made to the corporation (but never below zero). The basis for loans is established by the actual advances made to the corporation, and not by indirect loans. If the shareholder's basis is insufficient to allow a full flow-through and there is more than one type of loss (e.g., in the same year the S corporation incurs both a passive loss and a net capital loss), the flow-through amounts are determined on a pro rata basis.

Distributions made by an S corporation are taken into account *before* applying the loss limitations for the year.

Pylon, Inc., a calendar year S corporation, is partly owned by Doris, who has a beginning stock basis of \$10,000. During the year, Doris's share of a long-term capital gain (LTCG) is \$2,000, and her share of an ordinary loss is \$9,000. If Doris receives a \$6,000 distribution, her deductible loss is calculated as follows.

EXAMPLE

36

Beginning stock basis	\$10,000
Add: LTCG	<u>2,000</u>
Subtotal	\$12,000
Less: Distribution	<u>(6,000)</u>
Basis for loss limitation purposes	<u>\$ 6,000</u>
Deductible loss	<u>(\$ 6,000)</u>
Suspended loss	<u>(\$ 3,000)</u>

Doris's stock now has a basis of zero.

A shareholder's share of an NOL may be greater than both stock basis and loan basis. A shareholder is entitled to carry forward a loss to the extent that the loss for the year exceeds basis. Any loss carried forward may be deducted *only* by the *same* shareholder if and when the basis in the stock or loans to the corporation is restored.⁴⁷

Dana has a stock basis of \$4,000 in an S corporation. He has loaned \$2,000 to the corporation and has guaranteed another \$4,000 loan made to the corporation by a local bank. Although his share of the S corporation's NOL for the current year is \$9,500, Dana may deduct only \$6,000 of the NOL on his individual tax return. Dana may carry forward \$3,500 of the NOL, to be deducted when the basis in his stock or loan to the corporation is restored. Dana has a zero basis in both the stock and the loan after the flow-through of the \$6,000 NOL.

EXAMPLE

37

Any loss carryover due to insufficient basis remaining at the end of an approximately one-year post-termination transition period is *lost forever*. The post-termination period includes the 120-day period beginning on the date of any determination pursuant to an audit of a taxpayer that follows the termination of the S corporation's election and that

⁴⁷§ 1366(d).

adjusts a Subchapter S item.⁴⁸ Thus, if a shareholder has a loss carryover, he or she should increase the stock or loan basis and flow through the loss before disposing of the stock.

Net operating losses from C corporation years cannot be utilized at the corporate level (except with respect to built-in gains, discussed later in this chapter), nor can they be passed through to the shareholders. Further, the carryforward period continues to run during S status.⁴⁹ Consequently, the S election may not be appropriate for a C corporation with NOL carryforwards. When a corporation is expecting losses in the future, an S election should be made *before* the loss years.

At-Risk Rules

As discussed in Chapter 11, S corporation shareholders, like partners, are limited in the amount of loss they may deduct by their “at-risk” amounts. These rules apply to the shareholders, but not to the corporation. An amount at risk is determined separately for each shareholder. The amount of the corporate losses that are passed through and deductible by the shareholders is not affected by the amount the corporation has at risk.

EXAMPLE

38

Shareholder Ricketts has a basis of \$35,000 in his S corporation stock. He takes a \$15,000 nonrecourse loan from a local bank and lends the proceeds to the S corporation. Ricketts now has a stock basis of \$35,000 and a debt basis of \$15,000. However, due to the at-risk limitation, he can deduct only \$35,000 of losses from the S corporation.

Passive Losses and Credits

S corporations are not directly subject to the passive activity limits of § 469, but corporate rental activities are inherently passive, and other activities of an S corporation may be passive unless the shareholder(s) materially participate(s) in operating the business. If the corporate activity involves rentals or the shareholders do not materially participate, any loss or credit that flows through is passive. The shareholders can apply such losses or credits only against income from other passive activities.

A shareholder’s stock basis is reduced by passive losses that flow through to the shareholder, even though the shareholder may not be entitled to a current deduction due to the passive loss limitations. The existence of material participation is determined at the shareholder level.

EXAMPLE

39

Heather is a 50% owner of an S corporation engaged in a passive activity. A nonparticipating shareholder, she receives a salary of \$6,000 for services as a result of the passive activity. Heather has \$6,000 of earned income as a result of the salary. The \$6,000 salary creates a \$6,000 deduction/passive loss, which flows through to the shareholders. Heather’s \$3,000 share of the loss may not be deducted against the \$6,000 of earned income. Under § 469(e)(3), earned income is not taken into account in computing the income or loss from a passive activity.

LO.10

Compute the built-in gains and passive investment income penalty taxes.

22-3g Tax on Pre-Election Built-In Gain

Normally, an S corporation does *not* pay an income tax, because all items flow through to the shareholders. But an S corporation that previously was a C corporation may be required to pay a built-in gains tax, LIFO recapture tax, general business credit recapture, or passive investment income tax.

Without the **built-in gains tax** (§ 1374), it would be possible to avoid the corporate double tax on a disposition of appreciated property by electing S corporation status.

The § 1374 tax generally applies to C corporations converting to S status after 1986. It is a *corporate-level* tax on any built-in gain recognized when the S corporation disposes of an asset in a taxable disposition within 10 calendar years after the date on which the

⁴⁸§ 1377(b)(1).

⁴⁹§ 1371(b).

S election took effect. The 10-year holding period is reduced to 7 years for tax years beginning in 2009 and 2010, and to 5 years for 2011 through 2014.⁵⁰ The holding period begins on the date of the S election.

Not all of the states followed this temporary reduction of the recognition period. After 2014, the holding period returned to ten 12-month years.

General Rules

The base for the § 1374 tax includes any unrealized gain on appreciated assets (e.g., real estate, cash basis receivables, and goodwill) held by a corporation on the day it elects S status. The highest corporate tax rate (currently 35 percent) is applied to the unrealized gain when any of the assets are sold. Furthermore, the gain on the sale (net of the § 1374 tax)⁵¹ passes through as a taxable gain to shareholders.

Zinnia, Inc., a C corporation, owns a single asset with a basis of \$100,000 and a fair market value of \$500,000. Zinnia elects S corporation status. Section 1374 imposes a corporate-level tax that must be paid by Zinnia if it sells the asset after electing S status. Upon sale of the asset, the corporation owes a tax of \$140,000 ($\$400,000 \times 35\%$). The shareholders have a \$260,000 taxable gain ($\$400,000 - \$140,000$). Hence, the built-in gains tax effectively imposes a double tax on Zinnia and its shareholders.

EXAMPLE

40

The maximum amount of gain that is recognized over the required (5-, 7-, or 10-year) holding period is limited to the *aggregate net* built-in gain of the corporation at the time it converted to S status. Thus, at the time of the S election, unrealized gains of the corporation are reduced by unrealized losses. This net amount sets an upper limit on the tax base for the built-in gains tax.

Contributions of assets with realized losses on the date of conversion reduce the maximum built-in gain and any potential tax under § 1374.⁵² In addition, built-in losses and built-in gains are netted each year to determine the annual § 1374 tax base.

Normally, tax attributes of a C corporation do *not* carry over to a converted S corporation. For purposes of the tax on built-in gains, however, certain carryovers are allowed. In particular, an S corporation can offset built-in gains with unexpired NOLs or capital losses from C corporation years.

The Big Picture

Return to the facts of *The Big Picture* on p. 22-1. If Cane, Inc., becomes an S corporation, a built-in gain may be recognized. Assuming that Cane reports a \$50,000 built-in gain on conversion and that it holds a \$20,000 NOL carryforward for C corporation years before the S election, the NOL carryforward is applied against the built-in gain. Cane's built-in gains tax applies only to \$30,000.

EXAMPLE

41

LIFO Recapture Tax

To preclude deferral of gain recognition by a C corporation that is electing S status, any LIFO recapture amount at the time of the S election is subject to a corporate-level tax.

The taxable LIFO recapture amount equals the excess of the inventory's value under FIFO over the LIFO value. No negative adjustment is allowed if the LIFO value is higher than the FIFO value.

The resulting tax is payable in four equal installments, with the first payment due on or before the due date for the corporate return for the last C corporation year (without regard to any extensions). The remaining three installments are paid on or before the due dates of the succeeding corporate returns.

⁵⁰§ 1374(d)(7)(B).

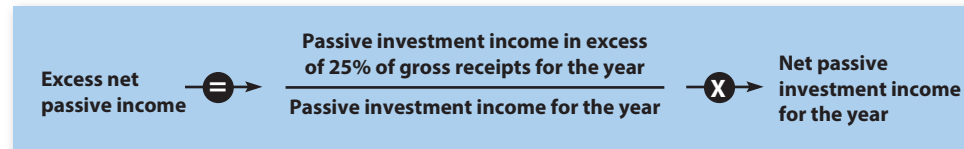
⁵¹§ 1366(f)(2).

⁵²§§ 1374(c)(2) and (d)(1).

No interest is due if payments are made by the due dates, and no estimated taxes are due on the four tax installments. The basis of the LIFO inventory is adjusted to account for this LIFO recapture amount, but the AAA is not decreased by payment of the tax.

22-3h Passive Investment Income Penalty Tax

A tax is imposed on the excess passive income of S corporations that possess AEP from C corporation years. The tax rate is the highest corporate rate for the year (35 percent currently). The rate is applied to excess net passive income (ENPI), which is determined using the following formula, and illustrated in Example 42.



Passive investment income (PII) includes gross receipts derived from royalties, passive rents, dividends, interest, and annuities. Only the net gain from the disposition of capital assets is taken into account in computing PII gross receipts.⁵³ Net passive income is passive income reduced by any deductions directly connected with the production of that income. Any passive income tax reduces the amount the shareholders must take into income.

The excess net passive income cannot exceed the S corporation's taxable income for the year, calculated as if it were a C corporation. This income amount is computed before considering any NOL deduction or the special deductions allowed by §§ 241–250 (except the organizational expense deduction).⁵⁴

EXAMPLE

42

Barnhardt Corporation, an S corporation, generates gross receipts for the year totaling \$264,000 (of which \$110,000 is PII). Expenditures directly connected to the production of the PII total \$30,000. Therefore, Barnhardt reports net PII of \$80,000 (\$110,000 – \$30,000), and its PII for the tax year exceeds 25% of its gross receipts by \$44,000 [\$110,000 PII – (25% × \$264,000)]. Excess net passive income (ENPI) is \$32,000, calculated as follows.

$$\text{ENPI} = \frac{\$44,000}{\$110,000} \times \$80,000 = \$32,000$$

Barnhardt's PII tax is \$11,200 (\$32,000 × 35%).

22-3i Other Operational Rules

Several other points may be made about the possible effects of various Code provisions on S corporations.

- An S corporation is required to make estimated tax payments with respect to tax exposure because of any recognized built-in gain and excess passive investment income.
- An S corporation is *not* subject to the 10 percent of taxable income limitation applicable to charitable contributions made by a C corporation.
- Any family member who renders services or furnishes capital to an S corporation must be paid reasonable compensation. Otherwise, the IRS can make adjustments to reflect the value of the services or capital.⁵⁵ This rule may make it more difficult for related parties to shift Subchapter S taxable income to children or other family members.
- Although § 1366(a)(1) provides for a flow-through of S items to a shareholder, it does not create self-employment income, nor is it subject to the additional Medicare

⁵³ §§ 1362(d)(3)(B), (C).

⁵⁴ §§ 248, 1374(d)(4), and 1375(a) and (b).

⁵⁵ § 1366(e). In addition, beware of an IRS search for the “real owner” of the stock under Reg. § 1.1373–1(a)(2).

tax on upper-income taxpayers.⁵⁶ This treatment of earned income of S corporations is attractive compared with the treatment of a proprietorship or a partnership whose income is taxed as self-employment income to the owners. Compensation for services rendered to an S corporation is, however, subject to FICA taxes.

S Corporations and SE Income

Mickey and Dana each own one-third of a fast-food restaurant, and their 14-year-old son owns the other shares. Both parents work full-time in the restaurant operations, but the son works infrequently. Neither parent receives a salary this year, when the taxable income of the S corporation is \$160,000. The IRS can require that reasonable compensation be paid to the parents to prevent the full one-third of the \$160,000 from being taxed to the son. Otherwise, this would be an effective technique to shift earned income to a family member to reduce the total family tax burden. Furthermore, low or zero salaries can reduce FICA taxes due to the Federal government.

EXAMPLE

43

Dave is a professor at a southeastern university, earning a salary of \$150,000. He also has consulting income of \$80,000. If the consulting business is organized as an S corporation, Dave should withdraw a reasonable salary from the S corporation for his services. The S corporation pays payroll and withholding tax on the salary. Dave receives a tax credit for any overpayment of the employee share of the FICA tax, but the S corporation does not receive a similar credit.

EXAMPLE

44

If the business is operated as a proprietorship, Dave is exempt from the Social Security portion of the self-employment tax because his university salary exceeds the annual FICA ceiling. Here, operating as a proprietorship offers a tax advantage over an S corporation.

- An S corporation is placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a cash basis related party.⁵⁷ Thus, the timing of the shareholder's income and the corporate deduction must match.
- An S corporation may not deduct a payment to one of its shareholders (e.g., a year-end performance bonus) until the payee reports the income.
- The S election is not recognized by the District of Columbia and several states, including Connecticut, Michigan, New Hampshire, and Tennessee. Thus, some or all of the entity's income may be subject to a state-level income tax (e.g., a "sting tax" on large S corporations in Massachusetts).
- An S corporation may issue § 1244 stock to its shareholders to obtain ordinary loss treatment.
- The § 1202 exclusion of gain on disposition of small business stock is *not* available for S stock.
- Losses may be disallowed due to a lack of a profit motive. If the activities at the corporate level are not profit-motivated, the losses may be disallowed under the hobby loss rules.⁵⁸
- A penalty is imposed for failure to file (including extensions) timely S corporation returns. The penalty is \$195 per month times the number of S corporation shareholders. The penalty is assessed against the corporation for a maximum of 12 months.⁵⁹
- Partnership treatment applies for certain fringe benefits to more-than-2 percent shareholder-employees of S corporations. Thus, these shareholders are not entitled to exclude certain fringe benefits from gross income. A more-than-2 percent shareholder-employee is allowed an above-the-line (*for* AGI) deduction on Form 1040 for accident and health insurance premiums.⁶⁰

⁵⁶Rev.Rul. 59-221, 1959-1 C.B. 225.

⁵⁷§ 267(b).

⁵⁸§ 183; *Michael J. Houston*, 69 TCM 2360, T.C.Memo. 1995-159; *Mario G. De Mendoza, III*, 68 TCM 42, T.C.Memo. 1994-314.

⁵⁹§ 6699.

⁶⁰§ 1372(a); Notice 2008-1, 2008-2 I.R.B. 251.



TAX IN THE NEWS The Self-Employment Income Advantage

A significant advantage of an S corporation involves the current definition of self-employment income. Although compensation for services rendered to an S corporation is subject to FICA taxes, a shareholder's share of income from an S corporation is not self-employment income. The rationale for this S corporation loophole is that the S shareholder does not personally carry on the entity's trade or business. In contrast, the earned income of a partnership or proprietorship is treated as self-employment income to the partner or proprietor.

The choice between a salary and pass-through income is not clear-cut, however.

- Although a salary is subject to payroll tax and pass-through income is not [*P.B. Ding v. Comm.*, 2000–1 USTC

¶50137, 84 AFTR 2d 99–7517, 200 F.3d 587 (CA–9, 1999)], this income does not accrue Social Security benefits for its recipient.

- S corporation income distributions do not count as compensation for computing an employee's contribution formula for a qualified retirement plan.
- The IRS and the courts require an S shareholder to take a reasonable salary (see footnote 63).
- If a partner or proprietor reports salary income from other sources and the aggregate salaries exceed the annual FICA ceiling, a partnership or proprietorship entity may provide tax savings over an S corporation.

LO.11

Engage in tax planning for S corporations.

22-4 TAX PLANNING

22-4a When the Election Is Advisable

Effective tax planning with S corporations begins with the determination of whether the election is appropriate. In this context, one should consider the following factors.

- Are losses from the business anticipated? If so, the S election may be highly attractive because these losses pass through to the shareholders.
- What are the tax brackets of the shareholders? If the shareholders are in high individual income tax brackets, it may be desirable to avoid S corporation status and have profits taxed to the corporation at lower C rates (e.g., 15 percent or 25 percent). However, the income still is not in the owners' hands.
- When the shareholders are in low individual income tax brackets, the pass-through of corporate profits is attractive, and reducing the combined income tax becomes the paramount consideration. Under these circumstances, the S election could be an effective tax planning tool. Note, however, that although an S corporation usually escapes Federal taxes, it may not be immune from state and local taxes imposed on corporations or from several Federal penalty taxes.
- Does a C corporation have an NOL carryover from a prior year? Such a loss cannot be used in an S year (except for purposes of the built-in gains tax). Even worse, S years count in the 20-year carryover limitation. Thus, even if the S election is made, one might consider terminating the election before the carryover limitation expires. Such a termination would permit the loss to be utilized by what is now a C corporation.
- Both individuals and C corporations are subject to the alternative minimum tax. Many of the tax preference and adjustment items are the same, but some apply only to corporate taxpayers while others are limited to individuals. The alternative minimum tax adjustment relating to adjusted current earnings could create havoc with some C corporations (refer to Chapter 15). S corporations are not subject to this tax.
- S corporations and partnerships have limited flexibility in the choice of a tax accounting period.⁶¹

⁶¹Entity tax-year constraints are discussed in Chapters 16 and 21.

22-4b Making a Proper Election

Once the parties have decided the election is appropriate, it becomes essential to ensure that the election is made properly.

- Make sure all shareholders consent. If any doubt exists concerning the shareholder status of an individual, it would be wise to have that party issue a consent anyway.⁶² Too few consents are fatal to the election; the same cannot be said for too many consents.
- Make sure the election is timely and properly filed. Either hand-carry the election to an IRS office or send it by certified or registered mail. The date used to determine timeliness is the postmark date, not the date the IRS receives the election. A copy of the election should become part of the corporation's permanent files.
- Ascertain when the timely election period begins to run for a newly formed corporation. An election made too soon (before the corporation is in existence) is worse than one made too late. If serious doubts exist as to when this period begins, filing more than one election might be considered a practical means of guaranteeing the desired result.

22-4c Preserving the Election

Recall that an election can be lost intentionally or unintentionally in several ways and that a five-year waiting period generally is imposed before another S election is available. To preserve an S election, the following points should be kept in mind.

- As a starting point, all parties concerned should be made aware of the various transactions that lead to the loss of an election.
- Watch for possible disqualification of a small business corporation. For example, the death of a shareholder could result in a nonqualifying trust becoming a shareholder.

22-4d Planning for the Operation of the Corporation

Operating an S corporation to achieve optimum tax savings for all parties involved requires a great deal of care and, most important, an understanding of the applicable tax rules.

Accumulated Adjustments Account

Although the corporate-level accumulated adjustments account (AAA) is used primarily by an S corporation with accumulated earnings and profits (AEP) from a Subchapter C year, all S corporations should maintain an accurate record of the AAA. Because there is a grace period for distributing the AAA after termination of the S election, the parties must be in a position to determine the balance of the account.

The AAA bypass election may be used to reduce exposure to the accumulated earnings tax or personal holding company tax (see Chapter 17) in post-S years. This bypass election allows AEP to be distributed instead.

Zebra, Inc., an S corporation during 2014, holds a significant amount in its AEP account. The shareholders expect to terminate the election in 2015, when Zebra will be subject to the lower corporate income tax rates. Because Zebra as a C corporation may be subject to the accumulated earnings penalty tax in 2015, the shareholders may want to use the AAA bypass election to distribute some or all of the AEP. Of course, any distributions of the AEP account in 2014 would be taxable to the shareholders.

EXAMPLE

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⁶²See *William B. Wilson*, 34 TCM 463, T.C.Memo. 1975-92.



TAX IN THE NEWS Some Guidelines for Compensating S Shareholder-Employees

An IRS fact sheet provides taxpayers with these factors to determine reasonable compensation for an S shareholder.

- Training, education, and experience.
- Duties and responsibilities.
- Time and effort devoted to business.
- Dividend history.
- Payments to nonshareholders-employees.
- Timing and manner of paying bonuses to key employees.
- What comparable businesses pay for similar services.
- Compensation agreements.
- Use of formula to determine compensation.

Source: FS-2008-25, Wage Compensation for S Corporation Officers, August 2008.

Salary Structure

The amount of salary paid to a shareholder-employee of an S corporation can have varying tax consequences and should be considered carefully. Larger amounts might be advantageous if the maximum contribution allowed for the shareholder-employee under the corporation's retirement plan has not been reached. Smaller amounts may be beneficial if the parties are trying to shift taxable income to lower-bracket shareholders, reduce payroll taxes, curtail a reduction of Social Security benefits, or restrict losses that do not pass through because of the basis limitation.⁶³

A strategy of decreasing compensation and correspondingly increasing distributions to shareholder-employees often results in substantial savings in employment taxes.

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 22-1. The two shareholders should consider reducing their \$92,000 salary and instead receiving a larger undistributed share of the S corporation income. A shareholder's share of pass-through S corporation income is not treated as self-employment income, whereas compensation is subject to the Social Security and Medicare taxes for the corporation and both employees.

The IRS can require that reasonable compensation be paid to family members who render services or provide capital to the S corporation. The IRS also can adjust the items taken into account by family-member shareholders to reflect the value of services or capital they provided (refer to Example 43).

Deductions for various tax-free fringe benefits are denied to a more-than-2 percent shareholder-employee of an S corporation. Such benefits include group term life insurance, medical insurance, and meals and lodging furnished for the convenience of the employer. These items are treated as wages and are subject to most payroll taxes. The employee can deduct medical insurance premiums on his or her tax return.

Loss Considerations

A net loss in excess of tax basis may be carried forward and deducted only by the same shareholder in succeeding years. Thus, before disposing of the stock, a shareholder should increase the basis of such stock/loan to flow through the loss. The next shareholder does not obtain the loss carryover.

⁶³Rev.Rul. 74-44, 1974-1 C.B. 287; *Spicer Accounting, Inc. v. U.S.*, 91-1 USTC ¶50,103, 66 AFTR 2d 90-5806, 918 F.2d 90 (CA-9, 1990); *Radtke v. U.S.*, 90-1 USTC ¶50,113, 65 AFTR 2d 90-1155, 895 F.2d 1196 (CA-7, 1990); *Joseph M. Grey Public Accountant, P.C.*, 119 T.C. 121 (2002); *David*

E. Watson, PC, v. U.S., 2010-1 USTC ¶50,444, 105 AFTR 2d 2010-2624, 714 F.Supp.2d 954 (S.D. Iowa). The IRS uses salary surveys and other statistical methods to determine the appropriate compensation level. *McAlary Ltd.*, TC Summary Opinion 2013-62.

Any unused loss carryover in existence upon the termination of the S election may be deducted only in the next tax year and is limited to the individual's *stock* basis (not loan basis) in the post-termination year.⁶⁴ The shareholder may want to purchase more stock to increase the tax basis to absorb the loss.

The NOL provisions create a need for sound tax planning during the last election year and the post-termination transition period. If it appears that the S corporation is going to sustain an NOL or use up any loss carryover, each shareholder's basis should be analyzed to determine whether it can absorb the share of the loss. If basis is insufficient to absorb the loss, further investments should be considered before the end of the post-termination transition year.

A calendar year C corporation has an NOL of \$20,000 in 2014. The corporation makes a valid S election in 2015 and has another \$20,000 NOL in that year. At all times during 2015, the stock of the corporation was owned by the same 10 shareholders, each of whom owned 10% of the stock. Tim, one of the 10 shareholders, has a stock basis of \$1,800 at the beginning of 2015. None of the 2014 NOL may be carried forward into the S year. Although Tim's share of the 2015 NOL is \$2,000, the deduction for the loss is limited to \$1,800 in 2015 with a \$200 carryover.

EXAMPLE

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Avoiding the Passive Investment Income Tax

Too much passive investment income (PII) may cause an S corporation to incur a penalty tax on excessive passive investment income and/or terminate the S election. Several planning techniques can be used to avoid both of these unfavorable events. The corporation might reduce taxable income below the excess net passive income; similarly, PII might be accelerated into years in which there is an offsetting NOL.

The tax also can be avoided if the corporation generates needed gross receipts. By increasing gross receipts without increasing PII, the amount of PII in excess of 25 percent of gross receipts is reduced.

An S corporation has paid a passive investment income penalty tax for two consecutive years. In the next year, the corporation has a large amount of AAA. One planning technique to address this situation is to manufacture a large amount of gross receipts without increasing PII through an action such as a merger with a grocery store. If the gross receipts from the grocery store are substantial, the amount of the PII in excess of 25% of gross receipts is reduced.

EXAMPLE

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Managing the Built-in Gains Tax

The taxable income limitation encourages an S corporation to create deductions or accelerate deductions in the years that built-in gains are recognized. Although the postponed built-in gain is carried forward to future years, the time value of money makes the postponement beneficial. For example, payment of compensation, rather than a distribution, creates a deduction that reduces taxable income and postpones the built-in gains tax.

Mundy, Inc., an S corporation converted from a C corporation, has built-in gain of \$110,000 and taxable income of \$120,000 before payment of salaries to its two shareholders. If Mundy pays at least \$120,000 in salaries to the shareholders (rather than a distribution), its taxable income drops to zero and the built-in gains tax is postponed. Thus, Mundy needs to keep the salaries as high as possible to postpone the built-in gains tax in future years and reap a benefit from the time value of money. Of course, paying the salaries may increase the payroll tax burden if the salaries are below FICA and FUTA limits.

EXAMPLE

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⁶⁴§ 1366(d)(3).

Controlling AMT Adjustments and Preferences

AMT items flow through proportionately to the shareholders, who, in computing the individual AMT, treat the adjustments and preferences as if they were directly realized. Thus, the S corporation may not take advantage of the AMT exemption available to a small corporation, but it never must compute an ACE adjustment. (See Chapter 15.)

Liquidation of an S Corporation

S corporations are subject to many of the same liquidation rules applicable to C corporations (refer to Chapter 20). In general, the distribution of appreciated property to S shareholders in complete liquidation is treated as if the property were sold to the shareholders in a taxable transaction. Unlike a C corporation, however, the S corporation itself incurs no incremental tax on the liquidation gains, because such gains flow through to the shareholders.

Any corporate-level gain increases the shareholder's stock basis by a like amount and reduces any gain realized by the shareholder when he or she receives the liquidation proceeds.

22-5 OVERALL COMPARISON: FORMS OF DOING BUSINESS

See Concept Summary 22.4 for a detailed comparison of the tax consequences of the following forms of doing business: sole proprietorship, partnership, limited liability entity, S corporation, and regular corporation.

Concept Summary 22.4

Tax Attributes of Different Forms of Business (Assume That Partners and Shareholders Are All Individuals)

	Sole Proprietorship	Partnership/Limited Liability Company*	S Corporation	Regular (C) Corporation**
Restrictions on type or number of owners	One owner. The owner must be an individual.	Must have at least 2 owners.	Only individuals, estates, certain trusts, and certain tax-exempt entities can be owners. Maximum number of shareholders limited to 100.***	None, except that some states require a minimum of 2 shareholders.
Incidence of tax	Sole proprietorship's income and deductions are reported on Schedule C of the individual's Form 1040. A separate Schedule C is prepared for each business.	Entity not subject to tax. Owners in their separate capacity subject to tax on their distributive share of income. Entity files Form 1065.	Except for certain built-in gains and passive investment income when earnings and profits are present from C corporation tax years, entity not subject to Federal income tax. S corporation files Form 1120S. Shareholders are subject to tax on income attributable to their stock ownership.	Income subject to double taxation. Entity subject to tax, and shareholder subject to tax on any corporate dividends received. Corporation files Form 1120.
Highest tax rate	35% at individual level (39.6% for certain high-income taxpayers).	35% at owner level (39.6% for certain high-income taxpayers).	35% at shareholder level (39.6% for certain high-income taxpayers).	35% at corporate level plus 0%/15%/20% on any corporate dividends at shareholder level (if qualified dividends; otherwise 39.6%). NIIT of 3.8% may apply to dividend income.

continued

Tax Attributes of Different Forms of Business—(Continued)

	Sole Proprietorship	Partnership/Limited Liability Company*	S Corporation	Regular (C) Corporation**
Self-employment (SE) tax on owner	Schedule C income subject to SE tax.	Guaranteed payment for services and distributive share of net earnings of general partner subject to SE tax.	Not applicable. Payroll taxes owed on reasonable compensation paid to shareholder/employee; no SE tax on shareholder's distributive share of earnings.	Not applicable. Payroll taxes owed on wages of shareholder/employee.
Choice of tax year	Same tax year as owner.	Selection generally restricted to coincide with tax year of majority owners or principal owners or to tax year determined under the least aggregate deferral method.	Restricted to a calendar year unless IRS approves a different year for business purposes or other exceptions apply.	Unrestricted selection allowed at time of filing first tax return.
Timing of taxation	Based on owner's tax year.	Owners report their share of income in their tax year with or within which the entity's tax year ends. Owners in their separate capacities are subject to payment of estimated taxes.	Shareholders report their shares of income in their tax year with or within which the corporation's tax year ends. Shareholders may be subject to payment of estimated taxes.	Corporation subject to tax at close of its tax year. May be subject to payment of estimated taxes. Dividends will be subject to tax at the shareholder level in the tax year received.
Basis for allocating income to owners	Not applicable (only one owner).	Profit and loss sharing agreement. Cash basis items of cash basis entities are allocated on a daily basis. Other entity items are allocated after considering varying interests of owners.	Pro rata share based on stock ownership. Shareholder's pro rata share is determined on a daily basis, according to the number of shares of stock held on each day of the corporation's tax year.	Not applicable.
Contribution of property to the entity	Not a taxable transaction.	Generally not a taxable transaction.	Is a taxable transaction unless the § 351 requirements are satisfied.	Is a taxable transaction unless the § 351 requirements are satisfied.
Character of income taxed to owners	Retains source characteristics.	Conduit—retains source characteristics.	Conduit—retains source characteristics.	All source characteristics are lost when income is distributed to owners.
Basis for allocating a net operating loss to owners	Not applicable (only one owner).	Profit and loss sharing agreement. Cash basis items of cash basis entities are allocated on a daily basis. Other entity items are allocated after considering varying interests of owners.	Prorated among shareholders on a daily basis.	Not applicable.
Limitation on losses deductible by owners	Investment plus liabilities.	Owner's investment plus share of liabilities.	Shareholder's investment plus loans made by shareholder to corporation.	Not applicable.
Subject to at-risk rules	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the shareholder level. Indefinite carryover of excess loss.	Yes, for closely held corporations. Indefinite carryover of excess loss.
Subject to passive activity loss rules	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the owner level. Indefinite carryover of excess loss.	Yes, at the shareholder level. Indefinite carryover of excess loss.	Yes, for closely held corporations and personal service corporations. Indefinite carryover of excess loss.

continued

Tax Attributes of Different Forms of Business—(Continued)

	Sole Proprietorship	Partnership/Limited Liability Company*	S Corporation	Regular (C) Corporation**
Tax consequences of earnings retained by entity	Taxed to owner when earned and increases his or her investment in the sole proprietorship.	Taxed to owners when earned and increases their respective interests in the entity.	Taxed to shareholders when earned and increases their respective bases in stock.	Taxed to corporation as earned and may be subject to penalty tax if accumulated unreasonably.
Nonliquidating distributions to owners	Not taxable.	Not taxable unless money received exceeds recipient owner's basis in entity interest. Existence of § 751 assets may cause recognition of ordinary income.	Generally not taxable unless the distribution exceeds the shareholder's AAA or stock basis. Existence of accumulated earnings and profits could cause some distributions to be dividends.	Taxable in year of receipt to extent of earnings and profits or if exceeds basis in stock.
Capital gains	Taxed at owner level with opportunity to use alternative tax rate.	Conduit—owners must account for their respective shares.	Conduit, with certain exceptions (a possible penalty tax)—shareholders must account for their respective shares.	Taxed at corporate level with a maximum 35% rate. No other benefits.
Capital losses	Only \$3,000 of capital losses can be offset each tax year against ordinary income. Indefinite carryover.	Conduit—owners must account for their respective shares.	Conduit—shareholders must account for their respective shares.	Carried back three years and carried forward five years. Deductible only to the extent of capital gains.
§ 1231 gains and losses	Taxable or deductible at owner level. Five-year lookback rule for § 1231 losses.	Conduit—owners must account for their respective shares.	Conduit—shareholders must account for their respective shares.	Taxable or deductible at corporate level only. Five-year lookback rule for § 1231 losses.
Foreign tax credits	Available at owner level.	Conduit—passed through to owners.	Generally conduit—passed through to shareholders.	Available at corporate level only.
§ 1244 treatment of loss on sale of interest	Not applicable.	Not applicable.	Available.	Available.
Basis treatment of entity liabilities	Includible in interest basis.	Includible in interest basis.	Not includible in stock basis.	Not includible in stock basis.
Built-in gains	Not applicable.	Not applicable.	Possible corporate tax.	Not applicable.
Special allocations to owners	Not applicable (only one owner).	Available if supported by substantial economic effect.	Not available.	Not applicable.
Availability of fringe benefits to owners	None.	None.	None unless a 2%-or-less shareholder.	Available within antidiscrimination rules.
Effect of liquidation/redemption/reorganization on basis of entity assets	Not applicable.	Usually carried over from entity to owner unless a § 754 election is made, excessive cash is distributed, or more than 50% of the capital interests are transferred within 12 months.	Taxable step-up to fair market value.	Taxable step-up to fair market value.
Sale of ownership interest	Treated as the sale of individual assets. Classification of recognized gain or loss depends on the nature of the individual assets.	Treated as the sale of an entity interest. Recognized gain or loss is classified as capital under § 741, subject to ordinary income treatment under § 751.	Treated as the sale of corporate stock. Recognized gain is classified as capital gain. Recognized loss is classified as capital loss, subject to ordinary loss treatment under § 1244.	Treated as the sale of corporate stock. Recognized gain is classified as capital gain. Recognized loss is classified as capital loss, subject to ordinary loss treatment under § 1244.

continued

Tax Attributes of Different Forms of Business—(Continued)

	Sole Proprietorship	Partnership/Limited Liability Company*	S Corporation	Regular (C) Corporation**
Distribution of appreciated property	Not taxable.	No recognition at the entity level.	Recognition at the corporate level to the extent of the appreciation. Conduit—amount of recognized gain is passed through to shareholders.	Taxable at the corporate level to the extent of the appreciation.
Splitting of income among family members	Not applicable (only one owner).	Difficult—IRS will not recognize a family member as an owner unless certain requirements are met.	Rather easy—gift of stock will transfer tax on a pro rata share of income to the donee. However, IRS can make adjustments to reflect adequate compensation for services.	Same as an S corporation, except that donees will be subject to tax only on earnings actually or constructively distributed to them. Other than unreasonable compensation, IRS generally cannot make adjustments to reflect adequate compensation for services and capital.
Organizational costs	Startup expenditures are eligible for \$5,000 limited expensing (subject to phaseout) and amortizing balance over 180 months.	Organizational costs are eligible for \$5,000 limited expensing (subject to phaseout) and amortizing balance over 180 months.	Same as partnership.	Same as partnership.
Charitable contributions	Limitations apply at owner level.	Conduit—owners are subject to deduction limitations in their own capacities.	Conduit—shareholders are subject to deduction limitations in their own capacities.	Limited to 10% of taxable income before certain deductions.
Alternative minimum tax	Applies at owner level. AMT rates are 26% and 28%.	Applies at the owner level rather than at the entity level. AMT preferences and adjustments are passed through from the entity to the owners.	Applies at the shareholder level rather than at the corporate level. AMT preferences and adjustments are passed through from the S corporation to the shareholders.	Applies at the corporate level. AMT rate is 20%. Exception for small corporations.
ACE adjustment	Does not apply.	Does not apply.	Does not apply.	The adjustment is made in calculating AMTI. The adjustment is 75% of the excess of adjusted current earnings over unadjusted AMTI. If the unadjusted AMTI exceeds adjusted current earnings, the adjustment is negative.
Tax preference items	Apply at owner level in determining AMT.	Conduit—passed through to owners who must account for such items in their separate capacities.	Conduit—passed through to shareholders who must account for such items in their separate capacities.	Subject to AMT at corporate level.

* Refer to Chapter 21 for additional details on partnerships and limited liability companies.

** Refer to Chapters 17 through 20 for additional details on regular (C) corporations.

*** Spouses and family members are treated as one shareholder.

REFOCUS ON THE BIG PICTURE

USING A FLOW-THROUGH ENTITY TO ACHIEVE DEDUCTIBILITY OF LOSSES



As long as Smith and Jones, the owners of Cane, Inc., maintain C corporation status, they cannot deduct on their individual tax returns any NOLs the business incurs. For the owners to deduct any future NOLs on their Forms 1040, Cane needs to be operated as a flow-through entity. The most logical alternative is to make an S election or to become a limited liability company.

An S election may be appropriate for Cane. Cane should make a timely election on Form 2553, and both shareholders must consent to the election. The owners should make the election on or before the fifteenth day of the third month of the current year.

Normally, an S corporation does not pay any income tax because all items (including NOLs) flow through to the shareholders. A C corporation making an S election may be required to pay a corporate-level built-in gains tax or a LIFO recapture tax.

Cane does not need to liquidate or engage in a tax-deferred reorganization when converting to an S corporation. An S corporation can have voting and nonvoting common stock, provided that all shares have the same economic rights to corporate income or loss.

Cane might get rid of the bonds that generate its tax-exempt income, which will not be reflected in the AAA. Although it is reflected in stock basis, tax-exempt income (as part of the OAA) is distributed to the shareholders only after the S corporation has distributed all of its C corporation earnings and profits.

What If?

Nonresident aliens cannot own S stock, so if joint ownership of the shares is desired among all of the spouses, a change in the spouses' residency must occur. When Cane begins to turn a profit, the S election will be less attractive, and termination of the S election should be considered by the parties.

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Key Terms

Accumulated adjustments account (AAA), 22-13

Accumulated earnings and profits (AEP), 22-13

Built-in gains tax, 22-22

Bypass election, 22-15

Other adjustments account (OAA), 22-16

Passive investment income (PII), 22-9

Previously taxed income (PTI), 22-15

S corporation, 22-2

Small business corporation, 22-3

Subchapter S, 22-2

Voluntary revocation, 22-8

Discussion Questions

1. **LO.1** Which of these taxes applies to an S corporation?
 - a. Alternative minimum tax.
 - b. Personal holding company tax.
 - c. Property tax assessed by the county.
2. **LO.2** Which of the following are requirements to be an S corporation?
 - a. Limited to a maximum of 100 shareholders.
 - b. Has no resident alien shareholders.
 - c. Has only one class of stock.
 - d. May have no straight debt.
 - e. Cannot have any earnings and profits (E & P).

3. **LO.2** One shareholder of an S corporation takes a short-term unwritten cash advance of \$9,100 during the tax year. Would this arrangement create a second class of stock? Explain.
4. **LO.2** Which of the following can be shareholders of an S corporation?
 - a. Partnership.
 - b. Limited liability partnership.
 - c. Corporation.
 - d. Limited liability company.
5. **LO.2** Joey lives in North Carolina, a common law state. He is a shareholder in an S corporation. If he marries a nonresident alien, will the S election terminate? Would your answer change if he lives in Louisiana? Explain.
6. **LO.2** Bob Roman, the major owner of an S corporation, approaches you for some tax planning help. He would like to exchange some real estate in a like-kind transaction under § 1031 for real estate that may have some environmental liabilities. Prepare a letter to Bob, outlining your suggestion. Bob's address is 8411 Huron Boulevard, West Chester, PA 19382.
7. **LO.2, 3** On March 2, 2015, the two 50% shareholders of a calendar year corporation decide to elect S status. One of the shareholders, Terry, purchased her stock from a previous shareholder (a nonresident alien) on January 18, 2015. Identify any potential problems for Terry and the corporation.
8. **LO.4** Caleb Samford calls you and says that his two-person S corporation was involuntarily terminated in February 2014. He asks you if they can make a new S election now, in November 2015. Draft a memo for the file, outlining what you told Caleb.
9. **LO.6** Using the categories in the following legend, classify each transaction as a plus (+) or minus (−) on Schedule M-2 of Form 1120S. An answer might look like one of these: +AAA or −OAA.

Issue ID
Communications

Issue ID

Communications

Legend

AAA = Accumulated adjustments account

OAA = Other adjustments account

NA = No direct effect on Schedule M-2

- a. Receipt of tax-exempt interest income.
 - b. Unreasonable compensation determined.
 - c. Depreciation recapture income.
 - d. Nontaxable life insurance proceeds.
 - e. Expenses related to tax-exempt securities.
 - f. Charitable contributions.
 - g. Business gifts in excess of \$25.
 - h. Nondeductible fines and penalties.
 - i. Administrative expenses.
10. **LO.6, 11** Collette's S corporation holds a small amount of accumulated earnings and profits (AEP), requiring the use of a more complex set of distribution rules. Collette's accountant tells her that this AEP forces the maintenance of the AAA figure each year. Discuss the issues that arise with respect to distributions when an S corporation holds AEP.

Issue ID

- Communications**
11. **LO.6, 8** Scott Tyrney owns 21% of an S corporation. He is confused with respect to the amounts of the corporate AAA and his stock basis. Write a brief memo to Scott, identifying the key differences between AAA and an S shareholder's stock basis.
 12. **LO.8** For each of the following independent statements, indicate whether the transaction will increase (+), decrease (−), or have no effect (*NE*) on the basis of a shareholder's stock in an S corporation.
 - a. Expenses related to tax-exempt income.
 - b. Short-term capital gain.
 - c. Nonseparately computed loss.
 - d. Section 1231 gain.
 - e. Depletion *not* in excess of basis.
 - f. Separately computed income.
 - g. Nontaxable return-of-capital distribution by the corporation.
 - h. Advertising expenses.
 - i. Business gifts in excess of \$25.
 - j. Depreciation recapture income.
 - k. Dividend income received by the S corporation.
 - l. LIFO recapture tax paid.
 - m. Collection of a bad debt previously deducted.
 - n. Long-term capital loss.
 - o. Cash distribution to shareholder out of AAA.
- Issue ID**
13. **LO.9** Sheila Jackson is a 50% shareholder in Washington, Inc., an S corporation. This year, Jackson's share of the Washington loss is \$100,000. Jackson has income from several other sources. Identify at least four tax issues related to the effects of the S corporation loss on Jackson's tax return.
- Decision Making**
14. **LO.1, 11** One of your clients is considering electing S status. Texas, Inc., is a six-year-old company with two equal shareholders, both of whom paid \$30,000 for their stock. Going into 2015, Texas has a \$110,000 NOL carryforward from prior years. Estimated income is \$40,000 for 2015 and \$25,000 for each of the next three years. Should Texas make an S election for 2015? Why or why not?

Computational Exercises

15. **LO.10** Matulis, Inc., a C corporation, owns a single asset with a basis of \$325,000 and a fair market value of \$800,000. Matulis holds a positive E & P balance. It elects S corporation status and then sells the asset. Compute the corporate-level built-in gains tax that must be paid by Matulis.
16. **LO.10** TyroneCo, an S corporation with a positive E & P balance, reports gross receipts for the year totaling \$400,000 (of which \$200,000 is PII). Expenditures directly connected to the production of the PII total \$80,000. Compute Tyrone's PII tax.
17. **LO.6** Dion, a shareholder, owned 20% of MeadowBrook's stock for 292 days and 25% for the remaining 73 days in the year. Using the per-day allocation method, compute Dion's share of the following S corporation items.

	Schedule K Totals	Dion's Schedule K-1 Totals
Ordinary income	\$60,000	\$ _____
Tax-exempt interest	1,000	\$ _____
Charitable contributions	3,400	\$ _____

18. **LO.6** Noelle, the owner of all of the shares of ClockCo, an S corporation, transfers her stock to Grayson on April 1. ClockCo reports a \$70,000 NOL for the entire tax year, but \$10,000 of the loss occurs during January–March. Without a short-year election, how much of the loss is allocated to Noelle and how much is allocated to Grayson? If the corporation makes the short-year election, how much of the loss is allocated to Grayson?
19. **LO.6** Greiner, Inc., a calendar year S corporation, holds no AEP. During the year, Chad, an individual Greiner shareholder, receives a cash distribution of \$30,000 from the entity. Chad’s basis in his stock is \$25,000. Compute Chad’s ordinary income and capital gain from the distribution. What is his stock basis after accounting for the payment?
20. **LO.6** Holbrook, a calendar year S corporation, distributes \$15,000 cash to its only shareholder, Cody, on December 31. Cody’s basis in his stock is \$20,000, Holbrook’s AAA balance is \$8,000, and Holbrook holds \$2,500 AEP before the distribution. Complete the chart below.

	Distribution from Account	Effect on Stock Basis	Balance after Distribution
From AAA Account	\$ _____	\$ _____	\$ _____
From AEP Account	\$ _____	\$ _____	\$ _____
From Cody’s stock basis	\$ _____	\$ _____	\$ _____

21. **LO.7** Vogel, Inc., an S corporation for five years, distributes a tract of land held as an investment to Jamari, its majority shareholder. The land was purchased for \$45,000 ten years ago and is currently worth \$120,000.
 - a. As a result of the distribution, what is Vogel’s recognized capital gain? How much is reported as a distribution to shareholders?
 - b. What is the net effect of the distribution on Vogel’s AAA?
 - c. Assume instead that the land had been purchased for \$120,000 and was currently worth \$45,000. How much would Vogel recognize as a loss? What would be the net effect on Vogel’s AAA? What would be Jamari’s basis in the land?
22. **LO.8** Jonas is a 60% owner of Ard, an S corporation. At the beginning of the year, his stock basis is zero. Jonas’s basis in a \$20,000 loan made to Ard and evidenced by Ard’s note has been reduced to \$0 by prior losses.
 During the year, Jonas’s net share of Ard’s taxable income is \$10,000. At the end of the year, Ard makes a \$15,000 cash distribution to Jonas. After these transactions, what is Jonas’s basis in his stock, and what is his basis in the debt? What is Jonas’s recognized capital gain?
23. **LO.9** Kaiwan, Inc., a calendar year S corporation, is partly owned by Sharrod, whose beginning stock basis is \$32,000. During the year, Sharrod’s share of a Kaiwan long-term capital gain (LTCG) is \$5,000, and his share of an ordinary loss is \$18,000. Sharrod then receives a \$20,000 cash distribution.
 Compute the following.
 - a. Sharrod’s deductible loss.
 - b. Sharrod’s suspended loss.
 - c. Sharrod’s new basis in the Kaiwan stock.

Problems

24. **LO.5, 6** The profit and loss statement of Kitsch Ltd., an S corporation, shows \$100,000 book income. Kitsch is owned equally by four shareholders. From supplemental data, you obtain the following information about items that are included in book income.

Selling expenses	\$ 21,200
Tax-exempt interest income	3,000
Dividends received	9,000
§1231 gain	7,000
Depreciation recapture income	11,000
Recovery of bad debts previously deducted	5,000
Long-term capital loss	(6,000)
Salary paid to owners (each)	(12,000)
Cost of goods sold	(91,000)

- Compute Kitsch's nonseparately stated income or loss for the tax year.
- What would be the share of this year's nonseparately stated income or loss items for James Billings, one of the Kitsch shareholders?

25. **LO.5, 6** Maul, Inc., a calendar year S corporation, incurred the following items.

Tax-exempt interest income	\$ 7,000
Sales	140,000
Depreciation recapture income	12,000
Long-term capital gain	20,000
§1231 gain	7,000
Cost of goods sold	(42,000)
Administrative expenses	(15,000)
Depreciation expense (MACRS)	(17,000)
Charitable contributions	(7,000)

- Calculate Maul's nonseparately computed income or loss.
- If Carl is a 40% owner of Maul, Inc., what is his share of the long-term capital gain?

26. **LO.5, 6** Zebra, Inc., a calendar year S corporation, incurred the following items this year. Sammy is a 40% Zebra shareholder throughout the year.

Operating income	\$100,000
Cost of goods sold	(40,000)
Depreciation expense (MACRS)	(10,000)
Administrative expenses	(5,000)
§1231 gain	21,000
Depreciation recapture income	25,000
Short-term capital loss from stock sale	(6,000)
Long-term capital loss from stock sale	(4,000)
Long-term capital gain from stock sale	15,000
Charitable contributions	(4,500)

- Calculate Sammy's share of Zebra's nonseparately computed income or loss.
- Calculate Sammy's share of any Zebra long-term capital gain.

27. **LO.6, 8, 9** Mary is a shareholder in CarrollCo, a calendar year S corporation. At the beginning of the year, her stock basis is \$10,000, her share of the AAA is \$2,000, and her share of corporate AEP is \$6,000.

At the end of the year, Mary receives from CarrollCo a \$6,000 cash distribution. Mary's share of S corporation items includes a \$2,000 long-term capital gain and a \$10,000 ordinary loss. Determine the effects of these events on Mary's share of the entity's AAA, her stock basis, and CarrollCo's AEP.

28. **LO.6** On January 1, 2015, Kinney, Inc., an S corporation, reports \$4,000 of accumulated E&P and a balance of \$10,000 in AAA. Kinney has two shareholders, Erin and Frank, each of whom owns 500 shares of Kinney's stock. Kinney's nonseparately stated ordinary income for the year is \$5,000.

Kinney distributes \$6,000 to each shareholder on July 1, and it distributes another \$3,000 to each shareholder on December 21. How are the shareholders taxed on the distributions?

29. **LO.5, 6** McLin, Inc., is a calendar year S corporation. Its AAA balance is zero.
- McLin holds \$90,000 of AEP. Tobias, the sole shareholder, has an adjusted basis of \$80,000 in his stock. Determine the tax aspects if a \$90,000 salary is paid to Tobias.
 - Same as part (a), except that McLin pays Tobias a \$90,000 cash distribution from AEP.
30. **LO.6, 7, 8** Tiger, Inc., a calendar year S corporation, is owned equally by four shareholders: Ann, Becky, Chris, and David. Tiger owns investment land that was purchased for \$160,000 four years ago. On September 14, when the land is worth \$240,000, it is distributed to David. Assuming that David's basis in his S corporation stock is \$270,000 on the distribution date, discuss any Federal income tax ramifications.
31. **LO.6, 11** During the year, Wheel, a calendar year S corporation in Stillwater, Oklahoma, generates the following AMT items: a positive adjustment of \$66,000 for mining exploration costs, an excess depletion tax preference of \$96,000, and a positive certified pollution control facility adjustment of \$36,000. The firm's positive ACE adjustment is \$102,000. If Pam Epstein is a one-third Wheel shareholder, what effect do these items have on her individual tax return?
32. **LO.6, 8, 9, 11** Spence, Inc., a calendar year S corporation, generates an ordinary loss of \$110,000 and makes a distribution of \$140,000 to its sole shareholder, Storm Nelson. Nelson's stock basis and AAA at the beginning of the year are \$200,000. Write a memo to your senior manager, Aaron McMullin, discussing the tax treatment of Spence's activities.
33. **LO.6** Lonergan, Inc., a calendar year S corporation in Athens, Georgia, had a balance in AAA of \$200,000 and AEP of \$110,000 on December 31, 2015. During 2016, Lonergan, Inc., distributes \$140,000 to its shareholders, while sustaining an ordinary loss of \$120,000. Calculate the balance in Lonergan's AAA and AEP accounts at the end of 2016.
34. **LO.6** If the beginning balance in Swan, Inc.'s OAA is \$6,700 and the following transactions occur, what is Swan's ending OAA balance?

Decision Making

Communications

Depreciation recapture income	\$ 21,600
Payroll tax penalty	(4,200)
Tax-exempt interest income	4,012
Nontaxable life insurance proceeds	100,000
Life insurance premiums paid (nondeductible)	(3,007)

35. **LO.6, 8** Cougar, Inc., is a calendar year S corporation. Cougar's Form 1120S shows nonseparately stated ordinary income of \$80,000 for the year. Johnny owns 40% of the Cougar stock throughout the year. The following information is obtained from the corporate records.

Tax-exempt interest income	\$ 3,000
Salary paid to Johnny	(52,000)
Charitable contributions	(6,000)
Dividends received from a non-U.S. corporation	5,000
Short-term capital loss	(6,000)
Depreciation recapture income	11,000
Refund of prior state income taxes	5,000
Cost of goods sold	(72,000)
Long-term capital loss	(7,000)
Administrative expenses	(18,000)
Long-term capital gain	14,000
Selling expenses	(11,000)

Johnny's beginning stock basis	\$ 32,000
Johnny's additional stock purchases	9,000
Beginning AAA	31,000
Johnny's loan to corporation	20,000

- Compute Cougar's book income or loss.
- Compute Johnny's ending stock basis.
- Calculate Cougar's ending AAA balance.

36. **LO.6,7,8** Money, Inc., a calendar year S corporation in Denton, Texas, has two unrelated shareholders, each owning 50% of the stock. Both shareholders have a \$400,000 stock basis as of January 1, 2015. At the beginning of 2015, Money has an AAA of \$300,000 and AEP of \$600,000. During 2015, Money has operating income of \$100,000. At the end of the year, Money distributes securities worth \$1 million, with an adjusted basis of \$800,000. Determine the tax effects of these transactions.
37. **LO.6,7,8** Assume the same facts as in Problem 36, except that the two shareholders consent to an AAA bypass election.
38. **LO.8,9** At the beginning of the tax year, Lizzie holds a \$10,000 stock basis as the sole shareholder of Spike, Inc., an S corporation. During the year, Spike reports the following. Determine Lizzie's stock basis at the end of the year and the treatment of her cash distribution.

Net taxable income from sales	\$ 25,000
Net short-term capital loss	(18,000)
Cash distribution to Lizzie, 12/31	15,000

39. **LO.8,9** Assume the same facts as in Problem 38, except that the cash distribution to Lizzie amounts to \$40,000. Determine Lizzie's stock basis at the end of the year and the treatment of her cash distribution.
40. **LO.8** Jeff, a 52% owner of an S corporation, has a stock basis of zero at the beginning of the year. Jeff's basis in a \$10,000 loan made to the corporation and evidenced by a corporate note has been reduced to zero by pass-through losses. During the year, his net share of the corporate taxable income is \$11,000. At the end of the year, Jeff receives a \$15,000 cash distribution. Discuss the tax effects of the distribution.
41. **LO.8** Assume the same facts as in Problem 40, except that there is no cash distribution, but the corporation repays the loan principal to Jeff. Discuss the tax effects.
42. **LO.8** Assume the same facts as in Problem 40, except that Jeff's share of corporate taxable income is only \$8,000 and there is no cash distribution. However, the corporation repays the \$10,000 loan principal to Jeff. Discuss the tax effects. Assume that there was no corporate note (i.e., only an account payable). Does this change your answer? Explain.

- Issue ID** 43. **LO.9** Maple, Inc., is an S corporation with a single shareholder, Bob Maple. Bob believes that his stock basis in the entity is \$50,000, but he has lost some of the records to substantiate this amount. Maple reports an ordinary loss for the year of \$80,000. What are the Federal income tax aspects to consider?
44. **LO.6,9** At the beginning of the year, Ann and Becky own equally all of the stock of Whitman, Inc., an S corporation. Whitman generates a \$120,000 loss for the year (not a leap year). On the 189th day of the year, Ann sells her half of the Whitman stock to her son, Scott. How much of the \$120,000 loss, if any, belongs to Scott?

45. **LO.6,9** In Problem 44, how much of the Whitman loss belongs to Ann and Becky? Becky's stock basis is \$41,300.
46. **LO.5,6,8,9** A calendar year S corporation reports an ordinary loss of \$80,000 and a capital loss of \$20,000. Mei Freiberg owns 30% of the corporate stock and has a \$24,000 basis in her stock. Determine the amounts of the ordinary loss and capital loss, if any, that flow through to Freiberg. Prepare a tax memo for the files, explaining your computations.
47. **LO.10** Whindy Corporation, an S corporation, reports a recognized built-in gain of \$80,000 and a recognized built-in loss of \$10,000 this year. Whindy holds an \$8,000 unexpired NOL carryforward from a C corporation year. Whindy's ordinary income for the year is \$65,000. Calculate any built-in gains tax.
48. **LO.10** Flint, an S corporation with substantial AEP, reports operating revenues of \$410,000, taxable interest income of \$390,000, operating expenses of \$260,000, and deductions attributable to the interest of \$150,000. Calculate any passive investment income penalty tax payable.
49. **LO.5,6,11** Bonnie and Clyde each own one-third of a fast-food restaurant, and their 13-year-old daughter owns all of the other shares. Both parents work full-time in the restaurant, but the daughter works infrequently. Neither Bonnie nor Clyde receives a salary during the year, when the ordinary income of the S corporation is \$180,000.
An IRS agent estimates that reasonable salaries for Bonnie, Clyde, and the daughter are \$30,000, \$35,000, and \$10,000, respectively. What adjustments would you expect the IRS to impose upon these taxpayers?
50. **LO.11** Friedman, Inc., an S corporation, holds some highly appreciated land and inventory and some marketable securities that have declined in value. It anticipates a sale of these assets and a complete liquidation of the company over the next two years. Arnold Schwartz, the CFO, calls you, asking how to treat these transactions. Prepare a tax memo indicating what you told Arnold in the phone conversation.
51. **LO.6,10** Samuel Reese sold 1,000 shares of his stock in Maroon, Inc., an S corporation. He sold the stock for \$15,700 after he had owned it for six years. Samuel had paid \$141,250 for the stock, which was issued under § 1244. Samuel is married and is the owner of the 1,000 shares. Determine the appropriate treatment of any gain or loss on the stock sale.
52. **LO.11** Blue is the owner of all of the shares of an S corporation, and Blue is considering receiving a salary of \$110,000 from the business. She will pay the 7.65% FICA taxes on the salary, and the S corporation will pay the same amount of FICA tax. If Blue reduces her salary to \$50,000 and takes an additional \$60,000 as a cash distribution, how would her Federal income tax liabilities change?
53. **LO.1,6,8,9,11** Orange, Inc., a calendar year corporation in Clemson, South Carolina, elects S corporation status for 2015. The company generated a \$74,000 NOL in 2014 and another NOL of \$43,000 in 2015. Orange recorded no other transactions for the year.
At all times in 2014 and 2015, the stock of the corporation is owned by the same four shareholders, each owning 25% of the stock. Pete, one of the shareholders, holds a \$6,020 basis in the Orange stock at the beginning of 2015. Identify the Federal income tax issues that Pete faces.

Communications

Issue ID

Communications

Decision Making

Issue ID

See Appendix E for Comprehensive Tax Return Problem—Form 1120S

Research Problems

THOMSON REUTERS

CHECKPOINT
 Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. The tax treatment of fringe benefits for more-than-2% shareholder-employees of S corporations is less favorable than that for nonowners or employees of some other entities. What fringe benefits are subject to this limitation? What fringe benefits escape this limitation?

Research Problem 2. Sean Moon is president, secretary, treasurer, sole director, and sole shareholder of Streetz, an S corporation real estate company. He manages all aspects of the company's operations, and he is the only person working at the company that holds a real estate broker's license. Sean works 12-hour days and takes few days off. During 2014 and 2015, Streetz's gross receipts and net income figures were reported as follows.

Year	Gross Receipts	Net Income
2014	\$376,453	\$122,605
2015	405,244	161,660
2016	518,189	231,454

Sean and his wife, Kim, filed joint Federal income tax returns, but they did not report any wages or salaries on line 7 of their returns. During 2016, Moon transferred \$240,000 from the S corporation to his personal account.

You are an expert witness for the IRS. Identify the items you would present to the U.S. Tax Court with respect to the amount of Moon's compensation that is subject to employment taxes and any other taxes due for the year 2016 (especially the Medicare net investment income tax). *Hint:* This is a reasonable compensation issue.

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Communications **Research Problem 3.** Make a graph of the growth in the number of S elections since 1980, using increments of no more than five years. On the same graph, show the maximum Federal income tax rates for those years as they applied to individuals and to C corporations. Send your graph in an e-mail to your instructor with some explanatory comments as to what you found.

Communications **Research Problem 4.** Summarize the trends in court decisions concerning salaries paid to shareholders of small S corporations. Title your essay "S Corporation Salaries: Too Much or Too Little?" Send your essay in an e-mail to your instructor.

Communications **Research Problem 5.** Find the PFS Planning Update entitled "Planning for the Net Investment Income Tax (NIIT), also known as the Medicare Contribution Tax" by PriceWaterhouseCoopers. How will the new NIIT affect S corporations?

7. An S corporation must separately pass through which of the following items to its shareholders?
- I. A net Section 1231 loss
 - II. Foreign income taxes
 - III. Investment interest expense
- a. All of the above
 - b. I and II
 - c. II and III
 - d. II only
8. Pankee Inc., was originally formed as a C corporation and made an S election 5 years ago. Which of the following statements correctly describes the taxability of Pankee's distributions to its shareholders?
- a. A distribution to the shareholders will be taxable to the shareholders, if it is treated as coming from the S corporation's accumulated adjusted account and represents an amount already taxed to the shareholders
 - b. A distribution to the shareholders will be nontaxable to the shareholders, if it is treated as coming from the S corporation's accumulated adjusted account and represents an amount already taxed to the shareholders
 - c. A distribution to the shareholders will be nontaxable to the shareholders, if it is treated as coming from the S corporation's accumulated earnings and profits, earned during its years as a C corporation
 - d. A distribution to the shareholders will be nontaxable to the shareholders regardless of whether it is treated as coming from the S corporation's accumulated adjusted account or its accumulated earnings and profits
9. An S corporation's revocation statement is effective if it is signed by shareholders owning:
- a. More than 50% of S corporation's voting stock only
 - b. 50% or more of S corporation's voting stock only
 - c. More than 50% of S corporations voting and nonvoting stock
 - d. 50% or more of S corporations voting and nonvoting stock
10. Zana Corp is a calendar year S corporation. Pack Corp, a C corporation, became a shareholder in Zana on September 4, 20X4 (the 247th day of the calendar year). During 20X4, Zana reported nonseparately computed income of \$182,500. Assuming no special elections are made, which scenario below describes the correct way to report Zana's income for the 2014 tax years?
- a. Zana should file a full year S corporation tax return reporting the entire income of \$182,500
 - b. Zana should file a full year C corporation tax return reporting the entire income of \$182,500
 - c. Zana should file a partial year S corporation tax return reporting income of \$59,500 and a partial year C corporation tax return reporting income of \$123,000
 - d. Zana should file a partial year S corporation tax return reporting income of \$123,000 and a partial year C corporation tax return reporting income of \$59,500
11. As of January 1, 20X4, Kirk owed all 300 shares of Cork Inc., a calendar year S corporation. On September 1, 20X4 (243 days after January 1), Kirk sold 50 shares each to Steve and Moe and kept the remaining 200 shares for himself. For the year ended December 31, 20X4, Cork reported nonseparately computed income of \$109,500 and made no distributions to its shareholders. What amount of nonseparately stated income from Cork should Kirk report on his 20X4 tax return?
- a. \$97,300
 - b. \$109,500
 - c. \$73,000
 - d. \$36,500



PART
8

ADVANCED TAX PRACTICE CONSIDERATIONS

CHAPTER **23**

Exempt Entities

CHAPTER **24**

Multistate Corporate Taxation

CHAPTER **25**

Taxation of International Transactions

CHAPTER **26**

Tax Practice and Ethics

When the taxpayer is exempt from Federal income taxation, disclosure and operating requirements often differ from those applicable to the corporate tax model. Many businesses operate in more than one U.S. state and must account for the taxable activities in each. Lastly, the conduct of a tax professional's practice is bound by ethical and operational constraints, exposing both the taxpayer and the tax advisor to penalties, interest, and other sanctions. In this Part of the text, we examine in more detail these aspects of tax practice.

Exempt Entities

LEARNING OBJECTIVES: *After completing Chapter 23, you should be able to:*

- | | |
|---|--|
| <p>LO.1 Identify the different types of exempt organizations.</p> <p>LO.2 Enumerate the requirements for exempt status.</p> <p>LO.3 Apply the tax consequences of exempt status, including the different consequences for public charities and private foundations.</p> <p>LO.4 Determine which exempt organizations are classified as private foundations.</p> | <p>LO.5 Recognize the taxes imposed on private foundations and calculate the related initial tax and additional tax amounts.</p> <p>LO.6 Determine when an exempt organization is subject to the unrelated business income tax and calculate the amount of the tax.</p> <p>LO.7 List the reports that exempt organizations must file with the IRS and the related due dates.</p> <p>LO.8 Identify tax planning opportunities for exempt organizations.</p> |
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CHAPTER OUTLINE

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|---|--|
| <p>23-1 Types of Exempt Organizations, 23-3</p> <p>23-2 Requirements for Exempt Status, 23-3
 23-2a Serving the Common Good, 23-3
 23-2b Not-for-Profit Entity, 23-3
 23-2c Net Earnings and Members of the Organization, 23-5
 23-2d Political Influence, 23-5</p> <p>23-3 Taxes on Exempt Entities, 23-6
 23-3a Prohibited Transactions, 23-6
 23-3b Feeder Organizations, 23-8</p> <p>23-4 Private Foundations, 23-9
 23-4a Tax Consequences of Private Foundation Status, 23-9
 23-4b Taxes Imposed on Private Foundations, 23-12</p> | <p>23-5 Unrelated Business Income Tax, 23-13
 23-5a Unrelated Trade or Business, 23-14
 23-5b Unrelated Business Taxable Income, 23-18</p> <p>23-6 Reporting Requirements, 23-23
 23-6a Obtaining Exempt Organization Status, 23-23
 23-6b Annual Filing Requirements, 23-23
 23-6c Disclosure Requirements, 23-24</p> <p>23-7 Tax Planning, 23-25
 23-7a General Considerations, 23-25
 23-7b Maintaining Exempt Status, 23-25
 23-7c Private Foundation Status, 23-25
 23-7d Unrelated Business Income Tax, 23-26</p> |
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THE BIG PICTURE

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EFFECT OF A FOR-PROFIT BUSINESS ON A TAX-EXEMPT ENTITY

For an entity to be tax-exempt, it must serve the common good. This common good can include a mission as broad as that of a public charity, such as the Red Cross, or as narrow as that of a private foundation that operates a historic museum that depicts life in the eighteenth century. Most exempt organizations are exempt under § 501(c)(3).

Hopeful, Inc., is a § 501(c)(3) organization that provides temporary lodging and psychological services for abused women. Its annual operating budget is \$12 million. More than two decades ago, Betty Jones was a recipient of the services provided by Hopeful. Now Hopeful's administrator has been notified by the attorney for Betty's estate that her will transfers to Hopeful the legal ownership (100 percent of the outstanding stock) of Taste Good Ice Cream, a chain of 40 gourmet ice cream shops located in Virginia, North Carolina, and South Carolina. The business has been in existence for eight years and has produced substantially higher profits each year.

Hopeful's board is considering the following options regarding the bequest from Betty and has hired you to provide an analysis of the tax consequences of each option.

- Sell the stock of Taste Good Ice Cream and contribute the net proceeds to Hopeful's endowment.
- Continue to conduct the Taste Good Ice Cream business as a division of Hopeful.
- Continue to conduct the business as a wholly owned subsidiary of Hopeful.

With the second and the third options, the existing management team will remain in place. After-tax profits not needed to expand the ice cream shop chain will be used by Hopeful in carrying out its exempt mission.

Read the chapter and formulate your response.

Entities classified as **exempt organizations** may be able to escape Federal income taxation altogether. The House Report on the Revenue Act of 1938 explains:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from the financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.¹

Accordingly, Subchapter F (Exempt Organizations) of the Code (§§ 501–530) provides the authority under which certain organizations are exempt from Federal income tax. Exempt status is not open-ended in that two general limitations exist. First, the nature or scope of the organization may result in it being only partially exempt from tax.² Second, the organization may engage in activities that are subject to special taxation.³

The tax-exempt sector is an important component of the U.S. economy. About 1.6 million tax-exempt entities file tax returns with the IRS. These entities employ almost 12 million workers, representing about 10 percent of the total U.S. workforce. They control about \$3.5 trillion in assets and account for about 5 percent of annual GDP. The IRS audits less than 1 percent of these entities every tax year. The Federal government gives up about \$100 billion per year in tax revenues by granting tax-exempt status to these entities.

On average, 75 percent of an exempt entity's revenues come from the sale of goods and services (e.g., ticket sales, subsidies from governmental agencies, school tuitions, medical charges paid to a clinic or hospital). Over 20 percent of revenues come from donors' gifts and grants. The rest is derived from investment gains and losses. A typical exempt organization uses a dual budgeting and reporting system.

- An *operating fund* is used to make expenditures in support of the entity's exempt purpose (e.g., providing hospital services or offering educational programs). Revenues are raised from donors, sales of goods and services, and contracts with governmental bodies or other exempt entities.
- An *endowment* carries long-term funds contributed by donors or accumulated from operating surpluses and used to provide support for the organization's mission. Usually, the entity's controlling documents require that the principal of the endowment be invested for the entity's security and growth, and that the operating budget can spend only the current income earned by the endowment fund.

In addition to being exempt from Federal income tax, an exempt organization may be eligible for other benefits, including the following.

- The organization may be exempt from state income tax, state franchise tax, sales tax, or property tax.
- The organization may receive discounts on postage rates.
- Donors of property to the exempt organization may qualify for charitable contribution deductions on their Federal and state income tax returns. However, not all exempt organizations are charities. For instance, one can claim a charitable contribution deduction for a gift to the Dallas Museum of Art, but not for a gift to the NFL or the Tempe Chamber of Commerce.

¹See 1939–1 (Part 2) C.B. 742 for a reprint of H.R. No. 1860, 75th Congress, 3rd Session.

²See the subsequent discussion of Unrelated Business Income Tax.

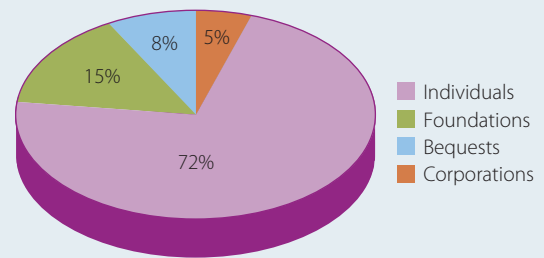
³See the subsequent discussions of Prohibited Transactions and Taxes Imposed on Private Foundations.



TAX IN THE NEWS Who Are the Donors?

Gifts are a major source of funds for many charities. Charitable giving by Americans in 2013 totaled \$335 billion, about 2 percent of GDP. This represents an increase of 4.4 percent over 2012. The bulk of charitable gifts are made by individuals and their estates.

Gifts by corporations have declined over time; gifts to charity now constitute less than one percent of corporate pre-tax profits. Gifts to religious organizations also have been declining, as church attendance and affiliation have decreased markedly in this century.



Source: Giving USA, 2014.

23-1 TYPES OF EXEMPT ORGANIZATIONS

An organization qualifies for exempt status *only* if it fits into one of the categories provided in the Code. Examples of qualifying exempt organizations and the specific statutory authority for their exempt status are listed in Exhibit 23.1.⁴

LO.1

Identify the different types of exempt organizations.

23-2 REQUIREMENTS FOR EXEMPT STATUS

Exempt status frequently requires more than mere classification in one of the categories of exempt organizations. Many of the organizations that qualify for exempt status share the following characteristics.

LO.2

Enumerate the requirements for exempt status.

- The organization serves some type of *common good*.⁵
- The organization is *not* a *for-profit* entity.⁶
- *Net earnings* do not benefit the members of the organization.⁷
- The organization does not exert *political influence*.⁸

23-2a Serving the Common Good

The underlying rationale for all exempt organizations is that they serve some type of *common good*. However, depending on the type of exempt organization, the term *common good* may be interpreted broadly or narrowly. If the test is interpreted broadly, the group being served is the general public or some large subgroup thereof. If it is interpreted narrowly, the group being served may be a specific neighborhood or interest group.

23-2b Not-for-Profit Entity

The organization may not be organized or operated for the purpose of making a profit. For some types of exempt organizations, the *for-profit prohibition* appears in the statutory language. For other types, the prohibition is implied.

⁴Section 501(a) provides for exempt status for organizations described in §§ 401 and 501. The orientation of this chapter is toward organizations that conduct business activities. Therefore, the exempt organizations described in § 401 (qualified pension, profit sharing, and stock bonus trusts) are outside the scope of the chapter and are not discussed.

⁵See, for example, §§ 501(c)(3) and (4).

⁶See, for example, §§ 501(c)(3), (4), (6), (13), and (14).

⁷See, for example, §§ 501(c)(3), (6), (7), (9), (10), (11), and (19).

⁸See, for example, § 501(c)(3).

EXHIBIT 23.1 **Types of Exempt Organizations**

Statutory Authority	Brief Description	Examples or Comments
§ 501(c)(1)	Federal and related agencies.	Commodity Credit Corporation, Federal Deposit Insurance Corporation, Federal Land Bank.
§ 501(c)(2)	Corporations holding title to property for and paying income to exempt organizations.	Corporation holding title to college fraternity house.
§ 501(c)(3)	Religious, charitable, educational, scientific, literary, etc., organizations.	Boy Scouts of America, Red Cross, Salvation Army, Episcopal Church, PTA, United Fund, University of Richmond.
§ 501(c)(4)	Civic leagues and employee unions.	Garden club, tenants' association promoting tenants' legal rights in entire community, League of Women Voters.
§ 501(c)(5)	Labor, agricultural, and horticultural organizations.	Teachers' association, organization formed to promote effective agricultural pest control, organization formed to test soil and to educate community members in soil treatment, garden club.
§ 501(c)(6)	Business leagues, chambers of commerce, real estate boards, etc.	Chambers of Commerce, American Plywood Association, National Football League (NFL), Professional Golfers Association (PGA) Tour, medical association peer review board, organization promoting acceptance of women in business and professions.
§ 501(c)(7)	Social clubs.	Country club, rodeo and riding club, press club, bowling club, college fraternities.
§ 501(c)(8)	Fraternal beneficiary societies.	Lodges. Must provide for the payment of life, sickness, accident, or other benefits to members or their dependents.
§ 501(c)(9)	Voluntary employees' beneficiary associations.	Provide for the payment of life, sickness, accident, or other benefits to members, their dependents, or their designated beneficiaries.
§ 501(c)(10)	Domestic fraternal societies.	Lodges. Must not provide for the payment of life, sickness, accident, or other benefits and must devote the net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.
§ 501(c)(11)	Local teachers' retirement fund associations.	Only permitted sources of income are amounts received from (1) public taxation, (2) assessments on teaching salaries of members, and (3) income from investments.
§ 501(c)(12)	Local benevolent life insurance associations, mutual or cooperative telephone companies, etc.	Local cooperative telephone company, local mutual water company, local mutual electric company.
§ 501(c)(13)	Cemetery companies.	Must be operated exclusively for the benefit of lot owners who hold the lots for burial purposes.
§ 501(c)(14)	Credit unions.	Other than credit unions exempt under § 501(c)(1).
§ 501(c)(15)	Mutual insurance companies.	Mutual fire insurance company, mutual automobile insurance company.
§ 501(c)(16)	Corporations organized by farmers' cooperatives for financing crop operations.	Related farmers' cooperative must be exempt from tax under § 521.
§ 501(c)(19)	Armed forces members' posts or organizations.	Veterans of Foreign Wars (VFW), Reserve Officers Association.
§ 501(c)(20)	Group legal service plans.	Provided by a corporation for its employees.
§ 501(d)	Religious and apostolic organizations.	Communal organization. Members must include pro rata share of the net income of the organization in their gross income as dividends.
§ 501(e)	Cooperative hospital service organizations.	Centralized purchasing organization for exempt hospitals.
§ 501(f)	Cooperative service organization of educational institutions.	Organization formed to manage universities' endowment funds.
§ 529	Qualified tuition programs.	Prepaid tuition and educational savings programs.
§ 530	Coverdell Education Savings Accounts.	Qualified education savings accounts.



FINANCIAL DISCLOSURE INSIGHTS Effects of Sarbanes-Oxley on Nonprofit Entities

The rules of the Sarbanes-Oxley Act do not apply to nonprofit entities. Nevertheless, some nonprofits voluntarily comply with its provisions. For example, New York's Julliard School and the International Swimming Hall of Fame in Fort Lauderdale have adopted the governance practices, code of ethics, and increased transparency required by Sarbanes-Oxley.

Factors contributing to the adoption of Sarbanes-Oxley rules by nonprofits include the following.

- Accounting firms that audit nonprofits want to see the same financial controls now in place at for-profits.
- Nonprofit trustees are demanding more transparency.
- Nonprofit trustees are concerned that their professional reputations could be hurt if money is misused or the nonprofit falters.

23-2c Net Earnings and Members of the Organization

What uses are appropriate for the net earnings of a tax-exempt organization? The logical answer would seem to be that the earnings should be used for the exempt purpose of the organization. However, where the organization exists for the good of a specific group of members, such an open-ended interpretation could permit net earnings to benefit specific group members. Therefore, the Code specifically prohibits certain types of exempt organizations from using their earnings in this way.

. . . no part of the net earnings . . . inures to the benefit of any private shareholder or individual.⁹

In other instances, a statutory prohibition is unnecessary because the definition of the exempt organization in the Code effectively prevents such use.

. . . the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.¹⁰

23-2d Political Influence

Religious, charitable, educational, etc., organizations (i.e., those exempt under § 501(c)(3)) generally are prohibited from attempting to influence legislation or participate in political campaigns. Participation in political campaigns includes participation both *on behalf of* a candidate and *in opposition to* a candidate.

Most of the other types of exempt organizations (e.g., those exempt under § 501(c)(4)) are permitted to attempt to influence legislation. Sometimes a charity simultaneously will operate a “political arm” in favor of its interests (i.e., an entity organized under a different section of the statute). Concept Summary 23.1 addresses the allowed political activities of exempt organizations.



Concept Summary 23.1

Political Activities of Exempt Entities

	Entity Is Exempt under Code Section	
	501(c)(3), a Charity	501(c)(4) and other sections
	Examples: Church, Museum, School, United Way	Examples: Chamber of Commerce, Sierra Club, National Rifle Association
Charitable contribution deduction available?	Yes	No
Political activity allowed?	No	Yes, but no direct gifts to Federal candidates
Entity discloses the donor's identity to the IRS?	No	Yes, if the annual gift is at least \$5,000

⁹§ 501(c)(6).

¹⁰§ 501(c)(10).



ETHICS & EQUITY For the Good of the People

Matthew Ayres is the founder, and the man behind the throne, of the Church for Today television ministry. Ministry broadcasts originate from church services in California and New York and are transmitted via satellite throughout the United States. In addition to receiving contributions from its members, the church solicits and receives donations from viewers of the TV broadcasts. The church is tax-exempt under § 501(c)(3).

The stated mission of the church is religious in nature. However, Matthew firmly believes, as do the members of the board of deacons of the church, that certain societal goals must be accomplished for the prophecies of the church to come true (i.e., their divine being expects them to be active missionaries). Among its societal goals, the church advocates government control and possession of all guns, the legalization of drugs, abortion on demand once approved by the appropriate government agency, the withdrawal of all U.S. troops from foreign soil and the termination of all military alliances, the abolition of capital punishment, and the availability of tuition-free university education to all U.S. citizens.

Matthew and the board of deacons are dismayed that American society has not adopted many of the religious beliefs that drive their goals. Accordingly, Matthew proposes to the board of deacons that the church take a more proactive role. The employment contract of the ministers now will require them to include the basic beliefs in their sermons in an active manner. All of the beliefs and societal goals must be covered quarterly, and every sermon must present at least one of the basic doctrines. The ministers will encourage the church members and TV viewers actively to support these positions at both the state and Federal levels.

As a new member of the board of deacons, you wholeheartedly support Matthew's position. However, you are concerned about the effects of this open advocacy of positions on the tax-exempt status of the church. Matthew responds that the "church has friends in high places" and assures you that the tax-exempt status will not be endangered. What should you do?

LO.3

Apply the tax consequences of exempt status, including the different consequences for public charities and private foundations.

23-3 TAXES ON EXEMPT ENTITIES

Most organizations that are appropriately classified as exempt organizations are exempt from Federal income tax. Four exceptions to this general statement exist, however. An exempt organization that engages in a *prohibited transaction* or is a so-called *feeder organization* is subject to tax. If the organization is classified as a *private foundation*, it may be partially subject to tax. Finally, an exempt organization is subject to tax on its *unrelated business taxable income*. The first two exceptions are discussed in Sections 23-3a and 23-3b. The last two exceptions are discussed in Sections 23-4 and 23-5.

23-3a Prohibited Transactions

If an exempt organization engages in a prohibited transaction¹¹ three negative results can be triggered. First, part or all of the organization's income may be subject to Federal income tax. Second and even worse, the organization may forfeit its exempt status. Finally, intermediate sanctions may be imposed on certain exempt organization insiders.

Effects of Lobbying

Organizations exempt under § 501(c)(3) (religious, charitable, educational, etc., organizations) are subject to limits on their attempts to influence legislation (lobbying activities), and they cannot participate in political campaigns.¹² A § 501(c)(3) organization that makes lobbying expenditures is subject to a 5 percent tax on the expenditures for the taxable year. A 5 percent tax also may be levied on the organization's management. The tax does not apply to private foundations.¹³

¹¹§ 503.

¹³§ 4912.

¹²§ 501(c)(3). Even a single Internet link to a partisan political site can taint the exempt entity.

Certain exempt organizations are permitted to engage in lobbying (but not political) activities that are greater than an insubstantial part of their activities by making a § 501(h) election.¹⁴ Eligible for the election are most § 501(c)(3) organizations, but not churches.

An eligible § 501(c)(3) organization must make an affirmative election to participate in lobbying activities on a limited basis. The lobbying expenditures of electing organizations then are subject to a ceiling. Exceeding the ceiling can lead to the forfeiture of exempt status. Even when the ceiling is not exceeded, a tax may be imposed on some of the lobbying expenditures (as discussed subsequently).

Two terms are key to the calculation of the ceiling amount: **lobbying expenditures** and **grass roots expenditures**. The same entity can incur both types of expenditures in the same tax year.

Lobbying expenditures are made for the purpose of influencing legislation by communicating with any legislator or staff member or with any government official or staff member who may participate in the formulation of legislation. Grass roots expenditures are made for the purpose of influencing legislation by attempting to affect the opinions of the general public or any segment thereof.

A statutory ceiling is imposed on both lobbying expenditures and grass roots expenditures. Those amounts are computed as follows.

- $150\% \times \text{Lobbying nontaxable amount} = \text{Lobbying expenditures ceiling}$.
- $150\% \times \text{Grass roots nontaxable amount} = \text{Grass roots expenditures ceiling}$.

The *lobbying nontaxable amount* is the lesser of (1) \$1 million or (2) the amount determined in Exhibit 23.2.¹⁵ The *grass roots nontaxable amount* is 25 percent of the lobbying nontaxable amount.¹⁶

An electing exempt organization is assessed a 25 percent tax on its **excess lobbying expenditures**.¹⁷ Excess lobbying expenditures are the greater of the following.¹⁸

- Excess of the lobbying expenditures for the taxable year over the lobbying nontaxable amount.
- Excess of the grass roots expenditures for the taxable year over the grass roots nontaxable amount.

Tan, Inc., a qualifying § 501(c)(3) organization, incurs lobbying expenditures of \$525,000 for the taxable year and grass roots expenditures of \$0. Exempt purpose expenditures for the taxable year are \$5 million. Tan elects to be eligible to make lobbying expenditures on a limited basis.

Applying the data in Exhibit 23.2, the lobbying nontaxable amount is \$400,000 [$\$225,000 + 5\% (\$5,000,000 - \$1,500,000)$]. The ceiling on lobbying expenditures is \$600,000 ($150\% \times \$400,000$).

Therefore, Tan's \$525,000 of lobbying expenditures are under the permitted \$600,000. However, the election results in the imposition of tax on the excess lobbying expenditures of \$125,000 ($\$525,000 \text{ lobbying expenditures} - \$400,000 \text{ lobbying nontaxable amount}$). The resulting tax liability is \$31,250 ($\$125,000 \times 25\%$).

EXAMPLE

1

EXHIBIT 23.2

Calculation of Lobbying Nontaxable Amount

Exempt Purpose Expenditures	Lobbying Nontaxable Amount Is
Not over \$500,000	20% of exempt purpose expenditures*
Over \$500,000 but not over \$1 million	\$100,000 + 15% of the excess of exempt purpose expenditures over \$500,000
Over \$1 million but not over \$1.5 million	\$175,000 + 10% of the excess of exempt purpose expenditures over \$1 million
Over \$1.5 million	\$225,000 + 5% of the excess of exempt purpose expenditures over \$1.5 million

*Exempt purpose expenditures generally are the amounts paid or incurred for the taxable year to accomplish the following purposes: religious, charitable, scientific, literary, educational, fostering of national or international amateur sports competition, or the prevention of cruelty to children or animals.

¹⁴Religious organizations and private foundations cannot make this election.

¹⁵§ 4911(c)(2).

¹⁶§ 4911(c)(4).

¹⁷§ 4911(a)(1).

¹⁸§ 4911(b).

If the electing organization's expenditures exceed the lobbying or grass roots expenditures ceiling, *all* of the lobbying expenditures are subject to the 5 percent tax that would have applied without the election. The tax exemption is at risk if the ceiling amount repeatedly is exceeded. See Exhibit 23.3.

Intermediate Sanctions on Excess Benefit Transactions

When an individual who is related to a § 501(c)(3) organization receives benefits that are inappropriate in the context of a charitable entity, the Code applies **intermediate sanctions**, rather than revoking the entity's exempt status.¹⁹ The intermediate sanctions take the form of excise taxes imposed on disqualified persons (any individuals who are in a position to exercise substantial influence over the affairs of the organization) who engage in *excess benefit transactions*. The tax also can be assessed on exempt organization managers who participate in such a transaction, knowing that it is improper. Such excess benefit transactions include transactions in which a disqualified person engages in a non-fair-market-value transaction with the exempt organization (e.g., the purchase of property from the exempt entity at a large discount) or receives unreasonable compensation.

The excise tax on the disqualified person is imposed at a rate of 25 percent of the excess benefit. For the exempt organization management, the excise tax is imposed at a rate of 10 percent of the excess benefit (unless such participation is not willful and is due to reasonable cause) with a statutory ceiling of \$20,000 for any excess benefit transaction. These excise taxes are referred to as first-level taxes.

A second-level tax is imposed on the disqualified person if the excess benefit transaction is not corrected (e.g., the excess amount is paid back to the charity) before the first-level tax is due. This excise tax is imposed at a rate of 200 percent of the excess benefit.

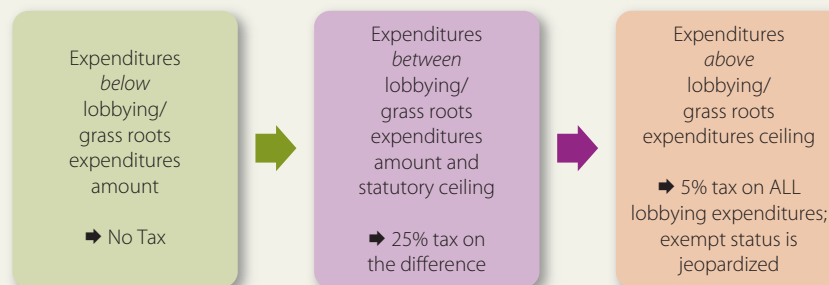
23-3b Feeder Organizations

A **feeder organization** carries on a trade or business for the benefit of an exempt organization and remits its profits to the exempt organization. Such organizations are not exempt from Federal income tax.²⁰ This provision is intended to prevent an entity whose primary purpose is to conduct a trade or business for profit from escaping taxation merely because all of its profits are payable to one or more exempt organizations.²¹

Concept Summary 23.2 provides an overview of the consequences of tax exempt status.

EXHIBIT 23.3 Taxes on Lobbying Expenditures

- **Without § 501(h) election:** A 5 percent tax is assessed on lobbying expenditures; exempt status is jeopardized.
- **With § 501(h) election:** Exempt status is not jeopardized unless the lobbying or grass roots expenditures ceiling repeatedly is exceeded.



¹⁹§ 4958.

²⁰§ 502(a).

²¹§ 502(b) identifies certain income and activities that are not subject to the feeder organization rules.

Concept Summary 23.2

Consequences of Exempt Status

General	<p>Exempt from Federal income tax.</p> <p>Exempt from most state and local income, franchise, sales, and property taxes.</p> <p>Qualify for reductions in postage rates.</p> <p>Gifts to the organization often can be deducted by donor.</p>
Exceptions	<p>May be subject to Federal income tax associated with the following.</p> <ul style="list-style-type: none"> • Engaging in a prohibited transaction (Section 23-3a). • Being a feeder organization (Section 23-3b). • Being a private foundation (Section 23-4). • Generating unrelated business taxable income (Section 23-5).

The Big Picture

Return to the facts of *The Big Picture* on p. 23-1. Recall that Hopeful, Inc., an exempt organization under § 501(c)(3) that provides temporary lodging and psychological services to abused women, is trying to decide what it should do with Taste Good Ice Cream, a chain of gourmet ice cream shops that it has received as a bequest. Assume that Hopeful has decided to operate Taste Good as a subsidiary, with the profits going to Hopeful to support its tax-exempt mission. The subsidiary will be a taxable entity (a feeder organization) subject to the Federal income tax using the corporate tax rates.

EXAMPLE

2

23-4 PRIVATE FOUNDATIONS

23-4a Tax Consequences of Private Foundation Status

Certain exempt organizations are classified as **private foundations**. This classification produces two negative consequences. First, the classification may have an adverse impact on the contributions received by the donee exempt organization. Contributions may decline because the tax consequences for donors may not be as favorable as those given to other exempt organizations.²² Second, the classification may result in taxation at the exempt organization level. The reason for this less beneficial tax treatment is that private foundations define common good more narrowly and therefore are seen as not being supported by, and operated for the good of, the public.

Definition of a Private Foundation

All § 501(c)(3) organizations are private foundations by default, unless one of the statutory exceptions applies. The following are *not* private foundations.²³

1. Churches; educational institutions; hospitals and medical research organizations; and governmental units (favored activities category).
2. Organizations that are broadly supported by the general public, by governmental units, or by organizations described in (1) above.
3. Entities organized and operated exclusively for the benefit of organizations described in (1) or (2) above (i.e., a supporting organization).
4. Entities organized and operated exclusively for testing for public safety.

LO.4

Determine which exempt organizations are classified as private foundations.

²²§ 170(e)(1)(B)(ii).

²³§ 509(a).

To meet the broadly supported requirement in (2) on the preceding page, both of the following tests must be satisfied.

- External support test.
- Internal support test.

Under the *external support test*, more than one-third of the organization's support each taxable year *normally* must come from the three groups listed in (2) on the preceding page, in the following forms.

- Gifts, grants, contributions, and membership fees.
- Gross receipts from admissions, sales of merchandise, performance of services, or the furnishing of facilities in an activity that is not an unrelated trade or business for purposes of the unrelated business income tax (discussed subsequently).
- Gross receipts from any person or governmental agency in excess of the greater of \$5,000 or 1 percent of the organization's support for the taxable year are not counted in the numerator of the support fraction.
- Amounts received from disqualified persons are not included in the numerator of the support fraction. Disqualified persons include:
 - Substantial contributors whose cumulative gifts and bequests to the exempt entity exceed both 2 percent of aggregate contributions received by the entity and \$5,000.
 - Members of the governing body of the exempt entity including officers, directors, trustees, and their families.
 - Generally, corporations, partnerships, trusts, and estates that are affiliated with a disqualified person, using a 35 percent ownership/beneficiary control test.

The *internal support test* limits the amount of support *normally* received from the following sources to one-third of the organization's support for the taxable year.²⁴

- Gross investment income (gross income from interest, dividends, rents, and royalties).
- Unrelated business taxable income (discussed subsequently) minus the related tax.

The intent of the two tests is to exclude from private foundation status those § 501(c)(3) organizations that are responsive to the general public, rather than to the private interests of a limited number of donors or other persons.

Concept Summary 23.3 shows the classifications of exempt organizations and indicates the potential negative consequences of classification as a private foundation.

EXAMPLE

3

Lion, Inc., a § 501(c)(3) organization, received the following support during the taxable year. None of the other exceptions to private foundation status applies to Lion.

Governmental unit A for services rendered	\$ 30,000
Governmental unit B for services rendered	20,000
General public for services rendered	20,000
Gross investment income	15,000
Contributions from individual substantial contributors (disqualified persons)	15,000
Total support	<u>\$100,000</u>

For purposes of the *external support test*, the support from A is counted only to the extent of \$5,000 (greater of \$5,000 or 1% of \$100,000 support). Likewise, for B, only \$5,000 is counted as support. Thus, the total countable support is \$30,000 (\$20,000 from the general public + \$5,000 + \$5,000), and Lion fails the test for the taxable year ($\$30,000/\$100,000 = 30\%$; needs to exceed 33.33%). The \$15,000 received from disqualified persons is excluded from the numerator but is included in the denominator.

continued

²⁴The external and internal support tests generally must be met in each of the four preceding tax years. When these tests are met, public charity

status is granted for the current year and for the subsequent year. Reg. §§ 1.509(a)-3(c) and 1.170A-9(e)(4)(i).

External Support Test	
Governmental unit A for services rendered	\$ 5,000
Governmental unit B for services rendered	5,000
General public for services rendered	<u>20,000</u>
Total countable support	<u>\$30,000</u>
$\frac{\$30,000}{\$100,000} = 30\%$	Fails external support test

In calculating the *internal support test*, only the gross investment income of \$15,000 is included in the numerator. Thus, the test is satisfied ($\$15,000/\$100,000 = 15\%$; cannot exceed 33.33%) for the taxable year.

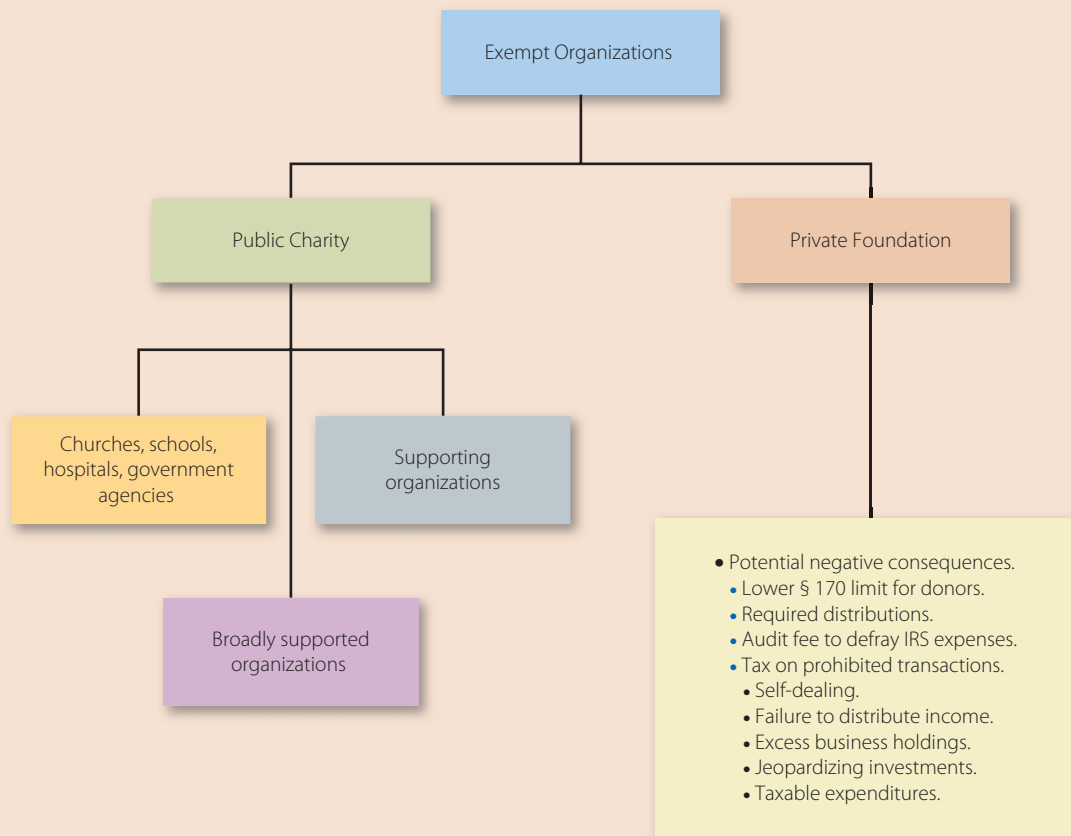
Internal Support Test	
Gross investment income	\$15,000
Unrelated business taxable income	<u>-0-</u>
Total countable support	<u>\$15,000</u>
$\frac{\$15,000}{\$100,000} = 15\%$	Passes internal support test

Because Lion did not satisfy both tests, it does not qualify as an organization that is broadly supported. Therefore, it is a private foundation.



Concept Summary 23.3

Exempt Organizations: Classification



LO.5

Recognize the taxes imposed on private foundations and calculate the related initial tax and additional tax amounts.

23-4b Taxes Imposed on Private Foundations

In general, a private foundation is exempt from Federal income tax. However, it may be subject to the following taxes.²⁵ Exhibit 23.4 includes additional information about these taxes.

- Tax based on investment income.
- Tax on self-dealing.
- Tax on failure to distribute income.
- Tax on excess business holdings.
- Tax on investments that jeopardize charitable purposes.
- Tax on taxable expenditures.

These taxes restrict the permitted activities of private foundations. Two levels of tax may be imposed on the private foundation and the foundation manager: an initial tax and an additional tax. The initial taxes (first-level), with the exception of the tax based on investment income, are imposed because the private foundation engages in an undesirable activity. The additional taxes (second-level) are imposed only if these activities (called *prohibited transactions*) are not corrected within a statutory time period.²⁶

The tax on a failure to distribute income will be used to illustrate how expensive these taxes can be and the related importance of avoiding their imposition. Both an initial (first-level) tax and an additional (second-level) tax may be imposed on a private nonoperating foundation for failure to distribute a sufficient portion of its income. It is imposed at a rate of 15 percent on the undistributed income for the taxable year that is not distributed by the end of the following taxable year. The tax applies on this undistributed income for each year until the tax is assessed by the IRS.

EXHIBIT 23.4 Taxes Imposed on Private Foundations

Type of Tax	Code Section	Purpose	Private Foundation		Foundation Manager	
			Initial Tax	Additional Tax	Initial Tax	Additional Tax
On investment income	§ 4940	Audit fee to defray IRS expenses.	2%*			
On self-dealing	§ 4941	Engaging in transactions with disqualified persons.	5%**	200%**	2.5%†	50%†
On failure to distribute income	§ 4942	Failing to distribute adequate amount of income for exempt purposes.	15%	100%		
On excess business holdings	§ 4943	Investments that enable the private foundation to control unrelated businesses (usually by owning >35% of outstanding shares).	5%	200%		
On jeopardizing investments	§ 4944	Speculative investments that put the private foundation's assets at risk.	5%	25%	5%**	5%†
On taxable expenditures	§ 4945	Expenditures that should not be made by private foundations.	10%	100%	2.5%†	50%†

*May be possible to reduce the tax rate to 1%. § 4940(e). An exempt operating foundation [see §§ 4940(d)(2) and 4942(j)(3)] is not subject to the tax.

**Imposed on the disqualified person rather than the foundation.

†Subject to a statutory ceiling of \$10,000.

‡Subject to a statutory ceiling of \$5,000.

²⁵ §§ 4940–4945.

²⁶ § 4961.



TAX IN THE NEWS Well-Funded Private Foundations

There are about 125,000 private foundations in the United States, and some of them are widely known, like the Gates and Ford Foundations. Private foundations control about \$1.25 trillion in assets.

Most foundations, though, are entities run by family groups, each with assets of between \$1 million and \$10 million. The number of these foundations has grown by ten times over the last decade, and they make over \$20 billion in grants every year.

A typical family foundation costs about \$25,000 in legal fees to set up, and most of them involve more than one generation of family members in the governance of the funds. The IRS examines these family foundations to make sure that they meet the 5 percent distribution requirement, and they look for excessive salaries and benefits that are paid to family members as directors or officers of the foundation.

The additional tax is imposed at a rate of 100 percent on the amount of the inadequate distribution. The additional tax effectively is waived if the undistributed income is distributed within 90 days after the IRS mails a deficiency notice for the additional tax.

Undistributed income is the excess of the amount that should have been distributed over qualifying distributions made by the entity. The tax applies if the entity did not distribute its minimum investment return (i.e., 5 percent of the fair market value of the foundation's assets, net of any outstanding debt).²⁷ The undistributed amount is reduced by related salaries and administrative expenses, so the actual required distribution usually is less than 5 percent of asset value. The 5 percent rule was designed to provide a minimum amount that private foundations would distribute every year, but it acts more as a ceiling amount; most private foundations make distributions of 6 percent of their assets or less per year.

Distributions can lead to one other favorable result for private foundations. If the entity increases its distributions for the tax year over its historical levels, the tax on investment income is reduced to 1 percent.

Gold, Inc., a private foundation, records undistributed income of \$80,000 for the 2013 taxable year. It distributes \$15,000 of this amount during 2014 and an additional \$45,000 during 2015. An IRS deficiency notice is mailed to Gold on August 5, 2016. The initial tax is \$12,750 [(\$65,000 × 15%) + (\$20,000 × 15%)].

As of the date of the deficiency notice, Gold has made no additional distributions from the 2013 undistributed income. Therefore, because the remaining undistributed income of \$20,000 has not been distributed by August 5, 2016, an additional tax of \$20,000 (\$20,000 × 100%) is imposed.

If Gold distributes the \$20,000 of 2013 undistributed income within 90 days of the deficiency notice, the additional tax is waived. Without this distribution, however, the foundation will owe \$32,750 in taxes (\$12,750 + \$20,000).

EXAMPLE

4

23-5 UNRELATED BUSINESS INCOME TAX

The **unrelated business income tax (UBIT)** is designed to treat charitable entities as if they were subject to the corporate income tax, chiefly because they compete with taxable enterprises. Thus, any resulting tax is computed using the rates that are applicable to a corporate taxpayer.²⁸

In general, **unrelated business income (UBI)** is derived from activities not related to the exempt purpose of the exempt organization. The tax is levied because the organization is engaging in substantial commercial activities.²⁹ Without such a tax, taxable business entities would be at a disadvantage when trying to compete with the exempt organization. Thus, the UBIT is intended to neutralize the exempt entity's tax advantage.³⁰

²⁷§ 4940.

²⁸§ 511(a)(1).

²⁹§ 512(a)(1).

³⁰Reg. § 1.513-1(b).

LO.6

Determine when an exempt organization is subject to the unrelated business income tax and calculate the amount of the tax.

It is the source of the business profits that triggers the UBIT, and not their use. UBI that is employed for the entity's exempt purpose still is subject to the tax.

The Big Picture

EXAMPLE

5

Return to the facts of *The Big Picture* on p. 23-1. Recall that Hopeful, Inc., an exempt organization under § 501(c)(3), has received Taste Good Ice Cream, a chain of gourmet ice cream shops, as a bequest. Assume that Hopeful has decided to operate Taste Good as a division. Although the income from Taste Good's shops will be used to support Hopeful's exempt purpose of providing temporary lodging and psychological services to abused women, the net revenue constitutes unrelated business income; therefore, it is subject to the UBIT.

The UBIT applies to all organizations that are exempt from Federal income tax under § 501(c), except Federal agencies. In addition, the tax applies to state colleges and universities.³¹

A materiality exception generally exempts an entity from being subject to the UBIT if such income is insignificant. This \$1,000 "standard deduction" generally available to all exempt organizations is discussed later.

23-5a Unrelated Trade or Business

An exempt organization may be subject to the UBIT in the following circumstances.³²

- The organization conducts a trade or business.
- The trade or business is not substantially related to the exempt purpose of the organization.
- The trade or business is regularly carried on by the organization.

However, the Code specifically exempts the following activities from classification as an unrelated trade or business.

- The individuals performing substantially all of the work of the trade or business do so without compensation (e.g., an orphanage operates a retail store for sales to the general public, and all of the work is done by volunteers).
- The trade or business consists of selling merchandise, and substantially all of the merchandise has been received as gifts or contributions (e.g., thrift shops).
- For § 501(c)(3) organizations and for state colleges or universities, the trade or business is conducted primarily for the convenience of the organization's members, students, patients, officers, or employees (e.g., a college bookstore and a laundry operated by the college for laundering dormitory linens and students' clothing).
- For most employee unions, the trade or business consists of selling to members, at their usual place of employment, work-related clothing and equipment and items normally sold through vending machines, snack bars, or food-dispensing facilities.

Definition of Trade or Business

Trade or business, for this purpose, is broadly defined. It includes any activity conducted for the production of income through the sale of merchandise or the performance of services. An activity need not generate a profit to be treated as a trade or business.³³

³¹§ 511(a)(2) and Reg. § 1.511-2(a)(2).

³²§ 513(a) and Reg. § 1.513-2(a).

³³Reg. § 1.513-1(b).

Health, Inc., is an exempt hospital that operates a pharmacy. The pharmacy provides medicines and supplies to the patients in the hospital (i.e., it contributes to the conduct of the hospital's exempt purpose). In addition, the pharmacy sells medicines and supplies to the general public. The activity of selling to the general public constitutes a trade or business for purposes of the UBIT.

EXAMPLE

6

Not Substantially Related to the Exempt Purpose

Exempt organizations frequently conduct unrelated trades or businesses to provide income to help defray the costs of conducting the exempt purpose. To be related to the accomplishment of the exempt purpose, the conduct of the business activities must be causally related and contribute importantly to the exempt purpose.³⁴

Is It a Trade or Business?

Art, Inc., an exempt organization, operates a school for training children in the performing arts. As an essential part of that training, the children perform for the general public. The children are paid at the minimum wage for the performances, and Art derives gross income by charging admission to the performances.

EXAMPLE

7

The income from admissions is not income from an unrelated trade or business, because the performances by the children contribute importantly to the accomplishment of the exempt purpose of providing training in the performing arts.

Assume the same facts as in Example 7, except that four performances are conducted each weekend of the year. Assume that this number of performances far exceeds that required for training the children. Thus, the part of the income derived from admissions for these excess performances is income from an unrelated trade or business.

EXAMPLE

8

The trade or business may sell merchandise that has been produced as part of the accomplishment of the exempt purpose. However, if the merchandise is not sold in substantially the same state it was in at the completion of the exempt purpose, the gross income subsequently derived from the sale of the merchandise is income from an unrelated trade or business.³⁵

Help-Self, Inc., an exempt organization, conducts programs for the rehabilitation of the handicapped. One of the programs includes training in radio and television repair. Help-Self derives gross income by selling the repaired items. The income is substantially related to the accomplishment of the exempt purpose.

EXAMPLE

9

Income derived by the organization from use for a nonexempt purpose is income from an unrelated trade or business.³⁶

Civil, Inc., an exempt organization, operates a museum. As part of the exempt purpose of the museum, educational lectures are given in the museum's theater during the operating hours of the museum. In the evening, when the museum is closed, the theater is leased to an individual who sells tickets and shows current movies to the general public. The lease income is derived from an unrelated trade or business.

EXAMPLE

10

³⁴Reg. § 1.513-1(d).

³⁵Reg. § 1.513-1(d)(4)(ii).

³⁶Reg. § 1.513-1(d)(4)(iii) addresses the allocation of expenses to exempt and nonexempt activities.



ETHICS & EQUITY Unrelated Business Income Tax: Substantially Related to the Charity's Exempt Purpose

Mops and More, a § 501(c)(3) organization, makes mops and brooms that it sells to the general public. The exempt organization's mission is to provide short-term employment opportunities and temporary housing for recovering drug addicts during the two-month period they are at a halfway house. Profits from the sales of the mops and brooms are used to support the halfway house.

The laborers are paid the minimum wage, with half of this amount going toward their room and board at the halfway house. In prior years, approximately 90 percent of the laborers involved in the production of the mops and brooms were recovering addicts staying at the halfway house. The remaining 10 percent were permanent employees who trained and supervised the recovering addicts.

In prior years, Mops and More has not filed a Form 990-T (Exempt Organization Business Income Tax Return). The treasurer of Mops and More believes that the sale of the mops and brooms does not constitute unrelated business income, because the production of the items is substantially related to the mission of the exempt organization.

For the current tax year, there is a substantial drop in the number of recovering addicts who stay at the halfway house. To meet production quotas, the organization hires foreign workers who are legally in this country on temporary visas. They account for 70 percent of the labor force in the current year.

The treasurer believes that this shift from recovering addicts to foreign workers is temporary in nature. So she does not believe it is necessary to file a Form 990-T. Has she acted appropriately?

Special Rule for Corporate Sponsorship Payments The term *unrelated trade or business* does not include the soliciting and receiving of qualified sponsorship payments.³⁷

A payment is a qualified sponsorship payment if it meets all of the following requirements.

- There is no arrangement or expectation that the trade or business making the payment will receive any substantial benefit other than the use or acknowledgment of its name, logo, or product lines in connection with the activities of the exempt organization.
- Such use or acknowledgment does not include advertising the payor's products or services.
- The payment does not include any amount that is contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to one or more events.

Sponsorship Payments

EXAMPLE

11

Pets, Inc., a manufacturer of cat food, contributes \$25,000 to Feline Care, Inc., an exempt organization that cares for abandoned cats. In return for the contribution, Feline agrees to put Pets' corporate logo in its monthly newsletter to donors. Under these circumstances, the \$25,000 payment is a qualified sponsorship payment and is not subject to the UBIT.

EXAMPLE

12

Assume the same facts as in Example 11, except that Feline agrees to endorse Pets' cat food in its monthly newsletter by stating that it feeds only Pets' cat food to its cats. The \$25,000 is not a qualified sponsorship payment and is subject to the UBIT.

Special Rule for Bingo Games A special provision applies in determining whether income from bingo games is from an unrelated trade or business. Under this provision, a *qualified bingo game* is not an unrelated trade or business if both of the following requirements are satisfied.³⁸

³⁷§ 513(i).

³⁸§ 513(f).

- The bingo game is legal under both state and local law.
- Commercial bingo games (conducted for a profit motive) ordinarily are not permitted in the jurisdiction.

Play, Inc., an exempt organization, conducts weekly bingo games. The laws of the state and municipality in which Play conducts the games expressly provide that exempt organizations may conduct bingo games, but they do not permit profit-oriented entities to do so.

Because both of the requirements for bingo games are satisfied, the bingo games conducted by Play are not an unrelated trade or business.

EXAMPLE

13

Special Rule for Distribution of Low-Cost Articles When a donor receives a product, like a briefcase, in exchange for a gift to a charity, it appears that a sale has occurred, and the entity has generated UBI. But where an exempt organization distributes low-cost items as an incidental part of its solicitation for charitable contributions, the activity is not considered an unrelated trade or business.

A low-cost article is an item that costs \$10.50 or less in 2015 (indexed annually). Examples of such items are pens, stamps, stickers, stationery, and address labels. If more than one item is distributed to a person during the calendar year, the costs of the items are combined.³⁹

Special Rule for Rental or Exchange of Membership Lists If an exempt organization conducts a trade or business that consists of either exchanging with or renting to other exempt organizations the organization's donor or membership list (mailing lists), the activity is not an unrelated trade or business.⁴⁰

Other Special Rules Other special rules are used in determining whether each of the following activities is an unrelated trade or business.⁴¹

- Qualified public entertainment activities (e.g., a state fair).
- Qualified convention and trade show activities.
- Certain services provided at cost or less by a hospital to other small hospitals.

Regularly Carried on by the Organization

Requiring the activity to be one that is regularly carried on by the exempt organization ensures that only activities that are actually competing with taxable organizations are subject to the UBIT. Accordingly, factors to be considered in applying the *regularly carried on* test include the frequency of the activity, the continuity of the activity, and the manner in which the activity is pursued.⁴²

Activity Regularly Carried On

Silver, Inc., an exempt organization, owns land that is located next to the state fairgrounds. During the 10 days of the state fair, Silver uses the land as a parking lot and charges individuals attending the state fair for parking there. The activity is not regularly carried on.

EXAMPLE

14

Black, Inc., an exempt organization, has its offices in the downtown area. It owns a parking lot adjacent to its offices on which its employees park during the week. On Saturdays, it rents the spaces in the parking lot to individuals shopping or working in the downtown area. Black is conducting a business activity on a year-round basis, even though it is only for one day per week. Thus, an activity is regularly being carried on.

EXAMPLE

15

³⁹§ 513(h)(1)(A).

⁴⁰§ 513(h)(1)(B).

⁴¹§§ 513(d) and (e).

⁴²§ 512(a)(1) and Reg. § 1.513-1(c).



TAX IN THE NEWS Should the NCAA Be Tax-Exempt?

The National Collegiate Athletic Association (NCAA) is a tax-exempt organization. Although donors cannot deduct contributions to the NCAA as charitable contributions, the NCAA itself does not pay taxes on its revenues.

Several members of Congress have questioned whether the NCAA should be tax-exempt. Among them is former Congressman Bill Thomas (served as chairman of the House

Ways and Means Committee), who suggested that the NCAA's tax-exempt status amounts to a government subsidy from the taxpayers. Another concern is that the NCAA's member educational institutions may be using their tax-exempt status to help pay for escalating athletic program costs, including coaches' multimillion-dollar salaries, chartered travel, and state-of-the-art athletic facilities.

23-5b Unrelated Business Taxable Income

General Tax Model

The model for computing unrelated business taxable income (UBTI) appears in Exhibit 23.5.

Positive adjustments⁴³

1. A charitable contribution deduction is permitted without regard to whether the gift is associated with the unrelated trade or business. However, to the extent the charitable contributions deducted in calculating net unrelated business income (see Exhibit 23.5) exceed 10 percent of UBTI (without regard to the charitable contribution deduction), the excess amount is disallowed (i.e., a positive adjustment results).

EXAMPLE

16

Brown, Inc., an exempt organization, has UBTI of \$100,000 (excluding any modifications associated with charitable contributions). Total charitable contributions (all associated with the unrelated trade or business) are \$13,000.

Assuming that the \$13,000 is deducted in calculating net unrelated business income, the excess of \$3,000 [$\$13,000 - 10\%(\$100,000)$] is a positive adjustment in calculating UBTI.

2. Unrelated debt-financed income net of the unrelated debt-financed deductions (see subsequent discussion).

Negative adjustments

1. Income from dividends, interest, and annuities, net of all deductions directly related to producing such income.
2. Royalty income, regardless of whether it is measured by production, gross income, or taxable income from the property, net of all deductions directly related to producing such income.

EXHIBIT 23.5

Tax Formula for Unrelated Business Taxable Income

Gross unrelated business income
 – Deductions related to the business income
 = Net unrelated business income
 ± Adjustments (positive and negative)
 – \$1,000 “standard deduction”
 = Unrelated business taxable income

⁴³§ 512(b) and Reg. § 1.512(b)-1.

3. Rent income from real property and from certain personal property net of all deductions directly related to producing such income. Personal property rents are included in the negative adjustment only if the personal property is leased with the real property. In addition, the personal property rent income must be incidental (does not exceed 10 percent of the gross rent income under the lease) to be used in computing the negative adjustment. The rents are not a negative adjustment, though, if more than 50 percent of the rent income under the lease is derived from personal property.

If the lessor of real property provides significant services to the lessee, such income, for this purpose, is not rent income.

Rentals as UBI

Beaver, Inc., an exempt organization, leases land and a building (realty) and computers (personalty) housed in the building. Under the lease, \$46,000 of the rent is for the land and building, and \$4,000 is for the computers. Expenses incurred for the land and building are \$10,000.

The net rent income from the land and building of \$36,000 (\$46,000 – \$10,000) and the income from the computers of \$4,000 are negative adjustments.

EXAMPLE

17

Assume the same facts as in Example 17, except that the rent income is \$35,000 from the land and building and \$15,000 from the computers.

Because the rent income from the computers exceeds \$5,000 ($10\% \times \$50,000$) and is not incidental, it is not a negative adjustment. The \$35,000 rent income from the land remains a negative adjustment.

EXAMPLE

18

Assume the same facts as in Example 17, except that the rent income is \$20,000 from the land and building and \$30,000 from the computers.

Because more than 50% of the rent income under the lease is from the computers, neither the rent income from the land and building nor that from the computers is a negative adjustment.

EXAMPLE

19

4. Gains and losses from the sale, exchange, or other disposition of property *except for* inventory.

Beaver, the owner of the land, building, and computers in Example 17, sells these assets for \$450,000. Their adjusted basis is \$300,000.

Beaver's recognized gain of \$150,000 is a negative adjustment.

EXAMPLE

20

5. Certain research income net of all deductions directly related to producing that income.

In addition to the positive and negative adjustments, a "standard deduction" of \$1,000 is allowed.⁴⁴

Petit Care, Inc., an exempt organization, reports net unrelated business income of \$800. Because Petit claims a \$1,000 "standard deduction," its UBTI is \$0. Therefore, its income tax liability is \$0.

EXAMPLE

21

After UBTI is determined, that amount is subject to tax using the regular corporate tax rates.

Patient, Inc., an exempt organization, has UBTI of \$500,000. Patient's income tax liability is \$170,000 ($\$500,000 \text{ UBTI} \times 34\% \text{ corporate tax rate}$).

EXAMPLE

22

Concept Summary 23.4 provides a summary of the UBIT rules.

⁴⁴§ 512(b)(12).



Concept Summary 23.4

Unrelated Business Income Tax

Purpose	To tax the entity on unrelated business income as if it were subject to the corporate income tax.
Applicable tax rates	Corporate tax rates.
Exempt organizations to which applicable	All organizations exempt under § 501(c), except Federal agencies.
Entities subject to the tax	The organization conducts a trade or business, the trade or business is not substantially related to the exempt purpose of the organization, and the trade or business is regularly carried on by the organization.
Exceptions to the tax	<ul style="list-style-type: none"> • All of the work is performed by volunteers. • Substantially all of the merchandise being sold has been received by gift. • For § 501(c)(3) organizations, the business is conducted primarily for the benefit of the organization's members, students, patients, officers, or employees. • For most employee unions, the trade or business consists of selling to members work-related clothing and equipment and items normally sold through vending machines, snack bars, or food-dispensing facilities. • Other items relating to bingo games, corporate sponsorships, list rentals, and the like.
\$1,000 "standard deduction"	If the gross income from an unrelated trade or business is less than \$1,000, it is not necessary to file a return associated with the unrelated business income tax.

Unrelated Debt-Financed Income

In the formula for calculating UBTI (see Exhibit 23.5), unrelated debt-financed income is one of the positive adjustments. Examples of income from debt-financed property include rent income from real estate or tangible personal property, dividends from corporate stock, and gains from the disposition of debt-financed property. Gains from dispositions of unrelated business income property also are included to the extent the gains are not otherwise treated as unrelated business income.

Without this provision, a tax-exempt organization could use borrowed funds to acquire unrelated business or investment property and use the exempt earnings from the acquisition to pay for the property.

Definition of Debt-Financed Income **Debt-financed income** is the gross income generated from debt-financed property. *Debt-financed property* is all property of the exempt organization that is held to produce income and on which there is acquisition indebtedness, *except* for the following.⁴⁵

- Property where substantially all (at least 85 percent) of the use is for the achievement of the exempt purpose of the exempt organization.⁴⁶
- Property whose gross income is otherwise treated as unrelated business income.
- Property whose gross income is from the following sources and is not otherwise treated as unrelated business income.
 - Income from research performed for the United States or a Federal governmental agency, or a state or a political subdivision thereof.
 - For a college, university, or hospital, income from research activities.

If the 85 percent test is not satisfied, only the portion of the property that is *not* used for the exempt purpose is debt-financed property.

⁴⁵§ 514(b).

⁴⁶Reg. § 1.514(b)-1(b)(1)(ii).

Deer, Inc., an exempt organization, owns a five-story office building on which there is acquisition indebtedness. Three of the floors are used for Deer's exempt purpose. The two other floors are leased to Purple Corporation. In this case, the *substantially all* test is not satisfied. Therefore, 40% of the office building is debt-financed property, and 60% is not.

EXAMPLE

23

Certain land that is acquired by an exempt organization for later exempt use is excluded from debt-financed property if the following requirements are satisfied.⁴⁷

- The principal purpose of acquiring the land is for use (substantially all) in achieving the organization's exempt purpose.
- This use will begin within 10 years of the acquisition date.
- At the date when the land is acquired, it is located in the *neighborhood* of other property of the organization for which substantially all of the use is for achieving the organization's exempt purpose.

If the exempt organization is a church, the 10-year period becomes a 15-year period and the neighborhood requirement is waived.

Definition of Acquisition Indebtedness Acquisition indebtedness is debt sustained by the exempt organization in association with the acquisition of property. More precisely, *acquisition indebtedness* consists of the unpaid amounts used to acquire or improve the debt-financed property.⁴⁸

Acquisition Indebtedness

Red, Inc., an exempt organization, acquires land for \$100,000. To finance the acquisition, Red mortgages the land and receives loan proceeds of \$80,000. Red leases the land to Duck Corporation. The mortgage is acquisition indebtedness.

EXAMPLE

24

Rose, Inc., an exempt organization, makes improvements to an office building that it rents to Bird Corporation. Excess working capital funds are used to finance the improvements. Rose is later required to mortgage its laboratory building, which it uses for its exempt purpose, to replenish working capital. The mortgage is acquisition indebtedness.

EXAMPLE

25

Portion of Debt-Financed Income and Deductions Treated as Unrelated Business Taxable Income Once the amount of the debt-financed income and deductions is determined, one must ascertain what portion thereof constitutes unrelated debt-financed income and deductions. The gross income from the property is multiplied by the following percentage.⁴⁹ This percentage cannot exceed 100.

$$\frac{\text{Average acquisition indebtedness for the property}}{\text{Average adjusted basis of the property}} = \text{Debt/basis percentage}$$

For debt-financed property, cost recovery deductions must apply the straight-line method. Once total expenses are computed, this amount is multiplied by the debt/basis percentage, to determine the deductions allowed.⁵⁰

If debt-financed property is disposed of during the taxable year at a gain, average acquisition indebtedness in the formula is replaced with highest amount of acquisition indebtedness for the tax year.⁵¹

⁴⁷§ 514(b)(3).

⁵⁰§ 514(a)(3).

⁴⁸§ 514(c)(1). Educational organizations can exclude certain debt incurred for real property acquisitions from acquisition indebtedness.

⁵¹§ 514(c)(7).

⁴⁹§ 514(a)(1).

EXAMPLE

26

White, Inc., an exempt organization, owns an office building that it leases to Squirrel Corporation for \$120,000 per year. The average acquisition indebtedness is \$300,000, and the average adjusted basis is \$500,000. Because the office building is debt-financed property, the gross unrelated debt-financed income is:

$$\frac{\$300,000}{\$500,000} \times \$120,000 = \$72,000.$$

If White's expenses associated with the office building lease (including straight-line cost recovery) equal \$50,000, then allowable deductions are:

$$\frac{\$300,000}{\$500,000} \times \$50,000 = \$30,000.$$

Thus, White's net unrelated debt-financed income is \$42,000 (\$72,000 – \$30,000).

Average Acquisition Indebtedness The *average acquisition indebtedness* for debt-financed property is the average amount of the outstanding debt for the taxable year (ignoring interest) during the portion of the year the property is held by the exempt organization.⁵²

EXAMPLE

27

On August 12, Yellow, Inc., an exempt organization, acquires a debt-financed office building for \$500,000. The initial mortgage on the property is \$400,000. The principal amount of the debt on August 12 and on the first of each subsequent month is as follows.

Month	Principal Amount
August 12	\$ 400,000
September 1	380,000
October 1	360,000
November 1	340,000
December 1	320,000
Total	<u>\$1,800,000</u>

Average acquisition indebtedness is \$360,000 (\$1,800,000 ÷ 5 months). August is treated as a full month.

Average Adjusted Basis The *average adjusted basis* of debt-financed property is calculated by summing the adjusted bases of the property on the first and last days during the taxable year the property is held by the exempt organization and then dividing by two.⁵³

EXAMPLE

28

Assume that the facts are the same as in Example 27. In addition, during the taxable year, depreciation of \$5,900 is deducted. The average adjusted basis is \$497,050 [(\$500,000 + \$494,100) ÷ 2].

⁵²§ 514(c)(7) and Reg. § 1.514(a)-1(a)(3). A partial month is treated as a full month.

⁵³§ 514(a)(1) and Reg. § 1.514(a)-1(a)(2).



TAX IN THE NEWS Charities and Federal Revenues

The Federal income tax deduction for charitable contributions is one of the Code's oldest and most popular provisions. Few politicians would risk their positions by proposing a repeal of the deduction or even a limit on it.

But in a time of budget deficits and increasing U.S. debt, one wonders whether the vaunted position that the deduction holds truly is warranted. Consider the following items from the viewpoint of the fiscal responsibility of the country.

- The charitable deduction is the fifth-largest tax expenditure. It “costs” the Federal government over \$50 billion per year in lost revenues.
- The benefits of the deduction skew heavily toward upper-income individuals.
 - A charitable contribution deduction is available only to itemizers, who make up the upper 30 to 35 percent of earners every year.
 - Because the Federal income tax rates are progressive, the donor's tax benefit increases as personal income rises.
 - By nature, some tax incentives (e.g., encouraging charitable gifts directly from IRAs) essentially are available only to upper-income individuals.
- About 85 percent of the benefit from the charitable deduction goes to individuals with annual incomes above \$100,000.
- Almost 60 percent of the benefit goes to individuals with annual incomes above \$200,000.
- Donors at different income levels are roughly equal in their proportionate generosity to charitable causes, but they tend to prefer different types of donees. Donors with an annual income of up to \$200,000 favor gifts to religious organizations. Donors above that income level favor gifts to medical, education, and arts entities (rather than social welfare agencies).
- It may not be appropriate for charitable entities to be largely exempt from Federal income tax on patent royalties and endowment income, when commercial and other non-exempt competitors must pay tax on profits related to these nonbusiness activities.

Given these factors, the charitable contribution deduction could be limited (or eliminated) via future tax reform.

23-6 REPORTING REQUIREMENTS

23-6a Obtaining Exempt Organization Status

Not all exempt organizations are required to obtain IRS approval to assure their exempt status. Among those required by statute to do so are organizations exempt under §§ 501(c)(3), 501(c)(9), and 501(c)(20).⁵⁴ A church need not apply for exempt status, though.

Even when not required to obtain IRS approval, most exempt organizations do apply for exempt status. Typically, an organization does not want to assume that it qualifies for exempt status and describe itself in that way to the public, only to have the IRS rule later that it does not qualify.

Organizations exempt under § 501(c)(3) use Form 1023 [Application for Recognition of Exemption under Section 501(c)(3)]; small organizations file Form 1023-EZ.⁵⁵ Form 1024 [Application for Recognition of Exemption under Section 501(a)] is used by most other types of exempt organizations.

If an organization is required to obtain IRS approval for its exempt status and does not do so, it does not qualify as an exempt organization.

23-6b Annual Filing Requirements

Most exempt organizations are required to file an annual information return.⁵⁶ The return is filed on Form 990 (Return of Organization Exempt from Income Tax). Religious groups and Federal agencies need not file Form 990.⁵⁷

LO.7

List the reports that exempt organizations must file with the IRS and the related due dates.

⁵⁴ §§ 505(c), 508(a), and 508(c).

⁵⁵ A small organization is defined as one that holds assets not in excess of \$250,000, and its annual gross receipts for the last 3 years have not exceeded \$50,000.

⁵⁶ § 6033(a)(1).

⁵⁷ § 6033(a)(3).

An exempt organization whose annual gross receipts normally are \$50,000 or less must file a Form 990-N, an online form known as the e-Postcard.⁵⁸ The e-Postcard is designed to be a simpler version of the full Form 990, to be used by small exempt entities. Supporting organizations and private foundations cannot use the Form 990-N.

The Form 990-EZ, another abbreviated version of the Form 990, can be used by exempt organizations with gross receipts less than \$200,000 and total assets less than \$500,000.

Private foundations must file Form 990-PF (Return of Private Foundation). Form 990-PF requires more information than does Form 990. Form 4720 (Return of Certain Excise Taxes on Charities and Other Persons) is used to compute any excise tax liabilities of the private foundation. The return is filed with the private foundation's Form 990-PF.

The due date for Form 990 or Form 990-PF is the fifteenth day of the fifth month after the end of the taxable year.

EXAMPLE

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Green, Inc., a § 501(c)(3) organization, has a fiscal year that ends June 30, 2015. The due date for the annual return is November 15, 2015.

If Green were a calendar year entity, the due date for the return would be May 15, 2016.

Exempt organizations incurring the UBIT file Form 990-T (Exempt Organization Business Income Tax Return). The return must be filed if the organization records gross income of at least \$1,000 from an unrelated trade or business.

EXAMPLE

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During the year, the First Church of Kentwood receives parishioner contributions of \$450,000. Of this amount, \$125,000 is designated for the church building fund. None of its receipts constitute unrelated business income. First Church is not required to file an annual return (Form 990) because churches are exempt from doing so. In addition, it is not required to file Form 990-T.

Colonial, Inc., is a private foundation. Gross receipts for the year total \$800,000, of which 40% is from admission fees paid by members of the general public who visit Colonial's museum of eighteenth-century life. The balance is endowment income and contributions from the founding donor. Because Colonial is a private foundation, it must file Form 990-PF.

Orange, Inc., is an exempt organization and is not a private foundation. Gross receipts for the year are \$20,000. None of this amount is unrelated business income. Orange is not required to file Form 990 because its annual gross receipts do not exceed \$50,000. However, it must file an e-Postcard (Form 990-N).

Restoration, Inc., is an exempt organization. Gross receipts for the year are \$100,000. None of this amount is unrelated business income. Restoration files Form 990-EZ because of its level of gross receipts.

During the year, the Second Church of Port Allen receives parishioner contributions of \$300,000. In addition, the church has unrelated business income of \$5,000. Second Church is not required to file Form 990 because churches are exempt from doing so. Form 990-T must be filed, however, because churches are not exempt from the UBIT and Second Church has exceeded the \$1,000 "standard deduction."

23-6C Disclosure Requirements

Exempt entities must make certain information readily available to the general public.⁵⁹ Copies of the following must be made available to anyone who asks.⁶⁰

- Form 990.
- Form 1023 (or Form 1024).

Copies of the three most recent returns of the Form 990 must be made available. Private foundations must make Form 990-PF available for public inspection.

⁵⁸Rev.Proc. 2011-15, 2011-3 I.R.B. 322.

⁵⁹§ 6104(d), Reg. § 301.6104(d), and T.D. 8818 (April 1999).

⁶⁰An Internet source of Forms 990 and 990-PF and other relevant materials on exempt entities is www.guidestar.org.

If an individual requests the entity's tax form in person, the exempt entity must provide a copy immediately. If the request is received in writing or by e-mail or fax, the copy must be provided within 30 days. The copy must be provided without charge, except for a reasonable fee for reproduction and mailing costs.

If the exempt entity has made the forms widely available to the general public, it is not required to fill individual requests. One technique for making the forms widely available is to put them online. Individual requests can be disregarded if the exempt entity can show that the request is part of a harassment campaign.

23-7 TAX PLANNING

23-7a General Considerations

Classification as an exempt organization should not be interpreted to mean that the organization need not be concerned with any Federal income tax. Such a belief can result in the organization engaging in transactions that produce a substantial tax liability.

An organization is exempt from taxation only if it fits into one of the categories enumerated in the Code. Thus, particular attention must be given to the qualification requirements. These requirements must continue to be satisfied to avoid termination of exempt status (in effect, they are now maintenance requirements).

23-7b Maintaining Exempt Status

To maintain exempt status, the organization must satisfy both an organizational test and an operational test. The organizational test requires that the entity satisfy the statutory requirements for exempt status on paper. The operational test ensures that the entity does, in fact, satisfy the statutory requirements for exempt status.

King Shipping Consum., Inc. (Zion Coptic Church, Inc.) illustrates that it is usually much easier to satisfy the organizational test than the operational test.⁶¹ Zion's stated purpose was to engage in activities usually and normally associated with churches. Based on this, the IRS approved Zion's exempt status as a § 501(c)(3) organization.

Zion's real intent, however, was to smuggle illegal drugs into the country and to distribute them for profit. The church's justification for the drugs was that it used marijuana in its sacrament. During a four-month period, however, the police confiscated 33 tons of marijuana from church members. The IRS calculated that even assuming the maximum alleged church membership of several thousand, each member would have had to consume over 33 pounds of marijuana during the four-month confiscation period.

The court concluded that Zion's real purpose was to cloak a large commercial drug smuggling operation. Because this activity was inconsistent with the religious purpose for exempt status, the court upheld the IRS's revocation of Zion's exempt status and the deficiency assessment of approximately \$1.6 million.

23-7c Private Foundation Status

Exempt organizations that can qualify as public charities receive more beneficial tax treatment than do those that qualify as private foundations. Thus, if possible, the organization should be structured to qualify as a public charity.

David has undeveloped land (\$25,000 adjusted basis, \$100,000 fair market value) that he is going to contribute to one of the following exempt organizations: Blue, Inc., a public charity, or Teal, Inc., a private foundation. David has owned the land for five years.

David asks the manager of each organization to describe the tax benefits of contributing to that organization. He tells them that he is in the 35% marginal income tax bracket.

continued

LO.8

Identify tax planning opportunities for exempt organizations.

EXAMPLE

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⁶¹58 TCM 574, T.C.Memo. 1989-593.

Based on the data provided by the managers, David decides to contribute the land to Blue, Inc. He calculates the amount of the charitable contribution under each option as follows.⁶²

Donee	Contribution Deduction	Tax Rate	Contribution Borne by U.S. Government
Blue	\$100,000	35%	\$35,000
Teal	\$25,000 (\$100,000 – \$75,000)	35%	8,750

If the organization is a private foundation, care must be exercised to avoid the assessment of a tax liability on one of the prohibited transactions. This objective can best be achieved by establishing controls that prevent the private foundation from engaging in transactions that trigger the imposition of the taxes. If an initial tax is assessed, corrective actions should be implemented to avoid the assessment of an additional tax.

23-7d Unrelated Business Income Tax

If the exempt organization conducts an unrelated trade or business, it may be subject to tax on the unrelated business income. Worse yet, the unrelated trade or business could result in the loss of exempt status if the IRS determines that the activity is the primary purpose of the organization. Thus, caution and planning should be used to eliminate the latter possibility and to minimize the former.

One approach that can be used to avoid the imposition of the UBIT is to establish a taxable subsidiary to conduct the unrelated trade or business. With a subsidiary, the revenues and expenses of the exempt organization can be separated from those of the unrelated trade or business. When the subsidiary remits its after-tax profits to the exempt organization in the form of dividends, the dividends will not be taxable to the exempt organization. In addition, having a taxable subsidiary conduct the unrelated trade or business avoids the possibility that the IRS will consider the unrelated business income to be an excessive percentage of the total revenues of the exempt organization. Such a view can lead to the IRS's questioning the exempt organization's right to retain its exempt status.

Another approach to avoiding the UBIT is to fail the definition of an unrelated trade or business. This is accomplished by *not* satisfying at least one of the following requirements.

- The organization conducts a trade or business.
- The trade or business is not substantially related to the exempt purpose of the organization.
- The trade or business is regularly carried on by the organization.

Even if the definitional requirements for an unrelated trade or business appear to be satisfied, the negative adjustments in calculating unrelated business taxable income (see Exhibit 23.5) can be used to minimize the tax liability.

Rental activities best illustrate the necessity of careful planning to avoid including the income from the activity in calculating unrelated business taxable income. The income from the rental of real property by an exempt organization is not part of unrelated business taxable income. However, leases must be drafted so as to preserve the negative adjustment and avoid any exposure to the UBIT.

⁶²See Chapter 10. Contributions of capital gain property made to private nonoperating foundations must be reduced by any asset appreciation.

REFOCUS ON THE BIG PICTURE

EFFECT OF A FOR-PROFIT BUSINESS ON A TAX-EXEMPT ENTITY

A § 501(c)(3) entity is exempt from Federal income tax only on the conduct of its charitable activities. However, if an exempt entity generates income from the conduct of a trade or business that is not related to the organization's exempt purpose, this income generally is subject to Federal income tax. These principles can be used in analyzing Hopeful's options for the ice cream business it inherited.



- *Sale of the stock of Taste Good Ice Cream.* A sale of the Taste Good Ice Cream stock is unlikely to result in much realized gain because the fair market value probably has not changed very much in the limited time between the date of Betty's death and the present. In any case, this amount is not relevant because any realized gain on the sale of the stock is tax-exempt under § 501(c)(3).
- *Conduct the ice cream business as a division of Hopeful.* Under this option, the taxable income of the ice cream chain is classified as unrelated business income. Because the ice cream division is competing with for-profit entities, it is subject to the Federal income tax that applies to corporate entities. In essence, the tax is levied because the exempt organization is engaging in substantial commercial activities.
- *Conduct the ice cream business as a wholly owned subsidiary of Hopeful.* Under this option, the ice cream chain subsidiary is classified as a feeder organization (i.e., carries on a trade or business for the benefit of an exempt organization and remits its profits to that entity). The Federal income tax consequences are the same as those under the prior option.

Hopeful's board of directors must decide whether they want Hopeful to be involved in the pursuit of a for-profit business and whether selling or operating the business can provide a greater economic benefit for Hopeful.

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Key Terms

Debt-financed income, 23-20

Excess lobbying expenditures, 23-7

Exempt organizations, 23-2

Feeder organization, 23-8

Grass roots expenditures, 23-7

Intermediate sanctions, 23-8

Lobbying expenditures, 23-7

Private foundations, 23-9

Unrelated business income (UBI), 23-13

Unrelated business income tax (UBIT), 23-13

Discussion Questions

1. **LO.3** An exempt organization appropriately makes the § 501(h) election to lobby on a limited basis. The amount of its lobbying expenditures is less than its lobbying expenditures ceiling, yet it is subject to a tax at a 25% rate. Explain.
2. **LO.5** Although private foundations generally are exempt from Federal income tax, they may be subject to two types of taxes. Identify these taxes and discuss why they are imposed on private foundations.
3. **LO.5** Sunset, Inc., a § 501(c)(3) exempt organization that is classified as a private foundation, generates investment income of \$500,000 for the current tax year. This amount represents 18% of Sunset's total income.

WWW

For the latest in changes to tax legislation, visit www.cengagebrain.com.

- a. What type of tax imposed on Sunset is associated with its investment income?
 - b. Is the receipt of this investment income likely to result in Sunset losing its exempt status? Why or why not?
 - c. Would your answers in (a) and (b) change if the \$500,000 represented greater than 50% of Sunset's total income? Explain.
- Issue ID** 4. **LO.4, 5** Really Welcome, Inc., a tax-exempt organization, receives 30% of its support from disqualified persons. Another disqualified person has agreed to match this support if Really Welcome will appoint him to the organization's board of directors. What tax issues are relevant to Really Welcome as it makes this decision?
5. **LO.6** Winston recently became the treasurer of Homeless, Inc., a § 501(c)(3) organization that feeds the homeless. One of the entity's directors has proposed that Homeless purchase and operate a fast-food franchise as part of Homeless, Inc., to raise additional revenue (a projected increase of 45%) to carry out its tax-exempt mission. Because the earnings generated by the fast-food franchise would be tax-exempt, substantial additional revenue would be provided. How should Winston respond?
 6. **LO.6** An exempt municipal hospital operates a pharmacy that is staffed by a pharmacist 24 hours per day. The pharmacy serves only hospital patients. Is the pharmacy likely an unrelated trade or business? Explain.
- Issue ID** 7. **LO.6** An exempt organization is considering conducting bingo games on Thursday nights as a way of generating additional revenue to support its exempt purpose. Before doing so, however, the president of the organization has come to you for advice regarding the effect on the organization's exempt status and whether the net income from the bingo games will be taxable. Identify the relevant tax issues.
8. **LO.6** Define each of the following with respect to unrelated debt-financed property.
 - a. Debt-financed income.
 - b. Debt-financed property.
 - c. Acquisition indebtedness.
 - d. Average acquisition indebtedness.
 - e. Average adjusted basis.
 9. **LO.1, 7** Tom is the treasurer of the City Garden Club, a new entity in the community. A friend who is the treasurer of the garden club in a neighboring community tells Tom that it is not necessary for City Garden Club to file a request for exempt status with the IRS. Has Tom received correct advice? Explain.
- Issue ID** 10. **LO.1, 7** Abby Sue recently became the treasurer of First Point Church. The church has been in existence for three years and has never filed anything with the IRS.
- a. Identify any reporting responsibilities that Abby Sue might have as church treasurer.
 - b. Would your answer in (a) change if First Point Church had been in existence for more than 10 years? Explain.
 - c. Would your answer in (a) change if First Point Church had reported some unrelated business income? Explain.
11. **LO.7** Shane and Brittany are treasurers for § 501(c)(3) exempt organizations. Neither exempt organization is a church. Each year, Shane's exempt organization files a Form 990 while Brittany's exempt organization files a Form 990-PF. Discuss the public disclosure requirements for each exempt organization.

Computational Exercises

12. **LO.3** Helpers, Inc., a qualifying § 501(c)(3) organization, incurs lobbying expenditures of \$250,000 for the taxable year and grass roots expenditures of \$0. Exempt purpose expenditures for the taxable year are \$1,200,000. Helpers elects to be eligible to make lobbying expenditures on a limited basis.
- What amount of lobbying expenditures is Helper allowed to deduct?
 - What is its tax liability as a result of the election?
13. **LO.3** Davis, an officer for a § 501(c)(3) organization, receives benefits that are inappropriate in the context of a charitable entity. The excess benefits are determined to be \$35,000. Davis does not pay back the organization the excess amount before the first-level tax is due.
- What amount of first-level taxes are imposed on Davis? On the exempt organization management?
 - What amount of second-level taxes are imposed on Davis?
14. **LO.5** Rejoice, Inc., a private foundation, has existed for 10 years. During this period, Rejoice, has been unable to satisfy the requirements for classification as a private operating foundation. At the end of 2013, it had undistributed income of \$160,000. Of this amount, \$90,000 was distributed in 2014, and \$70,000 was distributed during the first quarter of 2015. The IRS mailed a deficiency notice to Rejoice on August 1, 2016.
- What is the initial tax on the 2013 undistributed taxable income for 2014? In 2015?
 - What is the additional tax for 2016?
15. **LO.6** Mylo, Inc., an exempt organization, owns a building. Mylo's adjusted basis for the building is \$650,000. Of the building's total area of 8,000 square feet, the front portion (approximately 2,000 square feet) is used in carrying out Mylo's exempt purpose. The remainder of the building is leased to a taxable entity, for \$280,000 each year.
- The unamortized balance of a mortgage relating to the original acquisition of the building by Mylo is \$400,000.
- What portion of the building's adjusted basis is treated as debt-financed property?
 - How much of the mortgage is acquisition indebtedness?

Problems

16. **LO.2, 3** Wellness, Inc., a § 501(c)(3) organization, makes lobbying expenditures of \$340,000 this year. Exempt purpose expenditures were \$600,000 for the first six months of the year and \$950,000 for the last six months of the year. Determine the Federal income tax consequences to Wellness if:
- It does not make the § 501(h) lobbying election.
 - It does make the § 501(h) lobbying election.
17. **LO.3, 6, 8** Roadrunner, Inc., is an exempt medical organization. Quail, Inc., a sporting goods retailer, is a wholly owned subsidiary of Roadrunner. Roadrunner inherited the Quail stock last year from a major benefactor of the medical organization. Quail's taxable income is \$550,000. Quail will remit all of its earnings, net of any taxes, to Roadrunner to support the exempt purpose of the parent.

Decision Making
Communications

- a. Is Quail subject to Federal income tax? If so, calculate the liability.
 - b. Arthur Morgan, the treasurer of Roadrunner, has contacted you regarding minimizing or eliminating Quail's tax liability. He would like to know if the tax consequences would be better if Quail were liquidated into Roadrunner. Write a letter to Morgan that contains your advice. Roadrunner's address is 500 Rouse Tower, Rochester, NY 14627.
18. **LO.3** Initiate, Inc., a § 501(c)(3) organization, receives the following revenues and incurs the following expenses.

Grant from Gates Foundation	\$ 70,000
Charitable contributions received	625,000
Expenses in carrying out its exempt mission	500,000
Net income before taxes of Landscaping, Inc., a wholly owned for-profit subsidiary	400,000

Landscaping, Inc., remits all of its after-tax profits each year to Initiate. Calculate the amount of the Federal income tax, if any, for Initiate and for Landscaping.

- Communications** 19. **LO.4** Pigeon, Inc., a § 501(c)(3) organization, received support from the following sources.

Governmental unit A for services rendered	\$ 6,300
Governmental unit B for services rendered	4,500
Fees from the general public for services rendered (Each payment was of \$100)	75,000
Gross investment income	39,000
Contributions from disqualified persons	26,000
Contributions from other than disqualified persons (Each gift was of \$50)	<u>160,000</u>
Total support	<u>\$310,800</u>

- a. Does Pigeon satisfy the test for receiving broad public support? Why or why not?
 - b. Is Pigeon a private foundation? Be specific in your answer.
 - c. Arnold Horn, Pigeon's treasurer, has asked you to advise him on whether Pigeon is a private foundation. Write a letter to him in which you address the issue. His address is 250 Bristol Road, Charlottesville, VA 22903.
20. **LO.5** Gray, Inc., a private foundation, reports the following items of income and deductions. Gray is not an exempt operating foundation, and it is not eligible for the 1% tax rate.

Interest income	\$ 29,000
Rent income	61,000
Dividend income	15,000
Royalty income	22,000
Unrelated business income	80,000
Rent expenses	(26,000)
Unrelated business expenses	(12,000)

- a. Calculate Gray's net investment income.
 - b. Calculate Gray's tax on net investment income.
21. **LO.5** Salmon, Inc., a private foundation, has existed for 8 years. During this period, Salmon has been unable to satisfy the requirements for classification as a private operating foundation. At the end of 2013, it had undistributed income of \$350,000. Of this amount, \$185,000 was distributed in 2014, and \$165,000 was distributed during the first quarter of 2015. The IRS mailed a deficiency notice to Salmon on August 1, 2016.
- a. Calculate the initial tax for 2013, 2014, and 2015.
 - b. Calculate the additional tax for 2016.

22. **LO.5, 8** Otis is the CEO of Rectify, Inc., a private foundation. Otis invests \$500,000 (80%) of the foundation's investment portfolio in derivatives. Previously, the \$500,000 had been invested in corporate bonds with an AA rating that earned 4% per annum. If the derivatives investment works as Otis's investment adviser claims, the annual earnings could be as high as 20%. **Decision Making**
- Determine whether Rectify is subject to any of the taxes imposed on private foundations.
 - If so, calculate the amount of the initial tax.
 - If so, calculate the amount of the additional tax if the act causing the imposition of the tax is not addressed within the correction period.
 - Are Otis and the foundation better off financially if the prohibited transaction, if any, is addressed within the correction period? Explain.
23. **LO.5** The board of directors of White Pearl, Inc., a private foundation, consists of Charlyne, Beth, and Carlos. They vote unanimously to provide a \$325,000 grant to Marcus, their business associate. The grant is to be used for travel and education and does not qualify as a permitted grant to individuals (i.e., it is a taxable expenditure under § 4945). Each director knows that Marcus was selected for the grant because he is a friend of the organization and that the grant is a taxable expenditure.
- Calculate the initial tax imposed on White Pearl.
 - Calculate the initial tax imposed on the foundation manager (i.e., board of directors).
24. **LO.6** The Open Museum is an exempt organization that operates a gift shop. The museum's annual operations budget is \$3.2 million. Gift shop sales generate a profit of \$900,000. Another \$600,000 of investment income is generated by the museum's endowment fund. **Communications**
- Both the income from the gift shop and the endowment income are used to support the exempt purpose of the museum. The balance of \$1.7 million required for annual operations is provided through admission fees.
- Wayne Davis, a new board member, does not understand why the museum is subject to tax at all, particularly because all of the entity's profits are used in carrying out the mission of the museum. The museum's address is 250 Oak Avenue, Peoria, IL 61625.
- Calculate the amount of unrelated business income.
 - Assume instead that the endowment income is reinvested in the endowment fund, rather than being used to support annual operations. Calculate the amount of unrelated business income.
 - As the museum treasurer, write a letter to Wayne explaining the reason for the tax consequences. Mr. Davis's address is 45 Pine Avenue, Peoria, IL 61625.
25. **LO.6** Upward and Onward, Inc., a § 501(c)(3) organization that provides training programs for welfare recipients, reports the following income and expenses from the sale of products associated with the training program. Calculate Upward and Onward's UBIT.
- | | |
|----------------------------------|-----------|
| Gross income from sales | \$425,000 |
| Cost of goods sold | 106,000 |
| Advertising and selling expenses | 26,000 |
| Administrative expenses | 112,500 |
- Assume that the sale of the training program products is substantially related to Upward and Onward's exempt purpose.
 - Assume that the sale of the training program products is not substantially related to Upward and Onward's exempt purpose.

- Communications** 26. **LO.6** Perch, Inc., an exempt organization, records unrelated business taxable income of \$4 million.
- Calculate Perch's UBIT.
 - Prepare an outline of a presentation you are going to give to the new members of Perch's board on why Perch is subject to the UBIT even though it is an exempt organization.
27. **LO.6** For each of the following organizations, determine its UBTI and any related UBIT.
- AIDS, Inc., an exempt charitable organization that provides support for individuals with AIDS, operates a retail medical supply store open to the general public. The net income of the store, before any Federal income taxes, is \$305,000.
 - The local Episcopal Church operates a retail gift shop. The inventory consists of the typical items sold by commercial gift shops in the city. The director of the gift shop estimates that 80% of the gift shop sales are to tourists and 20% are to church members. The net income of the gift shop, before the salaries of the three gift shop employees and any Federal income taxes, is \$300,000. The salaries of the employees total \$80,000.
 - Education, Inc., a private university, has vending machines in the student dormitories and academic buildings on campus. In recognition of recent tuition increases, the university has adopted a policy of merely trying to recover its costs associated with the vending machine activity. For the current year, however, the net income of the activity, before any Federal income taxes, is \$75,000.
28. **LO.6** For each of the following organizations, determine its UBTI and any related UBIT.
- Worn, Inc., an exempt organization, provides food for the homeless. It operates a thrift store that sells used clothing to the general public. The thrift shop is staffed solely by four salaried employees. All of the clothes it sells are received as contributions. The \$100,000 profit generated for the year by the thrift shop is used in Worn's mission of providing food to the homeless.
 - Small, Inc., an exempt organization, recorded gross unrelated business income of \$900 and unrelated business expenses of \$400.
 - In Care, Inc., is a § 501(c)(3) exempt organization. It owns a convenience store and gas pumps, which it received as a bequest from a patron. The store/gas pumps entity is organized as StopBy, a C corporation. Because StopBy is profitable, In Care hires a manager and several employees to run the entity. For the current year, StopBy's profit is \$640,000. All of this amount is distributed by StopBy to In Care to use in carrying out its exempt mission.
29. **LO.6** Save the Squirrels, Inc., a § 501(c)(3) organization that feeds the squirrels in municipal parks, receives a \$250,000 contribution from Animal Feed, Inc., a corporation that sells animal feed. In exchange for the contribution, Save the Squirrels will identify Animal Feed as a major supporter in its monthly newsletter. Determine Save the Squirrels's UBTI and any related UBIT under the following independent assumptions.
- Save the Squirrels receives no other similar payments.
 - Save the Squirrels agrees to identify Animal Feed as a major supporter and to include a half-page advertisement for Animal Feed products in its monthly newsletter as a result of the contribution.
30. **LO.6** Fish, Inc., an exempt organization, reports unrelated business income of \$500,000 (before any charitable contribution deduction). During the year, Fish makes charitable contributions of \$54,000, of which \$38,000 are associated with the unrelated trade or business.
- Calculate Fish's unrelated business taxable income (UBTD).
 - Assume that the charitable contributions are \$41,000, of which \$38,000 are associated with the unrelated trade or business. Calculate the UBTI.

31. **LO.6** Rabbit, Inc., an exempt organization, reports net unrelated business income of \$75,000, excluding any rent income received. Rabbit owns two buildings that are leased to tenants. The net rent income on the first building is \$32,000, and that on the second building is \$35,000. The lessee of the first building is unrelated to Rabbit, whereas the lessee of the second building is a 100% owned for-profit subsidiary. Calculate Rabbit's unrelated business income.
32. **LO.6** Save, Inc., an exempt organization, sells the following assets during the tax year. Determine the effect of these transactions on Save's unrelated business taxable income.

Asset	Gain (Loss)	Use
Land and building	\$100,000	In exempt purpose
Land	25,000	In exempt purpose
Equipment	(12,000)	Leased to a taxable entity
Automobile	(9,000)	Leased to a taxable entity

33. **LO.6** Fix, Inc., an exempt organization, owns a one-story building. Fix's adjusted basis for the building is \$900,000. Of the building's total area of 10,000 square feet, the front portion (approximately 3,000 square feet) is used in carrying out Fix's exempt purpose. The remainder of the building is leased to Belts, Inc., a taxable entity, for \$300,000 each year. Belt uses the space to store its inventory.

The unamortized balance of a mortgage relating to the original acquisition of the building by Fix is \$600,000. Determine the portion of the building's adjusted basis that is treated as debt-financed property and the amount of the mortgage that is acquisition indebtedness.

34. **LO.7** Seagull, Inc., a § 501(c)(3) exempt organization, uses a tax year that ends on October 31. Seagull's gross receipts are \$600,000, and related expenses are \$580,000.
- Is Seagull required to file an annual Form 990?
 - If so, what is the due date?
35. **LO.7** Education, Inc., a § 501(c)(3) organization, is a private foundation with a tax year that ends on May 31. Gross receipts for the fiscal year are \$180,000, and the related expenses are \$160,000.
- Is Education required to file an annual information return?
 - If so, what form is used?
 - If so, what is the due date?
 - How would your answers in (a), (b), and (c) change if Education was an exempt organization that was not a private foundation?

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Wonderful Wilderness, Inc., is a tax-exempt organization. Its mission is to “explore, enjoy, and protect the wild places of the earth; practice and promote the responsible use of the earth's ecosystems and resources; educate and

Communications

enlist humanity to protect and restore the quality of the natural and human environment; and use all lawful means to carry out these objectives.”

Lloyd Morgan, the chief financial officer, presents you with the following information. Wonderful Wilderness raises funds to support its mission in a variety of ways, including contributions and membership fees. As part of this effort, Wonderful Wilderness develops and maintains mailing lists of its members, donors, catalog purchasers, and other supporters.

Wonderful Wilderness holds exclusive ownership rights to its mailing lists. To acquire the names of additional prospective members and supporters, Wonderful Wilderness occasionally exchanges membership lists with other organizations. In addition, Wonderful Wilderness permits other tax-exempt organizations and commercial entities to pay a fee, as set forth in a fee schedule, to use its mailing lists on a one-time basis per transaction.

Morgan is aware that the Federal income tax law applies a UBIT. He is also aware of the § 512(b)(2) provision that excludes royalties from the UBIT. An IRS agent has raised the issue that the revenue from the use of the mailing lists by other entities may be taxable as unrelated business income. Morgan wants you to research this issue for him.

Write a letter to Morgan that contains your findings, and prepare a memo for the tax research files. Wonderful Wilderness’s address is 100 Wilderness Way, Pocatello, ID 83209.

Communications Research Problem 2. Your client, Rich N. Ready, has come to you for advice. Rich is interested in many social welfare issues (e.g., access to higher education, welfare reform, and abortion rights). He wishes to use his wealth to educate the general public on these issues, as well as to influence related legislation. Further, he wants to assist the financing of campaigns for political candidates who reflect his views.

Rich’s friend Penny suggested that he organize a § 501(c)(4) organization, telling him that such organizations are not only tax exempt, but that they need not disclose the names of their donors. Thus, Rich could participate in these activities anonymously. However, Rich saw that the Internal Revenue Code requires that a § 501(c)(4) organization must be operated exclusively for “the promotion of social welfare.” This would seem to preclude the lobbying and political campaigning support that Rich desires.

Is a § 501(c)(4) organization appropriate for Rich’s plans? Summarize your findings in an e-mail to your instructor; be specific in your answer(s).

Communications Research Problem 3. Roger is the pastor at the Third Ecumenical Church in Atlanta. Over lunch with Priscilla, the pastor at another church with whom Roger went to seminary, Roger learns that another friend’s church recently had its tax-exempt status revoked for engaging in political activities. From time to time, certain political figures “give testimony” at Roger’s church. Being concerned about his own church’s tax-exempt status, he asks you to provide him with the types of activities his church should not engage in or permit.

Locate a Revenue Ruling that you can use to provide Roger with the desired information. Summarize the ruling with two PowerPoint slides.

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 4. Verify the exempt status of the symphony orchestra that performs closest to your home. Who are its three highest-paid associates? Send an e-mail to your instructor explaining how you found this information.

Research Problem 5. Use **www.guidestar.org** to obtain the following information on the Jamestown Yorktown Foundation, Inc., which is located in Williamsburg, Virginia.

- Locate the foundation's website.
- Under what paragraph of § 501(c) is the organization exempt from Federal income tax?
- Use the Form 990 to determine the amount of compensation paid to officers and directors.

Roger CPA Review Questions

1. Happy House, Inc., an exempt organization, has \$340,000 of gross unrelated business income (UBI) in its first year of operations. The following expenses were incurred in producing the UBI:

Expense	Amount
Cost of goods sold	\$100,000
Depreciation	18,000
Repairs and Maintenance	4,000
Miscellaneous	2,000

Happy House qualifies for the standard annual deduction and has documented plans for reinvesting 100% of net proceeds from UBI back into its exempt activities. The corporate tax rate is 34%. Considering only the above facts, what is Happy House's unrelated business income tax (UBIT) liability for the year?

- a. \$79,220 c. \$0
 b. \$73,440 d. \$73,100
2. The International Association of Accountants (IAA), a labor union, made a one-time donation to a political candidate who is also a member of the organization. In addition, the IAA has publicly endorsed the member-candidate through flyers mailed to its membership. Which of the following is true about the IAA exempt status?
- a. The IAA is entitled to exempt status because IRC 501(c) specifically allows labor unions to be exempt
 b. The IAA is entitled to exempt status because the candidate they supported is a member of the union
 c. The IAA is entitled to exempt status because they only made a one-time donation, which is not considered actual influence
 d. The IAA will be denied exempt status because they supported a specific political candidate
3. Which of the following exempt organizations are required to file an annual information return if gross receipts exceed \$50,000 in a year?
- I. A charity
 II. A labor union
 III. A church
- a. I, II, and III c. I only
 b. I and II d. II only

4. What is the due date for an exempt organization's annual information return?
 - a. The 15th day of the second month after the organization's year-end
 - b. The 15th day of the third month after the organization's year-end
 - c. The 15th day of the fourth month after the organization's year-end
 - d. The 15th day of the fifth month after the organization's year-end

Multistate Corporate Taxation

LEARNING OBJECTIVES: *After completing Chapter 24, you should be able to:*

- | | |
|---|---|
| <p>LO.1 Illustrate the computation of a multistate corporation's state tax liability.</p> <p>LO.2 Define nexus and explain its role in state income taxation.</p> <p>LO.3 Distinguish between allocation and apportionment of a multistate corporation's taxable income.</p> <p>LO.4 Describe the nature and treatment of business and nonbusiness income.</p> <p>LO.5 Discuss the sales, payroll, and property apportionment factors.</p> | <p>LO.6 Apply the unitary method of state income taxation.</p> <p>LO.7 Discuss the states' income tax treatment of S corporations, partnerships, and LLCs.</p> <p>LO.8 Describe other commonly encountered state and local taxes on businesses.</p> <p>LO.9 Recognize tax planning opportunities available to minimize a corporation's state and local tax liability.</p> |
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CHAPTER OUTLINE

- | | |
|--|---|
| <p>24-1 Overview of Corporate State Income Taxation, 24-2
 24-1a Computing State Income Tax, 24-3
 24-1b Operational Implications, 24-3
 24-1c State Modifications, 24-4
 24-1d The UDITPA and the Multistate Tax Commission, 24-7
 24-1e Jurisdiction to Impose Tax: Nexus and Public Law 86-272, 24-7</p> <p>24-2 Allocation and Apportionment of Income, 24-9
 24-2a The Apportionment Procedure, 24-9
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THE BIG PICTURE

STOCKBYTE/JUPITER IMAGES

MAKING A MULTISTATE LOCATION DECISION

LocalCo has customers in most U.S. states. It does not employ a traditional sales force. Instead, it sells its products exclusively through Internet solicitations and its elaborate website.

LocalCo has two product lines: cell phone accessories, which it manufactures in Alabama, and various sports-themed apparel items, all of which are produced in California. LocalCo has been quite profitable in the past, and it holds a sizable investment portfolio, made up chiefly of U.S. Treasury securities. Banking, payroll, and other administrative operations are located in rural New York State, where the entity is incorporated. LocalCo's rank-and-file employees receive compensation packages that are below the national median, but its top 10 executives are highly paid.

In an effort to "go green," LocalCo wants to hold down its costs for shipping raw materials to its manufacturing facilities and for sending its sold goods to customers. Thus, it is considering the construction of a sizable new multifunction building. Ideally, the new facility would have access to both interstate highways and a reliable airport with excess capacity for freight operations.

How will LocalCo's expansion decision be affected by state and local tax considerations?

Read the chapter and formulate your response.

Although most of this text concentrates on the effects of the Federal income tax law upon the computation of a taxpayer's annual tax liability, a variety of tax bases apply to most business taxpayers. For instance, a multinational corporation may be subject to tax in a number of different countries (see Chapter 25). Furthermore, estimates are that about 40 percent of the tax dollars paid by business taxpayers go to state and local authorities.

Businesses operate in a multistate environment for a variety of reasons. For the most part, nontax motivations drive such location decisions as where to build new plants or distribution centers or whether to move communications and data processing facilities and corporate headquarters. For instance, a business typically wants to be close to its largest markets and to operate in a positive private- and public-sector business climate, where it has access to well-trained and reasonably priced labor, suppliers and support operations, sources of natural resources, communication facilities, and transportation networks.

Many location decisions, though, are motivated by multistate tax considerations, such as the following.

- Tax credits and other incentives that encourage businesses to relocate, expand, or retain jobs in the area. Some of the incentives include *clawback* provisions, under which the tax savings granted must be returned to the state by the business if new job targets are not met or construction projects not completed.
- The compliance burdens created by each new level of tax compliance. For instance, how many tax returns must be filed by a three-shareholder S corporation operating in 15 states?
- Professional concerns in dealing with state and local revenue departments that differ in their levels of sophistication and operate on different time schedules. For example, the aggressiveness with which departments of revenue enforce their tax statutes varies greatly from state to state, even in a context of ongoing pressure to enhance revenues.
- The extent to which a local political climate encourages tax burdens on visitors and others who have no direct say in the reelection of local politicians.

This chapter reviews the basic tax concepts that are predominant among most states that impose a tax based on net income,¹ and it discusses the major areas in which tax planning can reduce a corporation's overall state tax burden. The discussion concludes with a review of other types of taxes used by the U.S. states, with a special focus on sales and use taxes.

24-1 OVERVIEW OF CORPORATE STATE INCOME TAXATION

Forty-six states and the District of Columbia impose a tax based on a corporation's taxable income. Because each state is free to create its own tax provisions, the tax practitioner could be faced with 47 entirely different state tax provisions.² Fortunately, however, to simplify the filing of tax returns and increase compliance with state tax laws, the majority of states "piggyback" onto the Federal income tax base. This means that they have adopted *en masse* part or all of the Federal provisions governing the

¹Some states refer to their tax on corporate income as a franchise tax, a business tax, a license tax, or a business profits tax. Although a franchise tax in some states is a business privilege tax based on a corporation's capital stock or net worth, several states use that term for the tax they impose on a corporation's net income.

²The District of Columbia operates in much the same manner as a state and imposes a tax based on income. Four states impose no corporate income tax at all: Nevada, South Dakota, Washington, and Wyoming. Corporations, however, are subject to a business and occupation tax in Washington. Several states base the tax on the entity's gross receipts, not on net income.

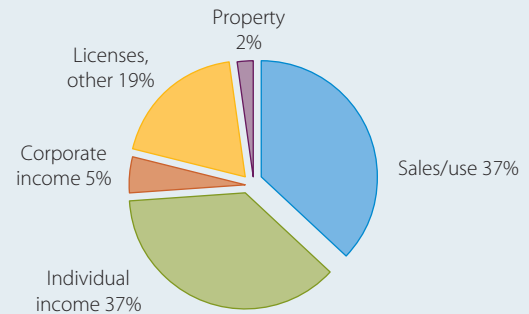


TAX IN THE NEWS Paying the States' Bills

The states collect over \$850 billion in taxes annually (i.e., over \$2,700 per U.S. individual). The corporate income tax accounts for only a small portion of the states' revenues—5 percent. This percentage is even less than the contribution of the Federal corporate tax to the U.S. government's revenues. Most of the states' property tax collections (2 percent of the total) are received by counties and smaller taxing jurisdictions.

Source: U.S. Census.

The States' Tax Revenue Sources, 2013



definition of income and the allowance of various exemptions, exclusions, and deductions. None of the states, however, have piggybacked their tax collections with the IRS.

24-1a Computing State Income Tax

In more than 40 of the states that impose a corporate income tax, the starting point in computing the tax base is taxable income as reflected on the Federal corporate income tax return (Form 1120). Those states whose computation of state taxable income is not coupled to the Federal tax return have their own state-specific definitions of gross and taxable income. Nonetheless, even these states typically adopt most Federal income and deduction provisions.

Although Federal tax law plays a significant role in the computation of state taxable income, there is a wide disparity in both the methods used to determine a state's taxable income and the tax rates imposed on that income. As only a few states apply more than one or two tax rates to taxable income, there is little progressivity to these tax systems.

State tax credits typically are designed to encourage increased hiring and investment in local facilities. Cities and states often use targeted tax credits to entice businesses to expand within their borders. For instance, a state might offer a \$10,000 credit for each new job created by the taxpayer or a 15 percent credit for taxpayers who purchase automobiles that were assembled in the state.

The formula used by a multistate corporation to determine its tax liability in a typical state is illustrated in Exhibit 24.1.

24-1b Operational Implications

Generally, the accounting period and methods used by a corporation for state tax purposes must be consistent with those used on the Federal return. States often apply different rules, however, in identifying the members of a group filing a consolidated return and the income of each group member that is subject to tax.

Most states piggyback onto the IRS's audit process. Consequently, virtually all of the states that levy an income tax require notification of the final settlement of a Federal income tax audit. State authorities then adjust the originally calculated state tax liability appropriately.

LO.1

Illustrate the computation of a multistate corporation's state tax liability.

EXHIBIT 24.1

Computing Corporate State Income Tax Liability

	Starting point in computing taxable income*
±	State modification items
	State tax base
±	Total net allocable income/(loss) (<i>nonbusiness income</i>)
	Total apportionable income/(loss) (<i>business income</i>)
×	State's apportionment percentage
	Income apportioned to the state
±	Income/(loss) allocated to the state
	State taxable income/(loss)
×	State tax rate
	Gross income tax liability for state
–	State's tax credits
	Net income tax liability for the state

*Most states use either line 28 or line 30 of the Federal corporate income tax return (Form 1120). In other states, the corporation is required to identify and report each element of income and deduction on the state return.

24-1c State Modifications

Federal taxable income generally is used as the starting point in computing the state's income tax base, but state adjustments or modifications often are made to Federal taxable income to:

- Reflect differences between state and Federal tax statutes.
- Remove income that a state is constitutionally prohibited from taxing.

The required modifications to Federal taxable income vary significantly among the states. Accordingly, this discussion is limited to the most common additions and subtractions that the states require. Exhibit 24.2 lists the most frequently encountered modifications. In computing the taxable income for a given state, only a selected number of these modifications may be applicable.



TAX IN THE NEWS Tax Incentives for Hollywood Glitter

Some of the states have been generous toward the television and movie industry in granting tax credits to production companies that make films and programs within their borders. Some significant location decisions have turned on tax consequences, including the shifting of *The Tonight Show* and *America's Got Talent* into New York City. Despite consistently low ratings, the decorated program *30 Rock* probably extended its life by a year or two, as its bottom line became more favorable due to the recovery of costs under various tax credits.

More than half of the U.S. states offer some type of film/television incentive. Further, studios and facilities in Michigan and North Carolina are seen by some as superior to those in Hollywood.

Canada and Germany long have enticed film projects away from the United States with their favorable tax credits. Often, the skyline in a movie that is set in a U.S. city actually is that of Toronto or Vancouver.

U.S. states annually allow about \$1.5 billion in tax breaks to the film industry, looking to spur economic activity at the filming site, but most of the credit-triggering dollars (like salaries and overhead) quickly "leave the set" for the home states of the visitors.

Fiscal critics would rather see these appropriations used to solve local problems, such as housing shortages and ineffective schools. But a tax incentive program is highly attractive to a politician who might attend an on-site reception with Brad Pitt and Angelina Jolie, so it is not likely that these subsidies will be eliminated.

EXHIBIT 24.2

Common State Modifications

Addition Modifications

- Interest income received on state and municipal obligations and any other interest income that is exempt from Federal income tax. For this purpose, some states exempt interest earned on their own obligations.
- Expenses deducted in computing Federal taxable income that are directly or indirectly related to U.S. obligations.
- Income-based franchise and income taxes imposed by any state and the District of Columbia that were deducted in computing Federal taxable income.
- The amount by which the Federal deductions for depreciation, amortization, or depletion exceed those permitted by the state.
- The amount by which the state gain or loss from the disposal of assets differs from the Federal gain or loss. Due to the difference in permitted depreciation methods and other adjustments, a corporation's assets may have different Federal and state tax bases. This adjustment is not necessary if the state and Federal basis provisions are identical.

Adjustments required as a result of different elections being made for state and Federal purposes. Examples of such elections include the methods under which income from installment sales or long-term contracts is determined.

Federal net operating loss deduction, if the starting point in the computation of taxable income is Federal taxable income after special deductions.

Subtraction Modifications

- Interest on U.S. obligations or obligations of Federal agencies to the extent included in Federal taxable income but exempt from state income taxes under U.S. law.
- Expenses that are directly or indirectly related to the state and municipal interest that is taxable for state purposes.
- Refunds of franchise and income taxes imposed by any state and the District of Columbia, to the extent included in Federal taxable income.
- The amount by which the state deductions for depreciation, amortization, or depletion exceed the deductions permitted for Federal tax purposes.

Adjustments required as a result of different elections being made for state and Federal purposes, as above.

Dividends received from other U.S. corporations, to the extent included in Federal taxable income.

Net operating loss deduction as determined for state tax purposes.

Federal income tax paid.

* Required by most states.

Computing State Taxable Income

Blue Corporation is subject to tax only in State A. The starting point in computing Blue's taxable income in State A is Federal taxable income. Modifications then are made to reflect, among other provisions, the exempt status of interest on A obligations, all dividends received from other U.S. corporations, and the disallowance of a deduction for state income taxes. Blue generated the following income and deductions this year.

Sales	\$1,500,000
Interest on Federal obligations	50,000
Interest on municipal obligations of State B	100,000
Dividends received from 50% owned U.S. corporations	200,000
Total income	<u>\$1,850,000</u>
Expenses related to Federal obligations	\$ 1,000
Expenses related to municipal obligations	5,000
State income tax expense	50,000
Depreciation allowed for Federal tax purposes (the deduction allowed for state purposes is \$300,000)	400,000
Other allowable deductions	<u>1,000,000</u>
Total deductions	<u>\$1,456,000</u>

continued

EXAMPLE

1

Blue's taxable income for Federal and state purposes is computed as follows.

Federal Taxable Income

Sales	\$1,500,000
Interest on Federal obligations	50,000
Dividends received from U.S. corporations	200,000
Total income	<u>\$1,750,000</u>
Expenses related to Federal obligations	\$ 1,000
State income tax expense	50,000
Depreciation	400,000
Other allowable deductions	1,000,000
Total deductions	<u>\$1,451,000</u>
Taxable income before special deductions	\$ 299,000
Less: Dividends received deduction (80% × \$200,000)	160,000
Federal taxable income	<u>\$ 139,000</u>

State A Taxable Income

Federal taxable income	\$139,000
Addition Modifications	
Interest on State B obligations	100,000
State income tax expense	50,000
Excess depreciation deduction allowed for Federal purposes (\$400,000 – \$300,000)	100,000
Expenses related to Federal obligations	1,000
Subtraction Modifications	
Expenses related to State B obligations	(5,000)
Dividends from other corporations, to extent included in Federal taxable income (\$200,000 – \$160,000)	(40,000)
Interest on Federal obligations	<u>(50,000)</u>
State A taxable income	<u>\$295,000</u>

EXAMPLE
2

Continue with the facts of Example 1, except that the \$100,000 of municipal bond interest was generated from State A obligations. The computation of Federal taxable income is unaffected by this change. Because A exempts interest on its own obligations from taxation, Blue's A taxable income now is \$200,000.

State A Taxable Income

Federal taxable income	\$139,000
Addition Modifications	
State income tax expense	50,000
Excess depreciation deduction allowed for Federal purposes (\$400,000 – \$300,000)	100,000
Expenses related to Federal obligations	1,000
Subtraction Modifications	
Dividends from other U.S. corporations, to extent included in Federal taxable income (\$200,000 – \$160,000)	(40,000)
Interest on Federal obligations	<u>(50,000)</u>
State A taxable income	<u>\$200,000</u>

24-1d The UDITPA and the Multistate Tax Commission

The Uniform Division of Income for Tax Purposes Act (**UDITPA**) is a model law relating to the assignment of income among the states for corporations that maintain operations in more than one state (multistate corporations). Many states have adopted the provisions of the UDITPA, either by joining the Multistate Tax Compact or by modeling their laws after the provisions of the UDITPA.

The **Multistate Tax Commission (MTC)** writes regulations and other rules that interpret the UDITPA. When a new MTC rule or regulation is created, the member states propose its adoption to their respective legislatures. The majority of member states adopt the regulations with no exceptions or only minor changes.³

24-1e Jurisdiction to Impose Tax: Nexus and Public Law 86-272

The state in which a business is incorporated has the jurisdiction to tax the corporation, regardless of the volume of its business activity within the state. Whether a state can tax the income of a business that is incorporated in another state usually depends on the relationship between the state and the corporation.

The term **nexus** describes the degree of business activity that must be present before a taxing jurisdiction has the right to impose a tax on an out-of-state entity's income. State law defines the measure of the relationship that is necessary to create nexus. Typically, sufficient nexus is present when a corporation derives income from sources within the state, owns or leases property in the state, employs personnel in the state, or has physical or financial capital there.

Public Law 86-272 limits the states' right to impose an income tax on certain interstate activities.⁴ This Federal law prohibits a state from taxing a business whose only connection with the state is to solicit orders for sales of tangible personal property that is sent outside the state for approval or rejection. If approved, the orders must be filled and shipped by the business from a point outside the state.

Only the sales of tangible personal property are immune from taxation under the law, however. Leases, rentals, and other dispositions of tangible personal property are not protected activities. Moreover, dispositions of real property and intangible property, as well as sales of services, are not protected by Public Law 86-272.

An activity that consists merely of solicitation is immune from taxation. The statute does not define the term *solicitation*, but the Supreme Court has held that *solicitation of orders* includes any explicit verbal request for orders and any speech or conduct that implicitly invites an order.⁵ The Court also created a *de minimis* rule, allowing immunity from nexus where a limited amount of solicitation occurs.

Exhibit 24.3 summarizes the activities the MTC has identified as being directly related to solicitation (protected activities) and activities unrelated to solicitation (which establish income tax nexus for the entity).

Independent Contractors

Public Law 86-272 extends immunity to certain in-state activities conducted by an independent contractor that would not be permitted if performed directly by the taxpayer. Generally, an independent contractor may engage in the following limited activities without establishing income tax nexus for the principal: (1) soliciting sales, (2) making sales, and (3) maintaining a sales office.

Concept Summary 24.1 places in context the role of multistate income tax planning for U.S. business entities.

LO.2

Define nexus and explain its role in state income taxation.

³Many of the states that are not members of the Multistate Tax Compact still model their laws after the UDITPA and the MTC regulations.

⁴15 U.S.C. 381-385.

⁵*Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992).

EXHIBIT 24.3

Common Nexus Definitions under Public Law 86-272

General rule: P.L. 86-272 immunity from nexus applies where the sales representative's activities are ancillary to the order-solicitation process.

Activities That Usually Do Not Create Nexus

- Advertising campaigns.
- Carrying free samples only for display or distribution.
- Owning or furnishing automobiles, phones, and computers to salespersons.
- Passing inquiries or complaints on to the home office.
- Checking customers' inventories for reorder.
- Maintaining a sample or display room for two weeks or less during the year.
- Maintaining an office for an employee, including an office in the home.

Activities Usually Sufficient to Establish Nexus

- Making repairs or providing maintenance.
- Collecting delinquent accounts; investigating creditworthiness.
- Conducting installation or supervising installation.
- Conducting training classes, seminars, or lectures for persons other than sales personnel.
- Approving or accepting orders.
- Picking up or replacing damaged or returned property.
- Hiring, training, or supervising personnel other than sales employees.
- Providing shipping information and coordinating deliveries.
- Carrying samples for sale, exchange, or distribution in any manner for consideration or other value.
- Owning, leasing, maintaining, or otherwise using any of the following facilities or property in the state.

• Real estate	• Purchasing office
• Parts department	• Warehouse
• Employment office	• Call center
• Meeting place for directors, officers, or employees	• Mobile retailing (e.g., trucks with driver-salespersons)

Factor Presence Nexus

A few states, following an MTC model statute, automatically assign nexus to a taxpayer that exceeds at least one of the following thresholds for the tax year. The factor presence nexus standard ties more closely the nexus rules with the apportionment formula of the jurisdiction, and it may provide additional uniformity among the states as to measuring the taxpayer's business activities.

- | | |
|------------------------|-------------------------|
| • \$50,000 of property | • 25% of total property |
| • \$50,000 of payroll | • 25% of total payroll |
| • \$500,000 of sales | • 25% of total sales |

Concept Summary 24.1

Multistate Taxation

1. For a profitable business entity that operates in multiple U.S. states, up to 40 percent of the total tax expense may be made up of levies by state and local governments.
2. State and local tax incentives might be used to accomplish political goals or to provide incentives for businesses to remain in, or relocate to, the taxing jurisdiction.
3. Complexities introduced by state and local taxes may be burdensome for multistate businesses.
4. Multistate income tax planning involves the reduction of the overall state and local tax burden. This may be the result of being subject to tax in the fewest number of states or of reducing the tax burden in a particular state.

24-2 ALLOCATION AND APPORTIONMENT OF INCOME

A corporation that conducts business activities in more than one state must determine the portion of its net income that is subject to tax by each state. A corporation that has established sufficient nexus with another state generally must both **allocate** and **apportion** its income.

Apportionment is a means by which a corporation's taxable income is divided among the states in which it conducts business. Under an apportionment procedure, a corporation determines allowable income and deductions for the company as a whole and then apportions some of its net income to a given state, according to an approved formula.

Allocation is a method under which specific components of a corporation's income, net of related expenses, are directly assigned to a certain state. Allocation differs from apportionment in that allocable income is assigned to a single state, whereas apportionable income is divided among several states. Nonapportionable (nonbusiness) income generally includes:

- Income or losses derived from the sale of nonbusiness real or tangible property, or
- Income or losses derived from rentals and royalties from nonbusiness real or tangible personal property.

This income is allocated to the state where the property that generated the income or loss is located.

As Exhibit 24.1 indicated, total allocable (nonapportionable) income or loss typically is removed from corporate net income before the state's apportionment percentage is applied. The nonapportionable income or loss assigned to a state then is combined with the income apportionable to that state to arrive at total income subject to tax in the state.

Green Corporation conducts business in States N, O, P, and Q. Green's \$900,000 taxable income consists of \$800,000 apportionable income and \$100,000 allocable income generated from transactions conducted in State Q. Green's sales, property, and payroll are evenly divided among the four states, and the states all employ an identical apportionment formula. Accordingly, \$200,000 of Green's income is taxable in each of States N, O, and P. Green is subject to income tax on \$300,000 of income in State Q.

Apportionable income	\$800,000
Apportionment percentage (apportionable income is divided equally among the four states)	× 25%
Income apportioned to each state	<u>\$200,000</u>

	State N	State O	State P	State Q
Income apportioned	\$200,000	\$200,000	\$200,000	\$200,000
Income allocated	—	—	—	100,000
Taxable income	<u>\$200,000</u>	<u>\$200,000</u>	<u>\$200,000</u>	<u>\$300,000</u>

LO.3

Distinguish between allocation and apportionment of a multistate corporation's taxable income.

EXAMPLE

3

24-2a The Apportionment Procedure

Apportionment assumes that the production of the taxpayer's income is linked to business activity, and the laws of each state define a number of factors believed to indicate the amount of corporate activity conducted within the state. However, apportionment often does not provide a uniform division of an organization's income based on its business activity, because each state is free to choose the type and number of factors it



TAX IN THE NEWS So Where Did You Work Today?

The dream of many intellectual-property employees is to work at home with the employer's computer and communications equipment. Not only is the dress code based on the worker's comfort, but the employee can avoid the time and cost of commuting. The employer saves by not having to provide office space.

But what are the tax effects when the employee or independent contractor submits work to an employer located in

a different state? The general rule has been that state income taxes fall in full in the state where the work is done. Is this still the rule, or must the employee apportion the hours of the day among the various states that receive the work product? If so, on what basis should such apportionment be made? Furthermore, how will the worker avoid potential taxation of the same income by more than one state?

believes are indicative of the business activity conducted within its borders. Therefore, a corporation may be subject to state income tax on more or less than 100 percent of its income.

An equally incongruous consequence of apportionment may occur when the operations in a state result in a loss.

EXAMPLE

4

Red Corporation's operations include two manufacturing facilities, one in State A and one in State B. The plant located in A generated \$500,000 of income, and the plant located in B generated a loss of \$200,000. Therefore, Red's total taxable income is \$300,000.

By applying the statutes of each state, Red determines that its apportionment factors for A and B are .65 and .35, respectively. Accordingly, Red's income is apportioned to the states as follows.

$$\text{Income apportioned to State A: } .65 \times \$300,000 = \$195,000$$

$$\text{Income apportioned to State B: } .35 \times \$300,000 = \$105,000$$

Red is subject to tax in B on \$105,000 of income, even though the operations conducted in that state resulted in a loss.

LO4

Describe the nature and treatment of business and nonbusiness income.

24-2b Apportionable Income

Apportionable income is assigned among the states by using an apportionment formula. In contrast, *nonapportionable income* is either apportioned or allocated to the state in which the income-producing asset is located. For instance, income derived from the rental of nonbusiness real property generally is allocated to the state in which the property is located.

Apportioning Taxable Income

EXAMPLE

5

TNT Corporation, a manufacturer of explosive devices, is a multistate taxpayer that has nexus with States P and Q. During the taxable year, TNT's net sales of explosive devices were \$900,000; \$600,000 of these sales were made in P, and \$300,000 were made in Q. The corporation also received \$90,000 from the rental of nonbusiness real property located in P.

Both states employ a three-factor apportionment formula under which sales, property, and payroll are equally weighted. However, the states do not agree on the definition of apportionable income. Under P's tax provisions, nonbusiness rent income is allocable and business income is apportionable, while Q requires a corporation to apportion all of its (business and nonbusiness)

continued

income. The sales factor (the ratio of in-state sales to total sales) for each of the states is computed as follows.

$$\text{State P: } \frac{\$600,000 \text{ (sales in State P)}}{\$900,000 \text{ (total sales)}} = 66.67\%$$

$$\text{State Q: } \frac{\$300,000 \text{ (sales in State Q)}}{\$990,000 \text{ (total sales)}^*} = 30.30\%$$

*Because rent income is treated as business income, rents are included in the denominator of the sales factor.

Continue with the facts of Example 5, except that the rent income was generated from property located in Q, rather than from property located in P. Although the sales factor for P remains the same, the sales factor for Q changes.

$$\text{State P: } \frac{\$600,000 \text{ (sales in State P)}}{\$900,000 \text{ (total sales)}} = 66.67\%$$

$$\text{State Q: } \frac{\$390,000 \text{ (sales in State Q)}}{\$990,000 \text{ (total sales)}} = 39.39\%$$

Due to the composition of the sales factor in the two states, TNT's income never is perfectly apportioned: the aggregate of the sales factors is either more or less than 100%.

EXAMPLE

6

Apportionable income arises from the taxpayer's regular course of business or constitutes an integral part of the taxpayer's regular business.⁶ In determining whether an item of income is apportionable (business) income, state courts have developed a variety of approaches to determine what constitutes a taxpayer's "regular course of business."⁷

A few states, including Connecticut and Rhode Island, fail to distinguish between apportionable and nonapportionable income. In these states, all of a corporation's income is deemed to be subject to apportionment.

Nonapportionable income is "all income other than apportionable income."⁸ Usually, nonapportionable income comprises passive and portfolio income, such as dividends, interest, rents, royalties, and certain capital gains. However, passive or portfolio income may be apportionable when the acquisition, management, and disposition of the underlying property constitute an integral part of the taxpayer's regular business operation.

Apportionable Income

Scarlet Corporation is subject to income tax in several states. Scarlet earned \$2.5 million from the sales of its products and \$1 million from the sale of assets that were unrelated to its regular business operations.

In the states that distinguish between business and nonbusiness income, \$2.5 million of Scarlet's income is apportioned to the state according to the state's apportionment formula. The gain on the sale of the nonbusiness assets is allocated to the state in which the assets were located. In the states that subject a corporation's entire income to apportionment, \$3.5 million (\$2,500,000 + \$1,000,000) is apportioned to the states in which the taxpayer conducts business.

EXAMPLE

7

⁶MTC Reg. IV.1.(a).

⁷*Atlantic Richfield Co. v. State of Colorado and Joseph F. Dolan*, 601 P.2d 628 (Colo.S.Ct., 1979); *Appeal of A. Epstein and Sons, Inc.* (Cal.State Bd. of Equalization, 1984).

⁸UDITPA § 1(c).

Apportionable Income

EXAMPLE

8

Gray Corporation owns and operates two manufacturing facilities, one in State A and the other in State B. Due to a temporary decline in sales, Gray has rented 10% of its A facility to an unaffiliated corporation. Gray generated \$100,000 net rent income and \$900,000 income from manufacturing.

Both A and B classify such rent income as allocable income. By applying the statutes of each state, as discussed in the next section, Gray determines that its apportionment factors are .40 for A and .60 for B.

Income Subject to Tax in State A

Taxable income	\$1,000,000
Less: Allocable income	(100,000)
Apportionable income	\$ 900,000
Times: Apportionment factor	× 40%
Income apportioned to State A	\$ 360,000
Plus: Income allocated to State A	100,000
Income subject to tax in State A	<u>\$ 460,000</u>

Income Subject to Tax in State B

Taxable income	\$1,000,000
Less: Allocable income	(100,000)
Apportionable income	\$ 900,000
Times: Apportionment factor	× 60%
Income apportioned to State B	\$ 540,000
Plus: Income allocated to State B	-0-
Income subject to tax in State B	<u>\$ 540,000</u>

EXAMPLE

9

Continue with the facts of Example 8, but assume that B does not distinguish between apportionable and nonapportionable income. Thus, all of Gray's income is apportionable.

Gray properly determines that its apportionment factors are .40 for A and .58 for B. Because the apportionment factors used by the two states are derived differently, Gray's income that is subject to tax is greater than \$1 million.

Income Subject to Tax in State A **\$ 460,000****Income Subject to Tax in State B**

Apportionable income	\$1,000,000
Times: Apportionment factor	× 58%
Income apportioned to State B	<u>\$ 580,000</u>

LO.5

Discuss the sales, payroll, and property apportionment factors.

24-2c **Apportionment Factors: Elements and Planning**

Apportionable income is divided among the states by determining the appropriate apportionment percentage for each state that has a right to tax the entity. To determine the apportionment percentage for each state, a ratio is established for each of the factors included in the state's apportionment formula. Each ratio is calculated by comparing the level of a specific business activity within a state to the total corporate activity of that type. The ratios then are summed, averaged, and appropriately weighted to determine the taxpayer's apportionment percentage for a specific state.

Although apportionment formulas vary among jurisdictions, the traditional three-factor formula equally weights sales, property, and payroll.⁹ However, most of the states now use a modified three-factor formula, where the sales factor receives more than a one-third weight.

The use of a higher-weighted sales factor tends to pull a larger percentage of an out-of-state corporation's income into the taxing jurisdiction of the state, because the corporation's major activity within the state—the sales of its products—is weighted more heavily than are its payroll and property activities. Overweighting the sales factor, however, provides tax relief for corporations that are domiciled in the state. Those corporations generally own significantly more property and incur more payroll costs (factors that are given less weight in the apportionment formula) within the state than do out-of-state corporations.

Musk Corporation realized \$500,000 of taxable income from the sales of its products in States A and B. Musk's activities in both states establish nexus for income tax purposes. Musk's sales, payroll, and property in the states include the following.

	State A	State B	Total
Sales	\$1,250,000	\$750,000	\$2,000,000
Property	2,500,000	–0–	2,500,000
Payroll	1,500,000	–0–	1,500,000

If State B uses an equally weighted three-factor apportionment formula, \$62,500 of Musk's taxable income is apportioned to B.

Sales (\$750,000/\$2,000,000)	=	37.5%
Property (\$0/\$2,500,000)	=	–0–
Payroll (\$0/\$1,500,000)	=	–0–
Sum of apportionment factors		<u>37.5%</u>
Average	÷	<u>3</u>
Apportionment factor for State B		12.5%
Taxable income	×	<u>\$500,000</u>
Income apportioned to State B		<u>\$ 62,500</u>

If State B uses a double-weighted sales factor in its three-factor apportionment formula, \$93,750 of Musk's taxable income is apportioned to B.

Sales (\$750,000/\$2,000,000)	=	37.5% × 2	=	75%
Property (\$0/\$2,500,000)	=			–0–
Payroll (\$0/\$1,500,000)	=			–0–
Sum of apportionment factors				<u>75%</u>
Average			÷	<u>4</u>
Apportionment factor for State B				18.75%
Taxable income			×	<u>\$500,000</u>
Income apportioned to State B				<u>\$ 93,750</u>

When a state uses a double-weighted sales factor, typically a larger percentage of an out-of-state corporation's income is subject to tax in the state. Here, an additional \$31,250 (\$93,750 – \$62,500) of Musk's income is subject to tax in B.

A single-factor apportionment formula consisting solely of a sales factor is even more detrimental to an out-of-state corporation than an apportionment factor that double-weights the sales factor.¹⁰

⁹Certain industries, such as financial services institutions, insurance companies, air and motor carriers, pipeline companies, and communications providers, typically are required to use special apportionment formulas.

¹⁰For 2014, California, Colorado, Georgia, Illinois, Indiana, Iowa, Maine, Michigan, Minnesota, Nebraska, New Jersey, New York, Oregon, Pennsylvania, South Carolina, Texas, Utah, and Wisconsin require the use of a single-factor apportionment formula for most business taxpayers.

EXAMPLE

10

EXAMPLE

11

Continue with the facts of Example 10. If State B uses a sales-factor-only apportionment formula, Musk's income apportionable to B becomes \$187,500.

Sales (\$750,000/\$2,000,000)	=	<u>37.50%</u>
Sum of apportionment factors		37.50%
Average	÷	<u>1</u>
Apportionment factor for State B		37.50%
Taxable income	×	<u>\$500,000</u>
Income apportioned to State B		<u><u>\$187,500</u></u>

Concept Summary 24.2 highlights the most important aspects of multistate income allocation and apportionment.

Concept Summary 24.2

Apportionable Income

1. Taxability of an organization's income in a state other than the one in which it is incorporated depends on the laws, regulations, and judicial interpretations of the other state; the nature and level of the corporation's activity in, or contacts with, that state; and, to a limited extent, the application of P.L. 86-272.
2. Each state has adopted its own multistate income tax laws, regulations, methods, and judicial interpretations; consequently, the nonuniformity of state income taxing provisions provides a multitude of planning techniques that allow a multistate corporation to reduce its overall state tax liability legally.
3. The apportionment procedure is used to assign the income of a multistate taxpayer to the various states in which business is conducted. Generally, nonapportionable income is allocated, rather than apportioned, directly to the state in which the nonbusiness income-generating assets are located.
4. The various state apportionment factors and formulas offer planning opportunities in that more or less than 100% of the taxpayer's income may be subjected to state income tax.
5. Some states employ an equally weighted three-factor apportionment formula. In some states, the sales factor is doubled, and in other states, only the sales factor is used in apportioning multistate taxable income. Generally, the greater the relative weight assigned to the sales factor, the greater the tax burden on out-of-state taxpayers.

24-2d The Sales Factor

The **sales factor** is a fraction whose numerator is the corporation's total receipts in the state during the tax period. The denominator is the corporation's total receipts generated everywhere during the tax period. Gross receipts for this purpose generally are net of returns, allowances, and discounts.

Because the sales factor is a component in the formula used to apportion a corporation's business income to a state, only receipts that generate apportionable income are includible in the fraction. The sales factor generally includes business income from the sale of inventory or services, interest, dividends, rentals, royalties, sales of assets, and other business income. Income on Federal obligations, however, is not included in the sales factor.

When the sale involves capital assets, some states require that the gross proceeds, rather than the net gain or loss, be included in the fraction. Most states allow incidental or occasional asset sales and sales of certain intangible assets to be excluded from gross receipts.¹¹

In determining the numerator of the sales factor, most states follow the UDITPA's "ultimate destination concept," under which tangible asset sales are assumed to take place at the point of delivery, not at the location at which the shipment originates.

¹¹MTC Reg. IV.18.(c).

Olive Corporation, whose only manufacturing plant is located in State A, sells its products to residents of A through its local retail store. Olive also ships its products to customers in States B and C. The products that are sold to residents of A are assigned to A, while the products that are delivered to B and C are assigned to B and C, respectively.

EXAMPLE

12

Dock Sales

Dock sales occur where a purchaser uses its owned or rented vehicles, or a common carrier with which it has made arrangements, to take delivery of the product at the seller's shipping dock. Most states apply the destination test to dock sales in the same manner it is applied to other sales. Thus, if the seller makes dock sales to a purchaser that has an out-of-state location to which it returns with the product, the sale is assigned to the purchaser's state.

Throwback Rule

Out-of-state sales that are not subject to tax in the destination state are pulled back into the origination state if that state has adopted a **throwback rule**. About half of the states apply this exception to the destination test.

The throwback rule provides that when a corporation is not subject to tax in the destination state or the purchaser is the U.S. government, the sales are treated as in-state receipts of the origination state, and the actual destination of the product is disregarded. Consequently, when the seller is immune from tax in the destination state under Public Law 86-272, the sales are considered to be in-state receipts of the origination state if that state has a throwback provision.

Braun Corporation's entire operations are located in State A. Seventy percent (\$700,000) of Braun's sales are made in A, and the remaining 30% (\$300,000) are made in State B. Braun's solicitation of sales in B is limited to mailing a monthly catalog to its customers in that state. However, Braun employees do pick up and replace damaged merchandise in State B.

The pickup and replacement of damaged goods establish nexus with A. Braun's activities in B are sufficient (as determined by A's law) to subject Braun to a positive tax, based on its income. Therefore, Braun is permitted to apportion its income between A and B. However, B's definition of activities necessary to create nexus is less strict than that imposed by A; in B, the mere pickup and replacement of damaged goods do not subject a corporation's income to tax.

Braun's taxable income is \$900,000. Both A and B impose a 10% corporate income tax and include only the sales factor in their apportionment formulas. If A has not adopted a throwback rule, Braun's effective state income tax rate is 7%.

	Apportionment Factors	Net Income	Tax Rate	Tax
State A	70%	\$900,000	10%	\$63,000
State B	*	900,000	10%	-0-
Total tax liability				<u>\$63,000</u>
Effective state income tax rate: \$63,000/\$900,000 =				<u>7%</u>

* As determined under B's laws, Braun's income is not apportionable to State B, because of insufficient nexus.

If A has adopted a throwback rule, Braun does not benefit from its lack of nexus with B, because the sales in B are considered to be in-state receipts of A. Thus, Braun's effective tax rate is 10%.

	Apportionment Factors	Net Income	Tax Rate	Tax
State A	100%	\$900,000	10%	\$90,000
State B	-0-	900,000	10%	-0-
Total tax liability				<u>\$90,000</u>
Effective state income tax rate: \$90,000/\$900,000 =				<u>10%</u>
Tax increase due to throwback provision (\$90,000 - \$63,000)				<u>\$27,000</u>

EXAMPLE

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24-2e The Payroll Factor

The **payroll factor** is determined by comparing the compensation paid for services rendered within a state to the total compensation paid by the corporation. Generally, the payroll factor is a fraction whose numerator is the total amount a corporation paid or accrued for compensation in a state during the tax period. The denominator is the total amount paid or accrued by the corporation for compensation during the tax period.

For purposes of the payroll factor, compensation includes wages, salaries, commissions, and any other form of remuneration paid or accrued to employees for personal services. Compensation may also include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services, if these amounts constitute Federal gross income.

Payments made to an independent contractor or any other person who is not properly classifiable as an employee generally are excluded from the numerator and denominator of the payroll factor. A few states, including Delaware and North Carolina, exclude from the payroll factor the compensation paid to corporate officers.

More than half of the states provide that earnings paid to a cash or deferred compensation plan, excluded from Federal gross income under § 401(k), are to be included in the numerator and the denominator of the payroll factor. Accordingly, the total compensation that is included in the denominator of a corporation's payroll factor may vary among the states in which the corporation's income is apportioned.

EXAMPLE

14

Mice Corporation's sales office and manufacturing plant are located in State A. Mice also maintains a manufacturing plant and sales office in State C. For purposes of apportionment, A defines payroll as all compensation paid to employees, including contributions to § 401(k) deferred compensation plans. Under the statutes of C, neither compensation paid to officers nor contributions to § 401(k) plans are included in the payroll factor. Mice incurred the following personnel costs.

	State A	State C	Total
Wages and salaries for employees other than officers	\$350,000	\$250,000	\$600,000
Salaries for officers	150,000	100,000	250,000
Contributions to § 401(k) plans	30,000	20,000	50,000
Total	<u>\$530,000</u>	<u>\$370,000</u>	<u>\$900,000</u>

The payroll factor for State A is computed as follows.

$$\frac{\$530,000}{\$900,000} = 58.89\%$$

Because C excludes from the payroll factor any compensation paid to officers and contributions to § 401(k) plans, C's factor is computed as follows.

$$\frac{\$250,000}{\$600,000} = 41.67\%$$

The aggregate of Mice's payroll factors is 100.56% (58.89% + 41.67%).

The compensation of an employee normally is not split between two or more states during the year, unless he or she is transferred or changes positions during the year. Instead, each employee's entire compensation is assigned to only one state. Under the UDITPA, compensation is treated as being paid in the state (it is included in the numerator of the payroll factor) in which the services primarily are performed.

When an employee's services are performed in more than one state, his or her entire compensation is attributed to the employee's base of operations or, if there is no base of operations in any state in which some part of the service is performed, to the place from which the services are directed or controlled. When no services are performed in

the state that serves as the base of operations or the place from which the services are directed, the employee’s compensation is attributed to his or her state of residency.¹²

Geese Corporation has its headquarters and a manufacturing plant in State A. Reggie, a resident of State Y, works at the A manufacturing plant. His compensation is included in the numerator of A’s payroll factor, as the service is performed entirely in A. None of Reggie’s compensation is included in the payroll factor of State Y, Reggie’s “home” state.

EXAMPLE

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Only compensation that is related to the production of apportionable income is included in the payroll factor.

The Payroll Factor

Dog Corporation, a manufacturer of automobile parts, is subject to tax in States X and Y. Dog incurred the following payroll costs.

EXAMPLE

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	State X	State Y	Total
Wages and salaries for officers and personnel of manufacturing facilities	\$450,000	\$350,000	\$800,000
Wages and salaries for personnel involved in nonapportionable rental activities	50,000	–0–	50,000

Dog’s payroll factors are computed as follows.

$$\text{Payroll factor for State X: } \$450,000 / \$800,000 = 56.25\%$$

$$\text{Payroll factor for State Y: } \$350,000 / \$800,000 = 43.75\%$$

Tall Corporation, a manufacturer of paper products, operates paper mills in States A and B. In addition, the corporation owns nonapportionable rental real property in A. Tall incurred the following compensation expenses.

EXAMPLE

17

	State A	State B	Total
Wages and salaries for mill employees	\$1,200,000	\$1,500,000	\$2,700,000
Wages and salaries for administrative staff	600,000	500,000	1,100,000
Compensation of officers	800,000	400,000	1,200,000

Ten percent of the time spent by the administrative staff located in A and 5% of the time spent by officers located in A are devoted to the operation, maintenance, and supervision of the allocable rental property. Both states exclude such rent income from the definition of apportionable income.

Payroll factor for State A

$$\frac{\$1,200,000 + 90\%(\$600,000) + 95\%(\$800,000)}{\$2,700,000 + 90\%(\$600,000) + \$500,000 + 95\%(\$800,000) + \$400,000} = \frac{\$2,500,000}{\$4,900,000} = 51.02\%$$

Payroll factor for State B

$$\frac{\$1,500,000 + \$500,000 + \$400,000}{\$2,700,000 + 90\%(\$600,000) + \$500,000 + 95\%(\$800,000) + \$400,000} = \frac{\$2,400,000}{\$4,900,000} = 48.98\%$$

¹²UDITPA § 14.

24-2f The Property Factor

The **property factor** generally is a fraction whose numerator is the average value of the corporation's real property and its tangible personal property owned and used or rented and used in the state during the taxable year. The denominator is the average value of all of the corporation's real property and its tangible personal property owned or rented and used during the taxable year, wherever it is located. In this manner, a state's property factor reflects the extent of total property usage by the taxpayer in the state.

For this purpose, property includes land, buildings, machinery, inventory, equipment, and other real and tangible personal property, other than coins or currency.¹³ Other types of property that may be included in the factor are offshore property, outer space property (satellites), and partnership property.

In the case of property that is in transit between locations of the taxpayer or between a buyer and seller, the assets are included in the numerator of the destination state. With respect to mobile or movable property such as construction equipment, trucks, and leased equipment, which is both in- and outside the state during the tax period, the numerator of a state's property factor generally is determined on the basis of the total time the property was within the state.

Property owned by the corporation typically is valued at its average original or historical cost plus the cost of additions and improvements, but without adjusting for depreciation. Some states allow property to be included at net book value or adjusted tax basis. The value of the property usually is determined by averaging the values at the beginning and end of the tax period. Alternatively, some states allow or require the amount to be calculated on a monthly basis if annual computation results in substantial distortions.

EXAMPLE

18

Blond Corporation, a calendar year taxpayer, owns property in States A and B. Both A and B require that the average value of assets be included in the property factor. A requires that the property be valued at its historical cost, and B requires that the property be included in the property factor at its net book value.

<i>Account Balances at January 1</i>			
	State A	State B	Total
Inventories	\$150,000	\$100,000	\$250,000
Building and machinery (cost)	200,000	400,000	600,000
Accumulated depreciation for building and machinery	(150,000)	(50,000)	(200,000)
Land	<u>50,000</u>	<u>100,000</u>	<u>150,000</u>
Total	<u>\$250,000</u>	<u>\$550,000</u>	<u>\$800,000</u>

<i>Account Balances at December 31</i>			
	State A	State B	Total
Inventories	\$250,000	\$200,000	\$450,000
Building and machinery (cost)	200,000	400,000	600,000
Accumulated depreciation for building and machinery	(175,000)	(100,000)	(275,000)
Land	<u>50,000</u>	<u>100,000</u>	<u>150,000</u>
Total	<u>\$325,000</u>	<u>\$600,000</u>	<u>\$925,000</u>

continued

¹³MTC Reg. IV.10.(a).

State A Property Factor

Historical Cost	January 1	December 31	Average
Property in State A	\$ 400,000*	\$ 500,000**	\$ 450,000
Total property	1,000,000 [†]	1,200,000 [‡]	1,100,000

* \$150,000 + \$200,000 + \$50,000.

** \$250,000 + \$200,000 + \$50,000.

† \$250,000 + \$600,000 + \$150,000.

‡ \$450,000 + \$600,000 + \$150,000.

$$\text{Property factor for State A: } \frac{\$450,000}{\$1,100,000} = 40.91\%$$

State B Property Factor

Net Book Value	January 1	December 31	Average
Property in State B	\$550,000	\$600,000	\$575,000
Total property	800,000	925,000	862,500

$$\text{Property factor for State B: } \frac{\$575,000}{\$862,500} = 66.67\%$$

Due to the variations in the property factors, the aggregate of Blond's property factors equals 107.58% (40.91% + 66.67%).

Leased property, when included in the property factor, is valued at eight times its annual rental. Annual rentals may include payments such as real estate taxes and insurance made by the lessee in lieu of rent.

Jasper Corporation is subject to tax in States D and G. Both states require that leased or rented property be included in the property factor at eight times the annual rental costs and that the average historical cost be used for other assets. Information regarding Jasper's property and rental expenses follows.

Average Historical Cost

Property located in State D	\$ 750,000
Property located in State G	450,000
Total property	<u>\$1,200,000</u>

Lease and Rental Expenses

State D	\$ 50,000
State G	150,000
Total	<u>\$200,000</u>

Property factor for State D

$$\frac{\$750,000 + 8(\$50,000)}{\$1,200,000 + 8(\$200,000)} = \frac{\$1,150,000}{\$2,800,000} = \underline{\underline{41.07\%}}$$

Property factor for State G

$$\frac{\$450,000 + 8(\$150,000)}{\$1,200,000 + 8(\$200,000)} = \frac{\$1,650,000}{\$2,800,000} = \underline{\underline{58.93\%}}$$

EXAMPLE**19**


FINANCIAL DISCLOSURE INSIGHTS State/Local Taxes and the Tax Expense

In applying GAAP principles for a business entity, state and local tax expenses are found in several places in the taxpayer's financial reports. In the tax footnote, the state/local tax costs often are reported in dollar and/or percentage terms, in both current and deferred components. The following are examples of state/local tax expenses that were reported in a recent year.

	Current State/ Local Tax Expenses (\$ million)	Deferred State/ Local Tax Expenses (\$ million)
Eli Lilly	\$ 49	(\$ 1)
ExxonMobil	340	221
Ryder Systems	6	3
Ford Motor	7	(59)

Corporations also report permanent book/tax differences in determining the effective tax rate for the reporting period. In a recent year, Berkshire Hathaway reported that state/local permanent book/tax differences reduced its effective income tax rate by about 1.5 percentage points. Ford Motor reported a similar rate reduction, but Ryder Systems' effective tax rate increased by about 6 percentage points for the year due to such permanent book/tax differences.

Only property that is used in the production of apportionable income is includible in the numerator and denominator of the property factor. In this regard, idle property, property under construction, and property that is used in producing nonapportionable income generally are excluded. However, assets that are temporarily idle or currently unused generally remain in the property factor.

LO.6

Apply the unitary method of state income taxation.

24-3 THE UNITARY THEORY

The **unitary theory** was developed in response to the early problems that states faced in attributing the income of a multistate business among the states in which the business was conducted. Originally, this theory was applied to justify apportionment of the income of multiple operating divisions within a single company. Over the years, however, the concept has been extended to require the combined reporting of certain affiliated corporations, including those outside the United States.

When two affiliated corporations are subject to tax in different states, each entity must file a return and report its income in the state in which it conducts business. Each entity reports its income separately from that of its affiliated corporations. In an effort to minimize overall state income tax, multistate entities have attempted to separate the parts of the business that are carried on in the various states.

EXAMPLE

20

Arts Corporation owns a chain of retail stores located in several states. To enable each store to file and report the income earned only in that state, each store was organized as a separate subsidiary in the state in which it did business. In this manner, each store is separately subject to tax only in the state in which it is located.

Most states attempt to assign as much of an entity's income to in-state sources as possible, so the *unitary* approach to computing state taxable income is attractive to them. Under this method, a corporation is required to file a **combined return** that includes the results from all of the operations of the related corporations, not just from those that transacted business in the state. In this manner, the unitary method allows a state to apply the apportionment formula to a firm's nationwide or worldwide unitary income. To include the activities of the corporation's subsidiaries in the apportionment formula, the state must determine that the subsidiaries' activities are an integral part of a unitary business and, as a result, are subject to apportionment.



GLOBAL TAX ISSUES Water's Edge Is Not a Day at the Beach

As a result of pressure from the business community, the Federal government, and foreign countries, most of the states that impose an income tax on a unitary business's worldwide operations permit a multinational business to elect **water's edge** unitary reporting as an alternative to worldwide unitary filing.

The water's edge provision permits a multinational corporation to elect to limit the reach of the state's taxing jurisdiction over out-of-state affiliates to activities occurring

within the boundaries of the United States. The decision to make a water's edge election may have a substantial effect on the tax liability of a multinational corporation. For instance, a water's edge election usually cannot be revoked for a number of years without permission from the appropriate tax authority.

Moreover, corporations making this election may be assessed an additional tax or fee for the privilege of excluding out-of-state entities from the combined report.

24-3a What Is a Unitary Business?

A unitary business operates as a unit and cannot be segregated into independently operating divisions. The operations are integrated, and each division depends on or contributes to the operation of the business as a whole. It is not necessary that each unit operating within a state contribute to the activities of all divisions outside the state.

The unitary theory ignores the separate legal existence of the entities and focuses instead on practical business realities. Accordingly, the separate entities are treated as a single business for state income tax purposes, and the apportionment formula is applied to the combined income of the unitary business.

What Is a Unitary Business?

Continue with the facts of Example 20. Arts manufactured no goods, but it housed the central management, purchasing, distribution, advertising, and administrative departments. The subsidiaries carried on a purely intrastate business, and they paid for the goods and services received at the parent company's cost, plus overhead.

Arts and the subsidiaries constitute a unitary business due to their unitary operations (purchasing, distribution, advertising, and administrative functions). Accordingly, in states that have adopted the unitary method, the income and apportionment factors of the entire unitary group are combined and apportioned to the states in which at least one member of the group has nexus.

EXAMPLE

21

Crafts Corporation organized its departments as separate corporations on the basis of function: mining copper ore, refining the ore, and fabricating the refined copper into consumer products. Even though the various steps in the process are operated substantially independently of each other with only general supervision from Crafts' executive offices, Crafts is engaged in a single unitary business. Its various divisions are part of a large, vertically structured enterprise in which each business segment needs the products or raw materials provided by another. The flow of products among the affiliates also provides evidence of functional integration, which generally requires some form of central decision or policy making, another characteristic of a unitary business.

EXAMPLE

22

More than half of the states require or allow unitary reporting. Notice that the application of the unitary theory is based on a series of subjective observations about the organization and operation of the taxpayer's businesses, whereas the availability of Federal controlled and affiliated group status (see Chapter 17) is based on objective, mechanical ownership tests.

24-3b Tax Effects of the Unitary Theory

Use of the unitary approach by a state eliminates several of the planning techniques that could be used to shift income between corporate segments to avoid or minimize state taxes. In addition, the unitary approach usually results in a larger portion of the

corporation's income being taxable in states where the compensation, property values, and sales prices are high relative to other states. This occurs because the larger in-state costs (numerators in the apportionment formula) include in the tax base a larger portion of the taxable income within the state's taxing jurisdiction. This has an adverse effect on the corporation's overall state tax burden if the states in which the larger portions are allocated impose a high tax rate relative to the other states in which the business is conducted.

The presence of a unitary business is favorable when losses of unprofitable affiliates may be offset against the earnings of profitable affiliates. It also is favorable when income earned in a high-tax state may be shifted to low-tax states due to the use of combined apportionment factors.

Effects of Unitary Computations

EXAMPLE

23

Rita Corporation owns two subsidiaries, Brown and Tan. Brown, located in State K, generated taxable income of \$700,000. During this same period, Tan, located in State M, generated a loss of \$400,000. If the subsidiaries are independent corporations, Brown is required to pay K tax on \$700,000 of income. However, if the corporations constitute a unitary business, the incomes, as well as the apportionment factors, of the two entities are combined. As a result, the combined income of \$300,000 (\$700,000 – \$400,000) is apportioned to unitary states K and M.

EXAMPLE

24

Eve Corporation, a wholly owned subsidiary of Dan Corporation, generated \$1 million taxable income. Eve's activities and sales are restricted to State P, which imposes a 10% income tax. Dan's income for the taxable period is \$1.5 million. Dan's activities and sales are restricted to State Q, which imposes a 5% income tax. Both states use a three-factor apportionment formula that equally weights sales, payroll, and property. Sales, payroll, and average property for each of the corporations are as follows.

	Eve Corporation	Dan Corporation	Total
Sales	\$3,000,000	\$7,000,000	\$10,000,000
Payroll	2,000,000	3,500,000	5,500,000
Property	2,500,000	4,500,000	7,000,000

If the corporations are independent entities, the overall state income tax liability is \$175,000.

State P (10% × \$1,000,000)	=	\$100,000
State Q (5% × \$1,500,000)	=	75,000
Total state income tax		<u>\$175,000</u>

If the corporations are members of a unitary business, the income and apportionment factors are combined in determining the income tax liability in unitary states P and Q. As a result of the combined reporting, the overall state income tax liability is reduced.

State P Income Tax		
Total apportionable income		\$2,500,000
Apportionment formula		
Sales (\$3,000,000/\$10,000,000)	=	30.00%
Payroll (\$2,000,000/\$5,500,000)	=	36.36%
Property (\$2,500,000/\$7,000,000)	=	35.71%
Total		<u>102.07%</u>
Average (102.07% ÷ 3)		× 34.02%
State P taxable income		\$ 850,500
Tax rate		× 10%
State P tax liability		<u>\$85,050</u>

continued

State Q Income Tax

Total apportionable income			\$2,500,000
Apportionment formula			
Sales (\$7,000,000/\$10,000,000)	=	70.00%	
Payroll (\$3,500,000/\$5,500,000)	=	63.64%	
Property (\$4,500,000/\$7,000,000)	=	64.29%	
Total		<u>197.93%</u>	
Average (197.93% ÷ 3)			× 65.98%
State Q taxable income			\$1,649,500
Tax rate			× 5%
State Q tax liability			<u>\$ 82,475</u>
Total state income tax, if unitary (\$85,050 + \$82,475)			\$167,525
Total state income tax, if nonunitary (\$100,000 + \$75,000)			<u>175,000</u>
Tax reduction from unitary combined reporting			<u>\$ 7,475</u>

The results of unitary reporting would have been detrimental if Q had imposed a higher rate of tax than P, because a larger percentage of the corporation's income is attributable to Q when the apportionment factors are combined.

The principles underlying apportionment factors and the unitary theory are set forth in Concept Summary 24.3.



Concept Summary 24.3

Using Apportionment Formulas

1. The sales factor is based on the destination concept except where a throwback rule applies.
2. The payroll factor generally includes compensation that is included in Federal gross income, but some states include excludible fringe benefits. An employee's compensation usually is not divided among states.
3. The property factor is derived using the average undepreciated historical costs for the assets and eight times the rental value of the assets.
4. The unitary theory may require the taxpayer to include worldwide activities and holdings in the apportionment factors. A water's edge election can limit these amounts to U.S. transactions.
5. When the unitary theory applies, a combined return is filed. This is different from the consolidated return that an affiliated group of corporations would file.

24-3c Consolidated and Combined Returns

As discussed in Chapter 17, an affiliated group of corporations may file a consolidated return if all members of the group consent. Once such a return has been filed, the group must continue to file on a consolidated basis as long as it remains in existence, or until permission to file separate returns has been obtained. The consolidated return essentially treats the controlled corporations as a single taxable entity. Thus, the affiliated group pays only one tax, based on the combined income of its members after certain adjustments (e.g., net operating losses) and eliminations (e.g., intercompany dividends and inventory profits).

Several states permit affiliated corporations to file a consolidated return if such a return has been filed for Federal purposes. The filing of a consolidated return is mandatory in only a few states.

Usually, only corporations that are subject to tax in the state can be included in a consolidated return, unless specific requirements are met or the state permits the inclusion of corporations without nexus.

Do not confuse elective consolidated returns with required combined returns in unitary states. A combined return is filed in every unitary state in which one or more of the affiliates have nexus. The computations reflect apportioned and allocated income of the unitary members, resulting in a summary of the taxable income of the entities in each state. The combined method chiefly permits the unitary taxpayer to develop the summary of assigned taxable incomes, which is accepted by (and disclosed to) all of the states.

LO.7

Discuss the states' income tax treatment of S corporations, partnerships, and LLCs.

24-4 TAXATION OF S CORPORATIONS

The majority of the states that impose a corporate income tax have special provisions, similar to the Federal law, that govern the taxation of S corporations. Only a few states—including New York and Louisiana—and the District of Columbia do not provide special (no corporate-level tax) treatment for Federal S corporations.

In the non-S election states, a Federal S corporation generally is subject to tax in the same manner as a regular C corporation. Accordingly, if a multistate S corporation operates in any of these states, it is subject to state income tax and does not realize one of the primary benefits of S status—the avoidance of double taxation. Other potential tax-related benefits of the S election, including the pass-through of net operating losses and the reduction in the rate of tax imposed on individual and corporate taxpayers, may be curtailed.

EXAMPLE

25

Bryan, an S corporation, has established nexus in States A and B. A recognizes S status, while B does not. Bryan generated \$600,000 of ordinary business income and \$100,000 of dividends that were received from corporations in which Bryan owns 50% of the stock. Bryan's State B apportionment percentage is 50%.

For B tax purposes, Bryan first computes its income as though it were a C corporation. It then apportions the resulting income to B. Assuming that B has adopted the Federal provisions governing the dividends received deduction, Bryan's income, determined as though it were a C corporation, is \$620,000 [$\$600,000 + (100\% - 80\%) \times \$100,000$]. Accordingly, Bryan may be subject to B corporate income tax on \$310,000 ($\$620,000 \times 50\%$ apportionment percentage) of taxable income.

24-4a Eligibility

All of the states that recognize S status permit a corporation to be treated as an S corporation for state purposes only if the corporation has a valid Federal S election in place. Generally, the filing of a Federal S election is sufficient to render the corporation an S corporation for state tax purposes. In most states, an entity that is an S corporation for Federal tax purposes automatically is treated as an S corporation for state tax purposes. New Jersey requires a separate state-level S election, and Pennsylvania allows the entity to *elect out* of its S status for state purposes.

24-4b State Tax Filing Requirements

About half of the states require the corporation to withhold taxes on the nonresident shareholders' portions of the entity's income.

EXAMPLE

26

Maple, an S corporation, is subject to income tax only in Vermont. On the last day of its taxable year, 40% of Maple's stock is held by nonresident shareholders. Maple withholds Vermont income tax for its nonresident shareholders.

In an effort to decrease compliance burdens and simplify the filing process for non-resident shareholders of S corporations, several states allow an S corporation to file a single income tax return and pay the resulting tax on behalf of some or all of its nonresident shareholders. State requirements for the filing of a “block” or **composite return** vary substantially.

24-5 TAXATION OF PARTNERSHIPS AND LLCs

Most states apply income tax provisions to partnerships, limited liability companies (LLCs), and limited liability partnerships (LLPs) in a manner that parallels Federal treatment. The entity is a tax-reporting, not a taxpaying, entity. Income, loss, and credit items are allocated and apportioned among the partners according to the terms of the partnership agreement and state income tax law.

Some states require that the entity make estimated tax payments on behalf of out-of-state partners. This approach helps to ensure that nonresident partners file appropriate forms and pay any resulting tax to the state. As is the case with S corporations, some states allow composite returns to be filed relative to out-of-state partners.

Generally, an in-state partner computes the income tax resulting from all of the flow-through income from the entity. The partner then is allowed a credit for income taxes paid to other states on this income.

Key issues facing partnerships doing business in multiple states include those listed here. Applicable law varies from state to state, and more complex transactions may not yet be addressed by existing law.

- Whether the partnership automatically has nexus with every state in which a partner resides.
- Whether a partner is deemed to have nexus with every state in which the partnership does business.
- How to assign the income/loss of a partner upon retirement or when a liquidating distribution is received.

24-6 OTHER STATE AND LOCAL TAXES

State and local governments apply a variety of taxes other than the income tax.

24-6a State and Local Sales and Use Taxes

Forty-five states and the District of Columbia impose a consumers’ sales tax on retail sales of tangible personal property for use or consumption. In many of these states, in-state localities, including cities, towns, school districts, and counties, also have the power to levy a sales tax. A consumers’ sales tax is a tax imposed directly on the purchaser who acquires the asset at retail; the tax is measured by the price of the sale. The vendor or retailer merely acts as a collection agent for the state.

A use tax is designed to complement the sales tax. The use tax has two purposes: to prevent consumers from evading sales tax by purchasing goods outside the state for in-state use and to provide an equitable sales environment between in-state and out-of-state retailers.

Generally, sales of tangible personal property are subject to tax. In several states, selected services are subject to tax.

Each jurisdiction that applies a sales/use tax defines its own tax base (i.e., which items are taxable and to whom). For a multistate business, complying with the thousands of sets of sales/use tax statutes and regulations can be a difficult burden. In an effort to ease this confusion, state and local government officials and the MTC developed the Streamlined Sales Tax Project (SSTP). Members working in conjunction with the SSTP write model laws for taxing jurisdictions to adopt, thereby allowing for a more

LO.8

Describe other commonly encountered state and local taxes on businesses.

uniform application of the rules and for a more efficient exchange of information among revenue agencies.

To date, the most popular SSTP rules are those defining which products and services are subject to sales/use tax. For instance, SSTP rules set out the items of clothing that would be subject to tax, but each jurisdiction decides on its own whether to include clothing in the tax base and whether to allow “back-to-school” clothing amnesties during specific weeks of the year. However, little interest has been shown in having identical sales/use tax rates among the jurisdictions.

Almost all of the states that have adopted a sales/use tax are members of the SSTP, but only about half of them automatically adopt model SSTP laws.

Sales/Use Tax Exemptions

A majority of the states exempt sales of certain items from the sales/use tax base. The most common exemptions and exclusions include the following.

- *Sales for resale* are exempt because the purchaser is not the ultimate user of the sold property. For instance, meat purchased by a grocer and a garment purchased by a retailer are not subject to sales/use tax under the resale rule.
- *Casual or occasional sales* that occur infrequently are exempt from the sales/use tax base chiefly for administrative convenience. Most states exclude rummage sales, the transfer of an entire business, sales of used autos, and the like under this rule.
- Most *purchases by exempt organizations* are excluded from taxable sales. Charities, governments and their agencies, and other organizations qualifying for Federal income tax exemption are relieved of sales/use tax liabilities in all of the states.
- *Sales of targeted items* can be exempt to improve the equity of the sales/use tax system. Sales of groceries, medical prescriptions and equipment, and school clothes can fall into this category and become nontaxable. Special exemptions for sales of farm, industrial, and computing equipment might also qualify under this type of exclusion.
- Certain *sales to manufacturers, producers, and processors* may also be exempt. Exemptions usually include one or more of the following.
 - Containers and other packing, packaging, and shipping materials actually used to transfer merchandise to customers of the purchaser.
 - Machines and specific processing equipment and repair parts or replacements exclusively and directly used in manufacturing tangible personal property.

Sales/Use Tax Nexus

A separate set of nexus rules applies in determining whether a seller must collect a sales/use tax from a customer. Strictly, the tax must be collected only if the seller has a *physical presence* (e.g., a store building but not a web page) in the state.

The regular solicitation of sales by independent brokers establishes sufficient nexus to require a nonresident seller to register and collect the use tax, even though the seller does not have regular employees, agents, and an office or other place of business in the state.¹⁴ As a result, a corporation may be required to collect sales and use taxes in a state even though it is immune from the imposition of an income tax.

Sales/Use Tax on Services

Most sales/use tax laws were developed 50 or more years ago, when the U.S. economy was based on manufacturing and merchandising. Today, with perhaps two-thirds of all retail transactions in the United States consisting at some level of the rendering of

¹⁴*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).



TAX IN THE NEWS Art Collectors and Sales/Use Tax Planning

Susanna lives in State Q, which applies a 9 percent sales/use tax rate. At a New York City auction, she acquires for \$20 million an important painting by the artist Jill Sanderson. How can Susanna avoid the \$1.8 million use tax when she moves the painting to be hung in the library of her Q home?

One idea is to make an immediate but temporary loan of the painting to an art museum in Eugene, Oregon. Oregon does not levy its own sales/use tax, and State Q applies a sales/use tax only upon the “first use” of a purchased item.

If the first use of the painting is the museum showing in Oregon, no use tax liability is created for the auction transaction in any state.

Most U.S. states apply a rule that requires a 90- to 120-day minimum period for that first use. Thus, a loan to the Eugene museum becomes an artistic triumph for the visitors to the museum in enjoying a painting that the institution likely never otherwise would have acquired and to Susanna, whose effective tax planning frees up cash to allow her perhaps to engage in another round of art collection.

services, the sales/use tax may be considered inadequate at generating revenues for the taxing jurisdictions. Consequently, some states have been adding specific service transactions to the sales/use tax base.

The services most commonly being subjected to tax include transactions involving hotels and restaurants, hair and beauty salons, entertainment events, cable and satellite television subscriptions, and lawn care. To date, taxation of legal/accounting, medical, education, and advertising services has been blocked by the professional associations of the providers of these services. Revenue shortfalls at the state and local level, however, may force legislatures to expand the sales/use tax base to include a broader array of services in the future.

24-6b Local Property Taxes

Property taxes, a major source of revenue at the city and county level, often are designated as *ad valorem* taxes because they are based on the value of property that is located in the state on a specific date. Generally, that date fixes taxable ownership, situs (location), and the valuation of the property. Nonetheless, to avoid tax evasion, personal property that is temporarily outside the state may be taxed at the domicile of the owner.

Property taxes can take the form of either real property taxes or personal property taxes. States apply different tax rates and means of assessment to the two classes of property. The methods of assessing the value of the real and tangible property also vary in different taxing jurisdictions.

Although a personal property tax may be imposed on both intangible and tangible property, most states limit the tax to tangible property. The distinction between the various items of personal property is important because special rates, computations, or exemptions may apply. For instance, inventory constitutes tangible personal property, but it is exempt from property taxation in most states.

24-6c Other Taxes

States may impose a variety of other state and local taxes on corporations, including incorporation or entrance fees or taxes, gross receipt taxes, stock transfer taxes, realty transfer and mortgage recording taxes, license taxes, and franchise taxes based on net worth or capital stock outstanding.

Administrative Taxes

An *incorporation tax* is an excise tax for the corporate privilege conferred on the business. At the time the business is incorporated, the state generally imposes a fee or tax for the privilege of conducting business as a corporation within the state. Similarly, an out-of-state corporation usually must pay an entrance fee or tax before it can transact business in a state other than its state of incorporation.



TAX IN THE NEWS How Do You Tax a Cloud?

The trend in the tech world toward *cloud computing* has reached the point where state legislatures must issue rulings concerning the sales/use taxation of this procedure.

Cloud computing has become feasible now that the Internet is supported by a great deal of high-speed bandwidth, allowing users to access files and programs quickly and accurately from almost any location. Under a cloud computing model, both software programs and specific user data files are stored on remote server computers, often rather than on the hard drives of the user's various workstations.

Under a cloud-based system, both a text document and the word processing program that modifies it are located on the server computer. A user can access and modify the file from a desktop at the office, from a laptop at home, and from a tablet or smartphone on the road. The edited file is saved and can be accessed later from any of the user's

locations or by another team member with whom the user is collaborating.

But how do sales/use tax laws address this new computing model? Assume that software is purchased or updated and that a sales/use tax applies. Where should the user remit the tax?

- To State A, where the server computer is housed?
- To State B, where the software manufacturer is based?
- To States C, D, or E, where the purchaser uses the files in a business or personal setting?

Retailers using the cloud to carry out virtual commerce create their own sales/use tax issues (i.e., to identify taxable events and to source them to a particular state). Such issues might involve the taxation of movie and music downloads, gift cards and discount codes, and the use of "virtual wallets" as payment devices.¹⁵

A *license tax* is an excise tax on the privilege of engaging in a certain business, occupation, or profession. A jurisdiction may impose business, occupational, or professional license taxes as a means of generating revenue or regulating the activities of the business, occupation, or profession for the public welfare.

Stock and realty transfer and mortgage recording taxes are nonrecurring taxes that are imposed at the time of recording or transfer. *Stock transfer taxes* are imposed on the transfer of shares or certificates of stock of domestic and foreign corporations. The tax typically is based on the number of shares transferred and the par or market value of the stock.

The base of the *realty transfer tax* usually is measured by the consideration paid or to be paid for the realty. The *mortgage recording tax* may be based on the actual consideration given, the value of the property, or the debt to be secured by the instrument.

Collections of Unclaimed Property

All of the U.S. states enforce rules that allow them to take possession of certain unclaimed property. In operation, this procedure acts like a tax on business with large consumer operations.

Unclaimed property might take the form of an unused gift card or a paycheck the employee has not yet cashed. On the balance sheet, these amounts are reported as payables by the business. After a stated period of time passes (usually 7 to 15 years) and an effort is made to contact the holder of the business's obligation, the value of the property reverts to the state. These rights of the states often are referred to as *escheat* laws.

Because unclaimed property rules are not enacted as a taxing statute, the usual nexus and apportionment tests do not apply. Instead, the property is taken by the state in which the business is incorporated.¹⁶

Capital Stock and Franchise Taxes

Typically, a *capital stock tax* is an excise tax imposed on a domestic corporation for the privilege of existing as a corporation or imposed on an out-of-state corporation, either for the privilege of doing business or for the actual transaction of business within the state. This annual tax usually is based on the book value of the corporation's net worth, including capital, surplus, and retained earnings.

¹⁵For example, see applications of the "true object" test for sales/use taxation in Texas: PLRs 200604534L and 200605591L.

¹⁶*Texas v. New Jersey*, 379 U.S. 674 (1965).

The majority of capital stock taxes are apportioned if the corporation does business or maintains an office in another state. In some states, however, the tax is levied on the entire authorized or issued capital stock of a domestic corporation, even though the corporation may be engaged in business in other states. For corporations based in other states, the tax is imposed only on the capital that is employed in the state as determined by an apportionment formula.

State Franchise Tax on Net Worth

The balance sheet of Bull, a domestic corporation of State A, at the end of its taxable year is as follows.

Cash	\$100,000
Equipment (net of \$50,000 accumulated depreciation)	150,000
Building (net of \$75,000 accumulated depreciation)	225,000
Land	<u>125,000</u>
Total assets	<u>\$600,000</u>
Accounts payable and other short-term liabilities	\$100,000
Long-term liabilities	200,000
Capital stock	50,000
Paid-in capital in excess of par value	50,000
Retained earnings	<u>200,000</u>
Total liabilities and equity	<u>\$600,000</u>

A imposes a 2% franchise tax based on the entire net worth of a domestic corporation. Bull is subject to a franchise tax in A of \$6,000 ($\$600,000 \text{ assets} - \$300,000 \text{ liabilities} = \$300,000 \text{ net worth} \times 2\% \text{ rate}$).

EXAMPLE

27

Continue with the facts of Example 27, except that A subjects a domestic corporation to tax only on the capital that is employed in the state. Bull properly determines that its A apportionment percentage is 20%. In this case, Bull's A franchise tax liability is \$1,200 ($\$300,000 \text{ net worth} \times 20\% \text{ apportionment percentage} = \$60,000 \text{ capital employed in A} \times 2\% \text{ rate}$).

EXAMPLE

28

ETHICS & EQUITY Encouraging Economic Development through Tax Concessions

The tax professional occasionally is in a position to negotiate with a state or city taxing jurisdiction to garner tax relief for a client as an incentive to locate a plant or distribution center in that geographic area. In times when construction budgets are high and interstate competition is fierce to attract or retain businesses that are making location decisions, such tax concessions can be significant.

For instance, to encourage a business to build a large distribution center in the area, community leaders might be agreeable to (1) paying for roads, sewer, water, and other improvements through taxpayer bonds; (2) reducing property taxes by 50 percent for the first 10 years of the center's operations; and (3) permanently excluding any distribution-related vehicles and equipment from the personal property tax.

An incentive-granting community provides the concessions even though the influx of new workers will place a great strain on public school facilities and likely necessitate improvements in traffic patterns and other infrastructure.

Consider the position of a large employer that has been located in the area for more than 50 years. By how much should it be willing to absorb the tax increases that result when economic development concessions are used to attract new, perhaps temporary, businesses to the area? Should the employer challenge the constitutionality of the grant of such sizable tax breaks to some, but not all, business taxpayers in the jurisdiction?

Should higher "impact fees" be assessed on new developments? Does your analysis change if the new business competes with the longtime resident for sales? For employees? For political power?

LO.9

Recognize tax planning opportunities available to minimize a corporation's state and local tax liability.

24-7 TAX PLANNING

The inconsistencies in the tax laws and rates among the states not only complicate state tax planning but also provide the nucleus of pertinent planning opportunities. Although several tax planning devices are available to a corporation that does business in only one state, most planning techniques are directed toward corporations that do business or maintain property in more than one state. All suggested tax planning strategies should be reviewed in light of practical business considerations and the additional administrative and other costs that may be incurred, because simply minimizing state taxes may not be prudent from a business perspective.

24-7a Selecting the Optimal State in Which to Operate

Because the states employ different definitions of the amount and type of activity necessary to establish nexus, a company has some latitude in selecting the states by which it will be taxed. When a corporation has only a limited connection with a high-tax state, it may abandon that activity by electing an alternative means of accomplishing the same result. For example, if providing a sales representative with a company-owned iPad constitutes nexus in an undesired state, the company could eliminate its connection with that state by reimbursing sales personnel for equipment expenses, instead of providing a company communications device. Similarly, when nexus is caused by conducting customer training sessions or seminars in the state, the corporation could bypass this connection. This can be done by sending the personnel to a nearby state in which nexus clearly has been established or in which the activity would not constitute nexus.

In addition, when sufficient activity originates from the repair and maintenance of the corporation's products or the activities performed by the sales representatives within the state, the organization could incorporate the service or sales divisions. This would invalidate a nonunitary state's right to tax the parent corporation's income; only the income of the service or sales divisions would be subject to tax. However, this technique is successful only if the incorporated division is a *bona fide* business operation. Therefore, the pricing of any sales or services between the new subsidiary and the parent corporation must be at arm's length, and the operations of the new corporation preferably should result in a profit.

Although planning techniques often are employed to disconnect a corporation's activities from an undesirable state, they also can be utilized to create nexus in a desirable state. For example, when the presence of a company-owned computer creates nexus in a desirable state, the corporation could provide its sales representatives in that state with company-owned equipment, rather than reimbursing or providing increased compensation for equipment costs.

Establishing nexus in a state is advantageous, for instance, when that state has a lower tax rate than the state in which the income currently is taxed or when losses or credits become available to reduce tax liabilities in the state.

EXAMPLE

29

Bird Corporation generates \$500,000 of taxable income from selling goods; specifically, 40% of its product is sold in State A and 60% in State B. Both states levy a corporate income tax and include only the sales factor in their apportionment formulas. The tax rate in A is 10%; B's rate is only 3%. Bird's manufacturing operation is located in A; therefore, the corporation's income is subject to tax in that state. Currently, Bird is immune from tax under P.L. 86-272 in B. Because A has adopted a throwback provision, Bird incurs \$50,000 of state income taxes.

	Apportionment Formula	Net Income	Tax Rate	Tax
State A	100/100	\$500,000	10%	\$50,000
State B	0/100	500,000	3%	—0—
Total tax liability				<u>\$50,000</u>

continued

Because B imposes a lower tax rate than A does, Bird substantially reduces its state tax liability if sufficient nexus is created with B.

	Apportionment Formula	Net Income	Tax Rate	Tax
State A	40/100	\$500,000	10%	\$20,000
State B	60/100	500,000	3%	9,000
Total tax liability				<u>\$29,000</u>

24-7b Restructuring Corporate Entities

One of the major objectives of state tax planning is to design the proper mix of corporate entities. An optimal mix of entities often generates the lowest combined state income tax for the corporation. The goal of designing a good corporate combination often is to situate the highly profitable entities in states that impose a low (or no) income tax.

Matching Tax Rates and Corporate Income

When the corporation must operate in a high-tax state, divisions that generate losses also should be located there. Alternatively, unprofitable or less profitable operations can be merged into profitable operations to reduce the overall income subject to tax in the state. An ideal candidate for this type of merger may be a research and development subsidiary that is only marginally profitable but is vital to the parent corporation's strategic goals. By using simulation models, a variety of different combinations can be tested to determine the optimal corporate structure.

Unitary Operations

By identifying the states that have adopted the unitary method and the criteria under which a particular state defines a unitary business, a taxpayer may reduce its overall state tax by restructuring its corporate relationships to create or guard against a unitary relationship. For instance, an independent business enterprise can be made unitary by exercising day-to-day operational control and by centralizing functions such as marketing, financing, accounting, and legal services.

The Big Picture

Return to the facts of *The Big Picture* on p. 24-1. LocalCo already operates in both unitary and nonunitary states. Application of unitary corporate income tax rules can make tax planning more difficult. Subjecting certain LocalCo activities to the unitary theory could either increase or decrease the combined corporate income tax liability of the affiliates, depending especially on the apportionment formulas applied in the unitary states.

LocalCo needs to make projections of the profitability of its operations in the new multifunction building. Then LocalCo should determine the income tax effects of expanding its operations into several target states, including both unitary and nonunitary jurisdictions, and compare how the unitary rules (and all associated compliance costs) affect its after-tax profits.

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Passive Investment Companies

The creation of a **passive investment company** is another restructuring technique utilized to minimize a nonunitary corporation's state tax burden. Nonbusiness or passive income generally is allocated to the state in which the income-producing asset is located, rather than apportioned among the states in which the corporation does business. Therefore, significant tax savings may be realized when nonbusiness assets are located in a state that either does not levy an income tax or provides favorable tax treatment for passive income.

The corporation need not be domiciled in the state to benefit from these favorable provisions. Instead, the tax savings can be realized by forming a passive investment subsidiary to hold the intangible assets and handle the corporation's investment activities.

The passive investment subsidiary technique usually produces the desired result in any no-tax state. Delaware, however, often is selected for this purpose due to its other corporate statutory provisions and favorable political, business, and legal climate.

Delaware does not impose an income tax upon a corporation whose only activity within the state is the maintenance and management of intangible investments and the collection and distribution of income from such investments or from tangible property physically located in another state. Consequently, trademarks, patents, stock, and other intangible property can be transferred to a Delaware corporation whose activity is limited to collecting passive income. The assets can be transferred to the subsidiary without incurring a Federal income tax under § 351 (see Chapter 18).

However, to receive the desired preferential state tax treatment, the holding company's activities within the state must be sufficient to establish income tax nexus in the state. The passive investment company should avoid performing any activity outside the state that may result in establishing nexus with another state. In addition, the formation of the subsidiary must be properly implemented to ensure the legal substance of the operation. The passive investment company must have a physical office, and it must function as an independent operation.

Because the subsidiary's activities are confined to Delaware (or some other no- or low-tax state) and its operations generate only passive income, its income will not be taxed in any nonunitary state. Moreover, most states exclude dividends from taxation or otherwise treat them favorably; therefore, the earnings of a passive investment subsidiary can be distributed as a dividend to the parent at a minimal tax cost. If the state in which the parent is located does not levy the full income tax on dividends received, the entire measure of passive income may escape taxation.

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Purple Corporation generates \$800,000 of taxable income; \$600,000 is income from its manufacturing operations, and \$200,000 is dividend income from passive investments. All of Purple's sales are made and assets are kept in State A, which imposes a 10% corporate income tax and permits a 100% deduction for dividends received from subsidiaries. The corporation is not subject to tax in any other state. Consequently, Purple incurs \$80,000 of income tax (tax base \$800,000 × tax rate 10%).

If Purple creates a passive investment subsidiary in State B, which does not impose an income tax upon a corporation whose only activity within the state is the maintenance and management of passive investments, Purple's tax liability is reduced by \$20,000 (a 25% decrease). Because passive income is nonapportionable income (allocated for state tax purposes to the state in which it is located), the income earned from its passive investments is not subject to tax in A.

	State A (Purple Corporation)	State B (Passive Investment Company)
Taxable income	\$600,000	\$200,000
Tax rate	× 10%	× 0-*
Tax liability	<u>\$ 60,000</u>	<u>\$ -0-</u>
Total tax liability		\$ 60,000
Tax imposed without restructuring		<u>80,000</u>
Tax reduction due to use of subsidiary		<u>\$ 20,000</u>

* B does not impose an income tax on a passive investment corporation.

The income earned by the subsidiary from its passive investments can be distributed to Purple as a dividend without incurring a tax liability because A allows a 100% deduction for dividends that are received from subsidiary corporations.

These desired results, however, will not be fully available in states that view the entire corporate operation as being unitary. Because those states require combined reporting, the income earned by the passive investment subsidiary is included in the corporation's apportionable or allocable income.



TAX IN THE NEWS Leave That Giraffe at Home!

Passive investment subsidiaries make some states very angry. Revenue departments complain that millions of dollars of taxable income are fleeing to Delaware or Nevada. Industrial states such as Ohio and Michigan regard the device as a means of creating a tax haven within the United States, in much the same way the Cayman Islands serve as a haven from the Federal income tax. Somewhat ironically, even the revenue authorities of Switzerland have criticized the United States for allowing such a technique to flourish, and some countries characterize the United States as a tax haven when the device is used.

One of the means by which the states have attacked the use of passive investment subsidiaries is the *Geoffrey* rule. The device is named after Geoffrey the Giraffe, the mascot of Toys “R” Us. Over a decade ago, the Supreme Court of South Carolina held that the presence of intangible assets,

including corporate logos and mascots such as Geoffrey, created nexus with the state. Thus, some taxable income could be apportioned to a state where the intangible asset is used. The *Geoffrey* decision came as a surprise to many tax advisers, and the rule now limits some of the planning opportunities formerly available to those operating in non-unitary jurisdictions.

About one-half of the states have attempted, usually through administrative rules, to adopt the *Geoffrey* approach. Other states either have not addressed the issue or purposely have ignored the rule to avoid the appearance of a hostile tax climate that could impede the recruitment of new businesses. Many states want to close this loophole but without seeming unfriendly to business.

The other popular approach used by the states to attack passive investment subsidiaries is to require combined reporting under the unitary theory.

24-7c Subjecting the Corporation’s Income to Apportionment

When a multistate organization is domiciled in a high-tax state, some of its apportionable income is eliminated from the tax base in that state. In light of the high tax rate, this may result in significant tax savings. Apportioning income will be especially effective where the income that is attributed to the other states is not subject to income tax. The income removed from the taxing jurisdiction of the domicile state entirely escapes state income taxation when the state to which the income is attributed (1) does not levy a corporate income tax, (2) requires a higher level of activity necessary to subject an out-of-state company to taxation than that adopted by the state of domicile, or (3) is prohibited under Public Law 86–272 from taxing the income (assuming that the domicile state has not adopted a throwback provision). Thus, the right to apportion income may provide substantial benefits because the out-of-state sales are excluded from the numerator of the sales factor and may not be taxed in another state.

However, to acquire the right to apportion its income, the organization must have sufficient activities in or contacts with one or more other states. Whether the type and amount of activities and/or contacts are considered adequate is determined by the other state’s nexus rules. Therefore, a corporation should analyze its current activities in and contacts with other states to determine which, if any, activities or contacts could be redirected so that the corporation gains the right to apportion its income.

The Big Picture

Return to the facts of *The Big Picture* on p. 24-1. Most corporate taxpayers consist of a parent corporation and perhaps one or more existing subsidiaries. Given its expansion plans, LocalCo has the opportunity to determine “from scratch” in which states it wants to create nexus for the operations in the multifunction building.

The tax professional needs to offer advice to LocalCo’s board of directors as to where the building might be situated and how the operations of any related sales and administrative

continued

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personnel might be structured in an effort to provide optimal tax consequences. Nexus issues to be considered include the following.

- Is income tax nexus created with the target state?
- Is sales/use tax nexus created with the target state?
- How are the income tax apportionment factors affected by the expansion plans (e.g., whether the target state uses a property factor in the apportionment formula and, if so, how it is weighted)?
- Would a building such as that planned by LocalCo receive any special computational treatment for the target state's property factor (e.g., in averaging the building's costs or applying accumulated depreciation)?



ETHICS & EQUITY Can You Be a Nowhere Adviser?

The intent of much of today's multistate income tax planning is to create so-called *nowhere sales*, such that the income from the transaction is not subject to tax in any state. Suppose, for instance, that a sale is made from Georgia (a state with no throwback rule) into Nevada (the place of ultimate destination, but a state with no income tax). No state-level income tax liability is generated.

Is it ethical for a tax adviser to suggest such a strategy? Could you ethically propose the establishment of a sales office in a nonthrowback state, thereby avoiding state income tax on a transaction that is fully taxable under Federal rules?

24-7d Planning with Apportionment Factors

Sales Factor

Manipulation of the sales factor often yields the greatest planning opportunities for a multistate corporation. In-state receipts include sales to purchasers with a destination point in that state; sales delivered to out-of-state purchasers are included in the numerator of the sales factor of the destination state. However, to be permitted to exclude out-of-state sales from the sales factor of the origination state, the seller generally must substantiate the shipment of goods to an out-of-state location. Therefore, the destinations of sales that a corporation makes and the means by which the goods are shipped must be carefully reviewed.

The corporation's overall state tax possibly can be reduced by establishing a better record-keeping system, or by manipulating the numerator of the sales factor by changing the delivery location or method.

For example, a corporation may substantially reduce its state income tax if the delivery location of its sales is changed from a state in which the company is taxed to one in which it is not. This technique may not benefit the corporation if the state in which the sales originate has adopted the throwback rule.

Property Factor

Because most fixed assets are physically stationary in nature, the property factor is not so easily manipulated. Nonetheless, significant tax savings can be realized by establishing a leasing subsidiary in a low- or no-tax state. If the property is located in a state that does not include leased assets in the property factor, the establishment of a subsidiary from which to lease the property eliminates the assets from the property factor in the parent's state.

Permanently idle property generally is excluded from the property factor. Accordingly, a corporation should identify and remove such assets from the property factor to

ensure that the factor is not distorted. It is equally important to identify and remove nonbusiness assets from the property factor in states that distinguish between apportionable and nonapportionable income.

The property factor valuations of Quake Corporation's holdings are as follows.

	State A	Total
Equipment (average historical cost)	\$1,200,000	\$2,000,000
Accumulated depreciation (average)	800,000	1,000,000

Twenty percent of the equipment in State A is fully depreciated and is idle. Assuming that A includes property in the factor at historical cost, Quake's property factor is 54.55% $[(\$1,200,000 - \$240,000 \text{ idle property})/(\$2,000,000 - \$240,000)]$. If the idle property is not removed from the property factor, Quake's property factor in A is incorrectly computed as 60% $(\$1,200,000/\$2,000,000)$.

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Payroll Factor

The payroll factor provides planning potential where several corporate employees spend substantial periods of time outside their state of employment or the corporation is able to relocate highly paid employees to low- or no-tax states.

Use of an independent contractor who works for more than one principal can be beneficial under certain circumstances. Because the commissions paid to independent contractors are excluded from the payroll factor, the taxpayer may reduce its payroll factor in a high-tax state.

Yellow Corporation's total payroll costs are \$1.4 million. Of this amount, \$1 million was attributable to State A, a high-tax state. Yellow's payroll factor in A is 71.43% $(\$1,000,000/\$1,400,000)$.

Assuming that \$200,000 of the A compensation had been paid to sales representatives and that Yellow replaced its sales force with independent contractors, Yellow's payroll factor in A would be reduced to 66.67% $[(\$1,000,000 - \$200,000)/(\$1,400,000 - \$200,000)]$.

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24-7e Sales/Use Tax Compliance

Today, state and local tax administrators face a major problem: how can governments get their sales/use tax revenues from mail-order, phone, and Internet sales? The problem is that the governments must rely on the seller to collect sales and use taxes, rather than collect them directly from the purchaser. Consequently, a seller conceivably must deal with thousands of different sales/use taxing jurisdictions, each with its own forms and filing deadlines, rates of applicable tax, and definitions of what is taxable or exempt. Examples of issues on which jurisdictions may disagree include the following.

- Are snack foods exempt groceries or taxable candy?
- Are therapeutic stockings exempt medical supplies or taxable clothing?
- Which types of software are subject to tax?

Large retailers such as Wal-Mart, Amazon, and Target can develop software to handle these problems, but smaller businesses cannot afford to create their own software or to purchase someone else's. The result has been a very low level of compliance by sellers with respect to out-of-state sales transactions.

Governments meanwhile have limited resources to enforce tax rules that have long been on the books. Many states ask individuals and businesses to include the unpaid use taxes for Internet, phone, and mail-order purchases on their annual income tax returns, but the number of taxpayers complying is insignificant. This is not a matter of "increasing the taxes on the Internet economy," but rather of collecting revenues that already are due and are desperately needed to balance state budgets.

24-7f **Sales/Use Taxes on Capital Changes**

The tax adviser must be aware of the effects that sales and use taxes may have on a transaction that might otherwise be free from income tax. For example, although the transfer of property to a controlled corporation in exchange for its stock generally is not subject to corporate income taxes, several states provide that such transfers constitute taxable sales for sales and use tax purposes. Similarly, a corporate reorganization may be structured to avoid the imposition of income taxes, but under the statutes of several states, such transfers are considered to be taxable sales and, accordingly, are subject to sales and use taxes.

24-7g **Capital Stock Taxation**

Capital stock tax liabilities can be significant for capital-intensive taxpayers to the extent they reinvest a large portion of retained earnings (the tax base) in productive assets. If all nontax factors are equal, a taxpayer with sizable exposure to a capital stock tax should consider the following techniques.

- Funding expansion with debt, rather than retained earnings.
- Funding subsidiary operations with debt, rather than direct capital contributions.
- Regularly paying dividends to parent companies that are domiciled in tax-favored states such as Delaware and Nevada.

REFOCUS ON THE BIG PICTURE

MAKING A MULTISTATE LOCATION DECISION



LocalCo holds a competitive advantage with the states and localities in negotiating where its new facility should be located. Politicians like to attract new facilities to their jurisdictions as a way to create construction jobs and to expand the income and sales/use tax base. LocalCo's top management should work with the governors and development executives of the states that are final candidates for the location of the proposed new building.

LocalCo's agenda for these negotiations should include the following items.

- Many states offer targeted tax incentives to attract and retain "clean" businesses such as LocalCo. These incentives might include property tax abatements, research and investment credits, and tax waivers for the state and local income and payroll taxes on new jobs. The company should determine whether it qualifies for any existing incentives. If a state does not currently offer incentives, perhaps its tax law could be amended to provide them.
- LocalCo also should ascertain how the potential locations apply income and sales/use taxes to Internet sales. How aggressive are these tax laws at the present time (e.g., as to the application of P.L. 86-272 and other nexus rules)? What is the level of projected state budget deficits and cash-flow needs, and what are the chances that the laws of the target states will be modified in the near future?
- Currently, LocalCo's manufacturing operations are split between a low-tax state (Alabama) and a high-tax state (California). Under a relocation plan that makes good business sense, nexus might be eliminated with California and shifted to a low-tax jurisdiction. Nevada is a good candidate, given its proximity to the current sportswear location.
- California applies the unitary theory of income taxation. LocalCo should determine whether unitary rules increase or decrease its total tax burden.

continued

- Corporate headquarters currently are located in New York, another high-tax jurisdiction. If the new facility is located in a corporation-favorable, low-tax state, the company should consider moving its headquarters there.
- Relocating the corporate headquarters would also benefit the entity's highly paid executives. The individual income and sales/use tax burden of employees should be a factor in LocalCo's decision.
- In any event, shifting the entity's investment income to a low-tax jurisdiction appears advisable. Use of a passive investment company will carry out this tax planning objective.
- States often assess special taxes on trucking and airport functions and might even apply different income tax apportionment formulas to these operations. LocalCo's tax department and its outside advisers should research these features of the various relevant tax systems to avoid any unexpected surprises.

What If?

If LocalCo did not have a history of strong profitability, some of these state and local tax recommendations might be different. In that case, the company would consider issues such as how a state applies loss and credit carryovers. In addition, if there is no state income tax liability to pay, income tax credits and deductions would be less attractive, so the negotiations might focus on property and payroll taxes instead.

Key Terms

Allocate, 24-9

Apportion, 24-9

Combined return, 24-20

Composite return, 24-25

Dock sales, 24-15

Multistate Tax Commission (MTC), 24-7

Nexus, 24-7

Passive investment company, 24-31

Payroll factor, 24-16

Property factor, 24-18

Public Law 86-272, 24-7

Sales factor, 24-14

Throwback rule, 24-15

UDITPA, 24-7

Unclaimed property, 24-28

Unitary theory, 24-20

Water's edge, 24-21

Discussion Questions

1. **LO.1** You are working with the top management of one of your clients in selecting the U.S. location for a new manufacturing operation. Craft a plan for the CEO to use in discussions with the economic development representatives of several candidate states. In no more than two PowerPoint slides, list some of the tax incentives the CEO should request from a particular state during the negotiations. Be both creative and aggressive in the requests.
2. **LO.1** Complete the following chart by indicating whether each item is true or false. Explain your answers by referencing the overlap of rules appearing in Federal and most state income tax laws.

Issue ID
Communications

Item	True or False
a. Most of the states start with Federal taxable income in computing state taxable income (i.e., taxable income is “piggybacked” with the Federal amount).	_____
b. The states use a wide variety of rules to compute corporate taxable income; thus, there is no “typical” state income tax computation.	_____
c. State rules as to which entities can join in a consolidated return match those of Federal law.	_____
d. The corporate income tax systems of most states can be described as having progressive rate structures.	_____
e. A typical state income tax credit would equal 10% of the costs incurred to purchase and install solar energy panels for an existing factory.	_____

- Communications**
3. **LO.2** In no more than three PowerPoint slides, list some general guidelines that a taxpayer can use to determine whether it has an obligation to file an income tax return with a particular state. (Include the terms *nexus* and *domicile* in your answer.)
 4. **LO.2** Josie is a sales representative for Talk2Me, a communications retailer based in Fort Smith, Arkansas. Josie’s sales territory is Oklahoma, and she regularly takes day trips to Tulsa to meet with customers.
 During a typical sales call, Josie takes the customers’ current orders and, using her wireless phone, sends the orders to headquarters in Fort Smith for immediate action. Approved orders are shipped from the Little Rock warehouse.
 Are Josie’s sales subject to the Oklahoma corporate income tax? Explain.
 5. **LO.2** Continue with the facts of Question 4. CheapPhones, one of Josie’s customers who is facing tight cash-flow problems, wants to return about 100 defective cell phones. Talk2Me tells Josie to bring the phones back to headquarters. Fearing that she will lose CheapPhones as a customer if she does not comply with the request, Josie says, “Let me save you the time and cost of packing and shipping the defective phones. Put them in the trunk of my car, and I’ll take them back.” Does Josie’s action change the answer to Question 4? Why or why not?
 6. **LO.3** Indicate whether each of the following items should be *allocated* or *apportioned* by the taxpayer in computing state corporate taxable income. Assume that the state follows the general rules of UDITPA.
 - a. Profits from sales activities.
 - b. Profits from consulting and other service activities.
 - c. Losses from sales activities.
 - d. Profits from managing the stock portfolio of a client.
 - e. Profits from managing one’s own stock portfolio.
 - f. Gain on the sale of a plot of land held by a real estate developer.
 - g. Gain on the sale of a plot of land held by a manufacturer, on which it may expand its factory.
 - h. Rent income received by a manufacturer from the leasing of space to a supplier.
 7. **LO.3** Regarding the apportionment formula used to compute state taxable income, does each of the following independent characterizations describe a taxpayer that is based in-state or out-of-state? Explain.
 - a. The sales factor is positively correlated with the payroll, but not the property, factor.
 - b. The sales factor is much higher than the property and payroll factors.
 - c. The property and payroll factors are much higher than those for other nexus states.

- d. The sales and payroll factors are low, but the property factor is very high.
- e. The sales factor is remaining constant, but the payroll factor is decreasing.
8. **LO.5** The trend in state income taxation is to move to an apportionment formula that places extra weight on the sales factor. Several states now use sales-factor-only apportionment. Explain why this development is attractive to the taxing states. **Issue ID**
9. **LO.5** Megan is an accountant for KnoxCo. She is a telecommuter and works most days from her home in Tennessee. Twice a month, she travels to Georgia for a staff meeting at the employer's Atlanta headquarters. In which state's payroll factor should Megan's compensation be included if:
- Megan is an employee and is covered by the qualified retirement plan of her Atlanta employer?
 - Megan works as an independent contractor for several clients, including the Atlanta-based firm?
 - Megan is an employee, and for one day each month, she provides accounting services for KnoxCo's Memphis rental properties?
10. **LO.5** Keystone, your tax consulting client, is considering an expansion program that would entail the construction of a new logistics center in State Q. List at least five questions you should ask in determining whether an asset that is owned by Keystone is to be included in State Q's property factor numerator. **Issue ID**
11. **LO.6** The trend in state income taxation is for states to adopt a version of the unitary theory of multijurisdictional taxation in their statutes and regulations.
- Explain why some states are attracted to the unitary theory and a combined reporting scheme of multistate income taxation.
 - Is the application of the unitary theory a help or a detriment to the taxpayer? Why?
12. **LO.6** State A enjoys a prosperous economy, with high real estate values and compensation levels. State B's economy has seen better days—property values are depressed, and unemployment is higher than in other states. Most consumer goods are priced at about 10% less in B than in A. Both A and B apply unitary income taxation to businesses that operate within the state. Does unitary taxation distort the assignment of taxable income between A and B? Explain. **Issue ID**
13. **LO.7** Evaluate this statement: An S corporation can facilitate the meeting of its state income tax filing obligations by developing a common spreadsheet that allocates and apportions income among the states with which it has nexus. This spreadsheet is attached to each of the state returns to be filed. (*Hint*: Use the term *composite return* in your answer.)
14. **LO.8** Create a PowerPoint outline describing the major exemptions and exclusions from the sales/use tax base of most states. Use your slides to discuss this topic with your accounting students' club. **Communications**
15. **LO.8** Your client, HillTop, is a retailer of women's clothing. It has increased sales during the holiday season by advertising gift cards for in-store and online use. HillTop has found that gift card holders who come into the store tend to purchase goods that total more than the amount of the gift card. Further, about one-third of the gift cards never are redeemed, thereby yielding cash to the company without a reduction of inventory. What are the tax issues confronting HillTop related to the gift cards?

- Communications** 16. **LO.2,9** Your client, Ecrú Limited, uses a small sales force to solicit sales of its wholesale restaurant supplies. Ecrú is based in State W, and the sales representatives are assigned territories in States X, Y, and Z. Ecrú owns no property and employs no other personnel outside of W.
- As Ecrú's tax adviser, you are to write a policy manual listing various "do's and don'ts" for the sales personnel so that Ecrú does not create income tax nexus with X, Y, and Z.
- To prepare for your assignment, write a memo for the tax research file, summarizing the rules as to the ability of a corporation to terminate or create income tax nexus. Make certain that you discuss the *Wrigley* case in your analysis.
- Communications** 17. **LO.9** Your client, Royal Corporation, generates significant interest income from its working capital liquid investments. Write a memo for the tax research file, discussing the planning opportunities presented by establishing a passive investment company. Support your memo with a diagram of the resulting flow of assets and income.
18. **LO.9** As the director of the multistate tax planning department of a consulting firm, you are developing a brochure to highlight the services it can provide. Part of the brochure is a list of five or so key techniques that clients can use to reduce state income tax liabilities. Develop this list for the brochure. Consider only income tax consequences in your analysis.

Computational Exercises

19. **LO.3** Castle Corporation conducts business in States 1, 2, and 3. Castle's \$630,000 taxable income consists of \$555,000 apportionable income and \$75,000 allocable income generated from transactions conducted in State 3. Castle's sales, property, and payroll are evenly divided among the three states, and the states all employ a three-equal-factors apportionment formula. How much of Castle's income is taxable in:
- State 1?
 - State 2?
 - State 3?
20. **LO.3** Fillon Corporation's operations include two manufacturing facilities, one in State A and one in State B. The plant located in A generated \$200,000 of income, and the plant located in B generated a loss of \$50,000. Therefore, Fillon's total taxable income is \$150,000. By applying the statutes of each state, Fillon determines that its apportionment factors for A and B are .70 and .30, respectively.
- How much of Fillon's income is apportioned to:
- State A?
 - State B?
21. **LO.4** Legends Corporation owns and operates two manufacturing facilities, one in State A and the other in State B. Due to a temporary decline in sales, Legend has rented 25% of its State A facility to an unaffiliated corporation. Legend generated \$200,000 net rent income and \$1,400,000 income from manufacturing. Both states classify the rent income as allocable (nonapportionable) income. By applying the statutes of each state, Legends determines that its apportionment factors are .70 for A and .30 for B.
- How much income is subject to tax in:
- State A?
 - State B?

22. **LO.5** Beckett Corporation realized \$800,000 of taxable income from the sales of its products in States A and B. Beckett's activities establish nexus for income tax purposes in both states. Beckett's sales, payroll, and property in the states include the following.

	State A	State B	Total
Sales	\$960,000	\$640,000	\$1,600,000
Property	180,000	-0-	180,000
Payroll	220,000	-0-	220,000

State B uses a double-weighted sales factor in its three-factor apportionment formula. How much of Beckett's taxable income is apportioned to State B?

23. **LO.5** Isle Corporation's entire operations are located in State A. Of Isle's \$600,000 sales, 60% are made in State A and 40% are made in State B. Isle's solicitation of sales in State B is limited to mailing a monthly catalog to its customers in that state. However, Isle's employees do pick up and replace damaged merchandise in State B. The pickup and replacement of damaged goods establish nexus with State A.

However, B's definition of activities necessary to create nexus is less strict than that imposed by A; in B, the mere pickup and replacement of damaged goods does not create nexus there. Isle's taxable income is \$60,000. Both states impose a 10% corporate income tax and include only the sales factor in their apportionment formulas.

Determine Isle's effective state income tax rate if:

- State A *has not* adopted a throwback rule.
 - If State A *has* adopted a throwback rule.
24. **LO.5** Sante Fe Corporation's sales office and manufacturing plant are located in State A. Sante Fe also maintains a manufacturing plant and sales office in State B. For purposes of apportionment, State A defines payroll as all compensation paid to employees, including contributions to § 401(k) deferred compensation plans. Under the statutes of State B, neither compensation paid to officers nor contributions to § 401(k) plans are included in the payroll factor. Sante Fe incurred the following personnel costs.

	State A	State B	Total
Wages and salaries for employees other than officers	\$ 60,000	\$40,000	\$100,000
Salaries for officers	40,000	20,000	60,000
Contributions to § 401(k) plans	20,000	10,000	30,000
Total	<u>\$120,000</u>	<u>\$70,000</u>	<u>\$190,000</u>

What is the payroll factor for:

- State A?
 - State B?
25. **LO.6** Chirp Corporation owns two subsidiaries, Song and Bird. Song, located in State A, generated taxable income of \$500,000. During this same period, Bird, located in State B, generated a loss of \$100,000.
- Determine Song's taxable income in States A and B, assuming that the subsidiaries constitute independent corporations under the tax law.
 - How does your answer change if the corporations constitute a unitary business?

Problems

26. **LO.1** Use Exhibit 24.1 to compute Balboa Corporation's State F taxable income for the year.

Addition modifications	\$29,000
Allocated income (total)	\$25,000
Allocated income (State F)	\$3,000
Allocated income (State G)	\$22,000
Apportionment percentage	40%
Credits	\$800
Federal taxable income	\$90,000
Subtraction modifications	\$15,000
Tax rate	5%

27. **LO.1,4** Use Exhibit 24.1 to provide the required information for Warbler Corporation, whose Federal taxable income totals \$10 million.

Warbler apportions 70% of its manufacturing income to State C. Warbler generates \$4 million of nonapportionable income each year, and 30% of that income is allocated to C. Applying the state income tax modifications, Warbler's total business income from the manufacturing operation this year is \$12 million.

- How much of Warbler's manufacturing income does State C tax?
 - How much of Warbler's allocable income does State C tax?
 - Explain your results.
28. **LO.1** For each of the following items considered independently, indicate whether the circumstances call for an addition modification (A), a subtraction modification (S), or no modification (N) in computing state taxable income. Then indicate the amount of any modification. The starting point in computing State Q taxable income is the year's Federal taxable income, before any deduction for net operating losses.
- Federal cost recovery = \$10,000, and Q cost recovery = \$15,000.
 - Federal cost recovery = \$15,000, and Q cost recovery = \$10,000.
 - Federal income taxes paid = \$30,000.
 - Refund received from last year's Q income taxes = \$3,000.
 - Local property taxes, deducted on the Federal return as a business expense = \$80,000.
 - Interest income from holding U.S. Treasury bonds = \$5,000.
 - Interest income from holding Q revenue anticipation bonds = \$3,000.
 - Interest income from State P school district bonds = \$10,000.
 - Change in the excess of FIFO inventory valuation over the Federal LIFO amount = \$6,000. Q does not allow the LIFO method.
 - An asset was sold for \$18,000; its purchase price was \$20,000. Accumulated Federal cost recovery = \$15,000, and accumulated Q cost recovery = \$8,000.
 - Dividend income received from State R corporation = \$30,000, subject to a Federal dividends received deduction of 70%.

29. **LO.1** Perk Corporation is subject to tax only in State A. Perk generated the following income and deductions.

Federal taxable income	\$300,000
State A income tax expense	15,000
Refund of State A income tax	3,000
Depreciation allowed for Federal tax purposes	200,000
Depreciation allowed for state tax purposes	120,000

Federal taxable income is the starting point in computing A taxable income. State income taxes are not deductible for A tax purposes. Determine Perk's A taxable income.

30. **LO.1** Fallow Corporation is subject to tax only in State X. Fallow generated the following income and deductions. State income taxes are not deductible for X income tax purposes.

Sales	\$4,000,000
Cost of sales	2,800,000
State X income tax expense	200,000
Depreciation allowed for Federal tax purposes	400,000
Depreciation allowed for state tax purposes	250,000
Interest income on Federal obligations	40,000
Interest income on X obligations	30,000
Expenses related to carrying X obligations	2,000

- The starting point in computing the X income tax base is Federal taxable income. Derive this amount.
 - Determine Fallow's X taxable income assuming that interest on X obligations is exempt from X income tax.
 - Determine Fallow's X taxable income assuming that interest on X obligations is subject to X income tax.
31. **LO.5** Dillman Corporation has nexus in States A and B. Dillman's activities for the year are summarized below.

	State A	State B	Total
Sales	\$1,200,000	\$ 400,000	\$1,600,000
Property			
Average historical cost	500,000	300,000	800,000
Average accumulated depreciation	(300,000)	(100,000)	(400,000)
Payroll	2,500,000	500,000	3,000,000
Rent expense	-0-	35,000	35,000

Determine the apportionment factors for A and B assuming that A uses a three-factor apportionment formula under which sales, property (net depreciated basis), and payroll are equally weighted and B employs a single-factor formula that consists solely of sales. State A has adopted the UDITPA with respect to the inclusion of rent payments in the property factor.

- LO.5** Assume the same facts as in Problem 31, except that A uses a single-factor apportionment formula that consists solely of sales and B uses a three-factor apportionment formula that equally weights sales, property (at historical cost), and payroll. State B does not include rent payments in the property factor.
- LO.5** Assume the same facts as in Problem 31, except that both states employ a three-factor formula, under which sales are double-weighted. The property factor in A is computed using historical cost, while this factor in B is computed using the net depreciated basis. Neither A nor B includes rent payments in the property factor.
- LO.5** Roger Corporation operates in two states, as indicated below. This year's operations generated \$400,000 of apportionable income.

	State A	State B	Total
Sales	\$800,000	\$200,000	\$1,000,000
Property	300,000	300,000	600,000
Payroll	200,000	50,000	250,000

Compute Roger's State A taxable income assuming that State A apportions income based on a:

- Three-factor formula, equally weighted.

- b. Double-weighted sales factor.
- c. Sales factor only.

- Decision Making** 35. **LO.5, 9** State E applies a throwback rule to sales, while State F does not. State G has not adopted an income tax to date. Clay Corporation, headquartered in E, reported the following sales for the year. All of the goods were shipped from Clay's E manufacturing facilities.

Customer	Customer's Location	This Year's Sales
ShellTell, Inc.	E	\$ 75,000,000
Tourists, Ltd.	F	40,000,000
PageToo Corp.	G	100,000,000
U.S. Department of Homeland Security	All 50 states	85,000,000
Total		<u>\$300,000,000</u>

- a. Determine Clay's sales factor in those states.
- b. Comment on Clay's location strategy using only your tax computations.

- Decision Making** 36. **LO.5, 9** Quinn Corporation is subject to tax in States G, H, and I. Quinn's compensation expense includes the following.

	State G	State H	State I	Total
Salaries and wages for nonofficers	\$200,000	\$400,000	\$400,000	\$1,000,000
Officers' salaries	-0-	-0-	500,000	500,000
Total				<u>\$1,500,000</u>

Officers' salaries are included in the payroll factor for G and I, but not for H. Compute Quinn's payroll factors for G, H, and I. Comment on your results.

37. **LO.5** Kim Corporation, a calendar year taxpayer, has manufacturing facilities in States A and B. A summary of Kim's property holdings follows.

	Beginning of Year		
	State A	State B	Total
Inventory	\$ 300,000	\$ 200,000	\$ 500,000
Plant and equipment	2,500,000	1,500,000	4,000,000
Accumulated depreciation: plant and equipment	(1,000,000)	(600,000)	(1,600,000)
Land	600,000	1,000,000	1,600,000
Rental property*	900,000	300,000	1,200,000
Accumulated depreciation: rental property	(200,000)	(90,000)	(290,000)
	End of Year		
	State A	State B	Total
Inventory	\$ 400,000	\$ 200,000	\$ 600,000
Plant and equipment	2,800,000	1,200,000	4,000,000
Accumulated depreciation: plant and equipment	(1,200,000)	(650,000)	(1,850,000)
Land	600,000	1,200,000	1,800,000
Rental property*	1,000,000	300,000	1,300,000
Accumulated depreciation: rental property	(250,000)	(100,000)	(350,000)

*Unrelated to regular business operations.

Determine Kim's property factors for the two states assuming that the statutes of both A and B provide that average historical cost of business property is to be included in the property factor.

38. **LO.6, 9** True Corporation, a wholly owned subsidiary of Trumaine Corporation, generated a \$400,000 taxable loss in its first year of operations. True's activities and sales are restricted to State A, which imposes an 8% income tax. In the same year, Trumaine's taxable income is \$1 million. Trumaine's activities and sales are restricted to State B, which imposes an 11% income tax. Both states use a three-factor apportionment formula that equally weights sales, payroll, and property, and both require a unitary group to file on a combined basis. Sales, payroll, and average property for each corporation are as follows.

Decision Making
Communications

	True Corporation	Trumaine Corporation	Total
Sales	\$2,500,000	\$4,000,000	\$6,500,000
Property	1,000,000	2,500,000	3,500,000
Payroll	500,000	1,500,000	2,000,000

True and Trumaine have been found to be members of a unitary business.

- Determine the overall state income tax for the unitary group.
 - Determine aggregate state income tax for the entities if they were nonunitary.
 - Incorporate this analysis in a letter to Trumaine's board of directors. Corporate offices are located at 1234 Mulberry Lane, Birmingham, AL 35298.
39. **LO.6** Chang Corporation is part of a three-corporation unitary business. The group has a water's edge election in effect with respect to unitary State Q. State B does not apply the unitary concept with respect to its corporate income tax laws. Nor does Despina, a European country to which Saldez paid a \$7 million value added tax this year.

Saldez was organized in Despina and conducts all of its business there. Given the summary of operations that follows, determine Chang's and Elena's sales factors in B and Q.

Corporation	Customer's Location	Sales
Chang	B	\$20,000,000
	Q	60,000,000
Elena	Q	70,000,000
Saldez	Despina	50,000,000

40. **LO.8** Using the following information from the books and records of Grande Corporation, determine Grande's total sales that are subject to State C's sales tax. Grande operates a retail general store.

Sales to C consumers, general merchandise	\$1,100,000
Sales to C consumers, crutches and other medical supplies	245,000
Sales to consumers in State D, via mail order	80,000
Purchases from suppliers	55,000

41. **LO.8** Indicate for each transaction whether a sales (*S*) or use (*U*) tax applies or whether the transaction is nontaxable (*N*). Where the laws vary among states, assume that the most common rules apply. All taxpayers are individuals.
- A resident of State A purchases an automobile in A.
 - A resident of State A purchases groceries in A.
 - A resident of State B purchases an automobile in A.
 - A charity purchases office supplies in A.
 - An A resident purchases in B an item that will be in the inventory of her business.

- Decision Making** 42. **LO.5,9** Dread Corporation operates in a high-tax state. The firm asks you for advice on a plan to outsource administrative work done in its home state to independent contractors. This work now costs the company \$750,000 in wages and benefits. Dread's total payroll for the year is \$8 million, of which \$6 million is for work currently done in the home state.
- Issue ID** 43. **LO.9** Prepare a PowerPoint presentation (maximum of six slides) entitled "Planning Principles for Our Multistate Clients." The slides will be used to lead a 20-minute discussion with colleagues in the corporate tax department. Keep the outline general, but assume that your colleagues have clients operating in at least 15 states. Address only income tax issues.
- Communications**

Research Problems

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

- Communications** **Research Problem 1.** Send an e-mail to the secretary of revenue for your home state, proposing adoption of at least two of the following provisions that do not currently exist.
- Exempt computer and communications technology from the apportionment weight for the property factor.
 - Subject advertising expenditures to the sales/use tax.
 - Allow an income tax credit for 20% of the cost of in-state construction projects that are substantially completed within the next 18 months.
 - Tax the income of vendors who do not have a physical presence in your state but sell to in-state customers online.
 - Add a "nexus team" to find the taxpayers operating in your state, but based in Ohio, Illinois, or Arizona.
 - Adopt the definitions and other rules of the Streamlined Sales Tax Project.
 - Allow an income tax credit for film and television producers equal to 30% of in-state expenditures.
 - Apply a tax on S corporations operating in the state equal to 2% of the entity's hypothetical Subchapter C taxable income.
 - Convert the corporate income tax to a tax on gross receipts, in an effort to tax the profits of passive investment companies owned by in-state parent entities.
- Communications** **Research Problem 2.** For your state and one of its neighbors, find the following income tax rules. Place your data in a chart, and e-mail your findings to your professor.
- To what extent does each state follow the rulings of the Multistate Tax Commission?
 - Does the state adopt pertinent changes to the Internal Revenue Code? If so, as of what date?
 - Has the state joined the Streamlined Sales Tax Project? If so, which of the project's rules has the state adopted? What is the effective date?
 - Is the tax effectiveness of a passive investment company limited in some way? Has the state adopted the *Geoffrey* approach to the taxation of income from intangibles? Explain.
 - Does the state apply entity-level income taxes for S corporations, partnerships, and LLCs? If so, what are the terms of those taxes?
 - Does the state levy a "minimum tax" or "alternative minimum tax"? If so, what are the terms and rates for the tax?

Research Problem 3. For your state and one of its neighbors, find the following sales/use tax rules. Place your data in a chart, and e-mail your findings to your professor.

- a. What are the requirements for the occasional-sale rule as an exception to the sales/use tax? Who can use this rule?
- b. Describe any exemptions from the sales/use tax base that are allowed for transactions involving groceries, school clothing and supplies, religious goods, and legal services.
- c. What is the discount allowed, if any, when a vendor remits sales/use tax to the state in a timely manner?
- d. Is manufacturing equipment exempt from the sales/use tax? Medical devices for a clinic? Medical devices for a consumer?
- e. Can a vendor use an electronic funds transfer system to remit its sales/use tax collections? If so, when is it required to do so?

Communications

Research Problem 4. Identify three states considered to be in the same economic region as your own. For each of the three states, answer the following questions. Answers to most can be found at www.taxadmin.org.

- What is the overall tax burden per capita, and where does it rank among all states?
- What is the overall tax burden as a percentage of personal income, and where does it rank among all states?
- From what source(s) does it raise most of its revenues (e.g., sales/use tax, highway tolls)?
- What is the highest marginal tax rate on corporate income?
- What is its apportionment formula, including factors and weights?

What advice or insight might you provide to your state legislature regarding your state's tax system, based on your responses to the above?

Research Problem 5. Read the “tax footnote” of five publicly traded U.S. corporations. Find the effective state/local income tax rates of each. Create a PowerPoint presentation (maximum of five slides) for your instructor, summarizing the search and reporting the findings.

Communications

CHAPTER
25

Taxation of International Transactions

LEARNING OBJECTIVES: *After completing Chapter 25, you should be able to:*

- LO.1** Explain the framework underlying the U.S. taxation of cross-border transactions.
- LO.2** Describe the interaction between Internal Revenue Code provisions and tax treaties.
- LO.3** Apply the rules for sourcing income and deductions into U.S. and foreign categories.
- LO.4** Apply foreign currency exchange rules as they affect the tax consequences of international transactions.
- LO.5** Work with the U.S. tax provisions affecting U.S. persons earning foreign-source income, including the rules relating to cross-border asset transfers, antideferral provisions, and the foreign tax credit.
- LO.6** Apply the U.S. tax provisions concerning nonresident alien individuals and foreign corporations.

CHAPTER OUTLINE

25-1 Overview of International Taxation, 25-2

25-2 Tax Treaties, 25-4

25-3 Sourcing of Income and Deductions, 25-6

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THE BIG PICTURE

GOING INTERNATIONAL

VoiceCo, a domestic corporation, designs, manufactures, and sells specialty microphones for use in theaters. All of its activities take place in Florida, although it ships products to customers all over the United States. When it receives inquiries about its products from foreign customers, VoiceCo decides to test the foreign market and places ads in foreign trade journals. Soon it is taking orders from foreign customers.

VoiceCo is concerned about its potential foreign income tax exposure. Although it has no assets or employees in the foreign jurisdictions, it now is involved in international commerce. Is VoiceCo subject to income taxes in foreign countries? Must it pay U.S. income taxes on the profits from its foreign sales? What if VoiceCo pays taxes to other countries? Does it receive any benefit from these payments on its U.S. tax return?

VoiceCo establishes a manufacturing plant in Ireland to meet the European demand for its products. VoiceCo incorporates the Irish operation as VoiceCo-Ireland, a foreign corporation. Ireland imposes only a 12.5 percent tax on VoiceCo-Ireland's profits. So long as VoiceCo-Ireland does not distribute profits to VoiceCo, will the profits escape U.S. taxation? What are the consequences to VoiceCo of being the owner of a so-called controlled foreign corporation? Does it have any reporting requirements with the IRS?

Read the chapter and formulate your response.

In today's global business environment, most large businesses are truly international in scope. Large U.S. corporations earn on average more than 20 percent of their profits overseas, with offshore sales by "all-American" companies Coca-Cola and Apple exceeding 60 percent of their totals for a typical year. "Offshore" companies like Honda and Toyota operate large manufacturing plants in the United States, with perhaps one-third of their total sales taking place in the United States.

Global trade is an integral part of the U.S. economy. In a recent year, U.S. exports and imports of goods and services totaled \$2.2 trillion and \$2.7 trillion, respectively. This international trade creates significant U.S. tax consequences for both U.S. and foreign entities. In the most recent year for which data are available, U.S. corporations reported \$470 billion in foreign-source income, paid \$128 billion in income taxes to foreign governments, and claimed foreign tax credits in excess of \$118 billion. U.S. corporations controlled by foreign owners reported \$130 billion in U.S. taxable income.

Cross-border transactions create the need for special tax considerations for both the United States and its trading partners. Tax planning opportunities can arise as different countries raise revenue through income and other taxes, applying various tax bases and tax rates. Exhibit 25.1 includes data about the top statutory tax rates that various countries apply to corporate taxable income.

From a U.S. perspective, international tax laws should promote the global competitiveness of U.S. enterprises and at the same time protect the tax revenue base of the United States. These two objectives sometimes conflict, however. The need to deal with both contributes to the complexity of the rules governing the U.S. taxation of cross-border transactions.

EXAMPLE

1

U.S. persons engage in activities outside the United States for many different reasons. Consider two U.S. corporations that have established sales subsidiaries in foreign countries. Dedalus, Inc., operates in Germany, a high-tax country, because customers demand local attention from sales agents. Mulligan, Inc., operates in the Cayman Islands, a low-tax country, simply to shift income outside the United States. U.S. tax law must fairly address both situations with the same law.

LO.1

Explain the framework underlying the U.S. taxation of cross-border transactions.

25-1 OVERVIEW OF INTERNATIONAL TAXATION

U.S. international tax provisions are concerned primarily with two types of potential taxpayers: U.S. persons earning foreign-source income and foreign persons earning U.S.-source income.¹ U.S. persons earning U.S.-source income are taxed under the purely

EXHIBIT 25.1

Top Statutory Corporate Income Tax Rates for Selected Countries

Bermuda	0.0%
Ireland	12.5%
United Kingdom	21.0%
Sweden	22.0%
Mexico	30.0%
Germany	30.2%
France	37.0%
Japan	37.0%
United States	39.1%

Note: Includes additional taxes on corporate taxable income levied by states, cities, provinces, cantons, and other smaller jurisdictions.

¹The term *person* includes an individual, corporation, partnership, trust, estate, or association. § 7701(a)(1). The terms *domestic* and *foreign* are defined in §§ 7701(a)(4) and (5).

domestic provisions of the Internal Revenue Code. Foreign persons earning foreign-source income are not within the taxing jurisdiction of the United States (unless this income is somehow connected to a U.S. trade or business). Exhibit 25.2 illustrates this categorization.

The United States taxes the worldwide income of U.S. taxpayers. Because foreign governments may also tax some of this income, these taxpayers may be subjected to double taxation. Special provisions such as the foreign tax credit can mitigate this problem. For non-U.S. taxpayers, the United States generally taxes only income earned within its borders. The U.S. taxation of cross-border transactions can be organized in terms of “outbound” and “inbound” taxation. **Outbound taxation** refers to the U.S. taxation of foreign-source income earned by U.S. taxpayers. **Inbound taxation** refers to the U.S. taxation of U.S.-source income earned by foreign taxpayers.

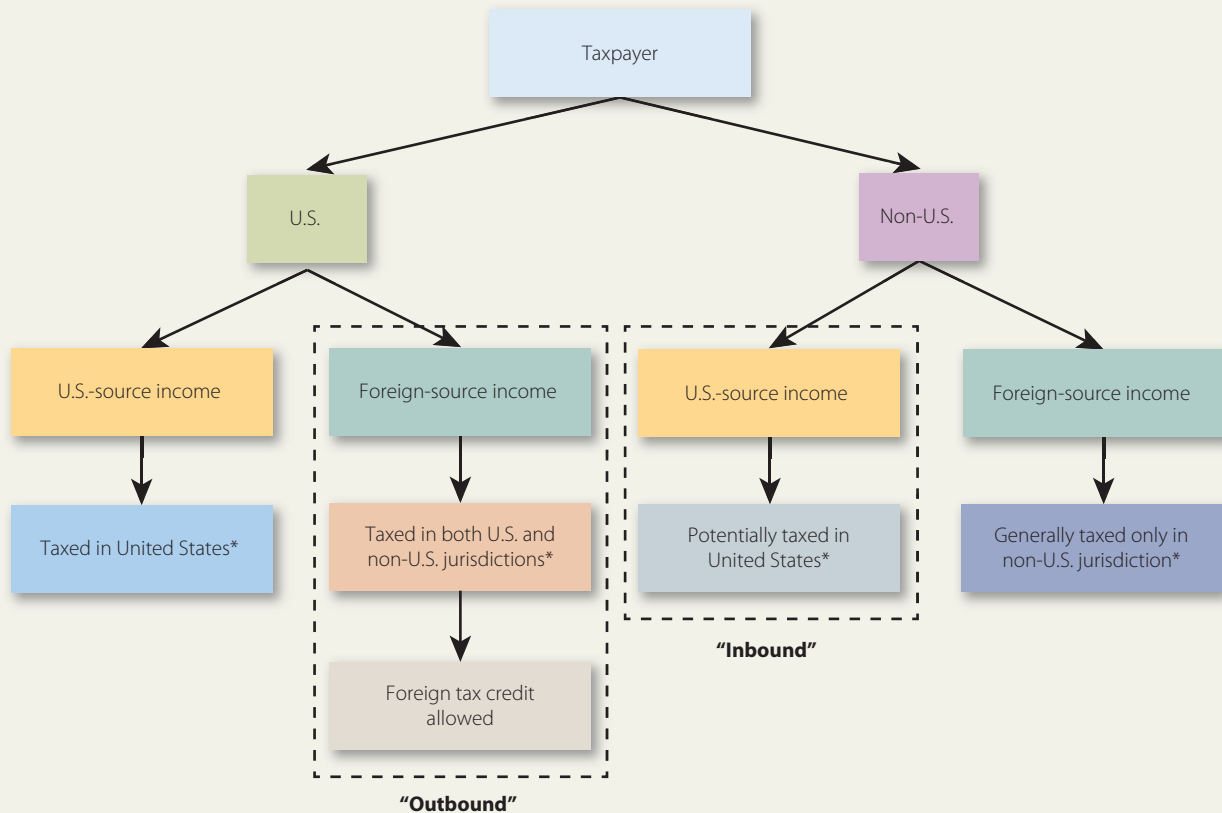
The Big Picture

EXAMPLE

2

Return to the facts of *The Big Picture* on p. 25-1. Assume that VoiceCo operates an unincorporated manufacturing branch in Singapore to take advantage of local materials and low labor costs. This branch income is taxed in the United States as part of VoiceCo’s worldwide income, but it also is taxed in Singapore. Without the availability of a foreign tax credit to mitigate this double taxation, VoiceCo would suffer an excessive tax burden and could not compete in a global environment.

EXHIBIT 25.2 U.S. Taxation of Cross-Border Transactions



*Income may or may not be subject to tax in the non-U.S. jurisdiction, depending on local country tax law. Some U.S.-source income is exempt from tax in the United States for both U.S. and non-U.S. persons.

GLOBAL TAX ISSUES Tax Reform Can Make Strange Bedfellows

As governments around the world seek new revenues to cover deficits, pay down debts, and stabilize their economies, new levels of political cooperation can emerge. Age-old banking secrecy rules and tax laws that allow entities to shift taxable income into low-taxing jurisdictions all are under serious scrutiny for the first time ever. The Organization for Economic Cooperation and Development (OECD), a group of about 35 developed countries dedicated to expanding economic progress and world trade, has developed a plan to curtail income shifting that solely is meant to reduce taxes. And the Group of 20, the largest economies in the world, has signed on to the principles of international tax reform.

Ireland, accused by several of its European Union partners and the European Commission of encouraging

tax-motivated income shifting through its very low tax rates on business income, is considering changes to its laws. Many U.S. manufacturing, pharmaceutical, and technology businesses are organized so that taxable sales are sourced to Ireland and subject to the low tax rates there. Intellectual property, such as patents and copyrights, is held by entities in Ireland, again shifting the resulting taxable income to its low tax rates. None of these arrangements are illegal, but with the increased international scrutiny concerning Ireland and its desire to continue to attract new business capital, Ireland is looking to toughen some of its laws and restrict those tax advantages.

As these efforts to increase the tax liabilities of multinational entities expand, tax planners will need to find different techniques to manage the tax costs of their operations.

The Big Picture

EXAMPLE

3

Return to the facts of *The Big Picture* on p. 25-1. VoiceCo's major competitor is a Swiss-based foreign corporation with operations in the United States. Although not a U.S. person, the Swiss competitor is taxed in the United States on its U.S.-source business income. If the Swiss competitor could operate free of U.S. tax, VoiceCo would face a serious competitive disadvantage.

LO.2

Describe the interaction between Internal Revenue Code provisions and tax treaties.

25-2 TAX TREATIES

The U.S. tax rules governing cross-border transactions are based on both the Internal Revenue Code and **tax treaties**. U.S. tax treaties are bilateral agreements between countries that provide tax relief for those persons covered by the treaties. Tax treaty provisions generally override the treatment otherwise called for under the Internal Revenue Code or foreign tax statutes. Taxpayers should attempt to resolve any conflicts between a treaty and local law. A common way of doing so is to apply the "later-in-time" rule, under which preference is given to whichever is newer, the treaty or the law.

Almost 70 income tax treaties between the United States and other countries are in effect (see Exhibit 25.3). These treaties generally provide *taxing rights* with regard to the taxable income of residents of one treaty country who have income sourced in the other treaty country. For the most part, neither country is prohibited from taxing the income of its residents. The treaties generally give one country primary taxing rights and require the other country to allow a credit for the taxes paid on the twice-taxed income.

EXAMPLE

4

ForCo, Ltd., a resident of a foreign country with which the United States has an income tax treaty, earns income attributable to a permanent establishment (e.g., place of business) in the United States.

Under the treaty, the United States has primary taxing rights with regard to this income. The other country can also require that the income be included in gross income and can subject the income to its income tax, but it must allow a credit for the taxes paid to the United States on the income.

EXHIBIT 25.3

U.S. Income Tax Treaties in Force as of 2014

Armenia	France	Lithuania	South Africa
Australia	Georgia	Luxembourg	Spain
Austria	Germany	Malta	Sri Lanka
Azerbaijan	Greece	Mexico	Sweden
Bangladesh	Hungary	Moldova	Switzerland
Barbados	Iceland	Morocco	Tajikistan
Belarus	India	Netherlands	Thailand
Belgium	Indonesia	New Zealand	Trinidad
Bulgaria	Ireland	Norway	Tunisia
Canada	Israel	Pakistan	Turkey
China	Italy	Philippines	Turkmenistan
Cyprus	Jamaica	Poland	Ukraine
Czech Republic	Japan	Portugal	United Kingdom
Denmark	Kazakhstan	Romania	Uzbekistan
Egypt	Korea, Republic of	Russia	Venezuela
Estonia	Kyrgyzstan	Slovak Republic	
Finland	Latvia	Slovenia	

Which country receives primary taxing rights usually depends on the residence of the taxpayer or the presence of a permanent establishment in a treaty country to which the income is attributable. Generally, a permanent establishment is a branch, an office, a factory, a workshop, a warehouse, or another fixed place of business.

Most U.S. income tax treaties reduce the withholding tax rate on certain items of investment income, such as interest and dividends. Exhibit 25.4 summarizes the treaty-based withholding rates for selected countries with respect to certain investment income. Lacking such a treaty provision, the withholding rate likely would be 30 percent.

The United States has developed a Model Income Tax Convention as the starting point for negotiating income tax treaties with other countries.²

EXHIBIT 25.4

Selected Tax Treaty Withholding Rates

	Interest	Dividends in General	Dividends Paid by U.S. Subsidiary to a Foreign Parent Corporation
Australia	10%	15%	5%
Canada	10	15	10
Ireland	0	15	5
Japan	10	10	0
Mexico	15	15	0
Philippines	15	25	20

²Treasury Department Model Income Tax Convention (November 15, 2006).
See <http://www.irs.gov/Individuals/InternationalTaxpayers/The-U.S.-Model-Income-Tax-Convention-and-Model-Technical-Explanation>.



FINANCIAL DISCLOSURE INSIGHTS Effective Tax Strategies Using Overseas Operations

In a global economy, publicly traded business entities can operate in many taxing jurisdictions. For instance, General Electric reports that it files current-year tax returns with more than 250 countries, amounting to over 7,000 income tax returns at the Federal and local levels worldwide. Note that this tax activity does not take into account the sales, value added, property, and other tax returns that are required by the U.S. states and localities.

The financial reports of profitable U.S. companies indicate that overseas operations can produce tax benefits of their

own, not taking into account the effects of increased market share and financial stability. For instance, the trucking firm Ryder Systems recently reported current tax refunds of about \$235,000 and deferred tax savings of about \$500,000 on non-U.S. profits of about \$11.5 million. In a recent period, Eli Lilly reduced its effective tax rate by about one-third due to overseas operations. And General Electric recently reduced its effective tax rate to a negative amount because of various income deferrals related to overseas earnings. These deferral techniques are addressed later in the chapter.

LO.3

Apply the rules for sourcing income and deductions into U.S. and foreign categories.

25-3 SOURCING OF INCOME AND DEDUCTIONS

The *sourcing* of income and deductions inside and outside the United States has a direct bearing on a number of tax provisions affecting both U.S. and foreign taxpayers. For example, foreign taxpayers generally are taxed only on income sourced inside the United States, and U.S. taxpayers receive relief from double taxation under the foreign tax credit rules based on their foreign-source income. Accordingly, an examination of sourcing rules is often the starting point in addressing international tax issues.

25-3a Income Sourced inside the United States

The determination of the source of income depends on the type of income realized (e.g., income from the sale of property versus income for the use of property).³

Interest

Interest income received from the U.S. government, from the District of Columbia, and from noncorporate U.S. residents or domestic corporations is sourced inside the United States.

There are a few exceptions to this rule. Certain interest received from a U.S. corporation that earned 80 percent or more of its active business income from foreign sources over the prior three-year period is treated as foreign-source income. Interest received on amounts deposited with a foreign branch of a U.S. corporation also is treated as foreign-source income if the branch is engaged in the commercial banking business.

EXAMPLE

5

John holds a bond issued by Delta, a domestic corporation. For the immediately preceding three tax years, 82% of Delta's gross income has been active foreign business income. The interest income that John receives for the current tax year from Delta is foreign-source income.

Dividends

Dividends received from domestic corporations (other than certain U.S. possessions corporations) are sourced inside the United States. Generally, dividends paid by a foreign corporation are foreign-source income. However, if a foreign corporation earned 25 percent or more of its gross income from income effectively connected with a U.S. trade or business for the three tax years immediately preceding the year of the dividend payment, that percentage of the dividend is treated as U.S.-source income.

³Rules pertaining to the sourcing of income are found in §§ 861–865.

Ann receives dividend income from the following corporations for the current tax year.

Amount	Corporation	Effectively Connected U.S. Income for Past Three Years	U.S.-Source Income
\$500	Green, domestic	85%	\$500
600	Brown, domestic	13%	600
300	Orange, foreign	92%	276

Because Green Corporation and Brown Corporation are domestic corporations, the dividends they pay are U.S.-source income. Orange Corporation is a foreign corporation that earned 92% of its business income over the prior three years from income effectively connected with a U.S. trade or business. Because Orange meets the 25% threshold, 92% of its dividend is U.S. source.

EXAMPLE

6

Personal Services Income

The source of income from personal services is determined by the location in which the services are performed (inside or outside the United States). A limited *commercial traveler* exception is available. Under this exception, personal services income must meet all of the following requirements to avoid being classified as U.S.-source income.

- The services must be performed by a nonresident alien who is in the United States for 90 days or less during the taxable year.
- The compensation may not exceed \$3,000 in total for the services performed in the United States.
- The services must be performed on behalf of:
 - A nonresident alien, foreign partnership, or foreign corporation that is not engaged in a U.S. trade or business or
 - An office or place of business maintained in a foreign country or possession of the United States by an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation.

Mark, a nonresident alien, is an engineer employed by a foreign oil company. He spent four weeks in the United States arranging the purchase of field equipment for his company. His salary for the four weeks was \$3,500. Even though the oil company is not engaged in a U.S. trade or business and Mark was in the United States for less than 90 days during the taxable year, the income is U.S.-source income because it exceeds \$3,000.

EXAMPLE

7

Rents and Royalties

Income received for the use of tangible property is sourced to the country in which the property is located. The source of income received for the use of intangible property (e.g., patents, copyrights, processes, and formulas) is the country in which the property is used.

Sale or Exchange of Property

Generally, the location of real property determines the source of any income derived from the property. Income from the disposition of U.S. real property interests is U.S.-source income.

The source of income from the sale of personal property (assets other than real property) depends on several factors, including the following.

- Whether the property was produced by the seller.
- What type of property was sold (e.g., inventory or a capital asset).
- Where the residence of the seller was.

Generally, income, gain, or profit from the sale of personal property is sourced according to the residence of the seller. Income from the sale of purchased inventory, however, is sourced in the country in which the sale takes place.⁴

When the seller has produced the inventory property, the income must be apportioned between the country of production and the country of sale. Gross income is sourced under a 50/50 allocation method unless the taxpayer elects to use another approved allocation process, such as the independent factory price (IFP) method or the separate books and records method.

The 50/50 method assigns one-half of the inventory profits from export sales to the location of the production assets and one-half to the place of title passage. For instance, if the manufacturer or producer regularly sells to wholly independent distributors, this can establish an *independent* factory or production price.

Income from the sale of personal property other than inventory is sourced at the residence of the seller unless one of the following exceptions applies.

- Gain on the sale of depreciable personal property is sourced according to prior depreciation deductions to the extent of the deductions. Any excess gain is sourced the same as the sale of inventory.
- Gain on the sale of intangibles is sourced according to prior amortization deductions to the extent of the deductions. Contingent payments, however, are sourced as royalty income.
- Gain attributable to an office or a fixed place of business maintained outside the United States by a U.S. resident is foreign-source income.
- Income or gain attributable to an office or a fixed place of business maintained in the United States by a nonresident is U.S.-source income.

Losses are sourced depending on the nature of the property. Different rules exist for the disposition of stock versus other personal property.⁵

Transportation and Communication Income

Income from transportation beginning *and* ending in the United States is U.S.-source income. Fifty percent of the income from transportation beginning *or* ending in the United States is U.S.-source income, unless the U.S. point is only an intermediate stop. Income from space and ocean activities conducted outside the jurisdiction of any country is sourced according to the residence of the person conducting the activity.

International communication income derived by a U.S. person is sourced 50 percent in the United States when transmission is between the United States and a foreign country. International communication income derived by foreign persons is foreign-source income unless it is attributable to an office or another fixed place of business in the United States. In that case, it is U.S.-source income.

Software Income

Income from the sale or license of software is sourced depending on how the income is classified. A transfer of software is classified as either the transfer of a copyright (e.g., the right to the computer program itself) or the transfer of a copyrighted article (the right to use a copy of the computer program).⁶ If the transfer is considered a transfer of a copyright, the income is sourced using the royalty income rules. If the transfer is considered a transfer of a copyrighted article, the income is treated as resulting from a sale of the article and is sourced based on the personal property sales rules.

⁴§§ 861(a)(6) and 865. The sale is deemed to take place where title passes. See Reg. § 1.861-7(c) regarding title passage. There has been considerable conflict in this area of tax law. See, for example, *Liggett Group, Inc.*, 58 TCM 1167, T.C.Memo. 1990-18.

⁵See Reg. § 1.861-8(e)(7) and Reg. § 1.865-1(a)(1). See Reg. §§ 1.865-2(a)(1) and (2) regarding the source of losses on the disposition of stock.

⁶Reg. § 1.861-18.

25-3b Income Sourced outside the United States

The provisions for sourcing income outside the United States are not as detailed and specific as those for determining U.S.-source income. If interest, dividends, compensation for personal services, income from the use or sale of property, or other income is not U.S.-source income, then it is foreign-source income.⁷

25-3c Allocation and Apportionment of Deductions

The United States levies a tax on *taxable income*. Deductions and losses, therefore, must be allocated and apportioned between U.S.- and foreign-source gross income to determine U.S.- and foreign-source taxable income. Deductions directly related to an activity or property are allocated to classes of income. This is followed by apportionment between the statutory and residual groupings (e.g., foreign versus domestic) on some reasonable basis.⁸ A deduction not definitely related to any class of gross income is ratably allocated to all classes of gross income and apportioned between U.S.- and foreign-source income.

Ace, Inc., a domestic corporation, reports \$2 million of gross income and a \$50,000 expense, all related to real estate activities. The expense is allocated and apportioned using gross income as a basis as follows.

EXAMPLE

8

	Gross Income		Allocation	Apportionment	
	Foreign	U.S.		Foreign	U.S.
Sales	\$1,000,000	\$500,000	\$37,500*	\$25,000	\$12,500**
Rentals	400,000	100,000	12,500	10,000	2,500***
			<u>\$50,000</u>	<u>\$35,000</u>	<u>\$15,000</u>

* \$50,000 × (\$1,500,000/\$2,000,000).

** \$37,500 × (\$500,000/\$1,500,000).

*** \$12,500 × (\$100,000/\$500,000).

If Ace could show that \$45,000 of the expense was directly related to sales income, the \$45,000 would be allocated to that class of gross income, with the remainder allocated and apportioned ratably based on gross income.

Interest expense is allocated and apportioned based on the theory that money is fungible. With limited exceptions, interest expense is attributable to all of the activities and property of the taxpayer, regardless of the specific purpose for incurring the debt on which interest is paid. Taxpayers allocate and apportion interest expense on the basis of either the fair market value or the tax book value of the leveraged assets.⁹

The Big Picture

Return to the facts of *The Big Picture* on p. 25-1. Assume that VoiceCo generates U.S.-source and foreign-source gross income for the current year. VoiceCo's assets (measured at tax book value) are as follows.

EXAMPLE

9

Assets generating U.S.-source income	\$18,000,000
Assets generating foreign-source income	<u>5,000,000</u>
	<u>\$23,000,000</u>

continued

⁷§ 862.

⁸Reg. § 1.861-8.

⁹Reg. § 1.861-9T. Reg. § 1.861-10T(b) describes circumstances in which interest expense can be directly allocated to specific debt. This exception to

the fungibility concept is limited to cases in which specific property is purchased or improved with nonrecourse debt.

VoiceCo incurs interest expense of \$800,000 for the current year. Using the tax book value method, interest expense is apportioned to foreign-source income as follows.

$$\frac{\$5,000,000 \text{ (foreign assets)}}{\$23,000,000 \text{ (total assets)}} \times \$800,000 = \$173,913$$

Specific rules also apply to research and development (R&D) expenditures, certain stewardship expenses, legal and accounting fees and expenses, income taxes, and losses. Although U.S. companies incur about 90 percent of their R&D expenditures at U.S. facilities, several billion dollars are spent on offshore R&D each year. The Regulations provide that a portion of a U.S. company's R&D expenditures is treated as foreign-source expense if the R&D relates to foreign product sales.

25-3d **Transfer Pricing**

Taxpayers may be tempted to minimize taxation by manipulating the source of income and the allocation of deductions arbitrarily through **transfer pricing**. This manipulation is more easily accomplished between or among related persons. The IRS uses § 482 to counter such actions. The provision gives the IRS the power to reallocate gross income, deductions, credits, or allowances between or among organizations, trades, or businesses owned or controlled directly or indirectly by the same interests. This can be done whenever the IRS determines that reallocation is necessary to prevent the evasion of taxes or to reflect income more clearly. Section 482 is a “one-edged sword” available only to the IRS. The taxpayer generally cannot invoke § 482 to reallocate income and expenses.¹⁰



ETHICS & EQUITY The Costs of Good Tax Planning

High Tech Tops (HTT), a C corporation based in California, manufactures resilient cases and covers for laptops, smart phones, and tablets. Its sales and profits have more than doubled in each of the last five years (i.e., the company is growth-oriented and recession-proof). Its employees and contractors make above-average wages, so they make important contributions to the local individual income, sales, and property tax collections.

But the Federal and state corporate income tax is another story. Using legal and effective transfer pricing techniques, HTT shifts most of its operating profits to low-tax subsidiaries in Ireland and Singapore. Most of the firm's executives, engineers, and designers are based in the United States, but almost all of the sales operations are run from overseas. HTT's customers live around the

world, but its tax liabilities are concentrated in the low-tax jurisdictions.

You are the president of State University, across town from HTT's headquarters. The company sends hundreds of its employees to take graduate and professional courses on your campus, and several of the corporate leaders are frequent guest speakers and adjunct lecturers in classes.

Still, the state income tax the company avoids through its transfer pricing plans would fund millions of dollars of campus growth and improvements for State University.

Should you become involved in the politics of the matter and lobby at your statehouse for tighter rules on transfer pricing? Such an action might result in tax increases that would improve your university's situation, but it might also force HTT to consider moving its headquarters to another location.

EXAMPLE

10

Consider the transaction depicted in Exhibit 25.5. A U.S. corporation manufactures and sells inventory to an unrelated foreign customer. The sales price for the inventory is \$1,000, and the related cost of goods sold (COGS) is \$600. All of the resulting profit of \$400 is taxed to the U.S. corporation, resulting in a \$140 U.S. income tax liability (\$400 × 35%). If the U.S. corporation has no business presence in the foreign jurisdiction and is merely selling to a customer located there, the foreign government is unlikely to impose any local income tax on the U.S. corporation. Consequently, the total tax burden imposed on the inventory sale is \$140.

continued

¹⁰Reg. § 1.482-1(a)(3).

Suppose instead that the U.S. corporation attempts to reduce its total tax expense by channeling the inventory sale through a subsidiary in the same country as the foreign customer. In this case, because the U.S. corporation controls the foreign subsidiary, it chooses an intercompany sales price (the transfer price) that moves a portion of the profits from the United States to the foreign country.

By selling the inventory it manufactured to its 100%-owned foreign subsidiary for \$700, the U.S. corporation reports only \$100 of profits and an associated U.S. tax liability of \$35. The foreign subsidiary then sells the inventory to the ultimate customer for \$1,000 and, with a \$700 COGS, earns a \$300 profit. In this example, the foreign country imposes only a 10% tax on corporate profits, resulting in a foreign income tax of \$30 (\$300 × 10%). By using a related foreign entity in a lower-tax jurisdiction, the U.S. corporation has lowered its overall tax liability on the sale from \$140 (all U.S.) to \$65 (\$35 U.S. and \$30 foreign).

The critical question is whether the IRS will view \$700 as the appropriate transfer price. The IRS may question why the foreign corporation deserved to earn \$300 of the total \$400 profit related to the manufacture and sale of the inventory. In general, the U.S. corporation must document the functions performed by the foreign corporation, the assets it owns that assist in producing the income, or the risks it takes (e.g., credit risk).

If the IRS does not consider the \$300 profit earned by the foreign corporation to be appropriate, it will adjust the transfer price upward. If the IRS determines that the transfer price should have been, for example, \$990, then the U.S. corporation reports a \$390 profit (with \$136.50 U.S. income tax) and the foreign corporation earns a \$10 profit (with \$1 in foreign income tax). With this change in transfer price, the U.S. corporation reduces its tax liability by only \$2.50 [\$140 – (\$136.50 + \$1)].

EXHIBIT 25.5 Transfer Pricing Example

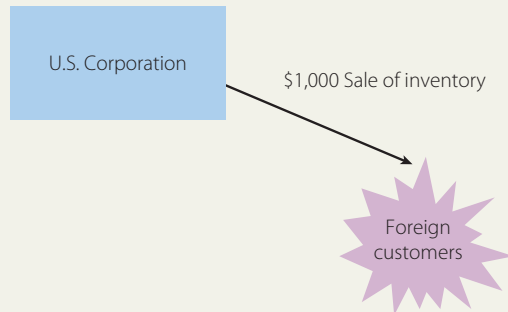
Sale Without Using Related Party

U.S. Corporation

Sales revenue	\$1,000
COGS	(600)
Profit	\$ 400
Tax @ 35%	\$ 140

Worldwide Tax Cost

U.S. tax	\$140
Foreign tax	0
Total tax	\$140



Sale Using Related Party

U.S. Corporation

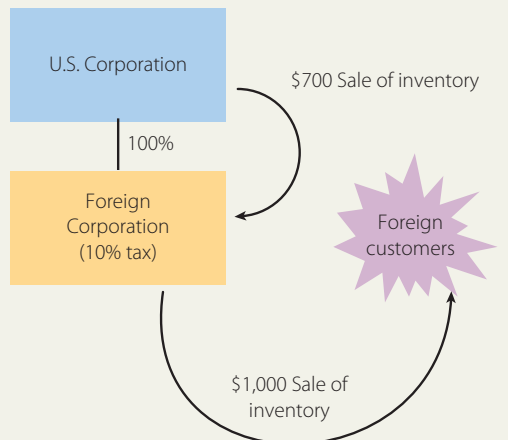
Sales revenue	\$700
COGS	(600)
Profit	\$100
Tax @ 35%	\$ 35

Foreign Corporation

Sales revenue	\$1,000
COGS	(700)
Profit	\$ 300
Tax @ 10%	\$ 30

Worldwide Tax Cost

U.S. tax	\$35
Foreign tax	30
Total tax	\$65



An accuracy-related penalty of 20 percent is imposed for net transfer price adjustments in a taxable year that exceed the lesser of \$5 million or 10 percent of the taxpayer's gross receipts.¹¹ In addition, a 40 percent penalty applies for "gross misstatements."

As an aid to reducing pricing disputes, the IRS initiated the Advance Pricing Agreement (APA) program, whereunder the taxpayer can propose a transfer pricing method for certain international transactions. The taxpayer provides relevant data, which then are evaluated by the IRS. If accepted, the APA provides a safe harbor transfer pricing result for the taxpayer. APAs can be complex in their application, and they may take three or four years to negotiate fully. About 200 APAs are in place or in various stages of negotiation.

LO.4

Apply foreign currency exchange rules as they affect the tax consequences of international transactions.

25-4 FOREIGN CURRENCY TRANSACTIONS

The relative value of a foreign currency and the U.S. dollar is described by the foreign exchange rate. Changes in this rate affect the dollar value of foreign property held by the taxpayer, the dollar value of foreign debts, and the dollar amount of gain or loss on a transaction denominated in a foreign currency. Almost every international tax issue requires consideration of currency exchange implications.

EXAMPLE

11

Dress, Inc., a domestic corporation, purchases merchandise for resale from Fiesta, Inc., a foreign corporation, for 50,000K (a foreign currency). On the date of purchase, 1K is equal to \$1 U.S. (1K:\$1). At this time, the account payable is \$50,000. On the date of payment by Dress (the foreign exchange date), the exchange rate is 1.25K:\$1. In other words, the foreign currency has been devalued in relation to the U.S. dollar, and Dress will pay Fiesta 50,000K, which will cost Dress only \$40,000. Dress must record the purchase of the merchandise at \$50,000 and recognize a foreign currency gain of \$10,000 (\$50,000 – \$40,000).

In recent years, U.S. currency abroad has amounted to more than 50 percent of the U.S. currency in circulation. Taxpayers may find it necessary to translate amounts denominated in foreign currency into U.S. dollars for any of the following purposes.

- Purchase of goods, services, and property.
- Sale of goods, services, and property.
- Collection of foreign receivables.
- Payment of foreign payables.
- Foreign tax credit calculations.
- Recognition of income or loss from foreign branch activities.

The foreign currency exchange rates, however, have no effect on the transactions of a U.S. person who arranges all international transactions in U.S. dollars.

EXAMPLE

12

Sellers, Inc., a domestic corporation, purchases goods from Rose, Ltd., a foreign corporation, and pays for these goods in U.S. dollars. Rose then exchanges the U.S. dollars for the currency of the country in which it operates. Sellers has no foreign exchange considerations with which to contend.

If, instead, Rose required Sellers to pay for the goods in a foreign currency, Sellers would have to exchange U.S. dollars to obtain the foreign currency to make payment. If the exchange rate changed from the date of purchase to the date of payment, Sellers would have a foreign currency gain or loss on the currency exchange.

¹¹§ 6662(e)(1)(B).

The following concepts are important when dealing with the tax aspects of foreign exchange.

- Foreign currency is treated as property other than money.
- Gain or loss on the exchange of foreign currency is considered separately from the underlying transaction (e.g., the purchase or sale of goods).
- No gain or loss is recognized until a transaction is closed.

25-4a Tax Issues

The following major tax issues must be considered when dealing with foreign currency exchange.

- The date of recognition of any gain or loss (see Concept Summary 25.1).
- The source (U.S. or foreign) of the foreign currency gain or loss.
- The character of the gain or loss (ordinary or capital).



Concept Summary 25.1

Recognition of Foreign Exchange Gain or Loss

Transaction	Date of Recognition
Purchase or sale of inventory or business asset	Date of disposition of foreign currency
Branch profits	Remittance of branch profits
Subpart F income	Receipt of previously taxed income (accumulated E & P)
Dividend from untaxed current or accumulated E & P	No exchange gain or loss to recipient

25-4b Functional Currency

The Code generally adopts the **functional currency** approach.¹² For book and tax purposes, the currency of the economic environment in which the foreign entity operates generally is used as the monetary unit to measure gains and losses.

All income tax determinations are made in the taxpayer's functional currency.¹³ A taxpayer's default functional currency is the U.S. dollar. In most cases, a **qualified business unit (QBU)** operating in a foreign country uses that country's currency as its functional currency. A QBU is a separate and clearly identified unit of a taxpayer's trade or business (e.g., a foreign branch).¹⁴

25-4c Branch Operations

When a foreign branch (QBU) uses a foreign currency as its functional currency, profit or loss is computed in the foreign currency and translated into U.S. dollars for tax purposes. The entire amount of profit or loss, not taking remittances into account, is translated using the average exchange rate for the taxable year. Exchange gain or loss is recognized upon remittances from the QBU. This exchange gain or loss is ordinary, and it is sourced according to the income to which the remittance is attributable.

25-4d Distributions from Foreign Corporations

An actual distribution of E & P from a foreign corporation is included in gross income by the U.S. recipient at the exchange rate in effect on the date of distribution.¹⁵ Thus, no exchange gain or loss is recognized.

¹²ASC 830 (SFAS 52).

¹³§ 985.

¹⁴Reg. § 1.989(a)–1(b). An individual is not a QBU; however, a trade or business conducted by an individual may be a QBU.

¹⁵§ 986(b).

Deemed dividend distributions under Subpart F (discussed later in the chapter) are translated at the average exchange rate for the corporation’s tax year to which the deemed distribution is attributable. Exchange gain or loss can result when an actual distribution of this previously taxed income is made.

25-4e Foreign Taxes

For purposes of the foreign tax credit, foreign taxes accrued generally are translated at the average exchange rate for the tax year to which the taxes relate. Under exceptions to this rule, foreign taxes are translated at the exchange rate in effect when the foreign taxes were paid.¹⁶

LO.5
Work with the U.S. tax provisions affecting U.S. persons earning foreign-source income, including the rules relating to cross-border asset transfers, antideferral provisions, and the foreign tax credit.

25-5 U.S. PERSONS WITH FOREIGN INCOME

U.S. taxpayers often “internationalize” gradually over time. A U.S. business may operate on a strictly domestic basis for several years, then explore foreign markets by exporting its products abroad, and later license its products to a foreign manufacturer or enter into a joint venture with a foreign partner. If its forays into foreign markets are successful, the U.S. business may create a foreign subsidiary and move a portion of its operations abroad by establishing a sales or manufacturing facility.

A domestically controlled foreign corporation can have significant U.S. tax consequences for the U.S. owners, and any U.S. taxpayer paying foreign taxes must consider the foreign tax credit provisions. Foreign businesses likewise enter the U.S. market in stages. In either case, each step generates increasingly significant international tax consequences. Exhibit 25.6 shows a typical timeline for “going global.”

The Big Picture

EXAMPLE

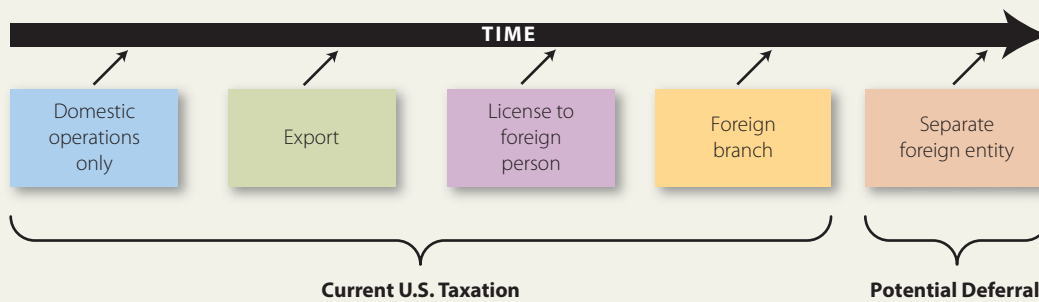
13

Return to the facts of *The Big Picture* on p. 25-1. It appears that VoiceCo has moved along the Exhibit 25.6 Global Activities Timeline, in that it is making export sales, and it has a manufacturing plant in Ireland.

25-5a Export Property

The easiest way for a U.S. enterprise to engage in global commerce is simply to sell U.S.-produced goods and services abroad. These sales can be conducted with little or no foreign presence and allow the business to explore foreign markets without making costly financial commitments to foreign operations.

EXHIBIT 25.6 Global Activities Timeline



¹⁶ §§ 986(a)(1)(B) and (C).

The U.S. tax consequences of simple export sales are straightforward. All such income is taxed in the United States to the U.S. taxpayer. Whether foreign taxes must be paid on this export income depends on the laws of the particular foreign jurisdiction and whether the U.S. taxpayer is deemed to have a foreign business presence there (often called a “permanent establishment”). In many cases, such export income is not taxed by a foreign jurisdiction.

25-5b Cross-Border Asset Transfers

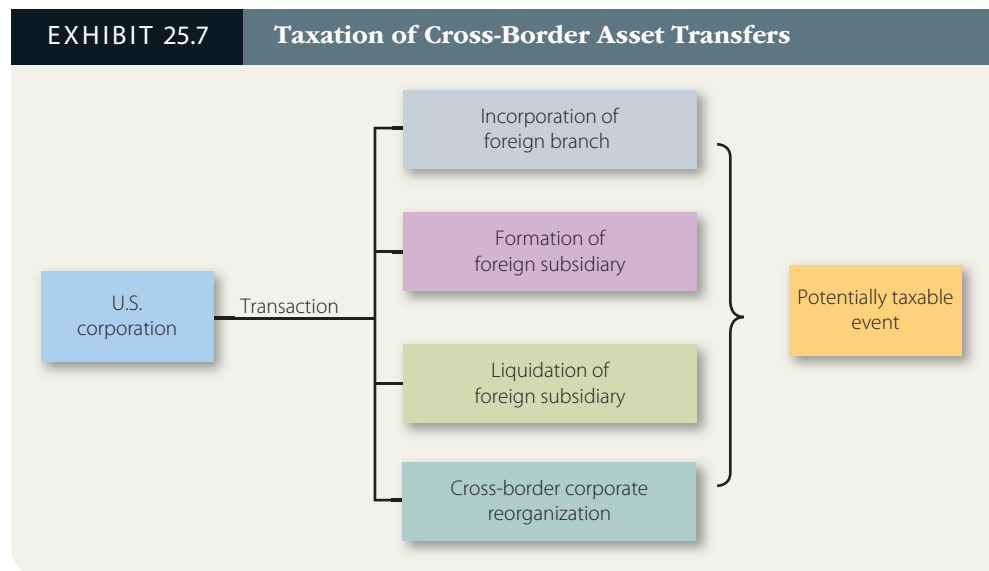
As part of “going international,” a U.S. taxpayer may decide to transfer assets outside the United States so that any foreign business will be conducted outside the U.S. tax jurisdiction. To originate investment through, or provide investment to, a foreign entity, the U.S. taxpayer must make some sort of transfer to the foreign entity. This may take the form of a cash investment or a transfer of assets of a U.S. entity.

In situations where potential taxable income is transferred to a corporation outside the U.S. taxing jurisdiction, the exchange may trigger an income tax. The tax result of transferring property to a foreign corporation depends on the nature of the exchange, the assets involved, the income potential of the property, and the character of the property in the hands of the transferor or transferee. Exhibit 25.7 summarizes the taxation of cross-border asset transfers.

Outbound Transfers

As discussed in Chapter 20, when assets are exchanged for corporate stock in a domestic transaction, realized gain or loss may be deferred rather than recognized. Similarly, deferral treatment may be available when the following “outbound” capital changes occur (i.e., moving corporate business across country borders and outside the United States).

- A U.S. corporation starts up a new corporation outside the U.S. (§ 351).
- A U.S. corporation liquidates a U.S. subsidiary into an existing foreign subsidiary (§ 332).
- A U.S. corporation incorporates a non-U.S. branch of a U.S. corporation, forming a new foreign corporation (§ 351).
- A foreign corporation uses a stock swap to acquire a U.S. corporation (Type “B” reorganization).
- A foreign corporation acquires substantially all of a U.S. corporation’s net assets (Type “C” reorganization).



These otherwise tax-deferred transactions may trigger current taxation when foreign corporations are involved. Usually, gain deferral is not allowed when assets are leaving the U.S. taxing jurisdiction.¹⁷ However, a major exception allows continued tax deferral for assets transferred to a foreign corporation to be used in a trade or business carried on outside the United States.

The trade or business exception does not apply to certain “tainted” assets, and the transfer of these assets outside the United States triggers immediate gain (but not loss) recognition. The following are “tainted” assets for this purpose.

- Inventory (raw goods, work-in-progress, and finished goods).
- Installment obligations and unrealized accounts receivable.
- Foreign currency.
- Property leased by the transferor unless the transferee is the lessee.

These tainted assets are likely to turn over quickly once the asset transfer is completed, and any appreciation is likely to be recognized outside the U.S. taxing jurisdiction. Consequently, § 367 requires recognition of this gain upon transfer of the asset outside the United States.

EXAMPLE

14

Amelia, Inc., a domestic corporation, incorporates its profitable Irish manufacturing branch and creates a new wholly owned foreign corporation, St. George, Ltd., to engage in manufacturing activities in Ireland. The transfer qualifies as tax deferred under § 351. The branch assets have always been used in Ireland. Amelia transfers the following branch assets to St. George upon its creation.

Asset	Tax Basis	Market Value	Built-In Gain/Loss
Raw materials inventory	\$100	\$ 400	\$ 300
Accounts receivable	200	250	50
Manufacturing equipment	450	925	475
Furniture and fixtures	150	50	(100)
Total	<u>\$900</u>	<u>\$1,625</u>	<u>\$ 725</u>

Although the \$725 in realized gain is deferred under § 351, the gain potentially is taxable under § 367 because the assets are leaving the U.S. taxing jurisdiction. The general rule of § 367 is that all of the realized gain is recognized by Amelia. However, because St. George will use the transferred assets in the active conduct of a foreign trade or business, the realized gain remains potentially deferred.

As the inventory and accounts receivable are “tainted assets,” Amelia recognizes a \$350 gain upon the transfer (\$300 gain attributable to inventory and \$50 gain from the accounts receivable). Gain is recognized on an asset-by-asset basis with no offset for losses on other assets.

Inbound and Offshore Transfers

One objective of § 367 is to prevent E & P that has accumulated in U.S.-owned foreign corporations from escaping U.S. taxation. Section 367(b) covers the tax treatment of inbound and offshore transfers with regard to stock of a controlled foreign corporation (CFC). (CFCs are discussed in more detail in a later section.) An example of an inbound transaction is the liquidation of a foreign corporation into a domestic parent under § 332.

25-5c Tax Havens

Many outbound transfers of assets to foreign corporations are to countries with tax rates higher than or equal to the U.S. rate. Thus, tax avoidance is not the motive for such transfers. Some U.S. corporations, however, make their foreign investment in

¹⁷§ 367.



GLOBAL TAX ISSUES Boom in Cross-Border Mergers but No Inversions

Recent years have seen an increase in the number of tax-deferred mergers taking place across national borders. Helen of Troy, the publicly traded cosmetics giant, converted itself from a U.S. corporation into a tax haven corporation without triggering any tax for its shareholders. Once outside the U.S. taxing jurisdiction, the “inverted” company essentially was subject to a territorial tax system, such that non-U.S. income no longer was subject to U.S. corporate income tax.

The U.S. Treasury responded to this transaction by issuing new rules to stop these so-called inversions unless very strict standards were met. A domestic corporation or partnership continues to be treated as domestic if:

- A foreign corporation acquires substantially all of its properties.
- The former shareholders (or partners) of the U.S. corporation (or partnership) hold 80 percent or more of the foreign corporation’s stock after the transaction.

- The foreign corporation does not have substantial business activities in its country of incorporation.

The entity is recognized as foreign only if at least 25 percent of its assets, income, and employees are located in the non-U.S. country where it is domiciled.

One might think that a tax-motivated merger creating a new offshore entity might be a way around the anti-inversion rules. For instance, U.S. income tax on offshore income largely would be avoided if DrugUSA merged with DrugCaymans, an entity based in the Cayman Islands. But Treasury rules limit the tax-effectiveness of such a transaction, even beyond the reach of the statute’s 80 percent test, in effect taxing DrugUSA as though it still were a U.S. entity.

(or through) a tax haven. A **tax haven** is a country where either locally sourced income or residents are subject to zero or low levels of local taxation. A tax haven usually applies minimal rules for a taxpayer to establish residency, and it adopts little or no cooperation in international exchanges of tax and financial information. The Bahamas, Monaco, and Panama, among other countries, often are seen as tax havens.

One method of potentially avoiding taxation is to invest through a foreign corporation incorporated in a tax haven. Because the foreign corporation is a resident of the tax haven, the income it earns is exempt from income tax or subject to low local rates. Tax haven countries also may have in effect provisions limiting the exchange of financial and commercial information.¹⁸

Exhibit 25.8 illustrates this use of a tax haven by a U.S. corporation. The U.S. corporation uses a foreign subsidiary corporation in a low- or no-tax country to earn either investment income or a portion of income from business activities (as illustrated previously in the transfer pricing discussion). Because the foreign subsidiary is not consolidated with the domestic parent under U.S. tax law (i.e., the foreign corporation is not a member of the U.S. corporation’s affiliated group) and is not itself engaged in any U.S. trade or business, the foreign corporation is not subject to U.S. taxation. Without the application of the transfer pricing rules or the Subpart F rules (discussed later), the foreign corporation’s income will escape U.S. taxation until the time that any foreign profits are repatriated back to the U.S. parent as a dividend or similar payment.

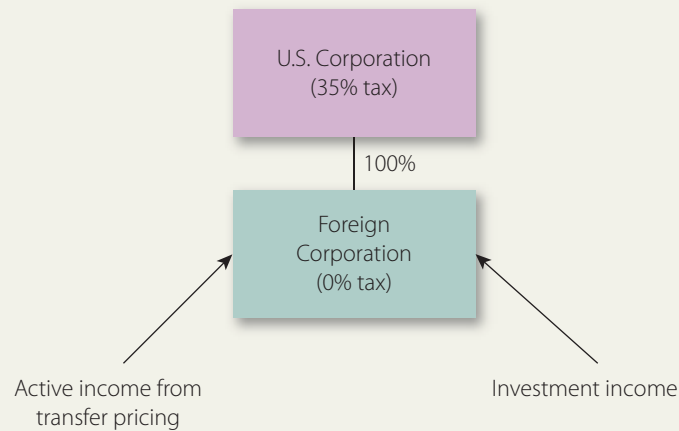
A tax haven also can, in effect, be created by an income tax treaty. For example, under an income tax treaty between Country A and Country B, residents of Country A are subject to a withholding tax of only 5 percent on dividend and interest income sourced in Country B. The United States and Country A have a similar treaty. The United States does not have a treaty with Country B, and the withholding tax is 30 percent. A U.S. corporation can create a foreign subsidiary in Country A and use that subsidiary to make investments in Country B.

This practice often is referred to as **treaty shopping**. If the Country B investment income had been earned directly by the U.S. corporation, it would have been subject to a 30 percent withholding tax. As a result of investing through the foreign subsidiary

¹⁸Additional limitations on the use of treaty benefits are contained in § 894(c).

EXHIBIT 25.8

Use of a Tax Haven Corporation



Without the use of a subsidiary in the tax haven, all of the investment and shifted active income would be taxed at the U.S. tax rate of 35 percent. This tax can be eliminated by shifting some of the taxpayer's assets and operations to the tax haven country.

created in Country A, the U.S. parent corporation pays only 10 percent in foreign taxes on the income earned (i.e., 5 percent to Country B and 5 percent to Country A).

25-5d Foreign Corporations Controlled by U.S. Persons

To minimize current tax liability, taxpayers often attempt to defer the recognition of taxable income. One way to do this is to shift the income-generating activity to a foreign entity that is not within the U.S. taxing jurisdiction. When a foreign corporation is used in this manner, offshore taxable income is not subject to U.S. income tax until it is repatriated to the United States (e.g., through dividend payments). This “defer until repatriation” opportunity allows an effective deferral of income tax, although the related cash amounts in many cases still are isolated outside of the United States. Current estimates of such unrepatriated cash range from \$2 trillion to \$3 trillion.



TAX IN THE NEWS The IRS Watches from Abroad

Taxpayers long have tried to shield information from the IRS about assets and income (e.g., in the proverbial Swiss bank account). Computing resources and cooperation among government taxing authorities make it more difficult to do so than ever before.

The IRS stations agents in Beijing, Hong Kong, Sydney, the British Virgin Islands (BVI), and other jurisdictions where it perceives that taxpayers are shifting financial resources with tax evasion motives. For instance, the Treasury pays attention when it learns that the profits of U.S. corporations entail over 1,000 percent of the GDP of the Cayman Islands and of the BVI. When U.S. profits constitute 38 percent of Ireland's GDP, and 15 percent of that of the Netherlands, something more than just business decisions likely are involved.

It often takes many years to put together a case to show the tax evasion activities of a U.S. person. Typical IRS

weapons include information-sharing agreements among governments and/or taxing agencies, whistleblower programs, and litigation.

The U.S. Foreign Account Tax Compliance Act (FATCA) requires that a bank (even one organized outside the United States) provide the IRS with certain identifying information about all U.S. persons with an account at the bank. Lacking such compliance information, the bank must pay a fine if it wants to hold assets in the United States.

FATCA, along with other efforts to disclose holdings in non-U.S. banks, can be an effective revenue-raiser for the United States. But as Switzerland starts to cooperate with other countries and discloses information about secret bank accounts, some investors move money to similar accounts in less cooperative countries, like Singapore and Hong Kong.

Because of the potential for abuse, Congress has enacted various provisions to limit the availability of deferral.



ETHICS & EQUITY Exporting U.S. Jobs or Improving U.S. Competitiveness?

U.S.-owned foreign corporations with exclusively overseas operations are not subject to U.S. corporate income tax on their profits. Such profits are taxed to the U.S. shareholders only upon repatriation back to the United States as dividends. In some cases, the U.S. shareholders are taxed on profits deemed to be repatriated before any actual distribution (Subpart F income). When there is no Subpart F income, however, U.S. owners of foreign corporations are able to defer indefinitely any U.S. tax on all of their foreign profits. When politicians complain that companies that export jobs are receiving tax breaks, they often are referring to this deferral privilege associated with tax-savvy foreign operations.

U.S. owners of foreign corporations point out that they must compete in a global environment. Many other countries,

such as the Netherlands, do not tax the offshore profits of foreign subsidiaries even if the profits are brought home. If a U.S.-owned foreign corporation cannot at least defer its U.S. taxes, it suffers a competitive disadvantage relative to a Dutch-owned subsidiary, for example. Others argue that the deferral privilege simply creates an unwarranted advantage for companies operating offshore compared with their U.S.-based counterparts.

Which argument do you find more compelling? How do you explain the incentive of tax deferral to U.S. workers whose jobs have moved offshore? How would you explain loss of tax deferral to the U.S. shareholders of a company that pays triple the corporate tax rate of its global competitors?

Controlled Foreign Corporations

Subpart F of the Code provides that certain types of income generated by controlled foreign corporations (CFCs) are included in current-year gross income by the U.S. shareholders, without regard to actual distributions.¹⁹

A **controlled foreign corporation (CFC)** is any non-U.S. corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or the total value of the stock of the corporation, is owned by U.S. shareholders on any day during the taxable year of the foreign corporation. The offshore subsidiaries of most multinational U.S. parent corporations are CFCs.

For purposes of determining whether a foreign corporation is a CFC, a **U.S. shareholder** is defined as a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of the foreign corporation. Stock owned directly, indirectly, and constructively is counted.

For Subpart F to apply, the foreign corporation must have been a CFC for an uninterrupted period of 30 days or more during the taxable year. When this is the case, U.S. shareholders include in gross income their pro rata share of Subpart F income and the increase of the CFC's investment in U.S. property for the tax year. This rule applies to U.S. shareholders who own stock in the corporation on the last day of the tax year or on the last day the foreign corporation is a CFC. The taxpayer includes a proportionate share of gross income in the year in which the CFC's taxable year ends.

Subpart F Constructive Dividends

Gray, Inc., a calendar year corporation, is a CFC for the entire tax year. Chance Company, a U.S. corporation, owns 60% of Gray's one class of stock for the entire year. Subpart F income is \$100,000, and no distributions have been made during the year. Chance, a calendar year taxpayer, includes \$60,000 in gross income as a constructive dividend from Gray for the tax year.

EXAMPLE

15

¹⁹ §§ 951–964.

Subpart F Constructive Dividends

EXAMPLE

16

Groth, Inc., is a CFC until July 1 of the calendar tax year and earns \$100,000 of Subpart F income. Terry, a U.S. citizen, owns 30% of its one class of stock for the entire year. She includes \$14,877 [$\$100,000 \times 30\% \times (181 \text{ days}/365 \text{ days})$] in gross income as a constructive dividend from Groth for the tax year.

Indirect ownership involves stock held through a foreign entity, such as a foreign corporation, foreign partnership, or foreign trust. This stock is considered to be actually owned proportionately by the shareholders, partners, or beneficiaries. Constructive ownership rules, with certain modifications, apply in determining whether a U.S. person is a U.S. shareholder and whether a foreign corporation is a CFC and for certain related-party provisions of Subpart F.²⁰

EXAMPLE

17

A non-U.S. corporation has the following shareholders.

Shareholders	Voting Power	Classification
Alan	30%	U.S. person
Bill (Alan's son)	9%	U.S. person
Carla	40%	Non-U.S. person
Dora	20%	U.S. person
Ed	1%	U.S. person

Alan, Bill, and Dora are U.S. shareholders. Alan owns 39% of the corporation (30% directly and 9% constructively through Bill). Bill also owns 39% of the corporation (9% directly and 30% constructively through Alan). Thus, Bill is a U.S. shareholder. Dora owns 20% directly. The corporation is a CFC because U.S. shareholders own 59% of the voting power.

Ed, a U.S. person, owns 1% and is not related to any of the other shareholders. Thus, Ed is not a U.S. shareholder and does not include any of the Subpart F income in gross income.

If Bill were not related to Alan or to any other U.S. persons who were shareholders, Bill would not be a U.S. shareholder, and the corporation would not be a CFC.

U.S. shareholders include their pro rata share of the applicable income in their gross income only to the extent of their actual ownership.

EXAMPLE

18

Bill, in Example 17, would recognize only 9% of the Subpart F income as a constructive dividend. Alan would recognize 30%, and Dora would recognize 20%.

Subpart F Income A U.S. shareholder of a CFC does not necessarily lose the ability to defer U.S. taxation of income earned by the CFC. Only certain income earned by the CFC triggers immediate U.S. taxation as a constructive dividend. This *Subpart F income* can be characterized as income with little or no economic connection with the CFC's country of incorporation. **Subpart F** income typically includes foreign base company income (FBCI), such as:

- Foreign base company sales income.
- Foreign base company services income.

Foreign base company (FBC) sales income is income derived by a CFC where the CFC has very little connection with the process that generates the income and a related party is involved. If the CFC earns income from the sale of property to customers

²⁰ §§ 958 and 318(a).

outside the CFC's country of incorporation and either the supplier or the customer is related to the CFC, such income is FBC sales income.

Ulysses, Ltd., is a CFC organized in the United Kingdom and owned 100% by Joyce, Inc., a U.S. corporation. Ulysses purchases finished inventory from Joyce and sells the inventory to customers in Hong Kong. This sales income constitutes FBC sales income.

EXAMPLE**19**

An exception applies to property that is manufactured, produced, grown, or extracted in the country in which the CFC was organized or created and to property sold for use, consumption, or disposition within that country. In both of these situations, the CFC has participated in the economic process that generates the income.

If Ulysses, from Example 19, purchases raw materials from Joyce and performs substantial manufacturing activity in the United Kingdom before selling the inventory to customers in Hong Kong, the income is not FBC sales income.

EXAMPLE**20**

Even without the manufacturing activity, sales to customers within the United Kingdom would not produce FBC sales income.

FBC services income is income derived from the performance of services for or on behalf of a related person and performed outside the country in which the CFC was created or organized. Income from services performed in connection with the sale of property by a CFC that has manufactured, produced, grown, or extracted such property is not FBC services income.

Subpart F Income Exceptions A *de minimis* rule provides that if the total amount of a foreign corporation's FBCI for the taxable year is less than the smaller of 5 percent of the CFC's gross income or \$1 million, none of its gross income is treated as FBCI for the tax year. At the other extreme, if a foreign corporation's FBCI exceeds 70 percent of total gross income, all of the corporation's gross income for the tax year is treated as Subpart F income.

FBCI subject to high foreign taxes is not included under Subpart F. The taxpayer must establish that the income was taxed by the other country at an effective rate of more than 90 percent of the maximum Federal corporate income tax rate. For example, the other country's effective income tax rate must be greater than 31.5 percent ($90\% \times 35\%$), where 35 percent represents the highest U.S. corporate rate.

Investment in U.S. Property In addition to Subpart F income, U.S. shareholders include in gross income their pro rata share of the CFC's increase in investment in U.S. property for the taxable year.²¹ U.S. property generally includes U.S. real property, debt obligations of U.S. persons, and stock in certain related domestic corporations. The CFC must have sufficient E & P to support such a deemed dividend.

Fleming, Ltd., a CFC, earned no Subpart F income for the taxable year. If Fleming lends \$100,000 to Lynn, its sole U.S. shareholder, this debt is considered an investment in U.S. property by Fleming because it now owns a U.S. note receivable. Holding the note triggers a constructive dividend of \$100,000 to Lynn, assuming that Fleming has sufficient E & P.

EXAMPLE**21**

Treatment of Previously Taxed Income Distributions from a CFC are treated as being first from E & P attributable to increases in investment in U.S. property previously taxed as a constructive dividend, second from E & P attributable to previously taxed Subpart F income, and third from other E & P. All such distributions reduce E & P. These rules keep Subpart F income from being taxed twice.

²¹§ 956.

EXAMPLE

22

Jet, Inc., a U.S. shareholder, owns 100% of a CFC, from which Jet receives a \$100,000 distribution. The CFC's E & P totals \$120,000 and is composed of the following amounts.

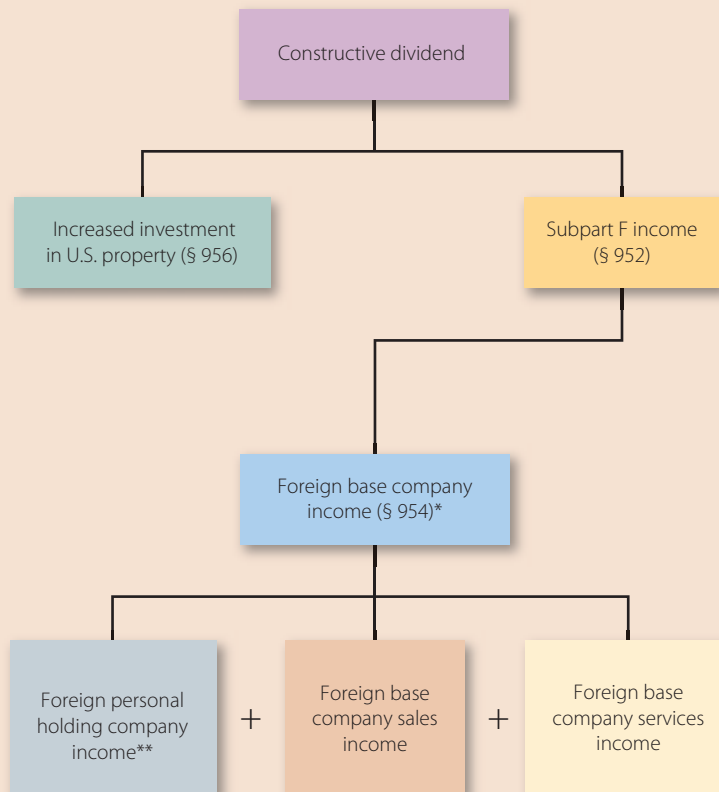
- \$50,000 attributable to previously taxed investment in U.S. property.
- \$30,000 attributable to previously taxed Subpart F income.
- \$45,000 attributable to other E & P.

Jet reports a taxable dividend of only \$20,000, attributable to other E & P. The remaining \$80,000 is drawn from previously taxed income. The CFC's E & P is reduced by \$100,000 (\$80,000 for the previously taxed income and \$20,000 from other E & P; the CFC has \$25,000 of E & P remaining, all "other E & P").

A U.S. shareholder's basis in CFC stock is increased by constructive dividends and decreased by subsequent distributions of previously taxed income. The various constructive dividend possibilities for CFC income appear in Concept Summary 25.2.

Concept Summary 25.2

Income of a CFC That Is Included in Gross Income of a U.S. Shareholder



*Plus all other income when foreign base company exceeds 70% of gross income.

**Not discussed in this chapter.

25-5e Foreign Tax Credit

The United States taxes its citizens and residents on their worldwide taxable income. This approach can result in double taxation for U.S. persons who work or invest abroad.



TAX IN THE NEWS Taxes Take a Smaller Bite Out of Apple

Apple, Inc., is a good case study for how effective tax planning can make a successful tech company even more profitable after taxes are considered. The company's business model produces plenty of free cash flow, but it operates in an industry that is based as much on intellectual property as physical plant and employee productivity. As the current tax laws largely were drafted to operate in a manufacturing and merchandising economy, Apple and other similar companies can exploit to their tax advantage a number of items that a more current tax code might address.

Apple's tax planning appears to follow the letter and the spirit of current tax law. Even though most of Apple's executives, engineers, and designers work in the United States, much of the company's profit is taxed elsewhere. Here are some highlights of how Apple uses current tax laws effectively.

- Over time, the company moves its physical plant to low-tax jurisdictions such as Nevada, Ireland, and the Netherlands.
- The company lobbies for and then uses tax incentives (e.g., for research and experimentation activities) that are offered by the Federal, state, and local government.
- Apple uses tax planning arrangements that create subsidiaries in low-tax countries (e.g., in the British Virgin

Islands). Using proper transfer pricing techniques, sales transactions are routed through the low-tax jurisdictions, and more profits are left after tax for corporate growth and development.

- Another tax-shifting strategy employs so-called commissionaires, who arrange sales of the company's goods but never take possession of any inventory. Thus, Apple's profit derived from the work distributors in high-tax countries is taxed in a low-tax country such as Singapore.

In response to criticism surrounding its tax planning, Apple counters that the company and its employees still pay billions of dollars in payroll, sales, property, and individual income taxes. And Apple's retail stores certainly draw customer traffic that benefits other tenants in shopping malls.

One downside of these tax-shifting strategies is that Apple can defer the Federal income tax on such profits only as long as the related cash remains overseas; a repatriation would trigger high-rate U.S. taxes. The U.S. Treasury might have a good argument if Apple's offshore cash was "idle," but surely most of it is used to grow the business as it operates in a global environment.

To reduce the possibility of double taxation, Congress enacted the **foreign tax credit (FTC)** provisions. Under these provisions, a qualified taxpayer is allowed a tax credit for foreign income taxes paid. The credit is a dollar-for-dollar reduction of U.S. income tax liability.

Ace Tools, Inc., a U.S. corporation, has a branch operation in Mexico, from which it earns taxable income of \$750,000 for the current year. Ace pays income tax of \$150,000 on these earnings to the Mexican tax authorities. Ace also includes the \$750,000 in gross income for U.S. tax purposes.

Before considering the FTC, Ace owes \$255,000 in U.S. income taxes on this foreign-source income. Thus, total taxes on the \$750,000 could equal \$405,000 (\$150,000 + \$255,000), a 54% effective rate. But Ace claims an FTC of \$150,000 against its U.S. tax liability on the foreign-source income. Ace's total taxes on the \$750,000 now are \$255,000 (\$150,000 + \$105,000), a 34% effective rate.

EXAMPLE

23

The FTC is elective for any particular tax year.²² Lacking an election to take the FTC, the taxpayer claims a deduction for foreign taxes paid or incurred. One cannot take a credit and a deduction for the same foreign income taxes.²³ However, a taxpayer can take a deduction in the same year as an FTC for foreign taxes that are not creditable (e.g., non-income taxes).

The Direct Credit

A direct FTC is allowed to U.S. taxpayers that pay or incur a foreign income tax. All of the taxes paid by the taxpayer to various countries on offshore business operations are combined to compute the FTC.

²²§ 901(a).

²³§ 275.

EXAMPLE

24

Snowball, Inc., a U.S. corporation, operates an unincorporated branch manufacturing operation in Australia. On its U.S. tax return, Snowball, Inc., reports \$450,000 of taxable income from the Australian branch and \$650,000 of taxable income from its U.S. operations. Snowball paid \$135,000 in Australian income taxes related to the \$450,000 in branch income. Snowball's U.S. tax liability after the FTC is determined as follows.

Australian branch income	\$ 450,000
U.S. operations income	650,000
Total taxable income	\$1,100,000
U.S. tax rate	× 34%
U.S. income tax before FTC	\$ 374,000
FTC	(135,000)
Net U.S. tax liability	<u>\$ 239,000</u>

Because the effective foreign tax rate (30%) is less than the U.S. rate (34%), the \$135,000 FTC is fully creditable without limitation (see the following discussion under FTC Limitations).

Many governments impose a withholding tax on the gross amount of certain payments of passive income to nonresidents of their countries. Even though the tax is withheld by the payor of the income, the tax is imposed directly on the recipient, who then claims a direct FTC.

EXAMPLE

25

MettCo, Inc., a domestic corporation, receives a \$5,000 dividend from DeanCo, Ltd., a foreign corporation. The foreign country imposes a 20% withholding tax on dividend payments to nonresidents. Accordingly, DeanCo withholds \$1,000 (\$5,000 × 20%) from the dividend and remits this tax to the local country tax authorities. DeanCo pays the remaining \$4,000 to MettCo.

Although MettCo did not directly pay the \$1,000 in foreign tax, the entire amount is a direct tax of MettCo for FTC purposes. MettCo reports \$5,000 in dividend income on its U.S. tax return (the gross amount of the dividend), but it receives an FTC against any U.S. tax for the \$1,000 in foreign withholding tax.

The Indirect Credit

If a U.S. corporation operates in a foreign country through a branch, the direct credit is available for foreign taxes paid. If, however, a U.S. corporation operates in a foreign country through a foreign subsidiary, the direct credit is not available for foreign taxes paid by the foreign corporation.

An indirect credit is available to U.S. corporate taxpayers that receive actual or constructive dividends from foreign corporations that have paid foreign income taxes.²⁴ These foreign taxes are deemed paid by the corporate shareholders in the same proportion as the dividends actually or constructively received bear to the foreign corporation's undistributed E & P.

$$\text{Indirect FTC} = \frac{\text{Actual or constructive dividend}}{\text{Undistributed E \& P}} \times \text{Foreign taxes paid}$$

A domestic corporation that chooses the FTC for deemed-paid foreign taxes must *gross up* (add to income) dividend income by the amount of deemed-paid taxes.²⁵

²⁴§ 902. In the formula for the indirect credit, only foreign taxes paid and E & P generated after 1986 are used.

²⁵§ 78.

Wren, Inc., a domestic corporation, owns 50% of Finch, Inc., a foreign corporation. Wren receives a dividend of \$120,000 from Finch. Finch paid foreign taxes of \$500,000 on its E & P, which totals \$1.2 million. Wren's deemed-paid foreign taxes for FTC purposes are \$50,000.

EXAMPLE

26

Cash dividend from Finch	\$120,000
Deemed-paid foreign taxes	
$\left(\frac{\$120,000}{\$1,200,000} \times \$500,000 \right)$	50,000
Gross income to Wren	\$170,000

The \$50,000 in deemed-paid foreign taxes triggers both gross income and a foreign tax credit.

Certain ownership requirements must be met before the indirect credit is available to a domestic corporation. The domestic corporation must own 10 percent or more of the voting stock of the foreign corporation. The credit also is available for deemed-paid foreign taxes of second- and third-tier foreign corporations if the 10 percent ownership requirement is met at the second- and third-tier level. The indirect credit also is available for foreign taxes paid by fourth- through sixth-tier foreign corporations if additional requirements are met, including the requirement that these corporations be CFCs. The § 902 ownership requirements are summarized in Exhibit 25.9.

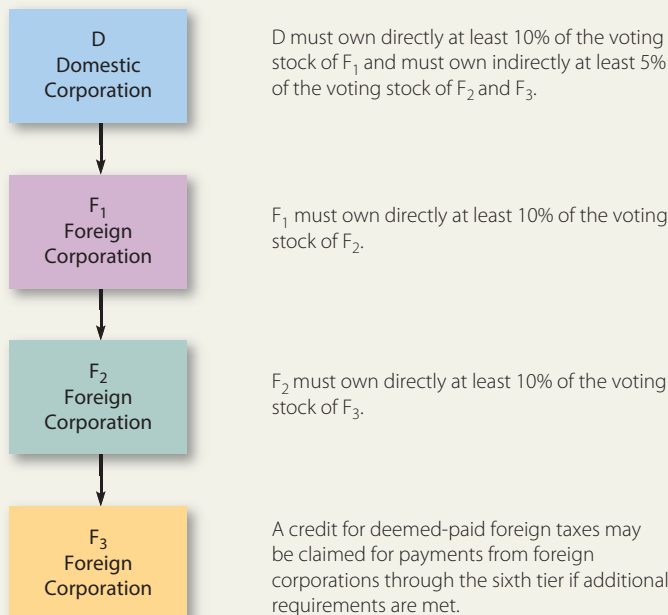
FTC Limitations

To prevent taxpayers from crediting foreign taxes against U.S. taxes levied on U.S.-source taxable income, the FTC is subject to a limitation. The FTC for any taxable year cannot exceed the lesser of two amounts: (1) the actual foreign taxes paid or accrued or (2) the U.S. taxes (before the FTC) on foreign-source taxable income. The FTC limitation is derived in the following manner.

$$\text{FTC limitation} = \frac{\text{Foreign-source taxable income}}{\text{Total taxable income}} \times \text{U.S. tax before FTC}$$

EXHIBIT 25.9

Section 902 Ownership Requirements



EXAMPLE

27

Charlotte, Inc., a domestic corporation that invests in foreign securities, reports total taxable income for the tax year of \$120,000, consisting of \$100,000 in U.S.-source business profits and \$20,000 of income from foreign sources. Foreign taxes of \$9,500 were withheld by foreign tax authorities. Charlotte's U.S. tax before the FTC is \$42,000. The company's FTC is limited to \$7,000 [$\$42,000 \times (\$20,000/\$120,000)$]. Charlotte's net U.S. tax liability is \$35,000.

As Example 27 illustrates, the limitation can prevent the total amount of foreign taxes paid in high-tax jurisdictions from being credited. Taxpayers could overcome this problem by generating additional foreign-source income that is subject to no or low foreign taxation.

EXAMPLE

28

Compare Domestic Corporation's FTC situations. In one, the corporation has only \$500,000 of highly taxed foreign-source income. In the other, Domestic also has \$100,000 of low-taxed foreign-source interest income.

	Only Highly Taxed Income	With Low-Taxed Interest Income
Foreign-source income	\$500,000	\$600,000
Foreign taxes	275,000	280,000
U.S.-source income	700,000	700,000
U.S. taxes (34%)	408,000	442,000
FTC limitation	170,000*	204,000**

* $\$408,000 \times (\$500,000/\$1,200,000)$.

** $\$442,000 \times (\$600,000/\$1,300,000)$.

Domestic's foreign taxes increase by only \$5,000 (\$280,000 – \$275,000), but its FTC limitation increases by \$34,000 (\$204,000 – \$170,000).

Example 28 illustrates a *cross-crediting* of foreign taxes from high- and low-taxed foreign income. To prevent this practice, the FTC rules require that a separate limitation be calculated for each of certain categories (or baskets) of foreign-source taxable income and the foreign taxes attributable to that income. There are two income baskets: passive income and all other (general). Passive income generally is investment-type income; general limitation income is typically from active business sources.

EXAMPLE

29

BenCo, Inc., a U.S. corporation, operates a foreign branch in France that earns taxable income of \$1.5 million from manufacturing operations and \$600,000 from passive activities. BenCo pays foreign taxes of \$600,000 (40%) and \$100,000 (16.67%), respectively, on this foreign-source income. The corporation also earns \$4 million of U.S.-source taxable income, resulting in worldwide taxable income of \$6.1 million. BenCo's U.S. taxes before the FTC are \$2,074,000 (at 34%). The following tabulation illustrates the effect of the separate limitation baskets on cross-crediting.

Foreign Income Category	Net Taxable Amount	Foreign Taxes	U.S. Tax before FTC at 34%	FTC with Separate Limits
General	\$1,500,000	\$600,000	\$510,000	\$510,000
Passive	600,000	100,000	204,000	100,000
Total	<u>\$2,100,000</u>	<u>\$700,000</u>	<u>\$714,000</u>	<u>\$610,000</u>

Without the separate limitation provisions, the FTC would be the lesser of (1) \$700,000 foreign taxes or (2) \$714,000 share of U.S. tax [$\$2,074,000 \times (\$2,100,000/\$6,100,000)$]. The "basket" provisions reduce the FTC by \$90,000 (\$700,000 – \$610,000). In this way, the foreign-source income taxed at the foreign tax rate of 40% cannot be aggregated with foreign-source income taxed at only 16.67%.



FINANCIAL DISCLOSURE INSIGHTS

Overseas Operations and Book-Tax Differences

Non-U.S. operations account for a large portion of the permanent book-tax differences of U.S. business entities. These differences may relate to different tax bases, different tax rate structures, or special provisions concerning tax-based financing with the other country. For instance, lower tax rates applied by Ireland, Bermuda, and the Netherlands recently reduced Cisco's current-year tax liabilities by about \$1 billion per year.

Tax planning strategies using non-U.S. operations also are found in the deferred tax asset and liability accounts. Tax deferrals allowed under current U.S. tax rules and carryforwards of the foreign tax credit can be substantial for some businesses. For example, IBM recently reported a deferred tax asset relating to delays in using its FTCs amounting to about \$500 million. For the operating arm of General Electric, that amount was about \$2 billion.

FTC Carryovers

The various FTC limitations can result in unused (noncredited) foreign taxes for the tax year. The carryback period is 1 year, and the carryforward period is 10 years.²⁶ The taxes can be credited in years when the formula limitation for that year exceeds the foreign taxes attributable to the same tax year.

The carryback and carryforward provisions are available only within a specific basket. In other words, excess foreign taxes in one basket cannot be carried over unless there is an excess limitation in the same basket for the carryover year.

The Alternative Minimum Tax FTC

For purposes of the alternative minimum tax (AMT), the FTC limitation is calculated by using foreign-source alternative minimum taxable income (AMTI) in the numerator and total AMTI in the denominator of the formula and the tentative minimum tax rather than the regular tax.

$$\text{AMT FTC limitation} = \frac{\text{Foreign-source AMTI}}{\text{Total AMTI}} \times \text{Tentative minimum tax}$$

The taxpayer may elect to use regular foreign-source taxable income in the numerator if it does not exceed total AMTI. The AMT FTC limit also is determined on a basket-by-basket basis.

Other Considerations

For a foreign levy to qualify for the FTC, it must be a tax, and its predominant character must be that of an income tax in the U.S. sense.²⁷ A levy is a tax if it is a compulsory payment, rather than a payment for a specific economic benefit such as the right to extract oil. A tax's predominant character is that of an income tax in the U.S. sense if it reaches realized net gain and is not a *soak-up* tax (i.e., does not depend on being credited against the income tax of another country). A tax that is levied in lieu of an income tax also is creditable.²⁸

JonesCo, a domestic corporation, generates \$2 million of taxable income from operations in Larissa, a foreign country. Larissan law levies a tax on income generated in Larissa by foreign residents only in cases in which the country of residence (such as the United States) allows a tax credit for foreign taxes paid. JonesCo will not be allowed an FTC for taxes paid to Larissa, because the foreign tax is a soak-up tax.

EXAMPLE

30

For purposes of the FTC, foreign taxes are attributable to the year in which they are paid or accrued. Taxpayers using the cash method of accounting for tax purposes may elect to take the FTC in the year in which the foreign taxes accrue.²⁹ The election is binding on the taxpayer for the year in which it is made and for all subsequent years.

²⁶§ 904(c).

²⁷Reg. § 1.901-2.

²⁸§ 903 and Reg. § 1.903-1.

²⁹§ 905.

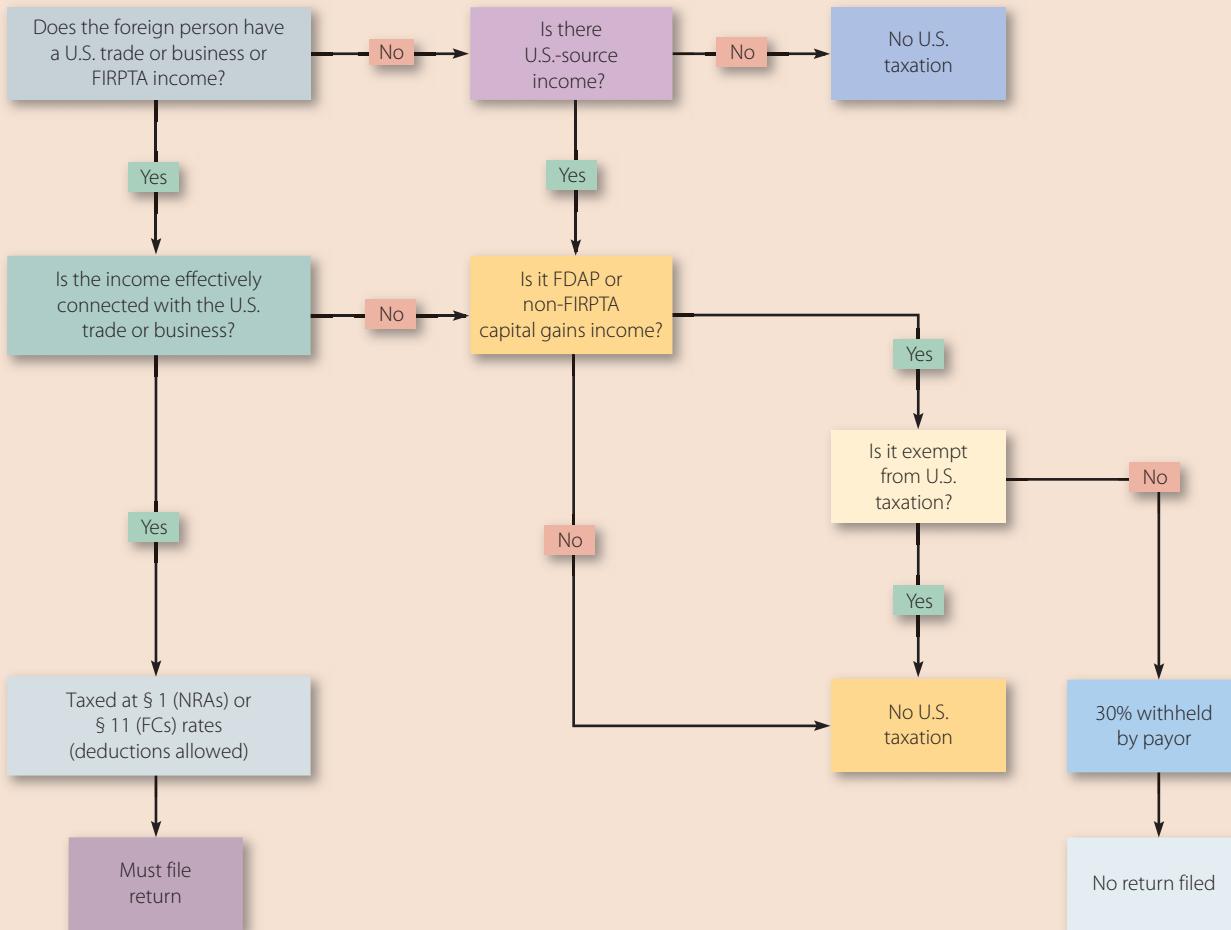
LO.6
 Apply the U.S. tax provisions concerning nonresident alien individuals and foreign corporations.

25-6 U.S. TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

Generally, only the U.S.-source income of nonresident alien individuals and foreign corporations is subject to U.S. taxation. This reflects the reach of the U.S. tax jurisdiction. The constraint, however, does not prevent the United States from also taxing the foreign-source income of nonresident alien individuals and foreign corporations when that income is effectively connected with the conduct of a U.S. trade or business.³⁰ Concept Summary 25.3 summarizes these tax rules.

Concept Summary 25.3

U.S. Taxation of NRAs and Foreign Corporations (FCs)



Note: The presence of a treaty can change the above results.

25-6a Nonresident Alien Individuals

A **nonresident alien (NRA)** individual is not a citizen or resident of the United States. For example, Prince William is an NRA, because he is not a citizen or resident of the United States. Citizenship is determined under the immigration and naturalization laws of the United States.³¹ Usually, citizenship statutes are broken down into two categories: nationality at birth or through naturalization.

³⁰ §§ 871, 881, and 882.

³¹ Title 8, Aliens and Nationality, *United States Code*.

Residency

An individual is a resident of the United States for income tax purposes if he or she meets either the green card test or the substantial presence test.³² If either of these tests is met for the calendar year, the individual is deemed a U.S. resident for the year.

A foreign person issued a green card is considered a U.S. resident on the first day he or she is physically present in the United States after issuance. The green card is Immigration Form I-551. Newly issued cards no longer are green, but the form still is referred to as the “green card.” Status as a U.S. resident remains in effect until the green card has been revoked or the individual has abandoned lawful permanent resident status.

The *substantial presence test* is applied to an alien without a green card. It is a mathematical test involving physical presence in the United States. An individual who is physically present in the United States for at least 183 days during the calendar year is a U.S. resident for income tax purposes.

This 183-day requirement also can be met over a three-year period that includes the two immediately preceding years and the current year, as long as the individual is present in the United States at least 31 days during the current year.³³ For this purpose, each day of the current calendar year is counted as a full day, each day of the first preceding year as one-third day, and each day of the second preceding year as one-sixth day. A nominal presence of 10 days or less can be ignored in determining whether the substantial presence test is met.

Li, who is not a U.S. citizen, was present in the United States for 90 days in 2014, 180 days in 2015, and 110 days in 2016. For Federal income tax purposes, Li is a U.S. resident for 2016, because she was physically present for 185 days $[(90 \text{ days} \times \frac{1}{6}) + (180 \text{ days} \times \frac{1}{3}) + (110 \text{ days} \times 1)]$ during the three-year period.

EXAMPLE

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When counting days of physical presence in the United States, there are several exceptions. Commuters from Mexico and Canada who are employed in the United States but return home each day do not count those work days as days of physical presence. The same is true for individuals who are prevented from leaving the United States by medical conditions that arose while the individuals were in the United States. Some individuals are exempt altogether from the substantial presence test, including foreign government-related individuals (e.g., diplomats), qualified teachers, trainees and students, and certain professional athletes.



ETHICS & EQUITY When Is Cash Repatriated?

Much of the U.S. income tax on the profits of multinational entities is deferred until the profits are repatriated to the United States. One might picture, as part of this deferral technique, overseas bank accounts holding piles of cash for the multinational business, perhaps waiting for a tax holiday or a change in the tax law that would allow the funds to return to the United States.

Change that picture, please. More than half of the “unrepatriated” earnings of Google and Microsoft, generated and held by their non-U.S. subsidiaries, are in U.S. bank accounts or invested in U.S. government or corporate bonds. Legally, such accounts are still “overseas”—at least

until they are moved to a U.S. account of the subsidiary or into the U.S. parent corporation’s control.

One might say that the United States benefits from these arrangements through the purchase of its government securities; Apple, Microsoft, Google, and Cisco alone hold over \$150 billion in U.S. Treasury debt overseas. And the entities probably would rather keep the funds in U.S. investments (or in U.S. bank accounts) to reduce risks associated with their portfolios.

Do you think that, when the profits physically are located in the United States, repatriation has occurred? Or should the legality of the owner of the investment accounts be respected? Is it fair to defer tax payments in this manner?

³²§ 7701(b).

³³§ 7701(b)(3)(A).

Nonresident Aliens Not Engaged in a U.S. Trade or Business

Certain U.S.-source income that is *not* effectively connected with the conduct of a U.S. trade or business is subject to a flat 30 percent tax. This income includes dividends; certain interest; rents; royalties; certain compensation; premiums; annuities; and other income of this type from fixed, determinable, annual, or periodic (FDAP) sources. This tax generally requires the payors of the income to withhold 30 percent of gross amounts.³⁴ This method eliminates the problems of ensuring payment by nonresidents and determining allowable deductions as well as, in most instances, the filing of tax returns by nonresidents.

Interest received from certain portfolio debt investments, even though U.S. sourced, is exempt from taxation when earned by non-U.S. persons. Interest earned on bank deposits also is exempt as long as it is not effectively connected with the conduct of a U.S. trade or business.

Capital gains *not* effectively connected with the conduct of a U.S. trade or business are exempt from this tax, as long as the NRA individual was not present in the United States for 183 days or more during the taxable year. If an NRA has not established a taxable year, the calendar year is used. NRAs are not permitted to carry forward capital losses.³⁵

Nonresident Aliens Engaged in a U.S. Trade or Business

Two important definitions determine the U.S. tax consequences to NRAs with U.S.-source income: “the conduct of a **U.S. trade or business**” and “**effectively connected income**.” Specifically, for an NRA’s noninvestment income to be subject to U.S. taxation, the NRA must be considered engaged in a U.S. trade or business and must earn income effectively connected with that business.

General criteria for determining whether a U.S. trade or business exists include the location of production activities, management, distribution activities, and other business functions. Trading in commodities and securities ordinarily does not constitute a trade or business. Dealers, however, need to avoid maintaining a U.S. trading office and trading for their own accounts.

The Code does not explicitly define a U.S. trade or business, but case law looks for activities carried on in the United States that are regular, substantial, and continuous.³⁶ Once an NRA is considered engaged in a U.S. trade or business, all U.S.-source income other than FDAP and capital gain income is considered effectively connected to that trade or business and is therefore subject to U.S. taxation.

EXAMPLE

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Vito, an NRA, produces wine for export. During the current year, Vito earns \$500,000 from exporting wine to unrelated wholesalers in the United States. The title to the wine passes to the U.S. wholesalers in New York. Vito has no offices or employees in the United States. The income from wine sales is U.S.-source income, but because Vito is not engaged in a U.S. trade or business, the income is not subject to taxation in the United States.

Vito begins operating a hot dog cart in New York City. This activity constitutes a U.S. trade or business. Consequently, all U.S.-source income other than FDAP or capital gain income is taxed in the United States as income effectively connected with a U.S. trade or business. Thus, both the hot dog cart profits and the \$500,000 in wine income are subject to U.S. income tax.

Effectively connected income is taxed at the same rates that apply to U.S. citizens and residents, and deductions for expenses attributable to that income are allowed. NRAs with income effectively connected with the conduct of a U.S. trade or business also are subject to the alternative minimum tax.

25-6b Foreign Corporations

A corporation created or organized in the United States is a domestic corporation. A foreign corporation is one that is not domestic. Thus, although McDonald’s is, in reality, a global corporation, it is considered a domestic corporation for U.S. tax purposes, solely because it was organized in the United States.

³⁴ §§ 871 and 1441.

³⁵ § 871(a)(2).

³⁶ See, for example, *Higgins v. Comm.*, 41-1 USTC ¶9233, 25 AFTR 1160, 61 S.Ct. 475 (1941) and *Continental Trading, Inc. v. Comm.*, 59-1 USTC ¶9316, 3 AFTR 2d 923, 265 F.2d 40 (CA-9, 1959).



FINANCIAL DISCLOSURE INSIGHTS Deferred Tax Assets Overseas

U.S. corporations are not the only entities that can have balance sheets with excessive deferred tax accounts. Restrictive regulatory rules as to how non-U.S. banks compute their capital amounts tend to create large deferred tax assets for them.

Deferred tax assets do not affect the entity's actual cash balances, but they can affect the stock price in the short term. Even professional equity analysts can have difficulty understanding announcements of tax adjustments to the balance sheet.

The following are estimates from JPMorgan Chase of the magnitude of deferred tax asset balances for selected banks overseas and banks in the United States.

	Percentage of Shareholder Equity Constituted by Deferred Tax Assets
Dexia	44%
Deutsche Bank	24
Monte dei Paschi	23
UBS	21
Credit Suisse	20
U.S. banks, average	11

Foreign corporations are taxed very much like NRAs. Capital gain income is exempt and a flat 30 percent tax rate is applied to U.S.-source FDAP income items if they are not effectively connected with a U.S. trade or business. Foreign corporations conducting a trade or business in the United States are subject to Federal income taxation on any U.S.-source income effectively connected with the trade or business.

Branch Profits Tax

The objective of the **branch profits tax** is to afford equal tax treatment to income generated by a domestic corporation controlled by a foreign corporation and to income generated by other U.S. operations controlled by foreign corporations. If the foreign corporation operates through a U.S. subsidiary (a domestic corporation), the income of the subsidiary is taxable by the United States when earned. A withholding tax applies when the branch income is repatriated (returned as dividends to the foreign parent).

In addition to the income tax imposed on effectively connected income of a foreign corporation, a tax equal to 30 percent of the **dividend equivalent amount (DEA)** for the taxable year is imposed on any foreign corporation with effectively connected income.³⁷ The DEA is the foreign corporation's effectively connected earnings for the taxable year, adjusted for increases and decreases in the corporation's U.S. net equity (investment in the U.S. operations).

The DEA is limited to E & P that is effectively connected, or treated as effectively connected, with the conduct of a U.S. trade or business. U.S. net equity is the sum of money and the aggregate adjusted basis of assets and liabilities directly connected to U.S. operations that generate effectively connected income.

Robin, Inc., a foreign corporation, operates a U.S. branch. It reports the following tax results and other information for the year.

Pretax earnings effectively connected with a U.S. trade or business	\$2,000,000
U.S. corporate tax (at 34%)	680,000
Remittance to home office	1,000,000
Increase in U.S. net equity	320,000

Robin's DEA and branch profits tax are computed as follows.

E & P effectively connected with a U.S. trade or business	\$1,320,000
(\$2,000,000 – \$680,000)	
Less: Increase in U.S. net equity	(320,000)
Dividend equivalent amount	\$1,000,000
Branch profits tax rate	× 30%
Branch profits tax	<u>\$ 300,000</u>

EXAMPLE

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³⁷§ 884.



GLOBAL TAX ISSUES Responses to Tax Increases

Taxpayers sometimes react to an increase in a tax bill in ways that affect many others. Famed French actor Gerard Depardieu recently renounced his citizenship rather than pay the country's temporary 75 percent tax on high earners. He now lives in Belgium and is a citizen of Russia.

The balance of power in European soccer also was affected by the French tax increase. Star players have moved to teams in Monaco, where the income tax rate is zero. Monaco pays its bills by applying a sales tax with a rate of about 20 percent. French soccer team owners say that

the tax will limit their ability to attract top players and lead to the "death of football (soccer) in France."

Income taxes in Italy often are subject to outright evasion. Seemingly, the fashion industry there routinely battles over taxes, resulting in large underpayments. The owners of Dolce & Gabbana were the latest to be caught. They used a shell corporation in the tax haven Luxembourg to shelter over \$1 billion in profits. The designers were required to pay over \$500 million in back taxes and spend 20 months in prison. In prior years, the owners of Gucci, Armani, Versace, and Etro fashion houses were found guilty of tax fraud.

The 30 percent rate of the branch profits tax may be reduced or eliminated by a treaty provision. If a foreign corporation is subject to the branch profits tax, no other U.S. tax is levied on the dividend actually paid by the corporation during the taxable year.

25-6c Foreign Investment in Real Property Tax Act

Prior to 1980, NRAs and foreign corporations could avoid U.S. taxation on gains from the sale of U.S. real estate if the gains were treated as capital gains and were not effectively connected with the conduct of a U.S. trade or business. In the mid-1970s, mid-western farmers pressured Congress to eliminate what they saw as a tax advantage that would allow nonresidents to bid up the price of farmland. This and other concerns about foreign ownership of U.S. real estate led to the enactment of the **Foreign Investment in Real Property Tax Act (FIRPTA)** of 1980.

Under FIRPTA, gains and losses realized by NRAs and foreign corporations from the sale or other disposition of U.S. real property interests (USRPIs) are treated as effectively connected with the conduct of a U.S. trade or business even when those individuals or corporations are not actually so engaged. Any direct interest in real property situated in the United States and any interest in a domestic corporation (other than solely as a creditor) are U.S. real property interests.

NRA individuals must pay a tax equal to the lesser of two amounts: (1) 26 (or 28) percent of their alternative minimum taxable income, or (2) regular U.S. rates on the net U.S. real property gain for the taxable year.³⁸ Any purchaser or agent acquiring a USRPI from a foreign person must withhold 10 percent of the amount realized on the disposition.³⁹

25-6d Expatriation to Avoid U.S. Taxation

U.S. taxation of U.S.-source income is required of individuals who relinquished their U.S. citizenship within 10 years of deriving that income if they gave up their citizenship to avoid U.S. taxation. Furthermore, NRAs who lost U.S. citizenship within a 10-year period immediately preceding the close of the tax year must pay taxes on their U.S.-source income as though they were still U.S. citizens. This provision applies only if the expatriation had as one of its principal purposes the avoidance of U.S. taxes. Individuals are presumed to have a tax avoidance purpose if they meet either of the following criteria.⁴⁰

- Average annual net income tax for the five taxable years ending before the date of loss of U.S. citizenship is more than \$160,000 in 2015 (\$157,000 in 2014).
- Net worth as of that date is at least \$2 million.

³⁸§ 897.

³⁹§ 1445.

⁴⁰§ 877(a)(2). The dollar amounts are adjusted for inflation each year.

These provisions also apply to “long-term lawful permanent residents” who cease to be taxed as U.S. residents. A long-term permanent resident is an individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least 8 taxable years during the previous 15-year period . An exception applies to certain individuals with dual citizenship.

The United States continues to treat individuals as U.S. citizens or residents until the taxpayers provide required information and an expatriation notice. Expatriates who are subject to the 10-year rule outlined previously must file an information disclosure statement annually. If an expatriate is physically present in the United States for more than 30 days during a calendar year during the 10-year period, the individual is taxed as a U.S. citizen or resident.⁴¹ These expatriation rules, taken as a whole, make it difficult to give up U.S. citizenship or residency simply to avoid U.S. taxation.

25-7 TAX PLANNING

25-7a The Foreign Tax Credit Limitation and Sourcing Provisions

The FTC limitation is partially based on the amount of foreign-source taxable income in the numerator of the limitation formula. Consequently, the sourcing of income is extremely important. Income that is taxed by a foreign tax jurisdiction benefits from the FTC only to the extent that it is classified as foreign-source income under U.S. tax law. Thus, elements that affect the sourcing of income, such as the place of title passage, should be considered carefully before a transaction is undertaken.

It may be possible for a U.S. corporation to alleviate the problem of excess foreign taxes by using the following techniques.

- Generate “same basket” foreign-source income that is subject to a tax rate lower than the U.S. tax rate.
- Reduce highly taxed foreign-source income in favor of foreign-source income that is taxed at a lower rate, by shifting operations or intangibles.
- Time the repatriation of foreign-source earnings to coincide with “excess limitation” years.
- Deduct foreign taxes for years when the deduction benefit would exceed the FTC benefit.
- Convert deductions related to foreign-source income so that they are related to U.S.-source income instead.

Increasing the FTC

Della, Inc., a U.S. corporation, reports U.S.-source taxable income of \$200,000, total taxable income of \$300,000, and a U.S. tax liability (before the FTC) of \$105,000. Della receives foreign-source taxable income, pays foreign income taxes, and computes an FTC as shown.

EXAMPLE

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Basket	Amount	Foreign Taxes	FTC Limitation	Allowed FTC
Passive	\$ 80,000	\$ 8,000	\$28,000	\$ 8,000
General	20,000	8,000	7,000	7,000
	<u>\$100,000</u>	<u>\$16,000</u>		<u>\$15,000</u>

If Della can shift \$10,000 of passive income into the general basket, the FTC is increased by \$1,000. The FTC limitation for the general basket increases to \$10,500 $[(\$30,000/\$300,000) \times \$105,000]$. This allows all \$8,000 of foreign taxes related to the general basket to be credited in the current year. The allowed FTC for the passive basket remains unchanged at \$8,000.

⁴¹§ 877(g)(1).

Increasing the FTC

EXAMPLE

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Donohoe, Inc., a U.S. corporation, reports total U.S. taxable income of \$100,000, classified as follows.

	Total	U.S.-Source Income	Foreign-Source Income—General
Gross income	\$150,000	\$100,000	\$ 50,000
Deductions	(50,000)	(40,000)	(10,000)
Taxable income	<u>\$100,000</u>	<u>\$ 60,000</u>	<u>\$ 40,000</u>

U.S. income tax before the FTC is \$34,000, and Donohoe's FTC limitation is \$13,600 ($\$40,000 / \$100,000 \times \$34,000$). If, through planning and analysis, Donohoe is able to convert \$5,000 of the deductions related to foreign-source income to U.S. source, the total taxable income would remain the same, but the FTC limitation would increase to \$15,300 ($\$45,000 / \$100,000 \times \$34,000$).

25-7b The Foreign Corporation as a Tax Shelter

An NRA who is able to hold U.S. investments through a foreign corporation can accomplish much in the way of avoiding U.S. taxation. Capital gains (other than dispositions of U.S. real property interests) are not subject to U.S. taxation. This assumes that they are not effectively connected with a U.S. trade or business. The NRA can dispose of the stock of a foreign corporation that holds U.S. real property and not be subject to taxation under FIRPTA. Furthermore, the stock of a foreign corporation is not included in the U.S. gross estate of a deceased NRA, even if all of the assets of the foreign corporation are located in the United States.

Caution is advised when the foreign corporation may generate income effectively connected with the conduct of a U.S. trade or business. The income may be taxed at a higher rate than if the NRA individually generated the income. The tradeoff between a higher U.S. tax on this income and protection from the U.S. estate tax and FIRPTA must be weighed.

25-7c Planning under Subpart F

Careful timing of investment in U.S. property can reduce the potential for constructive dividend income to U.S. shareholders. The gross income of U.S. shareholders attributable to investment in U.S. property is limited to the E & P of the CFC.⁴² E & P that is attributable to amounts that have been included in gross income as Subpart F income in either the current year or a prior tax year is not taxed again when invested in U.S. property.

25-7d Using the Check-the-Box Regulations

The check-the-box Regulations provide a great deal of flexibility for U.S.-based multinational corporations. Corporations can organize their branches and subsidiaries around the world in ways that optimize both local country and U.S. taxation. For example, a U.S. corporation may choose to treat its subsidiary in the United Kingdom as a partnership or unincorporated branch for U.S. tax purposes (thus taking advantage of loss flow-throughs) and a corporation under United Kingdom law (where certain tax and liability benefits may exist).

25-7e Transferring Intangible Assets Offshore

In many industries, a company's intangible assets, such as licenses and patents, produce a relatively large share of total income. For example, the license to use a

⁴² §§ 959(a)(1) and (2).

software program is much more valuable than the actual file that the customer acquires; thus, a large part of the profit from the sale of software accrues to the license holder.

Unlike manufacturing plants, intangible assets can be easily transferred to related entities outside the United States. Congress recognized this potential, and current year gain is recognized if intangibles are transferred outside the United States. To avoid this cross-border “toll charge,” companies should consider creating their intangibles offshore so that no subsequent transfer is required. Companies further may choose to perform their R&D activities within subsidiaries located in tax haven countries to create and keep their valuable intangibles in low-tax jurisdictions.

25-7f **Transfer Pricing**

U.S. multinational companies earn income across many different jurisdictions and operate through several different types of entities (e.g., subsidiary corporations, joint ventures, and partnerships). With proper planning and documentation, a U.S. corporation can organize its intercompany payments for goods and services, interest on debt, and royalties for use of intangible property in such a way as to minimize its worldwide tax burden. For example, a U.S. multinational may choose to borrow in high-tax jurisdictions (where the interest deduction will be more valuable) and earn royalty income in low-tax jurisdictions (where the income escapes heavy taxation).

REFOCUS ON THE BIG PICTURE

GOING INTERNATIONAL

Now you can address the questions about VoiceCo’s activities that were posed at the beginning of the chapter. Simply selling into a foreign jurisdiction may not trigger any overseas income tax consequences, but such income is taxed currently to VoiceCo in the United States. When VoiceCo sets up an Irish corporation, it benefits from deferral because as a manufacturer, it can avoid deemed dividends under Subpart F. However, passive-basket income may be earned by the Irish subsidiary.

VoiceCo must file Form 5471 to report the activities of its foreign subsidiary. If VoiceCo receives dividends from its foreign subsidiary, it can claim indirect foreign tax credits. What are the foreign tax implications if VoiceCo “checks the box” on its foreign subsidiary? The U.S. tax implications?

What If?

Suppose that although VoiceCo’s European sales become a substantial part of its total revenues, it decides not to create a foreign subsidiary. Instead, because shipping costs are high and customers demand quick turnaround on product orders, VoiceCo decides to license its design and manufacturing process to a local European musical instruments company for sales in Europe. The European company pays VoiceCo a royalty equal to 25 percent of the sales price on all of its sales of microphones based on VoiceCo’s design. The royalty income is foreign-source income (as the underlying intangible property is exploited outside the United States).

The European country imposes a 5 percent withholding tax on all royalty payments to VoiceCo. The royalties are part of its worldwide income and so are currently taxed to VoiceCo in the United States. Will VoiceCo receive a foreign tax credit for the withholding tax?



Key Terms

Branch profits tax, 25-31	Functional currency, 25-13	Tax haven, 25-17
Controlled foreign corporation (CFC), 25-19	Inbound taxation, 25-3	Tax treaties, 25-4
Dividend equivalent amount (DEA), 25-31	Nonresident alien (NRA), 25-28	Transfer pricing, 25-10
Effectively connected income, 25-30	Outbound taxation, 25-3	Treaty shopping, 25-17
Foreign Investment in Real Property Tax Act (FIRPTA), 25-32	Qualified business unit (QBU), 25-13	U.S. shareholder, 25-19
Foreign tax credit (FTC), 25-23	Subpart F, 25-20	U.S. trade or business, 25-30

Discussion Questions

- LO.1** “U.S. persons are taxed on their worldwide income.” Explain.
 - LO.1, 5** Liang, a U.S. citizen, owns 100% of ForCo, a foreign corporation not engaged in a U.S. trade or business. Is Liang subject to any U.S. income tax on her dealings with ForCo? Explain.
- Issue ID**
- LO.5** Randall operates his distribution business in several countries. He wants to move some equipment to a new office in South Africa. This equipment includes assets with a large acquisition price and accumulated MACRS depreciation. The assets to be transferred would generate a \$1 million realized gain if sold. Advise Randall on the tax effects of his proposed asset transfer.
- Communications**
- LO.5** Joy Marcus owns several income-producing assets, including a stock portfolio and a small services proprietorship. She wants to start up a new corporation in the country Molto, where the income tax rates are about one-third of those in the United States, and transfer all of her assets and operations there.
How tax-effective is Joy’s plan in shifting the income from her activities when they are placed in the Molto corporation? Write a memo for the tax research file highlighting the Federal income tax rules that apply.
 - LO.5** Five unrelated U.S. individuals own all of the shares of Popping, a corporation organized in the United States but operating fully in the country Vivace. Mariam, one of the shareholders, asks you whether the income from Popping will be taxed to her immediately as earned, as she believes the entity is classified as “a controlled foreign company (CFC).” Explain how the Federal income tax law applies to the profits earned by Popping. Use the correct Federal income tax terminology in your comments.
 - LO.5** QuinnCo could not claim all of the income taxes it paid to Japan as a foreign tax credit (FTC) this year. What computational limit probably kept QuinnCo from taking its full FTC? Explain.
- Issue ID**
- LO.5** Molly, Inc., a domestic corporation, owns 15% of PJ, Inc., and 12% of Emma, Inc., both foreign corporations. Molly is paid gross dividends of \$35,000 and \$18,000 from PJ and Emma, respectively. PJ withheld and paid more than \$10,500 in foreign taxes on the \$35,000 dividend.
PJ’s country of residence levies a 20% tax on dividends paid to nonresident corporations. However, the tax rate is increased to 30% if the recipient is a resident of a country that provides an FTC. Taxes of \$3,600 are withheld on the dividend from Emma.
What tax issues must be considered in determining the availability and amount of the FTC allowed to Molly, Inc.?
 - LO.5** HiramCo, a U.S. entity, operates a manufacturing business in both Mexico and Costa Rica, and it holds its investment portfolio in Sweden. How many foreign tax credit computations must HiramCo make? Be specific, and use the term *basket* in your answer.

9. **LO.6** Write a memo for the tax research file on the difference between “inbound” and “outbound” activities in the context of U.S. taxation of international income. **Communications**
10. **LO.1, 3, 5** Draft a short speech that you will give to your university’s Business Club. **Communications**
The title of your talk is “What Is Worldwide Taxation and How Can I Avoid It?”

Computational Exercises

11. **LO.3** Shonda receives dividend income from the following foreign and domestic corporations in the current tax year.

Corporation	Dividends Received	% of U.S. Income for Past 3 Years
Silver (foreign)	\$1,500	35%
Bronze (domestic)	1,000	20%
Copper (domestic)	2,000	80%

Determine the amount of U.S.-sourced income for each corporation.

12. **LO.5** Cordeio, Inc. is a CFC for the entire tax year. Vancy Company, a U.S. corporation, owns 75% of Cordeio’s one class of stock for the entire year. Subpart F income is \$450,000, and no distributions have been made during the year. Both entities use the calendar tax year.
- What amount does Vancy include in gross income as a constructive dividend for the tax year?
 - Assume that Cordeio Inc., is a CFC until March 1 of the calendar tax year. What amount does Vancy include in gross income as a constructive dividend for the tax year?
13. **LO.5** Enders, Inc., a domestic corporation that invests in foreign securities, reports total taxable income for the tax year of \$290,000, consisting of \$208,800 in U.S.-source business profits and \$81,200 of income from foreign sources. Foreign taxes of \$24,000 were withheld by foreign tax authorities. Enders’s U.S. tax before the FTC is \$78,000. Compute Enders’s FTC for the tax year.
14. **LO.5** Klein, a domestic corporation, receives a \$10,000 dividend from ForCo, a wholly owned foreign corporation. The deemed-paid FTC associated with this dividend is \$3,000. What is the total gross income included in Klein’s tax return as a result of this dividend?
15. **LO.6** Velocity, Inc., a foreign corporation, operates a U.S. branch. It reports the following tax results and other information for the year.

Pretax earnings effectively connected with a U.S. trade or business	\$900,000
U.S. corporate tax (at 34%)	306,000
Remittance to home office	400,000
Increase in U.S. net equity	194,000

- Compute Velocity’s dividend equivalent amount for the tax year.
- Determine Velocity’s liability for the branch profits tax for the year.

Problems

16. **LO.4,5** BlueCo, a domestic corporation, incorporates GreenCo, a new wholly owned entity in Germany. Under both German and U.S. legal principles, this entity is a corporation. BlueCo faces a 35% U.S. tax rate.

GreenCo earns \$1,500,000 in net profits from its German activities and makes no dividend distributions to BlueCo. How much U.S. income tax will BlueCo pay for the current year as a result of GreenCo's earnings, assuming no deemed dividend under Subpart F? Ignore any FTC implications.

17. **LO.3** Emma, a U.S. resident, received the following income items for the current tax year. Identify the source of each income item as either U.S. or foreign.
- \$600 interest from a savings account at a Florida bank.
 - \$5,000 dividend from U.S. Flower Company, a U.S. corporation that operates solely in the eastern United States.
 - \$7,000 dividend from Stern Corporation, a U.S. corporation that had total gross income of \$4 million from the active conduct of a foreign trade or business for the immediately preceding three tax years. Stern's total gross income for the same period was \$5 million.
 - \$10,000 dividend from International Consolidated, Inc., a foreign corporation that had gross income of \$4 million effectively connected with the conduct of a U.S. trade or business for the immediately preceding three tax years. International's total gross income for the same period was \$12 million.
 - \$5,000 interest on Warren Corporation bonds. Warren is a U.S. corporation that derived \$6 million of its gross income for the immediately preceding three tax years from operation of an active foreign business. Warren's total gross income for this same period was \$7.2 million.

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18. **LO.3** Gloria Martinez, an NRA, is a professional golfer. She played in seven tournaments in the United States in the current year and earned \$250,000 in prizes from these tournaments. She deposited the winnings in a bank account she opened in Mexico City after her first tournament win.

Gloria played a total of 30 tournaments for the year and earned \$800,000 in total prize money. She spent 40 days in the United States, 60 days in England, 20 days in Scotland, and the rest of the time in South America. Write a letter to Gloria explaining how much U.S.-source income she will generate, if any, from her participation in these tournaments and whether any of her winnings are subject to U.S. taxation. Gloria's address is AV Rio Branco, 149-4#, Rio de Janeiro, RJ 20180, Brazil.

19. **LO.3** Determine whether the source of income for the following sales is U.S. or foreign.
- Suarez, an NRA, sells stock in Home Depot, a U.S. corporation, through a broker in San Antonio.
 - Chris sells stock in IBM, a U.S. corporation, to her brother, Rich. Both Chris and Rich are NRAs, and the sale takes place outside the United States.
 - Crows, Inc., sells inventory produced in the United States to customers in Europe. Title passes in the international waters of the Atlantic Ocean.
 - Doubles, Inc., a U.S. corporation, manufactures equipment in Malaysia and sells the equipment to customers in the United States.
20. **LO.3** Chock, a U.S. corporation, purchases inventory for resale from distributors within the United States and resells this inventory at a \$1 million profit to customers outside the United States. Title to the goods passes outside the United States. What is the sourcing of Chock's inventory sales income?
21. **LO.3** Willa, a U.S. corporation, owns the rights to a patent related to a medical device. Willa licenses the rights to use the patent to IrishCo, which uses the patent in its manufacturing facility located in Ireland. What is the sourcing of the \$1 million royalty income received by Willa from IrishCo for the use of the patent?

22. **LO.3** USCo incurred \$100,000 in interest expense for the current year. The tax book value of USCo's assets generating foreign-source income is \$5 million. The tax book value of USCo's assets generating U.S.-source income is \$45 million. How much of the interest expense is allocated and apportioned to foreign-source income?
23. **LO.3** Create, Inc., produces inventory in its foreign manufacturing plants for sale in the United States. Its foreign manufacturing assets have a tax book value of \$5 million and a fair market value of \$15 million. Its assets related to the sales activity have a tax book value of \$2 million and a fair market value of \$5 million. Create's interest expense totaled \$400,000 for the current year.
- What amount of Create's interest expense is allocated and apportioned to foreign-source income using the tax book value method? Using the fair market method?
 - If Create wants to maximize its FTC, which method should it use?
24. **LO.4** Honk, Inc., a U.S. corporation, purchases weight-lifting equipment for resale from HiDisu, a Japanese corporation, for 60 million yen. On the date of purchase, 80 yen is equal to \$1 U.S. (¥80:\$1). The purchase is made on December 15, 2015, with payment due in 90 days. Honk is a calendar year taxpayer. On December 31, 2015, the foreign exchange rate is ¥84:\$1.
- On February 2, 2016, the invoice is paid when the exchange rate is ¥85:\$1. What amount of foreign currency gain or loss, if any, must Honk recognize for 2015 as a result of this transaction? For 2016?
25. **LO.4,5** Teal, Inc., a foreign corporation, pays a dividend to its shareholders on November 30. Red, Inc., a U.S. corporation and 7% shareholder in Teal, receives a dividend of 10,000K (a foreign currency). Pertinent exchange rates are as follows.

November 30	.9K:\$1
Average for year	.7K:\$1
December 31	2K:\$1

What is the dollar amount of the dividend received by Red, Inc.? Does Red have a foreign exchange gain or loss on receipt of the dividend?

26. **LO.5** Packard, Inc., a domestic corporation, operates a branch in Mexico. Over the last 10 years, this branch has generated \$30 million in losses. For the last 3 years, however, the branch has been profitable and has earned enough income to entirely offset the prior losses. Most of the assets are fully depreciated, and a net gain would be recognized if the assets were sold.
- Packard's CFO believes that Packard should incorporate the branch now, so that this potential gain can be transferred to a foreign corporation, thereby avoiding U.S. tax and, as an added benefit, avoiding U.S. taxes on future income. Draft a memo to Samuel Henderson, the CFO, addressing the tax issues involved in the proposed transaction.
27. **LO.5** USCo owns 65% of the voting stock of LandCo, a Country X corporation. Terra, an unrelated Country Y corporation, owns the other 35% of LandCo. LandCo owns 100% of the voting stock of OceanCo, a Country Z corporation. Assuming that USCo is a U.S. shareholder, do LandCo and OceanCo meet the definition of a CFC? Explain.
28. **LO.5** Hart Enterprises, a U.S. corporation, owns 100% of OK, Ltd., an Irish corporation. OK's gross income for the year is \$10 million. Determine OK's Subpart F income (before any expenses) from the transactions that it reported this year.
- OK received \$600,000 from sales of products purchased from Hart and sold to customers outside Ireland.
 - OK received \$1 million from sales of products purchased from Hart and sold to customers in Ireland.

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- c. OK received \$400,000 from sales of products purchased from unrelated suppliers and sold to customers in Germany.
 - d. OK purchased raw materials from Hart, used these materials to manufacture finished goods, and sold these goods to customers in Italy. OK earned \$300,000 from these sales.
 - e. OK received \$100,000 for the performance of warranty services on behalf of Hart. These services were performed in Japan for customers located in Japan.
 - f. OK received \$50,000 in dividend income from investments in Canada and Mexico.
29. **LO.5** Brandy, a U.S. corporation, operates a manufacturing branch in Chad, which does not have an income tax treaty with the United States. Brandy's worldwide Federal taxable income is \$30 million, so it is subject to a 35% marginal tax rate. Profits and taxes in Chad for the current year are summarized as follows. Compute Brandy's foreign tax credit associated with its operations in Chad.

Income Item	Chad Income This Year	Chad Tax Rate	Chad Tax Paid
Manufacturing profits	\$2,500,000	20%	\$500,000
Dividend	300,000	5%	15,000

30. **LO.5** Weather, Inc., a domestic corporation, operates in both Fredonia and the United States. This year, the business generated taxable income of \$600,000 from foreign sources and \$900,000 from U.S. sources. All of Weather's foreign-source income is in the general limitation basket. Weather's total taxable income is \$1.5 million. Weather pays Fredonia taxes of \$228,000. What is Weather's FTC for the tax year? Assume a 34% U.S. income tax rate.
31. **LO.5** Blunt, Inc., a U.S. corporation, earned \$600,000 in total taxable income, including \$80,000 in foreign-source taxable income from its German branch's manufacturing operations and \$30,000 in foreign-source taxable income from its Swiss branch's engineering services operations. Blunt paid \$32,000 in German income taxes and \$1,800 in Swiss income taxes. Compute Blunt's U.S. tax liability after any available FTCs. Blunt's marginal U.S. tax rate is 34%.
32. **LO.5** Dunne, Inc., a U.S. corporation, earned \$500,000 in total taxable income, including \$50,000 in foreign-source taxable income from its branch manufacturing operations in Brazil and \$20,000 in foreign-source income from interest earned on bonds issued by Dutch corporations. Dunne paid \$25,000 in Brazilian income taxes and \$3,000 in Dutch income taxes. Compute Dunne's U.S. tax liability after any available FTCs. Assume that the U.S. tax rate is 34%.
33. **LO.5** ABC, Inc., a domestic corporation, has \$50 million of taxable income, including \$15 million of general limitation foreign-source taxable income, on which ABC paid \$5 million in foreign income taxes. The U.S. tax rate is 35%. What is ABC's foreign tax credit?
34. **LO.5** Mary, a U.S. citizen, is the sole shareholder of CanCo, a Canadian corporation. During its first year of operations, CanCo earns \$14 million of foreign-source taxable income, pays \$6 million of Canadian income taxes, and distributes a \$2 million dividend to Mary. Can Mary claim a deemed-paid (indirect) FTC on her Form 1040 with respect to receipt of the dividend distribution from CanCo? Why or why not?
35. **LO.5** Elmwood, Inc., a domestic corporation, owns 15% of Correy, Ltd., a Hong Kong corporation. The remaining 85% of Correy is owned by Fortune Enterprises, a Canadian corporation. At the end of the current year, Correy has \$400,000 in undistributed E & P and \$200,000 in foreign taxes related to this E & P. On the last day of the year, Correy pays a \$40,000 dividend to Elmwood. Elmwood's taxable income before the dividend is \$200,000. What is Elmwood's tax liability after consideration of the dividend and any allowed FTC, assuming a 34% U.S. tax rate?

36. **LO.5** Warwick, Inc., a U.S. corporation, owns 100% of NewGrass, Ltd., a foreign corporation. NewGrass earns only general limitation income. During the current year, NewGrass paid Warwick a \$10,000 dividend. The deemed-paid foreign tax credit associated with this dividend is \$3,000. The foreign jurisdiction requires a withholding tax of 10%, so Warwick received only \$9,000 in cash as a result of the dividend. What is Warwick's total U.S. gross income reported as a result of the cash dividend?
37. **LO.5** Night, Inc., a domestic corporation, earned \$300,000 from foreign manufacturing activities on which it paid \$90,000 of foreign income taxes. Night's foreign sales income is taxed at a 50% foreign tax rate. What amount of foreign sales income can Night earn without generating any excess FTCs for the current year? Assume a 34% U.S. tax rate.
38. **LO.4, 5** Partin, Inc., a foreign subsidiary of Jones, Inc., a U.S. corporation, reports pre-tax income of 200,000 euros for the current year. Partin accrues 60,000 euros in foreign taxes on this income. The average exchange rate for the tax year to which the taxes relate is 1.35€:\$1. None of the income is Subpart F income. If the net earnings of 140,000 euros are distributed when the exchange rate is 1.25€:\$1, what are the deemed-paid taxes available to Jones? Assume that this is Partin's first year of operation.
39. **LO.5** Collins, Inc., a domestic corporation, operates a manufacturing branch in Singapore. During the current year, the manufacturing branch produces a loss of \$300,000. Collins also earns interest income from investments in Europe, where it earns \$800,000 in passive income. Collins paid no foreign income taxes related to the Singapore branch, but it paid \$64,000 in foreign income taxes related to the passive income. Collins pays U.S. income taxes at the 34% tax rate. What is Collins's allowable FTC for the current year?
40. **LO.5** Money, Inc., a U.S. corporation, has \$500,000 to invest overseas. For U.S. tax purposes, any additional gross income earned by Money will be taxed at 34%. Two possibilities for investment are:
- Invest the \$500,000 in common stock of Exco (a foreign corporation). Exco common stock pays a dividend of \$3 per share each year. The \$500,000 would purchase 10,000 shares (or 10%) of Exco's only class of stock (voting common). Exco expects to earn \$10 million before taxes this year and to be taxed at a flat rate of 40%. Its current E & P before taxes is estimated to be \$9.4 million. Exco's government does not withhold on dividends paid to foreign investors.
 - Invest the \$500,000 in Exco bonds that pay interest at 7% per year. Assume that the bonds will be acquired at par, or face, value. Exco's government withholds 25% on interest paid to foreign investors.

Decision Making

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Analyze these two investment opportunities, and determine which would give Money the better return after taxes. Make sure you consider the effect of the FTC. Write a letter to Money's CFO Jeffrey Howard, advising the corporation of your findings. Money's address is 9201 West South Street, Woodstock IL 60098.

41. **LO.2, 6** IrishCo, a manufacturing corporation resident in Ireland, distributes products through a U.S. office. Current-year taxable income from such sales in the United States is \$12 million. IrishCo's U.S. office deposits working capital funds in short-term certificates of deposit with U.S. banks. Current-year interest income from these deposits is \$150,000.
- IrishCo also invests in U.S. securities traded on the New York Stock Exchange. This investing is done by the home office. For the current year, IrishCo records realized capital gains of \$300,000 and dividend income of \$50,000 from these stock investments. Compute IrishCo's U.S. tax liability, assuming that the U.S.-Ireland income tax treaty reduces withholding on dividends to 15% and on interest to 5%. Assume a 34% U.S. tax rate.

42. **LO.6** Clario, S.A., a Peruvian corporation, manufactures furniture in Peru. It sells the furniture to independent distributors in the United States. Because title to the furniture passes to the purchasers in the United States, Clario reports \$2 million in U.S.-source income. Clario has no employees or operations in the United States related to its furniture business.

As a separate line of business, Clario buys and sells antique toys. Clario has a single employee operating a booth on weekends at a flea market in Waldo, Florida. The antique toy business generated \$85,000 in net profits from U.S. sources during the current year.

What is Clario's effectively connected income for the current year?

- Communications** 43. **LO.6** Trace, Ltd., a foreign corporation, operates a trade or business in the United States. Trace's U.S.-source income effectively connected with this trade or business is \$800,000 for the current year. Trace's current-year E & P is \$600,000. Trace's net U.S. equity was \$8.2 million at the beginning of the year and \$8.6 million at year-end. Trace is a resident in a country that has no income tax treaty with the United States.

Prepare a letter to Tanner Martin, Trace's Tax VP, reporting Trace's branch profits tax liability for the current year, along with at least one planning idea for reducing the branch profits tax. Trace uses the following address for its U.S. affairs: 9148 Church Street, Marietta GA 30060.

44. **LO.6** Martinho is a citizen of Brazil and lives there year-round. He has invested in a plot of Illinois farmland with a tax basis to him of \$1 million. Martinho has no other business or investment activities in the United States. He is not subject to the alternative minimum tax. Upon sale of the land for \$1.5 million to Emma, an Illinois person, what are the Federal income tax consequences to Martinho?
45. **LO.6** Continue with the facts of Problem 44. What are the Federal income tax withholding requirements with respect to Martinho's sale? Who pays the withheld amount to the U.S. Treasury?

- Issue ID**
Communications 46. **LO.6** John McPherson is single, an attorney, and a U.S. citizen. He recently attended a seminar where he learned he could give up his U.S. citizenship, move to Bermuda (where he would pay no income tax), and operate his law practice long distance via the Internet with no U.S. tax consequences. Write a letter informing John of the tax consequences of his proposed actions. His address is 1005 NE 10th Street, Gainesville, GA 32612.

Research Problems



Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

- Communications** **Research Problem 1.** Jerry Jeff Keen, the CFO of Boots Unlimited, a Texas corporation, has come to you regarding a potential restructuring of business operations. Boots has long manufactured its western boots in plants in Texas and Oklahoma. Recently, Boots has explored the possibility of setting up a manufacturing subsidiary in Ireland, where manufacturing profits are taxed at 10%. Jerry Jeff sees this as a great idea, given that the alternative is to continue all manufacturing in the United States, where profits are taxed at 34%.

Boots plans to continue all of the cutting, sizing, and hand tooling of leather in its U.S. plants. This material will be shipped to Ireland for final assembly, with the finished product shipped to retail outlets all over Europe and Asia.

Your initial concern is whether the income generated by the Irish subsidiary will be considered foreign base company income. Address this issue in a research memo, along with any planning suggestions.

Partial list of research aids:

§ 954(d).

Reg. § 1.954-3(a).

Bausch & Lomb, 71 TCM 2031, T.C.Memo. 1996-57.

Research Problem 2. Polly Ling is a successful professional golfer. She is a resident of a country that does not have a tax treaty with the United States. Ling plays matches around the world, about one-half of which are in the United States. Ling's reputation is without blemish; in fact, she is known as being exceedingly honest and upright, and many articles discuss how she is a role model for young golfers due to her tenacious and successful playing style and her favorable character traits. Every year, she reports the most penalty strokes on herself among the participants in womens' matches, and this is seen as reinforcing her image as an honest and respectful competitor.

This combination of quality play and laudable reputation has brought many riches to Ling. She comes to you with several Federal income tax questions. She knows that as a non-U.S. resident, any of her winnings from tournament play that occurs in the United States are subject to U.S. income taxation. But what about each of the following items? How does U.S. tax law affect Ling? Apply the sourcing rules in this regard, and determine whether the graduated U.S. Federal income tax rate schedules apply.

- Endorsement income from YourGolf, for wearing clothing during matches with its logo prominently displayed. Ling must play in at least 10 tournaments per year that are televised around the world. She also must participate in photo sessions and in blogs and tweets associated with the tournaments. Payment to Ling is structured as a flat fee, with bonuses paid if she finishes in the top five competitors for each match. This is known as an *on-court endorsement*.
- Endorsement income from GolfZone, for letting the company use her likeness in a video game that simulates golf tournaments among known golfers and other players that the (usually middle-aged men and women) gamers identify. In this way, the gamer seems to be playing against Ling on famous golf courses. Two-thirds of all dollar sales of the game licenses are to U.S. customers.
- Endorsement income from Eliteness, for appearing in print and Internet ads that feature Ling wearing the company's high-end watches. One-fifth of all dollar sales of the watches are to U.S. customers. The latter two items are known as *off-court endorsements*.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 3. Locate data on the size of the international economy, including data on international trade, foreign direct investment by U.S. firms, and investment in the United States by foreign firms. Useful web locations include www.census.gov and www.bea.gov. Prepare an analysis of the data for a three-year period using spreadsheet and graphing software, and e-mail the results to your instructor.

Research Problem 4. For your analysis, choose 10 countries, one of which is the United States. Create a table showing whether each country applies a worldwide or territorial approach to international income taxation. Then list the country's top income tax rate on business profits. Send a copy of this table to your instructor.



Internet
Activity

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Communications **Research Problem 5.** Find the text of various tax treaties currently in force in the United States. In an e-mail to your instructor, address the following items.

- a. How does the U.S. income tax treaty with Germany define “business profits” for multinational businesses?
- b. How does the U.S. income tax treaty with Japan treat the FIRPTA provisions?
- c. List five countries with which the United States has entered into an estate tax treaty.
- d. What is the effective date of the latest income tax treaty with the United Kingdom?
- e. List five countries with which the United States does *not* have in force a bilateral income tax treaty.

Tax Practice and Ethics

LEARNING OBJECTIVES: *After completing Chapter 26, you should be able to:*

- | | |
|---|---|
| <p>LO.1 Illustrate the organization and structure of the IRS.</p> <p>LO.2 Identify the various administrative pronouncements issued by the IRS and explain how they can be used in tax practice.</p> <p>LO.3 Describe the audit process, including how tax returns are selected for audit and the various types of audits.</p> <p>LO.4 Explain the taxpayer appeal process, including various settlement options available.</p> | <p>LO.5 Determine the amount of interest on a deficiency or a refund and when it is due.</p> <p>LO.6 List and explain the various penalties that can be imposed on acts of noncompliance by taxpayers and return preparers.</p> <p>LO.7 Recognize and apply the rules governing the statute of limitations on assessments and on refunds.</p> <p>LO.8 Summarize the legal and ethical guidelines that apply to those engaged in tax practice.</p> |
|---|---|

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THE BIG PICTURE

A TAX ADVISER'S DILEMMA

Campbell Corporation is preparing its Form 1120 for the tax year. The entity develops and manufactures a number of high-tech products, including a line of GPS applications that are downloaded onto tablets and smartphones. Campbell's research department needs to work with the U.S. government on this line of software because of the potential for security breaches when the software is used in sensitive parts of the world. Other efforts of the research department include traditional software architecture and development. Projections show that the GPS products will be highly profitable, with sales concentrated among various commercial and governmental communications providers around the world.

Some of the research department's work on the GPS products clearly qualifies for the Federal income tax credit for incremental research expenditures, but for some other items, the availability of the credit is not so certain. Because of the unclear language of the pertinent Regulations with regard to Campbell's setting or because of the innovative aspects of the products under development, the law is silent as to whether Campbell can claim the credit.

You are Campbell's tax adviser. This situation presents you with several levels of difficulty. How aggressive should you advise Campbell to be in reporting items on the Form 1120 that qualify for the incremental research credit? Will Campbell's taking an overly aggressive position on the credit trigger a tax preparer penalty for your tax consulting firm? What level of diligence should you exercise in advising Campbell as to whether specific expenditures qualify for the credit, given that your expertise with GPS software is limited to using the unit in your personal auto?

Read the chapter and formulate your response.

Few events arouse so much fear in the typical individual or corporation as the receipt of a letter from the Internal Revenue Service (IRS) notifying the taxpayer that prior years' tax returns are to be the subject of an audit. Almost immediately, calls are made to the tax adviser. Advice is sought as to what to reveal (or not reveal) in the course of the audit, how to delay or avoid the audit, and how friendly one should be with the auditor when he or she ultimately arrives.

Indeed, many tax practitioners' reputations with their clients have been made or broken by the way they are observed to behave under the pressure of an audit situation. The strategy and tactics of audits—including such seemingly unimportant issues as whether the tax adviser brings doughnuts or other refreshments to the audit session, the color of his or her clothes, and the most effective negotiation techniques—are the subject of both cocktail party banter and scholarly review.

In actuality, the tax professional can render valuable services to the taxpayer in an audit context, thereby ensuring that tax payments for the disputed years are neither under- nor overreported, as part of an ongoing tax practice. In this regard, the adviser must appreciate the following.

- The elements of the Treasury's tax administration process and opportunities for appeal within the structure of the IRS.
- The extent of the negative sanctions that can be brought to bear against taxpayers whose returns are found to have been inaccurate.
- The ethical and professional constraints on the advice tax advisers can give and the actions they can take on behalf of their clients, within the context of an adversarial relationship with the IRS.

26-1 TAX ADMINISTRATION

The Treasury has delegated the administration and enforcement of the tax laws to its subsidiary agency, the IRS. In this process, the Service is responsible for providing adequate information, in the form of publications and forms with instructions, to taxpayers so that they can comply with the laws in an appropriate manner. The IRS identifies delinquent tax payments and carries out assessment and collection procedures under the restrictions of due process and other constitutional guarantees. The agency also is responsible for collecting several taxes under the Affordable Care Act.

The IRS is one of the largest Federal agencies. It employs almost 90,000 staff members, and the total agency budget is over \$13 billion. In meeting its responsibilities, the Service conducts audits of selected tax returns. Just over 1 percent of all individual tax returns are subjected to audit in a given tax year. However, certain types of both taxpayers and income—including, for instance, high-income individuals, cash-oriented businesses, real estate transactions, and estate- and gift-taxable transfers—are subject to much higher probabilities of audit.

The audit rate for corporations with at least \$10 million in assets is about 17.5 percent, but the rate drops to about 1.2 percent for businesses with less than \$10 million in assets. In the past few years, the IRS has stepped up its audit and enforcement activities and is targeting narrower issues that are projected to produce more revenue for the time spent. Thus, audit rates for large corporations have decreased, although the dollars collected from such audits continue to increase.

Recently, much of the IRS's effort has been devoted to developing statutory and administrative requirements relative to information reporting and document matching. For instance, when a taxpayer engages in a like-kind exchange or sells a personal residence, various parties to the transaction are required to report the nature and magnitude of the transaction to the IRS. Later, the Treasury's computers determine whether the transaction has been reported properly by comparing the information reported by the third parties with the events included on the relevant taxpayers' returns for the year.



TAX IN THE NEWS How Big Is the Tax Gap?

As directed by Congress, the IRS estimates the size of the Federal income “tax gap”—the difference between how much tax *is* collected and how much *should be* collected.

According to the most recent analysis, the tax gap is a net amount of almost \$385 billion in income and employment taxes annually. More specifically, the underpayments total about \$450 billion per year but are offset by \$65 billion obtained through IRS enforcement efforts (e.g., audits and collection procedures).

The IRS maintains that only 85 percent of taxpayers report the “correct” amount of tax under the existing system of voluntary compliance, after accounting for audits. The main sources of the tax gap are:

- Underreporting net taxable income (84 percent of the tax gap).

- Underpayment of tax (10 percent of the tax gap).
- Nonfiling (6 percent of the tax gap).

If, by some miracle, the entire tax gap were collected each year, the current Federal budget deficit would be cut significantly. A complete elimination of the tax gap is unlikely to occur, however, for at least two reasons.

- Citizens are not likely to tolerate the increased audit activity and data collection necessary for the Treasury to collect all of the tax owed.
- Citizens who are so inclined will continue to commit tax fraud, even if statutory and administrative changes are made to the system to identify them. Tax cheats are always “one step ahead” of the government in this regard.

In addition, the IRS has been placing increasing pressure on the community of tax advisers. Severe penalties may be assessed on those who have prepared the appropriate return when the Service’s interpretation of applicable law conflicts with that of the preparer.

The IRS processes about 150 million individual income tax returns every year, of which about 90 percent are filed electronically (i.e., known as **e-filing**). It collects about \$2.5 trillion in annual tax revenues and pays refunds to about 110 million individual taxpayers every year. The average refund is more than \$2,750.

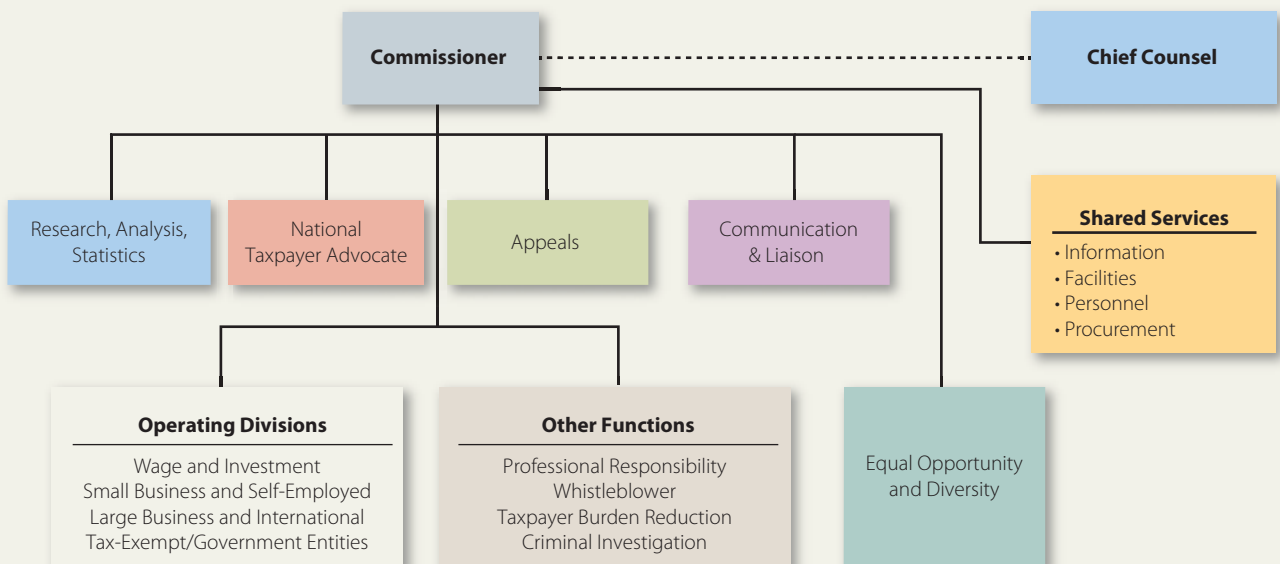
26-1a Organizational Structure of the IRS

The structure of the IRS is illustrated in Exhibit 26.1. The IRS Commissioner, a presidential appointee, has organized the day-to-day activities of the agency into four major operating divisions, based on the type of tax returns to be processed. Administrative functions, such as those relating to personnel and computer issues, are organized on a

LO.1

Illustrate the organization and structure of the IRS.

EXHIBIT 26.1 IRS National Office Organization



shared-services model, managed from the national office. Broader functions, such as litigation, investigations, and taxpayer relations, are managed at the national level as well.

The Chief Counsel, another presidential appointee, is the head legal officer of the IRS. The Chief Counsel's office provides legal advice to the IRS and guidance to the public on matters pertaining to the administration and enforcement of the tax laws. For instance, the Chief Counsel's duties include establishing uniform nationwide interpretive positions on the law, drafting tax guide material for taxpayers and IRS personnel, issuing technical rulings to taxpayers, and providing advice and technical assistance to IRS personnel. The Chief Counsel represents the IRS in all litigation before the Tax Court.

LO.2

Identify the various administrative pronouncements issued by the IRS and explain how they can be used in tax practice.

26-1b IRS Procedure—Letter Rulings

When a tax issue is controversial or a transaction involves considerable tax dollars, the taxpayer often wants to obtain either assurance or direction from the IRS as to the treatment of the event. The **letter ruling** process is an effective means of dealing directly with the IRS while in the planning stages of a large or otherwise important transaction.

Rulings issued by the National Office provide a written statement of the position of the IRS concerning the tax consequences of a course of action contemplated by the taxpayer. Letter rulings do not have the force and effect of law, but they do provide guidance and support for taxpayers in similar transactions. The IRS issues rulings only on uncompleted, actual (rather than hypothetical) transactions or on transactions that have been completed before the filing of the tax return for the year in question.

In certain circumstances, the IRS will not issue a ruling. It ordinarily will not rule in cases that essentially involve a question of fact.¹ For example, no ruling will be issued to determine whether compensation paid to employees is reasonable in amount and therefore allowable as a deduction.²

A letter ruling represents the current opinion of the IRS on the tax consequences of a transaction with a given set of facts. IRS rulings are not unchangeable. They can be declared obsolete or superseded by new rulings in response to tax law changes.

A ruling may be relied upon only by the taxpayer who requested and received it. It must be attached to the tax return for the year in question.

Letter rulings benefit both the IRS and the taxpayer. They not only help promote a uniform application of the tax laws but also may reduce the potential for litigation or disputes with IRS agents. In addition, they make the IRS aware of significant transactions being consummated by taxpayers. A fee of \$18,000 is charged for processing most ruling requests; the fee is reduced to \$2,000 if the taxpayer's income is less than \$250,000.

26-1c IRS Procedure—Other Issuances

In addition to issuing unpublished letter rulings and published rulings and procedures, the IRS issues determination letters and technical advice memoranda.

A **determination letter** relates to a completed transaction when the issue involved is covered by judicial or statutory authority, Regulations, or rulings. Determination letters are issued for various estate, gift, income, excise, and employment tax matters.

EXAMPLE

1

A group of physicians plans to form an entity to construct and operate a hospital. The determination letter procedure is appropriate to ascertain whether the group is subject to the Federal income tax or is tax-exempt.

A **technical advice memorandum (TAM)** is issued by the National Office to IRS personnel in response to a specific request by an agent, Appellate Conferee, or IRS executive. The taxpayer may request a TAM if an issue in dispute is not treated by the law or precedent and/or published rulings or Regulations. Technical advice requests arise from the audit process, whereas ruling requests are issued before any IRS audit.

¹Rev.Proc. 2015-1, 2015-1 I.R.B. 17.

²Rev.Proc. 2015-3, 2015-1 I.R.B. 132.



TAX IN THE NEWS Tax Preparation by the Numbers

The community of taxpayers and their tax preparers is extensive and increasingly is using electronic means to meet current filing requirements. The following summary is based on recent estimates.

Number of individuals who prepare Federal tax returns for a fee	1 million
Percentage of all Federal tax returns that were filed using computer software and/or a paid tax preparer	90%
Number of unpaid volunteers who registered with the IRS to assist taxpayers with filing requirements (e.g., through the VITA and Tax Counseling for the Elderly programs)	80,000

By one estimate, the cost of compliance with Federal tax laws exceeds \$425 billion per year. Roughly, this means

that compliance costs act as an additional tax of about 30 cents for every tax dollar collected. This amount exceeds the annual costs of compensation for all of the workers at Walmart, UPS, IBM, McDonald's, and Citigroup combined.

For this study, the following items were counted as costs of tax compliance.

- The value of taxpayers' time spent record keeping, filing, planning, and otherwise complying with the tax laws.
- Tax collection costs (chiefly wages and benefits) of IRS employees.
- Expenditures made to professional tax preparers, consultants, and other preparers.

26-1d Administrative Powers of the IRS

Examination of Records

The IRS can examine the taxpayer's books and records as part of the process of determining the correct amount of tax due. The IRS also can require the persons responsible for the return to appear and to produce any necessary books and records.³ Taxpayers are required to maintain certain record-keeping procedures and retain the records necessary to facilitate the audit.

Burden of Proof

If the taxpayer meets the record-keeping requirement and substantiates income and deductions properly, the IRS bears the burden of proof in establishing a tax deficiency during litigation. The taxpayer must have cooperated with the IRS regarding reasonable requests for information, documents, meetings, and interviews. For individual taxpayers, the IRS's burden of proof extends to penalties and interest amounts that it assesses in a court proceeding with the taxpayer.⁴

Assessment and Demand

The Code permits the IRS to assess a deficiency and to demand payment for the tax. However, no assessment or effort to collect the tax may be made until 90 days after a statutory notice of a deficiency (a *90-day letter*) is issued. The taxpayer therefore has 90 days to file a petition to the U.S. Tax Court, effectively preventing the deficiency from being assessed or collected pending the outcome of the case.⁵

Following assessment of the tax, the IRS issues a notice and demand for payment. The taxpayer can be given as little as 10 days to pay the tax after the demand for payment is issued. If the IRS believes the assessment or collection of a deficiency is in jeopardy, it may assess the deficiency and demand immediate payment.⁶

Collection

If the taxpayer neglects or refuses to pay the tax after receiving the demand for payment, a lien in favor of the IRS is placed on all property (realty and personalty, tangible and intangible) belonging to the taxpayer.

³§ 7602.

⁴§§ 7491(a)(1), (a)(2)(B), and (c).

⁵§§ 6212 and 6213.

⁶§ 6861. A jeopardy assessment is appropriate, for instance, when the IRS fears that the taxpayer will flee the country or destroy valuable property.

The levy power of the IRS is very broad. It allows the IRS to garnish (*attach*) wages and salary and to seize and sell all nonexempt property by any means. After a notice period, the IRS can make successive seizures on any property owned by the taxpayer until the levy is satisfied.⁷ A taxpayer's principal residence is exempt from the levy process, unless the disputed tax, interest, and penalty exceed \$5,000 and a U.S. District Court judge approves of the seizure.⁸

LO.3

Describe the audit process, including how tax returns are selected for audit and the various types of audits.

26-1e **The Audit Process****Selection of Returns for Audit**

The IRS utilizes mathematical formulas to select tax returns that are most likely to contain errors and yield substantial amounts of additional tax revenues upon audit. The IRS does not disclose all of its audit selection techniques. However, some observations can be made regarding the probability of a return's selection for audit.

- Certain groups of taxpayers are subject to audit more frequently than others. These groups include individuals with gross income in excess of \$200,000, self-employed individuals with substantial business income and deductions, and cash businesses where the potential for tax evasion is high.

EXAMPLE

2

Tracey owns and operates a liquor store. As nearly all of her sales are for cash, Tracey might be a prime candidate for an audit by the IRS. Cash transactions are easier to conceal than those made on credit.

- If a taxpayer has been audited in a past year and the audit led to the assessment of a substantial deficiency, the IRS often makes a return visit.
- An audit might materialize if information returns (e.g., Form W-2 and Form 1099) are not in substantial agreement with the income reported on the taxpayer's return. Obvious discrepancies do not necessitate formal audits and usually can be handled by correspondence with the taxpayer.

EXAMPLE

3

The IRS audits Phil's Form 1040 and finds that his dividend income increased sharply. The auditor wonders how Phil financed this stock purchase, as there were no corresponding stock sales on his return that would create cash with which to make the acquisition.

Upon further inquiry, the auditor learns that the dividend yielding stock was a gift to Phil from his mother, Julie. Accordingly, the IRS investigates whether Julie filed a Federal gift tax return for the year of the stock transfer.

- If an individual's itemized deductions are in excess of norms established for various income levels, the probability of an audit increases. Certain deductions (e.g., casualty and theft losses, business use of the home, and tax-sheltered investments) are sensitive areas, as the IRS realizes that many taxpayers determine the amount of the deduction incorrectly or may not be entitled to the deduction at all.
- Information often is obtained from outside sources, including other government agencies, news items, and informants.

EXAMPLE

4

After 15 years of employment, Betty is discharged by her employer, Dr. Franklin. Shortly thereafter, the IRS receives a letter from Betty stating that Franklin keeps two sets of books, one of which substantially understates his cash receipts.

⁷The taxpayer can keep certain personal and business property and a minimal amount of his or her income as a subsistence allowance, even if a lien is outstanding. § 6334.

⁸§§ 6334(a)(13)(A) and (e)(1).

The statistical models used by the IRS to select individual tax returns for audit come from random audits of a small number of taxpayers, who are required to document every entry they made on the Form 1040. The latest round of these National Research Program (NRP) audits resulted in the construction of new Discriminant Inventory Function (DIF) scores that project the amount of revenue the IRS will gain from pursuing tax returns with various statistical profiles. The higher the DIF score, the better the return to the IRS from pursuing the audit, and the higher the probability of selection for an examination.

These data-seeking audits are controversial and have led to taxpayer complaints to Congress about the stress they create.⁹ But the data from older DIF models no longer reflected the U.S. service-based, information-powered economy. Consequently, the underlying models require more frequent updating for effective enforcement of the tax laws. The IRS believes that by constantly updating the NRP data through a diligent review of randomly selected tax returns, changes in tax avoidance behaviors will be detected and fewer routine audits will be required.

Many individual taxpayers mistakenly assume that if they do not hear from the IRS within a few weeks after filing their return or if they receive a refund check, no audit will be forthcoming. As a practical matter, most individual returns are examined about two years from the date of filing. If a return is not audited within this time period, it generally remains unaudited. All large corporations, however, are subject to annual audits.

About one-third of all completed audits result in a “no change” recommendation for the taxpayer. A “no change” recommendation results for more than one-half of all partnership/LLC and S corporation audits.



ETHICS & EQUITY Can the IRS Pretend to Be Your Friend?

Should IRS agents be allowed to identify audit subjects by reading the society page of the newspaper, looking for indicators of wealth? What if the agency subscribes to Facebook and seeks comments from its “friends” as to income windfalls and stock market dealings? In the past, some state and local taxing agencies have used social networking sites for audit selection purposes. State and local revenue agents have used the sites to find self-employed individuals who advertise their business and report about upcoming income-producing events. The sites

also have been used to determine whether a taxpayer who has requested an extension of time to pay a delinquent tax actually is strapped for cash.

Some state tax officials claim that looking for a taxpayer’s self-declarations on a website is a much more efficient way to find income understatements than searching through most other sources of nonstatistical data. Should taxing agencies be using Google, Facebook, and other public-domain online sources of taxpayer information to help identify tax returns for audit?

Role of Informants

The IRS can pay rewards to persons who provide information that leads to the detection and punishment of those who violate the tax laws. The rewards are paid at the discretion of the IRS. Such a payment usually cannot exceed 15 percent of the taxes, fines, and penalties recovered as a result of such information.¹⁰

More than 100 informant rewards are paid in the typical year. In a recent year, the IRS collected about \$300 million in underpaid taxes from the informants’ program, and it paid rewards of over \$20 million (i.e., at approximately a 4 percent rate).

Another IRS office, through the so-called **Whistleblower Program**, offers special rewards to informants who provide information concerning businesses or high-income (gross income exceeds \$200,000) individuals when more than \$2 million of tax, penalty, and

⁹On average, the total annual NRP audit sample consists of 13,000 returns. Some of these returns are analyzed without contacting the taxpayer, and other taxpayers are contacted only by mail with queries about one or two

items. Only a few returns are subjected to “line-by-line” review. Most of the returns are reviewed for a period of three tax years.

¹⁰§ 7623 and Reg. § 301.7623-1.

interest is at stake. Some informants claim that hundreds of millions of dollars of tax, penalty, and interest are due from allegedly noncompliant taxpayers.

A whistleblower reward can reach 30 percent of the amount collected by the Treasury and traceable to the whistleblower's information. The reward can be reduced if the whistleblower participated in the original understatement of tax. About 400 cases are initiated every year as a result of tips from whistleblowers.

The whistleblower rewards are paid out of the taxes recovered under the informant and whistleblower programs. To claim a reward of this sort, an informant files Form 211 with the IRS. Federal income taxes are withheld from the whistleblower reward, usually at a 28 percent rate. A whistleblower has 30 days to appeal to the IRS if his or her claim is denied or reduced from the original amount requested.

A final decision on a whistleblower case might not be made until five to seven years after the date the claim is filed. The award itself constitutes gross income when it is received. Legal fees for the whistleblower tend to be about 30 percent of the award; such fees may be deductible by the informant.

Verification and Audit Procedures

The filed tax return immediately is reviewed for mathematical accuracy. A check is also made for deductions, exclusions, etc., that are clearly erroneous. One obvious error would be the failure to comply with the AGI limitation on the deduction for medical expenses.

About 2 percent of all paper-filed individual returns show a math error. The math error rate for e-filed returns is only .1 percent. When a math or clerical error occurs, the Service Center merely sends the taxpayer revised computations and a bill or refund as appropriate.

Taxpayers usually are able to settle routine tax disputes (e.g., queries involving the documentation of deductions) through a by-mail-only *correspondence audit* with the IRS, without the necessity of a formal meeting. The taxpayer receives a letter from the IRS, wherein the tax is recomputed upward (e.g., because the amount of reported wages does not match that on Form W-2). The taxpayer then complies by paying the additional tax or objects by providing information and documentation showing that the reported amount was correct. About two-thirds of all Form 1040 audits are handled in this way.

Office audits are conducted in an office of the IRS. In most instances, the taxpayer is required merely to substantiate a deduction, a credit, or an item of income that appears on the return. The taxpayer presents documentation in the form of canceled checks, invoices, etc., for the items in question.

The *field audit* procedure commonly is used for corporate returns and for returns of individuals engaged in business or professional activities. This type of audit generally involves a more complete examination of a taxpayer's transactions.

A field audit is conducted by IRS agents at the office or home of the taxpayer or at the office of the taxpayer's representative. The agent's work may be facilitated by a review of certain tax workpapers and discussions with the taxpayer's representative about items appearing on the tax return.

Prior to or at the initial interview, the IRS must provide the taxpayer with an explanation of the audit process that is the subject of the interview and describe the taxpayer's rights under that process. If the taxpayer clearly states at any time during the interview the desire to consult with an attorney, a CPA, or an enrolled agent or any other person permitted to represent the taxpayer before the IRS, then the IRS representative must suspend the interview.¹¹

Any officer or employee of the IRS must, upon advance request, allow a taxpayer to make an audio recording of any in-person interview with the officer or employee concerning the determination and collection of any tax.¹²

Settlement with the Revenue Agent

Following an audit, the IRS agent may either accept the return as filed or recommend certain adjustments. The **Revenue Agent's Report (RAR)** is reviewed within the IRS. In most instances, the agent's proposed adjustments are approved.

¹¹§ 7521(b).

¹²§ 7521(a).

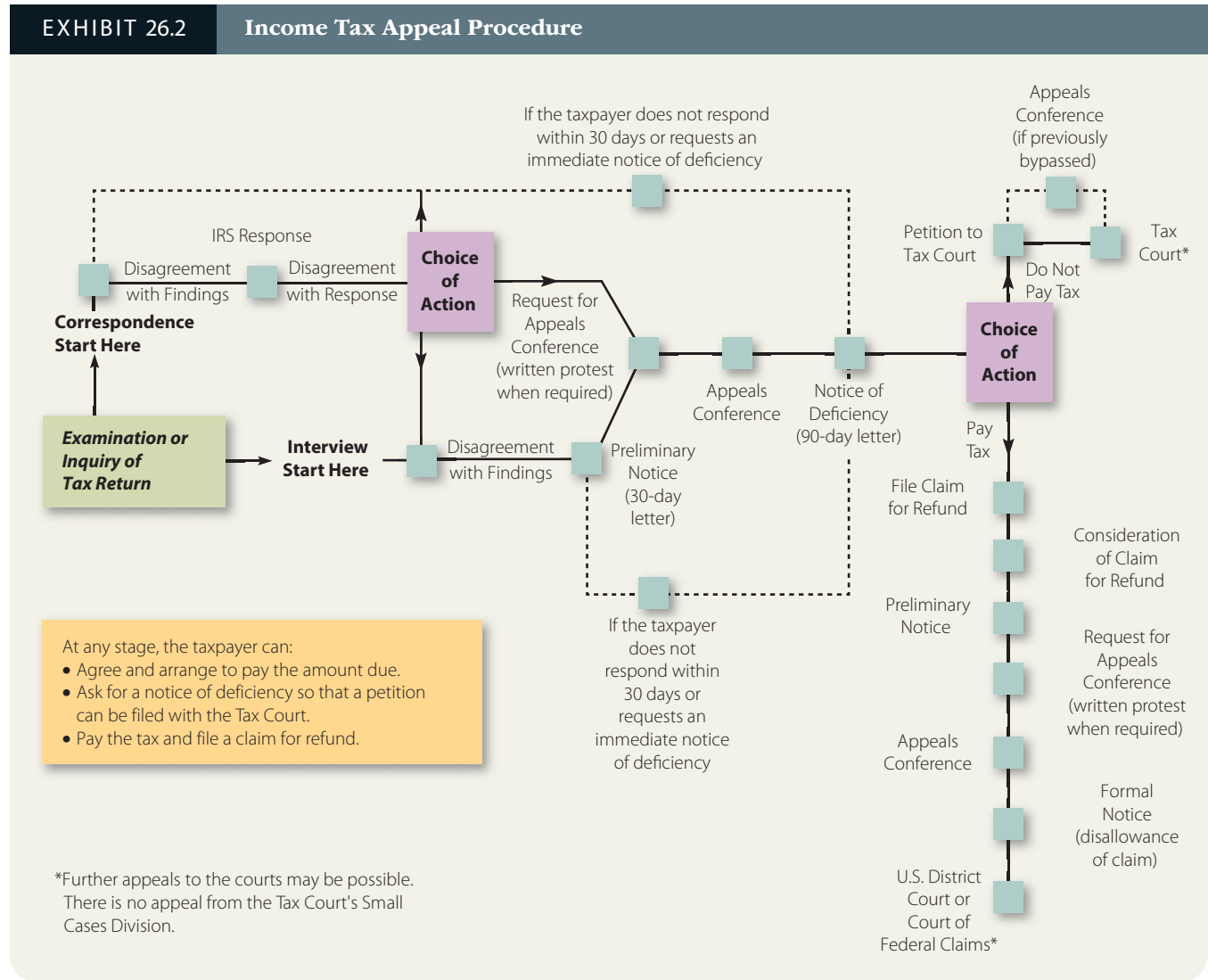
Agents must adhere strictly to IRS policy as reflected in published rulings, Regulations, and other releases. The agent cannot settle an unresolved issue based upon the probability of winning the case in court. Usually, issues involving factual questions can be settled at the agent level, and it may be advantageous for both the taxpayer and the IRS to reach agreement at the earliest point in the settlement process. For example, it may be to the taxpayer's advantage to reach agreement at the agent level and avoid any further opportunity for the IRS to raise new issues.

If agreement is reached upon the proposed deficiency, the taxpayer signs Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax). One advantage to the taxpayer of signing Form 870 at this point is that interest stops accumulating on the deficiency 30 days after the form is filed.¹³ When this form is signed, the taxpayer effectively waives the right to receive a statutory notice of deficiency (90-day letter) and to subsequently petition the Tax Court. In addition, it is no longer possible for the taxpayer later to go to the IRS Appeals Division.

26-1f The Taxpayer Appeal Process

If agreement cannot be reached at the agent level, the taxpayer receives a copy of the Revenue Agent's Report and a **30-day letter**. The taxpayer has 30 days to request an administrative appeal. If an appeal is not requested, a **90-day letter** is issued. Exhibit 26.2 illustrates the taxpayer's alternatives when a disagreement with the IRS persists.

LQ.4
Explain the taxpayer appeal process, including various settlement options available.



¹³§ 6601(c).

A taxpayer who wants to appeal must make an appropriate request to the Appeals Division. The request must be accompanied by a written protest, except in the following cases.

- The proposed tax deficiency does not exceed \$10,000 for any of the tax periods involved in the audit.
- The deficiency resulted from a correspondence or office audit (i.e., not as a result of a field audit).

The Appeals Division is authorized to settle all tax disputes based on the hazards of litigation (the chances of winning in court). Because the Appeals Division has final settlement authority until a 90-day letter has been issued, the taxpayer may be able to negotiate a settlement. In addition, an overall favorable settlement may be reached by “trading” disputed issues.

EXAMPLE

5

At the time Terri is audited, the corporation that she controls had advances outstanding to her in the amount of \$80,000. The IRS field agent held that these advances were constructive dividends to her (refer to the discussion in Chapter 19). Some facts point toward this result (e.g., the corporation is closely held, Terri has made no repayments, and the loan balance has increased over several years). Other facts, however, appear to indicate that these advances are bona fide loans (e.g., a written instrument provides for interest, Terri has the independent means of repayment, and the corporation has a good dividend-paying record).

The Appeals Division and Terri’s representative assess the hazards of litigation as being 50% for each side. Thus, if Terri chooses to take the issue to court, she would have an even chance of winning or losing her case. Based on this assessment, both sides agree to treat \$40,000 of the advance as a dividend and \$40,000 as a bona fide loan. The agreement enables Terri to avoid \$40,000 of dividend income (the loan portion) and saves her the cost of litigating the issue.

Thus, by going to the Appeals Division, Terri obtained a satisfactory settlement otherwise unobtainable from the agent.

Taxpayers who file a petition with the U.S. Tax Court have the option of having the case heard before the more informal Small Cases Division if the amount of tax in dispute does not exceed \$50,000.¹⁴ If the Small Cases Division is used, neither party may appeal the case.

If a settlement is reached with the Appeals Division, the taxpayer is required to sign Form 870-AD. Interest stops running on the deficiency when the Appeals Division accepts the Form 870-AD. According to the IRS, this settlement is binding upon both parties unless fraud, malfeasance, concealment, or misrepresentation of material fact has occurred.

The economic costs of a settlement offer from the Appeals Division should be weighed against the costs of litigation and the probability of winning the case. The taxpayer also should consider the effects of the settlement upon the tax liability for future periods in addition to the years under audit.

26-1g Offers in Compromise and Closing Agreements

The IRS can negotiate a compromise if the taxpayer’s ability to pay the tax is doubtful. If the taxpayer is financially unable to pay the total amount of the tax, a Form 656 (Offer in Compromise) is filed. An **offer in compromise** is appropriate in the following circumstances.¹⁵

- There is doubt as to the taxpayer’s liability for the tax (i.e., disputed issues still exist).
- There is doubt as to the collectibility of the tax (i.e., the taxpayer’s net worth and earnings capacity are low).
- Payment of the disputed amount would constitute an economic hardship for the taxpayer. For instance, the taxpayer is incapable of earning a living because of a long-term illness or disability, or liquidation of the taxpayer’s assets to pay the amount due would leave the taxpayer unable to meet basic living expenses.

¹⁴§ 7463(a).

¹⁵§ 7122 and Reg. § 301.7122-1(b).



ETHICS & EQUITY Our Taxing System of Self-Assessment

The United States is a large country of diverse taxpayers and businesses. Perhaps the only way the massive dollar amounts of Federal income taxes can be collected on a timely basis is through a *self-assessment* process, whereby the taxpayer is charged with disclosing a full picture of the tax year's results and the corresponding computation of taxable income. But a system of self-assessment depends heavily on the honesty and integrity of the taxpayers and their ability to know and comply with the pertinent tax rules.

A recent survey of taxpayer attitudes by the IRS Oversight Board revealed the results shown to the right.

Given the results of this survey, do you think the current self-assessment system is satisfactory? If not, should Congress create additional enforcement procedures to ensure taxpayer compliance? What sort of new reporting rules might be useful?

Why Do You Report and Pay Your Taxes Honestly? (more than one answer allowed)

Taxpayer Responses	Taxpayers for Whom This Reason is Key (Percent)
My own personal integrity	84%
A third party reported my information to the IRS (e.g., through a Form W-2 or 1099), so I must match that amount in my tax form	35%
Fear of an audit	37%
My neighbors report and pay their taxes honestly, so I will too	19%

What Is an Acceptable Amount by Which to Cheat on Your Income Taxes?

	Taxpayers Responding (Percent)
Not at all	86%
A little here and a little there	7%
As much as possible	5%
Other answers	2%

Source: 2013 Taxpayer Attitude Survey at www.tinyurl.com/13-TP-Attitudes.

The IRS investigates the offer by evaluating the taxpayer's financial ability to pay the tax. In some instances, the compromise settlement includes an agreement for final settlement of the tax through payments of a specified percentage of the taxpayer's future earnings. This settlement procedure usually entails lengthy negotiations with the IRS, but the presumption is that the agency will find terms upon which to enter into a compromise with the taxpayer.

A 20 percent nonrefundable current payment is required to set up the compromise offer, and a \$186 filing fee is required. Low-income individuals can apply for a waiver of the fee and of the 20 percent down payment.¹⁶

Every year, the IRS accepts about 10,000 offers in compromise, involving about \$150 million in unpaid taxes, interest, and penalties.

The IRS can agree to allow taxes to be paid on an installment basis if that arrangement facilitates the tax collection. An individual who has filed timely tax returns for five years is guaranteed the right to use an installment agreement when the amount in dispute does not exceed \$10,000. The taxpayer uses Form 9465 to initiate an installment plan. If the tax owed does not exceed \$50,000, a taxpayer can use an online application for an installment agreement.

A user fee is assessed with the application for the installment plan. The fee is between \$0 and \$120, depending on the taxpayer's income level and the form of payment (e.g., credit card or funds transfer).

The IRS provides an annual statement accounting for the status of the agreement. The agreement may later be modified or terminated because of (1) inadequate

¹⁶Reg. § 300.3(b)(1)(ii). "Low-income" is defined as less than 250% of the Federal poverty level.

information, (2) subsequent change in financial condition, or (3) failure to pay an installment when due or to provide requested information.¹⁷

A **closing agreement** is binding on both the taxpayer and the IRS except upon a subsequent showing of fraud, malfeasance, or misrepresentation of a material fact.¹⁸ The closing agreement may be used when disputed issues carry over to future years. It may also be employed to dispose of a dispute involving a specific issue for a prior year or a proposed transaction involving future years. If, for example, the IRS is willing to make substantial concessions in the valuation of assets for estate tax purposes, it may require a closing agreement from the recipient of the property to establish the income tax basis of the assets.

LO.5

Determine the amount of interest on a deficiency or a refund and when it is due.

26-1h **Interest****Determination of the Interest Rate**

Congress sets the interest rates applicable to Federal tax underpayments (deficiencies) and overpayments (refunds) close to the rates available in financial markets. The Code provides for the rates to be determined quarterly.¹⁹ Thus, the rates that are determined during March are effective for the following April through June.

For tax purposes, interest is based on the Federal short-term rates published periodically by the IRS in Revenue Rulings. They are based on the average market yield on outstanding marketable obligations of the United States with remaining maturity of three years or less.

For noncorporate taxpayers, the interest rate applicable to *both* overpayments and underpayments is 3 percent for the first quarter of 2015. For most corporate taxpayers, the rate is 2 percent for overpayments and 3 percent for underpayments. Corporations with large overpayments or underpayments are subject to different rates. IRS interest is compounded daily.²⁰ Tables for determining the daily compounded amount are available from the IRS and online.

IRS Deficiency Assessments

Interest usually accrues from the unextended due date of the return until 30 days after the taxpayer agrees to the deficiency by signing Form 870. If the taxpayer does not pay the amount shown on the IRS's notice and demand (final tax bill) within 30 days, interest again accrues on the deficiency.

Refund of Taxpayer's Overpayments

If an overpayment is refunded to the taxpayer within 45 days after the date the return is filed or is due, no interest is allowed. When the taxpayer files an amended return or makes a claim for refund of a prior year's tax (e.g., when net operating loss carrybacks result in refunds of a prior year's tax payments), however, interest is authorized from the original due date of the return through the date when the amended return is filed. In general, taxpayers applying for refunds receive interest as follows.

- When a return is filed after the due date, interest on any overpayment accrues from the date of filing. However, no interest is due if the IRS makes the refund within 45 days of the date of filing.

IRS Interest Payments**EXAMPLE****6**

Naomi, a calendar year taxpayer, files her 2014 return on December 1, 2015. The return reflects an overwithholding of \$2,500. On June 8, 2016, Naomi receives a refund of her 2014 overpayment. Interest on the refund began to accrue on December 1, 2015 (not April 15, 2015).

¹⁷§ 6159.

¹⁸§ 7121(b).

¹⁹§ 6621.

²⁰§ 6622.

IRS Interest Payments

Assume the same facts as in Example 6, except that the refund is paid to Naomi on January 5, 2016 (rather than June 8, 2016). No interest is payable by the IRS, because the refund was made within 45 days of the filing of the return.

EXAMPLE

7

- In no event will interest accrue on an overpayment unless the return that is filed is in “processable form.” Generally, this means that the return must contain enough information in a readable format to enable the IRS to identify the taxpayer and to determine the tax (and overpayment) involved.
- In the case of a carryback (e.g., net operating loss, capital loss, or tax credit), interest on any refund begins to accrue on the due date of the return (disregarding extensions) for the year in which the carryback arises. Even then, however, no interest accrues until a return is filed or, if the return has been filed, if the IRS pays the refund within 45 days.

Top Corporation, a calendar year taxpayer, incurs a net operating loss during 2015 that it can carry back to tax year 2013 and obtain a refund. On December 28, 2016, Top files a claim for refund. The earliest that interest can begin to accrue in this situation is March 15, 2016, but because the return was not filed until December 28, 2016, the later date controls. If, however, the IRS pays the refund within 45 days of December 28, 2016, no interest need be paid.

EXAMPLE

8



Concept Summary 26.1

Working with the IRS

1. The Internal Revenue Service (IRS) enforces the tax laws of the United States. Its size and form of organization reflect its various responsibilities relative to taxpayer interaction, litigation, and collection, as well as its internal functions.
2. The IRS issues various pronouncements in communicating its position on certain tax issues. These pronouncements promote the uniform enforcement of the tax law among taxpayers and among the internal divisions of the IRS. Taxpayers should seek such rulings and memoranda when the nature or magnitude of a pending transaction requires a high degree of certainty in the planning process.
3. IRS audits can take several forms. Taxpayers are selected for audit based on the probable net dollar return to the Treasury
4. from the process. Offers in compromise and closing agreements can be a useful means of completing an audit without resorting to litigation.
5. Certain IRS personnel are empowered to consider the hazards of litigation in developing a settlement with the taxpayer during the audit process.
6. The IRS pays interest to taxpayers on overpaid taxes, starting essentially 45 days after the due date of the return, in amounts tied to the Federal short-term rate. Interest paid to the IRS on underpayments is similarly based on the Federal rate, starting essentially on the due date of the return. Interest for both purposes is compounded daily.

26-1i Taxpayer Penalties

Congress has enacted a comprehensive array of penalties for improper actions by taxpayers. Tax penalties are meant to encourage compliance with the tax laws as part of a voluntary self-assessment system, not to generate revenue.²¹ In the typical year, about 40 million penalties are assessed, totaling almost \$30 billion in payments.

Tax penalties may involve both criminal and civil offenses. Criminal tax penalties are imposed only after the usual criminal process in which the taxpayer is entitled to the same constitutional guarantees as nontax criminal defendants. Normally, a criminal

LO.6

List and explain the various penalties that can be imposed on acts of noncompliance by taxpayers and return preparers.

²¹IRS Policy Statement 20-1, (6/29/2004), IRM § 1.2.20.1.1.

penalty provides for imprisonment. Civil tax penalties are collected in the same manner as other taxes and usually provide only for monetary fines. Criminal and civil penalties are not mutually exclusive; both types of sanctions may be imposed on a taxpayer.

The Code characterizes tax penalties as additions to tax; thus, the taxpayer cannot subsequently deduct them.

Ad valorem penalties are additions to tax that are based upon a percentage of the owed tax. *Assessable penalties*, on the other hand, typically include a flat dollar amount. Assessable penalties are not subject to review by the Tax Court, but ad valorem penalties are subject to the same deficiency procedures that apply to the underlying tax.

Failure to File and Failure to Pay

For a failure to file a tax return by the due date (including extensions), a penalty of 5 percent per month (up to a maximum of 25 percent) is imposed on the amount of tax shown as due on the return, with a minimum penalty amount of \$135.²² If the failure to file is attributable to fraud, the penalty becomes 15 percent per month, to a maximum of 75 percent of the tax.²³

For a failure to pay the tax due as shown on the return, a penalty of .5 percent per month (up to a maximum of 25 percent) is imposed on the amount of the tax. The penalty is doubled if the taxpayer fails to pay the tax after receiving a deficiency assessment.

In all of these cases, a fraction of a month counts as a full month. These penalties relate to the net amount of the tax due.

Obtaining an extension for filing a tax return does not by itself extend the date by which the taxes due must be paid. Thus, an application for an extended due date for a tax return almost always is accompanied by the taxpayer's payment of a good faith estimate of the taxes that will be owed with the return when it is filed by the extended due date. If the taxpayer does not make a good faith estimate and payment, the extension itself may be voided by the IRS (e.g., when the return is filed by the extended due date with a much larger amount due than had been estimated).

EXAMPLE

9

Conchita uses an automatic six-month extension for the filing of her Federal income tax return. Thus, the return is due on October 15, not on April 15. Conchita's application for the extension includes a \$5,000 check, the amount that she estimates her return will show as owing for the year when she files it in October.

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

EXAMPLE

10

Jason files his tax return 10 days after the due date. Along with the return, he remits a check for \$4,000, which is the balance of the tax he owes. Disregarding any interest liabilities, Jason's total penalties are as follows.

Failure to pay penalty (.5% × \$4,000)		\$ 20
Failure to file penalty (5% × \$4,000)	\$200	
Less: Failure to pay penalty for the same period	<u>(20)</u>	
Failure to file penalty		<u>180</u>
Total penalties		<u><u>\$200</u></u>

The penalties for one full month are imposed even though Jason was delinquent by only 10 days. Unlike the method used to compute interest, any part of a month is treated as a whole month.

²²§ 6651(a). The minimum penalty cannot exceed the amount of tax due on the return. Thus, if no tax is due, the penalty is zero.

²³§ 6651(f).



TAX IN THE NEWS Relying on “Really Good” Tax Advice

The Tax Court addressed the application of the reasonable cause exception to the negligence penalty. It appears that highly educated and experienced taxpayers have a difficult time avoiding the penalty by claiming that they relied on the advice of a professional tax adviser.

In *Stephen G. Woodsum*, 136 T.C. 585 (2011), the director of a private equity investment firm filed a tax return of over 100 pages with gross income of about \$29 million, mainly from investment transactions such as swaps and derivatives. One of the Forms 1099, reporting a \$3 million gain on a swap transaction, was omitted from the return. The Court classified this as a clerical error on the part of the tax preparer, and not as a piece of tax advice upon which the taxpayer relied. Thus, the taxpayer’s negligence penalty still applied. The Court found that the taxpayer did not review the tax return with reasonable rigor before signing it; had the financially savvy taxpayer performed more than a casual review of the transactions on the

return, the missing gain would not have “slipped through the cracks.”

The tax adviser in *Tony L. Robucci*, 100 TCM 1060, T.C.Memo. 2011–19, restructured his medical clinic to eliminate its exposure to Federal employment taxes. The restructuring entailed setting up a “shell” LLC. But the new entity did not trigger any meaningful change in the day-to-day operations of the clinic, and the taxpayer never participated in legal transfers of tangible or intangible assets. The Court stated that this highly educated taxpayer should have sought a “second opinion” after getting tax advice about the restructuring that was “too good to be true.” Citing *Neonatology Associates v. Comm.*, 2002–2 USTC ¶150,550, 90 AFTR 2d 2002–5442, 299 F.3d 221 (CA–3, 2002), the court charged that when “a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril.” Again, lacking a reasonable cause exception, the negligence penalty was allowed to stand.

These penalties can be avoided if the taxpayer shows that the failure to file and/or failure to pay was due to reasonable cause and not due to willful neglect. The Code is silent as to what constitutes reasonable cause, and the Regulations do little to clarify this important concept.²⁴ Reasonable cause for failure to pay is presumed under the automatic six-month extension (Form 4868) when the additional tax due is not more than 10 percent of the tax liability shown on the return. In addition, the courts have ruled on some aspects of **reasonable cause**.

- Reasonable cause was found where the taxpayer relied on the advice of a competent tax adviser given in good faith, the facts were fully disclosed to the adviser, and he or she considered that the specific question represented reasonable cause.²⁵ No reasonable cause was found, however, where the taxpayer delegated the filing task to another, even when that person was an accountant or an attorney.²⁶
- Among the reasons not qualifying as reasonable cause were lack of information on the due date of the return,²⁷ illness that did not incapacitate a taxpayer from completing a return,²⁸ refusal of the taxpayer’s spouse to cooperate for a joint return,²⁹ and ignorance or misunderstanding of the tax law.³⁰

Accuracy-Related Penalties

Major civil penalties relating to the accuracy of tax return data, including misstatements stemming from taxpayer negligence and improper valuation of income and deductions,

²⁴Reg. § 301.6651-1(c)(1) likens reasonable cause to the exercise of “ordinary business care and prudence” on the part of the taxpayer.

²⁵*Estate of Norma S. Bradley*, 33 TCM 70, T.C.Memo. 1974–17.

²⁶*U.S. v. Boyle*, 85–1 USTC ¶13,602, 55 AFTR 2d 85–1535, 105 S.Ct. 687 (USSC, 1985). This rule appears to apply to electronic as well as paper-based return filings, to employment as well as income taxes, and to returns where the tax preparer himself or herself commits a fraudulent act. *Brandon R. Ballantyne*, 99 TCM 1523, T.C.Memo. 2010–125; *McNair Eye Center, Inc.*, 99 TCM 1345, T.C.Memo. 2010–81. Knowledgeable taxpayers such as a tax attorney are held to a higher standard in determining

negligence. *Pelton & Gunther P.C.*, 78 TCM 578, T.C.Memo. 1999–339. A taxpayer might be negligent if, when a complicated tax issue is involved, a tax expert is *not* consulted. *Zmuda v. Comm.*, 84–1 USTC ¶9,442, 53 AFTR 2d 84–1269, 731 F.2d 1417 (CA–9, 1984).

²⁷*Beck Chemical Equipment Co.*, 27 T.C. 840 (1957).

²⁸*Alex and Tonya Oria*, 94 TCM 170, T.C.Memo. 2007–276, and *Babetta Schmidt*, 28 T.C. 367 (1957). Compare *Estate of Kirchner*, 46 B.T.A. 578 (1942).

²⁹*Electric and Neon, Inc.*, 56 T.C. 1324 (1971).

³⁰*Stevens Brothers Foundation, Inc.*, 39 T.C. 93 (1965).

are coordinated under the umbrella term **accuracy-related penalties**.³¹ This consolidation of related penalties into a single levy eliminates the possibility that multiple penalties will apply to a single understatement of tax.

The accuracy-related penalties each amount to 20 percent of the portion of the tax underpayment that is attributable to one or more of the following infractions.

- Negligence or disregard of rules and regulations.
- Substantial understatement of tax liability.
- Substantial valuation overstatement.
- Substantial valuation understatement.

The penalties apply only where the taxpayer fails to show a *reasonable basis* for the position taken on the return.³²

Negligence

For purposes of this accuracy-related penalty, **negligence** includes any failure to make a reasonable attempt to comply with the provisions of the tax law. The penalty also applies to any disregard (whether careless, reckless, or intentional) of rules and Regulations.³³ The penalty can be avoided upon a showing of reasonable cause and the fact that the taxpayer acted in good faith.³⁴

The negligence penalty applies to *all* taxes, except when fraud is involved. A negligence penalty may be assessed when the taxpayer fails to report gross income, overstates deductions, or fails to keep adequate records. When the taxpayer takes a nonnegligent position on the return that is contrary to a judicial precedent or published pronouncement of the IRS, the penalty is waived if the taxpayer has a reasonable basis for the interpretation and has disclosed the disputed position on Form 8275.

Substantial Understatement of Tax Liability

The understatement penalty is designed to strike at middle- and high-income taxpayers who are tempted to play the so-called audit lottery.³⁵ Some taxpayers take questionable and undisclosed positions on their tax returns in the hope the return will not be selected for audit. Disclosing the positions would have called attention to the return and increased the probability of audit.

A substantial understatement of a tax liability transpires when the understatement exceeds the larger of 10 percent of the tax due or \$5,000. For a C corporation, a substantial understatement is the lesser of the following.³⁶

- 10 percent of the tax due, but at least \$10,000.
- \$10 million.

The understatement to which the penalty applies is the difference between the amount of tax required to be paid and the amount of tax actually shown on the return.

The penalty is avoided under any of the following circumstances.³⁷

- The taxpayer has **substantial authority** for the treatment. Substantial authority exists when it is perhaps 40 percent likely that a court would find in favor of the taxpayer's position. This conclusion might be reached with an examination of pertinent statutory, administrative, and judicial tax law.
- There is a *reasonable basis* for the tax return position, which is adequately disclosed in the return by attaching Form 8275.

³¹§ 6662.

³²Reg. § 1.6662-3(b)(3). Most tax professionals measure this standard as a 20% probability of prevailing in court.

³³§ 6662(c). There can be no intentional disregard of the rules where the underlying law is unclear, complex, or subject to disagreement. *James J. Freeland*, 51 TCM 253, T.C.Memo. 1986-10, and *Lansdown v. Comm.*, 96-1 USTC ¶50,025, 77 AFTR 2d 96-491, 73 F.3d 373 (CA-10, 1996).

³⁴§ 6664(c)(1).

³⁵§ 6662(b)(2).

³⁶§ 6662(d)(1).

³⁷§ 6662(d)(2)(B). Substantial authority is measured as of either the last day of the tax year to which the return relates or the date the return was filed. Reg. § 1.6662-4(d)(3)(iv)(C).

Penalty for Overvaluation

The objective of the overvaluation penalty is to deter taxpayers from inflating values (or basis), usually of charitable contributions of property, to reduce income taxes.³⁸

- The penalty is 20 percent of the additional tax that would have been paid had the correct valuation been used.
- The penalty applies only when the valuation used by the taxpayer is 150 percent or more of the correct valuation. The penalty is doubled if the valuation error is *gross* (overstated by 200 percent or more).
- The penalty applies only when the resulting income tax underpayment exceeds \$5,000 (\$10,000 for C corporations).

Gretchen (a calendar year taxpayer) purchased a painting for \$10,000. When the painting is worth \$18,000 (as later determined by the IRS), Gretchen donates it to an art museum. Based on the appraisal of a cousin who is an amateur artist, she deducts \$40,000 for the donation. Because Gretchen was in the 30% tax bracket, overstating the deduction by \$22,000 results in a tax underpayment of \$6,600.

Gretchen's penalty for overvaluation is \$2,640, or *double* the regular penalty of \$1,320 (20% × \$6,600 underpayment).

EXAMPLE

11

The substantial valuation overstatement penalty is avoided if the taxpayer can show reasonable cause and good faith. However, when the overvaluation involves *charitable deduction property*, the taxpayer must substantiate both of the following.

- The claimed value of the property is based on a qualified appraisal made by a qualified appraiser.
- The taxpayer made a good faith investigation of the value of the contributed property.³⁹

Based on these criteria, Gretchen in Example 11 would find it difficult to avoid the penalty. A cousin who is an amateur artist does not meet the definition of a qualified appraiser. Likewise, Gretchen apparently has not made her own good faith investigation of the value of the contributed property.

Penalty for Undervaluation

When attempting to minimize the income tax, it is to the benefit of taxpayers to *overvalue* deductions. When attempting to minimize transfer taxes (estate and gift taxes), however, executors and donors may be inclined to *undervalue* the assets transferred. A lower valuation reduces estate and gift taxes. An accuracy-related penalty is imposed for substantial estate or gift tax valuation understatements.⁴⁰ As with other accuracy-related penalties, reasonable cause and good faith on the part of the taxpayer are a defense.

- The penalty is 20 percent of the additional transfer tax that would have been due had the correct valuation been used on Form 706 (estate tax return) or Form 709 (gift and generation-skipping tax return).
- The penalty applies only if the value of the property claimed on the return is 65 percent or less than the amount determined to be correct. The penalty is doubled if the reported valuation error is *gross* (reported value is 40 percent or less than the correct determination).
- The penalty applies only to an additional transfer tax liability in excess of \$5,000.

³⁸ §§ 6662(b)(3), (e), and (h).

³⁹ §§ 6664(c)(2) and (3).

⁴⁰ §§ 6662(b)(5), (g), and (h).

Appraiser's Penalty

When a valuation penalty arises because of the taxpayer's reliance on an appraisal, a further penalty can apply.⁴¹ If the appraiser knew or reasonably should have known that the appraisal would be used as part of a tax or refund computation and that the appraised value more likely than not was improper, then the appraiser pays a penalty equal to the lesser of:

- 10 percent of the tax understatement, but at least \$1,000, or
- 125 percent of the gross income received by the appraiser from the engagement (e.g., the appraisal fee collected).

Penalty for Improper Refund Claim

Whenever a taxpayer files a claim for a tax refund and the refund claim later is found to exceed the final amount allowed by the IRS or a court, a penalty of 20 percent of the disallowed refund results.⁴² The penalty is waived if the taxpayer can show a *reasonable basis* for the refund claim (i.e., probably a 20 percent chance that a court would allow the refund). This penalty is meant to discourage the taxpayer from overstating the amount of the refund requested from the IRS. It does not apply to claims for the earned income tax credit.

Civil Fraud Penalty

A 75 percent civil penalty is imposed on any underpayment resulting from **fraud** by the taxpayer who has filed a return.⁴³ For this penalty, the burden of proof *is on the IRS* to show that the taxpayer acted with a specific intent to evade a tax.

Once the IRS initially has established that fraud occurred, the taxpayer then bears the burden of proof to show by a preponderance of the evidence the portion of the underpayment that is not attributable to fraud.

Although the Code and Regulations do not provide any assistance in ascertaining what constitutes civil fraud, it is clear that mere negligence on the part of the taxpayer is not fraud. Fraud has been found in cases of manipulations of the books, substantial omissions from income, and erroneous deductions.⁴⁴

EXAMPLE

12

Frank underpaid his income tax by \$90,000. The IRS can prove that \$60,000 of the underpayment was due to fraud. The civil fraud penalty is \$45,000 (75% × \$60,000).

Failure to Pay Estimated Taxes

A penalty is imposed for a failure to pay estimated income taxes. The penalty applies to individuals and corporations and is based on the rate of interest in effect for deficiency assessments.⁴⁵ The penalty also applies to trusts and certain estates that are required to make estimated tax payments. The penalty is not imposed if the tax due for the year (less amounts withheld and credits) is less than \$500 for corporations, \$1,000 for all others. For employees, an equal part of withholding is deemed paid on each due date.

Quarterly payments are to be made on or before the fifteenth day of the fourth month (April 15 for a calendar year taxpayer), sixth month, ninth month, and the first month of the following year. Corporations must make the last quarterly payment by the twelfth month of the same year.

⁴¹§ 6695A.

⁴²§ 6676.

⁴³§ 6663. As noted later in the chapter, underpayments traceable to fraudulent acts are not subject to a statute of limitations.

⁴⁴*Dogget v. Comm.*, 60-1 USTC ¶9342, 5 AFTR 2d 1034, 275 F.2d 823 (CA-4, 1960); *Harvey Brodsky*, 21 TCM 578, T.C.Memo. 1962-105; and *Lash v. Comm.*, 57-2 USTC ¶9725, 51 AFTR 492, 245 F.2d 20 (CA-1, 1957).

⁴⁵§§ 6655 (corporations) and 6654 (other taxpayers). Other computations can avoid the penalty. See §§ 6654(d)(2) and (k), 6655(e) and (i).



TAX IN THE NEWS First-Time Tax Violators Can Get Off with Just a Warning

Tax penalties can be a harsh wake-up call when a taxpayer understates a tax liability, and there appears to be “no mercy” when a penalty is applied. Often, a tax penalty arises when the taxpayer has undergone a change in life/business circumstances (e.g., as the consequence of a divorce, retirement, or merger). The taxpayer may not have prepared adequately for the resulting tax increase, and a penalty results, but the taxpayer’s legitimate response might be “I didn’t mean to do it; I just didn’t know the rules.”

The Federal income tax law does allow a measure of mercy, though. A procedure exists under which the taxpayer can apply for an abatement (waiver) of a tax penalty. The IRS has discretion to allow the waiver, but the guidelines make certain the abatement if all of the following circumstances are met.

- The penalty relates to a single tax year.
- The taxpayer asserts a *reasonable cause* for the understatement of tax.
- The taxpayer otherwise is current as to tax filings and payment compliance.
- The taxpayer has not been assessed any other penalties of a significant amount on similar tax returns within the last three years.

An IRS oversight study estimates that only 10 percent of eligible taxpayers claim the first-time penalty waiver. This likely is because the IRS does not advertise the abatement procedure and because guidelines for the program are difficult to find at www.irs.gov.

An individual’s underpayment of estimated tax is the difference between the estimates that were paid and the least of:

- 90 percent of the current-year tax,
- 100 percent of the prior-year tax (the tax year must have been a full 12 months, and a return must have been filed), and
- 90 percent of the tax that would be due on an annualized income computation for the period running through the end of the quarter.

If the taxpayer’s prior-year AGI exceeds \$150,000, the 100 percent requirement becomes 110 percent.

A corporation’s underpayment of estimated tax is the difference between the estimates that were paid and the least of:

- The current-year tax,
- The prior-year tax, and
- The tax on an annualized income computation using one of three methods of computation sanctioned by the Code.

For the prior-year alternative, (1) the prior tax year must have been a full 12 months, (2) a nonzero tax amount must have been generated for that year, and (3) large corporations (taxable income of \$1 million or more in any of the three immediately preceding tax years) can use the alternative only for the first installment of a year.

In computing the penalty, Form 2210 (Underpayment of Estimated Tax by Individuals) or Form 2220 (Underpayment of Estimated Tax by Corporations) is used.

False Information with Respect to Withholding

Withholding from wages is an important element of the Federal income tax system, which is based on a pay-as-you-go approach. One way employees might hope to avoid this withholding would be to falsify the information provided to the employer on Form W-4 (Employee Withholding Allowance Certificate). For example, by overstating the number of exemptions, income tax withholdings could be reduced or completely eliminated.

To encourage compliance, a civil penalty of \$500 applies when a taxpayer claims withholding allowances based on false information. The criminal penalty for willfully

failing to supply information or for willfully supplying false or fraudulent information in connection with wage withholding is an additional fine of up to \$1,000 and/or up to one year of imprisonment.⁴⁶

Failure to Make Deposits of Taxes and Overstatements of Deposits

When a business is not doing well or cash-flow problems develop, employers have a great temptation to “borrow” from Uncle Sam. One way this can be done is to fail to pay to the IRS the amounts that have been withheld from the wages of employees for FICA and income tax purposes. The IRS can apply a number of weapons to discourage the practice.

- A penalty of up to 15 percent of any underdeposited amount not paid, unless the employer can show that the failure is due to reasonable cause and not to willful neglect.⁴⁷
- Various criminal penalties.⁴⁸
- A 100 percent penalty if the employer’s actions are willful.⁴⁹ The penalty is based on the amount of the tax evaded (i.e., not collected or not accounted for or paid over). Because the penalty is assessable against the “responsible person” of the business, more than one party may be vulnerable (e.g., the president and treasurer of a corporation, the third-party payroll service of the entity). Although the IRS may assess the penalty against several persons, it cannot collect more than 100 percent of the tax that is due.
- In addition to these penalties, the actual tax due must be remitted. For instance, an employer remains liable for the employees’ income and payroll taxes that should have been paid.

Failure to Provide Information Regarding Tax Shelters

The IRS has identified over two dozen transactions that it regards as “tax shelters.” These arrangements, often involving leveraged financing and accelerated interest and cost recovery deductions, allegedly are motivated solely by the desire to reduce taxes and have no business or profit-seeking goals. Over the last two decades, the IRS has struggled with numerous means of identifying taxpayers who use such tax shelters.

A tax shelter organizer must register the shelter with the IRS before any sales are made to investors.⁵⁰ A penalty of up to \$10,000 is assessed if the required information is not filed with the Service. This includes a description of the shelter and the tax benefits that are being used to attract investors.

Criminal Penalties

In addition to civil fraud penalties, the Code contains numerous criminal sanctions that carry various monetary fines and/or imprisonment. The difference between civil and criminal fraud is often one of degree. Thus, § 7201, dealing with attempts to evade or defeat a tax, contains the following language.

Any person who *willfully* attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than five years, or both, together with the costs of prosecution. [Emphasis added.]

As to the burden of proof, the IRS must show that the taxpayer was guilty of willful evasion “beyond the shadow of any reasonable doubt.” Thus, to avoid a criminal tax penalty, the taxpayer needs to create a degree of reasonable doubt as to guilt. To do so,

⁴⁶ §§ 6682 and 7205.

⁴⁷ § 6656.

⁴⁸ See, for example, § 7202 (willful failure to collect or pay over a tax).

⁴⁹ § 6672.

⁵⁰ § 6111.

the taxpayer might assert that he or she was confused or ignorant about the application of the tax law or relied on the erroneous advice of a competent tax adviser. Another defense against a criminal tax penalty is the lack of capacity to plan and carry out tax evasion (e.g., mental disease or other medical disorder).

Violations of the Federal criminal code in the context of filing tax returns also may arise from other crimes that are not provided for in the Internal Revenue Code. Examples include:

- Making a false claim against the Federal government.
- Participating in a conspiracy to evade Federal taxes (i.e., in addition to the tax understatement).
- Making a false statement to the Federal government or filing a false document (i.e., perjury).

26-1j Statutes of Limitations

A **statute of limitations** defines the period of time during which one party may pursue against another party a cause of action or other suit allowed under the governing law. Failure to satisfy any requirement provides the other party with an absolute defense should the statute be invoked. Inequity would result if no limits were placed on such suits. Permitting an extended period of time to elapse between the initiation of a claim and its pursuit could place the defense at a serious disadvantage. Witnesses may have died or disappeared; records or other evidence may have been discarded or destroyed.

Assessment and the Statute of Limitations

In general, any tax that is imposed must be assessed within three years of the later of (a) the filing date of the return or (b) the unextended due date of the return.⁵¹ Some exceptions to this three-year limitation exist.

- If no return is filed or a fraudulent return is filed, assessments can be made at any time. There is, in effect, no statute of limitations in these cases.
- If a taxpayer omits an amount of gross income in excess of 25 percent of the gross income stated on the return, the statute of limitations is increased to six years. The courts have interpreted this rule as including only items affecting income and not the omission of items affecting deductions, operating losses, or cost of sales.⁵² *Gross income* here includes capital gains, but not reduced by capital losses.

During 2010, Jerry recorded the following income transactions (all of which were duly reported on his timely filed return).

Gross receipts		\$ 480,000
Cost of sales		<u>(400,000)</u>
Net business income		\$ 80,000
Capital gains and losses		
Capital gain	\$ 36,000	
Capital loss	<u>(12,000)</u>	<u>24,000</u>
Total income		<u><u>\$ 104,000</u></u>

Jerry retains your services in 2015 as a tax consultant. It seems that he inadvertently omitted some income on his 2010 return, and he wants to know if he is “safe” under the statute of limitations. The three-year statute of limitations has expired, but the six-year statute of limitations still applies, putting Jerry in a vulnerable position only if he omitted more than \$129,000 on his 2010 return [(\$480,000 + \$36,000) × 25%].

LO.7

Recognize and apply the rules governing the statute of limitations on assessments and on refunds.

EXAMPLE

13

⁵¹§§ 6501(a) and (b)(1).

⁵²*The Colony, Inc. v. Comm.*, 58-2 USTC ¶9593, 1 AFTR 2d 1894, 78 S.Ct. 1033 (USSC, 1958).

- The statute of limitations may be extended for a fixed period of time by mutual consent of the IRS and the taxpayer. This extension covers a definite period and is made by signing Form 872 (Consent to Extend the Time to Assess Tax). The extension frequently is requested by the IRS when the lapse of the statutory period is imminent and the audit has not been completed. This practice often is applied to audits of corporate taxpayers and explains why many corporations have more than three “open years.”

The statute also is suspended when the taxpayer is “financially disabled”; that is, the taxpayer has been rendered unable to manage his or her financial affairs by a physical or mental impairment that is likely to last for a year or more or to cause the taxpayer’s death. The statute continues to run if another party is authorized to act for the taxpayer in financial matters.⁵³

Refund Claims and the Statute of Limitations

To receive a tax refund, the taxpayer is required to file a valid refund claim. The official form for filing a claim is Form 1040X for individuals and Form 1120X for corporations. If the refund claim does not meet certain procedural requirements, the IRS may reject the claim with no consideration of its merit.

- A separate claim must be filed for each taxable period.
- The grounds for the claim must be stated in sufficient detail.
- The statement of facts must be sufficient to permit the IRS to evaluate the merits of the claim.

The refund claim must be filed within three years of the filing of the tax return or within two years following the payment of the tax if this period expires on a later date.⁵⁴

EXAMPLE

14

On March 10, 2013, Louise filed her 2012 income tax return reflecting a tax of \$10,500. On July 11, 2014, she filed an amended 2012 return showing an additional \$3,000 of tax that was then paid. On May 19, 2016, she filed a claim for refund of \$4,500.

Assuming that Louise is correct in claiming a refund, how much tax can she recover? The answer is only \$3,000. Because the claim was not filed within the three-year statute of limitations period, Louise is limited to the amount she actually paid during the last two years.

Special rules are available for claims relating to bad debts and worthless securities. A seven-year period of limitations applies in lieu of the normal three-year rule.⁵⁵ The extended period is provided in recognition of the inherent difficulty of identifying the exact year in which a bad debt or security becomes worthless.

LO.8

Summarize the legal and ethical guidelines that apply to those engaged in tax practice.

26-2 THE TAX PROFESSION AND TAX ETHICS

Society and its governments expect taxpayers to comply with the letter and the spirit of the tax laws. Tax audits and penalties encourage a high degree of technical tax conformity, but the proper functioning of a voluntary tax compliance system also depends on the ethics of the taxpayer and the tax adviser.

The Treasury and various professional organizations have issued ethical guidelines that are relevant to the tax profession. Professional licensing agencies also are likely to require tax professionals to receive training in ethics to obtain initial certification and to remain in good standing over time.

⁵³Suspension of the statute of limitations has been allowed by some courts when attributable to a taxpayer disability or IRS misconduct. See *Brockamp v. Comm.*, 97-1 USTC ¶50,216, 79 AFTR 2d 97-986, 117 S.Ct. 849 (USSC, 1997). §§ 6501(c)(4) and 6511(h).

⁵⁴§§ 6511(a) and 6513(a).

⁵⁵§ 6511(d)(1).

26-2a The Tax Professional

Who is a tax practitioner? What services does the practitioner perform? A number of different groups apply constraints on the way a tax professional conducts his or her practice.

Generally, practice before the IRS is limited to CPAs, attorneys, and persons who have been enrolled to practice before the IRS [enrolled agents (EAs)]. In most cases, EAs are admitted to practice only if they pass an examination administered by the IRS. CPAs and attorneys are not required to take this examination and are automatically admitted to practice if they are in good standing with the appropriate licensing board regulating their profession.

Persons other than CPAs, attorneys, and EAs may be allowed to practice before the IRS in limited situations. **Circular 230** (“Regulations Governing Practice before the Internal Revenue Service”) issued by the Treasury Department permits certain notable exceptions.

- A taxpayer always may represent himself or herself. A person also may represent a member of the immediate family if no compensation is received for such services.
- Full-time employees may represent their employers.
- Corporations may be represented by any of their officers.
- Partnerships may be represented by any of the partners.
- Trusts, receiverships, guardianships, or estates may be represented by their trustees, receivers, guardians, or administrators or executors, respectively.
- A taxpayer may be represented by the registered tax return preparer who prepared the return for the year in question. See the following discussion.

All nonattorney tax practitioners should avoid becoming engaged in activities that constitute the *unauthorized practice of law*. If they engage in this practice (e.g., by drafting legal documents for a third party), action could be instituted against them in the appropriate state court by the local or state bar association. What actions constitute the unauthorized practice of law is largely undefined, though, and such charges are filed only rarely today.

26-2b Licensing Tax Preparers

There are no minimum education or experience requirements for those who are paid to file Federal tax returns for others. But the IRS does require that all paid tax return preparers, including CPAs and attorneys, obtain a Preparer Tax Identification Number (PTIN) before they assist taxpayers with returns for a new filing season.

For preparers who also are CPAs, attorneys, or EAs, the fee to obtain PTINs is about \$65 per year. This amount is in addition to any other professional, certification, or licensing fee the preparer might be required to pay (e.g., annual fees to maintain a CPA certificate).

Upon receiving a PTIN, the tax professional can refer to himself or herself as a “registered tax return preparer.” All of the provisions of Circular 230 (discussed in the next section) apply to the registered preparer, including those regarding advertising and solicitation of clients. The PTIN holder can neither use the term *certified* in describing this designation nor assert that the IRS endorses his or her practice in any way.

A registered tax return preparer (who is not also a CPA or an attorney) may represent the taxpayer for whom a signed return was prepared before IRS revenue agents, but not before appeals officers, revenue officers, or IRS counsel.

The IRS may use PTIN data to identify preparers who commit a pattern of errors or who participate in fraudulent actions. With more than 1 million paid preparers at work in any filing season, the IRS uses an outside consultant to manage the registration and testing functions.



ETHICS & EQUITY Who Cheats and Why?

Tax compliance for business income reported on the Form 1040, Schedules C, E, and F, tends to be much lower than that for the rest of individuals' taxable income. Because of the use of Forms W-2 and 1099, the reporting of taxable transactions by wage earners and many investors is fairly thorough and tax compliance rates are high. But business income often entails the use of cash, or it is not reported to the IRS under current disclosure rules; so tax cheating may be more common on that part of the tax return.

A recent academic analysis of Schedule C data brings up another motivation for high or low compliance with the tax laws. Occupations (reported by industry codes) in which "integrity" is of higher value might be expected to show

higher tax compliance rates. Integrity may be defined as an activity involving a public or professional reputation or one exposed to professional sanctions such as a loss of license to practice.

Assume that the importance (or lack thereof) of one's business integrity affects the taxpayer's willingness to comply with the tax law. List three occupations where this criterion might lead to high tax compliance. To low tax compliance. For instance, who might be most likely to understate a tax liability on a Form 1040: an attorney, a member of the clergy, or a plumbing contractor? What should the IRS do with such academic data about taxpayer behavior?

26-2c IRS Rules Governing Tax Practice

Circular 230 prescribes the rules governing practice before the IRS. Following are some of the most important rules imposed on CPAs, attorneys, EAs, and all others who prepare tax returns for compensation.

- A prohibition against taking an undisclosed position on a tax return unless there is a *reasonable basis* that the position will be sustained on its merits. Generally, this standard is met when a person knowledgeable in the tax law would conclude that the position has a greater than 20 percent probability of prevailing in the court of final jurisdiction.
- A requirement that nonfrivolous tax return positions that fail the reasonable basis standard be disclosed in the return (i.e., using Form 8275).
- A prohibition against taking frivolous tax return positions. A **frivolous return** is a return with a less than 5 percent chance of being sustained by the court of final jurisdiction.

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 26-1. Campbell has developed a testing program to be used by its in-house engineers before a new GPS app is released to the public; Campbell wants to claim the research credit for that program. Based on their tax research on this issue, the members of your firm's tax department have severe doubts about taking the credit for this program. Your firm's position is that there is a one-in-six chance that the courts would allow Campbell's credit.

Claiming the credit fails the reasonable basis standard of Circular 230, although it is a non-frivolous filing position. Therefore, if Campbell claims the credit, you must insist that its Form 1120 include a separate disclosure on the return, probably using Form 8275.

- A requirement to inform clients of penalties likely to apply to return positions and of ways such penalties can be avoided.
- A requirement to make known to a client any error or omission the client may have made on any return or other document submitted to the IRS.
- A duty to submit, in a timely fashion, records or information lawfully requested by the IRS.
- An obligation to exercise *due diligence* and to use the *best practices* of the tax profession in preparing, reviewing, and filing tax returns accurately.

Your niece, Selma, plans to start a tax return preparation service. She seeks advice on what procedures and practices to establish in order to develop and maintain a successful business. As a starting point, Selma should set up a standardized procedure for receiving, processing, and reviewing client tax returns. A key to achieving a high quality product would be an appropriate choice of tax accounting software. She should be sure that all client data are kept confidential and that the electronic files holding such data are secure and properly backed up.

Any employees who are hired should be technically competent and properly indoctrinated as to office procedure. All hires will be subject to a background check and be made aware that they are expected to participate in continuing education covering developments in tax law changes. Finally, Selma should formulate adequate disclaiming language so that e-mail recipients do not assume that the content represents technical advice that justifies individual reliance.

EXAMPLE

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- A restriction against unreasonably delaying the prompt disposition of any matter before the IRS.
- A restriction against charging the client a contingent fee for preparing an original return. Such a fee can be charged when the tax professional deals with an audited or amended return and when assisting the taxpayer in filing a refund claim.
- A restriction against charging the client “an unconscionable fee” for representation before the IRS.
- A restriction against representing clients with conflicting interests.

Nothing prevents the “unlicensed” tax practitioner from advertising his or her specialty, directly soliciting clients, or engaging in other actions that are regulated by the standards of conduct controlling CPAs, attorneys, and EAs. Nevertheless, some constraints do govern all parties engaged in rendering tax returns for the general public.

- A person who holds himself or herself out to the general public as possessing tax expertise could be liable to the client if services are performed in a negligent manner. At a minimum, the practitioner is liable for any interest and penalties the client incurs because of the practitioner’s failure to exercise due professional care.
- If a practitioner agrees to perform a service (e.g., prepare a tax return) and subsequently fails to do so, the aggrieved party may be in a position to obtain damages for breach of contract.
- All persons who prepare tax returns or refund claims for a fee must sign as preparer of the return.⁵⁶ Failure to comply with this requirement could result in a penalty assessment against the preparer.
- Various penalties apply concerning the deliberate filing of false or fraudulent returns. These felonies apply to a tax practitioner who either was aware of the situation or actually perpetrated the false information or the fraud.⁵⁷
- Penalties are prescribed for tax practitioners who disclose to third parties information they have received from clients in connection with the preparation of tax returns or the rendering of tax advice.⁵⁸

Sarah operates a tax return preparation service. Her brother-in-law, Butch, has just taken a job as a life insurance salesperson. To help Butch find contacts, Sarah furnishes him with a list of the names and addresses of all of her clients who report AGI of \$50,000 or more. Sarah is subject to the disclosure penalty.

EXAMPLE

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Circular 230 is administered by the IRS Office of Professional Responsibility (OPR). Among other duties, the OPR carries out disciplinary hearings and issues penalties, such as fines and licensing restrictions and retractions, relative to tax preparers. The accountability board of most states includes a member of the OPR, so a Circular 230 violation could lead to the loss or suspension of a CPA’s license at the state level as well.

⁵⁶Reg. § 1.6065-1(b)(1). Rev.Rul. 84-3, 1984-1 C.B. 264, contains a series of examples illustrating when a person is deemed to be a preparer of the return.

⁵⁷§ 7206.

⁵⁸§ 7216.

26-2d Preparer Penalties

The Code provides penalties to discourage improper actions by tax practitioners. **Tax preparer** penalties are assessed on any person who prepares for compensation, or engages employees to prepare, a substantial portion of any Federal tax return or refund claim. The following individuals are exempt from the preparer penalties.

- An IRS employee.
- A volunteer who prepares tax returns in a government assistance effort such as Tax Counseling for the Elderly (TCE) or the Volunteer Income Tax Assistance (VITA) program.
- An employee preparing a return for the employer.
- A fiduciary preparing a return for a trust or an estate.
- An individual who provides only data processing, typing, reproduction, or other assistance in preparing a return.

The preparer penalties are applied on a “one preparer per firm, per filing position” basis, so penalty dollars can compound quickly within the tax practice. Some of the most important tax preparer penalties include the following.

1. A penalty for understatements due to taking an **unreasonable position** on a tax return.⁵⁹ The penalty is imposed if the tax position:
 - Is not disclosed on the return and there was no *substantial authority* (i.e., a greater than 40 percent chance) that the tax position would be sustained by its merits on a final court review, or
 - Is disclosed on the return and there was not a *reasonable basis* (i.e., probably a 20 percent chance) for the position.

The penalty is computed as the greater of \$1,000 or one-half of the income of the practitioner that is attributable to the return or claim that violated the conduct standard. The penalty can be avoided by showing reasonable cause and by showing that the preparer acted in good faith.

EXAMPLE

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Josie is the tax return preparer for Hal’s Form 1040. The return includes a deduction that has a 60% chance of being sustained on its merits because it is contrary to an applicable tax Regulation. If a court denies the deduction, Josie is not assessed a penalty for taking an unreasonable position on the tax return.

Now assume that Hal’s deduction has a 30% chance of being sustained on its merits. If a court denies the deduction, Josie is assessed the penalty (unless the disputed position was disclosed on the return with a Form 8275–R). The amount of the penalty is the greater of \$1,000 or one-half of Josie’s fees for preparing Hal’s Form 1040.

What if Hal’s deduction has a 15% chance of being sustained on its merits? If a court denies the deduction, Josie is assessed a penalty for taking an unreasonable tax return position (even if the disputed position was disclosed on the return with a Form 8275–R). The amount of the penalty is the greater of \$1,000 or one-half of Josie’s fees for preparing Hal’s Form 1040.

2. A penalty for willful and reckless conduct.⁶⁰ The penalty applies if any part of the understatement of a taxpayer’s liability on a return or claim for refund is due to:
 - The preparer’s willful attempt to understate the taxpayer’s tax liability in any manner.
 - Any reckless or intentional disregard of IRS rules or Regulations by the preparer.

The penalty is computed as the greater of \$5,000 or one-half of the income of the practitioner that is attributable to the return or claim that violated the conduct

⁵⁹§ 6694(a). For the most part, these standards match those that apply to the taxpayer penalties of § 6662(d). Stricter disclosure standards apply for tax shelter items and reportable transactions. § 6662A.

⁶⁰§ 6694(b).

standard. Adequate disclosure can avoid the penalty. If both this penalty and the unreasonable position penalty (see item 1) apply to the same return, the reckless conduct penalty is reduced by the amount of the penalty for unreasonable positions.

3. A \$1,000 (\$10,000 for the tax returns of corporations) penalty per return or document is imposed against persons who aid in the preparation of returns or other documents they know (or have reason to believe) would result in an understatement of the tax liability of another person.⁶¹ Thus, this penalty also applies to those other than the preparer of the actual tax return (e.g., advisers, attorneys, corporate officers and executives, and tax shelter promoters). Clerical assistance in the return preparation process does not incur the penalty.

If this penalty applies, neither the unreasonable position penalty (item 1) nor the willful and reckless conduct penalty (item 2) is assessed.

4. A \$50 penalty is assessed against the preparer for failure to sign a return or furnish the preparer's PTIN.⁶²
5. A \$50 penalty is assessed if the preparer fails to furnish a copy of the return or claim for refund to the taxpayer.
6. A \$500 penalty may be assessed if a preparer endorses or otherwise negotiates a check for refund of tax issued to the taxpayer.

26-2e Privileged Communications

Communications between an attorney and client long have been protected from disclosure to other parties (such as the IRS and the courts). A similar privilege of confidentiality extends to tax advice between a taxpayer and tax practitioner, as that term was used previously. The privilege is not available for matters involving criminal charges or questions brought by other agencies, such as the Securities and Exchange Commission.⁶³ Nor is it allowed in matters involving promoting or participating in tax shelters.

A taxpayer likely will want to protect documents such as the tax adviser's research memo detailing the strengths and weaknesses of a tax return position or a conversation about an appeals strategy. The confidentiality privilege should be interpreted in the following manner.

- The privilege for CPAs applies only to tax advice. Only attorneys can exercise the privilege concerning advice rendered as a business consultant, an estate/financial planner, etc.
- The privilege is not available for tax accrual workpapers prepared as part of an independent financial audit.

26-2f AICPA Statements on Standards for Tax Services

Tax practitioners who are CPAs, attorneys, or EAs must abide by the codes or canons of professional ethics applicable to their respective professions. The various codes and canons have much in common with and parallel the standards of conduct set forth in Circular 230.⁶⁴

The AICPA has issued a series of Statements on Standards for Tax Services (SSTs). The Statements are enforceable standards of professional practice for AICPA members working in state or Federal tax practice. The SSTs comprise part of the AICPA's Code of Professional Conduct. Together with the provisions of Circular 230 and the penalty provisions of the Code, the SSTs make up a set of guidelines for the conduct of the tax practitioner who is also a CPA. Other sources of professional ethics are issued by state bar associations and CPA societies, the American Bar Association, and the associations of enrolled agents.

Key provisions of some of the SSTs are presented next.

⁶¹§ 6701.

⁶²§ 6695.

⁶³§ 7525(a)(1).

⁶⁴For an additional discussion of tax ethics, see Sawyers, Raabe, Whittenburg, and Gill, *Federal Tax Research*, 10th ed. (Cengage Learning, 2015), especially Chapters 1 and 14.



ETHICS & EQUITY Where Does My Cost Saving Go?

As is the case in many other U.S. industries, tax return preparers have been outsourcing some of their operations to lower-cost locations overseas. By some estimates, over 5 million state and Federal tax returns are completed in India alone, and such estimates are probably understated because of a lack of disclosure by tax practitioners. Tax and consulting firms defend the practice as a cost-saving measure and contend that the confidentiality of taxpayer data is not compromised.

AICPA ethics rules (applying both to tax return preparation and other work) require:

- Notice to the taxpayer before any data are shared with a third-party service provider.
- Acceptance by the practitioner of full responsibility for the third party's work (i.e., as to quality and security).

Should any cost saving that outsourcing provides be passed on to the client in the form of lower fees? Do you expect that this will occur?

Statement No. 1: Tax Return Positions

Under certain circumstances, a CPA may take a position that is contrary to that taken by the IRS. To do so, however, the CPA must have a good faith belief that the position has a realistic possibility (i.e., probably a one-in-three chance) of being sustained administratively or judicially on its merits if challenged. If the taxing authority (e.g., a state revenue statute) uses a lower standard than that of a *realistic possibility*, this higher standard still applies.

The client should be fully advised of the risks involved and the penalties that may result if the position taken on the tax return is not successful. The client also should be informed that disclosure on the return may avoid some or all of these penalties.

In no case, though, should the CPA exploit the audit lottery. That is, the CPA should not take a questionable position based on the probabilities that the client's return will not be chosen by the IRS for audit. Furthermore, the CPA should not "load" the return with questionable items in the hope that they might aid the client in a later settlement negotiation with the IRS.

The Big Picture

EXAMPLE

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Return to the facts of *The Big Picture* on p. 26-1. Campbell's new marketing program solicits the opinions of a virtual focus group to test ideas for new products. Based on your tax research, you believe that because the program relies on innovative algorithms that use online contacts to carry out the focus group activities, the program might qualify for the Federal income tax research credit even though it involves marketing research that is excluded from the credit under § 41(d)(4). Still, you believe that there is only a 30% chance the courts would allow the credit.

You meet with Shelly Watkins, Campbell's tax director, to convey the results of your research. Watkins agrees that the research credit would be turned down by an IRS auditor, but she says that Campbell never has been audited and that it is not likely to be audited as long as its legal structure and income levels do not significantly change. Watkins believes that Campbell's corporate officers will sign off on the credit, given both the firm's weak cash position and the low chances that the item will be discovered.

As a CPA, you must inform Campbell that claiming the credit for this activity does not have a realistic possibility of being sustained on its merits and that certain penalties will be assessed if the credit is claimed and not further disclosed on the return.

Whether the credit is claimed is the decision of your client, the taxpayer. But if Campbell wants to claim the credit without the required additional disclosures, you must terminate your engagement with Campbell, under the SSTS and other AICPA provisions.

Statement No. 2: Questions on Returns

A CPA should make a reasonable effort to obtain from the client, and provide, appropriate answers to all questions on a tax return before signing as preparer. Reasonable grounds may exist for omitting an answer.

- The information is not readily available, and the answer is not significant in amount in computing the tax.
- The meaning of the question as it applies to a particular situation is genuinely uncertain.
- The answer to the question is voluminous.

The fact that an answer to a question could prove disadvantageous to the client does not justify omitting the answer.

Statement No. 3: Procedural Aspects of Preparing Returns

In preparing a return, a CPA may in good faith rely without verification on information furnished by the client or by third parties. However, the CPA should make reasonable inquiries if the information appears to be incorrect, incomplete, or inconsistent. In this regard, the CPA should refer to the client's returns for prior years whenever appropriate.

Assuring Taxpayer Compliance

A CPA normally can take a client's word for the validity of dependency exemptions. But suppose a recently divorced client wants to claim his three children as dependents when he does not have custody. You must act in accordance with § 152(e)(2) in preparing the return, and this will require evidence of a waiver by the custodial parent. Without this waiver, you should not claim the dependency exemptions on your client's tax return.

EXAMPLE

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While preparing Sunni's income tax return, you review her prior year's income tax return. In comparing the dividend income reported on the Schedule B for the two years, you note a significant decrease from last year's amounts. Further investigation reveals the variation is due to a stock sale this year that was unknown to you until now. Thus, the review of the prior year's return has unearthed a transaction that should be reported on this year's return.

EXAMPLE

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If the Code or Regulations require certain types of verification (as is the case with travel and entertainment expenditures), the CPA must advise the client of these rules. Further, inquiry must be made to ascertain whether the client has complied with the verification requirements.

Statement No. 4: Estimates

A CPA may prepare a tax return using estimates received from a taxpayer if it is impracticable to obtain exact data. The estimates must be reasonable under the facts and circumstances as known to the CPA. When estimates are used, they should be presented in such a manner as to avoid the implication of greater accuracy than exists.

Statement No. 5: Recognition of Administrative Proceeding or Court Decision

As facts may vary from year to year, so may the position taken by a CPA. In these types of situations, the CPA is not bound by an administrative or judicial proceeding involving a prior year.

As part of a prior year's audit of Ramon Corporation's income tax return, the IRS disallowed \$78,000 of the \$600,000 salary paid to its president and sole shareholder on the grounds that it is unreasonable. You are the CPA who has been engaged to prepare Ramon's income tax return for 2015. Again, the corporation paid its president a salary of \$600,000 and chose to deduct this amount. Because you are not bound for 2015 by what the IRS deemed reasonable for the prior tax year, the full \$600,000 can be claimed as a salary deduction, assuming that you and Ramon both believe that the entire salary represents reasonable compensation.

EXAMPLE

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Statement No. 6: Knowledge of Error

A CPA should promptly advise a client upon learning of an error in a previously filed return or upon learning of a client's failure to file a required return, where the error has a significant (material in amount) effect on the tax liability. The advice can be oral or written and should include a recommendation of the corrective measures, if any, to be taken. The error or other omission should not be disclosed to the IRS without the client's consent.

If the past error is material and is not corrected by the client, the CPA may be unable to prepare the current year's tax return. The CPA must consider the cumulative effects of the error on the taxpayer's liabilities for all tax years, including those in the future.

EXAMPLE**23**

In preparing a client's 2015 income tax return, you discover that final inventory for 2014 was materially understated. First, you should advise the client to file an amended return for 2014 reflecting the correct amount in final inventory. Second, if the client refuses to make this adjustment, you should consider whether the error will preclude you from preparing a substantially correct return for 2015. Because this will probably be the case (last year's closing inventory becomes this year's beginning inventory), you should withdraw from the engagement.

If the client corrects the error, you may proceed with the preparation of the 2015 tax return. You must assure yourself that the error is not repeated on the return that you are preparing.

Statement No. 7: Advice to Clients

In providing tax advice to a client, the CPA must use judgment to ensure that the advice reflects professional competence and appropriately serves the client's needs. No standard format or guidelines can be established to cover all situations and circumstances involving written or oral advice by the CPA.

The CPA may communicate with the client when subsequent developments affect previous advice on significant matters. However, the CPA is not expected to assume responsibility for initiating the communication, unless he or she has agreed to do so in the engagement letter with the client.

The rules regarding professional standards and ethics in tax practice are set forth at the top of the next page.

26-3 TAX PLANNING

26-3a Strategies in Seeking an Administrative Ruling

Determination Letters

In many instances, the request for an advance ruling or a determination letter from the IRS is a necessary or desirable planning strategy. The receipt of a favorable ruling or determination reduces the risk associated with a transaction when the tax results are in doubt. For example, the initiation or amendment of a qualified pension or profit sharing plan should be accompanied by a determination letter. Otherwise, upon subsequent IRS review, the plan may not qualify, and the tax deductibility of contributions to the plan will be disallowed. In some instances, the potential tax effects of a transaction are so numerous and of such consequence that proceeding without a ruling is unwise.

Letter Rulings

In some cases, it may not be necessary or desirable to request an advance ruling. For example, it generally is not desirable to request a ruling if the tax results are doubtful and the company is committed to completing the transaction in any event. If a ruling is requested and negotiations with the IRS indicate that an adverse determination will be



Concept Summary 26.2

Tax Profession and Ethics

1. The Treasury assesses penalties when the taxpayer fails to file a required tax return or pay a tax. Penalties also are assessed when an inaccurate return is filed due to negligence or other disregard of IRS rules. Tax preparers are subject to penalties for assisting a taxpayer in filing an inaccurate return, failing to follow IRS rules in an appropriate manner, or mishandling taxpayer data or funds.
2. Statutes of limitations place outer boundaries on the timing and amounts of proposed amendments to completed tax returns that can be made by the taxpayer or the IRS.
3. Tax practitioners must operate under constraints imposed on them by codes of ethics or pertinent professional societies and by Treasury Circular 230. These rules also define the parties who can represent others in an IRS proceeding.
4. A limited privilege of confidentiality exists between the taxpayer and tax preparer.

forthcoming, it usually is possible to have the ruling request withdrawn. However, the National Office of the IRS may forward its findings, along with a copy of the ruling request, to local IRS personnel. In determining the advisability of a ruling request, the taxpayer should consider the potential exposure of other items in the tax returns of all “open years.”

A ruling request may delay the consummation of a transaction if the issues are novel or complex. Frequently, a ruling can be processed within six months, although in some instances, a delay of a year or more may be encountered.

Technical Advice Memoranda

A taxpayer in the process of contesting a proposed deficiency with the Appeals Division should consider requesting a technical advice memorandum from the IRS. If the memorandum is favorable to the taxpayer, it is binding on the Appeals Division. The request may be particularly appropriate when the practitioner believes that the agent or Appeals Division has been too literal in interpreting an IRS ruling.

26-3b Considerations in Handling an IRS Audit

As a general rule, a taxpayer should attempt to settle disputes at the earliest possible stage of the administrative appeal process. It usually is possible to limit the scope of the examination by furnishing pertinent information requested by the agent. Extraneous information or fortuitous comments may result in the opening of new issues and should be avoided. Agents usually appreciate prompt and efficient responses to inquiries, because their performance may in part be judged by their ability to close or settle assigned cases.

To the extent possible, it is advisable to conduct the investigation of field audits in the practitioner’s office, rather than the client’s office. This procedure permits greater control over the audit investigation and facilitates the agent’s review and prompt closure of the case.

Many practitioners believe that it is generally not advisable to have clients present at the scheduled conferences with the agent, because the client may give emotional or gratuitous comments that impair prompt settlement. If the client is not present, however, he or she should be advised of the status of negotiations. The client makes the final decision on any proposed settlement.

Preparing for the Audit

The tax professional must prepare thoroughly for the audit or Appeals proceeding. Practitioners often cite the following steps as critical to such preparations. Carrying out a level of due diligence in preparing for the proceeding is part of the tax professional’s responsibility in representing the client.

- Make certain that both sides agree on the issues to be resolved in the audit. The goal here is to limit the agent’s list of open issues.
- Identify all of the facts underlying the issues in dispute, including those favorable to the IRS. Gather evidence to support the taxpayer’s position, and evaluate the evidence supporting the other side.

- Research current tax law authorities as they bear on the facts and open issues. Remember that the IRS agent is bound only by Supreme Court cases and IRS pronouncements. Determine the degree of discretion that the IRS is likely to have in disposing of the case.
- Prepare a list of points supporting and contradicting the taxpayer's case. Include both minor points bearing little weight and core principles. Short research memos also will be useful in the discussion with the agent. Points favoring the taxpayer should be mentioned during the discussion and "entered into the record."
- Prepare tax and interest computations showing the effects of points that are in dispute so that the consequences of closing or compromising an issue can be readily determined.
- Determine a "litigation point" (i.e., at which the taxpayer will withdraw from further audit negotiation and pursue the case in the courts). This position should be based on the dollars of tax, interest, and penalty involved; the chances of prevailing in various trial-level courts; and other strategies discussed with the taxpayer. One must have an "end game" strategy for the audit, and thorough tax research is critical in developing that position in this context.

Documentation Issues

The tax practitioner's workpapers should include all research memoranda, and a list of resolved and unresolved issues should be continually updated during the course of the IRS audit. Occasionally, agents request access to excessive amounts of accounting data to engage in a so-called fishing expedition. Providing blanket access to working papers should be avoided. Workpapers should be reviewed carefully to minimize opportunities for the agent to raise new issues not otherwise apparent. It generally is advisable to provide the agent with copies of specific workpapers upon request.

In unusual situations, a Special Agent may appear to gather evidence in the investigation of possible criminal fraud. When this occurs, the taxpayer should be advised to seek legal counsel to determine the extent of his or her cooperation in providing information to the agent. If the taxpayer receives a Revenue Agent's Report, it generally indicates that the IRS has decided not to initiate criminal proceedings. The IRS usually does not take any action on a tax deficiency until the criminal matter has been resolved.

26-3c Statute of Limitations

Extending the Statute

The IRS requests an extension of the statute of limitations when it finds that there is insufficient time to complete an audit or appellate review. The taxpayer is not compelled to agree to the extension request and may be averse to giving the IRS more time. But adverse consequences can result if the taxpayer denies the IRS request.

EXAMPLE

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Although the statute of limitations governing Thornton's tax return is scheduled to expire in 15 days, the IRS has requested an extension for another 60 days. It wants to complete a more thorough investigation into a disputed \$50,000 deduction. If Thornton refuses to agree to the extension, the IRS likely will disallow the entire deduction. However, if Thornton agrees to the extension, all or part of the deduction may be salvaged.

A disadvantage of extending the statute is that the IRS sometimes can raise new issues during the extension period. However, the taxpayer can take the following protective measures as a condition to agreeing to the extension.

- Shorten the extension period requested before signing the Form 872. This will reduce the chance that the IRS will find and investigate new issues.
- Restrict the scope of the issues covered by the extension (e.g., extend the period only as to the computation of cost of goods sold).

- Instead of Form 872, use a Form 872–A. This allows for an open-ended termination date of the extension. Consequently, when the examination of a disputed issue is completed, the taxpayer can request that the IRS close off the extension. This reduces the chances that the IRS will find and pursue any new issues.

26-3d Penalties

The failure-to-file and failure-to-pay penalties are not a threat for most individual taxpayers. Those penalties are computed as a percentage of the unpaid tax liability; because most taxpayers receive a refund on the Form 1040, the penalty as computed would be zero.

The penalty for failure to pay estimated taxes can become quite severe. Often trapped by the provision are employed taxpayers with outside income. They may forget about the outside income and assume that the amount withheld from wages and salaries is adequate to cover their liability. Not only does April 15 provide a real shock (in terms of the additional tax owed) for these persons, but a penalty situation may have evolved. One way for an employee to mitigate this problem is described in the following example.

Patty, a calendar year taxpayer, is employed by Finn Corporation and earns (after withholding) a monthly salary of \$4,000 payable at the end of each month. Patty also receives income from outside sources (interest, dividends, and consulting fees). After some quick calculations in early October, Patty determines that she has underestimated her tax liability by \$7,500 and will be subject to the penalty for the first two quarters of the year and part of the third quarter. Patty, therefore, completes a new Form W–4 in which she raises her income tax withholding by \$2,500 a month. As a result, an extra \$7,500 is paid to the IRS on Patty’s account for the payroll period from October through December.

Patty avoids penalties for the underpayment for the first three quarters because withholding of taxes is allocated pro rata over the year involved. Thus, a portion of the additional \$7,500 withheld in October–December is assigned to the January 1–April 15 period, the April 16–June 15 period, etc. Had Patty merely paid the IRS an additional \$7,500 in October, the penalty would still have been assessed for the earlier quarters.

EXAMPLE

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To avoid tax preparer penalties, the tax professional must carry out a number of quality control measures within the context of his or her firm.

- Adopt a “tone at the top” that stresses ethical tax practice, emphasizing at all times the importance of integrity and objectivity in the context of client advocacy.
- Establish and follow ethical guidelines with respect to all forms of client communication and documentation, including tax returns and written, spoken, and electronic tax advice.
- Apply ethical standards even before an engagement letter is prepared for a potential client. The client should be aware of, and participate in, this dedication to ethical behavior.
- Stay current on changes to penalties, ethical guidelines, and Circular 230 provisions through an ongoing educational effort that communicates rule changes and the firm’s best practices to all who handle tax return data.
- Monitor the compliance of all members of the firm with the established ethical guidelines. Use a peer review process periodically to confirm that the system is working as designed and to bring third-party suggestions into the process.

26-3e Privileged Communications

The CPA needs to exercise care to ensure that the privilege of confidentiality will apply to his or her tax work. Taking the following steps can help.

- Segregate the time spent and documents produced in rendering services for tax compliance from that devoted to tax advice. Doing this will protect the privilege from being waived as to the tax advice.

- Explain the extent of the privilege to the client—specify what will and will not be protected from the IRS in a dispute.
- Do not inadvertently waive the privilege, for example, by telling “too much” to the IRS or to a third party who is not protected by the privilege.
- Indemnify the CPA for time spent protecting and enforcing the privilege once it is challenged.

REFOCUS ON THE BIG PICTURE

A TAX ADVISER’S DILEMMA



Your work with Campbell Corporation and its incremental research credit may prove troublesome. To avoid the taxpayer and tax preparer penalties, substantial authority must exist for claiming the credit, but the tax cases and Regulations do not appear to provide much guidance with respect to research expenditures of this sort. How does one craft a tax return position when the tax law largely is silent as to the particulars of the facts of the taxpayer’s situation? How much risk of incurring a tax penalty are the taxpayer and your firm willing to assume in deciding how and whether to report these expenditures?

Beyond the monetary effects of claiming the credit, you and the client must consider the publicity aspects of taking this issue to court: Does Campbell want to be the “test case” in the Tax Court on this matter? What would be the effects on your consulting firm if a preparer penalty or even loss of professional certification were to result? If the credit is to be claimed, what degree of “disclosure” does the law require?

At a minimum, your firm and Campbell’s tax department must conduct thorough research of analogous situations in the law in which the incremental research credit was and was not allowed for the taxpayer. Due diligence in this regard would require that you examine how other software applications and similar technological innovations, probably having nothing to do with GPS software and national security concerns, were treated for tax credit purposes. Constrained only by the budget dollars that Campbell is willing to dedicate to this task, your research is likely to be both interesting and frustrating, as no “on point” resolution is likely to be found prior to a later audit of the Form 1120 and its disclosures.

What If?

The risk profiles of the tax adviser and a client seldom are identical. What position should your firm take if Campbell’s tax department decides to claim the full incremental research credit for an item on which the tax law is silent or unclear, but your firm recommends that a special disclosure be made on the return concerning the item? A disclosure of this sort would protect the parties from later assessment of tax penalties, but Campbell believes that drawing attention to the credit item would increase the likelihood of a targeted audit of the expenditures by the IRS.

Although you are certain that tax fraud is not a problem on the Campbell return, you are concerned about the ramifications of Campbell’s desire to omit the recommended disclosure. Your firm might decide to leave the Campbell engagement altogether if it is especially sensitive to exposure to penalties or if it is not certain that adequate research has been done to support the tax return position. Charges of a lack of due diligence by your firm might be brought by the IRS, the firm’s professional ethics or certification bodies, or the issuer of its malpractice insurance. Clearly, none of these results is attractive to your firm.

Key Terms

Accuracy-related penalties, 26-16	Letter ruling, 26-4	Tax preparer, 26-26
Circular 230, 26-23	Negligence, 26-16	Technical advice memorandum (TAM), 26-4
Closing agreement, 26-12	Ninety-day letter, 26-9	Thirty-day letter, 26-9
Determination letter, 26-4	Offer in compromise, 26-10	Unreasonable position, 26-26
E-filing, 26-3	Reasonable cause, 26-15	Whistleblower Program, 26-7
Enrolled agents (EAs), 26-23	Revenue Agent's Report (RAR), 26-8	
Fraud, 26-18	Statute of limitations, 26-21	
Frivolous return, 26-24	Substantial authority, 26-16	

Discussion Questions

- LO.1** As a tax professional with a diverse group of clients and tax issues, why is it important that you understand how the IRS is organized and how its personnel are selected?
- LO.1** Your tax client Chen asks whether it is likely that her Form 1040 will be audited this year. You suspect that Chen might modify the information she reports on her return based on your answer. Address Chen's question, and provide her with a justification to comply fully with the tax law's reporting requirements.
- LO.1** Recently, a politician was interviewed about fiscal policy, and she mentioned reducing the "tax gap." Explain what this term means. What are some of the pertinent political and economic issues relative to the tax gap?
- LO.1** Review Exhibit 26.1, and identify the following.
 - The title of the IRS's chief executive officer.
 - The title of the "IRS's attorney."
 - The names of the four major operating divisions of the IRS.
 - The placement in the IRS organization of the Appeals and Criminal Investigation functions.
- LO.3** During an interview with an IRS official on *Dateline*, the interviewer asks, "So how do you decide which Forms 1040 get audited and which do not?" How should the IRS official respond, taking into account that only some of the audit selection process is public information?
- LO.3** On June 10, Ming states, "I filed my Form 1040 on April 5 and haven't heard from the IRS since then, so I know I will not be audited!" Evaluate Ming's assumption.
- LO.3** You overhear Matheus say, "I am so glad to be divorced from my cheating wife Larissa. She keeps two sets of books in her design business, and I wish the IRS would find out about it." Is Matheus a candidate for the informant reward program that is operated by the IRS? Explain how the program works and how a reward might be paid to Matheus.
- LO.6** Which of the valuation penalties is likely to arise when an aggressive taxpayer reports:
 - A charitable contribution?
 - A business deduction?
 - A decedent's taxable estate?

Issue ID

9. **LO.4, 5** Indicate whether each of the following statements is true or false.
 - a. The government never pays a taxpayer interest on an overpayment of tax.
 - b. The IRS can compromise on the amount of tax liability if there is doubt as to the taxpayer's ability to pay.
 - c. The IRS is required to accept Colin's application for an installment plan that delays the payment of her \$6,000 outstanding tax liability.
 - d. The offer in compromise program attempts to allow upper-income taxpayers additional time in which to pay delinquent tax amounts.
10. **LO.4, 6** In each of the following cases, distinguish between the terms.
 - a. Offer in compromise and closing agreement.
 - b. Failure to file and failure to pay.
 - c. 90-day letter and 30-day letter.
 - d. Negligence and fraud.
 - e. Criminal and civil tax fraud.

Issue ID

11. **LO.7** Discuss the concept of statutes of limitations in the context of the Federal income tax law.
 - a. Who benefits when the statute applies—the government, the taxpayer, both?
 - b. What happens when the statute is scheduled to expire within two weeks but the IRS audit will not be completed by then?
12. **LO.8** Give the Circular 230 position concerning each of the following situations sometimes encountered in the tax profession.
 - a. Taking an aggressive pro-taxpayer position on a tax return.
 - b. Not having a quality review process for a return completed by a partner of the tax firm.
 - c. Purposely delaying compliance with a document request received from the IRS.
 - d. Not keeping up with changes in the tax law.
 - e. Charging \$1,500 to complete a Form 1040-EZ.
 - f. When representing a taxpayer in a Federal income tax audit, charging a fee equal to one-third of the reduction of the tax proposed by the IRS agent.
 - g. Representing both the husband and wife as to tax matters when negotiating their divorce.
 - h. Advertising on the Web for new tax clients and including *Se habla español* in the text of the ads.
13. **LO.8** Indicate whether each of the following parties could be subject to the tax preparer penalties.
 - a. Tom prepared Sally's return for \$250.
 - b. Theresa prepared her grandmother's return for no charge.
 - c. Georgia prepared her church's return for \$500 (she would have charged an unrelated party \$3,000 for the same work).
 - d. Geoff prepared returns for low-income taxpayers under his college's VITA program.
 - e. Hildy prepared the return of her corporate employer.
 - f. Heejeo, an administrative assistant for an accounting firm, processed a client's return through TurboTax.

Communications

14. **LO.8** Using PowerPoint slides, list at least three of the Statements on Standards for Tax Services that apply to CPAs. For each standard you choose, provide a short explanation of its content.

Computational Exercises

15. **LO.6** Alexi files her tax return 20 days after the due date. Along with the return, she remits a check for \$3,000, which is the balance of the tax she owes. Disregarding any interest liabilities, compute Alexi's total penalties for this period.
16. **LO.6** Marcella (a calendar year taxpayer) purchased a sculpture for \$5,000. When the sculpture is worth \$12,000 (as later determined by the IRS), Marcella donates it to the Peoria Museum of Art, a public charity. Based on the appraisal of a friend, Marcella deducts \$38,000 for the donation. Because Marcella was in the 28% tax bracket, overstating the deduction by \$26,000 results in a tax underpayment of \$7,280. Compute Marcella's overvaluation penalty.
17. **LO.6** Rivera underpaid her income tax by \$45,000. The IRS can prove that \$40,000 of the underpayment was due to fraud. Determine Rivera's civil fraud penalty.
18. **LO.7** On June 15, 2014, Sheridan filed his 2013 income tax return reflecting a tax of \$10,500. On October 5, 2015, he filed an amended 2013 return showing an additional \$6,400 of tax, which he paid with the amended return. On August 22, 2017, he filed a claim for a refund of \$7,000. How much Federal income tax can Sheridan recover on the amended return?

Problems

19. **LO.5** Gordon paid the \$10,000 balance of his Federal income tax three months late. Ignore daily compounding of interest. Determine the interest rate that applies relative to this amount, assuming that:
 - a. Gordon is an individual.
 - b. Gordon is a C corporation.
 - c. The \$10,000 is not a tax that is due, but is a refund payable by the IRS to Gordon (an individual).
 - d. The \$10,000 is not a tax that is due, but is a refund payable by the IRS to Gordon (a C corporation).
20. **LO.6** Rita forgot to pay her Federal income tax on time. When she actually filed, she reported a balance due. Compute Rita's failure to file penalty in each of the following cases.
 - a. Two months late, \$1,000 additional tax due.
 - b. Five months late, \$3,000 additional tax due.
 - c. Eight months late, \$4,000 additional tax due.
 - d. Two and a half months late, \$3,000 additional tax due.
 - e. Five months late due to fraud by Rita, \$4,000 additional tax due.
 - f. Ten months late due to fraud by Rita, \$15,000 additional tax due.
21. **LO.6** Wade filed his Federal income tax return on time but did not remit the balance due. Compute Wade's failure to pay penalty in each of the following cases. The IRS has not issued a deficiency notice.
 - a. Four months late, \$3,000 additional tax due.
 - b. Ten months late, \$4,000 additional tax due.
 - c. Five years late, \$5,000 additional tax due.

22. **LO.6** Compute the failure to pay and failure to file penalties for John, who filed his 2015 income tax return on December 20, 2016, paying the \$10,000 amount due at that time. On April 1, 2016, John received a six-month extension of time in which to file his return. He has no reasonable cause for failing to file his return by October 15 or for failing to pay the tax that was due on April 15, 2016. John's failure to comply with the tax laws was not fraudulent.
23. **LO.6** Olivia, a calendar year taxpayer, does not file her 2015 Form 1040 until December 12, 2016. At this point, she pays the \$40,000 balance due on her 2015 tax liability of \$70,000. Olivia did not apply for and obtain any extension of time for filing the 2015 return. When questioned by the IRS on her delinquency, Olivia asserts: "If I was too busy to file my regular tax return, I was too busy to request an extension."
- Is Olivia liable for any penalties for failure to file and for failure to pay?
 - If so, compute the penalty amounts.
24. **LO.6** Maureen, a calendar year individual taxpayer, files her 2014 return on November 4, 2016. She did not obtain an extension for filing her return, and the return reflects additional income tax due of \$15,000.
- What are Maureen's penalties for failure to file and to pay?
 - Would your answer to (a) change if Maureen, before the due date of the return, had retained a CPA to prepare the return and it was the CPA's negligence that caused the delay? Explain.
25. **LO.6** Blair underpaid her taxes by \$250,000. A portion of the underpayment was shown to be attributable to Blair's negligence (\$100,000). A court found that the rest of the deficiency constituted civil fraud (\$150,000). Compute the total fraud and negligence penalties incurred.
26. **LO.6** Compute the overvaluation penalty for each of the following independent cases involving the fair market value of charitable contribution property. In each case, assume a marginal income tax rate of 35%.

	Taxpayer	Corrected IRS Value	Reported Valuation
a.	Individual	\$ 40,000	\$ 50,000
b.	C corporation	30,000	50,000
c.	S corporation	40,000	50,000
d.	Individual	150,000	200,000
e.	Individual	150,000	250,000
f.	C corporation	150,000	750,000

27. **LO.6** Compute the undervaluation penalty for each of the following independent cases involving the value of a closely held business in the decedent's gross estate. In each case, assume a marginal estate tax rate of 40%.

	Reported Value	Corrected IRS Valuation
a.	\$ 20,000	\$ 25,000
b.	100,000	150,000
c.	150,000	250,000
d.	150,000	500,000

28. **LO.6** Singh, a qualified appraiser of fine art and other collectibles, was advising Colleen when she was determining the amount of the charitable contribution deduction for a gift of sculpture to a museum. Singh sanctioned a \$900,000 appraisal, even though he knew the market value of the piece was only \$300,000. Colleen assured Singh that she had never been audited by the IRS and that the risk of the government questioning his appraisal was negligible.

But Colleen was wrong, and her return was audited. The IRS used its own appraisers to set the value of the sculpture at \$400,000. Colleen is in the 33% Federal income tax bracket, while Singh's fee for preparing the appraisal was \$20,000.

- a. Compute the penalty the IRS can assess against Singh. (Do not consider the valuation penalty as to Colleen's return.)
 - b. What is the penalty if Singh's appraisal fee was \$7,500 (not \$20,000)?
29. **LO.6** The Eggers Corporation filed an amended Form 1120, claiming an additional \$400,000 deduction for payments to a contractor for a prior tax year. The amended return was based on the entity's interpretation of a Regulation that defined deductible advance payment expenditures. The nature of Eggers's activity with the contractor did not exactly fit the language of the Regulation. Nevertheless, because so much tax was at stake, Eggers's tax department decided to broaden its interpretation and claim the deduction.
- Eggers's tax department estimated that there was only a 15% chance that Eggers's interpretation would stand up to a Tax Court review.
- a. What is the amount of tax penalty that Eggers is risking by taking this position?
 - b. What would be the result if there was a 45% chance that Eggers's interpretation of the Regulation was correct?
30. **LO.6** Kaitlin donated a painting to the local art museum. As she is subject to a 35% marginal tax rate, she needs a large charitable contribution deduction for the year. She engaged Vargas (who was referred to her by the staff of the museum) to provide an appraisal of the painting before she filed her Form 1040 for the year. Kaitlin told Vargas, "Be kind to me on this appraisal, and I'll send several more clients to you in the future." Kaitlin paid Vargas a \$45,000 fee for his services.
- Vargas completed his appraisal and determined that the painting was worth \$500,000 under current market conditions. Still, in light of Kaitlin's promise of future business, Vargas sent Kaitlin an official appraisal reporting a \$900,000 value for the artwork. Vargas had never compromised his integrity, but this time the temptation was too much.
- Kaitlin used the appraisal to claim a \$900,000 deduction for her charitable gift. Kaitlin will incur a valuation penalty now that her Form 1040 has been audited and the IRS has determined that the correct amount of the deduction is \$500,000. But is Vargas also exposed to a Federal tax penalty? Explain.
31. **LO.6** Trudy's AGI last year was \$200,000. Her Federal income tax came to \$65,000, which she paid through a combination of withholding and estimated payments. This year, her AGI will be \$300,000, with a projected tax liability of \$45,000, all to be paid through estimates.
- a. Ignore the annualized income method. Compute Trudy's quarterly estimated tax payment schedule for this year.
 - b. Assume instead that Trudy's AGI last year was \$100,000 and resulted in a Federal income tax of \$20,000. Determine her quarterly estimated tax payment schedule for this year.
32. **LO.6** Kold Services Corporation estimates that its 2015 taxable income will be \$500,000. Thus, it is subject to a flat 34% income tax rate and incurs a \$170,000 liability. For each of the following independent cases, compute Kold's 2015 minimum quarterly estimated tax payments that will avoid an underpayment penalty.
- a. For 2014, taxable income was (\$200,000). Kold carried back all of this loss to prior years and exhausted the entire net operating loss in creating a zero 2014 liability.
 - b. For 2014, taxable income was \$450,000, and tax liability was \$153,000.
 - c. For 2013, taxable income was \$2 million, and tax liability was \$680,000. For 2014, taxable income was \$400,000, and tax liability was \$136,000.

Decision Making
Communications

33. **LO.6** The Leake Company, owned equally by Jacquie (chair of the board of directors) and Jeff (company president), is in very difficult financial straits. Last month, Jeff used the \$300,000 withheld from employee paychecks for Federal payroll and income taxes to pay a creditor who threatened to cut off all supplies. To keep the company afloat, Jeff used these government funds willfully for the operations of the business, but even that effort was not enough. The company missed the next two payrolls, and today other creditors took action to shut down Leake altogether.

How much will the IRS assess in taxes and penalties in this matter and from whom? How can you as a tax professional best offer service to Jacquie, Jeff, and Leake? Address these matters in a memo for the tax research file.

34. **LO.7** Keely filed her 2016 Form 1040 on April 4, 2017. What is the applicable statute of limitations in each of the following independent situations?
- The taxpayer incurred a bad debt loss that she failed to claim.
 - A taxpayer inadvertently omitted a large amount of gross income.
 - Same as (b), except that the omission was deliberate.
 - A taxpayer innocently overstated her deductions by a large amount.
 - What if no return was filed by the taxpayer?
35. **LO.7** Loraine (a calendar year taxpayer) reported the following transactions, all of which were properly included in a timely filed return.

Gross receipts		\$ 975,000
Cost of sales		<u>(850,000)</u>
Gross profit		\$ 125,000
Capital gain	\$ 40,000	
Capital loss	<u>(25,000)</u>	<u>15,000</u>
Total income		<u>\$ 140,000</u>

- Presuming the absence of fraud, how much of an omission from gross income is required before the six-year statute of limitations applies?
- Would it matter if cost of sales had been inadvertently overstated by \$150,000?
- How does the situation change in the context of fraud by Loraine?

Decision Making

36. **LO.5, 7** On April 3, 2013, Luis filed his 2012 income tax return, which showed a tax due of \$75,000. On June 1, 2015, he filed an amended return for 2012 that showed an additional tax of \$10,000. Luis paid the additional amount. On May 18, 2016, Luis filed a claim for a 2012 refund of \$25,000.
- If Luis's claim for a refund is correct in amount, how much tax will he recover?
 - What is the period that government-paid interest runs with respect to Luis's claim for a refund?
 - How would you have advised him differently?
37. **LO.8** Rod's Federal income tax returns (Form 1040) for the indicated years were prepared by the following persons.

Year	Preparer
1	Rod
2	Ann
3	Cheryl

Ann is Rod's next-door neighbor and owns and operates a pharmacy. Cheryl is a licensed CPA and is engaged in private practice. In the event Rod is audited and all three returns are examined, who may represent him before the IRS at the agent level? Who may represent Rod before the Appeals Division?

38. **LO.8** Christie is the preparer of the Form 1120 for Yostern Corporation. On the return, Yostern claimed a deduction that the IRS later disallowed on audit.

Compute the tax preparer penalty that could be assessed against Christie in each of the following independent situations.

	Form 8275 Disclosure on the Return of the Disputed Deduction?	Tax Reduction Resulting from the Deduction	Probability That the Courts Would Approve the Deduction	Christie's Fee to Complete Yostern's Return
a.	No	\$40,000	65%	\$7,000
b.	No	40,000	35	7,000
c.	No	40,000	35	1,500
d.	Yes	40,000	35	7,000
e.	Yes	40,000	15	4,000

39. **LO.8** Discuss which penalties, if any, might be imposed on the tax adviser in each of the following independent circumstances. In this regard, assume that the tax adviser:
- Suggested to the client various means by which to acquire excludible income.
 - Suggested to the client various means by which to conceal cash receipts from gross income.
 - Suggested to the client means by which to improve her cash flow by delaying for six months or more the deposit of the employees' share of Federal employment taxes.
 - Failed, because of pressing time conflicts, to conduct the usual review of the client's tax return. The IRS later discovered that the return included fraudulent data.
 - Failed, because of pressing time conflicts, to conduct the usual review of the client's tax return. The IRS later discovered a mathematical error in the computation of the personal exemption.
40. **LO.8** Compute the preparer penalty the IRS could assess on Gerry in each of the following independent cases.
- On March 21, the copy machine was not working, so Gerry gave original returns to her 20 clients that day without providing any duplicates for them. Copies for Gerry's files and for use in preparing state tax returns had been made on March 20.
 - Because Gerry extended her vacation a few days, she missed the Annual Tax Update seminar that she usually attends. As a result, she was unaware that Congress had changed a law affecting limited partnerships. The change affected the transactions of 25 of Gerry's clients, all of whom understated their tax as a result.
 - Gerry heard that the IRS was increasing its audits of corporations that hold assets in a foreign trust. As a result, Gerry instructed the intern who prepared the initial drafts of the returns for five corporate clients to leave blank the question about such trusts. Not wanting to lose his position, the intern, a senior accounting major at State University, complied with Gerry's instructions.
41. **LO.8** You are the chair of the Ethics Committee of your state's CPA Licensing Commission. Interpret controlling AICPA authority in addressing the following assertions by your membership.
- When a CPA has reasonable grounds for not answering an applicable question on a client's return, a brief explanation of the reason for the omission should not be provided, because it would flag the return for audit by the IRS.
 - If a CPA discovers during an IRS audit that the client has a material error in the return under examination, he should immediately withdraw from the engagement.
 - If the client tells you that she paid \$500 for office supplies but has lost the receipts, you should deduct an odd amount on her return (e.g., \$499), because an even amount (\$500) would indicate to the IRS that her deduction was based on an estimate.

Decision Making

- d. If a CPA knows that the client has a material error in a prior year's return, he should not, without the client's consent, disclose the error to the IRS.
- e. If a CPA's client will not correct a material error in a prior year's return, the CPA should not prepare the current year's return for the client.

Research Problems

THOMSON REUTERS

CHECKPOINT
 Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Communications

Research Problem 1. Lopez always had taken his Form 1040 data to the franchise tax preparers in a local mall, but this year, his friend Cheryl asked to prepare his return. Cheryl quoted a reasonable fee, and Lopez reasoned that, with finances especially tight in Cheryl's household, she could use the money.

Lopez delivered his Forms W-2 and 1099 and other documentation and said, "I'll pick up the finished return from you on Monday." Cheryl completed the return by that deadline, and without signing and reviewing the forms, Lopez allowed Cheryl to e-file it that day. The arrangement was that Cheryl would receive the refund through a special bank account and write Lopez a check for that amount, less her fee. When the refund came through about three weeks later, Cheryl wrote Lopez a check for \$2,400, and all parties were satisfied. Lopez gladly used Cheryl to e-file the next year's return using the same procedures.

To his surprise, Lopez received a letter from the IRS about 18 months later. The auditor had found that the return Cheryl had e-filed vastly overstated deductions, created false dependency exemptions (using Social Security numbers that did not exist), and wrongly calculated the earned income tax credit. According to the audit report, the refund issued was \$4,500—Cheryl had pocketed the difference. Thus, the corrected tax liability meant that Lopez now owed \$7,000 in tax, before considering interest and penalties.

Lopez contends that he relied on Cheryl's expertise in the tax law and e-filing procedures. Consequently, there was reasonable cause for the underpayment of tax, and the IRS should waive the understatement and negligence penalties. The IRS has expressed sympathy for Lopez's position, but it maintains that the penalty should stand. What do you think? Summarize your findings in a memo for the tax research file.

Communications

Research Problem 2. Blanche Creek (111 Elm Avenue, Plymouth, IN 46563) has engaged your firm because she has been charged with failure to file her 2015 Federal Form 1040. Blanche maintains that the "reasonable cause" exception should apply. During the entire tax filing season in 2016, she was under a great deal of stress at work and in her personal life. As a result, Blanche developed a sleep disorder, which was treated through a combination of pills and counseling.

Your firm ultimately prepared the 2015 tax return for Blanche, but it was filed far beyond the due date. Blanche is willing to pay the delinquent tax and related interest. However, she believes that the failure to pay penalty is unfair, as she was ill. Consequently, she could not be expected to keep to the usual deadlines for filing.

Write a letter to Blanche concerning these matters.

Communications

Research Problem 3. Your firm is preparing the Form 1040 of Norah McGinty, a resident, like you, of Oklahoma. You have contracted for the last three filing seasons with a firm in India, Tax Express Bangalore, to prepare initial drafts of tax returns using tax software that you provide to Tax Express. You find that the use of Tax Express Bangalore's services significantly increases the profits of your Form 1040 practice.

Your firm uses Tax Express annually to help prepare Forms 1040 for about 500 of your clients. Three of your tax managers, JaJuan, Max, and Emma, spend several

weeks in the autumn every year in India, training the Bangalore staff in Federal tax law changes and in the operations of your tax software packages.

Phil, a tax associate in your Norman office, is handling Norah's return this year. Phil works with Norah to complete the online tax questionnaire that summarizes her taxable events and the related dollar amounts. The questionnaire includes the Social Security numbers of Norah and her two dependent children. The children are young, and their income levels do not require them to complete income tax returns.

Phil sends the completed questionnaire and electronic files of supporting documents to the Bangalore staff at the end of the work day on Monday, using a secure file transfer site. Upon arriving at work Thursday morning, Phil finds that Tax Express has completed the Form 1040, including a payment voucher. Phil reviews the return, makes a few minor changes to it, and then meets with Norah on Saturday to convey to her the finalized documents. Norah reviews the form, and she signs it and writes a check for the amount due, mailing the return to the IRS Service Center from her home on the following Monday.

In a memo for the tax research file, discuss any special rules from the Code and Regulations that might affect your firm's use of Tax Express Bangalore for your client Norah McGinty.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet
Activity

Research Problem 4. Taxpayers generally “go to jail” on tax charges only when criminal activities have been involved. Find information about the criminal tax prosecutions the Treasury undertakes. Compare data for the last year of information available from the IRS and for five years prior to that.

Communications

How many criminal tax charges are initiated in a year? How much time does a criminal tax case take from the filing of charges to disposition by the IRS or a court? What issues tend to be the focus of a criminal tax prosecution? How much additional tax, interest, and penalty revenue does the Treasury collect due to its criminal prosecutions? Summarize your findings for your classmates in no more than four PowerPoint slides.

Research Problem 5. Every year toward the end of the Form 1040 filing season, suggestions are offered to taxpayers about how to pay their taxes if they lack the funds to do so. The discussions address filing extensions, installment plans, and credit card payments. Find two online videos of this sort. Summarize the video clips, and develop a speech outline and no more than four PowerPoint slides for a presentation you will make to your town's Young Executives Club.

Communications

Roger CPA Review Questions

1. Which of the following situations will result in a tax preparer's penalty?
 - I. At a client's insistence, the preparer takes and properly discloses a tax position which does not meet the reasonable basis standard
 - II. The preparer discloses a client's personally identifying information to outside parties in order to permit the electronic preparation and submission of the client's return
 - III. The preparer provides his Preparer Tax Identification Number but fails to sign a client's tax return
 - a. II only
 - b. I, II, and III
 - c. I only
 - d. I and III only

2. In which of the following cases is a CPA not subject to a penalty stemming from a position taken on a tax return?
 - I. The position had a “reasonable chance of being sustained”
 - II. The position had a “realistic possibility” of being sustained
 - III. The position was “more likely than not” to be sustained
 - a. I only
 - b. II only
 - c. III only
 - d. I, II, and III
3. Scott is preparing Allison’s 20X4 tax return. Allison’s gross income in 20X4 was \$75,000. In calculating her deductions to arrive at Adjusted Gross Income (AGI), Allison estimates that she paid around \$2,000 in student loan interest. Her student loan servicing company, Crippling Lifetime Debt (CLD), went out of business and her debt was transferred to other loan servicers. Allison monitored all of her account records online, which are no longer readily available because of CLD’s closing. Based on Allison’s monthly payments which he viewed in her bank activity, Scott believes Allison’s estimate is reasonable. May Scott use Allison’s estimate to arrive at Allison’s AGI?
 - a. Yes, because it is less than 10% of Allison’s AGI
 - b. No, because the records at the new loan servicers will be able to confirm or dispute Allison’s estimate
 - c. Yes, because Scott believes the estimate is reasonable
 - d. No, because it is an adjustment for AGI
4. While preparing Margaret’s 20X4 tax return, John discovers an error on her 20X3 tax return, which Margaret prepared herself, in which Margaret’s Adjusted Gross Income (AGI) was understated by \$10,000, roughly ten percent of her AGI. What is John’s responsibility concerning the error?
 - a. Do nothing, since the understatement was less than 25% of Margaret’s AGI
 - b. Correct the error without Margaret’s knowledge on her 20X4 tax return
 - c. Request that Margaret correct the error, and notify the IRS if she doesn’t
 - d. Request that Margaret correct the error, and consider withdrawing from the engagement if she doesn’t
5. Which of the following parties are *not* affected by Treasury Circular 230?
 - a. Attorneys
 - b. IRS Agents
 - c. CPAs
 - d. Enrolled Agents



PART

9

FAMILY TAX PLANNING

CHAPTER **27**

The Federal Gift and Estate Taxes

CHAPTER **28**

Income Taxation of Trusts and Estates

Family tax planning has as its objective the minimization of *all* taxes imposed on the family unit. Carrying out this objective requires familiarity with the rules applicable to transfers by gift and by death. These rules must then be applied to reduce the transfer tax burden. Finally, entities created as a result of these transfers (trusts and estates) are subject to unique income tax rules.

The Federal Gift and Estate Taxes

LEARNING OBJECTIVES: *After completing Chapter 27, you should be able to:*

- | | |
|--|--|
| LO.1 Explain the nature of the Federal gift and estate taxes. | LO.6 Identify the components of the gross estate. |
| LO.2 List and analyze the Federal gift tax formula. | LO.7 Describe the components of the taxable estate. |
| LO.3 List and analyze the Federal estate tax formula. | LO.8 Calculate the Federal estate tax liability. |
| LO.4 Illustrate the operation of the Federal gift tax. | LO.9 Review and demonstrate the role of the generation-skipping transfer tax. |
| LO.5 Calculate the Federal gift tax. | LO.10 Recognize strategies to minimize Federal gift and estate taxes. |

CHAPTER OUTLINE

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THE BIG PICTURE

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AN EVENTFUL AND FINAL YEAR

Over his lifetime, Peter Hood started and purchased numerous automobile dealerships that he eventually transferred to a newly formed entity, Hood Corporation. Upon his death in 2000, the stock in Hood Corporation passed in equal shares to Peter's surviving spouse, Martha, and their adult children, John and Helen.

For John Hood, 2014 proved to be an eventful and final tax year. Among the major happenings were the following.

- In January, John's divorce from his first wife, Hannah, became final.
- In February, he married Ashley, the manager of one of the Hood car dealerships.
- He made various gifts to family members.
- In July, his mother died of a heart condition, and John served as executor of her estate.
- In late November, he was seriously injured in a car accident (caused by another motorist).
- In early December, he carried out some predeath planning.
- John died of his injuries in mid-December.

What are some of the tax problems (i.e., income, gift, and estate taxes) that might be encountered as a result of these events?

Read the chapter and formulate your response.

Until now, this text has dealt primarily with the various applications of the Federal income tax. Also important in the Federal tax structure are various excise taxes that cover transfers of property. Sometimes called transaction taxes, excise taxes are based on the value of the property transferred and not on the income derived from the property. Two such taxes—the Federal gift tax and the Federal estate tax—are the central focus of this chapter.

LO.1

Explain the nature of the Federal gift and estate taxes.

27-1 TRANSFER TAXES—IN GENERAL

To better understand the Federal gift and estate taxes, one should be familiar with certain tax and legal concepts. What, for example, is the nature of these taxes, upon whom are they imposed, and what is the valuation used for their imposition?

27-1a Nature of the Taxes

Historical Background

Federal tax law imposes a tax on the gratuitous transfer of property in one of two ways. If the transfer occurs during the owner's life, it is subject to the Federal gift tax. If the property passes by virtue of the death of the owner, the Federal estate tax applies. Originally, the two taxes were governed by different rules, including a separate set of tax rates. As Congress believed that lifetime transfers of wealth should be encouraged, the gift tax rates were 25 percent lower than the estate tax rates.¹

The Tax Reform Act of 1976 significantly changed the approach taken by the Federal gift and estate taxes. Recognizing that prior rules had not significantly stimulated a preference for lifetime over death transfers, Congress decided that all transfers should be taxed the same way. Consequently, much of the distinction between life and death transfers was eliminated. Instead of subjecting these different types of transfers to two separate tax rate schedules, the Act substituted a **unified transfer tax** that covered all gratuitous transfers. Thus, gifts were subject to tax at the same rates as those applicable to transfers at death.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) made further changes. Reacting to general public sentiment, Congress concluded that the Federal estate tax was objectionable because it leads to the breakup of family farms and other closely held businesses. Thus, by scheduled increases in the unified tax credit applicable to estates, the estate tax was eliminated by 2010, but the gift tax was retained.

After 2010, the estate tax was reinstated and placed on a parity with the gift tax. The unified tax credit was increased to \$5 million starting in 2011 and made subject to adjustment each year for inflation. The top unified transfer tax rate was raised to 40 percent (from 35 percent).²

Persons Subject to the Tax

The Federal gift tax is imposed on the right of one person (the donor) to transfer property to another (the donee) for less than full and adequate consideration. The tax is payable by the donor.³ If the donor fails to pay the tax when due, the donee may be held liable for the tax to the extent of the value of the property received.⁴

Upon the death of an individual, the Federal estate tax is imposed on the entire estate.⁵ The executor (or administrator) of the estate has the obligation to pay any estate tax that may be due.

¹The estate tax was enacted in 1916. Because the estate tax could be avoided by making transfers just prior to dying (i.e., "deathbed gifts"), a gift tax was added in 1932.

²The Obama Administration has proposed reducing the credit to \$3.5 million and raising the maximum rate to 55%. The proposal is not likely to be enacted by Congress.

³§ 2502(c).

⁴§ 6324(b). Known as the doctrine of transferee liability, this rule also operates to enable the IRS to enforce the collection of other taxes (e.g., income tax and estate tax).

⁵§ 2001(a). Subchapter A (§§ 2001 through 2058) covers the estate tax treatment of those who are either residents or citizens. Subchapter B (§§ 2101 through 2108) covers the estate tax applicable to NRAs.



GLOBAL TAX ISSUES U.S. Transfer Taxes and NRAs

For individuals who are neither residents nor citizens of the United States (i.e., nonresident aliens, or NRAs), the Federal gift tax applies only to gifts of property situated within the United States. Exempted, however, are gifts of intangibles, such as stocks and bonds.

For decedents who are NRAs, the Federal estate tax is imposed on the value of property located within the United States. Unlike the gift tax, however, the estate tax applies to

stock in U.S. corporations. Special reporting procedures apply to the estate taxation of NRAs—see the instructions to Form 706-NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States.

Source: Code §§ 2101(a), 2501(a)(2), and 2511(a).

If the transferor is a resident or citizen of the United States, then the location of the property transferred is immaterial. Thus, a gift by a U.S. resident of property located in Honduras is subject to the Federal gift tax. For a U.S. citizen or resident, the place of residence at the time of the transfer is not relevant. For these purposes, “United States” includes only the 50 states and the District of Columbia and does not include U.S. possessions or territories.⁶

Types of Tax at Death

Taxes payable by virtue of a person’s death fall into two categories: estate and inheritance. The U.S. government, some states, and several foreign countries impose estate taxes. Inheritance taxes are imposed by some states and other countries. Some states and countries use both types of taxes.

The Federal estate tax differs in several respects from the typical *inheritance tax*. First, the Federal estate tax is levied on the decedent’s entire estate. It is a tax on the right to pass property at death. Inheritance taxes apply to the right to receive property at death and are therefore levied on the heirs. Second, the relationship of the heirs to the decedent usually has a direct bearing on the amount of the inheritance tax. In general, the more closely related the parties, the larger the exemptions and the lower the applicable rates.⁷ Except for transfers to surviving spouses that may result in a marital deduction, the relationship of the heirs to the decedent has no effect on the Federal estate tax.

Formula for the Gift Tax

Like the income tax, which uses taxable income (and not gross income) as a tax base, the gift tax usually does not apply to the full amount of the gift. Deductions and the annual exclusion may be allowed to arrive at an amount called the **taxable gift**.⁸ However, unlike the income tax, which does not consider taxable income from prior years, *prior taxable gifts* must be added to arrive at the tax base to which the unified transfer tax rate is applied. Otherwise, the donor could start over again each year with a new set of progressive rates.

Don makes taxable gifts of \$1 million in 2007 and \$1 million in 2009. Presuming no other taxable gifts and *before applying the unified tax credit*, Don must pay a tax of \$345,800 (see Appendix A) on the 2007 transfer and a tax of \$780,800 (see Appendix A) on the 2009 transfer (using a tax base of \$2 million). If the 2007 taxable gift had not been included in the tax base for the 2009 gift, the tax would have been \$345,800. The correct tax liability of \$780,800 is more than twice \$345,800!

LO.2

List and analyze the Federal gift tax formula.

EXAMPLE

1

⁶§ 7701(a)(9).

⁷For example, one state’s inheritance tax provides an unlimited exemption for a surviving spouse and charities, \$100,000 for Class A heirs (lineal descendants and ascendants), \$500 for Class B heirs (collateral heirs), and

\$100 for Class C (other relatives and strangers). Beginning tax rates applicable to the nonexempt portion range from 2% to 10%, with the top rate applicable to Class C heirs reaching 20%.

⁸§ 2503(a).

Because the gift tax is cumulative in effect, a credit is allowed for the gift taxes paid on prior taxable gifts included in the tax base.

EXAMPLE
2

Assume the same facts as in Example 1. Don will be allowed a credit of \$345,800 against the gift tax of \$780,800. Thus, his gift tax liability for 2009 becomes \$435,000 (\$780,800 – \$345,800).

Because Congress did not intend for the gift tax to apply to smaller transfers, it provided for an annual exclusion. The exclusion amount periodically is adjusted for *significant* inflation. For 2013 through 2015, the amount allowed is \$14,000 (for the period 2009–2012, the exclusion was \$13,000).⁹ The formula for the gift tax is set forth in Concept Summary 27.1.



Concept Summary 27.1

Gift Tax Formula

Determine whether the transfers are considered gifts by referring to §§ 2511 through 2519; list the fair market value of only the covered transfers		\$xxx,xxx
Claim the annual exclusion (\$14,000 per donee) as available	\$xx,xxx	
Determine the charitable and marital deductions	xx,xxx	(xx,xxx)
Taxable gifts [as defined by § 2503(a)] for the current period		\$ xx,xxx
Add: Taxable gifts from prior years		xx,xxx
Total of current and past taxable gifts		\$ xx,xxx
Compute the gift tax on the total of current and past taxable gifts by using the rates in Appendix A		\$ x,xxx
Subtract: Gift tax paid on past taxable gifts and the unified tax credit		(xxx)
Gift tax due on transfers during the current period		\$ xxx

LO 3

List and analyze the Federal estate tax formula.

Formula for the Federal Estate Tax

The Federal unified transfer tax at death, commonly known as the Federal estate tax, appears in Concept Summary 27.2. The gross estate is determined by using the fair market value of the property on the date of the decedent’s death (or on the alternate valuation date if applicable).

The gross estate includes all of the property a decedent owns at the time of death. The inclusion may even extend to property the decedent no longer owns—see the later discussion of gifts made within three years of death¹⁰ and certain incomplete transfers.¹¹ Moreover, the gross estate is to be distinguished from the probate estate, which is property that is subject to administration by the executor.

Deductions from the gross estate to arrive at the taxable estate are quite extensive. In addition to the debts of the decedent (e.g., mortgages, credit card accounts, and unpaid medical bills), they even include current and past income taxes (both Federal and state). As in the case of the Federal gift tax, transfers to charity and to a spouse are deductible.

Note that the taxable estate must be adjusted further to arrive at a tax base before a tentative estate tax can be determined. The further adjustment requires the consideration of prior taxable gifts. The reason post-1976 taxable gifts are added to the taxable estate to arrive at the tax base goes back to the scheme of the unified transfer tax. Starting in 1977, all transfers, whether lifetime or by death, were to be treated the same. Consequently, taxable gifts made after 1976 must be accounted for upon the death of the donor. Any possible double tax effect of including these gifts is eliminated by allowing a credit against the estate tax for the gift taxes previously paid.

⁹§ 2503(b)(2).

¹⁰§ 2035.

¹¹§§ 2036–2038.

Concept Summary 27.2

Estate Tax Formula

Gross estate (§§ 2031–2046)		\$xxx,xxx
Subtract:		
Expenses, indebtedness, and taxes (§ 2053)	\$xx,xxx	
Losses (§ 2054)	xx,xxx	
Charitable bequests (§ 2055)	xx,xxx	
Marital deduction (§§ 2056 and 2056A)	xx,xxx	
State death taxes (§ 2058)	xx,xxx	(xx,xxx)
Taxable estate (§ 2051)		\$ xx,xxx
Add: Post-1976 taxable gifts [§ 2001(b)]		x,xxx
Tax base		\$xxx,xxx
Tentative tax on total tax base [§ 2001(c)]		\$ xx,xxx
Subtract:		
Unified transfer tax on post-1976 taxable gifts (gift taxes paid)	\$ x,xxx	
Tax credits (including the unified tax credit) (§§ 2010–2016)	x,xxx	(x,xxx)
Estate tax due		\$ x,xxx

Role of the Unified Tax Credit

The purpose of the **unified transfer tax credit** is to allow donors and decedents to transfer specified amounts of wealth without being subject to the gift and estate taxes. Exhibit 27.1 shows the unified tax credit applicable to transfers by gift and by death from 2000 through 2015. As the credits are subject to indexation for inflation, the amounts for years beyond 2015 cannot yet be determined.¹²

EXHIBIT 27.1

Partial List of Unified Tax Credits

Year of Transfer	Gift Tax		Estate Tax	
	Credit	Exclusion Amount	Credit	Exclusion Amount
2000 and 2001	\$ 220,550	\$ 675,000	\$ 220,550	\$ 675,000
2002 and 2003	345,800	1,000,000	345,800	1,000,000
2004 and 2005	345,800	1,000,000	555,800	1,500,000
2006, 2007, and 2008	345,800	1,000,000	780,800	2,000,000
2009	345,800	1,000,000	1,455,800	3,500,000
2010	330,800*	1,000,000	–0–	–0–
2011	1,730,800	5,000,000	1,730,800	5,000,000
2012	1,772,800	5,120,000	1,772,800	5,120,000
2013	2,045,800	5,250,000	2,045,800	5,250,000
2014	2,081,800	5,340,000	2,081,800	5,340,000
2015	2,117,800	5,430,000	2,117,800	5,430,000

*Maximum gift tax rate of 35%.

¹²The unified transfer tax credits prior to 2000 can be found in §§ 2010 and 2505.

The **exclusion amount** (also termed the **exemption equivalent amount** and the **bypass amount**) is the amount of the transfer that will pass free of the gift or estate tax by virtue of the credit.

EXAMPLE

3

In 2015, Janet makes a taxable gift of \$5.43 million. Presuming that she has made no prior taxable gifts, Janet will not owe any gift tax. Under the applicable tax rate schedule (see Appendix A), the tax on \$5.43 million is \$2,117,800, which is the exact amount of the credit allowed.¹³

27-1b Valuation for Estate and Gift Tax Purposes (§ 2032)

The value of the property on the date of its transfer generally determines the amount that is subject to the gift tax or the estate tax. Under certain conditions, however, an executor can elect to value estate assets on the **alternate valuation date**. The election is made by the executor of the estate and is irrevocable.

The alternate valuation date election was designed as a relief provision to ease the economic hardship that could result when estate assets decline in value over the six months after the date of death. If the election is made, all assets of the estate are valued six months after death *or* on the date of disposition if this occurs earlier.¹⁴ The election covers *all* assets in the gross estate and cannot be applied to only a portion of the property.

EXAMPLE

4

Robert's gross estate consists of the following property:

	Value on Date of Death	Value Six Months Later
Land	\$4,800,000	\$4,840,000
Stock in Brown Corporation	900,000	700,000
Stock in Green Corporation	500,000	460,000
Total	<u>\$6,200,000</u>	<u>\$6,000,000</u>

If Robert's executor elects the alternate valuation date, the estate must be valued at \$6 million. It is not permissible to value the land at its date of death value (\$4.8 million) and choose the alternate valuation date for the rest of the gross estate.

The election of the alternate valuation date must decrease the value of the gross estate *and* decrease the estate tax liability. The reason for this last requirement is that the income tax basis of property acquired from a decedent will be the value used for estate tax purposes. Without a special limitation, the alternate valuation date could be elected solely to add to income tax basis.

EXAMPLE

5

Al's gross estate consists of assets with a date of death value of \$6 million and an alternate valuation date value of \$6.1 million. Under Al's will, all of his property passes outright to Jean (Al's wife). Because of the marital deduction, no estate tax results regardless of which value is used. But if the alternate valuation date could be elected, which it cannot, Jean would have an income tax basis of \$6.1 million in the property acquired from Al.

27-1c Key Property Concepts

When property is transferred either by gift or at death, the form of ownership can have a direct bearing on any transfer tax consequences. Understanding the different forms of ownership is necessary for working with Federal gift and estate taxes.

¹³The rate schedules are contained in § 2001(c), and *some* are reproduced in Appendix A of this text. Unlike the unified tax credit, the tax rate schedules are *not* indexed for inflation.

¹⁴§ 2032(a)(1). For this purpose, the term *disposition* is broadly defined. It includes the transfer of property to an heir to satisfy a bequest and the use of property to fund a testamentary trust. Reg. § 20.2032-1(c).

Undivided Ownership

Assume that Dan and Vicky own an undivided but equal interest in a tract of land. Such ownership can fall into any of four categories: joint tenancy, tenancy by the entirety, tenancy in common, or community property.

If Dan and Vicky hold ownership as **joint tenants** or **tenants by the entirety**, the right of survivorship exists. This means that the last tenant to survive receives full ownership of the property. Thus, if Dan predeceases Vicky, the land belongs entirely to Vicky. None of the land passes to Dan's heirs or is subject to administration by Dan's executor. A tenancy by the entirety is a joint tenancy between husband and wife.¹⁵

If Dan and Vicky hold ownership as **tenants in common** or as community property, death does not defeat an owner's interest. Thus, if Dan predeceases Vicky, Dan's half interest in the land passes to his estate or heirs.

Community property interests arise from the marital relationship. Normally, all property acquired after marriage, except by gift or inheritance, by husband and wife residing in a community property state becomes part of the community. The following states have the community property system in effect: Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, Wisconsin, and (by election of the spouses) Alaska. All other states follow the common law system of ascertaining a spouse's rights to property acquired after marriage.

Partial Interests

Interests in assets can be divided in terms of rights to income and rights to principal. Particularly when property is placed in trust, it is not uncommon to carve out various income interests that must be accounted for separately from the ultimate disposition of the property itself.

Under Bill's will, a ranch is to be placed in trust, life estate to Sam, Bill's son, with remainder to Sam's children (Bill's grandchildren). Under this arrangement, Sam is the life tenant and, as such, is entitled to the use of the ranch (including any income) during his life. Upon Sam's death, the trust terminates, and its principal passes to his children. Thus, Sam's children receive outright ownership of the ranch when Sam dies.

EXAMPLE

6

27-2 THE FEDERAL GIFT TAX

27-2a General Considerations

In working with the gift tax, it is first necessary to determine whether a gift has in fact taken place. In addition, some transfers are excluded from the gift tax.

Requirements for a Gift

For a gift to be complete under state law, the following elements must be present.

- A donor competent to make the gift.
- A donee capable of receiving and possessing the property.
- Donative intent on behalf of the donor.
- Actual or constructive delivery of the property to the donee or the donee's representative.
- Acceptance of the gift by the donee.

¹⁵Some state laws do not use the term *tenancy by the entirety* but, nevertheless, recognize a joint tenancy between spouses.

LO.4

Illustrate the operation of the Federal gift tax.

Incomplete Transfers

The Federal gift tax does not apply to transfers that are incomplete. Thus, if the transferor retains the right to reclaim the property or has not really parted with the possession of the property, a taxable event has not taken place.

EXAMPLE

7

Lesly creates a trust with income payable to Mary for life, remainder to Paul. Under the terms of the trust instrument, Lesly can revoke the trust at any time and repossess the trust principal and the income earned. No gift takes place on the creation of the trust; Lesly has not ceased to have dominion and control over the property. However, if after the transfer, Lesly relinquishes his right to terminate the trust, the transfer becomes complete, and the Federal gift tax applies.

Business versus Personal Setting

In a business setting, full and adequate consideration for an exchange is apt to exist; thus, gifts in a business setting are rare. If the parties are acting in a personal setting, a gift is usually the result. It is the position of the IRS that valuable consideration (such as would preclude a gift result) does not include a payment or transfer based on “love and affection ... promise of marriage, etc.”¹⁶ Consequently, property settlements in consideration of marriage (i.e., pre- or antenuptial agreements) are regarded as gifts.

ETHICS & EQUITY It's the Thought That Counts

Joe (age 86) and Nicole (age 22) are married. Two days later, they exchange wedding gifts. Joe's gift to Nicole is stock in IBM (valued at \$2 million), while Nicole's

gift to Joe is a bottle of cologne (value of \$32). What tax goals are they trying to accomplish? Will their plan work?

Do not conclude that the presence of *some* consideration is enough to preclude Federal gift tax consequences. Again, the answer may rest on whether the transfer occurred in a business setting.

EXAMPLE

8

Peter sells Bob some real estate for \$40,000. Unknown to Peter, the property contains valuable mineral deposits and is really worth \$200,000. Peter may have made a bad business deal, but he has not made a gift of \$160,000 to Bob.

Certain Excluded Transfers

Transfers to political organizations are exempt from the application of the Federal gift tax.¹⁷ This provision in the Code made unnecessary the previous practice whereby candidates for public office established multiple campaign committees to maximize the number of annual exclusions available to their contributors. As noted, an annual exclusion of \$14,000 for each donee passes free of the Federal gift tax.

The Federal gift tax does not apply to tuition payments made to an educational organization (e.g., a college) on another's behalf. Nor does it apply to amounts paid on another's behalf for medical care.¹⁸ In this regard, the law is realistic because it is unlikely that most donors would recognize these items as being transfers subject to the gift tax. The payments, however, must be made directly to the provider (e.g., college, doctor, or hospital). There is no requirement that the beneficiary of the service (e.g., student or patient) qualify as a dependent of the person making the payment.

¹⁶Reg. § 25.2512-8.

¹⁷§ 2501(a)(5).

¹⁸§ 2503(e).

The Big Picture

Return to the facts of *The Big Picture* on p. 27-1. After Peter died in 2000, his widow, Martha, continued to live in the family home and refused to move in with either of her children (John or Helen). As Martha's health and mental condition deteriorated, her children did everything possible to keep the family housekeeper from quitting. In fact, Helen paid for the housekeeper's gallbladder operation, and John paid the college tuition of her oldest son.

Neither Helen nor John has made gifts to the housekeeper or her son that are subject to taxation. Gifts would have occurred, however, if Helen and John had reimbursed the housekeeper for the amounts involved, instead of paying the providers (i.e., physician, hospital, and college) directly.

EXAMPLE

9

Satisfying an obligation of support is not subject to the gift tax. Thus, no gift takes place when parents pay for their children's education because one of the obligations of parents is to educate their children. What constitutes an obligation of support is determined by applicable state law. In many states, for example, adult children may have an obligation of support with respect to providing for indigent parents.

Lifetime versus Death Transfers

Be careful to distinguish between lifetime (*inter vivos*) and death (testamentary) transfers.

Dudley buys a 12-month certificate of deposit (CD) from State Bank and lists ownership as follows: "Dudley, payable on proof of death to Faye." Nine months later, Dudley dies. When the CD matures, Faye collects the proceeds from State Bank. No gift takes place when Dudley invests in the CD; Faye has received a mere expectancy (i.e., to obtain ownership of the CD upon Dudley's death). At any time before his death, Dudley may withdraw the funds or delete Faye's name from the account, thereby cutting off her expectancy. Furthermore, no gift occurs upon Dudley's death as the CD passes to Faye by testamentary disposition. As noted later, the CD will be included in Dudley's gross estate as property in which the decedent had an interest (§ 2033).

EXAMPLE

10

The payable on death (POD) designation used in Example 10 is a form of ownership frequently used in a family setting when investments are involved (e.g., stocks and bonds and savings accounts). It is very similar in effect to a revocable trust (see Example 7). Both carry the advantage of avoiding the probate estate. The POD designation, however, is simpler to use in the case of bank accounts and securities, and it avoids the need of having to create a formal trust.

27-2b Transfers Subject to the Gift Tax

Whether a transfer is subject to the Federal gift tax depends upon the application of §§ 2511 through 2519 and the applicable Regulations.

Certain Property Settlements (§ 2516)

Normally, the settlement of certain marital rights is not regarded as being for consideration and is subject to the Federal gift tax.¹⁹ As a special exception to this general approach, Congress enacted § 2516. By this provision, transfers of property interests made under the terms of a written agreement between spouses in settlement of their marital or property rights are deemed to be for adequate consideration. The transfers are exempt from the Federal gift tax if a final decree of divorce is obtained within the three-year period beginning on the date one year before the parties entered into the agreement. Likewise excluded are transfers to provide a reasonable allowance for the support of minor children (including legally adopted children) of a marriage. The agreement need not be approved by the divorce decree.

¹⁹Reg. § 25.2512-8.

The Big Picture

EXAMPLE

11

Return to the facts of *The Big Picture* on p. 27-1. Recall that John and Hannah's divorce became final in January 2014. After extended but amicable negotiations, in September 2012, John and Hannah agreed on a property settlement. In return for the receipt of \$200,000 and title to their home, Hannah released all of her marital rights. Shortly thereafter, John made the transfer. Under § 2516, the property settlement resulted in no gift tax consequences to John.

Disclaimers (§ 2518)

A **disclaimer** is a refusal by a person to accept property that is designated to pass to him or her. The effect of the disclaimer is to pass the property to someone else.

The Big Picture

EXAMPLE

12

Return to the facts of *The Big Picture* on p. 27-1. Recall that Martha died of a heart condition in July. Under her will, her estate passes in equal parts to her son and daughter or, if they disclaim, to their children. (Under a buy-sell agreement, Martha's stock in Hood Corporation is redeemed by the corporation with the insurance proceeds from a policy it took out on her life.) Helen disclaims her share of the inheritance, and the assets pass to her children.

Why might Helen disclaim her inheritance and have the property pass directly from Martha to the children? By doing so, an extra transfer tax may be avoided. If the disclaimer does not take place (Helen accepts the inheritance) and the property eventually passes to the children (either by gift or by death), the later transfer is subject to the application of either the gift tax or the estate tax.

The Federal gift tax can also be avoided in cases of a partial disclaimer of an undivided interest.

The Big Picture

EXAMPLE

13

Assume the same facts as in Example 12. John's share of his inheritance from Martha also includes the family hunting lodge. Except for the hunting lodge, John disclaims his share of the inheritance, and the remaining assets pass to his children.

To be effective, the disclaimer must be in writing and timely made. Generally, this means no later than nine months after the right to the property arose. Furthermore, the person making the disclaimer must not have accepted any benefits or interest in the property.

Other Transfers Subject to Gift Tax

Other transfers that may carry gift tax consequences (e.g., the creation of joint ownership) are discussed and illustrated in connection with the Federal estate tax.

Income Tax Considerations

Generally, a donor has no income tax consequences on making a gift. A donee recognizes no income on the receipt of a gift.²⁰ A donee's income tax basis in the property received depends on a number of factors (e.g., donor's basis, year of gift, and gift tax incurred by donor) and is discussed in Chapter 13.

²⁰Both gifts and inheritances are excluded from income under § 103. See Chapter 5.

27-2c Annual Exclusion

The first \$14,000 of gifts (except gifts of future interests in property) made to any one person during any calendar year is excluded in determining the total amount of taxable gifts for the year.²¹ The **annual exclusion** applies to all gifts of a present interest made during the calendar year in the order in which they are made until the \$14,000 exclusion per donee is exhausted. For a gift in trust, each beneficiary of the trust is treated as a separate person for purposes of the exclusion.

During 2015, Laura makes the following cash gifts: \$8,000 to Rita and \$15,000 to Maureen. Laura may claim an annual exclusion of \$8,000 with respect to the gift to Rita and \$14,000 with respect to the gift to Maureen.

EXAMPLE

14

A **future interest** is defined as an interest that will come into being (as to use, possession, or enjoyment) at some future date. Examples of future interests include rights such as remainder interests that are commonly encountered when property is transferred to a trust. A *present interest* is an unrestricted right to the immediate use, possession, or enjoyment of property or of the income.

By a lifetime gift, Ron transfers property to a trust with a life estate (with income payable annually) to June and remainder upon June's death to Albert. Ron made two gifts when the trust was created: one to June of a life estate and one to Albert of a remainder interest. The life estate is a present interest and qualifies for the annual exclusion. Albert's remainder is a future interest and does not qualify for the exclusion. Note that Albert's interest does not come into being until some future date (upon the death of June).

EXAMPLE

15

Although Example 15 indicates that the gift of an income interest is a present interest, this is not always the case. If a possibility exists that the income beneficiary may not receive the immediate enjoyment of the property, the transfer is of a future interest.

Assume the same facts as in Example 15, except that the income from the trust need not be payable annually to June. It may, at the trustee's discretion, be accumulated and added to corpus. Because June's right to receive the income from the trust is conditioned on the trustee's discretion, it is not a present interest. No annual exclusion is allowed. The mere possibility of diversion is enough. It would not matter if the trustee never exercised the discretion to accumulate and did, in fact, distribute the trust income to June annually.

EXAMPLE

16

Trust for Minors

Section 2503(c) offers an exception to the future interest rules just discussed. Under this provision, a transfer for the benefit of a person who has not attained the age of 21 on the date of the gift may be considered a gift of a present interest. This is true even though the minor is not given the unrestricted right to the immediate use, possession, or enjoyment of the property. For the exception to apply, however, certain stringent conditions must be satisfied. One such condition is that all of the property and its income must be made available to the minor upon attaining age 21. Thus, the exception allows a trustee to accumulate income on behalf of a minor beneficiary without converting the income interest to a future interest.

Contributions to Qualified Tuition Programs

For income tax purposes, § 529 plans possess attributes that reflect the best of all possible worlds. Although no up-front deduction is allowed,²² income earned by the fund

²¹§ 2503(b).

²²Depending on the taxpayer's home state, some (or all) of the contributions into the plan may be deductible for *state* income tax purposes.

accumulates free of income tax and distributions are not taxed if they are used for higher education purposes. A special provision allows a donor to enjoy a gift tax advantage by using five years of annual exclusions.

EXAMPLE

17

Trevor and Audrey would like to start building a college education fund for their 10-year-old granddaughter Loni. In 2015, Trevor contributes \$140,000 to the designated carrier of their state's § 529 plan. By electing to split the gift and using five annual exclusions [2 (number of donors) × \$14,000 (annual exclusion) × 5 years = \$140,000], no taxable gift results. (The gift-splitting election is discussed in detail later in this chapter.) Making the five-year election precludes Trevor and Audrey from using any annual exclusion on gifts to Loni for the next four years.²³

These college plans are not included in the gross estate of the transferor.²⁴ This is preferential treatment because § 529 plans are incomplete transfers (e.g., some or all of the funds may be returned if college is not attended). As noted later, incomplete transfers are invariably subject to the estate tax.

27-2d Deductions

In arriving at taxable gifts, a deduction is allowed for transfers to certain qualified charitable organizations. On transfers between spouses, a marital deduction may be available. Because both the charitable and marital deductions apply in determining the Federal estate tax, they are discussed later in the chapter.

27-2e Computing the Federal Gift Tax**The Unified Transfer Tax Rate Schedule**

The top rates of the unified transfer tax rate schedule originally reached as high as 70 percent. Over the years, these top rates were reduced to 55 percent and then to 45 percent for 2007.²⁵

Effective for 2011 and 2012, the top rate was 35 percent for both the gift tax and the estate tax. Beginning with 2013, the top rate is 40 percent. The unified transfer tax rate schedule applies to all transfers (by gift or death) after 1976. Different rate schedules applied for pre-1977 gifts and pre-1977 death transfers.

The Election to Split Gifts by Married Persons

To understand the reason for the gift-splitting election of § 2513, consider the following situations.

Effect of Splitting Gifts**EXAMPLE**

18

Dick and Margaret are husband and wife who reside in Michigan, a common law state. Dick has been the only breadwinner in the family, and Margaret has no significant property of her own. Neither has made any prior taxable gifts. In 2015, Dick makes a gift to Leslie of \$6,028,000. Presuming that the election to split gifts did not exist, Dick's gift tax is as follows.

Amount of gift	\$ 6,028,000
Subtract: Annual exclusion	(14,000)
Taxable gift	<u>\$ 6,014,000</u>
Gift tax on \$6,014,000 per Appendix A, [\$345,800 + 40%(\$6,014,000 - \$1,000,000)]	\$ 2,351,400
Subtract: Unified transfer tax credit for 2015	<u>(2,117,800)</u>
Gift tax due on the 2015 taxable gift	<u>\$ 233,600</u>

²³Trevor and Audrey could resort to § 2503(e)(2)(A) to avoid any gift at all. As mentioned earlier, a *direct* payment of tuition to certain educational institutions is exempt from the gift tax. But this rule does not help build an education fund for future use, as § 529 does. Recall that Loni, the granddaughter, is 10 years old.

²⁴§ 529(c)(4).

²⁵§ 2001(c)(2)(B). The rates for 2015 are in Appendix A.

Effect of Splitting Gifts

EXAMPLE

19

Assume the same facts as in Example 18, except that Dick and Margaret have always resided in California, a community property state. Even though Dick is the sole breadwinner, income from personal services generally is community property. Consequently, the gift to Leslie probably involves community property. If this is the case, the gift tax is as follows.

	Dick	Margaret
Amount of gift	\$ 3,014,000	\$ 3,014,000
Subtract: Annual exclusion	(14,000)	(14,000)
Taxable gift	<u>\$ 3,000,000</u>	<u>\$ 3,000,000</u>
Gift tax on \$3,000,000 per Appendix A [\$345,800 + 40%(\$3,000,000 – \$1,000,000)]	\$ 1,145,800	\$ 1,145,800
Subtract: Unified transfer tax credit for 2015	(2,117,800)	(2,117,800)
Gift tax due on the 2015 taxable gift	<u>\$ -0-</u>	<u>\$ -0-</u>

As the results of Examples 18 and 19 indicate, married donors residing in community property jurisdictions possessed a significant gift tax advantage over those residing in common law states. To rectify this inequity, the Revenue Act of 1948 incorporated the predecessor to § 2513 into the Code. Under this provision, a gift made by a person to someone other than his or her spouse may be considered, for Federal gift tax purposes, as having been made one-half by each spouse.

Returning to Example 18, Dick and Margaret could treat the gift passing to Leslie as being made one-half by each of them, even though the property belonged to Dick. As a result, the parties are able to achieve the same tax consequence as in Example 19. As is the case with the owner spouse, any past taxable gifts of the nonowner spouse must be taken into account in determining the current gift tax.

To split gifts, the spouses must be legally married to each other at the time of the gift. This includes those of same-sex couples if the marriage occurred in a state that legally recognizes same-sex marriage. If they are divorced later in the calendar year, they may still split the gift if neither marries anyone else during that year. They both must indicate on their separate gift tax returns their consent to have all gifts made in that calendar year split between them. In addition, both must be citizens or residents of the United States on the date of the gift. A gift from one spouse to the other spouse cannot be split. Such a gift might, however, be eligible for the marital deduction.

The election to split gifts is not necessary when husband and wife transfer jointly owned or community property to a third party. It is needed if the gift consists of the separate property of one of the spouses. Community property rules generally define separate property as property acquired before marriage and property acquired after marriage by gift or inheritance. The election, then, is not limited to residents of common law states.

27-2f Procedural Matters

Having determined which transfers are subject to the Federal gift tax and the various deductions and exclusions available to the donor, the procedural aspects of the tax should be considered. The following sections discuss the return itself, the due dates for filing and paying the tax, and other related matters.

The Federal Gift Tax Return

For transfers by gift, a Form 709 (U.S. Gift Tax Return) must be filed whenever the gifts for any one calendar year exceed the annual exclusion or involve a gift of a future interest. The Form 709 also must be filed when the election to split gifts is made by the nonowner spouse (see Example 21). A Form 709 need not be filed, however, for transfers

between spouses that are offset by the unlimited marital deduction, regardless of the amount of the transfer.²⁶

When Must A Form 709 Be Filed?

EXAMPLE

20

In 2015, Larry makes five gifts, each in the amount of \$14,000, to his five children. If the gifts do not involve future interests, a Form 709 need not be filed to report the transfers.

EXAMPLE

21

During 2015, Esther makes a gift of \$28,000 cash of her separate property to her daughter. To double the amount of the annual exclusion allowed, Jerry (Esther's husband) is willing to split the gift. Because the § 2513 election can be made only on a gift tax return, a Form 709 must be filed even though no gift tax will be due as a result of the transfer.

In Example 21, no gift tax return would be necessary if the transfer consisted of community property. Because two donors are now involved, the cap for filing becomes more than \$28,000, rather than more than \$14,000.

Presuming that a gift tax return is due, it must be filed on or before the fifteenth day of April following the year of the gift.²⁷ As with other Federal taxes, when the due date falls on Saturday, Sunday, or a legal holiday, the date for filing the return is the next business day. Note that the filing requirements for Form 709 have no correlation to the accounting year used by a donor for Federal income tax purposes. Thus, a fiscal year taxpayer must follow the April 15 rule for any reportable gifts. If sufficient reason is shown, the IRS is authorized to grant reasonable extensions of time for filing the return.²⁸

Key gift tax provisions are reviewed in Concept Summary 27.3.

Concept Summary 27.3

Federal Gift Tax Provisions

1. The Federal gift tax applies to all gratuitous transfers of property made by U.S. citizens or residents. In this regard, it does not matter where the property is located.
2. In the eyes of the IRS, a gratuitous transfer is one not supported by full and adequate consideration. If the parties are acting in a business setting, such consideration usually exists. If purported sales are between family members, a gift element may be suspected.
3. Property settlements can escape the gift tax if a divorce occurs within a prescribed period of time.
4. A disclaimer is a refusal by a person to accept property designated to pass to that person. The effect of a disclaimer is to pass the property to someone else. If certain conditions are satisfied, the issuance of a disclaimer will not be subject to the Federal gift tax.
5. Except for gifts of future interests, a donor is allowed an annual exclusion. The future interest limitation does not apply to certain trusts created for minors.
6. The election to split a gift enables a married couple to be treated as two donors. The election doubles the annual exclusion and makes the nonowner spouse's unified tax credit available to the owner spouse.
7. The election to split gifts is not necessary if the property is jointly owned by the spouses. That is the case when the property is part of the couple's community.
8. In determining the tax base for computing the gift tax, all prior taxable gifts must be added to current taxable gifts. Thus, the gift tax is cumulative in nature.
9. Gifts are reported on Form 709. The return is due on April 15 following the year of the gift.

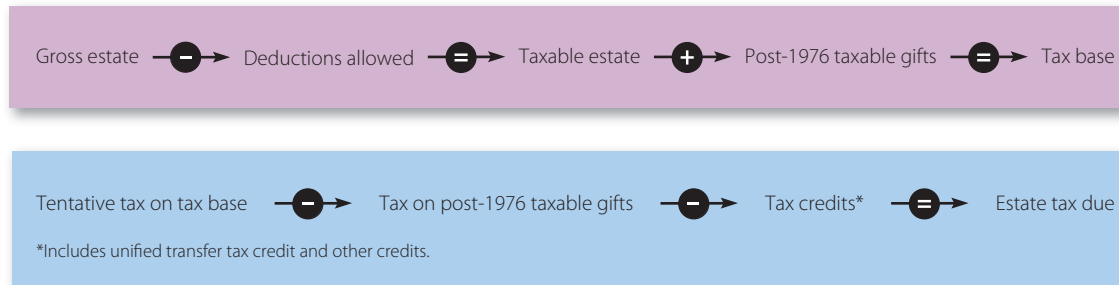
²⁶§ 6019(a)(2).

²⁷§ 6075(b)(1).

²⁸§ 6081. Under § 6075(b)(2), an extension of time granted to a calendar year taxpayer for filing an income tax return automatically extends the due date of a gift tax return.

27-3 THE FEDERAL ESTATE TAX

The following discussion of the estate tax coincides with the formula that appeared earlier in the chapter in Concept Summary 27.2. The key components in the formula are the gross estate, the taxable estate, the tax base, and the credits allowed against the tentative tax. This formula can be summarized as follows:



27-3a Gross Estate

Simply stated, the **gross estate** includes all property subject to the Federal estate tax. Thus, the gross estate depends on the provisions of the Internal Revenue Code as supplemented by IRS pronouncements and the judicial interpretations of Federal courts.

In contrast to the gross estate, the **probate estate** is controlled by state (rather than Federal) law. The probate estate consists of all of a decedent's property subject to administration by the executor or administrator of the estate. The administration is supervised by a local court of appropriate jurisdiction (usually called a probate court). An executor is the decedent's personal representative appointed under the decedent's will. When a decedent dies without a will or fails to name an executor in the will (or that person refuses to serve), the local probate court appoints an administrator.

The probate estate is frequently smaller than the gross estate. It contains only property owned by the decedent at the time of death and passing to heirs under a will or under the law of intestacy (the order of distribution for those dying without a will). As noted later, such items as the proceeds of many life insurance policies and distributions from retirement plans become part of the gross estate but are not included in the probate estate.

All states provide for an order of distribution in the event someone dies *intestate* (i.e., without a will). After the surviving spouse receives some or all of the estate, the preference is usually in the following order: down to lineal descendants (e.g., children and grandchildren), up to lineal ascendants (e.g., parents and grandparents), and out to collateral relations (e.g., brothers, sisters, aunts, and uncles).

Property Owned by the Decedent (§ 2033)

Property owned by the decedent at the time of death is included in the gross estate. The nature of the property or the use to which it was put during the decedent-owner's lifetime has no significance as far as the estate tax is concerned. Thus, personal effects (such as clothing), stocks, bonds, mutual funds, furniture, jewelry, bank accounts, and certificates of deposit are all included in the deceased's gross estate. No distinction is made between tangible and intangible, depreciable and nondepreciable, or business and personal assets. However, a deceased spouse's gross estate does not include the surviving spouse's share of the community property.

The application of § 2033 is illustrated as follows:

Property Owned at Death

Irma dies owning some City of Denver bonds. The fair market value of the bonds plus any interest accrued to the date of Irma's death is included in her gross estate. Although interest on municipal bonds normally is not taxable under the Federal income tax, it is property owned by Irma at the time of death. However, any interest accrued after death is not part of Irma's gross estate.

LO.6

Identify the components of the gross estate.

EXAMPLE

22

Property Owned at Death

EXAMPLE

23

Sharon dies on April 7, when she owns stock in Robin Corporation and in Wren Corporation. On March 2, both corporations had authorized a cash dividend payable on May 4. Robin's dividend is payable to shareholders of record as of April 2. Wren's date of record is April 9. Sharon's gross estate includes the following: the stock in Robin, the stock in Wren, and the dividend on the Robin stock. It does not include the dividend on the Wren stock because Sharon dies before the April 9 date of record.

EXAMPLE

24

Ray dies holding some promissory notes issued to him by his son. In his will, Ray forgives these notes, relieving the son of the obligation to make any payments. The fair market value of these notes is included in Ray's gross estate.

The Big Picture

EXAMPLE

25

Return to the facts of *The Big Picture* on p. 27-1. At the time of his death, John was the president of Hood Corporation. John's estate receives a distribution from Hood's qualified pension plan of \$1.1 million consisting of the following.

Hood's contributions	\$450,000
John's after-tax contributions	350,000
Income earned by the plan	300,000

John's estate also receives \$150,000 from Hawk Insurance Company. The payment represents the maturity value of term life insurance from a group plan that Hood maintains for its employees. As to these amounts, John's gross estate includes \$1,250,000 (\$1,100,000 + \$150,000). For income tax purposes, however, \$750,000 (\$450,000 + \$300,000) is subject to tax, while \$500,000 (\$350,000 + \$150,000) is not.

Regarding the result reached in Example 25, retirement plan benefits are invariably subject to estate tax. Besides the conventional qualified pension and profit-sharing plans involved in Example 25, retirement plans include those under § 401(k), § 403(b) for teachers, § 457 for government employees, Keogh (H.R. 10) for self-employed persons, and IRAs—both traditional and Roth. Inclusion in the gross estate occurs irrespective of income tax consequences. Thus, a benefit paid under a Roth IRA is fully subject to the estate tax even though it may not be taxable as income to the beneficiary. The possibility of an income tax deduction for estate taxes paid is covered in Chapter 28 in connection with the discussion of income in respect of a decedent.

In addition to the items noted previously, § 2033 operates to include in the gross estate many assets that can be of significant value. Examples include:

- Real estate holdings (but see § 2040 for jointly owned property).
- Present value of future royalty rights (e.g., patents, copyrights, and mineral interests).
- Interests in a business (i.e., sole proprietorship and partnership).
- Collectibles (e.g., works of art and coin collections).
- Renewal value of leasehold interests.
- Terminable interests (e.g., life estates in realty or trusts) held by a surviving spouse as to which a deceased spouse's estate has made a QTIP election (discussed later in this chapter).
- Unmatured insurance policies on the lives of others.
- Proceeds from casualty and life insurance policies payable to the estate.
- Present value of pending and potential lawsuits or past judgments rendered.

The Big Picture

Return to the facts of *The Big Picture* on p. 27-1. Recall that John's death ultimately resulted from injuries suffered in a car accident caused by another motorist. In addition, John's auto was destroyed in the accident. Presuming that the other driver is solvent or carries casualty insurance, John's gross estate should include the present value of any expected settlement that could result from possible legal action. At the least, his estate must include the recovery expected from his own casualty policy.

EXAMPLE

26

Adjustments for Gifts Made within Three Years of Death (§ 2035)

At one time, all taxable gifts made within three years of death were included in the donor's gross estate unless it could be shown that the gifts were not made in contemplation of death. The special three-year rule for "deathbed gifts" was needed because the gift and estate taxes had not yet been merged into a unified tax. Making such gifts prior to death was advantageous then, as the lower tax rates of the separate gift tax applied.

Post-1976 taxable gifts are added to the taxable estate in arriving at the tax base for determining the estate tax liability—see Concept Summary 27.2 earlier in the chapter. Nevertheless, the three-year rule for inclusion in the gross estate has been retained for the following items.

- Any gift tax paid on gifts made within three years of death. Called the *gross-up* procedure, this prevents the gift tax amount from escaping the estate tax.
- Any property interests transferred by gift within three years of death that would have been included in the gross estate and consist of transfers with a retained life estate (§ 2036), transfers taking effect at death (§ 2037), revocable transfers (§ 2038), and proceeds of life insurance (§ 2042). Most of these transfers are discussed later in the chapter.

Before her death in 2015, Jennifer made the following taxable gifts.

Year of Gift	Nature of the Asset	Fair Market Value		Gift Tax Paid
		Date of Gift	Date of Death	
2006	Hawk Corporation stock	\$200,000	\$1,300,000	\$ -0-
2013	Insurance policy on Jennifer's life	80,000 (cash value)	1,000,000 (face value)	-0-
2013	Land	800,000	810,000	16,000

EXAMPLE

27

Jennifer's *gross estate* includes \$1,016,000 (\$1,000,000 life insurance proceeds + \$16,000 gross-up for the gift tax on the 2013 taxable gift) as to these transfers. Referring to the formula for the estate tax (Concept Summary 27.2), the 2006 taxable gift is added to the *taxable estate* (at the fair market value on the date of the gift) in arriving at the tax base.

In the case of the Hawk stock, notice the substantial saving in transfer taxes that will occur. The gift tax (although none resulted) is based on \$200,000, whereas an estate tax would have applied to \$1.3 million. Thus, the appreciation of \$1.1 million has escaped any transfer tax. Jennifer's estate is allowed a credit for the gift tax paid on the 2013 transfer of land.

The three-year rule also applies in testing qualification under several other relatively narrow provisions.²⁹

²⁹ §§ 2035(c)(1) and (2).

Transfers with a Retained Life Estate (§ 2036) and Revocable Transfers (§ 2038)

Code §§ 2036 and 2038 were enacted on the premise that the estate tax can be avoided on lifetime transfers only if the decedent does not retain control over the property. The logic of this approach is somewhat difficult to dispute. One should not be able to escape the tax consequences of property transfers at death while remaining in a position during life to enjoy some or all of the fruits of ownership.

Under § 2036, the value of any property transferred by the deceased during lifetime for less than adequate consideration must be included if either of the following was retained:

- The possession or enjoyment of, or the right to the income from, the property.
- The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income.

The decedent is considered to have the right to the income from the property to the extent that such income is to be applied toward the discharge of his or her legal obligation.

The Big Picture

EXAMPLE

28

Return to the facts of *The Big Picture* on p. 27-1. Before Peter Hood died in 2000, he established several trusts. One trust grants John an income interest for life (i.e., a life estate), and upon his death, the trust passes to his children (i.e., remainder interest). Upon John's death, none of the trust property is included in his gross estate. Although he held a life estate, he was not the transferor (Peter was) of the property placed in trust.

The Big Picture

EXAMPLE

29

Return to the facts of *The Big Picture* on p. 27-1. Immediately after inheriting the family hunting lodge from his mother (see Example 13), John transfers it to a newly created trust. Under the terms of the trust instrument, he retains a life estate, remainder to his children and Helen (John's sister). Upon John's death, the property in the trust will be included in his gross estate under § 2036.

In both of the preceding examples, a gift occurred when the trusts were created. In Example 28, Peter made a gift of the entire amount placed in trust. In Example 29, John made a gift of only the remainder interest.

Another type of lifetime transfer that is drawn into a decedent's gross estate is covered by § 2038. The gross estate includes the value of property interests transferred by the decedent (except to the extent that the transfer was made for full consideration) if the enjoyment of the property transferred was subject, at the date of the decedent's death, to any power of the decedent to *alter, amend, revoke, or terminate* the transfer.

The classic § 2038 situation results from the use of a revocable trust. Example 7 (earlier in this chapter) illustrates the use of a revocable trust and shows what happens when the right of revocation is released during the life of the creator of the trust. When the right of revocation is relinquished within three years of death, the trust is included in the creator's gross estate.

Joint Interests (§§ 2040 and 2511)

Recall that joint tenancies and tenancies by the entirety are characterized by the right of survivorship. Thus, upon the death of a joint tenant, title to the property passes to the surviving tenant. None of the property is included in the *probate* estate of the deceased tenant. In the case of tenancies in common and community property, death does not defeat an ownership interest; rather, the deceased owner's interest is part of the probate estate.

The *Federal estate tax treatment* of tenancies in common or of community property follows the logical approach of taxing only the portion of the property included in the deceased owner's probate estate.

Homer, Wilma, and Thelma acquire a tract of land with ownership listed as tenants in common, each party furnishing \$200,000 of the \$600,000 purchase price. When the property is worth \$900,000, Homer dies. If Homer's undivided interest in the property is $33\frac{1}{3}\%$, the gross estate and probate estate each include \$300,000. This one-third interest is also the same amount that passes to Homer's heirs.

EXAMPLE

30

Unless the parties have provided otherwise, each tenant is deemed to own an interest equal to the portion of the original consideration he or she furnished. The parties in Example 30 could have provided that Homer would receive an undivided one-half interest in the property although he contributed only one-third of the purchase price. In that case, Wilma and Thelma have made a gift to Homer when the tenancy was created, and Homer's gross estate and probate estate each include \$450,000.

For certain joint tenancies, the tax consequences are different. All of the property is included in the deceased co-owner's gross estate unless it can be proved that the surviving co-owners contributed to the cost of the property.³⁰ If a contribution can be shown, the amount to be *excluded* is calculated by the following formula:

$$\frac{\text{Surviving co-owner's initial contribution}}{\text{Total initial cost of the property}} \times \text{Fair market value of the property at death}$$

In computing a survivor's contribution, any funds received as a gift *from the deceased co-owner* and applied to the cost of the property cannot be counted. However, income or gain from gift assets can be counted.

Keith and Steve (father and son) acquire a tract of land with ownership listed as joint tenancy with right of survivorship. Keith furnished \$400,000 and Steve \$200,000 of the \$600,000 purchase price. Of the \$200,000 provided by Steve, \$100,000 had previously been received as a gift from Keith. When the property is worth \$900,000, Keith dies. Because only \$100,000 of Steve's contribution can be counted (the other \$100,000 was received as a gift from Keith), Steve has furnished only one-sixth ($\$100,000/\$600,000$) of the cost. Thus, Keith's gross estate must include five-sixths of \$900,000, or \$750,000.

This result presumes that Steve can prove that he did in fact make the \$100,000 contribution. In the absence of such proof, the full value of the property is included in Keith's gross estate. Keith's death makes Steve the immediate owner of the property by virtue of the right of survivorship. None of the property is part of Keith's probate estate.

EXAMPLE

31

If the co-owners receive the property as a gift or bequest *from another*, each owner is deemed to have contributed to the cost (or value on date of death) of his or her own interest.

The Big Picture

Return to the facts of *The Big Picture* on p. 27-1. During his lifetime, Peter Hood purchased timberland, listing title as follows: "John and Helen Hood as equal tenants in common." John's basis in the property is one-half of Peter's cost. Upon John's death, one-half of the value of the timberland is included in his gross estate.

EXAMPLE

32

³⁰§ 2040(a).

The Big Picture

EXAMPLE

33

Return to the facts of *The Big Picture* on p. 27-1. In her will, Martha leaves the Hood family residence to her children (John and Helen) as joint tenants with right of survivorship. John's income tax basis is one-half of the value on Martha's death. On John's later death, one-half of the value at that time will be included in his gross estate. Keep in mind that under the right of survivorship, outright ownership goes to Helen and none of the property passes to John's heirs.

To simplify the joint ownership rules for *married persons*, § 2040(b) provides for an automatic inclusion rule upon the death of the first joint-owner spouse to die. Regardless of the amount contributed by each spouse, one-half of the value of the property is included in the gross estate of the spouse who dies first. The special rule eliminates the need to trace the source of contributions and recognizes that any inclusion in the gross estate is neutralized by the marital deduction.

The Big Picture

EXAMPLE

34

Return to the facts of *The Big Picture* on p. 27-1. Recall that after his divorce from Hannah, John married Ashley. Because Hannah kept John's prior home as part of the property settlement (see Example 11), he purchased a new residence. He listed title to the property as "John and Ashley Hood, tenancy by the entirety with right of survivorship." Upon John's death, only one-half of the value of the property is included in his gross estate.

If Ashley had died first, one-half of the value of the residence would have been included in her gross estate even though she made no contribution to its cost.

In Example 34, inclusion in the gross estate of the first spouse to die is neutralized by the unlimited marital deduction allowed for estate tax purposes (see the discussion of the marital deduction later in the chapter). Under the right of survivorship, the surviving joint tenant obtains full ownership of the property. The marital deduction generally is allowed for property passing from one spouse to another.

Whether a *gift* results when property is transferred into some form of joint ownership depends on the consideration furnished by each of the contributing parties for the ownership interest acquired.

Joint Ownership and Gift Tax Result

EXAMPLE

35

Brenda and Sarah purchase real estate as tenants in common. Of the \$800,000 purchase price, Brenda furnishes \$600,000, and Sarah furnishes only \$200,000. If they are equal owners in the property, Brenda has made a gift to Sarah of \$200,000.

EXAMPLE

36

Martha purchases real estate for \$900,000, the title to the property being listed as follows: "Martha, Sylvia, and Dan as joint tenants with the right of survivorship." If under state law the mother (Martha), the daughter (Sylvia), and the son (Dan) are deemed to be equal owners in the property, Martha is treated as having made gifts of \$300,000 to Sylvia and \$300,000 to Dan.

Several important *exceptions* exist to the general rule that the creation of a joint ownership with disproportionate interests resulting from unequal consideration triggers gift treatment. First, if the transfer involves a joint bank account, there is no gift at the time of the contribution. If a gift occurs, it is when the noncontributing party withdraws the funds provided by the other joint tenant. Second, the same rule applies to the purchase of U.S. savings bonds.³¹ Again, any gift tax consequences are postponed

³¹Reg. § 25.2511-1(h)(4).

until the noncontributing party appropriates some or all of the proceeds for his or her individual use.

Life Insurance (§ 2042)

Under § 2042, the gross estate includes life insurance on the decedent's life if:

- the policy's proceeds are receivable by the estate,
- the proceeds are receivable by another for the benefit of the estate, or
- the decedent possessed any of the incidents of ownership in the policy.

Life insurance on the life of another owned by a decedent at the time of death is included in the gross estate under § 2033 (property in which the decedent had an interest) and not under § 2042. The amount includible is the replacement value of the policy.³² Under these circumstances, inclusion of the face amount of the policy is inappropriate as the policy has not yet matured.

At the time of his death, Luigi owned a life insurance policy on the life of Benito, face amount of \$500,000 and replacement value of \$50,000, with Sofia as the designated beneficiary. Because the policy had not matured at Luigi's death, § 2042 would be inapplicable. However, § 2033 (property in which the decedent had an interest) compels the inclusion of \$50,000 (the replacement value) in Luigi's gross estate. If Luigi and Sofia owned the policy as community property, only \$25,000 would be included in Luigi's gross estate.

EXAMPLE

37

In the frequent situation where the beneficiary of the insurance is neither the insured nor the owner of the policy, no tax consequences ensue upon the beneficiary's death. Thus, in Example 37, if Sofia predeceases Benito, no transfer takes place because the policy has not matured. Sofia's interest as a beneficiary is a mere expectancy and not a property interest possessing any value.

The term *life insurance* includes whole life policies, term insurance, group life insurance, travel and accident insurance, endowment contracts (before being paid up), and death benefits paid by fraternal societies operating under the lodge system.³³

As just noted, proceeds of insurance on the life of the decedent receivable by the executor or administrator or payable to the decedent's estate are included in the gross estate. The estate need not be specifically named as the beneficiary. Assume, for example, that the proceeds of the policy are receivable by an individual beneficiary and are subject to an obligation, legally binding upon the beneficiary, to pay taxes, debts, and other charges enforceable against the estate. The proceeds are included in the decedent's gross estate to the extent of the beneficiary's obligation. If the proceeds of an insurance policy made payable to a decedent's estate are community assets and, under state law, one-half belongs to the surviving spouse, only one-half of the proceeds will be considered as receivable by or for the benefit of the decedent's estate.

Proceeds of insurance on the life of the decedent not receivable by or for the benefit of the estate are includible if the decedent at death possessed any of the incidents of ownership in the policy. In this connection, the term *incidents of ownership* means more than the ownership of the policy in a technical legal sense. Generally speaking, the term refers to the right of the insured or his or her estate to the economic benefits of the policy. Thus, it also includes the power to change beneficiaries, revoke an assignment, pledge the policy for a loan, or surrender or cancel the policy.³⁴

³²Reg. § 20.2031-8(a)(1).

³³Reg. § 20.2042-1(a)(1). As to travel and accident insurance, see *Comm. v. Estate of Noel*, 65-1 USTC ¶12,311, 15 AFTR 2d 1397, 85 S.Ct. 1238 (USSC,

1965). As to employer-sponsored group term life insurance, see Example 25 earlier in this chapter.

³⁴Reg. § 20.2042-1(c)(2).

EXAMPLE

38

At the time of death, Broderick was the insured under a policy (face amount of \$1 million) owned by Gregory, with Demi as the designated beneficiary. Broderick took out the policy five years ago and immediately transferred it as a gift to Gregory. Under the assignment, Broderick transferred all rights in the policy except the right to change beneficiaries. Broderick died without having exercised this right, and the policy proceeds are paid to Demi. Under § 2042(2), Broderick's retention of an incident of ownership in the policy (i.e., the right to change beneficiaries) causes \$1 million to be included in his gross estate.

Assuming that the deceased-insured holds the incidents of ownership in a policy, how much is included in the gross estate if the insurance policy is a community asset? Only one-half of the proceeds becomes part of the deceased spouse's gross estate.

Merely purchasing a life insurance contract and designating someone else as the beneficiary thereunder does not constitute a *gift*. As long as the purchaser still owns the policy, nothing has really passed to the beneficiary. Even on the death of the insured-owner, no gift takes place. The proceeds paid to the beneficiary constitute a testamentary and not a lifetime transfer. But consider the following possibility.

EXAMPLE

39

Kurt purchases an insurance policy on his own life and transfers the policy to Olga. Kurt retains no interest in the policy (such as the power to change beneficiaries). In these circumstances, Kurt has made a gift to Olga. Furthermore, if Kurt continues to pay the premiums on the transferred policy, each payment constitutes a separate gift.

Under certain conditions, the death of the insured may constitute a gift to the beneficiary of part or all of the proceeds. This occurs when the owner of the policy is not the insured.

EXAMPLE

40

Randolph owns an insurance policy on the life of Frank, with Tracy as the designated beneficiary. Up until the time of Frank's death, Randolph retained the right to change the beneficiary of the policy. The proceeds paid to Tracy by the insurance company by reason of Frank's death constitute a gift from Randolph to Tracy.³⁵

See Concept Summary 27.4 for a review of the components of the gross estate.

Concept Summary 27.4

Federal Estate Tax Provisions—Gross Estate

1. The starting point for applying the Federal estate tax is to determine which assets are subject to tax. Such assets comprise a decedent's gross estate.
2. The gross estate generally will not include any gifts made by the decedent within three years of death. It does include any gift tax paid on these transfers.
3. Based on the premise that one should not continue to enjoy or control property and not have it subject to the estate tax, certain incomplete transfers are included in the gross estate.
4. Upon the death of a joint tenant, the full value of the property is included in the gross estate unless the survivor(s) made a contribution toward the cost of the property. Spouses are subject to a special rule that calls for automatic inclusion of half of the value of the property in the gross estate of the first tenant to die. The creation of joint ownership is subject to the gift tax when a tenant receives a lesser interest in the property than is warranted by the consideration furnished.
5. If the decedent is the insured, life insurance proceeds are included in the gross estate if either of two conditions is satisfied. First, the proceeds are paid to the estate or for the benefit of the estate. Second, the decedent possessed incidents of ownership (e.g., the right to change beneficiaries) over the policy.

³⁵*Goodman v. Comm.*, 46-1 USTC ¶10,275, 34 AFTR 1534, 156 F.2d 218 (CA-2, 1946).

27-3b Taxable Estate

After the gross estate has been determined, the next step is to compute the taxable estate. By virtue of § 2051, the **taxable estate** is the gross estate less the following: expenses, indebtedness, and taxes (§ 2053); losses (§ 2054); charitable transfers (§ 2055); the marital deduction (§§ 2056 and 2056A); and the deduction for state death taxes (§ 2058). As previously noted, the charitable and marital deductions also have gift tax ramifications.

LO.7

Describe the components of the taxable estate.

Expenses, Indebtedness, and Taxes (§ 2053)

A deduction is allowed for funeral expenses; expenses incurred in administering property; claims against the estate; and unpaid mortgages and other charges against property, whose value is included in the gross estate (without reduction for the mortgage or other indebtedness).

Expenses incurred in administering community property are deductible only in proportion to the deceased spouse's interest in the community.³⁶

Administration expenses include commissions of the executor or administrator, attorney's fees of the estate, accountant's fees, court costs, and certain selling expenses for disposition of estate property.

Claims against the estate include property taxes accrued before the decedent's death, unpaid income taxes on income received by the decedent before he or she died, and unpaid gift taxes on gifts made by the decedent before death.

Amounts that may be deducted as claims against the estate are only for enforceable personal obligations of the decedent at the time of death. Deductions for claims founded on promises or agreements are limited to the extent the liabilities were contracted in good faith and for adequate and full consideration. However, a pledge or subscription in favor of a public, charitable, religious, or educational organization is deductible to the extent that it would have constituted an allowable deduction had it been a bequest.³⁷

Deductible funeral expenses include the cost of interment, the burial plot or vault, a gravestone, perpetual care of the grave site, and the transportation expense of the person bringing the body to the place of burial. No deduction is allowed for cemetery lots the decedent acquired before death for himself or herself and family, but the lots are not included in the decedent's gross estate under § 2033 (property in which the decedent had an interest).

Losses (§ 2054)

Section 2054 permits an estate tax deduction for losses from casualty or theft incurred during the period when the estate is being settled. As is true with casualty or theft losses for income tax purposes, any anticipated insurance recovery must be taken into account in arriving at the amount of the deductible loss. Unlike the income tax, however, the deduction is not limited by a floor (e.g., \$100) or a percentage amount (10 percent of adjusted gross income).

If the casualty occurs to property after it has been distributed to an heir, the loss belongs to the heir and not to the estate. If the casualty occurs before the decedent's death, it should be claimed on the appropriate Form 1040. The fair market value of the property (if any) on the date of death plus any insurance recovery is included in the gross estate.

As is true of certain administration expenses, a casualty or theft loss of estate property can be claimed as an income tax deduction on the fiduciary return of the estate (Form 1041). But a double deduction prohibition applies, and claiming the income tax deduction requires a waiver of the estate tax deduction.³⁸

³⁶*U.S. v. Stapf*, 63-2 USTC ¶12,192, 12 AFTR 2d 6326, 84 S.Ct. 248 (USSC, 1963).

³⁸§ 642(g).

³⁷§ 2053(c)(1)(A) and Reg. § 20.2053-5.

Transfers to Charity (§§ 2055 and 2522)

A deduction is allowed for the value of property in the decedent's gross estate that is transferred by the decedent through testamentary disposition to (or for the use of) any of the following:

- Federal, state, and local governments and agencies.
- Any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.
- Various veterans' organizations.

The organizations just described are identical to those that qualify for the Federal gift tax deduction under § 2522. With the following exceptions, they are also the same organizations that qualify a donor for an income tax deduction under § 170.

- Certain nonprofit cemetery associations qualify for income tax but not estate and gift tax purposes.
- Foreign charities may qualify under the estate and gift tax but not under the income tax.

No deduction is allowed unless the charitable bequest is specified by a provision in the decedent's will or the transfer was made before death and the property is subsequently included in the gross estate. Generally speaking, a deduction does not materialize when an individual dies intestate (without a will).

The amount of the bequest to charity must be mandatory and cannot be left to someone else's discretion. It is, however, permissible to allow another person, such as the executor of the estate, to choose which charity will receive the specified donation. Likewise, a bequest may be expressed as an alternative and still be effective if the noncharitable beneficiary disclaims (refuses) the intervening interest before the due date for the filing of the estate tax return (nine months after the decedent's death plus any filing extensions).

The Big Picture

EXAMPLE

41

Return to the facts of *The Big Picture* on p. 27-1. After John's accident, he was in the intensive care unit at a local hospital. Although physically incapacitated, he was mentally alert. In early December, he reviewed his financial affairs with his attorney and CPA and executed a new will. His prior will, drawn up several years ago, contained a bequest to the Hood Scholarship Foundation (HSF), an organization created by Peter (John's father) to provide financial assistance to community college students. As HSF's qualified status had never been evaluated by the IRS, the attorney agreed to apply for a determination letter.

John's new will kept the bequest, but only if the IRS approved HSF's qualified status. John's CPA arranged to have all of John's medical expenses (e.g., hospital and physicians) paid as incurred. He also advised John to make a substantial payment on his property taxes and state income taxes.

Marital Deduction (§§ 2056, 2056A, and 2523)

The **marital deduction** originated with the Revenue Act of 1948 as part of the same legislation that permitted married persons to secure the income-splitting advantages of filing joint income tax returns. The purpose of these statutory changes was to eliminate the major tax variations that existed between taxpayers residing in community property and common law states. The marital deduction was designed to provide equity in the estate and gift tax areas.

In a community property state, for example, no marital deduction generally was allowed because the surviving spouse already owned one-half of the community and that portion was not included in the deceased spouse's gross estate. In a common law state, however, most if not all of the assets often belonged to the breadwinner of the

family. When that spouse died first, all of these assets were included in the gross estate. To equalize the situation, therefore, a marital deduction, usually equal to one-half of all separate assets, was allowed upon the death of the first spouse.

Ultimately, Congress decided to dispense with these historical justifications and recognize husband and wife as a single economic unit. Consistent with the approach taken under the income tax, spouses are considered as one for transfer tax purposes. By making the marital deduction unlimited in amount, neither the gift tax nor the estate tax is imposed on outright interspousal transfers of property. The unlimited marital deduction even includes one spouse's share of the community property transferred to the other spouse.

The marital deduction is available to same-sex couples who were married in a jurisdiction that legally recognizes same-sex marriage. Registered domestic partnerships, civil unions, and similar formal relationships *are not* denominated as marriages, so no marital deduction can be claimed.

Passing Requirement Under § 2056, the marital deduction is allowed only for property that is included in the deceased spouse's gross estate and that passes or has passed to the surviving spouse. In determining whether the parties are legally married, look to state law. In this regard, some foreign divorces may raise doubts as to the validity of a subsequent remarriage. Having an ex-spouse does not qualify the decedent for a marital deduction if, in fact, the divorce is valid and final.

The Big Picture

Return to the facts of *The Big Picture* on p. 27-1 and Example 41. In reviewing John's prior will, the parties discovered that one of the main beneficiaries was Hannah, John's first wife. The new will substituted Ashley (John's present wife) for Hannah, thereby salvaging a marital deduction.

EXAMPLE

42

Property that passes from the decedent to the surviving spouse includes any interest received as (1) the decedent's heir or donee, (2) the decedent's surviving tenant by the entirety or joint tenant, or (3) the beneficiary of insurance on the life of the decedent.

At the time of his death in the current year, Matthew owned an insurance policy on his own life (face amount of \$500,000) with Ella (his wife) as the designated beneficiary. Matthew and Ella also owned real estate (worth \$600,000) as tenants by the entirety (Matthew had furnished all of the purchase price). As to these transfers, \$800,000 (\$500,000 + \$300,000) is included in Matthew's gross estate, and this amount represents the property that passes to Ella for purposes of the marital deduction.³⁹

EXAMPLE

43

Disclaimers can affect the amount passing to the surviving spouse. If, for example, the surviving spouse holds the remainder interest (i.e., recovers the balance of the estate) under the will of the deceased spouse, a disclaimer by another heir increases the amount passing to the surviving spouse. This, in turn, will increase the amount of the marital deduction allowed to the estate of the deceased spouse.

A problem arises when a property interest passing to the surviving spouse is subject to a mortgage or other encumbrance. In this case, only the net value of the interest after reduction by the amount of the mortgage or other encumbrance qualifies for the marital deduction. To allow otherwise results in a double deduction because a decedent's liabilities are separately deductible under § 2053.

In his will, Jacob leaves real estate (fair market value of \$500,000) to Rachel, his wife. If the real estate is subject to a mortgage of \$100,000 (upon which Jacob was personally liable), the marital deduction is limited to \$400,000 (\$500,000 – \$100,000). The \$100,000 mortgage is deductible under § 2053 as an obligation of the decedent (Jacob).

EXAMPLE

44

³⁹Inclusion in the gross estate falls under § 2042 (proceeds of life insurance) and § 2040 (joint interests). Although Matthew provided the full purchase

price for the real estate, § 2040(b) requires inclusion of only half of the value of the property when one spouse predeceases the other.

However, if the executor is required under the terms of the decedent's will or under local law to discharge the mortgage out of other assets of the estate or to reimburse the surviving spouse, the payment or reimbursement is an additional interest passing to the surviving spouse.

EXAMPLE

45

Assume the same facts as in Example 44, except that Jacob's will directs that the real estate is to pass to Rachel free of any liabilities. Accordingly, Jacob's executor pays off the mortgage by using other estate assets and distributes the real estate to Jacob's wife. The marital deduction now becomes \$500,000.

Federal estate taxes or other death taxes paid out of the surviving spouse's share of the gross estate are not included in the value of property passing to the surviving spouse. Therefore, it is usually preferable for the deceased spouse's will to provide that death taxes be paid out of the portion of the estate that does not qualify for the marital deduction.

Terminable Interest Limitation Certain interests in property passing from the deceased spouse to the surviving spouse are referred to as **terminable interests**. Such an interest will terminate or fail after the passage of time, upon the happening of some contingency, or upon the failure of some event to occur. Examples are life estates, annuities, estates for terms of years, and patents. A terminable interest will not qualify for the marital deduction if another interest in the same property passed from the deceased spouse to some other person, and by reason of the passing, that other person or his or her heirs may enjoy part of the property after the termination of the surviving spouse's interest.⁴⁰

Transfers by Death and Gift Compared**EXAMPLE**

46

Vicky's will places her property in trust with a life estate to her husband, Brett, remainder to Andrew or his heirs. The interest passing from Vicky to Brett does not qualify for the marital deduction. Brett's interest will terminate upon his death, and Andrew or his heirs will then possess or enjoy the property.

EXAMPLE

47

Assume the same facts as in Example 46, except that Vicky created the trust during her life. No marital deduction is available for gift tax purposes for the same reason as in Example 46.⁴¹

The justification for the terminable interest rule can be illustrated by examining the possible results of Examples 46 and 47 more closely. Without the rule, Vicky could have passed property to Brett at no cost because of the marital deduction. Yet, on Brett's death, none of the property would have been included in his gross estate. Section 2036 (transfers with a retained life estate) would not apply to Brett because he was not the original transferor of the property. The marital deduction should not be available in situations where the surviving spouse can enjoy the property and still pass it to another without tax consequences. The marital deduction is intended to merely postpone the transfer tax upon the death of the first spouse and to shift any such tax to the surviving spouse.

Consistent with the objective of the terminable interest rule, the marital deduction is allowed for transfers of **qualified terminable interest property (QTIP)**. This is defined as property that passes from one spouse to another by gift or at death and for which the transferee-spouse has a qualifying income interest for life.

⁴⁰§§ 2056(b)(1) and 2523(b)(1).

⁴¹Examples 46 and 47 contain the potential for a qualified terminable interest property (QTIP) election discussed later in this section.

For a donee or a surviving spouse, a qualifying income interest for life exists under the following conditions:

- The person is entitled for life to all of the income from the property (or a specific portion of it), payable at annual or more frequent intervals.
- No person has a power to appoint any part of the property to any person other than the surviving spouse during his or her life.⁴²

If these conditions are met, an election can be made to claim a marital deduction as to the QTIP. For estate tax purposes, the executor of the estate makes the election on Form 706 (estate tax return). For gift tax purposes, the donor spouse makes the election on Form 709 (gift tax return). The election is irrevocable.

If the election is made, a transfer tax is imposed on the QTIP when the surviving spouse disposes of it by gift or upon death. If the disposition occurs during life, the gift tax applies, measured by the fair market value of the property as of that time.⁴³ If no lifetime disposition takes place, the fair market value of the property on the date of death (or alternate valuation date if applicable) is included in the gross estate of the second spouse to die.⁴⁴

Effect of QTIP Election

In 1990, Clyde dies and provides in his will that certain assets (fair market value of \$2.1 million) are to be transferred to a trust under which Lily (Clyde's wife) is granted a life estate with the remainder passing to their children upon Lily's death. Presuming that all of the preceding requirements are satisfied and Clyde's executor so elects, his estate receives a marital deduction of \$2.1 million.

EXAMPLE

48

Assume the same facts as in Example 48, with the further stipulation that Lily dies in 2015 when the trust assets are worth \$6.4 million. This amount is included in her gross estate.

EXAMPLE

49

Because the estate tax is imposed on assets not physically included in the probate estate, the law allows the tax liability for those assets to be shifted to the heirs. The amount shifted is determined by comparing the estate tax liability both with and without the inclusion of the QTIP. This right of recovery can be canceled by a provision in the deceased spouse's will.⁴⁵

One also can avoid the terminable interest rule by using a general **power of appointment**.⁴⁶ With this arrangement, the donee (or surviving) spouse holds a right to appoint (i.e., transfer) the trust assets to himself or herself or to whomever else he or she chooses (e.g., various creditors, the estate itself, or creditors of the estate). Because the existence of this power (whether exercised or not) causes either the gift or estate tax to apply to the spouse, an offsetting marital deduction is allowed for the donor spouse.⁴⁷

Most estate planners prefer the QTIP option for avoiding the terminable interest rule, as the QTIP gives the donee (or surviving) spouse less control over the trust assets.

State Death Taxes (§ 2058)

About 20 states, and a number of cities, counties, and similar jurisdictions, levy taxes when property passes to another party because of the death of a decedent. These taxes

⁴² §§ 2523(f) and 2056(b)(7).

⁴³ §§ 2519 and 2511.

⁴⁴ § 2044.

⁴⁵ § 2207A(a).

⁴⁶ Powers of appointment—see § 2014 (estate tax) and § 2514 (gift tax)—are not discussed in this text.

⁴⁷ § 2056(b)(5) and § 2523(e).

can be assessed at marginal rates of almost 20 percent, and the applicable exemption amounts typically are less than that for the Federal estate tax.

The § 2058 deduction mitigates the effect of subjecting property to multiple taxes payable because of a death. The deduction reduces the Federal taxable estate by the amount of state and local estate, inheritance, or other succession taxes paid.

LO.8

Calculate the Federal estate tax liability.

27-3c Computing the Federal Estate Tax

Once the taxable estate has been determined, post-1976 taxable gifts are added to arrive at the tax base and the estate tax can be computed.

EXAMPLE

50

Horton dies in 2015, leaving a taxable estate of \$5.7 million. In 2002, he made a taxable gift of \$100,000 upon which he paid no tax due to the availability of the unified tax credit. Horton's estate tax is \$148,000, as determined below (see Concept Summary 27.2).

Taxable estate	\$ 5,700,000
Add: Post-1976 taxable gift	100,000
Tax base	<u>\$ 5,800,000</u>
Tentative tax on tax base from tax rate schedule (Appendix A) [\$345,800 + 40%(\$5,800,000 – \$1,000,000)]	\$ 2,265,800
Less: Unified tax credit for 2015	<u>(2,117,800)</u>
Estate tax due	<u>\$ 148,000</u>

27-3d Estate Tax Credits

To place in context the role of estate tax credits in the determination of the Federal estate tax liability, see Concept Summary 27.2 earlier in the chapter.

Unified Tax Credit (§ 2010)

The role of the unified tax credit was discussed in connection with Example 3, and its application was illustrated in Example 50. The amount of the credit depends on the year the transfer occurred, and this information is contained in Exhibit 27.1.

Credit for Tax on Prior Transfers (§ 2013)

Suppose Floyd owns some property that he passes at death to Sarah. Shortly thereafter, Sarah dies and passes the property to Juan. Assuming that both estates are subject to the Federal estate tax, the successive deaths result in a multiple tax effect. To mitigate the possible multiple taxation that might result, § 2013 provides relief in the form of a credit for Federal estate tax paid on prior transfers. In the preceding hypothetical case, Sarah's estate may be able to claim as an estate tax credit some of the taxes paid by Floyd's estate.

The credit is limited to the lesser of the following:

1. The amount of the Federal estate tax attributable to the transferred property in the transferor's estate.
2. The amount of the Federal estate tax attributable to the transferred property in the decedent's estate.

To apply the limitations, certain adjustments must be made that are not covered in this text.⁴⁸ However, it is not necessary for the transferred property to be identified in the present decedent's estate or for it to be in existence at the time of the present decedent's death. It is sufficient that the transfer of property was subjected to the Federal

⁴⁸See the instructions to Form 706 and Reg. §§ 20.2013-2 and -3.



GLOBAL TAX ISSUES Treaty Relief Is Not Abundant!

One means of mitigating double taxation at the international level is to take advantage of treaty provisions. A treaty will determine which country has primary taxing rights, and this may depend on such factors as the domicile of the decedent or the nature of the property involved (e.g., personalty or realty). Unfortunately, the United States has estate tax conventions with only 16 countries: Australia, Austria*, Canada, Denmark*, Finland,

France*, Germany*, Greece, Ireland, Italy, Japan*, the Netherlands, Norway, the Republic of South Africa, Switzerland, and the United Kingdom*. In contrast, almost 70 countries have income tax treaties with the United States. Thus, treaty relief in the estate tax area is not as widespread as with income tax situations.

*Indicates the existence of a gift tax treaty as well.

estate tax in the estate of the transferor and that the transferor died within the prescribed period of time. Exhibit 27.2 shows the correlation between the credit allowed and the time interval between the two deaths.

Importance of Time Interval Between Successive Deaths

Under Floyd's will, Sarah inherits property. One year later, Sarah dies. Assume that the estate tax attributable to the inclusion of the property in Floyd's gross estate was \$150,000 and that the estate tax attributable to the inclusion of the property in Sarah's gross estate is \$120,000. Under these circumstances, Sarah's estate claims a credit against the estate tax of \$120,000 (refer to limitation 2).

EXAMPLE

51

Assume the same facts as in Example 51, except that Sarah dies three years after Floyd. The applicable credit is now 80% of \$120,000, or \$96,000 (see Exhibit 27.2).

EXAMPLE

52

Credit for Foreign Death Taxes (§ 2014)

A credit is allowed against the estate tax for any estate, inheritance, legacy, or succession tax actually paid to a foreign country. For purposes of this provision, the term *foreign country* means not only states in the international sense but also possessions or political subdivisions of foreign states and possessions of the United States.

27-3e Procedural Matters

A Federal estate tax return, if required, is due nine months after the date of the decedent's death.⁴⁹ The time limit applies to all estates regardless of the nationality or residence of

EXHIBIT 27.2

Credit for Tax on Prior Transfers

Interval between Deaths	Credit Allowed
Within 2 years	100%
Within 3 to 4 years	80%
Within 5 to 6 years	60%
Within 7 to 8 years	40%
Within 9 to 10 years	20%

⁴⁹§ 6075(a).

the decedent. Frequently, an executor will request and obtain from the IRS an extension of time for filing Form 706 (estate tax return).⁵⁰ Also available is an *automatic* six-month extension of time to file the estate tax return. To receive the extension, the executor must file Form 4768 [Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes].

The Form 706 filing requirements parallel the exclusion amounts of the unified tax credit available for each year (refer to Exhibit 27.1). The filing requirements may be lower when the decedent has made taxable gifts after 1976.⁵¹

Concept Summary 27.5 highlights the major components in arriving at the taxable estate and the mechanics of determining the estate tax liability.

Concept Summary 27.5

Federal Estate Tax Provisions—Taxable Estate and Procedural Matters

1. In moving from the gross estate to the taxable estate, certain deductions are allowed.
 2. Under § 2053, deductions are permitted for various administration expenses (e.g., executor's commissions), professional fees (e.g., appraisal, accounting, and legal), debts of the decedent, certain unpaid taxes, and funeral expenses.
 3. Casualty and theft losses occurring during the settlement of the estate and not compensated for by insurance can be deducted (§ 2054).
 4. Charitable transfers are deductible if the designated organization holds qualified status with the IRS at the time of death (§ 2055).
 5. Transfers to a surviving spouse yield a marital deduction if they do not violate the terminable interest rule (§ 2056).
- The terminable interest rule can be avoided by making a QTIP election.
6. A deduction is allowed for certain state and local death taxes paid (§ 2058).
 7. The tax base for determining the estate tax is the taxable estate plus post-1976 taxable gifts.
 8. Using the unified transfer tax rates appearing in Appendix A, determine the tax on the tax base.
 9. From the tax determined under item 8, subtract the credits allowed under §§ 2010–2016.
 10. If required, a Federal estate tax return (Form 706) must be filed within nine months of the date of the decedent's death.

LO.9

Review and demonstrate the role of the generation-skipping transfer tax.

27-4 THE GENERATION-SKIPPING TRANSFER TAX (GSTT)

To prevent partial avoidance of Federal gift and estate taxes on large transfers, the tax law imposes an additional generation-skipping transfer tax.

27-4a The Problem

Previously, it was possible to bypass a generation of transfer taxes by structuring the transaction carefully.

Types of Generation-Skipping Transfers

EXAMPLE

53

Under his will, Edward creates a trust, life estate to Stephen (Edward's son) and remainder to Ava (Edward's granddaughter) upon Stephen's death. Edward is subject to the Federal estate tax, but no tax results upon Stephen's death. Stephen held a life estate, but § 2036 does not apply because he was not the grantor of the trust. Nor does § 2033 (property owned by the decedent) come into play because Stephen's interest disappeared upon his death. The ultimate result is that the property in trust skips a generation of transfer taxes.

⁵⁰§ 6081.

⁵¹§ 6018(a)(3).

Types of Generation-Skipping Transfers

Joshua dies at age 89 and leaves all of his property to a trust. Under the terms of the trust instrument, trust income and corpus are to be distributed equally over a 10-year period to Amber and Ethan. Amber is Joshua's 22-year-old third wife, and Ethan is his 30-year-old grandson. As a result of this arrangement, the following tax consequences ensue: The estate tax applies upon Joshua's death, income earned by the trust will be subject to income tax (see Chapter 28), and normally no transfer tax results when distributions of trust income and corpus occur.

EXAMPLE

54

Amy gives assets to Eric (her grandson). Called a direct skip, the gift would circumvent any transfer taxes that would have resulted had the assets been channeled through Eric's parents.

EXAMPLE

55

27-4b **The Solution**

The generation-skipping transfer tax (GSTT) is designed to preclude the avoidance of either the estate tax or the gift tax by making transfers that bypass the next lower generation. In the typical family setting, this involves transfers from grandparents to grandchildren. Such transfers, in effect, would skip any transfer tax that would result if the property were channeled through the children.

The GSTT is triggered by any of these three events: a taxable *termination* occurs, a taxable *distribution* takes place, or a *direct skip* is made.⁵² Example 53 illustrates a termination event. Upon Stephen's death, the fair market value of the trust property that passes to Ava is subject to the GSTT (imposed on the trust). The GSTT will have the effect of reducing the amount Ava receives from the trust.

Example 54 illustrates a distribution event. When the trust makes a distribution to Ethan, the GSTT applies (imposed on Ethan). Any distribution to Amber is not subject to the GSTT because the spouse of the transferor (Joshua in this case) is deemed to be of the same generation.⁵³ The results reached in Example 54 show how ludicrous the application of the GSTT rules can be. Amber (age 22) is treated as being in the same generation as Joshua (age 89), while Ethan (age 30) is two generations removed!

Example 55 illustrates a lifetime version of the direct skip event.⁵⁴ In this situation, the GSTT is imposed upon Amy when the gift is made to Eric. Not only will Amy be subject to the GSTT, but the amount of the tax represents an additional gift to Eric.⁵⁵

The GSTT rate is the highest rate under the gift and estate tax schedules (i.e., 40 percent after 2012). An exemption is allowed equal to the exclusion amount applicable to the Federal estate tax (see Exhibit 27.1).⁵⁶ For a donor who is married, the election to split the gift (under § 2513) can double the amount of the exemption.⁵⁷

27-5 **TAX PLANNING**27-5a **The Federal Gift Tax**

For gifts that generate a tax, consideration must be given to the time value to the donor of the gift taxes paid. Because the donor loses the use of these funds, the expected interval between a gift (the imposition of the gift tax) and death (the imposition of the estate tax) may make the gift less attractive from an economic standpoint. On the plus side, however, are the estate tax savings that result from any gift tax paid. Because these funds are no longer in the gross estate of the donor (except for certain gifts within three years of death), the estate tax thereon is avoided.

LO.10

Recognize strategies to minimize Federal gift and estate taxes.

⁵²§ 2611.⁵³§ 2651(c)(1).⁵⁴§ 2612(c)(1). A direct skip can also take place in a testamentary transfer.⁵⁵§ 2515.⁵⁶§ 2631(c).⁵⁷§ 2652(a)(2).

Gifts possess distinct advantages. First, and often most important, income from the property is generally shifted to the donee. If the donee is in a lower bracket than the donor, the family unit will save on income taxes. Second, the proper spacing of gifts can further cut down the Federal gift tax by maximizing the number of annual exclusions available. Third, many states impose some type of tax at death, but only a relatively few impose a gift tax. Thus, a gift may completely avoid a state transfer tax.

In minimizing gift tax liability in lifetime giving, the optimum use of the annual exclusion can have significant results. Because a new annual exclusion is available each year, spacing gifts over multiple years increases the amount that can be transferred free of gift tax.

EXAMPLE**56**

Starting in 2003, Cora makes gifts in the amount of the annual exclusion to each of her five grandchildren. Taking into account the changes in the amount of the annual exclusion allowed, Cora will have transferred \$815,000 through 2015 with no gift tax consequences.

Years		Amount of Exclusion
2003–2005	$\$11,000$ (annual exclusion) \times 5 (number of donees) \times 3 (number of years)	\$165,000
2006–2008	$\$12,000$ (annual exclusion) \times 5 (number of donees) \times 3 (number of years)	180,000
2009–2012	$\$13,000$ (annual exclusion) \times 5 (number of donees) \times 4 (number of years)	260,000
2013–2015	$\$14,000$ (annual exclusion) \times 5 (number of donees) \times 3 (number of years)	210,000

For married donors, the § 2513 election to split gifts can double the amount of a tax-free transfer. Referring to Example 56, if Cora is married and her husband Julio makes the § 2513 election, \$1,630,000 [$\$815,000$ (amount allowed Cora) \times 2 (number of donors)] can be transferred with no gift tax consequences.

27-5b The Federal Estate Tax

Controlling the Amount of the Gross Estate

Presuming that an estate tax problem is anticipated, the starting point for planning purposes is to reduce the size of the potential gross estate. Aside from initiating a program of lifetime giving, as described next, several other possibilities exist.

Proper Handling of Estate Tax Deductions

Estate taxes can be saved either by reducing the size of the gross estate or by increasing the total allowable deductions. Thus, the lower the taxable estate, the less the amount of estate tax generated. Planning in the deduction area generally involves the following considerations:

- Making proper use of the marital deduction.
- Working effectively with the charitable deduction.
- Taking advantage of the bypass amount.
- Optimizing other deductions and losses allowed under §§ 2053 and 2054.

Approach to the Marital Deduction

When planning for the estate tax marital deduction, both tax and nontax factors have to be taken into account. Based on the time value of taxes deferred, taxpayers should try to postpone estate taxation as long as possible. Usually, by maximizing the marital deduction on the death of the first spouse to die, not only are taxes saved, but the

surviving spouse is enabled to trim his or her future estate by entering into a program of lifetime gifts. By making optimum use of the annual exclusion, considerable amounts can be shifted without incurring *any* transfer tax.

Effectively Working with the Charitable Deduction

As a general guide to obtain overall tax savings, lifetime charitable transfers are preferred over testamentary dispositions. For example, an individual who gave \$20,000 to a qualified charity during his or her life would secure an income tax deduction, avoid any gift tax, and reduce the gross estate by the amount of the gift. By way of contrast, if the \$20,000 had been willed to charity, no income tax deduction would be available, and the amount of the transfer would be includible in the decedent's gross estate (although later deducted for estate tax purposes). In short, the lifetime transfer provides a double tax benefit (income tax deduction plus reduced estate taxes) at no gift tax cost (§ 2522). The testamentary transfer merely neutralizes the effect of the inclusion of the property in the gross estate (inclusion under § 2033 and then deduction under § 2055).

On occasion, a charitable bequest depends on the issuance of a disclaimer by a non-charitable heir.⁵⁸ Such a situation frequently arises with special types of property or collections, which the decedent may believe a noncharitable heir should have a choice of receiving.

Use of Disclaimers in Charitable Bequests

Megan specified in her will that her valuable art collection is to pass to her son or, if the son refuses, to a designated and qualified art museum. At the time the will was drawn, Megan knew that her son was not interested in owning the collection. If, after Megan's death, the son issues a timely disclaimer, the collection will pass to the designated museum, and Megan's estate is allowed a charitable deduction for its estate tax value.

EXAMPLE

57

Dick's will specifies that one-half of his disposable estate is to pass to his wife and the remainder of his property to a designated and qualified charitable organization. If the wife issues a timely disclaimer after Dick's death, all of the property passes to the charity and qualifies for the § 2055 charitable deduction.

EXAMPLE

58

Did the son in Example 57 act wisely if he issued the disclaimer in favor of the museum? Although the disclaimer will provide Megan's estate with a deduction for the value of the art collection, consider the income tax deduction alternative. If the son accepts the bequest, he can still dispose of the collection (and fulfill his mother's philanthropic objectives) through a lifetime donation to the museum. At the same time, he obtains an income tax deduction of his own. Whether this will save taxes for the family unit depends on a comparison of Megan's estate tax bracket with the estimated income tax bracket of the son. If the value of the collection runs afoul of the percentage limitations, the donation can be spread over more than one year. If this is done, and to protect against the contingency of the son's dying before the entire collection is donated, the son can neutralize any potential estate tax consequences by providing in his will for the undonated balance to pass to the museum.

The use of a disclaimer in Example 58 would be sheer folly. It would not reduce Dick's estate tax; it would merely substitute a charitable deduction for the marital deduction. Whether or not the wife issues a disclaimer, no estate taxes will be due. The wife should accept her bequest and, if she is so inclined, make lifetime gifts of it to a qualified charity. In so doing, she generates an income tax deduction for herself.

⁵⁸As noted earlier in this chapter, a disclaimer is a refusal to accept the property. If the disclaimer is timely made, the property is not treated as having passed through the person issuing the disclaimer and a gift tax is avoided.

A special provision permits, under very limited circumstances, a tax-free distribution from an IRA to a qualified charity. The provision does not generate a charitable deduction, but allows the donor to avoid the recognition of income that normally results when a distribution occurs. An estate tax savings also takes place because the donor will no longer own the amount donated upon his or her later death.⁵⁹ For the provision to apply, the donor must be age 70½ or older. The exclusion is limited to \$100,000 per year and is available only for distributions made after 2005 and before 2015.

Taking Advantage of the Bypass Amount

The bypass amount, also known as the exclusion amount or the exemption equivalent amount, is the amount that can pass free of a transfer tax due to the unified credit. The bypass amount can increase because the unified credit is subject to indexation.

Year	Credit	Bypass Amount
2011	\$1,730,800	\$5,000,000
2012	1,772,800	5,120,000
2013	2,045,800	5,250,000
2014	2,081,800	5,340,000
2015	2,117,800	5,430,000

In the past, a bypass amount frequently was wasted upon the death of the first spouse. Human nature often compels a spouse to leave all of his or her assets to the survivor.

EXAMPLE

59

Ethan and Hope are married, and each has a net worth of \$3.5 million. Upon Ethan's prior death in 2009, his will passed his \$3.5 million to Hope. Although Ethan avoided any estate tax due to the marital deduction, he wasted his bypass amount and concentrated \$7 million in Hope's potential estate.

After 2010, the result reached in Example 59 is different; the bypass amount (also known as the exclusion amount) is "portable," meaning that a **deceased spouse's unused exclusion (DSUE)** amount can be transferred to the surviving spouse.⁶⁰

EXAMPLE

60

Assume the same facts as in Example 59, except that Ethan dies in 2015 with a net worth of \$5.43 million, all of which he passes to Hope. Presuming a proper election was made on his return, Ethan's DSUE amount becomes available. Hope now can use an exclusion amount of \$10.86 million [\$5.43 million (Ethan's DSUE amount) + \$5.43 million (her own exclusion amount)].

The election is made by the executor of the deceased spouse's estate by a timely filing of a Form 706. To mitigate the burden of having to file a Form 706 in cases where no such form is otherwise required, the IRS will allow the executor to use reasonable estimates of value in completing the return. If the election is not made by the executor of the deceased spouse's estate, then any DSUE amount is lost. The election requirement could be a real trap for the unwary in cases involving a "poor spouse" where no Form 706 is due.

EXAMPLE

61

In 2015, Rowena dies leaving a gross estate of \$5 million, all of which she passes to Christopher, her surviving spouse. The executor of Rowena's estate does not file a Form 706, as no Federal estate tax is due. Because no DSUE election was made, Christopher cannot use any of Rowena's "wasted" exemption equivalent. Rowena's executor needed to file a Form 706 to create the DSUE amount for Christopher.

⁵⁹§ 408(d)(8).

⁶⁰§ 2010(c).

If a surviving spouse is predeceased by more than one spouse, the DSUE amount that is available for such a surviving spouse is limited to the unused exclusion of the *last* surviving spouse.

Proper Handling of Other Deductions and Losses under §§ 2053 and 2054

Many § 2053 and § 2054 deductions and losses may be claimed either as estate tax deductions or as income tax deductions of the estate on the fiduciary return (Form 1041), but a choice must be made.⁶¹ The deduction for income tax purposes is not allowed unless the estate tax deduction is waived. It is possible for these deductions to be apportioned between the two returns.

REFOCUS ON THE BIG PICTURE

AN EVENTFUL AND FINAL YEAR

By making use of § 2516, John was able to carry out a property settlement with Hannah without incurring any gift tax consequences (see Example 11). Both Helen and John acted wisely when they chose to disclaim most of their inheritance from their mother. By making the disclaimers, they were able to pass the property to their children without a transfer tax being imposed (see Examples 12 and 13).

Section 2033 operates to include in the gross estate not only John's retirement plan benefits but also any settlement from a potential lawsuit (see Examples 25 and 26). Section 2036 did not apply to the trust that John's father (Peter) created, but it did apply to the one John set up (see Examples 28 and 29). The difference in treatment occurs when it is the owner who retains an interest in the property, thereby making the transfer incomplete.

John's pre-death planning was highly advantageous in several respects.

- By drawing up a new will, the loss of the charitable and marital deductions was avoided (see Examples 41 and 42).
- By prepaying state and local property and income taxes and staying current on medical expenses, John improved his Federal income tax position (see Example 41). He also avoided any estate taxes on the amounts used to pay these expenses.



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Key Terms

Alternate valuation date, 27-6

Annual exclusion, 27-11

Bypass amount, 27-6

Deceased spouse's unused exclusion (DSUE), 27-34

Disclaimer, 27-10

Exclusion amount, 27-6

Exemption equivalent amount, 27-6

Future interest, 27-11

Gross estate, 27-15

Joint tenants, 27-7

Marital deduction, 27-24

Power of appointment, 27-27

Probate estate, 27-15

Qualified terminable interest property (QTIP), 27-26

Taxable estate, 27-23

Taxable gift, 27-3

Tenants by the entirety, 27-7

Tenants in common, 27-7

Terminable interests, 27-26

Unified transfer tax, 27-2

Unified transfer tax credit, 27-5

⁶¹§ 642(g) and Reg. § 20.2053-1(d).

Discussion Questions

1. **LO.1** Why can the unified transfer tax be categorized as an excise tax? In this regard, how does it differ from an income tax?
- Issue ID** 2. **LO.1** Kim, a wealthy Korean national, is advised by his physicians to have an operation performed at the Mayo Clinic. Kim is hesitant to come to the United States because of the possible tax consequences. If the procedure is not successful, Kim does not want his wealth to be subject to the Federal estate tax. Are Kim's concerns justified? Explain.
3. **LO.1** Arturo is a citizen and resident of Argentina. Attracted by the low prices due to the housing slump, Arturo buys developed real estate in various locations within the United States. What are the U.S. transfer tax consequences if Arturo:
 - a. Makes gifts of the properties to his children during his lifetime?
 - b. Dies and passes the properties to his children?
- Communications** 4. **LO.2** A new out-of-state client, Robert Ball, has asked you to prepare a Form 709 for a large gift he made in 2015. When you request copies of any prior gift tax returns he may have filed, he responds, "What do gifts in prior years have to do with 2015?" Send a letter to Robert at 4560 Walton Lane, Benton, AR 72015, clarifying this matter.
5. **LO.2, 4, 5** Regarding the formula for the Federal gift tax (see Concept Summary 27.1), comment on the following observations.
 - a. A credit is allowed for the gift taxes actually paid on prior gifts.
 - b. The annual exclusion is adjusted each year for inflation.
 - c. The charitable and marital deductions play an important role.
 - d. Some gratuitous transfers might not be subject to the gift tax.
6. **LO.3** Regarding the formula for the Federal estate tax (see Concept Summary 27.2), comment on the following.
 - a. The gross estate includes only property interests owned by the decedent at the time of death.
 - b. The gross estate is not the same as the probate estate.
 - c. In arriving at the taxable estate, all prior gifts must be added to the gross estate.
 - d. $\text{Taxable estate} \times \text{Applicable unified transfer tax rate} = \text{Estate tax due}$.
7. **LO.3** As to the alternate valuation date of § 2032, comment on the following.
 - a. The justification for the election.
 - b. The main heir prefers the date of death value.
 - c. An estate asset is sold seven months after the decedent's death.
 - d. Effect of the election on income tax basis.
- Issue ID** 8. **LO.4** Gus (age 84) and Belle (age 18) are married in early 2015. Late in 2015, Belle confronts Gus about his failure to transfer to her the considerable amount of property he previously promised. Gus reassures Belle that she will receive the property when he dies. Because the transfer occurs at death, the estate tax marital deduction will avoid any taxes. Comment on the issues involved and any misconceptions Gus may have.
- Issue ID** 9. **LO.4, 6** At a local bank, Jack purchases for \$100,000 a five-year CD listing title as follows: "Meredith, payable on death to Briana." Four years later, Meredith dies. Briana, Meredith's daughter, then redeems the CD when it matures. Discuss the transfer tax consequences if Meredith is:
 - a. Jack's wife.
 - b. Jack's ex-wife.
 - c. Jack's girlfriend.

10. **LO.4** Derek dies intestate (i.e., without a will) and is survived by a daughter, Ruth, and a grandson, Ted (Ruth's son). Derek's assets include a large portfolio of stocks and bonds and a beach house. Ruth has considerable wealth of her own, while Ted has just finished college and is unemployed. Under applicable state law, the order of priority as to heirship favors children followed by grandchildren. **Issue ID**
- To minimize future transfer taxes, what action might Ruth take?
 - What if Ruth wants only the beach house?
11. **LO.4** Qualified tuition programs under § 529 enjoy significant tax advantages. Describe these advantages with regard to the Federal:
- Income tax.
 - Gift tax.
 - Estate tax.
12. **LO.5** Regarding the gift-splitting provision of § 2513, comment on the following.
- What it was designed to accomplish.
 - How the election is made.
 - The treatment of any taxable gifts previously made by the nonowner spouse.
 - The utility of the election in a community property jurisdiction.
13. **LO.5** In connection with the filing of a Federal gift tax return, comment on the following.
- No Federal gift tax is due.
 - The gift is between spouses.
 - The donor uses a fiscal year for Federal income tax purposes.
 - The donor obtained from the IRS an extension of time for filing his or her Federal income tax return.
14. **LO.4** In each of the following independent situations, indicate whether the transfer is subject to the Federal gift tax.
- Asa contributes to his mayor's reelection campaign fund. The mayor has promised to try to get some of Asa's property rezoned from residential to commercial use.
 - Mary Ann inherits her father's collection of guns and mounted animals. Five months later, she disclaims any interest in the mounted animals.
 - Same as (b). Ten months later, Mary Ann disclaims any interest in the guns.
 - Haydon pays an orthodontist for the dental work performed on Michele, his dependent cousin.
 - Same as (d), except that Michele is not Haydon's dependent.
 - Floyd creates a revocable trust with his children as the beneficiaries.
 - Florence purchases a U.S. savings bond listing herself and Taylor (her daughter) as joint owners.
 - Same as (g). One year later, Taylor predeceases Florence.
 - Same as (g). One year later, Florence predeceases Taylor.
15. **LO.6** At the time of Emile's death, he was a joint tenant with Colette in a parcel of real estate. With regard to the inclusion in Emile's gross estate under § 2040, comment on the following *independent* assumptions:
- Emile and Colette received the property as a gift from Douglas.
 - Colette provided the entire purchase price of the property.
 - Colette's contribution was received as a gift from Emile.
 - Emile's contribution was derived from income generated by property he received as a gift from Colette.

16. **LO.6** With regard to “life insurance,” comment on the following.
- What the term includes (i.e., types of policies).
 - The meaning of “incidents of ownership.”
 - When a gift occurs upon maturity of the policy.
 - The tax consequences when the owner of the policy predeceases the insured and the beneficiary.
 - The tax consequences when the owner-insured gives the policy to the beneficiary and dies shortly after making the gift.
- Issue ID** 17. **LO.6, 7** Due to the negligence of the other driver, Adam’s car is completely destroyed, and he is seriously injured. Two days later, Adam dies from injuries suffered in the accident.
- What, if any, are the estate tax consequences of these events?
 - Are there any income tax consequences to Adam or his estate? Explain.
18. **LO.7** Bernice dies and, under a will, passes real estate to her surviving husband. The real estate is subject to a mortgage. For estate tax purposes, how will any marital deduction be determined? Can Bernice’s estate deduct the mortgage under § 2053? Explain.
- Issue ID** 19. **LO.8** Three unmarried and childless sisters live together. All are of advanced age and in poor health, and each owns a significant amount of wealth. Each has a will that passes her property to her surviving sister(s) or, if no survivor, to their church. Within a period of two years and on different dates, all three sisters die. Discuss the Federal estate tax consequences of these deaths.

Computational Exercises

20. **LO.2** Elizabeth, a widow since 2000, made taxable gifts of \$3 million in 2011 and \$4 million in 2015. She paid no gift tax on the 2011 transfer. What is her tax base for determining any gift tax on the 2015 gift?
21. **LO.3** Carter died in 2015 with a gross estate of \$6 million. Before he was married in 2002, Carter had made taxable gifts of \$400,000 upon which he paid no gift tax. All of Carter’s property passes to his surviving spouse. Referring to the formula for the Federal estate tax, as to Carter’s estate, what is his:
- Taxable estate?
 - Tax base?
22. **LO.3** Mary dies in 2015, and included in her gross estate are the following assets:

	Fair Market Value	
	Date of Death	Six Months Later
Stock in Orange Corporation	\$3,000,000	\$3,100,000
Stock in Crimson Corporation	6,100,000	5,900,000

- How much is included in her gross estate if the alternate valuation date is elected?
 - Suppose all of Mary’s assets pass to her surviving spouse?
23. **LO.4** During the year, Fred makes the following transfers:
- \$1,000 to his mayor’s reelection campaign.
 - \$21,000 to his aunt, Ava, to reimburse her for what she paid the hospital for her gallbladder operation. (Ava is not Fred’s dependent.)
 - \$18,000 paid directly to the surgeon who performed Ava’s gallbladder operation.
 - \$22,000 to purchase a used pickup truck for his son to use while attending college.

Which of these transfers are subject to the Federal gift tax? (Include the total amount and disregard the annual exclusion.)

24. **LO.4** In 2013 and with \$200,000, Alice purchases a CD at State Bank listing title as follows: "Alice, payable on proof of death to Clark." Alice dies in 2015, and Clark (Alice's nephew) redeems the CD (now worth \$205,000). Disregarding the annual exclusion, what is Alice's gift in:
- 2013?
 - 2015?
25. **LO.5** In 2015, Christian wants to transfer as much as possible to his four adult married children (including spouses) and eight minor grandchildren without using any unified transfer tax credit.
- How much can Christian give?
 - What if Christian's wife, Mia, joins in the gifts?
26. **LO.5** In 2015, Noah and Sophia want to make a maximum contribution to their state's qualified tuition program (Code § 529 plan) on behalf of their minor granddaughter, Amanda, without exceeding the annual exclusion. How much can they give?
27. **LO.6** At his death, Andrew was a participant in his employer's contributory qualified pension plan. His account reflects the following:
- | | |
|-------------------------|-------------|
| Employer's contribution | \$1,000,000 |
| Andrew's contribution | 800,000 |
| Income earned | 500,000 |
- As to this plan, how much is included in Andrew's gross estate?
 - If paid to Andrew's surviving spouse, how much qualifies for the marital deduction?
 - How much is subject to the Federal income tax?
28. **LO.6** In 2001, Mason buys real estate for \$1.5 million and lists ownership as follows: "Mason and Dana, joint tenants with the right of survivorship." Mason dies first in 2015 when the real estate is valued at \$2 million. How much is included in Mason's gross estate if Mason and Dana are:
- Brother and sister.
 - Husband and wife.
29. **LO.6** Matthew owns an insurance policy (face amount of \$500,000) on the life of Emily, with Lily as the designated beneficiary. If Emily dies first and the \$500,000 is paid to Lily, how much as to this policy is included in:
- Matthew's gross estate?
 - Emily's gross estate?
30. **LO.7** Donald dies in 2014, and under his will, a trust is created in the amount of \$6 million with the following provisions: life estate to Cindy (Donald's wife) and remainder to their children. His will also passes land (cost basis of \$1 million and fair market value of \$3 million) to the Salvation Army for the site of a new homeless housing project.
- If a QTIP election is made, how much will these transactions reduce Donald's gross estate to arrive at the taxable estate?
 - If a QTIP election is not made?
31. **LO.8** Under Emma's will, Addison inherits property that generates an estate tax of \$800,000. Three years later, Addison dies and the property generates an estate tax of \$700,000. To how much of a credit for estate tax on prior transfers is Addison's estate entitled?

32. **LO.9** In 2000 and with \$5 million, Paul's will creates a trust with the following provisions: life estate to Jacob (Paul's son) and remainder to Anastasia (Paul's granddaughter and Jacob's daughter). Jacob dies in 2015 when the value of the trust is \$8 million.
- Does a generation skipping transfer result?
 - If so, when and in what amount?
33. **LO.10** During 2015, Charley wants to take advantage of the annual exclusion and make gifts to his 6 married children (including their spouses) and his 12 minor grandchildren.
- How much property can Charley give away without creating a taxable gift?
 - Does your answer change if Charley's wife, Coleen, elects to join in making the gifts? Explain.

Problems

34. **LO.3** In each of the following independent situations, indicate whether the alternate valuation date can be elected. Explain why or why not. All deaths occur in 2015.

Decedent	Value of Gross Estate		Estate Tax Liability	
	Date of Death	Six Months Later	Date of Death	Six Months Later
Jayden	\$6,000,000	\$5,900,000	\$240,000	\$239,000
Isabella	6,100,000	6,000,000	265,000	260,000
Liam	6,100,000	6,000,000	200,000	210,000
Lily	6,500,000	6,400,000	205,000	204,000

35. **LO.4** Carl made the following transfers during the current year.
- Transferred \$900,000 in cash and securities to a revocable trust, life estate to himself and remainder interest to his three adult children by a former wife.
 - In consideration of their upcoming marriage, gave Lindsey (age 21) a \$90,000 convertible.
 - Purchased a \$100,000 certificate of deposit listing title as "Carl, payable on proof of death to Lindsey."
 - Established a joint checking account with his wife, Lindsey, in December of the current year with \$30,000 of funds he inherited from his parents. In January of the following year, Lindsey withdrew \$15,000 of the funds.
 - Purchased for \$80,000 a paid-up insurance policy on his life (maturity value of \$500,000). Carl designated Lindsey as the beneficiary.
 - Paid \$13,400 to a college for his niece's tuition and \$6,000 for her room and board. The niece is not Carl's dependent.
 - Gave his aunt \$52,000 for her heart bypass operation. The aunt is not Carl's dependent.

What are Carl's taxable gifts for the current year?

- Issue ID** 36. **LO.4, 7** In May 2014, Dudley and Eva enter into a property settlement preparatory to the dissolution of their marriage. Under the agreement, Dudley is to pay Eva \$6 million in satisfaction of her marital rights. Of this amount, Dudley pays \$2.5 million immediately, and the balance is due one year later. The parties are divorced in July. Dudley dies in December, and his estate pays Eva the remaining \$3.5 million in May 2015. Discuss the tax ramifications of these transactions to the parties involved.

37. **LO.4** Jesse dies intestate (i.e., without a will) in May 2014. Jesse's major asset is a tract of land. Under applicable state law, Jesse's property will pass to Lorena, who is his only child. In December 2014, Lorena disclaims one-half of the property. In June 2015, Lorena disclaims the other half interest. Under state law, Lorena's disclaimer results in the property passing to Arnold (Lorena's only child). The value of the land (in its entirety) is as follows: \$2 million in May 2014, \$2.1 million in December 2014, and \$2.2 million in June 2015. Discuss the transfer tax ramifications of these transactions. **Issue ID**
38. **LO.5** Using property she inherited, Myrna makes a gift of \$6.2 million to her adult daughter, Doris. The gift takes place in 2015. Neither Myrna nor her husband, Greg, has made any prior taxable gifts. Determine the gift tax liability if:
- The § 2513 election to split gifts is not made.
 - The § 2513 election to split gifts is made.
 - What are the tax savings from making the election?
39. **LO.6, 7** At the time of his death this year on September 4, Kenneth owned the following assets.

	Fair Market Value
City of Boston bonds	\$2,500,000
Stock in Brown Corporation	900,000
Promissory note issued by Brad (Kenneth's son)	600,000

In October, the executor of Kenneth's estate received the following: \$120,000 interest on the City of Boston bonds (\$10,000 accrued since September 4) and a \$7,000 cash dividend on the Brown stock (date of record was September 5). The declaration date on the dividend was August 12.

The \$600,000 loan was made to Brad in late 2010, and he used the money to create a very successful business. The note was forgiven by Kenneth in his will.

What are the estate tax consequences of these transactions?

40. **LO.6** At the time of her death on September 4, 2015, Alicia held the following assets.

	Fair Market Value
Bonds of Emerald Tool Corporation	\$ 900,000
Stock in Drab Corporation	1,100,000
Insurance policy (face amount of \$400,000) on the life of her father, Mitch	80,000*
Traditional IRAs	300,000

*Cash surrender value.

Alicia was also the life tenant of a trust (fair market value of \$2 million) created by her late husband Bert. (The executor of Bert's estate had made a QTIP election.) In October, Alicia's estate received an interest payment of \$11,500 (\$6,000 accrued before September 4, 2015) paid by Emerald and a cash dividend of \$9,000 from Drab. The Drab dividend was declared on August 19 and was payable to date of record shareholders on September 3, 2015. Although Mitch survives Alicia, she is the designated beneficiary of the policy. The IRAs are distributed to Alicia's children. What amount is included in Alicia's gross estate?

41. **LO.6** Assume the same facts as in Problem 40 with the following modifications.
- Mitch is killed in a rock slide while mountain climbing in November 2015, and the insurer pays Alicia's estate \$400,000.
 - Bert's executor did not make a QTIP election.

- Alicia's IRAs were the Roth type (not traditional).
- The record date for the Drab Corporation dividend is September 5 (not September 3).
- On November 7, 2015, Alicia's estate receives from the IRS an \$8,000 income tax refund on the taxes she paid for the preceding calendar year.

What amount is included in Alicia's gross estate?

42. **LO.6, 7** At the time of Matthew's death, he was involved in the following transactions.
- Matthew was a participant in his employer's contributory qualified pension plan. The plan balance of \$2 million is paid to Olivia, Matthew's daughter and beneficiary. The distribution consists of the following.
- | | |
|-----------------------------------|-----------|
| Employer contributions | \$900,000 |
| Matthew's after-tax contributions | 600,000 |
| Income earned by the plan | 500,000 |
- Matthew was covered by his employer's group term life insurance plan for employees. The \$200,000 proceeds are paid to Olivia, the designated beneficiary.
- What are the estate tax consequences?
 - The income tax consequences?
 - Would the answer to part (a) change if Olivia was Matthew's surviving spouse (not his daughter)? Explain.
43. **LO.4, 6** Before her death in early 2015, Katie made the following transfers.
- In 2008, purchased stock in Green Corporation for \$200,000, listing title as follows: "Katie, payable on proof of death to my son Travis." Travis survives Katie, and the stock is worth \$300,000 when Katie dies.
 - In 2013, purchased an insurance policy on her life for \$200,000, listing Paul, another of Katie's sons, as the designated beneficiary. The policy has a maturity value of \$1 million and was immediately transferred to Paul as a gift.
 - In 2013, made a gift of land (basis of \$300,000; fair market value of \$1.3 million) to Adriana, Katie's only daughter. As a result of the transfer, Katie paid a gift tax of \$150,000. The value of the land is still \$1.3 million at Katie's death.
 - In 2013, established a savings account with Noah, her grandfather. Title to the account was listed as "Katie and Noah, joint tenants with right of survivorship." Of the \$200,000 deposited in the account, Katie furnished \$20,000 and Noah contributed the balance. At Katie's death, the balance was \$206,000.
- As to these transfers, how much is included in Katie's gross estate?
- Issue ID** 44. **LO.4, 6, 7** In 2005, using \$2.5 million in community property, Quinn creates a trust, life estate to his wife, Eve, and remainder to their children. Quinn dies in 2011 when the trust is worth \$3.6 million, and Eve dies in 2015 when the trust is worth \$5.6 million.
- Did Quinn make a gift in 2005? Explain.
 - How much, if any, of the trust is included in Quinn's gross estate in 2011?
 - How much, if any, of the trust is included in Eve's gross estate in 2015?
 - Would any of the above answers change if Quinn had used his separate property (rather than community property) when he created the trust? Explain.
45. **LO.6, 9** At the time of his death, Garth held a life estate in the Myrtle Trust with the remainder passing to Garth's adult children. The trust was created by Myrtle (Garth's mother) in 1984 with securities worth \$900,000. The Myrtle Trust had a value of \$4.7 million when Garth died. Discuss the estate tax ramifications as to Garth.

46. **LO.6** In 2007, Peggy, a widow, places \$3 million in trust, life estate to her children, remainder to her grandchildren, but retains the right to revoke the trust. In 2013, when the trust is worth \$3.1 million, Peggy rescinds her right to revoke the trust. Peggy dies in 2015 when the trust is worth \$3.2 million. What are Peggy's transfer tax consequences in:
- 2007?
 - 2013?
 - 2015?
47. **LO.6** At the time of his death on July 9, 2015, Aiden was involved in the following real estate.

	Fair Market Value (on July 9, 2015)
Apartment building	\$2,100,000
Tree farm	1,500,000
Pastureland	750,000
Residence	900,000

The apartment building was purchased by Chloe, Aiden's mother, and is owned in a joint tenancy with her. The tree farm and pastureland were gifts from Chloe to Aiden and his two sisters. The tree farm is held in joint tenancy, and the pastureland is owned as tenants in common. Aiden purchased the residence and owns it with his wife as tenants by the entirety. How much is included in Aiden's gross estate based on the following assumptions?

- Aiden dies first and is survived by Chloe, his sisters, and his wife.
 - Aiden dies after Chloe, but before his sisters and his wife.
 - Aiden dies after Chloe and his sisters, but before his wife.
 - Aiden dies last (i.e., he survives Chloe, his sisters, and his wife).
48. **LO.4, 6, 7** In 2002, Gordon purchased real estate for \$900,000 and listed title to the property as "Gordon and Fawn, joint tenants with right of survivorship." Gordon predeceases Fawn in 2015 when the real estate is worth \$2.9 million. Gordon and Fawn are brother and sister.
- Did a gift occur in 2002? Explain.
 - What, if any, are the estate tax consequences in 2015?
 - Under part (b), would your answer change if it was Fawn (not Gordon) who died in 2015? Explain.
49. **LO.4, 6, 7** Assume the same facts as in Problem 48, except that Gordon and Fawn are husband and wife (not brother and sister).
- What are the gift tax consequences in 2002?
 - What are the estate tax consequences in 2015?
 - Under part (b), would your answer change if it was Fawn (not Gordon) who died in 2015? Explain.
50. **LO.5, 6, 7** In each of the *independent* situations below, determine the transfer tax (i.e., estate and gift) consequences of what has occurred. (In all cases, assume that Gene and Mary are married and that Ashley is their daughter.)
- Mary purchases an insurance policy on Gene's life and designates Ashley as the beneficiary. Mary dies first, and under her will, the policy passes to Gene.
 - Gene purchases an insurance policy on his life and designates Ashley as the beneficiary. Gene gives the policy to Mary and continues to pay the premiums thereon. Two years after the gift, Gene dies first, and the policy proceeds are paid to Ashley.

- c. Gene purchases an insurance policy on Mary's life and designates Ashley as the beneficiary. Ashley dies first one year later.
 - d. Assume the same facts as in part (c). Two years later, Mary dies. Because Gene has not designated a new beneficiary, the insurance proceeds are paid to him.
 - e. Gene purchases an insurance policy on his life and designates Mary as the beneficiary. Gene dies first, and the policy proceeds are paid to Mary.
51. **LO.7** While vacationing in Florida in November 2015, Sally was seriously injured in an automobile accident (she died several days later). How are the following transactions handled for tax purposes?
- a. Bruce, Sally's son and executor, incurred \$6,200 in travel expenses in flying to Florida, retrieving the body, and returning it to Frankfort, Kentucky, for burial.
 - b. Early in 2015, Sally had pledged \$50,000 to the building fund of her church. Bruce paid this pledge from the assets of the estate.
 - c. Prior to her death, Sally had promised to give her nephew, Gary, \$20,000 when he passed the bar exam. Gary passed the exam in late 2015, and Bruce kept Sally's promise by paying him \$20,000 from estate assets.
 - d. At the scene of the accident and before the ambulance arrived, someone took Sally's jewelry (i.e., Rolex watch and wedding ring) and money. The property (valued at \$33,000) was not insured and was never recovered.
 - e. As a result of the accident, Sally's auto was totally destroyed. The auto had a basis of \$52,000 and a fair market value of \$28,000. In January 2016, the insurance company pays Sally's estate \$27,000.
52. **LO.7** Roy dies and is survived by his wife, Marge. Under Roy's will, all of his otherwise uncommitted assets pass to Marge. Based on the following property interests, determine the marital deduction allowed to Roy's estate.
- a. Timberland worth \$1.2 million owned by Roy, Marge, and Amber (Marge's sister) as equal tenants in common. Amber furnished the original purchase price.
 - b. Residence of Roy and Marge worth \$900,000 owned by them as tenants by the entirety with right of survivorship. Roy provided the original purchase price.
 - c. Insurance policy on Roy's life (maturity value of \$1 million) owned by Marge and payable to her as the beneficiary.
 - d. Insurance policy on Roy's life (maturity value of \$500,000) owned by Roy with Marge as the designated beneficiary.
 - e. Distribution from a qualified pension plan of \$1.6 million (Roy matched his employer's contribution of \$500,000) with Marge as the designated beneficiary.
53. **LO.8** On the advice of her estate planner, Grace made taxable gifts of \$5 million in 2011. Grace dies in late 2015 leaving a taxable estate of \$1.1 million. Grace has always been single and never made any taxable gifts before 2011. Determine her estate tax liability.
54. **LO.8** Under Rowena's will, Mandy (Rowena's sister) inherits her property. One year later, Mandy dies. Based on the following independent assumptions, what is Mandy's credit for the tax on prior transfers?
- a. The estate tax attributable to the inclusion of the property in Rowena's gross estate is \$700,000, and the estate tax attributable to the inclusion of the property in Mandy's gross estate is \$800,000.
 - b. The estate tax attributable to the inclusion of the property in Rowena's gross estate is \$1.2 million, and the estate tax attributable to the inclusion of the property in Mandy's gross estate is \$1.1 million.
 - c. Would your answers to parts (a) and (b) change if Mandy died seven years (rather than one year) after Rowena?

55. **LO.9** In 2015, Loretta makes a taxable gift of \$2 million to her granddaughter, Bertha. Presuming that Loretta used up both her unified transfer tax credit and her generation-skipping transfer tax credit, how much tax does Loretta owe as a result of the transfer?

See Appendix E for Comprehensive Tax Return Problems—Forms 706 and 709

Research Problems

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

THOMSON REUTERS
CHECKPOINT
Student Edition

Research Problem 1. Grace Lang was employed as a waitress at the Pancake House in Grand Bay, Alabama. While working the morning shift on March 7, 1999, one of Grace’s customers left her a Florida lottery ticket as a tip. When Grace discovered that she had won part of the Florida Lotto jackpot, the following steps were taken.

- Upon advice of her father and legal counsel, the Lang Corporation was formed and immediately made an S election.
- Grace received 49% of the stock in Lang, and the 51% balance was distributed to family members.
- Grace had the Florida gaming authorities designate the Lang Corporation as the recipient of the prize money—approximately \$10 million payable over 30 years.
- Grace’s coworkers at the Pancake House filed suit against Grace based on an agreement they had to share any lottery winnings equally. The Alabama courts eventually decided that such an agreement did exist but that it was not enforceable. (Alabama law does not permit enforcement of contracts involving illegal activities—gambling is illegal in Alabama.)

In 2007, the IRS determined that Grace had made taxable gifts in 1999 when she shifted some of the lottery winnings to family members. She made the gifts by having 51% of the Lang Corporation stock issued to them. (As Lang is an S corporation, the lottery income passes through to the shareholders.)

Grace disputed the gift tax assessment by contending that her actions were required by the Lang family agreement. Under this agreement, it was understood that each member would take care of the others in the event he or she came into a “substantial amount” of money. Because Grace was bound by the Lang family agreement, she was compelled to relinquish any right to 51% of the Lang stock. Thus, the satisfaction of an obligation is not a gift. As no gift occurred, the imposition of the gift tax is not appropriate.

Who should prevail?

Partial list of research aids:

Estate of Emerson Winkler, 36 TCM 1657, T.C.Memo. 1997–4.

Tonda Lynn Dickerson, 103 TCM 1280, T.C.Memo. 2012–60.

Research Problem 2. In 2000, June, a 75-year-old widow, creates an irrevocable trust naming her five adult grandchildren as the beneficiaries. The assets transferred in trust consist of marketable securities (worth \$800,000) and June’s personal residence

(worth \$400,000). Bob, June's younger brother and a practicing attorney, is designated as the trustee. Other provisions of the trust are as follows.

- Bob is given the discretion to distribute the income to the beneficiaries based on their need or add it to corpus. He is also given the power to change trust investments and to terminate the trust.
- The trust is to last for June's lifetime or, if sooner, until termination by Bob.
- Upon termination of the trust, the principal and any accumulated income are to be distributed to the beneficiaries (June's grandchildren).

For 2000, June files a Form 709 to report the transfer in trust and pays a gift tax based on value of \$1.2 million (\$800,000 + \$400,000).

After the transfer in trust and up to the time of her death, June continues to occupy the residence. Although she pays no rent, she maintains the property and pays the yearly property taxes. June never discussed the matter of her continued occupancy of the residence with either Bob or the beneficiaries of the trust.

Upon June's death in 2008, the value of the trust is \$2.3 million, broken down as follows: marketable securities and cash (\$1.6 million) and residence (\$700,000). Shortly thereafter, Bob sells the residence, liquidates the trust, and distributes the proceeds to the beneficiaries.

What are the estate tax consequences of these transactions to June?

Partial list of research aids:

§ 2036.

Gynn v. U.S., 71-1 USTC ¶12,742, 27 AFTR 2d 71-1653, 437 F.2d 1148 (CA-4, 1971).

Estate of Eleanor T. R. Trotter, 82 TCM 633, T.C.Memo. 2001-250.

Estate of Lorraine C. Disbrow, 91 TCM 794, T.C.Memo. 2006-34.

Research Problem 3. Before her death in 2009, Lucy entered into the following transactions.

- a. In 2000, Lucy borrowed \$600,000 from her brother, Irwin, so that Lucy could start a business. The loan was on open account, and no interest or due date was provided for. Under applicable state law, collection on the loan was barred by the statute of limitations before Lucy died. Because the family thought that Irwin should recover his funds, the executor of the estate paid him \$600,000.
- b. In 2007, she borrowed \$300,000 from a bank and promptly loaned that sum to her controlled corporation. The executor of Lucy's estate prepaid the bank loan, but never attempted to collect the amount due Lucy from the corporation.
- c. In 2008, Lucy promised her sister, Ida, a bequest of \$500,000 if Ida would move in with her and care for her during an illness (which eventually proved to be terminal). Lucy never kept her promise, as her will was silent on any bequest to Ida. After Lucy's death, Ida sued the estate and eventually recovered \$600,000 for breach of contract.
- d. One of the assets in Lucy's estate was a palatial residence that passed to George under a specific provision of the will. George did not want the residence, preferring cash instead. Per George's instructions, the residence was sold. Expenses incurred in connection with the sale were claimed as § 2053 expenses on Form 706 filed by Lucy's estate.
- e. Before her death, Lucy incurred and paid certain medical expenses but did not have the opportunity to file a claim for partial reimbursement from her insurance company. After her death, the claim was filed by Lucy's executor, and the reimbursement was paid to the estate.

Discuss the estate and income tax ramifications of each of these transactions.

Partial list of research aids:

§§ 61(a)(1) and (12), 111, 213, 691, 2033, and 2053.

Reg. §§ 20.2053-4(d)(4) and (7), Example (7).

Estate of Allie W. Pittard, 69 T.C. 391 (1977).

Joseph F. Kenefic, 36 TCM 1226, T.C.Memo. 1977-310.

Hibernia Bank v. U.S., 78-2 USTC ¶13,261, 42 AFTR 2d 78-6510, 581 F.2d 741 (CA-9, 1978).

Rev.Rul. 78-292, 1978-2 C.B. 233.

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.



Internet Activity

Communications

Research Problem 4. What type of transfer tax, if any, does your home state impose? What about the state(s) contiguous to your home state? (For Alaska, use Washington; for Hawaii, use California.)

Research Problem 5. The IRS makes available several publications that can prove useful to those involved in the administration of estates. Retrieve and summarize three topics from each of the following documents.

- a. Publication 559.
- b. Publication 510.
- c. Publication 950.

Roger CPA Review Questions

1. Which of the following are valid deductions from decedent's gross estate?
 - I. State death taxes
 - II. Foreign death taxes
 - III. Medical and funeral expenses
 - a. All of the above
 - b. I and II, but not III
 - c. I and III, but not II
 - d. II and III, but not I
2. Bizz, a cash-basis calendar-year taxpayer, died on August 14, 2013. The fair market value of Bizz's estate at date of death was \$10,720,000. What amount of Bizz's estate is effectively tax-free if the maximum basic exclusion amount is taken on his estate tax return?
 - a. \$1,000,000
 - b. \$2,625,000
 - c. \$5,250,000
 - d. \$5,470,000
3. Which of the following conditions must be true for the executor to value the estate assets within six months after the decedent's death?
 - I. The value of the estate must not exceed \$5,250,000
 - II. The executor of the decedent's estate makes the alternate valuation date election
 - III. None of the property included in the gross estate is sold or distributed within six months of the date of death
 - a. II only
 - b. II and III only
 - c. I and II only
 - d. All of the above
4. Disregarding any extensions, within how many months after the date of death of the decedent is the payment of Federal estate tax due?
 - a. 6
 - b. 9
 - c. 3½
 - d. 4½
5. Roger Crocker, a U.S. citizen, died on July 1, 2013, leaving an adjusted gross estate that included the following assets.

Asset	Fair Market Value on Date of Death
Jewelry and art	\$2,100,000
4 multi-family apartment buildings	5,200,000
Personal property	3,400,000

Under the terms of Roger's will, \$3,400,000 of his personal property was bequeathed outright to his widow, free of estate and inheritance tax. The remainder of the estate was split equally among his three children. Roger made no other taxable gifts during his lifetime. In computing Roger's taxable estate, the executor of the estate should claim marital deduction of:

- a. \$0
 b. \$3,400,000
 c. \$5,250,000
 d. \$5,350,000
6. Pickle, a U.S. citizen, died in 20X4. Pickle made taxable gifts that year of \$290,000 that are not included in Pickle's gross estate. On date of Pickle's death, his estate was \$2,700,000 and his will did not allow for charitable or marital bequeaths. What tax forms must Pickle's estate file for the 20X4 taxable year?

	Form 709	Form 706
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

7. During 20X4, Mitchael, a single individual, made the following cash gifts:

Donee	Amount
Alexandra	\$ 7,200
Kaila	15,000
Marinka	34,000

Alexandra used the money to pay for her medical expenses, whereas Kaila and Marinka used the money for personal purposes. Mitchael did not make any gifts in prior years.

In filing the 20X4 gift tax return, Mitchael was entitled to a maximum annual exclusion of:

- a. \$56,200
 b. \$42,000
 c. \$35,200
 d. \$0
8. During 20X4, Mitchael, a single individual, made the following cash gifts:

Donee	Amount
Alexandra	\$ 7,200
Kaila	15,000
Marinka	34,000

Alexandra used the money to pay for her medical expenses, whereas Kaila and Marinka used the money for personal purposes. Mitchael did not make any gifts in prior years.

In filing the 20X4 gift tax return, Michael will report a *taxable* gift of:

- a. \$0
 b. \$14,200
 c. \$21,000
 d. \$56,200
9. Cook made the following gifts during the year:
- I. \$14,000 for medical expenses paid directly to a hospital on behalf of an individual
 II. \$45,000 for tuition paid directly to an accredited university of an individual
 III. \$150,000 for campaign expenses paid to a political organization

Which of the gifts made by Cook require him to file a gift tax return for the year?

- a. I and III, but not II
 b. II and III, but not I
 c. III only
 d. None of the above

10. Identify the correct statement regarding portability of a deceased spouse's unused lifetime exclusion amount.
- a. It can be granted via an amended tax return of the surviving spouse
 - b. It permits the surviving spouse to apply the decedent's unused exclusion amount to the surviving spouse's own transfers during life, but not at death
 - c. It is granted via an election on the decedent's fiduciary income tax return
 - d. It can be elected only through a timely filing of a Form 706

Income Taxation of Trusts and Estates

LEARNING OBJECTIVES: *After completing Chapter 28, you should be able to:*

LO.1

Use working definitions with respect to trusts, estates, beneficiaries, and other parties.

LO.2

Identify the steps in determining the accounting and taxable income of a trust or an estate and the related taxable income of the beneficiaries.

LO.3

Illustrate the uses and implications of distributable net income.

LO.4

Apply the Subchapter J rules in a manner that minimizes the income taxation of trusts and estates and still accomplishes the intended objectives of the grantor or decedent.

CHAPTER OUTLINE

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- 28-1b What Is an Estate?, 28-5

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THE BIG PICTURE

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SETTING UP A TRUST TO PROTECT A FAMILY

Anna Jiang is the main breadwinner in her family, which includes her husband Tom, a social worker, and two children, Bobby, age 6, and Sally, age 8. Anna has accumulated about \$2 million in after-tax investment accounts, largely made up of growth stocks that do not regularly pay dividends; she inherited most of these securities when her grandmother died about five years ago. Anna has addressed the problem of probate costs through joint property ownership, life insurance policies, and beneficiary arrangements for her retirement plans. She and Tom update their wills every five years or so.

Because there is a history of Alzheimer's disease in her family, Anna Jiang wants to make certain that if she becomes unable to work and cannot manage her financial assets, Tom and the children will have adequate cash flow from the investment assets. One of Anna's colleagues at the office suggests that Anna should set up a trust to take care of her family in case a medical problem ever arises.

Read the chapter and formulate your response.

Taxpayers create trusts for a variety of reasons. Some trusts are established primarily for tax purposes, but most are designed to accomplish a specific financial goal or to provide for the orderly management of assets in case of an emergency.

Because a trust is a separate tax entity, its gross income and deductions must be measured and an annual tax return must be filed. Similarly, when an individual dies, a legal entity is created in the form of his or her estate. This chapter examines the rules related to the income taxation of trusts and estates.

28-1 AN OVERVIEW OF SUBCHAPTER J

The income taxation of trusts and estates is governed by Subchapter J of the Internal Revenue Code, §§ 641 through 692. Certain similarities are apparent between Subchapter J and the income taxation of individuals (e.g., the definitions of gross income and deductible expenditures), partnerships and limited liability entities (e.g., the pass-through principle), and S corporations (e.g., the pass-through principle and the trust or estate as a separate taxable entity). Trusts also involve several important new concepts, however, including the determination of *distributable net income* and the *tier system* of distributions to beneficiaries.

Exhibit 28.1 lists some of the more common reasons that might prompt an individual to create a trust, and Exhibit 28.2 illustrates the structure of a typical trust and estate.

28-1a What Is a Trust?

The Code does not contain a definition of a trust. However, the term usually refers to an arrangement created by a will or by an *inter vivos* (lifetime) declaration through which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries.¹ Usually, trust operations are controlled by the trust document and by the fiduciary laws of the state in which the trust documents are executed.

Typically, the creation of a trust involves at least three parties: (1) The **grantor** (sometimes referred to as the settlor or donor) transfers selected assets to the trust entity. (2) The trustee, who usually is either an individual or a corporation, is charged with

LO.1

Use working definitions with respect to trusts, estates, beneficiaries, and other parties.

EXHIBIT 28.1

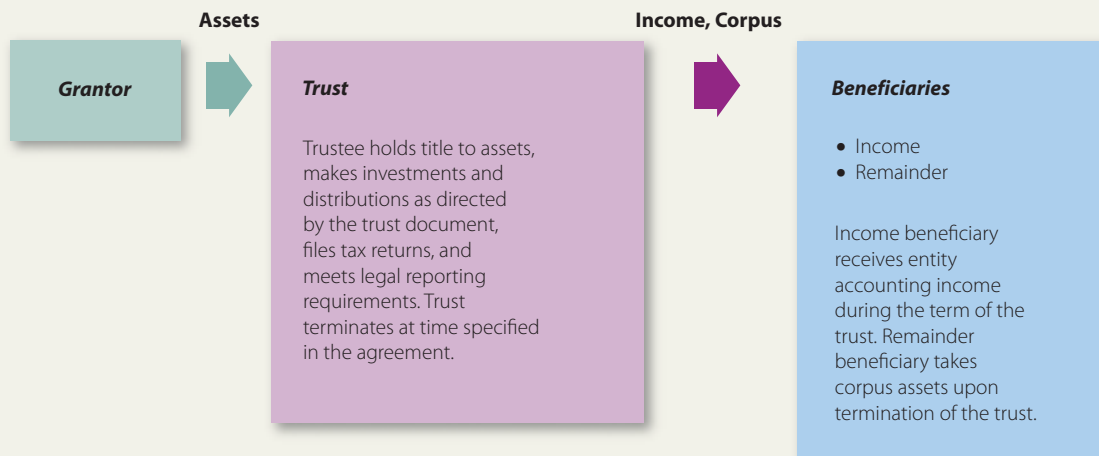
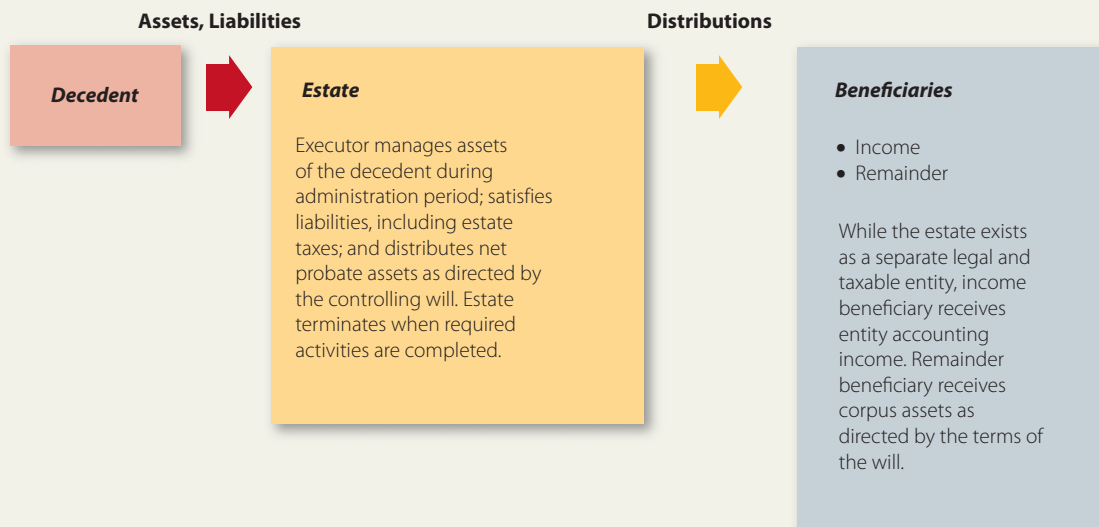
Common Motivations for Creating a Trust

Type of Trust	Financial and Other Goals
Life insurance trust	Holds life insurance policies on the insured, removes the proceeds of the policies from the gross estate (if an irrevocable trust), and safeguards against receipt of the proceeds by a young or inexperienced beneficiary.
"Living" (revocable) trust	Manages assets, reduces probate costs, provides privacy for asset disposition, protects against medical or other emergencies, and provides relief from the necessity of day-to-day management of the underlying assets.
Trust for minors	Provides funds for a college education or other needs of the minor and transfers accumulated income without permanently parting with the underlying assets.
Retirement trust	Manages asset contributions as dictated by the terms of a qualified retirement plan. Usually, it is exempt from Federal income tax.
Divorce trust	Manages the assets of an ex-spouse and ensures that they are distributed in a timely fashion to specified beneficiaries (e.g., as alimony or child support).

¹Reg. § 301.7701-4(a).

EXHIBIT 28.2

Structure of a Typical Trust and Estate

TRUST**ESTATE**

the fiduciary duties associated with the trust. (3) The beneficiary is designated to receive income or property from the trust.

In some situations, fewer than three persons may be involved, as specified by the trust agreement. For instance, an elderly individual who no longer can manage his or her own property (e.g., because of ill health) may create a trust under which he or she is both the grantor and the beneficiary. In this case, a family member or corporate trustee is charged with the management of the grantor's assets.

In another situation, the grantor might designate himself or herself as the trustee of the trust assets. For example, someone who wants to transfer selected assets to a minor child or elderly parent could use a trust entity to ensure that the beneficiary does not

waste the property. By naming himself or herself as the trustee, the grantor retains virtual control over the property that is transferred.

When only one party is involved (when the same individual is grantor, trustee, and sole beneficiary of the trust), Subchapter J rules do not apply and the entity (known as a **grantor trust**) is ignored for Federal income tax purposes.

Other Definitions

When the grantor transfers title of selected assets to a trust, those assets become the **corpus** (body), or principal, of the trust. Trust corpus, in most situations, earns *income*, which may be distributed to the beneficiaries or accumulated for the future by the trustee, as the trust instrument directs.

In a typical trust, the grantor creates two types of beneficiaries: one who receives the accounting income of the trust (a concept that will be defined in a later section of the chapter), and one who receives the trust corpus that remains at the termination of the trust as a legal entity. Beneficiaries in the former category hold an *income interest* in the trust, and those in the latter category hold a *remainder interest* in the trust's assets. If the grantor retains the remainder interest, the interest is known as a **reversionary interest** (corpus reverts to the grantor when the trust entity terminates).

The trust document establishes the term of the trust. The term may be for a specific number of years (*term certain*) or until the occurrence of a specified event. For instance, a trust might exist:

- for the life of the income beneficiary, in which case the income beneficiary is known as a *life tenant* in the trust corpus;
- for the life of some other individual (e.g., one's parent);
- until the income or remainder beneficiary reaches the age of majority; or
- until the beneficiary, or another individual, marries, receives a promotion, or reaches some specified age.

The trustee may be required to distribute the accounting income of the entity according to a distribution schedule specified in the agreement. Usually, though, the trustee is given more discretion with respect to the timing and nature of the distributions. If the trustee can determine, within guidelines that may be included in the trust document, either the timing of the income or corpus distributions or the specific beneficiaries who will receive them (from among those identified in the agreement), the trust is called a discretionary or **sprinkling trust**. Here, the trustee can “sprinkle” the distributions among the various beneficiaries. As discussed in Chapter 27, family-wide income taxes can be reduced by directing income to those who are subject to lower marginal tax rates. Thus, by giving the trustee a sprinkling power, the income tax liability of the family unit can be manipulated by applying the terms of the trust agreement.

For purposes of certain provisions of Subchapter J, a trust must be classified as either a **simple trust** or a **complex trust**. A simple trust:

- is required to distribute its entire accounting income to designated beneficiaries every year,
- has no beneficiaries that are qualifying charitable organizations, and
- makes no distributions of trust corpus during the year.

A complex trust is any trust that is not a simple trust.² These criteria are applied to the trust every year. Thus, every trust is classified as a complex trust in the year in which it terminates (because it distributes all of its corpus during that year).

²Reg. § 1.651(a)-1.

28-1b What Is an Estate?

An estate is created upon the death of every individual. The entity is charged with collecting and conserving all of the individual's assets, satisfying all liabilities, and distributing the remaining assets to the heirs identified by state law or the will.

Typically, the creation of an estate involves at least three parties: the decedent, all of whose probate assets are transferred to the estate for disposition; the executor, who is appointed under the decedent's valid will (or the administrator, if no valid will exists); and the beneficiaries of the estate, who are to receive assets or income from the entity, as the decedent has indicated in the will. Refer to Exhibit 28.2 for an illustration of these relationships.

An estate's operations are controlled by the probate laws of the decedent's state of residence and by the terms of the will as interpreted by the probate court. If the decedent did not execute a valid will, state law dictates who will carry out the executor's duties, and which beneficiaries will receive which of the decedent's assets and liabilities.

An estate is a separate legal and taxable entity. The termination date of the estate is somewhat discretionary, as it occurs when all of the assets and income of the decedent have been distributed, all estate and decedent liabilities have been satisfied, and all other business of the entity is completed. Thus, there may be an incentive to use the estate as part of an income-shifting strategy (e.g., where the income beneficiaries are subject to low marginal tax rates).

Maria dies, and her estate holds a high-yield investment portfolio. Paulo, the income beneficiary, is subject to a 15% marginal state and Federal income tax rate, while Julia, the remainder beneficiary, is subject to a 30% marginal rate. The tax adviser might suggest that Maria's estate delay its final distribution of assets by a year or more to take advantage of the income tax reduction that is available before the entity terminates.

EXAMPLE

1

If an estate's existence is unduly prolonged, however, the IRS can terminate it for Federal income tax purposes after the expiration of a reasonable period for completing the duties of administration.³



ETHICS & EQUITY To Whom Can I Trust My Pet?

Humane societies encourage the general public to care for their own pets and to adopt those who need owners. It is not uncommon to find provisions in a will to establish a trust or an endowment to care for the pets that the deceased leaves behind. After all, over 60 percent of all individuals live with a pet and more than \$50 billion is spent each year in caring for these companions.

Boilerplate legal language is available to establish a pet-assistance trust. The trust should provide a guaranteed distribution for pet care, including the costs of pet sitters, kennels, and veterinary fees. A few states (e.g., Kentucky and Minnesota) do not recognize such trusts, however.

When decedents establish permanent funds to provide for a favorite pet, the surviving (human) family members may not be so enthused. In a few cases, the survivors challenge the terms of the will or trust, often requesting that a judge downsize the principal amount involved or reduce the specified annual distributions. In this way, the human heirs benefit from any adjustment that is made.

How would you advise a client who wants to establish a well-funded trust to care for Fifi when the family members have income and asset needs of their own?

³Reg. § 1.641(b)-3(a).

28-2 NATURE OF TRUST AND ESTATE TAXATION

In general, the taxable income of a trust or an estate is taxed to the entity or to its beneficiaries to the extent that each has received the accounting income of the entity. Thus, Subchapter J creates a modified pass-through principle relative to the income taxation of trusts, estates, and their beneficiaries. Whoever receives the accounting income of the entity, or some portion of it, is liable for the income tax that results.

Subchapter J produces a significant amount of income tax revenue. About 3 million Forms 1041 are filed every year, and these returns reflect the following approximate aggregate amounts.

- Gross income of over \$100 billion.
- Taxable income of \$50 billion.
- Tax liability of over \$13 billion.

EXAMPLE

2

Adam receives 80% of the accounting income of the Zero Trust. The trustee accumulated the other 20% of the income at her discretion under the trust agreement and added it to trust corpus. Adam is liable for income tax only on the amount of the distribution, while Zero is liable for the income tax on the accumulated portion of the income.

Concept Summary 28.1 summarizes the major similarities and differences between the taxation of trusts and estates and that of other pass-through entities—partnerships, limited liability entities, and S corporations.

Concept Summary 28.1

Tax Characteristics of Major Pass-Through Entities

Tax Treatment	Subchapter K (Partnerships, LLCs)	Subchapter S (S Corporations)	Subchapter J (Trusts, Estates)
Taxing structure	Pure pass-through, only one level of Federal income tax.	Chiefly pass-through, usually one level of Federal income tax.	Modified pass-through, Federal income tax falls on the recipient(s) of entity accounting income.
Entity-level Federal income tax?	Never.	Rarely. See Chapter 22.	Yes, if the entity retains any net taxable income amounts.
Form for reporting income and expense pass-through	Schedules K and K-1, Form 1065.	Schedules K and K-1, Form 1120S.	Schedules K and K-1, Form 1041.
Subject to entity-level AMT?	No, but preferences and adjustments pass through to owners.	No, but preferences and adjustments pass through to owners.	Yes, if the entity retains any AMT-related accounting income amounts.
Controlling documents	Partnership agreement, LLC charter.	Corporate charter and bylaws.	Trust document or will, state fiduciary or probate law.

28-2a Tax Accounting Periods and Methods

An estate or a trust may use many of the tax accounting methods available to individuals. The method of accounting used by the grantor of a trust or the decedent of an estate need not carry over to the entity.

An estate has the same options for choosing a tax year as any new taxpayer. Thus, the estate of a calendar year decedent dying on March 3 can select any fiscal year or report on a calendar year basis. To eliminate the possibility of deferring the taxation of

fiduciary-source income simply by using a fiscal tax year, virtually all trusts (other than tax-exempt trusts) are required to use a calendar tax year.⁴

28-2b Tax Rates and Personal Exemption

Congress's desire to stop trusts from being used as income-shifting devices has made the fiduciary entity the highest-taxed taxpayer in the Code. The entity reaches the 39.6 percent marginal rate with only \$12,300 of 2015 taxable income, so the grantor's ability to shift income in a tax-effective manner is nearly eliminated. Exhibit 28.3, which lists the 2015 taxes paid by various entities on taxable income of \$50,000, shows how expensive the taxes on an accumulation of income within an estate or a trust can be. Given the current tax rates for individuals, proper income shifting might move assets *out of* the estate or trust and into the hands of the grantor or beneficiary.

A fiduciary's dividend income and net long-term capital gain is taxed at a nominal rate of no more than 20 percent. In addition to the regular income tax, an estate or a trust may be subject to the alternative minimum tax and the additional tax on net investment income (discussed later in the chapter). Estimated tax payments must take into account any liabilities for these taxes.⁵

Both trusts and estates are allowed a personal exemption in computing the fiduciary tax liability. All estates are allowed a personal exemption of \$600. The exemption available to a trust depends upon the type of trust involved. A trust that is required to distribute all of its income currently is allowed an exemption of \$300. All other trusts are allowed an exemption of \$100 per year.⁶

The classification of trusts as to the appropriate personal exemption is similar but not identical to the distinction between simple and complex trusts. The classification as a simple trust is more stringent.

Three trusts appear to operate in a similar fashion, but they are subject to different Subchapter J classifications and exemptions.

Trust Alpha is required to distribute all of its current accounting income to Susan. Thus, it is allowed a \$300 personal exemption. No corpus distributions or charitable contributions are made during the year. Accordingly, Alpha is a simple trust.

Trust Beta is required to distribute all of its current accounting income; it is allowed a \$300 personal exemption. The beneficiaries of these distributions are specified in the trust instrument: one-half of accounting income is to be distributed to Tyrone, and one-half is to be distributed to State University, a qualifying charitable organization. Because Beta has made a charitable distribution for the tax year, it is a complex trust.

The trustee of Trust Gamma can, at her discretion, distribute the current-year accounting income or corpus of the trust to Dr. Chapman. As the trustee is not required to distribute current accounting income, only a \$100 personal exemption is allowed. During the current year, the trustee distributed all of the accounting income of the entity to Dr. Chapman, but made no corpus or charitable distributions. Nonetheless, because it lacks the current-year income distribution requirement, Gamma is a complex trust.

EXAMPLE

3

EXHIBIT 28.3

Comparative Tax Liabilities

Filing Status/Entity	Taxable Income	Marginal Income Tax Rate (%)	2015 Tax Liability
Single	\$50,000	25	\$ 8,294
Married, filing jointly	50,000	15	6,578
C corporation	50,000	15	7,500
Trust or estate	50,000	39.6	18,109

⁴§ 645.

⁵§§ 55, 1411.

⁶§ 642(b).

28-2c **Alternative Minimum Tax**

The alternative minimum tax (AMT) may apply to a trust or an estate in any tax year. Given the nature and magnitude of the tax preferences, adjustments, and exemptions that determine alternative minimum taxable income (AMTI), however, most trusts and estates are unlikely to incur the tax.

In general, derivation of AMTI for the entity follows the rules that apply to individual taxpayers. Thus, the corporate ACE adjustment does not apply to fiduciary entities, but AMTI may be created through the application of most of the other AMT preference and adjustment items discussed in Chapter 15.

The fiduciary's AMT is computed using Schedule I of Form 1041. Two full pages of the Form 1041 are dedicated to the computation of taxable income and other items when the AMT applies to the trust or estate. A minimum tax credit might be available in future years through these computations.

For 2015, the entity has a \$23,800 annual AMT exemption. The exemption phases out at a rate of one-fourth of the amount by which AMTI exceeds \$79,450.

A 26 percent AMT rate is applied to AMTI, increasing to 28 percent when AMTI in excess of the exemption reaches \$185,400.

28-2d **Additional Tax on Net Investment Income**

Trusts and estates that are subject to the highest Federal income tax rate for the tax year must pay an additional tax to support the Medicare system. Thus, a 3.8 percent additional tax applies to the entity's undistributed net investment income (NII) that exceeds \$12,150 for 2014 and \$12,300 for 2015. These amounts are indexed annually.

NII includes gross income (less deductions) from interest, dividends, royalties, rents, and passive activities. NII also includes net recognized gains from the disposition of assets producing such income (e.g., capital gains). NII items make up the majority of income items for many investment-oriented fiduciary entities. The NII tax is in addition to the entity's ordinary income tax (maximum rate 39.6 percent) and net capital gains tax (maximum rate 20 percent).

EXAMPLE

4

The Zeta Trust reports \$20,000 of net investment income and \$30,000 in net profits from an active business operation for 2015. Zeta retains all of the business profits but, under the terms of the trust agreement, distributes \$5,000 cash from the NII to its sole beneficiary Victoria. Zeta's liability under the additional tax on NII is \$103 [3.8% tax × (\$15,000 undistributed portfolio income – \$12,300 income amount at which the top tax rate applies)].

Tax-exempt trusts also are exempt from the additional tax on NII. Non-U.S. trusts and estates are not subject to the tax, but if they distribute NII to U.S. beneficiaries, the recipients are subject to the tax. The tax on NII is paid by the grantor of a grantor trust (described earlier in the chapter).

LO.2

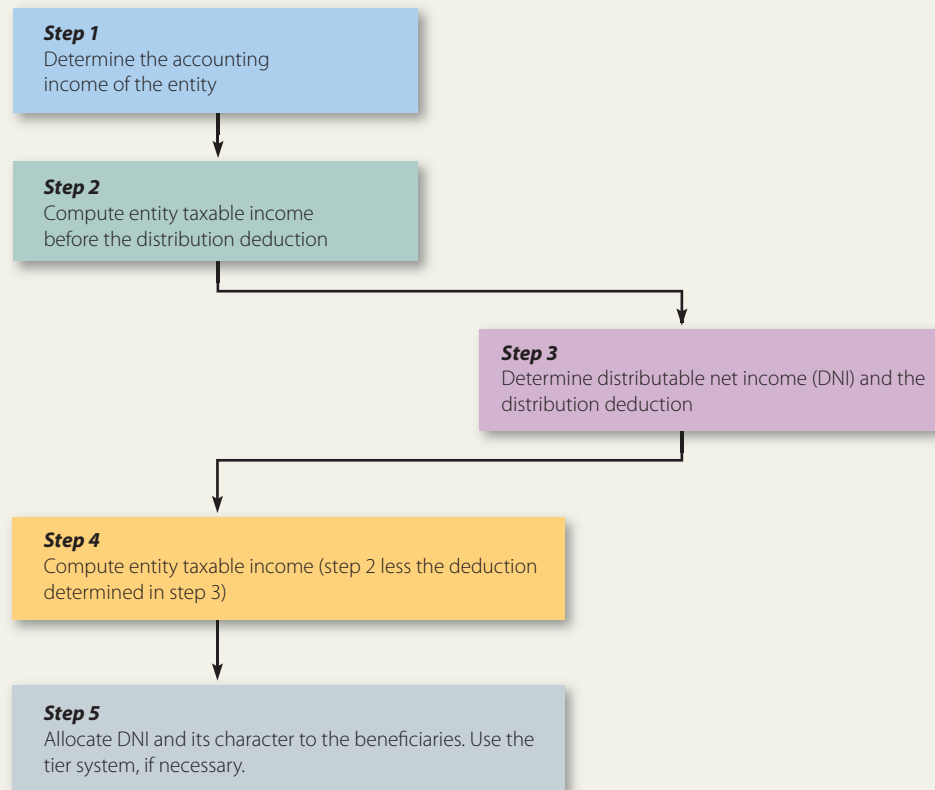
Identify the steps in determining the accounting and taxable income of a trust or an estate and the related taxable income of the beneficiaries.

28-3 **TAXABLE INCOME OF TRUSTS AND ESTATES**

Generally, the taxable income of an estate or a trust is computed similarly to that for an individual. Subchapter J does, however, include several important exceptions and provisions that make it necessary to use a systematic approach to calculating the taxable income of these entities. Exhibit 28.4 illustrates the procedure implied by the Code, and Exhibit 28.5 presents a systematic computation method followed in this chapter.

EXHIBIT 28.4

Accounting Income, Distributable Net Income, and Taxable Income of the Entity and Its Beneficiaries—The Five-Step Procedure



28-3a Entity Accounting Income

Step 1 in determining the taxable income of a trust or an estate is to compute the entity's accounting income for the period. Although this prerequisite is not apparent from a cursory reading of Subchapter J, a closer look at the Code reveals a number of references to the *income* of the entity.⁷ Wherever the term *income* is used in Subchapter J without some modifier (e.g., *gross income* or *taxable income*), the statute is referring to the accounting income of the trust or estate for the tax year.

A definition of **entity accounting income** is critical to understanding the Subchapter J computation of fiduciary taxable income. Under state law, entity accounting income is the amount the income beneficiary of the trust or estate is eligible to receive from the entity. More importantly, the calculation of accounting income is virtually under the control of the grantor or decedent (through a properly drafted trust agreement or will). If the document has been drafted at arm's length, a court will enforce a fiduciary's good faith efforts to carry out the specified computation of accounting income.

Entity accounting income generally is defined by state laws that are derived from the Uniform Principal and Income Act (latest major revision, 1997). Most states have adopted some form of the Uniform Act, which essentially constitutes generally accepted accounting principles (GAAP) in the fiduciary tax setting.

⁷For example, see §§ 651(a)(1), 652(a), and 661(a)(1).

EXHIBIT 28.5		Computational Template Applying the Five-Step Procedure		
Item	Totals	Accounting Income	Taxable Income	Distributable Net Income/Distribution Deduction
Income	_____	_____	_____	
Income	_____	_____	_____	
Expense	_____	_____	_____	
Expense	_____	_____	_____	
Personal exemption			_____	
Accounting income/taxable income before the distribution deduction		_____	_____	_____
		Step 1	Step 2	
Exemption				_____
Corpus capital gain/loss				_____
Net exempt income				_____
Distributable net income				_____
Distribution deduction			_____	Step 3
Entity taxable income			_____	Step 4

Beneficiary taxable income is addressed in **Step 5**.

When specific items of income and expenditure are allocated either to the income beneficiaries or to corpus, the desires of the grantor or decedent are put into effect. Exhibit 28.6 shows typical assignments of revenue and expenditure items to fiduciary income or corpus. Examples 5 through 7 illustrate that the amounts received by beneficiaries can vary widely, due to changes in these allocations under the terms of the trust agreement.

Where the controlling document is silent as to whether an item should be assigned to income or corpus, state fiduciary law prevails. These allocations are an important determinant of the benefits received from the entity by its beneficiaries and the timing of those benefits.

EXHIBIT 28.6		Common Allocations of Items to Income or Corpus	
Allocable to Income		Allocable to Corpus	
Ordinary and operating net income from trust assets		Depreciation on business assets	
Interest, dividend, rent, and royalty income		Casualty gain/loss on income-producing assets	
Stock dividends		Insurance recoveries on income-producing assets	
One-half of fiduciary fees/commissions		Capital gain/loss on investment assets	
		Stock splits	
		One-half of fiduciary fees/commissions	

Entity Accounting Income

The Arnold Trust is a simple trust. Mrs. Bennett is its sole beneficiary. In the current year, the trust earns \$20,000 in taxable interest and \$15,000 in tax-exempt interest. In addition, the trust recognizes an \$8,000 long-term capital gain. The trustee assesses a fee of \$11,000 for the year. If the trust agreement allocates fees and capital gains to corpus, trust accounting income is \$35,000 and Mrs. Bennett receives that amount. Thus, the income beneficiary receives no immediate benefit from the trust's capital gain, and she bears none of the financial burden of the fiduciary's fees.

EXAMPLE

5

Interest income	\$35,000
Long-term capital gain	± -0-*
Fiduciary's fees	± -0-*
Trust accounting income	<u>\$35,000</u>

* Allocable to corpus.

Assume the same facts as in Example 5, except that the trust agreement allocates the fiduciary's fees to income. The trust accounting income is \$24,000, and Mrs. Bennett receives that amount.

EXAMPLE

6

Interest income	\$35,000
Long-term capital gain	± -0-*
Fiduciary's fees	-11,000
Trust accounting income	<u>\$24,000</u>

* Allocable to corpus.

Assume the same facts as in Example 5, except that the trust agreement allocates to income all capital gains and losses and one-half of the trustee's commissions. The trust accounting income is \$37,500, and Mrs. Bennett receives that amount.

EXAMPLE

7

Interest income	\$ 35,000
Long-term capital gain	+8,000
Fiduciary's fees	<u>-5,500*</u>
Trust accounting income	<u>\$ 37,500</u>

* One-half allocable to corpus.

28-3b Gross Income

The gross income of an estate or a trust is similar to that of an individual. In determining the gain or loss to be recognized by an estate or a trust upon the sale or other taxable disposition of assets, the rules for basis determination are similar to those applicable to other taxpayers. Thus, an estate's basis for property received from a decedent is stepped up or stepped down to the gross estate valuation (refer to Chapters 13 and 27 for a more detailed discussion). Property received as a gift during the donor's lifetime (e.g., in irrevocable trust arrangements) usually takes the donor's basis. Property purchased by the trust from a third party is assigned a basis equal to the purchase price.

Noncash Property Distributions

In general, the entity does not recognize gain or loss upon its distribution of property to a beneficiary under the provisions of the will or trust document. The distributed property has the same basis to the beneficiary of the distribution as it did to the estate or trust. Moreover, the distribution absorbs distributable net income (DNI) and qualifies for a distribution deduction (both of which are explained later in this chapter) to the extent

of the lesser of the distributed asset's basis to the beneficiary or the asset's fair market value as of the distribution date.⁸

The Big Picture

EXAMPLE

8

Return to the facts of *The Big Picture* on p. 28-1. Assume that Anna has established the Jiang Family Trust. The trust distributes a painting (basis of \$40,000 and fair market value of \$90,000) to beneficiary Sally. Sally's basis in the painting is \$40,000. The distribution absorbs \$40,000 of the Jiang Trust's DNI, and the trust claims a \$40,000 distribution deduction relative to the transaction.

A trustee or an executor can elect to recognize gain or loss with respect to all of its in-kind property distributions for the year. If the election is made, the beneficiary's basis in the asset is equal to the asset's fair market value as of the distribution date. The distribution absorbs DNI and qualifies for a distribution deduction to the extent of the asset's fair market value. However, the related-party rules can restrict an estate's or trust's deduction for such losses. Generally, related parties include a trust, its trustee, its grantor, and its beneficiaries, as well as an estate, its executor, and its beneficiaries.

Distributing Appreciated Property

EXAMPLE

9

The Green Estate distributes an antique piano, basis to Green of \$10,000 and fair market value of \$15,000, to beneficiary Kyle. The executor elects that Green recognize the related \$5,000 gain on the distribution. Accordingly, Kyle's basis in the piano is \$15,000 (\$10,000 basis to Green + \$5,000 gain recognized). The election likely increased the Federal income tax paid related to the gain, as Green almost certainly is subject to a higher marginal income tax rate than is Kyle. Without the election, Green would not recognize any gain, and Kyle's basis in the piano would be \$10,000.

EXAMPLE

10

Assume the same facts as in Example 9, except that Green's basis in the piano is \$18,000. The executor elects that Green be assigned the related \$3,000 loss on the distribution. Accordingly, Kyle's basis in the piano is \$15,000 (\$18,000 – \$3,000). Without the election, Kyle's basis in the piano would be \$18,000.

The estate cannot deduct this loss, however. Because an estate and its beneficiaries are related parties, realized losses cannot be recognized immediately.⁹ The loss can be recognized if Kyle later sells the piano to an unrelated party.

Income in Respect of a Decedent

The gross income of a trust or an estate includes **income in respect of a decedent (IRD)** that the entity received.¹⁰ For a cash basis decedent, IRD includes accrued salary, interest, rent, and other income items that were not constructively received before death. For both cash and accrual basis decedents, IRD includes, for instance, death benefits from qualified retirement plans and deferred compensation contracts.

The tax consequences of IRD can be summarized as follows.

- The fair market value of the right to IRD on the appropriate valuation date is included in the decedent's gross estate. Thus, it is subject to the Federal estate tax.¹¹
- The decedent's basis in the property carries over to the recipient (the estate or heirs). There is no step-up or step-down in the basis of IRD items.

⁸§ 643(e).

⁹§ 267(b)(13).

¹⁰See § 691 and the Regulations thereunder. The concept of IRD was introduced in Chapter 27.

¹¹To mitigate the effect of double taxation (imposition of both the estate tax and the income tax), § 691(c) allows the recipient an income tax deduction for the incremental estate tax attributable to the net IRD. For individual recipients, this is an itemized deduction, not subject to the 2%-of-AGI floor.



TAX IN THE NEWS A Trend Toward Dynasty Trusts

In a continuing attempt to discourage tax-motivated income shifting among family members, steep income tax rates on estates and trusts are also being seen at the state level. Although a few states (e.g., Alaska, Nevada, Texas, and Washington) do not impose any income tax on fiduciary entities, those that do are tending to increase their rates as part of their efforts to solve budget deficit woes.

Other states, however, have relaxed some of the rules that affect trusts. In such cases, the objectives are to attract dollars to the state and to expand opportunities for attorneys, tax advisers, and other professionals who create and administer the entities.

If a trust can survive for a long period of time, without making distributions or terminations that cause the generation-skipping tax, trust corpus can grow in a steady and tax-free manner. Wealthy individuals use these “dynasty trusts” as a form of inheritance, and many states also allow the trust assets to be protected from claims of the grantor’s creditors.

Dynasty trusts operate like growth stocks. They minimize income distributions by investing profits and new capital in the family businesses, artwork, and multiple homes for the beneficiaries.

- The recipient of the income recognizes gain or loss, measured by the difference between the amount realized and the adjusted basis of the IRD in the hands of the decedent. The character of the gain or loss depends on the treatment that it would have received had it been realized by the decedent before death. Thus, if the decedent would have realized capital gain, the recipient must do likewise.
- Expenses related to the IRD (such as interest, taxes, and depletion) that were not reported properly on the final income tax return of the decedent may be claimed by the recipient. These items are known as **deductions in respect of a decedent**. Typically, such deductions also include fiduciary fees, commissions paid to dispose of estate assets, and state income taxes payable. They are deductible for both Federal estate and income tax purposes, *for or from* adjusted gross income (AGI) as would have been the case for the decedent.

Working With IRD

Amanda died on July 13 of the current year. On August 2, the estate received a check (before deductions) for \$1,200 from Amanda’s former employer; this was Amanda’s compensation for the last pay period of her life. On November 23, the estate received a \$45,000 distribution from the qualified profit sharing plan of Amanda’s employer, the full amount to which Amanda was entitled under the plan. Both Amanda and the estate are calendar year, cash basis taxpayers.

The last salary payment and the profit sharing plan distribution constitute IRD to the estate. Amanda had earned these items during her lifetime, and the estate had an enforceable right to receive each of them after Amanda’s death. Consequently, the gross estate includes \$46,200 with respect to these two items. However, the income tax basis to the estate for these items is not stepped up (from zero to \$1,200 and \$45,000, respectively) upon distribution to the estate.

The estate must report gross income of \$46,200 for the current tax year with respect to the IRD items. The income recognized upon the receipt of the IRD is \$46,200 [$\$1,200 + \$45,000$ (amounts realized) – \$0 (adjusted bases)].

EXAMPLE

11

Assume the same facts as in Example 11. Amanda’s last paycheck was reduced by \$165 for state income taxes that were withheld by the employer. The \$165 tax payment is a deduction in respect of a decedent and is allowed as a deduction on *both* Amanda’s estate tax return *and* the estate’s income tax return.

EXAMPLE

12



TAX IN THE NEWS Coordinate Your Deductions

The deduction under § 691(c) may be one of the more obscure provisions of the tax law, but its benefits can add up fast. The deduction is allowed on the tax return of the recipient of income in respect of a decedent (IRD). IRD often is received by the estate of the decedent or a trust that he or she created under the will or during lifetime. The deduction is for the Federal estate tax attributable to the IRD item. For an individual, it is a miscellaneous itemized deduction *not* subject to the 2 percent-of-AGI floor.

Because IRD often includes the value of the survivorship feature on pensions and other retirement plans and assets, the amount subject to the estate tax can be substantial. Thus, when the current-year income tax for the IRD recipient is computed, the § 691(c) deduction can be extremely valuable in offsetting the IRD received.

For instance, suppose a decedent's IRA balance generates \$450,000 in attributable estate tax. If the recipient of the IRA takes the net-of-tax distribution in one year, the § 691(c) deduction shelters \$450,000 in gross income and may be worth over \$150,000 in Federal income taxes saved.

But taking the § 691(c) deduction is more complex than it looks. Because different tax advisers often prepare the Form 706 for the estate and the Form 1040 or 1041 for the IRD recipient, the § 691(c) deduction can get lost altogether or at least be miscomputed. When the IRD is paid out over several years, computing the § 691(c) deduction can become complex. And tax software and IRS forms and publications say relatively little about it.

Including the IRD in both the taxpayer's gross estate and the gross income of the estate may seem harsh. Nevertheless, the tax consequences of IRD are similar to the treatment that applies to all of a taxpayer's earned income. The item is subject to income tax upon receipt, and to the extent it is not consumed by the taxpayer before death, it is included in the gross estate.

28-3c Ordinary Deductions

As a general rule, the taxable income of an estate or a trust is similar to that of an individual.¹² Deductions are allowed for ordinary and necessary expenses paid or incurred in carrying on a trade or business; for the production or collection of income; for the management, conservation, or maintenance of property; and in connection with the determination, collection, or refund of any tax.¹³ Reasonable administration expenses, including fiduciary fees and litigation costs in connection with the duties of administration, also can be deductible.

Expenses attributable to the production or collection of tax-exempt income are not deductible.¹⁴ The amount of the disallowed deduction is found by using a formula based on the composition of the income elements of entity accounting income for the year of the deduction. The deductibility of the fees is determined strictly by the Code (under §§ 212 and 265), and the allocation of expenditures to income and to corpus is controlled by the trust agreement or will or by state law.

EXAMPLE

13

The Silver Trust operates a business and invests idle cash in marketable securities. Its sales proceeds for the current year are \$180,000. Expenses for wages, cost of sales, and office administration are \$80,000. Interest income recognized is \$20,000 from taxable bonds and \$50,000 from tax-exempt bonds. The trustee claims a \$35,000 fee for its activities. According to the trust agreement, \$30,000 of this amount is allocated to the income beneficiaries, and \$5,000 is allocated to corpus.

Sales income	\$180,000
Cost of sales	−80,000
Interest income (\$50,000 is exempt)	+70,000
Fiduciary's fees, as allocated	−30,000
Trust accounting income	<u>\$140,000</u>

continued

¹²§ 641(b).

¹³§§ 162 and 212.

¹⁴§ 265.

The sales proceeds are included in the gross income of the trust under § 61. The costs associated with the business are deductible in full under § 162. The taxable income is included in Silver's gross income under § 61, but the tax-exempt income is excluded under § 103. The fiduciary's fees are deductible by Silver under § 212, but a portion of the deduction is lost because § 265 prohibits deductions for expenses incurred in the generation of tax-exempt income.

Specifically, 50/250 of the fees of \$35,000 can be traced to tax-exempt income, so \$7,000 of the fees is nondeductible. For purposes of the computation, only the income elements of the year's trust accounting income are included in the denominator. Moreover, the allocation of portions of the fees to income and to corpus is irrelevant in the calculation. The disallowed deduction for fiduciary's fees is computed in the following manner.

$$\begin{aligned} \$35,000^* \text{ (total fees paid)} \times \frac{\$50,000^{**} \text{ (exempt income elements of trust accounting income)}}{\$250,000^{**} \text{ (all income elements of trust accounting income)}} \\ = \$7,000 \text{ (amount disallowed)} \end{aligned}$$

*All fees, and not just those that are allocated to income, are deductible by the trust under § 212.

The numerator and denominator of this fraction are **not reduced by expense items allocable to income (e.g., cost of sales).

Amounts deductible as administration expenses or losses for estate tax purposes (under §§ 2053 and 2054) cannot be claimed by the estate for income tax purposes, unless the estate waives the estate tax deduction. Although these expenses cannot be deducted twice, they may be allocated as the fiduciary sees fit between Forms 706 and 1041; they need not be claimed in their entirety on either return.¹⁵ As discussed earlier, the prohibition against double deductions does not extend to *deductions in respect of a decedent*.

Trusts and estates are allowed cost recovery deductions. Such deductions are assigned proportionately among the recipients of the entity accounting income.¹⁶

Cost Recovery Deductions

Lisa and Martin are the equal income beneficiaries of the Needle Trust. Under the terms of the trust agreement, the trustee has complete discretion as to the timing of the distributions from Needle's current accounting income. The trust agreement allocates all depreciation expense to income. In the current year, the trustee distributes 40% of the current trust accounting income to Lisa and 40% to Martin; thus, 20% of the income is accumulated. The depreciation deduction allowable to Needle is \$100,000. This deduction is allocated among the trust and its beneficiaries on the basis of the distribution of current accounting income: Lisa and Martin each claim a \$40,000 deduction, and the trust can deduct \$20,000.

EXAMPLE

14

Assume the same facts as in Example 14, except that the trust agreement allocates all depreciation expense to corpus. There is no change in the tax result; Lisa and Martin both still claim a \$40,000 depreciation deduction, and Needle retains its \$20,000 deduction. The Code assigns the depreciation deduction proportionately to the recipients of entity accounting income. Allocation of depreciation to income or to corpus is irrelevant in determining which party can properly claim the deduction.

EXAMPLE

15

When a trust sells property received by transfer from the grantor, the amount of depreciation subject to recapture includes the depreciation claimed by the grantor before the transfer of the property to the trust. However, depreciation recapture potential disappears at death.

¹⁵Reg. § 1.642(g)-2.

¹⁶§§ 167(h) and 611(b)(3) and (4).

EXAMPLE

16

Jaime transferred an asset to the Shoulder Trust via a lifetime gift. The asset's total depreciation recapture potential was \$40,000. If Shoulder sells the asset at a gain, ordinary income not to exceed \$40,000 is recognized by the trust. Had Jaime transferred the asset after his death to his estate through a bequest, the \$40,000 recapture potential would have disappeared.

If a trust or an estate operates a trade or business, the entity may be eligible for the domestic production activities deduction (DPAD).¹⁷ Computation of qualified production activities income (QPAI) is made at the entity level. Each beneficiary receives, as a pass-through from the entity, his or her share of QPAI and the W-2 wages paid, based on the proportion of entity accounting income received. The DPAD then can be claimed at the beneficiary level. See Chapter 7 for further discussion of the DPAD.

28-3d Deductions for Losses

An estate or a trust is allowed a deduction for casualty or theft losses that are not reimbursed by insurance or other arrangements. Such losses may also be deductible by an estate for Federal tax purposes under § 2054. An estate is not allowed an income tax deduction unless the estate tax deduction is waived.

The net operating loss (NOL) deduction is available for estates and trusts (i.e., where trade or business income is generated). The net capital losses of an estate or a trust can be claimed by the fiduciary. The tax treatment of these losses is the same as for individual taxpayers.

Fiduciary entities are subject to the passive activity limitations; passive losses can be deducted by the trust or estate only against income from passive sources. The required material participation must be provided by the trustee or executor; the actions of employees or third-party agents¹⁸ cannot be used to meet these tests.

28-3e Charitable Contributions

An estate or a complex trust is allowed a deduction for contributions to charitable organizations under certain conditions.¹⁹

- The contribution is made pursuant to the will or trust instrument, and its amount is determinable using the language of that document.
- The recipient is a qualified organization. For this purpose, qualified organizations include the same charities for which individual and corporate donors are allowed deductions, except that estates and trusts are permitted a deduction for contributions to certain foreign charitable organizations.
- Generally, the contribution is claimed in the tax year it is paid, but a fiduciary can treat amounts paid in the year immediately following as a deduction for the preceding year. Under this rule, estates and complex trusts receive more favorable treatment than do individuals or C corporations.

Unlike the charitable contribution deductions of individuals and corporations, the deductions of estates and complex trusts are not limited in amount (e.g., to a percentage of taxable or adjusted gross income). Nonetheless, the deduction is limited to amounts that have been included in the gross income of the entity.

A contribution is deemed to have been made proportionately from each of the income elements of entity accounting income. However, if the will or trust agreement requires that the contribution be made from a specific type of income or from the current income from a specified asset, the allocation of the contribution to taxable and tax-exempt income will not be required.

¹⁷§ 199(d)(1).

¹⁸§469; TAM 201317010 (4/13).

¹⁹§ 642(c)(1) and Reg. §§ 1.642(c)-1 and -3.

The Big Picture

Return to the facts of *The Big Picture* on p. 28-1. Again assume that Anna has established the Jiang Family Trust. The trust reports gross rent income of \$80,000, expenses attributable to the rents of \$60,000, and tax-exempt interest from state bonds of \$20,000. Under the trust agreement, the trustee is to pay 30% of the annual trust accounting income to the United Way, a qualifying organization. Accordingly, the trustee pays \$12,000 to the charity (i.e., $30\% \times \$40,000$). The charitable contribution deduction allowed is \$9,600 [$(\$80,000/\$100,000) \times \$12,000$], even if the payment to the charity is not made until the following tax year.

EXAMPLE

17

The Big Picture

Assume the same facts as in Example 17, except that the trust instrument also requires that the contribution be paid from the net rent income. The agreement controls, and the allocation formula need not be applied. The entire \$12,000 is allowed as a charitable deduction.

EXAMPLE

18

28-3f Deduction for Distributions to Beneficiaries

The modified pass-through approach of Subchapter J is embodied in the deduction allowed to trusts and estates for the distributions made to beneficiaries during the year. Some portion of any distribution that a beneficiary receives from a trust may be subject to income tax on the beneficiary's own return. At the same time, the distributing entity is allowed a deduction for some or all of the distribution.

Consequently, the modified pass-through principle of Subchapter J is implemented. A good analogy is to the taxability of corporate profits distributed to employees as taxable wages. The corporation is allowed a deduction for the payment, but the employee receives gross income in the form of compensation.

Distributable Net Income

A critical value that is used in computing the amount of the entity's distribution deduction is **distributable net income (DNI)**. As it is defined in Subchapter J, DNI serves several functions. Concept Summary 28.2 illustrates these critical roles of DNI.

- DNI is the maximum amount of the distribution on which the beneficiaries can be taxed.²⁰
- DNI is the maximum amount the entity can use as a distribution deduction for the year.²¹
- The makeup of DNI carries over to the beneficiaries (the items of income and expenses retain their DNI character in the hands of the distributees).²²

Subchapter J defines DNI in a circular manner, however. The DNI value is necessary to determine the entity's distribution deduction and therefore its taxable income for the year. Nonetheless, the Code defines DNI as a modification of the entity's taxable income itself. Using the systematic approach to determining the taxable income of the entity and its beneficiaries, as shown earlier in Exhibit 28.4, compute *taxable income before the distribution deduction*, modify that amount to determine DNI and the distribution deduction, return to the calculation of *taxable income*, and apply the deduction that has resulted.

Taxable income before the distribution deduction (Step 2) includes all of the entity's items of gross income, deductions, gains, losses, and exemptions for the year. Therefore, to compute this amount, (1) determine the appropriate personal exemption for the year and (2) account for all of the other gross income and deductions of the entity.

²⁰ §§ 652(a) and 662(a).

²¹ §§ 651(b) and 661(c).

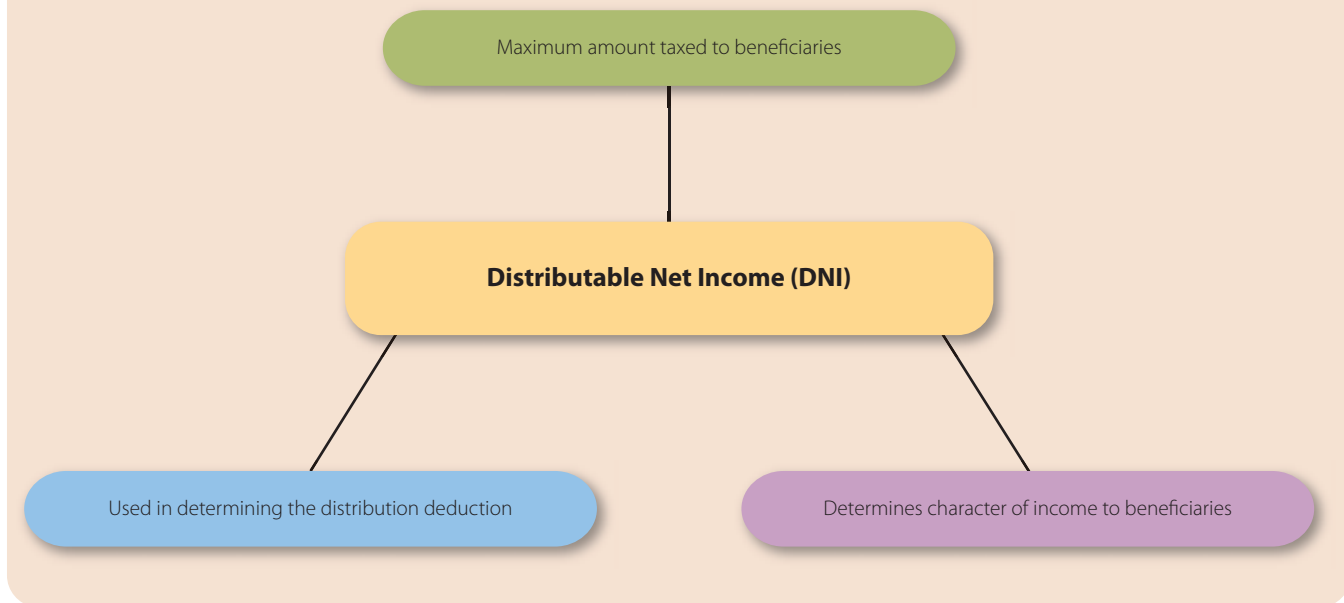
²² §§ 652(b) and 662(b).

LO.3

Illustrate the uses and implications of distributable net income.

Concept Summary 28.2

Uses of the DNI Amount



Step 3 in Exhibit 28.4 is the determination of *distributable net income*, computed by making the following adjustments to the entity's *taxable income before the distribution deduction*.²³

- Add back the personal exemption.
- Add back *net* tax-exempt interest; reduce the total tax-exempt interest by charitable contributions and by related expenses not deductible under § 265.
- Add back the entity's net capital losses.
- Subtract any net capital gains allocable to corpus. The only net capital gains included in DNI are those attributable to income beneficiaries or to charitable contributions.

Because taxable income before the distribution deduction is computed by deducting all of the expenses of the entity (whether they were allocated to income or to corpus), DNI is reduced by expenses that are allocated to corpus. The effect is to reduce the taxable income of the income beneficiaries. The actual distributions to the beneficiaries exceed DNI because the distributions are not reduced by expenses allocated to corpus. Aside from this shortcoming of Subchapter J, DNI offers a good approximation of the current-year economic income available for distribution to the entity's income beneficiaries.

Distribution Deduction

DNI includes the net tax-exempt interest income of the entity, so that amount must be removed from DNI in computing the distribution deduction. Moreover, for estates and complex trusts, DNI and the distribution amount may not be the same; the amount actually distributed during the year may include discretionary distributions of income and distributions of corpus permissible under the will or trust instrument.

The distribution deduction for estates and complex trusts is computed as the lesser of (1) the deductible portion of DNI or (2) the taxable amount actually distributed to the beneficiaries during the year. For a simple trust, however, full distribution is always assumed, relative to both the entity and its beneficiaries, in a manner similar to the pass-through entities.

²³These and other (less common) adjustments are detailed in § 643.

DNI and Distribution Deduction

The Zinc Trust is a simple trust. Because of severe liquidity problems, its year 1 accounting income is not distributed to its sole beneficiary, Mark, until early in year 2. Zinc still is allowed a full distribution deduction for, and Mark still is taxable upon, the entity's year 1 income in year 1.

EXAMPLE

19

The Pork Trust is required to distribute its current accounting income annually to its sole income beneficiary, Barbara. Capital gains and losses and all other expenses are allocable to corpus. In the current year, Pork incurs the following items.

Dividend income	\$25,000
Taxable interest income	15,000
Tax-exempt interest income	20,000
Net long-term capital gains	10,000
Fiduciary's fees	6,000

EXAMPLE

20

Item	Totals	Accounting Income	Taxable Income	Distributable Net Income/ Distribution Deduction
Dividend income	\$25,000	\$25,000	\$ 25,000	
Taxable interest income	15,000	15,000	15,000	
Exempt interest income	20,000	20,000		
Net long-term capital gain	10,000		10,000	
Fiduciary fees	6,000		(4,000)	
Personal exemption			(300)	
Accounting income/taxable income before the distribution deduction		<u>\$60,000</u>	\$ 45,700	\$ 45,700
		Step 1	Step 2	
Exemption				300
Corpus capital gain/loss				(10,000)
Net exempt income				<u>18,000</u>
Distributable net income				<u>\$ 54,000</u>
Distribution deduction			Step 3 (36,000)	
Entity taxable income			Step 4 <u>\$ 9,700</u>	

- Step 1.* Trust accounting income is \$60,000; this includes the tax-exempt interest income, but not the fees or the capital gains, pursuant to the trust document. Barbara receives \$60,000 from the trust for the current year.
- Step 2.* Taxable income before the distribution deduction is computed as directed by the Code. The tax-exempt interest is excluded under § 103. Only a portion of the fees is deductible $\{[(\$60,000 - \$20,000)/\$60,000] \times \$6,000 = \$4,000\}$ because some of the fees $(\$6,000 - \$4,000)$ are traceable to the tax-exempt income. The trust claims a \$300 personal exemption, as it is required to distribute its annual trust accounting income.
- Step 3.* DNI and the distribution deduction reflect the required adjustments. The distribution deduction is the lesser of the distributed amount (\$60,000) or the deductible portion of DNI $[\$54,000 - (\$20,000 - \$2,000 = \$18,000 \text{ net exempt income})]$.
- Step 4.* Finally, return to the computation of the taxable income of the Pork Trust. A simple test should be applied at this point to ensure that the proper figure for the trust's taxable income has been determined. On what is Pork to be taxed? Pork has distributed to Barbara \$60,000, which is all of its gross income except the \$10,000 net long-term capital gains. The \$300 personal exemption reduces Pork's taxable income to \$9,700.

DNI and Distribution Deduction

EXAMPLE

21

The Quick Trust is required to distribute all of its current accounting income equally to its two beneficiaries, Faith and the Universal Church, a qualifying charitable organization. Capital gains and losses and depreciation expenses are allocable to income. Fiduciary fees are allocable to corpus. In the current year, Quick incurs various items as indicated.

Item	Totals	Accounting Income	Taxable Income	Distributable Net Income/ Distribution Deduction
Rent income	\$100,000	\$100,000	\$100,000	
Expenses—rent income	30,000	(30,000)	(30,000)	
Depreciation—rent income	15,000	(15,000)		
Net long-term capital gain	20,000	20,000	20,000	
Charitable contribution			(37,500)	
Fiduciary fees	18,000		(18,000)	
Personal exemption			(300)	
Accounting income/taxable income before the distribution deduction		<u>\$ 75,000</u>	\$ 34,200	\$34,200
		Step 1	Step 2	
Exemption				300
Corpus capital gain/loss				
Net exempt income				
Distributable net income				<u>\$34,500</u>
Distribution deduction			Step 3 (34,500)	
Entity taxable income			Step 4 (\$ 300)	

- Step 1.** Trust accounting income of \$75,000 reflects the indicated allocations of items to income and to corpus. Each income beneficiary receives \$37,500.
- Step 2.** In the absence of tax-exempt income, a deduction is allowed for the full amount of the fiduciary's fees. Quick is a complex trust, but because it is required to distribute its full accounting income annually, a \$300 exemption is allowed. The trust properly does not deduct any depreciation for the rental property. The depreciation deduction is available only to the recipients of the entity's accounting income for the period. Thus, the deduction is split equally between Faith and the church. The deduction probably is of no direct value to the church, a tax-exempt organization. The trust's charitable contribution deduction is based on the \$37,500 the charity actually received (one-half of trust accounting income).
- Step 3.** As there is no tax-exempt income, the only adjustment needed to compute DNI is to add back the trust's personal exemption. Subchapter J requires no adjustment for the charitable contribution. DNI is computed only from the perspective of Faith, who also received \$37,500 from the trust.
- Step 4.** Perform the simple test (referred to previously) to ensure that the proper taxable income for the Quick Trust has been computed. All of the trust's gross income has been distributed to Faith and the charity. As is the case with most trusts that distribute all of their accounting income, the Quick Trust "wastes" the personal exemption.

28-3g Tax Credits

An estate or a trust may claim the foreign tax credit to the extent that it is not passed through to the beneficiaries.²⁴ Similarly, other credits are apportioned between the estate or trust and the beneficiaries on the basis of the entity accounting income allocable to each.

²⁴ §§ 642(a)(1) and 901.

Concept Summary 28.3 outlines the procedures used to determine the Federal taxable income of an estate or trust.



Concept Summary 28.3

Principles of Fiduciary Taxation

1. Estates and trusts are temporary entities created to locate, maintain, and distribute assets, and to satisfy liabilities according to the wishes of the decedent or grantor as expressed in the will or trust document.
2. Generally, the estate or trust acts as a conduit of the taxable income that it receives. To the extent the income is distributed by the entity, it is taxed to the beneficiary. Taxable income retained by the entity is taxed to the entity itself.
3. The entity's accounting income first must be determined. Accounting conventions that are stated in the controlling document or, lacking such provisions, in state law allocate specific items of receipt and expenditure either to income or to corpus. Income beneficiaries typically receive payments from the entity that are equal to the accounting income.
4. The taxable income of the entity is computed using the scheme in Exhibit 28.4. The entity usually recognizes income in respect of a decedent.
5. Deductions for fiduciary's fees and for charitable contributions may be reduced if the entity received any tax-exempt income during the year. Cost recovery deductions are assigned proportionately to the recipients of accounting income.
6. Upon election, realized gain or loss on assets that are properly distributed in kind can be recognized by the entity.

28-4 TAXATION OF BENEFICIARIES

The beneficiaries of an estate or a trust receive taxable income from the entity under the modified pass-through principle of Subchapter J. Distributable net income determines the maximum amount that can be taxed to the beneficiaries for any tax year. The constitution of DNI also carries over to the beneficiaries (e.g., net long-term capital gains and dividends retain their character when they are distributed from the entity to the beneficiary).

A beneficiary includes in gross income an amount based upon the DNI of the trust for any taxable year or years of the entity ending with or within his or her taxable year.²⁵

28-4a Distributions by Simple Trusts

The amount taxable to the beneficiaries of a trust is limited by the trust's DNI. However, because DNI includes net tax-exempt income, the amount included in the gross income of the beneficiaries could be less than DNI. When there is more than one income beneficiary, the elements of DNI are apportioned ratably according to the amount required to be distributed currently to each.

A simple trust has ordinary income of \$40,000, a long-term capital gain of \$15,000 (allocable to corpus), and a trustee commission expense of \$4,000 (payable from corpus). The two income beneficiaries, Allie and Bart, are entitled to the trust's annual accounting income, based on shares of 75% and 25%, respectively.

Although Allie receives \$30,000 as her share ($75\% \times$ trust accounting income of \$40,000), she is allocated DNI of only \$27,000 ($75\% \times$ \$36,000). Likewise, Bart is entitled to receive \$10,000 ($25\% \times$ \$40,000), but he is allocated DNI of only \$9,000 ($25\% \times$ \$36,000). The \$15,000 capital gain is taxed to the trust.

EXAMPLE

22

²⁵§§ 652(c) and 662(c).

28-4b Distributions by Estates and Complex Trusts

Typically, an estate or a complex trust makes only discretionary distributions. In those cases, the DNI is apportioned ratably according to the distributed amounts.

A computational problem arises with estates and complex trusts when more than one beneficiary receives a distribution from the entity and the controlling document does not require a distribution of the entire accounting income of the entity.

EXAMPLE

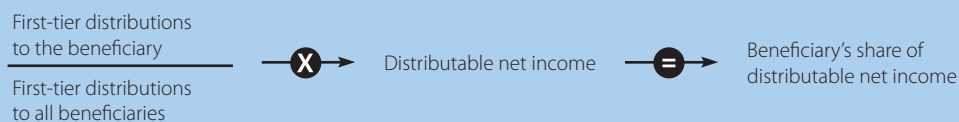
23

The trustee of the Wilson Trust has the discretion to distribute the income or corpus of the trust in any proportion between the two beneficiaries of the trust, Wong and Washington. Under the trust instrument, Wong must receive \$15,000 from the trust every year. In the current year, the trust's accounting income is \$50,000, and its DNI is \$40,000. The trustee pays \$15,000 to Wong and \$25,000 to Washington.

How is Wilson's DNI to be divided between Wong and Washington? Several arbitrary methods of allocating DNI between the beneficiaries could be devised. Subchapter J resolves the problem by creating a two-tier system to govern the taxation of beneficiaries in such situations.²⁶ The tier system determines which distributions will be included in the gross income of the beneficiaries in full, which will be included in part, and which will not be included at all.

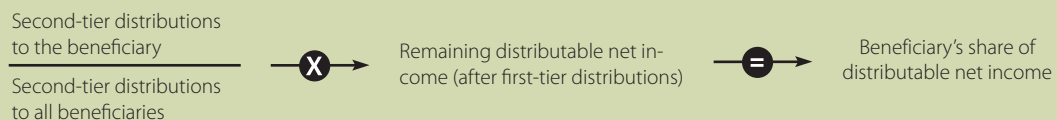
First and Second Tiers

Income that is required to be distributed currently, whether or not it is distributed, is categorized as a *first-tier distribution*. All other discretionary amounts paid, credited, or distributed are *second-tier distributions*.²⁷ A formula is used to allocate DNI among the appropriate beneficiaries when only first-tier distributions are made and those amounts exceed DNI.



When both first-tier and second-tier distributions are made and the first-tier distributions exceed DNI, the above formula is applied to the first-tier distributions. In this case, none of the second-tier distributions are taxed, because all of the DNI has been allocated to the first-tier beneficiaries.

If both first-tier and second-tier distributions are made and the first-tier distributions do not exceed DNI, but the total of both first-tier and second-tier distributions does exceed DNI, the second-tier beneficiaries recognize income as shown below.



²⁶ §§ 662(a)(1) and (2).

²⁷ Reg. §§ 1.662(a)-2 and -3.

Distributing DNI

The trustee of the Gray Trust is required annually to distribute \$10,000 each to Harriet and Wally, the two beneficiaries of the entity. In addition, the trustee can distribute other amounts of trust income or corpus at his sole discretion. In the current year, the trust reports accounting income of \$60,000 and DNI of \$50,000. However, the trustee distributes only the required \$10,000 each to Harriet and to Wally. The balance of the income is accumulated and added to trust corpus.

In this case, only first-tier distributions have been made, but the total amount of the distributions does not exceed DNI for the year. Although DNI is the maximum amount included by the beneficiaries for the year, they can include no more in gross income than is distributed by the entity. Thus, both Harriet and Wally may be subject to tax on \$10,000 as their proportionate shares of DNI.

EXAMPLE

24

Assume the same facts as in Example 24, except that DNI is \$12,000. Harriet and Wally each receive \$10,000, but they cannot be taxed in total on more than DNI. Each is taxed on \$6,000 [DNI \$12,000 \times (\$10,000/\$20,000 of the first-tier distributions)].

EXAMPLE

25

Return to the facts in Example 23. Wong receives a first-tier distribution of \$15,000. Second-tier distributions include \$20,000 to Wong and \$25,000 to Washington. Wilson's DNI is \$40,000. The DNI is allocated between Wong and Washington as follows.

(1) First-tier distributions

To Wong	\$15,000 DNI
To Washington	—0—
Remaining DNI = \$25,000	

(2) Second-tier distributions

To Wong	\$11,111 DNI [(20/45) \times \$25,000]
To Washington	\$13,889 DNI [(25/45) \times \$25,000]

EXAMPLE

26

Assume the same facts as in Example 26, except that accounting income is \$80,000 and DNI is \$70,000. DNI is allocated between Wong and Washington as follows.

(1) First-tier distributions

To Wong	\$15,000 DNI
To Washington	—0—
Remaining DNI = \$55,000	

(2) Second-tier distributions

To Wong	\$20,000 DNI
To Washington	\$25,000 DNI

EXAMPLE

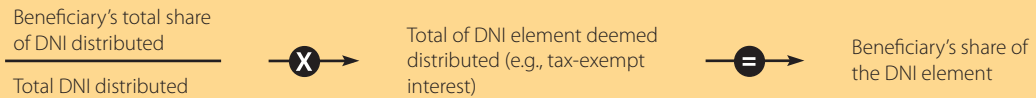
27

28-4c Character of Income

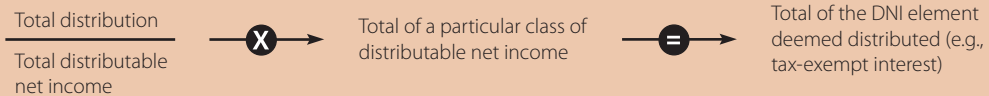
Consistent with the modified pass-through principle of Subchapter J, various classes of income (e.g., dividends, passive or portfolio gain and loss, AMT preferences, tax-exempt interest) retain the same character for the beneficiaries that they had when they were received by the entity. If there are multiple beneficiaries *and* if all of the DNI is distributed, a problem arises in allocating the various classes of income among the beneficiaries.

Distributions are treated as consisting of the same proportion as the items that enter into the computation of DNI. This allocation does not apply, however, if local law or the governing instrument specifically allocates different classes of income to different beneficiaries.²⁸

²⁸Reg. § 1.662(b)-1 seems to allow special allocations, but see *Harkness v. U.S.*, 72-2 USTC ¶9740, 30 AFTR 2d 72-5754, 469 F.2d 310 (Ct.Cls., 1972).



If the entity distributes only a part of its DNI, the amount of a specific class of DNI that is deemed distributed first must be determined.



DNI Flow-Throughs

EXAMPLE

28

The Baron Trust has DNI of \$40,000, including the following: \$10,000 of taxable interest, \$10,000 of tax-exempt interest, and \$20,000 of passive activity income. The trustee distributes, at her discretion, \$8,000 to Mike and \$12,000 to Nancy.

Beneficiary	Amount Received	Income Type		
		Taxable Interest	Exempt Interest	Passive Income
Mike	\$ 8,000	\$2,000*	\$2,000	\$4,000
Nancy	12,000	3,000	3,000	6,000

*\$8,000 distribution/\$40,000 total DNI \times \$10,000 taxable interest in DNI.

EXAMPLE

29

Continue with the facts of Example 28. The character of the income that flows through to Mike and Nancy is effective for all other tax purposes. For instance, the \$4,000 passive activity income that is allocated to Mike is available for offset against passive losses that he incurred from limited partnerships and rental activities for the year. Similarly, the \$3,000 taxable interest income allocated to Nancy can be used to increase the amount of investment interest expense deductible by her in the year of the flow-through. The interest is treated as portfolio income to the same extent as that received directly by the taxpayer.

Special Allocations

Under limited circumstances, the parties may modify the character-of-income allocation method set forth above. A modification is permitted only to the extent the allocation is required in the trust instrument, and only to the extent it has an economic effect independent of the cash-flow and income tax consequences of the allocation.²⁹

EXAMPLE

30

Return to the facts in Example 28. Assume that the beneficiaries are elderly individuals who have pooled their investment portfolios to avail themselves of the trustee's professional asset management skills. Suppose the trustee has the discretion to allocate different classes of income to different beneficiaries and she designates \$10,000 of Nancy's \$12,000 distribution as being from the tax-exempt income. Such a designation *would not be recognized* for tax purposes, and the allocation method of Example 28 must be used.

continued

²⁹Reg. § 1.652(b)-2(b). This is similar to the § 704(b)(2) requirement for partnerships.

Suppose, however, the trust instrument stipulated that Nancy was to receive all of the income from the tax-exempt securities because she alone contributed the exempt securities to trust corpus. Under this provision, the \$10,000 of the nontaxable interest is paid to Nancy. This allocation is *recognized*, and \$10,000 of Nancy's distribution is tax-exempt.

28-4d Losses in the Termination Year

The ordinary net operating and capital losses of a trust or an estate do not flow through to the entity's beneficiaries, as would such losses from a partnership or an S corporation. However, in the year in which an entity terminates its existence, the beneficiaries do receive a direct benefit from the loss carryovers of the trust or estate.³⁰

Net operating losses and net capital losses are subject to the same carryover rules that otherwise apply to an individual. Consequently, NOLs can be carried back 2 years and then carried forward 20 years, while net capital losses can be carried forward only and for an indefinite period of time.

If the entity incurs a negative taxable income in the last year of its existence, the excess of deductions over the entity's gross income flows through directly to the beneficiaries. The net loss is available as a deduction *from* AGI in the beneficiary's tax year with or within which the entity's tax year ends. The amount allowed is in proportion to the relative amount of corpus assets that each beneficiary receives upon the termination of the entity, and it is subject to the 2-percent-of-AGI floor.

Any carryovers of the entity's other losses flow through to the beneficiaries in the year of termination in proportion to the relative amount of corpus assets that each beneficiary receives. Beneficiaries who are individuals use these carryovers as deductions *for* AGI.

The Edgar Estate terminates on December 31, 2015. It had used a fiscal year ending July 31. For the termination year, the estate incurred a \$15,000 negative taxable income. In addition, the estate held an unused NOL carryover of \$23,000 from the year ending July 31, 2010, and an unused net long-term capital loss carryover of \$10,000 from the year ending July 31, 2013. Dawn receives \$60,000 of the total \$100,000 corpus upon termination; she is a calendar-year taxpayer.

Dawn can claim an itemized deduction of \$9,000 $[(\$60,000/\$100,000) \times \$15,000]$ for the entity's negative taxable income in the year of termination. This deduction is subject to the 2%-of-AGI floor on her miscellaneous itemized deductions. In addition, Dawn can claim a \$13,800 deduction *for* AGI in 2015 $(60\% \times \$23,000)$ for Edgar's NOL carryover, and she can use \$6,000 of the estate's net long-term capital loss carryover with her other 2015 capital transactions.

EXAMPLE

31

28-5 PROCEDURAL MATTERS

The fiduciary is required to file a Form 1041 (U.S. Income Tax Return for Estates and Trusts) in the following situations.³¹

- For an estate that has gross income of \$600 or more for the year.
- For a trust that either has any taxable income or, if there is no taxable income, has gross income of \$600 or more.

The fiduciary return (and any related tax liability) is due, before extensions, no later than the fifteenth day of the fourth month following the close of the entity's taxable year. While a paper return may be filed, the IRS encourages electronic filing of the Form 1041 and schedules.

Many fiduciary entities recognize capital gains during the year, through sales of assets that are part of corpus. In that event, a Schedule D is filed with the Form 1041, and the fiduciary entity or its beneficiaries can qualify for the lower tax rates on long-term capital gains.

³⁰Reg. §§ 1.642(h)-1 and -2.

³¹§§ 6012(a)(3) and (4).



TAX IN THE NEWS Don't Trust Your Dictionary

Today, the middle and upper classes often are including trusts in their estate plans. Usually, the purpose of the trust is to spare the survivors the time and effort required to work through a state's probate proceedings.

But planning for death can sometimes lead to confusion about terminology, especially between a living trust and a living will. A "living trust" is typically created to hold the assets of the decedent-to-be, including investments, home-stead, and household goods. Assets are retitled in the name of the trustee, who periodically files a Form 1041 for the new entity. The idea underlying the living trust is to reduce the probate estate. This, in turn, lowers the fees for carrying out the probate process. Such fees often total 5 percent or so of the date of death value of the probate assets.

The living trust accomplishes virtually no Federal tax savings. The trust assets are included in the decedent's gross estate, as the living trust is an incomplete transfer (see Chapter 27). For the most part, the entity is treated as a grantor trust. Because of the retained investment and distribution powers, the donor is still liable for taxes on the taxable income of the fiduciary.

A "living will," on the other hand, is a document that conveys powers to relatives and third parties to make medical and financial decisions when the decedent-to-be can no longer do so. More appropriately referred to as a "health care power of attorney," the document expresses the person's wishes as to how and when to reduce specified medical treatments (including directives for removing life support systems).

The pass-through of income and deduction items to the beneficiary is accomplished through Schedule K-1 to Form 1041. This form is similar in format and function to the Schedule K-1 for partners and S corporation shareholders (see Chapters 21 and 22). Because the typical fiduciary entity records only a few transactions during the year, the Schedule K-1 for Form 1041 is less detailed than those for Forms 1065 and 1120S. See the specimen Form 1041 and schedules in Appendix B to this text.

Trusts and estates must make estimated Federal income tax payments using the same quarterly schedule that applies to individual taxpayers. This requirement applies to estates and grantor trusts only for tax years that end two or more years after the date of the decedent's death. Charitable trusts and private foundations are exempt from estimated payment requirements altogether.³²

LO.4

Apply the Subchapter J rules in a manner that minimizes the income taxation of trusts and estates and still accomplishes the intended objectives of the grantor or decedent.

28-6 TAX PLANNING

Many of the tax planning possibilities for estates and trusts were discussed in Chapter 27. However, several specific tax planning possibilities are available to help minimize the income tax effects on estates and trusts and their beneficiaries.

28-6a A Trust or an Estate as an Income-Shifting Device

The compressed and highly progressive tax rate schedule applicable to Subchapter J entities has reversed the traditional techniques by which families set aside funds for long-term activities such as business startups, college education, and home purchases. When the tax rate schedules for trusts and estates were more accommodating, high-income individuals would shift income-producing assets to trusts to take advantage of the lower effective tax rate that would fall on the income accumulated within the trust. The target of the plan, usually a child, would receive the accumulated income (and, perhaps, trust corpus) at a designated age, and more funds would be available because a lower tax rate had been applied over the life of the investment in the trust.

Today, such an income shift would *deplete*, rather than shelter, the family's assets, as the rates falling on individuals are more graduated than are those applicable to fiduciaries; the kiddie tax also penalizes attempts to shift taxable income to children. Assuming

³²§ 6654(l).

that the objectives of the plan remain unchanged, possible strategies in view of these rate changes include the following.

- Trust corpus should be invested in growth assets that are low on yield but high on appreciation, so that the trustee can determine the timing of the gain and somewhat control the effective tax rate that applies.
- Trust corpus should be invested in tax-exempt securities such as municipal bonds and mutual funds that invest in them to eliminate the tax costs associated with the investment. If this approach is taken, a trust might be unnecessary—the parent should simply retain full control over the assets and invest in the exempt securities in his or her own account.
- The grantor should retain high-yield assets, rather than contribute them to a fiduciary entity, so that control over the assets is not surrendered when the tax cost is too high.
- Use of trust vehicles should be reserved for cases where professional management of the assets is necessary for portfolio growth and the additional tax costs can be justified.

28-6b **Income Tax Planning for Estates**

As a separate taxable entity, an estate can select its own tax year and accounting methods. The executor of an estate should consider selecting a fiscal year because this will determine when beneficiaries must include income distributions from the estate in their own tax returns. Beneficiaries must include the income for their tax year with or within which the estate's tax year ends. Proper selection of the estate's tax year can result in a smoothing out of income and a reduction of the income taxes for all parties involved.

Caution should be taken in determining when the estate is to be terminated. Selecting a fiscal year for the estate can result in a bunching of income to the beneficiaries in the year in which the estate is closed. Prolonging the termination of an estate can be effective income tax planning, but the IRS carefully examines the purpose of keeping the estate open. Because the unused losses of an estate pass through to the beneficiaries only in the termination year, the estate should be closed when the beneficiaries can enjoy the maximum tax benefit of such losses.

The timing and amounts of income distributions to the beneficiaries also present important tax planning opportunities. If the executor can make discretionary income distributions, he or she should evaluate the relative marginal income tax rates of the estate and its beneficiaries. By timing the distributions properly, the overall income tax liability can be minimized. Care should be taken, however, to time the distributions in light of the estate's DNI.

Distribution Strategies

For several years before his death on March 7, Don had entered into annual deferred compensation agreements with his employer. These agreements collectively called for the payment of \$200,000 six months after Don's retirement or death. To provide a maximum 12-month period within which to generate deductions to offset this large item of income in respect of a decedent, the executor or administrator of the estate should elect a fiscal year ending August 31. The election is made simply by filing the estate's first tax return for the short period of March 7 to August 31.

EXAMPLE

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Carol, the sole beneficiary of an estate, is a calendar year, cash basis taxpayer. If the estate elects a fiscal year ending January 31, all distributions during the period of February 1 to December 31, 2014, are reported on Carol's tax return for calendar year 2015 (due April 15, 2016). Thus, assuming estimated tax requirements otherwise have been met, any income taxes that result from a \$50,000 distribution made by the estate on February 20, 2014, may be deferred until April 15, 2016.

EXAMPLE

33

Distribution Strategies

EXAMPLE

34

Assume the same facts as in Example 33. If the estate is closed on December 15, 2015, the DNI for both the fiscal year ending January 31, 2015, and the final tax year ending December 15, 2015, is included in Carol's tax return for the same calendar year. To avoid the effect of this bunching of income, the estate should not be closed until early in calendar year 2016.

In general, those beneficiaries who are subject to high income tax rates should be made beneficiaries of second-tier (but not IRD) distributions of the estate. Most likely, these individuals will have less need for an additional steady stream of (taxable) income while their income tax savings can be relatively large. Moreover, a special allocation of tax-favored types of income and expenses should be considered. For example, tax-exempt income can be directed more easily to beneficiaries in higher income tax brackets.

EXAMPLE

35

Review Examples 26 and 27 carefully. Note, for instance, the flexibility that is available to the executor or administrator in timing the second-tier distributions of income and corpus of the estate. To illustrate, if Washington is subject to a high tax rate, distributions to him should be minimized except in years when DNI is low. In this manner, Washington's exposure to gross income from the distributions can be controlled so that most of the distributions he receives will be free of income tax.

28-6c **Income Tax Planning with Trusts**

The great variety in the structuring of trusts provides the grantor, trustee, and beneficiaries with excellent opportunities for tax planning. Many of the same tax planning opportunities available to the executor of an estate are available to the trustee. For instance, the distributions from a trust are taxable to the trust's beneficiaries to the extent of the trust's DNI. If income distributions are discretionary, the trustee can time the distributions to minimize the income tax consequences to all parties.

28-6d **Distributions of In-Kind Property**

The ability of the trustee or executor to elect to recognize the realized gain or loss relative to a distributed noncash asset allows the gain or loss to be allocated to the optimal taxpayer.

EXAMPLE

36

The Yorba Linda Estate distributed some inventory, basis of \$40,000 and fair market value of \$41,500, to beneficiary Larry. Yorba Linda is subject to a 25% marginal income tax rate, and Larry is subject to a 33% marginal rate. The executor of Yorba Linda should elect that the entity recognize the related \$1,500 realized gain, thereby subjecting the gain to the estate's lower marginal tax rate.

Tax without election, at Larry's 33% rate	\$495
Tax with election, at estate's 25% rate	375

28-6e **Additional Taxes on Capital Gains and Net Investment Income**

Aggressive income shifting among a fiduciary entity and its beneficiaries may be prompted by the fiduciary's exposure to the liabilities for additional Federal income taxes on capital gains and net investment income. These additional taxes apply only to "high-income" taxpayers, but the income level at which the tax applies is much lower for fiduciaries than it is for individuals.

Thus, investment income and capital gains might best be distributed to individual beneficiaries, removing the items from the additional taxable income of the fiduciary, perhaps without creating an additional tax liability for the beneficiary.



ETHICS & EQUITY Who Should Be a Trustee?

For decades, grantors have chosen a family member to be the trustee of the family savings, the children's education fund, or whatever other assets are placed into management by the trust. The relative chosen is often the most trusted but not always the one with the business skills. Now, however, as the financial world has become more complex, with wild stock market fluctuations, increased fiduciary standards, and potential conflicts of interest, some are questioning the wisdom of using a family member as the trustee.

Using a trust company or other financial institution as a trustee usually results in more stable investment returns, eliminating both the highs and the lows of the stock market cycle. Institutions also can bring other advantages.

- They do not die, run away, become mentally or physically incapacitated, or otherwise unexpectedly become unqualified for the position.
- They are not easily swayed by emotional appeals; nor do they react to family jealousies.
- They are prohibited by law from acting under a conflict of interest, such as might exist between family members when the related trustee is also a trust beneficiary.

On the negative side, human trustees often waive or discount their fiduciary fee, while institutions do not. Especially for trusts with a small corpus, institutional trustees can be prohibitively expensive. And the trust company most often is oriented toward expanding its customer base, rather than offering individual attention to existing clients.

How would you advise a client to address this delicate issue? Compromise solutions might be to:

- Appoint co-trustees. Aunt Grace or Uncle Roberto can provide the personal touch and ensure that trust decisions recognize family needs, while the trust company maximizes investment returns and furnishes professional management.
- Keep the family trustee, but hire professionals to provide advice only when needed, at an hourly rate. This approach avoids the fees based on asset values that trust companies usually charge.
- Use the advisory services of the mutual funds in which trust assets are invested to manage and distribute the corpus and income.

The tax also can be reduced if the fiduciary invests in securities that produce tax-exempt or tax-deferred income, or meets the material participation requirement for otherwise passive activities. In addition, the tax liability can be minimized if the entity invests in assets that produce a low yield (like growth stocks or funds), and if it arranges its portfolio to produce a low turnover rate.

REFOCUS ON THE BIG PICTURE

SETTING UP A TRUST TO PROTECT A FAMILY

Anna Jiang and her family should consider the creation of one or more trusts to provide security in case Anna is incapacitated by medical problems and unable to manage the family's finances. Some suggestions for the family might be:

- Anna transfers some or all of the \$2 million assets to the Jiang Family Trust, with quarterly income payable to Tom and the children. Recipients would be designated by the trustee, but all of the entity's accounting income must be distributed. In this way, the income could be directed to the beneficiary most in need (e.g., to pay for education expenses or to start a new business). The children could be named first-tier beneficiaries, with Tom as a second-tier income beneficiary.
- While Anna is still healthy and earning a regular salary, the trustee could accumulate the accounting income and allow the corpus to build up. Alternatively, the trustee could make gifts to charity or fund education plans for Bobby and Sally.



continued

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- Anna should provide clear instructions to the trustee as to her preferences on how the trust corpus should be invested and specify which of Tom's and the children's expenses should and should not be covered.
- The children should be named as remainder beneficiaries of the Jiang Family Trust. In case the trust corpus exceeds the estate tax bypass amount, other remainder beneficiaries could be named to avoid any generation-skipping tax (see Chapter 27).
- Amendments to the trust document should be considered whenever Tom and Anna update their wills.

What If?

If Anna remains healthy, the Jiang Family Trust might be terminated when the children reach the age of majority, as the need for financial support will have diminished. However, if Tom is unable or unwilling to take over management of the assets, the trust should continue. In this event, the trustee might shift the focus to funding long-term care for the couple, making charitable gifts, or financing the education needs of grandchildren.

The controlling trust document should be worded to provide flexibility as to the purposes and termination date of the trust. The trustee should be chosen from family members or business associates who know Anna and Tom well and are familiar with the couple's objectives.

Key Terms

Complex trust, 28-4

Corpus, 28-4

Deductions in respect of a decedent, 28-13

Distributable net income (DNI), 28-17

Entity accounting income, 28-9

Grantor, 28-2

Grantor trust, 28-4

Income in respect of a decedent (IRD), 28-12

Reversionary interest, 28-4

Simple trust, 28-4

Sprinkling trust, 28-4

Discussion Questions

- Communications**
1. **LO.1** A local bank has asked you to speak at its Building Personal Wealth Conference on the topic of "What Should Your Trust Do for You?" Develop at least four PowerPoint slides, each one listing a function that a trust might be able to accomplish for an individual who has more than a modest level of financial resources.
 2. **LO.1** In general terms, describe how the following entities are subject to the Federal income tax. (Answer only for the entity, not for its owners, beneficiaries, etc.)
 - a. C corporations (Subchapter C).
 - b. Partnerships (Subchapter K).
 - c. S corporations (Subchapter S).
 - d. Trusts and estates (Subchapter J).
- Communications**
3. **LO.1** Your college's accounting group has asked you to give a 10-minute speech titled "Trusts, Estates, and the AMT." The audience will be students who have completed at least one course concerning Federal income taxation. Develop a brief outline for your remarks.

4. **LO.1** Create a fact pattern that illustrates each of the following tax situations. Be specific.
- A simple trust.
 - A complex trust with a \$300 personal exemption.
 - A complex trust with a \$100 personal exemption.

5. **LO.2** Using Exhibit 28.4 as a guide, describe the computation of a fiduciary entity's accounting income, taxable income, and distributable net income.

6. **LO.2** The Liu Trust is short of cash. It is required to distribute \$100,000 to Yang every year, and that payment is due in six weeks. In its asset corpus, Liu holds a number of investments that are valued at \$100,000. One of them is a plot of land with a tax basis to the trust of \$80,000. Assuming that the trust agreement allows, what are the Federal income tax consequences if Liu distributes this land to Yang?

7. **LO.2** In its first tax year, the Vasquez Estate generated \$50,000 of taxable interest income and \$30,000 of tax-exempt interest income. It paid fiduciary fees of \$8,000. The estate is subject to a 35% marginal estate tax rate and a 40% marginal income tax rate. How should the executor assign the deductions for the payment of the fees?

Decision Making

8. **LO.2** The Sterling Trust owns a business and generated \$100,000 in depreciation deductions for the tax year. Mona is one of the income beneficiaries of the entity. Given the following information, can Mona deduct any of the Sterling depreciation on her Form 1040? If so, how much is her deduction?

Sterling's taxable income from the business	\$ 800,000
Sterling's gross income from the business	4,000,000
Mona's share of trust accounting income	500,000
Total trust accounting income	2,500,000
Mona's share of distributable net income	1,200,000
Total distributable net income	1,600,000

9. **LO.2** In year 1, the Helpful Trust agreed to make a \$50,000 contribution to Local Soup Kitchen, a charitable organization. Helpful's board agreed to the gift at a November year 1 meeting, but the check was not issued until February 20, year 2 (i.e., during the next tax year).
- Can the trust claim a charitable contribution deduction? If so, describe how Helpful should treat its gift.
 - Would the answer to part (a) change if the check was issued on May 1, year 2? If so, how?

10. **LO.3** One of the key concepts in fiduciary income taxation is that of *distributable net income* (DNI). List the major functions of DNI on one PowerPoint slide, with no more than five bullets, to present to your classmates as part of the discussion of this chapter of the text. Just review the uses of DNI in Subchapter J, and do not discuss its computation.

Communications

11. **LO.4** Comment on the following items relative to tax planning strategies of a fiduciary entity.
- To reduce taxes for a typical family, should income be shifted *to* a trust or *from* a trust? Why?
 - From a tax planning standpoint, who should invest in tax-exempt bonds, the trust or its beneficiaries?
 - To reduce overall taxes, should a high-income, wealthy beneficiary be assigned to the first or second tier of trust distributions? Why?
 - To minimize taxes, how should a trust treat the distribution of an in-kind asset? Why?

Decision Making

Computational Exercises

12. **LO.2** The Biltmore Trust is a simple trust. Crawford is its sole beneficiary. In the current year, the trust earns \$3,200 in taxable interest and \$8,000 in tax-exempt interest. In addition, the trust recognizes a \$2,500 long-term capital gain. The trustee assesses a fee of \$1,800 for the year.
- Compute trust accounting income, where the trust agreement allocates fees and capital gains to corpus.
 - Same as (a), except that fees are allocated to income.
13. **LO.2** The Hosta Trust reports gross rent income of \$72,000, expenses attributable to the rents of \$55,000, and tax-exempt interest from state bonds of \$18,000. Under the trust agreement, the trustee is to pay 20% of the annual trust accounting income to the American Red Cross, a qualifying charitable organization. Compute Hosta's charitable contribution deduction.

Problems

14. **LO.1** Complete the following chart, indicating the comparative attributes of the typical simple trust and complex trust by answering yes/no or explaining the differences between the entities where appropriate.

Attribute	Simple Trust	Complex Trust
Trust could incur its own tax liability for the year	_____	_____
Trust generally distributes all of the DNI	_____	_____
Trust can deduct its charitable contributions in the year of or the year after payment	_____	_____
Trust could claim a foreign tax credit	_____	_____
Maximum tax rate on net long-term capital gains = 20%	_____	_____
AMT preferences and adjustments flow through to beneficiaries ratably	_____	_____
Trust can adopt the FIFO method for its inventory assets; the grantor had been using lower of cost or market	_____	_____
Trust can use a tax year other than the calendar year	_____	_____
Amount of personal exemption	_____	_____

15. **LO.1** Compute the Federal income tax liability for the Valerio Trust. The entity reports the following transactions for the 2015 tax year. The trustee accumulates all accounting income for the year.

Operating income from a business	\$ 500,000
Dividend income, all from U.S. corporations	30,000
Interest income, City of San Antonio bonds	40,000
Fiduciary fees, deductible portion	(15,000)
Net rental losses, passive activity	(100,000)

16. **LO.2** The Polozzi Trust will incur the following items in the next tax year, its first year of existence.

Interest income	\$ 25,000
Rent income	100,000
Cost recovery deductions for the rental activity	35,000
Capital gain income	40,000
Fiduciary and tax preparation fees	7,000

Betty, the grantor of the trust, is working with you on the language in the trust instrument relative to the derivation of annual accounting income for the entity. She will name Shirley as the sole income beneficiary and Benny as the remainder beneficiary.

- a. Suggest language to Betty that will maximize the annual income distribution to Shirley.
 - b. Suggest language to Betty that will minimize the annual distribution to Shirley and maximize the accumulation on Benny's behalf.
17. **LO.2** Complete the chart below, indicating the Calvet Trust's entity accounting income for each of the alternatives. For this purpose, use the following information.

Interest income, taxable	\$300,000
Interest income, tax-exempt	30,000
Interest income, tax-exempt but AMT preference item	20,000
Long-term capital gain	40,000
Trustee fee	10,000

Trust Agreement Provisions	Trust Accounting Income
Fees and capital gains allocable to corpus	_____
Capital gains allocable to corpus, one-half of fees allocable to income	_____
Capital gains allocable to income, silent concerning allocation of fees	_____
Fees and exempt income allocable to corpus, silent concerning allocation of capital gain/loss	_____

18. **LO.1, 2, 3** Complete the following chart, indicating the comparative attributes of the typical trust and estate by answering yes/no or explaining the differences between the entities where appropriate.

Attribute	Estate	Trust
Separate income tax entity	_____	_____
Controlling document	_____	_____
Can have both income and remainder beneficiaries	_____	_____
Computes entity accounting income before determining entity taxable income	_____	_____
Termination date is determinable from controlling document	_____	_____
Document identifies both income and remainder beneficiaries	_____	_____
Generally must use calendar tax year	_____	_____

19. **LO.2** Sanchez incurred the following items.

Business income	\$80,000
Tax-exempt interest income	40,000
Payment to charity from 2016 Sanchez gross income, paid 3/1/17	20,000

Complete the following chart, indicating the charitable contributions deduction under the various assumptions.

Assumption	2016 Deduction for Contribution
Sanchez is a cash basis individual.	_____
Sanchez is an accrual basis corporation.	_____
Sanchez is a trust.	_____

20. **LO.2, 3** The Allwardt Trust is a simple trust that correctly uses the calendar year for tax purposes. Its income beneficiaries (Lucy and Ethel) are entitled to the trust's annual accounting income in shares of one-half each.

For the current tax year, Allwardt reports the following.

Ordinary income	\$100,000
Long-term capital gains, allocable to corpus	30,000
Trustee commission expense, allocable to corpus	5,000

Use the format of Exhibit 28.5 to address the following items.

- How much income is each beneficiary entitled to receive?
 - What is the trust's DNI?
 - What is the trust's taxable income?
 - How much gross income is reported by each of the beneficiaries?
21. **LO.2, 3** Assume the same facts as in Problem 20, except that the trust instrument allocates the capital gain to income.
- How much income is each beneficiary entitled to receive?
 - What is the trust's DNI?
 - What is the trust's taxable income?
 - How much gross income is reported by each of the beneficiaries?
22. **LO.3** The Kilp Sisters Trust is required to distribute \$60,000 annually equally to its two income beneficiaries, Clare and Renee. If trust income is not sufficient to pay these amounts, the trustee can invade corpus to the extent necessary.
- During the current year, the trust generates only taxable interest income and records DNI of \$160,000; the trustee distributes \$30,000 to Clare and \$150,000 to Renee.
- How much of the \$150,000 distributed to Renee is included in her gross income?
 - How much of the \$30,000 distributed to Clare is included in her gross income?
 - Are these distributions first-tier or second-tier distributions?
23. **LO.3** The Dolce Estate reports the following items for the current tax year.

Dividend income	\$ 50,000
Taxable interest income	8,000
Passive activity income	30,000
Tax-exempt interest income	<u>12,000</u>
Distributable net income	<u><u>\$100,000</u></u>

Dolce’s two noncharitable income beneficiaries, Brenda and Del, receive cash distributions of \$20,000 each. How much of each class of income is deemed to have been distributed to Brenda? To Del?

24. **LO.2, 3** The trustee of the Pieper Trust can distribute any amount of accounting income and corpus to the trust’s beneficiaries, Lydia and Kent. This year, the trust incurred the following.

Taxable interest income	\$40,000
Tax-exempt interest income	20,000
Long-term capital gains—allocable to corpus	80,000
Fiduciary’s fees—allocable to corpus	9,000

The trustee distributed \$26,000 to Lydia and \$13,000 to Kent.

- a. What is Pieper’s trust accounting income?
 - b. What is Pieper’s DNI?
 - c. What is Pieper’s taxable income?
 - d. What amounts are taxed to each of the beneficiaries?
25. **LO.2** Each of the following items was incurred by José, the cash basis, calendar year decedent. Under the terms of the will, Dora took immediate ownership in all of José’s assets, except the dividend-paying stock. The estate received José’s final paycheck.

Decision Making

Applying the rules for income and deductions in respect of a decedent, indicate on which return each item should be reported: Dora’s income tax return (Form 1040), the estate’s first income tax return (Form 1041), or the estate’s estate tax return (Form 706). More than one alternative may apply in some cases.

Item Incurred	Form(s) Reported on
a. Wages, last paycheck	_____
b. State income tax withheld on last paycheck	_____
c. Capital gain portion of installment payment received	_____
d. Ordinary income portion of installment payment received	_____
e. Dividend income, record date was two days prior to José’s death	_____
f. Unrealized appreciation on a mutual fund investment	_____
g. Depreciation recapture accrued as of date of death	_____
h. Medical expenses of last illness	_____
i. Apartment building, rents accrued but not collected as of death	_____
j. Apartment building, property tax accrued and assessed but not paid as of death	_____

26. **LO.3** Determine the tax effects of the indicated losses for the Yellow Estate for both tax years. The estate holds a variety of investment assets, which it received from the decedent, Mrs. Yellow. The estate’s sole income and remainder beneficiary is Yellow, Jr. All taxpayers use a calendar tax year.

Tax Year	Loss Generated
2016 (first tax year)	Taxable income (\$300) Capital loss (\$12,000)
2017 (final tax year)	Taxable income, all classified as ordinary (\$20,000)

See Appendix E for Comprehensive Tax Return Problem—Form 1041

Research Problems

THOMSON REUTERS

CHECKPOINT
 Student Edition

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Communications

Research Problem 1. Grinder Ltd. is an S corporation that is wholly owned by Juan Plowright. Because several of Juan's ancestors have had Alzheimer's disease, Juan is transferring many of his assets to trusts, and he is funding living wills in anticipation of future medical issues.

Juan wants to transfer his Grinder stock to a trust, but he wants to keep control over its operations for as long as possible. Thus, he wants to retain a right to revoke the trust, until such time as the trustee (a Grinder executive who is on good terms with Juan) and a medical professional determine that Juan no longer is competent. You have explained to Juan that this entity is a grantor trust and that there are no income-shifting or transfer-tax-saving aspects in using such a trust.

The pertinent tax issues to be addressed are summarized below.

- Does the grantor trust terminate Grinder's status as an S corporation?
- Will Grinder's S election survive Juan's death? Under the terms of Juan's will, the S shares will be held by his estate and not be distributed to his niece Beatriz until she reaches age 25.

All parties are residents of New Mexico. Cite and summarize your findings in an outline for a talk that you will deliver next week to your school's Accounting Club.

Research Problem 2. For three generations, the Dexter family has sent its children to Private University, preparing them for successful professional careers. The Edna Dexter Trust was established in the 1950s by LaKeisha's late grandmother and has accumulated a sizable corpus. It makes distributions to Edna's descendants rarely, and then only when they need large capital amounts. For example, two years ago, the trust distributed \$500,000 to DuJuan Dexter to aid him in starting a practice in retirement and elder law. In most years, the trust's income is donated to a single charity.

Under the terms of the trust, Bigby Dexter, LaKeisha's uncle and legal guardian, can specify the trust beneficiaries and the amounts to be distributed to them. He also can replace the trustee and designate the charity that will receive the year's contribution. Accordingly, the trust falls under the grantor trust rules of § 678, and Bigby reports the trust's transactions on his own Form 1040.

LaKeisha wants to attend the prestigious local Academy High School, which will require a four-year expenditure for tuition and fees of \$100,000, payable in advance. She approaches the Edna Dexter trustee and requests a current-year distribution of this amount, payable directly to the Academy. Under the laws of the state, the parent or guardian has the responsibility to provide a child with a public school education (no tuition charge) until age 16.

If the payment to the Academy is made, how is it treated under the Subchapter J rules: as a charitable contribution to the Academy, as a corpus distribution to LaKeisha, or in some other manner?

Internet Activity



Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Communications

Research Problem 3. How many estates filed a Form 1041 last year? Simple trusts? Complex trusts? Grantor trusts? How much Federal income tax has been collected on Forms 1041 over the last three tax years? Summarize your findings in a series of graphs to share with your classmates.

Research Problem 4. Under the income tax laws of your state applicable to fiduciaries, how are the following items allocated among the entity and the beneficiaries? Put your findings in a PowerPoint presentation for your classmates.

- Capital gain.
- Cost recovery.
- Fiduciary fees.
- Exempt interest income.
- AMT adjustments.
- General business credits.

Communications

Research Problem 5. Create no more than three PowerPoint slides, summarizing your state's definitions of and rules for using the following terms. *Hint:* Your state might not use these terms at all, or it might use a term that differs slightly; so make sure your Internet research is broad enough to find the equivalent terminology.

- Living will.
- Living trust.
- Health care power of attorney.
- Durable power of attorney.

Communications

Roger CPA Review Questions

1. On February 14, 20X5 Charlie Crooker created Charlie's Trust for the benefit of his children. During 20X5, the assets within the trust earned income of \$12,000. What is the amount of the *standard deduction* available to Charlie's Trust when filing its fiduciary income tax return?
 - a. \$600
 - b. \$300
 - c. \$100
 - d. \$0
2. Don Donovan, a U.S. citizen, died on April 1, 20X5. In computing the estate taxable income for 20X5, the executor of Don Donovan's estate could claim a charitable contribution deduction if which of the following is (are) true?
 - I. The recipient of the charitable contribution is a qualified charitable organization
 - II. Don Donovan's will specifically provided for the contribution
 - III. Charitable contributions must be paid from amounts included in the estate's gross income from the year of contribution or from funds permanently set aside for such contributions
 - a. All of the above
 - b. I and II, but not III
 - c. II and III, but not I
 - d. II only
3. Patrick, a cash-basis taxpayer, died on February 3, 20X4. In 20X4, the estate executor made cash distributions of \$1,500 to Patrick's brother, the sole heir of the estate. The following is additional information related to Patrick's estate.

20X4 Estate Income

\$7,500 Taxable rental income
\$8,000 Taxable interest

20X4 Estate Disbursements

\$2,500 Charitable contributions from gross income to a public charity, made under the terms of the will

For the 20X4 calendar year, what was the estate's distributable net income (DNI)?

- a. \$15,500
- b. \$13,000
- c. \$11,500
- d. \$5,000



Appendix A

Tax Rate Schedules and Tables

[The 2015 Tax Table and 2015 Sales Tax Tables can be accessed at the IRS website:
(www.irs.gov) when released.]

2014	Income Tax Rate Schedules	A-2
2015	Income Tax Rate Schedules	A-2
2014	Tax Table	A-3
2014	Optional Sales Tax Tables	A-15
	Income Tax Rates—Estates and Trusts	A-22
	Income Tax Rates—Corporations	A-22
	Unified Transfer Tax Rates (For Gifts Made and for Deaths in 2007–2009)	A-23
	Gift Tax Rates (For Gifts Made Only in 2010)	A-23
	Unified Transfer Tax Rates (For Gifts Made and for Deaths in 2011–2012)	A-24
	Unified Transfer Tax Rates (For Gifts Made and for Deaths after 2012)	A-24

2014 Tax Rate Schedules

Single—Schedule X				Head of household—Schedule Z			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 9,075	.....10%	\$ 0	\$ 0	\$ 12,950	.....10%	\$ 0
9,075	36,900	\$ 907.50 + 15%	9,075	12,950	49,400	\$ 1,295.00 + 15%	12,950
36,900	89,350	5,081.25 + 25%	36,900	49,400	127,550	6,762.50 + 25%	49,400
89,350	186,350	18,193.75 + 28%	89,350	127,550	206,600	26,300.00 + 28%	127,550
186,350	405,100	45,353.75 + 33%	186,350	206,600	405,100	48,434.00 + 33%	206,600
405,100	406,750	117,541.25 + 35%	405,100	405,100	432,200	113,939.00 + 35%	405,100
406,750	.....	118,118.75 + 39.6%	406,750	432,200	.....	123,424.00 + 39.6%	432,200
Married filing jointly or Qualifying widow(er)—Schedule Y-1				Married filing separately—Schedule Y-2			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 18,150	.....10%	\$ 0	\$ 0	\$ 9,075	.....10%	\$ 0
18,150	73,800	\$ 1,815.00 + 15%	18,150	9,075	36,900	\$ 907.50 + 15%	9,075
73,800	148,850	10,162.50 + 25%	73,800	36,900	74,425	5,081.25 + 25%	36,900
148,850	226,850	28,925.00 + 28%	148,850	74,425	113,425	14,462.50 + 28%	74,425
226,850	405,100	50,765.00 + 33%	226,850	113,425	202,550	25,382.50 + 33%	113,425
405,100	457,600	109,587.50 + 35%	405,100	202,550	228,800	54,793.75 + 35%	202,550
457,600	.....	127,962.50 + 39.6%	457,600	228,800	.....	63,981.25 + 39.6%	228,800

2015 Tax Rate Schedules

Single—Schedule X				Head of household—Schedule Z			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 9,225	.....10%	\$ 0	\$ 0	\$ 13,150	.....10%	\$ 0
9,225	37,450	\$ 922.50 + 15%	9,225	13,150	50,200	\$ 1,315.00 + 15%	13,150
37,450	90,750	5,156.25 + 25%	37,450	50,200	129,600	6,872.50 + 25%	50,200
90,750	189,300	18,481.25 + 28%	90,750	129,600	209,850	26,722.50 + 28%	129,600
189,300	411,500	46,075.25 + 33%	189,300	209,850	411,500	49,192.50 + 33%	209,850
411,500	413,200	119,401.25 + 35%	411,500	411,500	439,000	115,737.00 + 35%	411,500
413,200	.....	119,996.25 + 39.6%	413,200	439,000	.....	125,362.00 + 39.6%	439,000
Married filing jointly or Qualifying widow(er)—Schedule Y-1				Married filing separately—Schedule Y-2			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 18,450	.....10%	\$ 0	\$ 0	\$ 9,225	.....10%	\$ 0
18,450	74,900	\$ 1,845.00 + 15%	18,450	9,225	37,450	\$ 922.50 + 15%	9,225
74,900	151,200	10,312.50 + 25%	74,900	37,450	75,600	5,156.25 + 25%	37,450
151,200	230,450	29,387.50 + 28%	151,200	75,600	115,225	14,693.75 + 28%	75,600
230,450	411,500	51,577.50 + 33%	230,450	115,225	205,750	25,788.75 + 33%	115,225
411,500	464,850	111,324.00 + 35%	411,500	205,750	232,425	55,662.00 + 35%	205,750
464,850	.....	129,996.50 + 39.6%	464,850	232,425	.....	64,998.25 + 39.6%	232,425

2014 Tax Table



See the instructions for line 44 to see if you must use the Tax Table below to figure your tax.

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on Form 1040, line 43, is \$25,300. First, they find the \$25,300-25,350 taxable income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the taxable income line and filing status column meet is \$2,891. This is the tax amount they should enter on Form 1040, line 44.

Sample Table

At Least	But Less Than	Single	Married filing jointly*	Married filing separately	Head of a household
Your tax is—					
25,200	25,250	3,330	2,876	3,330	3,136
25,250	25,300	3,338	2,884	3,338	3,144
25,300	25,350	3,345	2,891	3,345	3,151
25,350	25,400	3,353	2,899	3,353	3,159

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
0	5	0	0	0	0	1,000						2,000					
5	15	1	1	1	1	1,000	1,025	101	101	101	101	2,000	2,025	201	201	201	201
15	25	2	2	2	2	1,025	1,050	104	104	104	104	2,025	2,050	204	204	204	204
25	50	4	4	4	4	1,050	1,075	106	106	106	106	2,050	2,075	206	206	206	206
50	75	6	6	6	6	1,075	1,100	109	109	109	109	2,075	2,100	209	209	209	209
						1,100	1,125	111	111	111	111	2,100	2,125	211	211	211	211
75	100	9	9	9	9	1,125	1,150	114	114	114	114	2,125	2,150	214	214	214	214
100	125	11	11	11	11	1,150	1,175	116	116	116	116	2,150	2,175	216	216	216	216
125	150	14	14	14	14	1,175	1,200	119	119	119	119	2,175	2,200	219	219	219	219
150	175	16	16	16	16	1,200	1,225	121	121	121	121	2,200	2,225	221	221	221	221
175	200	19	19	19	19	1,225	1,250	124	124	124	124	2,225	2,250	224	224	224	224
200	225	21	21	21	21	1,250	1,275	126	126	126	126	2,250	2,275	226	226	226	226
225	250	24	24	24	24	1,275	1,300	129	129	129	129	2,275	2,300	229	229	229	229
250	275	26	26	26	26	1,300	1,325	131	131	131	131	2,300	2,325	231	231	231	231
275	300	29	29	29	29	1,325	1,350	134	134	134	134	2,325	2,350	234	234	234	234
300	325	31	31	31	31	1,350	1,375	136	136	136	136	2,350	2,375	236	236	236	236
325	350	34	34	34	34	1,375	1,400	139	139	139	139	2,375	2,400	239	239	239	239
350	375	36	36	36	36	1,400	1,425	141	141	141	141	2,400	2,425	241	241	241	241
375	400	39	39	39	39	1,425	1,450	144	144	144	144	2,425	2,450	244	244	244	244
400	425	41	41	41	41	1,450	1,475	146	146	146	146	2,450	2,475	246	246	246	246
425	450	44	44	44	44	1,475	1,500	149	149	149	149	2,475	2,500	249	249	249	249
450	475	46	46	46	46	1,500	1,525	151	151	151	151	2,500	2,525	251	251	251	251
475	500	49	49	49	49	1,525	1,550	154	154	154	154	2,525	2,550	254	254	254	254
500	525	51	51	51	51	1,550	1,575	156	156	156	156	2,550	2,575	256	256	256	256
525	550	54	54	54	54	1,575	1,600	159	159	159	159	2,575	2,600	259	259	259	259
550	575	56	56	56	56	1,600	1,625	161	161	161	161	2,600	2,625	261	261	261	261
575	600	59	59	59	59	1,625	1,650	164	164	164	164	2,625	2,650	264	264	264	264
600	625	61	61	61	61	1,650	1,675	166	166	166	166	2,650	2,675	266	266	266	266
625	650	64	64	64	64	1,675	1,700	169	169	169	169	2,675	2,700	269	269	269	269
650	675	66	66	66	66	1,700	1,725	171	171	171	171	2,700	2,725	271	271	271	271
675	700	69	69	69	69	1,725	1,750	174	174	174	174	2,725	2,750	274	274	274	274
700	725	71	71	71	71	1,750	1,775	176	176	176	176	2,750	2,775	276	276	276	276
725	750	74	74	74	74	1,775	1,800	179	179	179	179	2,775	2,800	279	279	279	279
750	775	76	76	76	76	1,800	1,825	181	181	181	181	2,800	2,825	281	281	281	281
775	800	79	79	79	79	1,825	1,850	184	184	184	184	2,825	2,850	284	284	284	284
800	825	81	81	81	81	1,850	1,875	186	186	186	186	2,850	2,875	286	286	286	286
825	850	84	84	84	84	1,875	1,900	189	189	189	189	2,875	2,900	289	289	289	289
850	875	86	86	86	86	1,900	1,925	191	191	191	191	2,900	2,925	291	291	291	291
875	900	89	89	89	89	1,925	1,950	194	194	194	194	2,925	2,950	294	294	294	294
900	925	91	91	91	91	1,950	1,975	196	196	196	196	2,950	2,975	296	296	296	296
925	950	94	94	94	94	1,975	2,000	199	199	199	199	2,975	3,000	299	299	299	299

* This column must also be used by a qualifying widow(er).

(Continued)

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
3,000						6,000						9,000					
3,000	3,050	303	303	303	303	6,000	6,050	603	603	603	603	9,000	9,050	903	903	903	903
3,050	3,100	308	308	308	308	6,050	6,100	608	608	608	608	9,050	9,100	908	908	908	908
3,100	3,150	313	313	313	313	6,100	6,150	613	613	613	613	9,100	9,150	915	915	915	915
3,150	3,200	318	318	318	318	6,150	6,200	618	618	618	618	9,150	9,200	923	918	923	918
3,200	3,250	323	323	323	323	6,200	6,250	623	623	623	623	9,200	9,250	930	923	930	923
3,250	3,300	328	328	328	328	6,250	6,300	628	628	628	628	9,250	9,300	938	928	938	928
3,300	3,350	333	333	333	333	6,300	6,350	633	633	633	633	9,300	9,350	945	933	945	933
3,350	3,400	338	338	338	338	6,350	6,400	638	638	638	638	9,350	9,400	953	938	953	938
3,400	3,450	343	343	343	343	6,400	6,450	643	643	643	643	9,400	9,450	960	943	960	943
3,450	3,500	348	348	348	348	6,450	6,500	648	648	648	648	9,450	9,500	968	948	968	948
3,500	3,550	353	353	353	353	6,500	6,550	653	653	653	653	9,500	9,550	975	953	975	953
3,550	3,600	358	358	358	358	6,550	6,600	658	658	658	658	9,550	9,600	983	958	983	958
3,600	3,650	363	363	363	363	6,600	6,650	663	663	663	663	9,600	9,650	990	963	990	963
3,650	3,700	368	368	368	368	6,650	6,700	668	668	668	668	9,650	9,700	998	968	998	968
3,700	3,750	373	373	373	373	6,700	6,750	673	673	673	673	9,700	9,750	1,005	973	1,005	973
3,750	3,800	378	378	378	378	6,750	6,800	678	678	678	678	9,750	9,800	1,013	978	1,013	978
3,800	3,850	383	383	383	383	6,800	6,850	683	683	683	683	9,800	9,850	1,020	983	1,020	983
3,850	3,900	388	388	388	388	6,850	6,900	688	688	688	688	9,850	9,900	1,028	988	1,028	988
3,900	3,950	393	393	393	393	6,900	6,950	693	693	693	693	9,900	9,950	1,035	993	1,035	993
3,950	4,000	398	398	398	398	6,950	7,000	698	698	698	698	9,950	10,000	1,043	998	1,043	998
4,000						7,000						10,000					
4,000	4,050	403	403	403	403	7,000	7,050	703	703	703	703	10,000	10,050	1,050	1,003	1,050	1,003
4,050	4,100	408	408	408	408	7,050	7,100	708	708	708	708	10,050	10,100	1,058	1,008	1,058	1,008
4,100	4,150	413	413	413	413	7,100	7,150	713	713	713	713	10,100	10,150	1,065	1,013	1,065	1,013
4,150	4,200	418	418	418	418	7,150	7,200	718	718	718	718	10,150	10,200	1,073	1,018	1,073	1,018
4,200	4,250	423	423	423	423	7,200	7,250	723	723	723	723	10,200	10,250	1,080	1,023	1,080	1,023
4,250	4,300	428	428	428	428	7,250	7,300	728	728	728	728	10,250	10,300	1,088	1,028	1,088	1,028
4,300	4,350	433	433	433	433	7,300	7,350	733	733	733	733	10,300	10,350	1,095	1,033	1,095	1,033
4,350	4,400	438	438	438	438	7,350	7,400	738	738	738	738	10,350	10,400	1,103	1,038	1,103	1,038
4,400	4,450	443	443	443	443	7,400	7,450	743	743	743	743	10,400	10,450	1,110	1,043	1,110	1,043
4,450	4,500	448	448	448	448	7,450	7,500	748	748	748	748	10,450	10,500	1,118	1,048	1,118	1,048
4,500	4,550	453	453	453	453	7,500	7,550	753	753	753	753	10,500	10,550	1,125	1,053	1,125	1,053
4,550	4,600	458	458	458	458	7,550	7,600	758	758	758	758	10,550	10,600	1,133	1,058	1,133	1,058
4,600	4,650	463	463	463	463	7,600	7,650	763	763	763	763	10,600	10,650	1,140	1,063	1,140	1,063
4,650	4,700	468	468	468	468	7,650	7,700	768	768	768	768	10,650	10,700	1,148	1,068	1,148	1,068
4,700	4,750	473	473	473	473	7,700	7,750	773	773	773	773	10,700	10,750	1,155	1,073	1,155	1,073
4,750	4,800	478	478	478	478	7,750	7,800	778	778	778	778	10,750	10,800	1,163	1,078	1,163	1,078
4,800	4,850	483	483	483	483	7,800	7,850	783	783	783	783	10,800	10,850	1,170	1,083	1,170	1,083
4,850	4,900	488	488	488	488	7,850	7,900	788	788	788	788	10,850	10,900	1,178	1,088	1,178	1,088
4,900	4,950	493	493	493	493	7,900	7,950	793	793	793	793	10,900	10,950	1,185	1,093	1,185	1,093
4,950	5,000	498	498	498	498	7,950	8,000	798	798	798	798	10,950	11,000	1,193	1,098	1,193	1,098
5,000						8,000						11,000					
5,000	5,050	503	503	503	503	8,000	8,050	803	803	803	803	11,000	11,050	1,200	1,103	1,200	1,103
5,050	5,100	508	508	508	508	8,050	8,100	808	808	808	808	11,050	11,100	1,208	1,108	1,208	1,108
5,100	5,150	513	513	513	513	8,100	8,150	813	813	813	813	11,100	11,150	1,215	1,113	1,215	1,113
5,150	5,200	518	518	518	518	8,150	8,200	818	818	818	818	11,150	11,200	1,223	1,118	1,223	1,118
5,200	5,250	523	523	523	523	8,200	8,250	823	823	823	823	11,200	11,250	1,230	1,123	1,230	1,123
5,250	5,300	528	528	528	528	8,250	8,300	828	828	828	828	11,250	11,300	1,238	1,128	1,238	1,128
5,300	5,350	533	533	533	533	8,300	8,350	833	833	833	833	11,300	11,350	1,245	1,133	1,245	1,133
5,350	5,400	538	538	538	538	8,350	8,400	838	838	838	838	11,350	11,400	1,253	1,138	1,253	1,138
5,400	5,450	543	543	543	543	8,400	8,450	843	843	843	843	11,400	11,450	1,260	1,143	1,260	1,143
5,450	5,500	548	548	548	548	8,450	8,500	848	848	848	848	11,450	11,500	1,268	1,148	1,268	1,148
5,500	5,550	553	553	553	553	8,500	8,550	853	853	853	853	11,500	11,550	1,275	1,153	1,275	1,153
5,550	5,600	558	558	558	558	8,550	8,600	858	858	858	858	11,550	11,600	1,283	1,158	1,283	1,158
5,600	5,650	563	563	563	563	8,600	8,650	863	863	863	863	11,600	11,650	1,290	1,163	1,290	1,163
5,650	5,700	568	568	568	568	8,650	8,700	868	868	868	868	11,650	11,700	1,298	1,168	1,298	1,168
5,700	5,750	573	573	573	573	8,700	8,750	873	873	873	873	11,700	11,750	1,305	1,173	1,305	1,173
5,750	5,800	578	578	578	578	8,750	8,800	878	878	878	878	11,750	11,800	1,313	1,178	1,313	1,178
5,800	5,850	583	583	583	583	8,800	8,850	883	883	883	883	11,800	11,850	1,320	1,183	1,320	1,183
5,850	5,900	588	588	588	588	8,850	8,900	888	888	888	888	11,850	11,900	1,328	1,188	1,328	1,188
5,900	5,950	593	593	593	593	8,900	8,950	893	893	893	893	11,900	11,950	1,335	1,193	1,335	1,193
5,950	6,000	598	598	598	598	8,950	9,000	898	898	898	898	11,950	12,000	1,343	1,198	1,343	1,198

* This column must also be used by a qualifying widow(er).

(Continued)

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
12,000						15,000						18,000					
12,000	12,050	1,350	1,203	1,350	1,203	15,000	15,050	1,800	1,503	1,800	1,606	18,000	18,050	2,250	1,803	2,250	2,056
12,050	12,100	1,358	1,208	1,358	1,208	15,050	15,100	1,808	1,508	1,808	1,614	18,050	18,100	2,258	1,808	2,258	2,064
12,100	12,150	1,365	1,213	1,365	1,213	15,100	15,150	1,815	1,513	1,815	1,621	18,100	18,150	2,265	1,813	2,265	2,071
12,150	12,200	1,373	1,218	1,373	1,218	15,150	15,200	1,823	1,518	1,823	1,629	18,150	18,200	2,273	1,819	2,273	2,079
12,200	12,250	1,380	1,223	1,380	1,223	15,200	15,250	1,830	1,523	1,830	1,636	18,200	18,250	2,280	1,826	2,280	2,086
12,250	12,300	1,388	1,228	1,388	1,228	15,250	15,300	1,838	1,528	1,838	1,644	18,250	18,300	2,288	1,834	2,288	2,094
12,300	12,350	1,395	1,233	1,395	1,233	15,300	15,350	1,845	1,533	1,845	1,651	18,300	18,350	2,295	1,841	2,295	2,101
12,350	12,400	1,403	1,238	1,403	1,238	15,350	15,400	1,853	1,538	1,853	1,659	18,350	18,400	2,303	1,849	2,303	2,109
12,400	12,450	1,410	1,243	1,410	1,243	15,400	15,450	1,860	1,543	1,860	1,666	18,400	18,450	2,310	1,856	2,310	2,116
12,450	12,500	1,418	1,248	1,418	1,248	15,450	15,500	1,868	1,548	1,868	1,674	18,450	18,500	2,318	1,864	2,318	2,124
12,500	12,550	1,425	1,253	1,425	1,253	15,500	15,550	1,875	1,553	1,875	1,681	18,500	18,550	2,325	1,871	2,325	2,131
12,550	12,600	1,433	1,258	1,433	1,258	15,550	15,600	1,883	1,558	1,883	1,689	18,550	18,600	2,333	1,879	2,333	2,139
12,600	12,650	1,440	1,263	1,440	1,263	15,600	15,650	1,890	1,563	1,890	1,696	18,600	18,650	2,340	1,886	2,340	2,146
12,650	12,700	1,448	1,268	1,448	1,268	15,650	15,700	1,898	1,568	1,898	1,704	18,650	18,700	2,348	1,894	2,348	2,154
12,700	12,750	1,455	1,273	1,455	1,273	15,700	15,750	1,905	1,573	1,905	1,711	18,700	18,750	2,355	1,901	2,355	2,161
12,750	12,800	1,463	1,278	1,463	1,278	15,750	15,800	1,913	1,578	1,913	1,719	18,750	18,800	2,363	1,909	2,363	2,169
12,800	12,850	1,470	1,283	1,470	1,283	15,800	15,850	1,920	1,583	1,920	1,726	18,800	18,850	2,370	1,916	2,370	2,176
12,850	12,900	1,478	1,288	1,478	1,288	15,850	15,900	1,928	1,588	1,928	1,734	18,850	18,900	2,378	1,924	2,378	2,184
12,900	12,950	1,485	1,293	1,485	1,293	15,900	15,950	1,935	1,593	1,935	1,741	18,900	18,950	2,385	1,931	2,385	2,191
12,950	13,000	1,493	1,298	1,493	1,299	15,950	16,000	1,943	1,598	1,943	1,749	18,950	19,000	2,393	1,939	2,393	2,199
13,000						16,000						19,000					
13,000	13,050	1,500	1,303	1,500	1,306	16,000	16,050	1,950	1,603	1,950	1,756	19,000	19,050	2,400	1,946	2,400	2,206
13,050	13,100	1,508	1,308	1,508	1,314	16,050	16,100	1,958	1,608	1,958	1,764	19,050	19,100	2,408	1,954	2,408	2,214
13,100	13,150	1,515	1,313	1,515	1,321	16,100	16,150	1,965	1,613	1,965	1,771	19,100	19,150	2,415	1,961	2,415	2,221
13,150	13,200	1,523	1,318	1,523	1,329	16,150	16,200	1,973	1,618	1,973	1,779	19,150	19,200	2,423	1,969	2,423	2,229
13,200	13,250	1,530	1,323	1,530	1,336	16,200	16,250	1,980	1,623	1,980	1,786	19,200	19,250	2,430	1,976	2,430	2,236
13,250	13,300	1,538	1,328	1,538	1,344	16,250	16,300	1,988	1,628	1,988	1,794	19,250	19,300	2,438	1,984	2,438	2,244
13,300	13,350	1,545	1,333	1,545	1,351	16,300	16,350	1,995	1,633	1,995	1,801	19,300	19,350	2,445	1,991	2,445	2,251
13,350	13,400	1,553	1,338	1,553	1,359	16,350	16,400	2,003	1,638	2,003	1,809	19,350	19,400	2,453	1,999	2,453	2,259
13,400	13,450	1,560	1,343	1,560	1,366	16,400	16,450	2,010	1,643	2,010	1,816	19,400	19,450	2,460	2,006	2,460	2,266
13,450	13,500	1,568	1,348	1,568	1,374	16,450	16,500	2,018	1,648	2,018	1,824	19,450	19,500	2,468	2,014	2,468	2,274
13,500	13,550	1,575	1,353	1,575	1,381	16,500	16,550	2,025	1,653	2,025	1,831	19,500	19,550	2,475	2,021	2,475	2,281
13,550	13,600	1,583	1,358	1,583	1,389	16,550	16,600	2,033	1,658	2,033	1,839	19,550	19,600	2,483	2,029	2,483	2,289
13,600	13,650	1,590	1,363	1,590	1,396	16,600	16,650	2,040	1,663	2,040	1,846	19,600	19,650	2,490	2,036	2,490	2,296
13,650	13,700	1,598	1,368	1,598	1,404	16,650	16,700	2,048	1,668	2,048	1,854	19,650	19,700	2,498	2,044	2,498	2,304
13,700	13,750	1,605	1,373	1,605	1,411	16,700	16,750	2,055	1,673	2,055	1,861	19,700	19,750	2,505	2,051	2,505	2,311
13,750	13,800	1,613	1,378	1,613	1,419	16,750	16,800	2,063	1,678	2,063	1,869	19,750	19,800	2,513	2,059	2,513	2,319
13,800	13,850	1,620	1,383	1,620	1,426	16,800	16,850	2,070	1,683	2,070	1,876	19,800	19,850	2,520	2,066	2,520	2,326
13,850	13,900	1,628	1,388	1,628	1,434	16,850	16,900	2,078	1,688	2,078	1,884	19,850	19,900	2,528	2,074	2,528	2,334
13,900	13,950	1,635	1,393	1,635	1,441	16,900	16,950	2,085	1,693	2,085	1,891	19,900	19,950	2,535	2,081	2,535	2,341
13,950	14,000	1,643	1,398	1,643	1,449	16,950	17,000	2,093	1,698	2,093	1,899	19,950	20,000	2,543	2,089	2,543	2,349
14,000						17,000						20,000					
14,000	14,050	1,650	1,403	1,650	1,456	17,000	17,050	2,100	1,703	2,100	1,906	20,000	20,050	2,550	2,096	2,550	2,356
14,050	14,100	1,658	1,408	1,658	1,464	17,050	17,100	2,108	1,708	2,108	1,914	20,050	20,100	2,558	2,104	2,558	2,364
14,100	14,150	1,665	1,413	1,665	1,471	17,100	17,150	2,115	1,713	2,115	1,921	20,100	20,150	2,565	2,111	2,565	2,371
14,150	14,200	1,673	1,418	1,673	1,479	17,150	17,200	2,123	1,718	2,123	1,929	20,150	20,200	2,573	2,119	2,573	2,379
14,200	14,250	1,680	1,423	1,680	1,486	17,200	17,250	2,130	1,723	2,130	1,936	20,200	20,250	2,580	2,126	2,580	2,386
14,250	14,300	1,688	1,428	1,688	1,494	17,250	17,300	2,138	1,728	2,138	1,944	20,250	20,300	2,588	2,134	2,588	2,394
14,300	14,350	1,695	1,433	1,695	1,501	17,300	17,350	2,145	1,733	2,145	1,951	20,300	20,350	2,595	2,141	2,595	2,401
14,350	14,400	1,703	1,438	1,703	1,509	17,350	17,400	2,153	1,738	2,153	1,959	20,350	20,400	2,603	2,149	2,603	2,409
14,400	14,450	1,710	1,443	1,710	1,516	17,400	17,450	2,160	1,743	2,160	1,966	20,400	20,450	2,610	2,156	2,610	2,416
14,450	14,500	1,718	1,448	1,718	1,524	17,450	17,500	2,168	1,748	2,168	1,974	20,450	20,500	2,618	2,164	2,618	2,424
14,500	14,550	1,725	1,453	1,725	1,531	17,500	17,550	2,175	1,753	2,175	1,981	20,500	20,550	2,625	2,171	2,625	2,431
14,550	14,600	1,733	1,458	1,733	1,539	17,550	17,600	2,183	1,758	2,183	1,989	20,550	20,600	2,633	2,179	2,633	2,439
14,600	14,650	1,740	1,463	1,740	1,546	17,600	17,650	2,190	1,763	2,190	1,996	20,600	20,650	2,640	2,186	2,640	2,446
14,650	14,700	1,748	1,468	1,748	1,554	17,650	17,700	2,198	1,768	2,198	2,004	20,650	20,700	2,648	2,194	2,648	2,454
14,700	14,750	1,755	1,473	1,755	1,561	17,700	17,750	2,205	1,773	2,205	2,011	20,700	20,750	2,655	2,201	2,655	2,461
14,750	14,800	1,763	1,478	1,763	1,569	17,750	17,800	2,213	1,778	2,213	2,019	20,750	20,800	2,663	2,209	2,663	2,469
14,800	14,850	1,770	1,483	1,770	1,576	17,800	17,850	2,220	1,783	2,220	2,026	20,800	20,850	2,670	2,216	2,670	2,476
14,850	14,900	1,778	1,488	1,778	1,584	17,850	17,900	2,228	1,788	2,228	2,034	20,850	20,900	2,678	2,224	2,678	2,484
14,900	14,950	1,785	1,493	1,785	1,591	17,900	17,950	2,235	1,793	2,235	2,041	20,900	20,950	2,685	2,231	2,685	2,491
14,950	15,000	1,793	1,498	1,793	1,599	17,950	18,000	2,243	1,								

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
21,000						24,000						27,000					
21,000	21,050	2,700	2,246	2,700	2,506	24,000	24,050	3,150	2,696	3,150	2,956	27,000	27,050	3,600	3,146	3,600	3,406
21,050	21,100	2,708	2,254	2,708	2,514	24,050	24,100	3,158	2,704	3,158	2,964	27,050	27,100	3,608	3,154	3,608	3,414
21,100	21,150	2,715	2,261	2,715	2,521	24,100	24,150	3,165	2,711	3,165	2,971	27,100	27,150	3,615	3,161	3,615	3,421
21,150	21,200	2,723	2,269	2,723	2,529	24,150	24,200	3,173	2,719	3,173	2,979	27,150	27,200	3,623	3,169	3,623	3,429
21,200	21,250	2,730	2,276	2,730	2,536	24,200	24,250	3,180	2,726	3,180	2,986	27,200	27,250	3,630	3,176	3,630	3,436
21,250	21,300	2,738	2,284	2,738	2,544	24,250	24,300	3,188	2,734	3,188	2,994	27,250	27,300	3,638	3,184	3,638	3,444
21,300	21,350	2,745	2,291	2,745	2,551	24,300	24,350	3,195	2,741	3,195	3,001	27,300	27,350	3,645	3,191	3,645	3,451
21,350	21,400	2,753	2,299	2,753	2,559	24,350	24,400	3,203	2,749	3,203	3,009	27,350	27,400	3,653	3,199	3,653	3,459
21,400	21,450	2,760	2,306	2,760	2,566	24,400	24,450	3,210	2,756	3,210	3,016	27,400	27,450	3,660	3,206	3,660	3,466
21,450	21,500	2,768	2,314	2,768	2,574	24,450	24,500	3,218	2,764	3,218	3,024	27,450	27,500	3,668	3,214	3,668	3,474
21,500	21,550	2,775	2,321	2,775	2,581	24,500	24,550	3,225	2,771	3,225	3,031	27,500	27,550	3,675	3,221	3,675	3,481
21,550	21,600	2,783	2,329	2,783	2,589	24,550	24,600	3,233	2,779	3,233	3,039	27,550	27,600	3,683	3,229	3,683	3,489
21,600	21,650	2,790	2,336	2,790	2,596	24,600	24,650	3,240	2,786	3,240	3,046	27,600	27,650	3,690	3,236	3,690	3,496
21,650	21,700	2,798	2,344	2,798	2,604	24,650	24,700	3,248	2,794	3,248	3,054	27,650	27,700	3,698	3,244	3,698	3,504
21,700	21,750	2,805	2,351	2,805	2,611	24,700	24,750	3,255	2,801	3,255	3,061	27,700	27,750	3,705	3,251	3,705	3,511
21,750	21,800	2,813	2,359	2,813	2,619	24,750	24,800	3,263	2,809	3,263	3,069	27,750	27,800	3,713	3,259	3,713	3,519
21,800	21,850	2,820	2,366	2,820	2,626	24,800	24,850	3,270	2,816	3,270	3,076	27,800	27,850	3,720	3,266	3,720	3,526
21,850	21,900	2,828	2,374	2,828	2,634	24,850	24,900	3,278	2,824	3,278	3,084	27,850	27,900	3,728	3,274	3,728	3,534
21,900	21,950	2,835	2,381	2,835	2,641	24,900	24,950	3,285	2,831	3,285	3,091	27,900	27,950	3,735	3,281	3,735	3,541
21,950	22,000	2,843	2,389	2,843	2,649	24,950	25,000	3,293	2,839	3,293	3,099	27,950	28,000	3,743	3,289	3,743	3,549
22,000						25,000						28,000					
22,000	22,050	2,850	2,396	2,850	2,656	25,000	25,050	3,300	2,846	3,300	3,106	28,000	28,050	3,750	3,296	3,750	3,556
22,050	22,100	2,858	2,404	2,858	2,664	25,050	25,100	3,308	2,854	3,308	3,114	28,050	28,100	3,758	3,304	3,758	3,564
22,100	22,150	2,865	2,411	2,865	2,671	25,100	25,150	3,315	2,861	3,315	3,121	28,100	28,150	3,765	3,311	3,765	3,571
22,150	22,200	2,873	2,419	2,873	2,679	25,150	25,200	3,323	2,869	3,323	3,129	28,150	28,200	3,773	3,319	3,773	3,579
22,200	22,250	2,880	2,426	2,880	2,686	25,200	25,250	3,330	2,876	3,330	3,136	28,200	28,250	3,780	3,326	3,780	3,586
22,250	22,300	2,888	2,434	2,888	2,694	25,250	25,300	3,338	2,884	3,338	3,144	28,250	28,300	3,788	3,334	3,788	3,594
22,300	22,350	2,895	2,441	2,895	2,701	25,300	25,350	3,345	2,891	3,345	3,151	28,300	28,350	3,795	3,341	3,795	3,601
22,350	22,400	2,903	2,449	2,903	2,709	25,350	25,400	3,353	2,899	3,353	3,159	28,350	28,400	3,803	3,349	3,803	3,609
22,400	22,450	2,910	2,456	2,910	2,716	25,400	25,450	3,360	2,906	3,360	3,166	28,400	28,450	3,810	3,356	3,810	3,616
22,450	22,500	2,918	2,464	2,918	2,724	25,450	25,500	3,368	2,914	3,368	3,174	28,450	28,500	3,818	3,364	3,818	3,624
22,500	22,550	2,925	2,471	2,925	2,731	25,500	25,550	3,375	2,921	3,375	3,181	28,500	28,550	3,825	3,371	3,825	3,631
22,550	22,600	2,933	2,479	2,933	2,739	25,550	25,600	3,383	2,929	3,383	3,189	28,550	28,600	3,833	3,379	3,833	3,639
22,600	22,650	2,940	2,486	2,940	2,746	25,600	25,650	3,390	2,936	3,390	3,196	28,600	28,650	3,840	3,386	3,840	3,646
22,650	22,700	2,948	2,494	2,948	2,754	25,650	25,700	3,398	2,944	3,398	3,204	28,650	28,700	3,848	3,394	3,848	3,654
22,700	22,750	2,955	2,501	2,955	2,761	25,700	25,750	3,405	2,951	3,405	3,211	28,700	28,750	3,855	3,401	3,855	3,661
22,750	22,800	2,963	2,509	2,963	2,769	25,750	25,800	3,413	2,959	3,413	3,219	28,750	28,800	3,863	3,409	3,863	3,669
22,800	22,850	2,970	2,516	2,970	2,776	25,800	25,850	3,420	2,966	3,420	3,226	28,800	28,850	3,870	3,416	3,870	3,676
22,850	22,900	2,978	2,524	2,978	2,784	25,850	25,900	3,428	2,974	3,428	3,234	28,850	28,900	3,878	3,424	3,878	3,684
22,900	22,950	2,985	2,531	2,985	2,791	25,900	25,950	3,435	2,981	3,435	3,241	28,900	28,950	3,885	3,431	3,885	3,691
22,950	23,000	2,993	2,539	2,993	2,799	25,950	26,000	3,443	2,989	3,443	3,249	28,950	29,000	3,893	3,439	3,893	3,699
23,000						26,000						29,000					
23,000	23,050	3,000	2,546	3,000	2,806	26,000	26,050	3,450	2,996	3,450	3,256	29,000	29,050	3,900	3,446	3,900	3,706
23,050	23,100	3,008	2,554	3,008	2,814	26,050	26,100	3,458	3,004	3,458	3,264	29,050	29,100	3,908	3,454	3,908	3,714
23,100	23,150	3,015	2,561	3,015	2,821	26,100	26,150	3,465	3,011	3,465	3,271	29,100	29,150	3,915	3,461	3,915	3,721
23,150	23,200	3,023	2,569	3,023	2,829	26,150	26,200	3,473	3,019	3,473	3,279	29,150	29,200	3,923	3,469	3,923	3,729
23,200	23,250	3,030	2,576	3,030	2,836	26,200	26,250	3,480	3,026	3,480	3,286	29,200	29,250	3,930	3,476	3,930	3,736
23,250	23,300	3,038	2,584	3,038	2,844	26,250	26,300	3,488	3,034	3,488	3,294	29,250	29,300	3,938	3,484	3,938	3,744
23,300	23,350	3,045	2,591	3,045	2,851	26,300	26,350	3,495	3,041	3,495	3,301	29,300	29,350	3,945	3,491	3,945	3,751
23,350	23,400	3,053	2,599	3,053	2,859	26,350	26,400	3,503	3,049	3,503	3,309	29,350	29,400	3,953	3,499	3,953	3,759
23,400	23,450	3,060	2,606	3,060	2,866	26,400	26,450	3,510	3,056	3,510	3,316	29,400	29,450	3,960	3,506	3,960	3,766
23,450	23,500	3,068	2,614	3,068	2,874	26,450	26,500	3,518	3,064	3,518	3,324	29,450	29,500	3,968	3,514	3,968	3,774
23,500	23,550	3,075	2,621	3,075	2,881	26,500	26,550	3,525	3,071	3,525	3,331	29,500	29,550	3,975	3,521	3,975	3,781
23,550	23,600	3,083	2,629	3,083	2,889	26,550	26,600	3,533	3,079	3,533	3,339	29,550	29,600	3,983	3,529	3,983	3,789
23,600	23,650	3,090	2,636	3,090	2,896	26,600	26,650	3,540	3,086	3,540	3,346	29,600	29,650	3,990	3,536	3,990	3,796
23,650	23,700	3,098	2,644	3,098	2,904	26,650	26,700	3,548	3,094	3,548	3,354	29,650	29,700	3,998	3,544	3,998	3,804
23,700	23,750	3,105	2,651	3,105	2,911	26,700	26,750	3,555	3,101	3,555	3,361	29,700	29,750	4,005	3,551	4,005	3,811
23,750	23,800	3,113	2,659	3,113	2,919	26,750	26,800	3,563	3,109	3,563	3,369	29,750	29,800	4,013	3,559	4,013	3,819
23,800	23,850	3,120	2,666	3,120	2,926	26,800	26,850	3,570	3,116	3,570	3,376	29,800	29,850	4,020	3,566	4,020	3,826
23,850	23,900	3,128	2,674	3,128	2,934	26,850	26,900	3,578	3,124	3,578	3,384	29,850	29,900	4,028	3,574	4,028	3,834
23,900	23,950	3,135	2,681	3,135	2,941	26,900	26,950	3,585	3,131	3,585	3,391	29,900	29,950	4,035	3,581	4,035	3,841
23,950	24,000	3,143	2,6														

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
30,000						33,000						36,000					
30,000	30,050	4,050	3,596	4,050	3,856	33,000	33,050	4,500	4,046	4,500	4,306	36,000	36,050	4,950	4,496	4,950	4,756
30,050	30,100	4,058	3,604	4,058	3,864	33,050	33,100	4,508	4,054	4,508	4,314	36,050	36,100	4,958	4,504	4,958	4,764
30,100	30,150	4,065	3,611	4,065	3,871	33,100	33,150	4,515	4,061	4,515	4,321	36,100	36,150	4,965	4,511	4,965	4,771
30,150	30,200	4,073	3,619	4,073	3,879	33,150	33,200	4,523	4,069	4,523	4,329	36,150	36,200	4,973	4,519	4,973	4,779
30,200	30,250	4,080	3,626	4,080	3,886	33,200	33,250	4,530	4,076	4,530	4,336	36,200	36,250	4,980	4,526	4,980	4,786
30,250	30,300	4,088	3,634	4,088	3,894	33,250	33,300	4,538	4,084	4,538	4,344	36,250	36,300	4,988	4,534	4,988	4,794
30,300	30,350	4,095	3,641	4,095	3,901	33,300	33,350	4,545	4,091	4,545	4,351	36,300	36,350	4,995	4,541	4,995	4,801
30,350	30,400	4,103	3,649	4,103	3,909	33,350	33,400	4,553	4,099	4,553	4,359	36,350	36,400	5,003	4,549	5,003	4,809
30,400	30,450	4,110	3,656	4,110	3,916	33,400	33,450	4,560	4,106	4,560	4,366	36,400	36,450	5,010	4,556	5,010	4,816
30,450	30,500	4,118	3,664	4,118	3,924	33,450	33,500	4,568	4,114	4,568	4,374	36,450	36,500	5,018	4,564	5,018	4,824
30,500	30,550	4,125	3,671	4,125	3,931	33,500	33,550	4,575	4,121	4,575	4,381	36,500	36,550	5,025	4,571	5,025	4,831
30,550	30,600	4,133	3,679	4,133	3,939	33,550	33,600	4,583	4,129	4,583	4,389	36,550	36,600	5,033	4,579	5,033	4,839
30,600	30,650	4,140	3,686	4,140	3,946	33,600	33,650	4,590	4,136	4,590	4,396	36,600	36,650	5,040	4,586	5,040	4,846
30,650	30,700	4,148	3,694	4,148	3,954	33,650	33,700	4,598	4,144	4,598	4,404	36,650	36,700	5,048	4,594	5,048	4,854
30,700	30,750	4,155	3,701	4,155	3,961	33,700	33,750	4,605	4,151	4,605	4,411	36,700	36,750	5,055	4,601	5,055	4,861
30,750	30,800	4,163	3,709	4,163	3,969	33,750	33,800	4,613	4,159	4,613	4,419	36,750	36,800	5,063	4,609	5,063	4,869
30,800	30,850	4,170	3,716	4,170	3,976	33,800	33,850	4,620	4,166	4,620	4,426	36,800	36,850	5,070	4,616	5,070	4,876
30,850	30,900	4,178	3,724	4,178	3,984	33,850	33,900	4,628	4,174	4,628	4,434	36,850	36,900	5,078	4,624	5,078	4,884
30,900	30,950	4,185	3,731	4,185	3,991	33,900	33,950	4,635	4,181	4,635	4,441	36,900	36,950	5,088	4,631	5,088	4,891
30,950	31,000	4,193	3,739	4,193	3,999	33,950	34,000	4,643	4,189	4,643	4,449	36,950	37,000	5,100	4,639	5,100	4,899
31,000						34,000						37,000					
31,000	31,050	4,200	3,746	4,200	4,006	34,000	34,050	4,650	4,196	4,650	4,456	37,000	37,050	5,113	4,646	5,113	4,906
31,050	31,100	4,208	3,754	4,208	4,014	34,050	34,100	4,658	4,204	4,658	4,464	37,050	37,100	5,125	4,654	5,125	4,914
31,100	31,150	4,215	3,761	4,215	4,021	34,100	34,150	4,665	4,211	4,665	4,471	37,100	37,150	5,138	4,661	5,138	4,921
31,150	31,200	4,223	3,769	4,223	4,029	34,150	34,200	4,673	4,219	4,673	4,479	37,150	37,200	5,150	4,669	5,150	4,929
31,200	31,250	4,230	3,776	4,230	4,036	34,200	34,250	4,680	4,226	4,680	4,486	37,200	37,250	5,163	4,676	5,163	4,936
31,250	31,300	4,238	3,784	4,238	4,044	34,250	34,300	4,688	4,234	4,688	4,494	37,250	37,300	5,175	4,684	5,175	4,944
31,300	31,350	4,245	3,791	4,245	4,051	34,300	34,350	4,695	4,241	4,695	4,501	37,300	37,350	5,188	4,691	5,188	4,951
31,350	31,400	4,253	3,799	4,253	4,059	34,350	34,400	4,703	4,249	4,703	4,509	37,350	37,400	5,200	4,699	5,200	4,959
31,400	31,450	4,260	3,806	4,260	4,066	34,400	34,450	4,710	4,256	4,710	4,516	37,400	37,450	5,213	4,706	5,213	4,966
31,450	31,500	4,268	3,814	4,268	4,074	34,450	34,500	4,718	4,264	4,718	4,524	37,450	37,500	5,225	4,714	5,225	4,974
31,500	31,550	4,275	3,821	4,275	4,081	34,500	34,550	4,725	4,271	4,725	4,531	37,500	37,550	5,238	4,721	5,238	4,981
31,550	31,600	4,283	3,829	4,283	4,089	34,550	34,600	4,733	4,279	4,733	4,539	37,550	37,600	5,250	4,729	5,250	4,989
31,600	31,650	4,290	3,836	4,290	4,096	34,600	34,650	4,740	4,286	4,740	4,546	37,600	37,650	5,263	4,736	5,263	4,996
31,650	31,700	4,298	3,844	4,298	4,104	34,650	34,700	4,748	4,294	4,748	4,554	37,650	37,700	5,275	4,744	5,275	5,004
31,700	31,750	4,305	3,851	4,305	4,111	34,700	34,750	4,755	4,301	4,755	4,561	37,700	37,750	5,288	4,751	5,288	5,011
31,750	31,800	4,313	3,859	4,313	4,119	34,750	34,800	4,763	4,309	4,763	4,569	37,750	37,800	5,300	4,759	5,300	5,019
31,800	31,850	4,320	3,866	4,320	4,126	34,800	34,850	4,770	4,316	4,770	4,576	37,800	37,850	5,313	4,766	5,313	5,026
31,850	31,900	4,328	3,874	4,328	4,134	34,850	34,900	4,778	4,324	4,778	4,584	37,850	37,900	5,325	4,774	5,325	5,034
31,900	31,950	4,335	3,881	4,335	4,141	34,900	34,950	4,785	4,331	4,785	4,591	37,900	37,950	5,338	4,781	5,338	5,041
31,950	32,000	4,343	3,889	4,343	4,149	34,950	35,000	4,793	4,339	4,793	4,599	37,950	38,000	5,350	4,789	5,350	5,049
32,000						35,000						38,000					
32,000	32,050	4,350	3,896	4,350	4,156	35,000	35,050	4,800	4,346	4,800	4,606	38,000	38,050	5,363	4,796	5,363	5,056
32,050	32,100	4,358	3,904	4,358	4,164	35,050	35,100	4,808	4,354	4,808	4,614	38,050	38,100	5,375	4,804	5,375	5,064
32,100	32,150	4,365	3,911	4,365	4,171	35,100	35,150	4,815	4,361	4,815	4,621	38,100	38,150	5,388	4,811	5,388	5,071
32,150	32,200	4,373	3,919	4,373	4,178	35,150	35,200	4,823	4,369	4,823	4,629	38,150	38,200	5,400	4,819	5,400	5,079
32,200	32,250	4,380	3,926	4,380	4,186	35,200	35,250	4,830	4,376	4,830	4,636	38,200	38,250	5,413	4,826	5,413	5,086
32,250	32,300	4,388	3,934	4,388	4,194	35,250	35,300	4,838	4,384	4,838	4,644	38,250	38,300	5,425	4,834	5,425	5,094
32,300	32,350	4,395	3,941	4,395	4,201	35,300	35,350	4,845	4,391	4,845	4,651	38,300	38,350	5,438	4,841	5,438	5,101
32,350	32,400	4,403	3,949	4,403	4,209	35,350	35,400	4,853	4,399	4,853	4,659	38,350	38,400	5,450	4,849	5,450	5,109
32,400	32,450	4,410	3,956	4,410	4,216	35,400	35,450	4,860	4,406	4,860	4,666	38,400	38,450	5,463	4,856	5,463	5,116
32,450	32,500	4,418	3,964	4,418	4,224	35,450	35,500	4,868	4,414	4,868	4,674	38,450	38,500	5,475	4,864	5,475	5,124
32,500	32,550	4,425	3,971	4,425	4,231	35,500	35,550	4,875	4,421	4,875	4,681	38,500	38,550	5,488	4,871	5,488	5,131
32,550	32,600	4,433	3,979	4,433	4,239	35,550	35,600	4,883	4,429	4,883	4,689	38,550	38,600	5,500	4,879	5,500	5,139
32,600	32,650	4,440	3,986	4,440	4,246	35,600	35,650	4,890	4,436	4,890	4,696	38,600	38,650	5,513	4,886	5,513	5,146
32,650	32,700	4,448	3,994	4,448	4,254	35,650	35,700	4,898	4,444	4,898	4,704	38,650	38,700	5,525	4,894	5,525	5,154
32,700	32,750	4,455	4,001	4,455	4,261	35,700	35,750	4,905	4,451	4,905	4,711	38,700	38,750	5,538	4,901	5,538	5,161
32,750	32,800	4,463	4,009	4,463	4,269	35,750	35,800	4,913	4,459	4,913	4,719	38,750	38,800	5,550	4,909	5,550	5,169
32,800	32,850	4,470	4,016	4,470	4,276	35,800	35,850	4,920	4,466	4,920	4,726	38,800	38,850	5,563	4,916	5,563	5,176
32,850	32,900	4,478	4,024	4,478	4,284	35,850	35,900	4,928	4,474	4,928	4,734	38,850	38,900	5,575	4,924	5,575	5,184
32,900	32,950	4,485	4,031	4,485	4,291	35,900	35,950	4,935	4,481	4,935	4,741	38,900	38,950	5,588	4,931	5,588	5,191
32,950	33,000	4,493	4,039	4,493	4,299	35,950	36,000	4,943	4,								

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
Your tax is—						Your tax is—						Your tax is—					
39,000						42,000						45,000					
39,000	39,050	5,613	4,946	5,613	5,206	42,000	42,050	6,363	5,396	6,363	5,656	45,000	45,050	7,113	5,846	7,113	6,106
39,050	39,100	5,625	4,954	5,625	5,214	42,050	42,100	6,375	5,404	6,375	5,664	45,050	45,100	7,125	5,854	7,125	6,114
39,100	39,150	5,638	4,961	5,638	5,221	42,100	42,150	6,388	5,411	6,388	5,671	45,100	45,150	7,138	5,861	7,138	6,121
39,150	39,200	5,650	4,969	5,650	5,229	42,150	42,200	6,400	5,419	6,400	5,679	45,150	45,200	7,150	5,869	7,150	6,129
39,200	39,250	5,663	4,976	5,663	5,236	42,200	42,250	6,413	5,426	6,413	5,686	45,200	45,250	7,163	5,876	7,163	6,136
39,250	39,300	5,675	4,984	5,675	5,244	42,250	42,300	6,425	5,434	6,425	5,694	45,250	45,300	7,175	5,884	7,175	6,144
39,300	39,350	5,688	4,991	5,688	5,251	42,300	42,350	6,438	5,441	6,438	5,701	45,300	45,350	7,188	5,891	7,188	6,151
39,350	39,400	5,700	4,999	5,700	5,259	42,350	42,400	6,450	5,449	6,450	5,709	45,350	45,400	7,200	5,899	7,200	6,159
39,400	39,450	5,713	5,006	5,713	5,266	42,400	42,450	6,463	5,456	6,463	5,716	45,400	45,450	7,213	5,906	7,213	6,166
39,450	39,500	5,725	5,014	5,725	5,274	42,450	42,500	6,475	5,464	6,475	5,724	45,450	45,500	7,225	5,914	7,225	6,174
39,500	39,550	5,738	5,021	5,738	5,281	42,500	42,550	6,488	5,471	6,488	5,731	45,500	45,550	7,238	5,921	7,238	6,181
39,550	39,600	5,750	5,029	5,750	5,289	42,550	42,600	6,500	5,479	6,500	5,739	45,550	45,600	7,250	5,929	7,250	6,189
39,600	39,650	5,763	5,036	5,763	5,296	42,600	42,650	6,513	5,486	6,513	5,746	45,600	45,650	7,263	5,936	7,263	6,196
39,650	39,700	5,775	5,044	5,775	5,304	42,650	42,700	6,525	5,494	6,525	5,754	45,650	45,700	7,275	5,944	7,275	6,204
39,700	39,750	5,788	5,051	5,788	5,311	42,700	42,750	6,538	5,501	6,538	5,761	45,700	45,750	7,288	5,951	7,288	6,211
39,750	39,800	5,800	5,059	5,800	5,319	42,750	42,800	6,550	5,509	6,550	5,769	45,750	45,800	7,300	5,959	7,300	6,219
39,800	39,850	5,813	5,066	5,813	5,326	42,800	42,850	6,563	5,516	6,563	5,776	45,800	45,850	7,313	5,966	7,313	6,226
39,850	39,900	5,825	5,074	5,825	5,334	42,850	42,900	6,575	5,524	6,575	5,784	45,850	45,900	7,325	5,974	7,325	6,234
39,900	39,950	5,838	5,081	5,838	5,341	42,900	42,950	6,588	5,531	6,588	5,791	45,900	45,950	7,338	5,981	7,338	6,241
39,950	40,000	5,850	5,089	5,850	5,349	42,950	43,000	6,600	5,539	6,600	5,799	45,950	46,000	7,350	5,989	7,350	6,249
40,000						43,000						46,000					
40,000	40,050	5,863	5,096	5,863	5,356	43,000	43,050	6,613	5,546	6,613	5,806	46,000	46,050	7,363	5,996	7,363	6,256
40,050	40,100	5,875	5,104	5,875	5,364	43,050	43,100	6,625	5,554	6,625	5,814	46,050	46,100	7,375	6,004	7,375	6,264
40,100	40,150	5,888	5,111	5,888	5,371	43,100	43,150	6,638	5,561	6,638	5,821	46,100	46,150	7,388	6,011	7,388	6,271
40,150	40,200	5,900	5,119	5,900	5,379	43,150	43,200	6,650	5,569	6,650	5,829	46,150	46,200	7,400	6,019	7,400	6,279
40,200	40,250	5,913	5,126	5,913	5,386	43,200	43,250	6,663	5,576	6,663	5,836	46,200	46,250	7,413	6,026	7,413	6,286
40,250	40,300	5,925	5,134	5,925	5,394	43,250	43,300	6,675	5,584	6,675	5,844	46,250	46,300	7,425	6,034	7,425	6,294
40,300	40,350	5,938	5,141	5,938	5,401	43,300	43,350	6,688	5,591	6,688	5,851	46,300	46,350	7,438	6,041	7,438	6,301
40,350	40,400	5,950	5,149	5,950	5,409	43,350	43,400	6,700	5,599	6,700	5,859	46,350	46,400	7,450	6,049	7,450	6,309
40,400	40,450	5,963	5,156	5,963	5,416	43,400	43,450	6,713	5,606	6,713	5,866	46,400	46,450	7,463	6,056	7,463	6,316
40,450	40,500	5,975	5,164	5,975	5,424	43,450	43,500	6,725	5,614	6,725	5,874	46,450	46,500	7,475	6,064	7,475	6,324
40,500	40,550	5,988	5,171	5,988	5,431	43,500	43,550	6,738	5,621	6,738	5,881	46,500	46,550	7,488	6,071	7,488	6,331
40,550	40,600	6,000	5,179	6,000	5,439	43,550	43,600	6,750	5,629	6,750	5,889	46,550	46,600	7,500	6,079	7,500	6,339
40,600	40,650	6,013	5,186	6,013	5,446	43,600	43,650	6,763	5,636	6,763	5,896	46,600	46,650	7,513	6,086	7,513	6,346
40,650	40,700	6,025	5,194	6,025	5,454	43,650	43,700	6,775	5,644	6,775	5,904	46,650	46,700	7,525	6,094	7,525	6,354
40,700	40,750	6,038	5,201	6,038	5,461	43,700	43,750	6,788	5,651	6,788	5,911	46,700	46,750	7,538	6,101	7,538	6,361
40,750	40,800	6,050	5,209	6,050	5,469	43,750	43,800	6,800	5,659	6,800	5,919	46,750	46,800	7,550	6,109	7,550	6,369
40,800	40,850	6,063	5,216	6,063	5,476	43,800	43,850	6,813	5,666	6,813	5,926	46,800	46,850	7,563	6,116	7,563	6,376
40,850	40,900	6,075	5,224	6,075	5,484	43,850	43,900	6,825	5,674	6,825	5,934	46,850	46,900	7,575	6,124	7,575	6,384
40,900	40,950	6,088	5,231	6,088	5,491	43,900	43,950	6,838	5,681	6,838	5,941	46,900	46,950	7,588	6,131	7,588	6,391
40,950	41,000	6,100	5,239	6,100	5,499	43,950	44,000	6,850	5,689	6,850	5,949	46,950	47,000	7,600	6,139	7,600	6,399
41,000						44,000						47,000					
41,000	41,050	6,113	5,246	6,113	5,506	44,000	44,050	6,863	5,696	6,863	5,956	47,000	47,050	7,613	6,146	7,613	6,406
41,050	41,100	6,125	5,254	6,125	5,514	44,050	44,100	6,875	5,704	6,875	5,964	47,050	47,100	7,625	6,154	7,625	6,414
41,100	41,150	6,138	5,261	6,138	5,521	44,100	44,150	6,888	5,711	6,888	5,971	47,100	47,150	7,638	6,161	7,638	6,421
41,150	41,200	6,150	5,269	6,150	5,529	44,150	44,200	6,900	5,719	6,900	5,979	47,150	47,200	7,650	6,169	7,650	6,429
41,200	41,250	6,163	5,276	6,163	5,536	44,200	44,250	6,913	5,726	6,913	5,986	47,200	47,250	7,663	6,176	7,663	6,436
41,250	41,300	6,175	5,284	6,175	5,544	44,250	44,300	6,925	5,734	6,925	5,994	47,250	47,300	7,675	6,184	7,675	6,444
41,300	41,350	6,188	5,291	6,188	5,551	44,300	44,350	6,938	5,741	6,938	6,001	47,300	47,350	7,688	6,191	7,688	6,451
41,350	41,400	6,200	5,299	6,200	5,559	44,350	44,400	6,950	5,749	6,950	6,009	47,350	47,400	7,700	6,199	7,700	6,459
41,400	41,450	6,213	5,306	6,213	5,566	44,400	44,450	6,963	5,756	6,963	6,016	47,400	47,450	7,713	6,206	7,713	6,466
41,450	41,500	6,225	5,314	6,225	5,574	44,450	44,500	6,975	5,764	6,975	6,024	47,450	47,500	7,725	6,214	7,725	6,474
41,500	41,550	6,238	5,321	6,238	5,581	44,500	44,550	6,988	5,771	6,988	6,031	47,500	47,550	7,738	6,221	7,738	6,481
41,550	41,600	6,250	5,329	6,250	5,589	44,550	44,600	7,000	5,779	7,000	6,039	47,550	47,600	7,750	6,229	7,750	6,489
41,600	41,650	6,263	5,336	6,263	5,596	44,600	44,650	7,013	5,786	7,013	6,046	47,600	47,650	7,763	6,236	7,763	6,496
41,650	41,700	6,275	5,344	6,275	5,604	44,650	44,700	7,025	5,794	7,025	6,054	47,650	47,700	7,775	6,244	7,775	6,504
41,700	41,750	6,288	5,351	6,288	5,611	44,700	44,750	7,038	5,801	7,038	6,061	47,700	47,750	7,788	6,251	7,788	6,511
41,750	41,800	6,300	5,359	6,300	5,619	44,750	44,800	7,050	5,809	7,050	6,069	47,750	47,800	7,800	6,259	7,800	6,519
41,800	41,850	6,313	5,366	6,313	5,626	44,800	44,850	7,063	5,816	7,063	6,076	47,800	47,850	7,813	6,266	7,813	6,526
41,850	41,900	6,325	5,374	6,325	5,634	44,850	44,900	7,075	5,824	7,075	6,084	47,850	47,900	7,825	6,274	7,825	6,534
41,900	41,950	6,338	5,381	6,338	5,641	44,900	44,950	7,088	5,831	7,088	6,091	47,900	47,950	7,838	6,281	7,838	6,541
41,950	42,000	6,350	5,389	6,350	5,649	44,950	45,000	7,100	5,839	7,100	6,099	47,95					

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
Your tax is—						Your tax is—						Your tax is—					
48,000						51,000						54,000					
48,000	48,050	7,863	6,296	7,863	6,556	51,000	51,050	8,613	6,746	8,613	7,169	54,000	54,050	9,363	7,196	9,363	7,919
48,050	48,100	7,875	6,304	7,875	6,564	51,050	51,100	8,625	6,754	8,625	7,181	54,050	54,100	9,375	7,204	9,375	7,931
48,100	48,150	7,888	6,311	7,888	6,571	51,100	51,150	8,638	6,761	8,638	7,194	54,100	54,150	9,388	7,211	9,388	7,944
48,150	48,200	7,900	6,319	7,900	6,579	51,150	51,200	8,650	6,769	8,650	7,206	54,150	54,200	9,400	7,219	9,400	7,956
48,200	48,250	7,913	6,326	7,913	6,586	51,200	51,250	8,663	6,776	8,663	7,219	54,200	54,250	9,413	7,226	9,413	7,969
48,250	48,300	7,925	6,334	7,925	6,594	51,250	51,300	8,675	6,784	8,675	7,231	54,250	54,300	9,425	7,234	9,425	7,981
48,300	48,350	7,938	6,341	7,938	6,601	51,300	51,350	8,688	6,791	8,688	7,244	54,300	54,350	9,438	7,241	9,438	7,994
48,350	48,400	7,950	6,349	7,950	6,609	51,350	51,400	8,700	6,799	8,700	7,256	54,350	54,400	9,450	7,249	9,450	8,006
48,400	48,450	7,963	6,356	7,963	6,616	51,400	51,450	8,713	6,806	8,713	7,269	54,400	54,450	9,463	7,256	9,463	8,019
48,450	48,500	7,975	6,364	7,975	6,624	51,450	51,500	8,725	6,814	8,725	7,281	54,450	54,500	9,475	7,264	9,475	8,031
48,500	48,550	7,988	6,371	7,988	6,631	51,500	51,550	8,738	6,821	8,738	7,294	54,500	54,550	9,488	7,271	9,488	8,044
48,550	48,600	8,000	6,379	8,000	6,639	51,550	51,600	8,750	6,829	8,750	7,306	54,550	54,600	9,500	7,279	9,500	8,056
48,600	48,650	8,013	6,386	8,013	6,646	51,600	51,650	8,763	6,836	8,763	7,319	54,600	54,650	9,513	7,286	9,513	8,069
48,650	48,700	8,025	6,394	8,025	6,654	51,650	51,700	8,775	6,844	8,775	7,331	54,650	54,700	9,525	7,294	9,525	8,081
48,700	48,750	8,038	6,401	8,038	6,661	51,700	51,750	8,788	6,851	8,788	7,344	54,700	54,750	9,538	7,301	9,538	8,094
48,750	48,800	8,050	6,409	8,050	6,669	51,750	51,800	8,800	6,859	8,800	7,356	54,750	54,800	9,550	7,309	9,550	8,106
48,800	48,850	8,063	6,416	8,063	6,676	51,800	51,850	8,813	6,866	8,813	7,369	54,800	54,850	9,563	7,316	9,563	8,119
48,850	48,900	8,075	6,424	8,075	6,684	51,850	51,900	8,825	6,874	8,825	7,381	54,850	54,900	9,575	7,324	9,575	8,131
48,900	48,950	8,088	6,431	8,088	6,691	51,900	51,950	8,838	6,881	8,838	7,394	54,900	54,950	9,588	7,331	9,588	8,144
48,950	49,000	8,100	6,439	8,100	6,699	51,950	52,000	8,850	6,889	8,850	7,406	54,950	55,000	9,600	7,339	9,600	8,156
49,000						52,000						55,000					
49,000	49,050	8,113	6,446	8,113	6,706	52,000	52,050	8,863	6,896	8,863	7,419	55,000	55,050	9,613	7,346	9,613	8,169
49,050	49,100	8,125	6,454	8,125	6,714	52,050	52,100	8,875	6,904	8,875	7,431	55,050	55,100	9,625	7,354	9,625	8,181
49,100	49,150	8,138	6,461	8,138	6,721	52,100	52,150	8,888	6,911	8,888	7,444	55,100	55,150	9,638	7,361	9,638	8,194
49,150	49,200	8,150	6,469	8,150	6,729	52,150	52,200	8,900	6,919	8,900	7,456	55,150	55,200	9,650	7,369	9,650	8,206
49,200	49,250	8,163	6,476	8,163	6,736	52,200	52,250	8,913	6,926	8,913	7,469	55,200	55,250	9,663	7,376	9,663	8,219
49,250	49,300	8,175	6,484	8,175	6,744	52,250	52,300	8,925	6,934	8,925	7,481	55,250	55,300	9,675	7,384	9,675	8,231
49,300	49,350	8,188	6,491	8,188	6,751	52,300	52,350	8,938	6,941	8,938	7,494	55,300	55,350	9,688	7,391	9,688	8,244
49,350	49,400	8,200	6,499	8,200	6,759	52,350	52,400	8,950	6,949	8,950	7,506	55,350	55,400	9,700	7,399	9,700	8,256
49,400	49,450	8,213	6,506	8,213	6,767	52,400	52,450	8,963	6,956	8,963	7,519	55,400	55,450	9,713	7,406	9,713	8,269
49,450	49,500	8,225	6,514	8,225	6,781	52,450	52,500	8,975	6,964	8,975	7,531	55,450	55,500	9,725	7,414	9,725	8,281
49,500	49,550	8,238	6,521	8,238	6,794	52,500	52,550	8,988	6,971	8,988	7,544	55,500	55,550	9,738	7,421	9,738	8,294
49,550	49,600	8,250	6,529	8,250	6,806	52,550	52,600	9,000	6,979	9,000	7,556	55,550	55,600	9,750	7,429	9,750	8,306
49,600	49,650	8,263	6,536	8,263	6,819	52,600	52,650	9,013	6,986	9,013	7,569	55,600	55,650	9,763	7,436	9,763	8,319
49,650	49,700	8,275	6,544	8,275	6,831	52,650	52,700	9,025	6,994	9,025	7,581	55,650	55,700	9,775	7,444	9,775	8,331
49,700	49,750	8,288	6,551	8,288	6,844	52,700	52,750	9,038	7,001	9,038	7,594	55,700	55,750	9,788	7,451	9,788	8,344
49,750	49,800	8,300	6,559	8,300	6,856	52,750	52,800	9,050	7,009	9,050	7,606	55,750	55,800	9,800	7,459	9,800	8,356
49,800	49,850	8,313	6,566	8,313	6,869	52,800	52,850	9,063	7,016	9,063	7,619	55,800	55,850	9,813	7,466	9,813	8,369
49,850	49,900	8,325	6,574	8,325	6,881	52,850	52,900	9,075	7,024	9,075	7,631	55,850	55,900	9,825	7,474	9,825	8,381
49,900	49,950	8,338	6,581	8,338	6,894	52,900	52,950	9,088	7,031	9,088	7,644	55,900	55,950	9,838	7,481	9,838	8,394
49,950	50,000	8,350	6,589	8,350	6,906	52,950	53,000	9,100	7,039	9,100	7,656	55,950	56,000	9,850	7,489	9,850	8,406
50,000						53,000						56,000					
50,000	50,050	8,363	6,596	8,363	6,919	53,000	53,050	9,113	7,046	9,113	7,669	56,000	56,050	9,863	7,496	9,863	8,419
50,050	50,100	8,375	6,604	8,375	6,931	53,050	53,100	9,125	7,054	9,125	7,681	56,050	56,100	9,875	7,504	9,875	8,431
50,100	50,150	8,388	6,611	8,388	6,944	53,100	53,150	9,138	7,061	9,138	7,694	56,100	56,150	9,888	7,511	9,888	8,444
50,150	50,200	8,400	6,619	8,400	6,956	53,150	53,200	9,150	7,069	9,150	7,706	56,150	56,200	9,900	7,519	9,900	8,456
50,200	50,250	8,413	6,626	8,413	6,969	53,200	53,250	9,163	7,076	9,163	7,719	56,200	56,250	9,913	7,526	9,913	8,469
50,250	50,300	8,425	6,634	8,425	6,981	53,250	53,300	9,175	7,084	9,175	7,731	56,250	56,300	9,925	7,534	9,925	8,481
50,300	50,350	8,438	6,641	8,438	6,994	53,300	53,350	9,188	7,091	9,188	7,744	56,300	56,350	9,938	7,541	9,938	8,494
50,350	50,400	8,450	6,649	8,450	7,006	53,350	53,400	9,200	7,099	9,200	7,756	56,350	56,400	9,950	7,549	9,950	8,506
50,400	50,450	8,463	6,656	8,463	7,019	53,400	53,450	9,213	7,106	9,213	7,769	56,400	56,450	9,963	7,556	9,963	8,519
50,450	50,500	8,475	6,664	8,475	7,031	53,450	53,500	9,225	7,114	9,225	7,781	56,450	56,500	9,975	7,564	9,975	8,531
50,500	50,550	8,488	6,671	8,488	7,044	53,500	53,550	9,238	7,121	9,238	7,794	56,500	56,550	9,988	7,571	9,988	8,544
50,550	50,600	8,500	6,679	8,500	7,056	53,550	53,600	9,250	7,129	9,250	7,806	56,550	56,600	10,000	7,579	10,000	8,556
50,600	50,650	8,513	6,686	8,513	7,069	53,600	53,650	9,263	7,136	9,263	7,819	56,600	56,650	10,013	7,586	10,013	8,569
50,650	50,700	8,525	6,694	8,525	7,081	53,650	53,700	9,275	7,144	9,275	7,831	56,650	56,700	10,025	7,594	10,025	8,581
50,700	50,750	8,538	6,701	8,538	7,094	53,700	53,750	9,288	7,151	9,288	7,844	56,700	56,750	10,038	7,601	10,038	8,594
50,750	50,800	8,550	6,709	8,550	7,106	53,750	53,800	9,300	7,159	9,300	7,856	56,750	56,800	10,050	7,609	10,050	8,606
50,800	50,850	8,563	6,716	8,563	7,119	53,800	53,850	9,313	7,166	9,313	7,869	56,800	56,850	10,063	7,616	10,063	8,619
50,850	50,900	8,575	6,724	8,575	7,131	53,850	53,900	9,325	7,174	9,325	7,881	56,850	56,900	10,075	7,624	10,075	8,631
50,900	50,950	8,588	6,731	8,588	7,144	53,900	53,950	9,338	7,181	9,338	7,894	56,900	56,950	10,088	7,631	10,088	8,644
50,950	51,000	8,600	6,739	8,600	7,156	53,950	5										

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				Your tax is—	If line 43 (taxable income) is—		And you are—				Your tax is—	If line 43 (taxable income) is—		And you are—				Your tax is—
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household		At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household		At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	
57,000						60,000						63,000								
57,000	57,050	10,113	7,646	10,113	8,669	60,000	60,050	10,863	8,096	10,863	9,419	63,000	63,050	11,613	8,546	11,613	10,169			
57,050	57,100	10,125	7,654	10,125	8,681	60,050	60,100	10,875	8,104	10,875	9,431	63,050	63,100	11,625	8,554	11,625	10,181			
57,100	57,150	10,138	7,661	10,138	8,694	60,100	60,150	10,888	8,111	10,888	9,444	63,100	63,150	11,638	8,561	11,638	10,194			
57,150	57,200	10,150	7,669	10,150	8,706	60,150	60,200	10,900	8,119	10,900	9,456	63,150	63,200	11,650	8,569	11,650	10,206			
57,200	57,250	10,163	7,676	10,163	8,719	60,200	60,250	10,913	8,126	10,913	9,469	63,200	63,250	11,663	8,576	11,663	10,219			
57,250	57,300	10,175	7,684	10,175	8,731	60,250	60,300	10,925	8,134	10,925	9,481	63,250	63,300	11,675	8,584	11,675	10,231			
57,300	57,350	10,188	7,691	10,188	8,744	60,300	60,350	10,938	8,141	10,938	9,494	63,300	63,350	11,688	8,591	11,688	10,244			
57,350	57,400	10,200	7,699	10,200	8,756	60,350	60,400	10,950	8,149	10,950	9,506	63,350	63,400	11,700	8,599	11,700	10,256			
57,400	57,450	10,213	7,706	10,213	8,769	60,400	60,450	10,963	8,156	10,963	9,519	63,400	63,450	11,713	8,606	11,713	10,269			
57,450	57,500	10,225	7,714	10,225	8,781	60,450	60,500	10,975	8,164	10,975	9,531	63,450	63,500	11,725	8,614	11,725	10,281			
57,500	57,550	10,238	7,721	10,238	8,794	60,500	60,550	10,988	8,171	10,988	9,544	63,500	63,550	11,738	8,621	11,738	10,294			
57,550	57,600	10,250	7,729	10,250	8,806	60,550	60,600	11,000	8,179	11,000	9,556	63,550	63,600	11,750	8,629	11,750	10,306			
57,600	57,650	10,263	7,736	10,263	8,819	60,600	60,650	11,013	8,186	11,013	9,569	63,600	63,650	11,763	8,636	11,763	10,319			
57,650	57,700	10,275	7,744	10,275	8,831	60,650	60,700	11,025	8,194	11,025	9,581	63,650	63,700	11,775	8,644	11,775	10,331			
57,700	57,750	10,288	7,751	10,288	8,844	60,700	60,750	11,038	8,201	11,038	9,594	63,700	63,750	11,788	8,651	11,788	10,344			
57,750	57,800	10,300	7,759	10,300	8,856	60,750	60,800	11,050	8,209	11,050	9,606	63,750	63,800	11,800	8,659	11,800	10,356			
57,800	57,850	10,313	7,766	10,313	8,869	60,800	60,850	11,063	8,216	11,063	9,619	63,800	63,850	11,813	8,666	11,813	10,369			
57,850	57,900	10,325	7,774	10,325	8,881	60,850	60,900	11,075	8,224	11,075	9,631	63,850	63,900	11,825	8,674	11,825	10,381			
57,900	57,950	10,338	7,781	10,338	8,894	60,900	60,950	11,088	8,231	11,088	9,644	63,900	63,950	11,838	8,681	11,838	10,394			
57,950	58,000	10,350	7,789	10,350	8,906	60,950	61,000	11,100	8,239	11,100	9,656	63,950	64,000	11,850	8,689	11,850	10,406			
58,000						61,000						64,000								
58,000	58,050	10,363	7,796	10,363	8,919	61,000	61,050	11,113	8,246	11,113	9,669	64,000	64,050	11,863	8,696	11,863	10,419			
58,050	58,100	10,375	7,804	10,375	8,931	61,050	61,100	11,125	8,254	11,125	9,681	64,050	64,100	11,875	8,704	11,875	10,431			
58,100	58,150	10,388	7,811	10,388	8,944	61,100	61,150	11,138	8,261	11,138	9,694	64,100	64,150	11,888	8,711	11,888	10,444			
58,150	58,200	10,400	7,819	10,400	8,956	61,150	61,200	11,150	8,269	11,150	9,706	64,150	64,200	11,900	8,719	11,900	10,456			
58,200	58,250	10,413	7,826	10,413	8,969	61,200	61,250	11,163	8,276	11,163	9,719	64,200	64,250	11,913	8,726	11,913	10,469			
58,250	58,300	10,425	7,834	10,425	8,981	61,250	61,300	11,175	8,284	11,175	9,731	64,250	64,300	11,925	8,734	11,925	10,481			
58,300	58,350	10,438	7,841	10,438	8,994	61,300	61,350	11,188	8,291	11,188	9,744	64,300	64,350	11,938	8,741	11,938	10,494			
58,350	58,400	10,450	7,849	10,450	9,006	61,350	61,400	11,200	8,299	11,200	9,756	64,350	64,400	11,950	8,749	11,950	10,506			
58,400	58,450	10,463	7,856	10,463	9,019	61,400	61,450	11,213	8,306	11,213	9,769	64,400	64,450	11,963	8,756	11,963	10,519			
58,450	58,500	10,475	7,864	10,475	9,031	61,450	61,500	11,225	8,314	11,225	9,781	64,450	64,500	11,975	8,764	11,975	10,531			
58,500	58,550	10,488	7,871	10,488	9,044	61,500	61,550	11,238	8,321	11,238	9,794	64,500	64,550	11,988	8,771	11,988	10,544			
58,550	58,600	10,500	7,879	10,500	9,056	61,550	61,600	11,250	8,329	11,250	9,806	64,550	64,600	12,000	8,779	12,000	10,556			
58,600	58,650	10,513	7,886	10,513	9,069	61,600	61,650	11,263	8,336	11,263	9,819	64,600	64,650	12,013	8,786	12,013	10,569			
58,650	58,700	10,525	7,894	10,525	9,081	61,650	61,700	11,275	8,344	11,275	9,831	64,650	64,700	12,025	8,794	12,025	10,581			
58,700	58,750	10,538	7,901	10,538	9,094	61,700	61,750	11,288	8,351	11,288	9,844	64,700	64,750	12,038	8,801	12,038	10,594			
58,750	58,800	10,550	7,909	10,550	9,106	61,750	61,800	11,300	8,359	11,300	9,856	64,750	64,800	12,050	8,809	12,050	10,606			
58,800	58,850	10,563	7,916	10,563	9,119	61,800	61,850	11,313	8,366	11,313	9,869	64,800	64,850	12,063	8,816	12,063	10,619			
58,850	58,900	10,575	7,924	10,575	9,131	61,850	61,900	11,325	8,374	11,325	9,881	64,850	64,900	12,075	8,824	12,075	10,631			
58,900	58,950	10,588	7,931	10,588	9,144	61,900	61,950	11,338	8,381	11,338	9,894	64,900	64,950	12,088	8,831	12,088	10,644			
58,950	59,000	10,600	7,939	10,600	9,156	61,950	62,000	11,350	8,389	11,350	9,906	64,950	65,000	12,100	8,839	12,100	10,656			
59,000						62,000						65,000								
59,000	59,050	10,613	7,946	10,613	9,169	62,000	62,050	11,363	8,396	11,363	9,919	65,000	65,050	12,113	8,846	12,113	10,669			
59,050	59,100	10,625	7,954	10,625	9,181	62,050	62,100	11,375	8,404	11,375	9,931	65,050	65,100	12,125	8,854	12,125	10,681			
59,100	59,150	10,638	7,961	10,638	9,194	62,100	62,150	11,388	8,411	11,388	9,944	65,100	65,150	12,138	8,861	12,138	10,694			
59,150	59,200	10,650	7,969	10,650	9,206	62,150	62,200	11,400	8,419	11,400	9,956	65,150	65,200	12,150	8,869	12,150	10,706			
59,200	59,250	10,663	7,976	10,663	9,219	62,200	62,250	11,413	8,426	11,413	9,969	65,200	65,250	12,163	8,876	12,163	10,719			
59,250	59,300	10,675	7,984	10,675	9,231	62,250	62,300	11,425	8,434	11,425	9,981	65,250	65,300	12,175	8,884	12,175	10,731			
59,300	59,350	10,688	7,991	10,688	9,244	62,300	62,350	11,438	8,441	11,438	9,994	65,300	65,350	12,188	8,891	12,188	10,744			
59,350	59,400	10,700	7,999	10,700	9,256	62,350	62,400	11,450	8,449	11,450	10,006	65,350	65,400	12,200	8,899	12,200	10,756			
59,400	59,450	10,713	8,006	10,713	9,269	62,400	62,450	11,463	8,456	11,463	10,019	65,400	65,450	12,213	8,906	12,213	10,769			
59,450	59,500	10,725	8,014	10,725	9,281	62,450	62,500	11,475	8,464	11,475	10,031	65,450	65,500	12,225	8,914	12,225	10,781			
59,500	59,550	10,738	8,021	10,738	9,294	62,500	62,550	11,488	8,471	11,488	10,044	65,500	65,550	12,238	8,921	12,238	10,794			
59,550	59,600	10,750	8,029	10,750	9,306	62,550	62,600	11,500	8,479	11,500	10,056	65,550	65,600	12,250	8,929	12,250	10,806			
59,600	59,650	10,763	8,036	10,763	9,319	62,600	62,650	11,513	8,486	11,513	10,069	65,600	65,650	12,263	8,936	12,263	10,819			
59,650	59,700	10,775	8,044	10,775	9,331	62,650	62,700	11,525	8,494	11,525	10,081	65,650	65,700	12,275	8,944	12,275	10,831			
59,700	59,750	10,788	8,051	10,788	9,344	62,700	62,750	11,538	8,501	11,538	10,094	65,700	65,750	12,288	8,951	12,288	10,844			
59,750	59,800	10,800	8,059	10,800	9,356	62,750	62,800	11,550	8,509	11,550	10,106	65,750	65,800	12,300	8,959	12,300	10,856			
59,800	59,850	10,813	8,066	10,813	9,369	62,800	62,850	11,563	8,516	11,563	10,119	65,800	65,850	12,313	8,966	12,313	10,869			
59,850	59,900	10,825	8,074	10,825	9,381	62,850	62,900	11,575	8,524	11,575	1									

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
66,000						69,000						72,000					
66,000	66,050	12,363	8,996	12,363	10,919	69,000	69,050	13,113	9,446	13,113	11,669	72,000	72,050	13,863	9,896	13,863	12,419
66,050	66,100	12,375	9,004	12,375	10,931	69,050	69,100	13,125	9,454	13,125	11,681	72,050	72,100	13,875	9,904	13,875	12,431
66,100	66,150	12,388	9,011	12,388	10,944	69,100	69,150	13,138	9,461	13,138	11,694	72,100	72,150	13,888	9,911	13,888	12,444
66,150	66,200	12,400	9,019	12,400	10,956	69,150	69,200	13,150	9,469	13,150	11,706	72,150	72,200	13,900	9,919	13,900	12,456
66,200	66,250	12,413	9,026	12,413	10,969	69,200	69,250	13,163	9,476	13,163	11,719	72,200	72,250	13,913	9,926	13,913	12,469
66,250	66,300	12,425	9,034	12,425	10,981	69,250	69,300	13,175	9,484	13,175	11,731	72,250	72,300	13,925	9,934	13,925	12,481
66,300	66,350	12,438	9,041	12,438	10,994	69,300	69,350	13,188	9,491	13,188	11,744	72,300	72,350	13,938	9,941	13,938	12,494
66,350	66,400	12,450	9,049	12,450	11,006	69,350	69,400	13,200	9,499	13,200	11,756	72,350	72,400	13,950	9,949	13,950	12,506
66,400	66,450	12,463	9,056	12,463	11,019	69,400	69,450	13,213	9,506	13,213	11,769	72,400	72,450	13,963	9,956	13,963	12,519
66,450	66,500	12,475	9,064	12,475	11,031	69,450	69,500	13,225	9,514	13,225	11,781	72,450	72,500	13,975	9,964	13,975	12,531
66,500	66,550	12,488	9,071	12,488	11,044	69,500	69,550	13,238	9,521	13,238	11,794	72,500	72,550	13,988	9,971	13,988	12,544
66,550	66,600	12,500	9,079	12,500	11,056	69,550	69,600	13,250	9,529	13,250	11,806	72,550	72,600	14,000	9,979	14,000	12,556
66,600	66,650	12,513	9,086	12,513	11,069	69,600	69,650	13,263	9,536	13,263	11,819	72,600	72,650	14,013	9,986	14,013	12,569
66,650	66,700	12,525	9,094	12,525	11,081	69,650	69,700	13,275	9,544	13,275	11,831	72,650	72,700	14,025	9,994	14,025	12,581
66,700	66,750	12,538	9,101	12,538	11,094	69,700	69,750	13,288	9,551	13,288	11,844	72,700	72,750	14,038	10,001	14,038	12,594
66,750	66,800	12,550	9,109	12,550	11,106	69,750	69,800	13,300	9,559	13,300	11,856	72,750	72,800	14,050	10,009	14,050	12,606
66,800	66,850	12,563	9,116	12,563	11,119	69,800	69,850	13,313	9,566	13,313	11,869	72,800	72,850	14,063	10,016	14,063	12,619
66,850	66,900	12,575	9,124	12,575	11,131	69,850	69,900	13,325	9,574	13,325	11,881	72,850	72,900	14,075	10,024	14,075	12,631
66,900	66,950	12,588	9,131	12,588	11,144	69,900	69,950	13,338	9,581	13,338	11,894	72,900	72,950	14,088	10,031	14,088	12,644
66,950	67,000	12,600	9,139	12,600	11,156	69,950	70,000	13,350	9,589	13,350	11,906	72,950	73,000	14,100	10,039	14,100	12,656
67,000						70,000						73,000					
67,000	67,050	12,613	9,146	12,613	11,169	70,000	70,050	13,363	9,596	13,363	11,919	73,000	73,050	14,113	10,046	14,113	12,669
67,050	67,100	12,625	9,154	12,625	11,181	70,050	70,100	13,375	9,604	13,375	11,931	73,050	73,100	14,125	10,054	14,125	12,681
67,100	67,150	12,638	9,161	12,638	11,194	70,100	70,150	13,388	9,611	13,388	11,944	73,100	73,150	14,138	10,061	14,138	12,694
67,150	67,200	12,650	9,169	12,650	11,206	70,150	70,200	13,400	9,619	13,400	11,956	73,150	73,200	14,150	10,069	14,150	12,706
67,200	67,250	12,663	9,176	12,663	11,219	70,200	70,250	13,413	9,626	13,413	11,969	73,200	73,250	14,163	10,076	14,163	12,719
67,250	67,300	12,675	9,184	12,675	11,231	70,250	70,300	13,425	9,634	13,425	11,981	73,250	73,300	14,175	10,084	14,175	12,731
67,300	67,350	12,688	9,191	12,688	11,244	70,300	70,350	13,438	9,641	13,438	11,994	73,300	73,350	14,188	10,091	14,188	12,744
67,350	67,400	12,700	9,199	12,700	11,256	70,350	70,400	13,450	9,649	13,450	12,006	73,350	73,400	14,200	10,099	14,200	12,756
67,400	67,450	12,713	9,206	12,713	11,269	70,400	70,450	13,463	9,656	13,463	12,019	73,400	73,450	14,213	10,106	14,213	12,769
67,450	67,500	12,725	9,214	12,725	11,281	70,450	70,500	13,475	9,664	13,475	12,031	73,450	73,500	14,225	10,114	14,225	12,781
67,500	67,550	12,738	9,221	12,738	11,294	70,500	70,550	13,488	9,671	13,488	12,044	73,500	73,550	14,238	10,121	14,238	12,794
67,550	67,600	12,750	9,229	12,750	11,306	70,550	70,600	13,500	9,679	13,500	12,056	73,550	73,600	14,250	10,129	14,250	12,806
67,600	67,650	12,763	9,236	12,763	11,319	70,600	70,650	13,513	9,686	13,513	12,069	73,600	73,650	14,263	10,136	14,263	12,819
67,650	67,700	12,775	9,244	12,775	11,331	70,650	70,700	13,525	9,694	13,525	12,081	73,650	73,700	14,275	10,144	14,275	12,831
67,700	67,750	12,788	9,251	12,788	11,344	70,700	70,750	13,538	9,701	13,538	12,094	73,700	73,750	14,288	10,151	14,288	12,844
67,750	67,800	12,800	9,259	12,800	11,356	70,750	70,800	13,550	9,709	13,550	12,106	73,750	73,800	14,300	10,159	14,300	12,856
67,800	67,850	12,813	9,266	12,813	11,369	70,800	70,850	13,563	9,716	13,563	12,119	73,800	73,850	14,313	10,166	14,313	12,869
67,850	67,900	12,825	9,274	12,825	11,381	70,850	70,900	13,575	9,724	13,575	12,131	73,850	73,900	14,325	10,174	14,325	12,881
67,900	67,950	12,838	9,281	12,838	11,394	70,900	70,950	13,588	9,731	13,588	12,144	73,900	73,950	14,338	10,181	14,338	12,894
67,950	68,000	12,850	9,289	12,850	11,406	70,950	71,000	13,600	9,739	13,600	12,156	73,950	74,000	14,350	10,206	14,350	12,906
68,000						71,000						74,000					
68,000	68,050	12,863	9,296	12,863	11,419	71,000	71,050	13,613	9,746	13,613	12,169	74,000	74,050	14,363	10,219	14,363	12,919
68,050	68,100	12,875	9,304	12,875	11,431	71,050	71,100	13,625	9,754	13,625	12,181	74,050	74,100	14,375	10,231	14,375	12,931
68,100	68,150	12,888	9,311	12,888	11,444	71,100	71,150	13,638	9,761	13,638	12,194	74,100	74,150	14,388	10,244	14,388	12,944
68,150	68,200	12,900	9,319	12,900	11,456	71,150	71,200	13,650	9,769	13,650	12,206	74,150	74,200	14,400	10,256	14,400	12,956
68,200	68,250	12,913	9,326	12,913	11,469	71,200	71,250	13,663	9,776	13,663	12,219	74,200	74,250	14,413	10,269	14,413	12,969
68,250	68,300	12,925	9,334	12,925	11,481	71,250	71,300	13,675	9,784	13,675	12,231	74,250	74,300	14,425	10,281	14,425	12,981
68,300	68,350	12,938	9,341	12,938	11,494	71,300	71,350	13,688	9,791	13,688	12,244	74,300	74,350	14,438	10,294	14,438	12,994
68,350	68,400	12,950	9,349	12,950	11,506	71,350	71,400	13,700	9,799	13,700	12,256	74,350	74,400	14,450	10,306	14,450	13,006
68,400	68,450	12,963	9,356	12,963	11,519	71,400	71,450	13,713	9,806	13,713	12,269	74,400	74,450	14,463	10,319	14,463	13,019
68,450	68,500	12,975	9,364	12,975	11,531	71,450	71,500	13,725	9,814	13,725	12,281	74,450	74,500	14,475	10,331	14,475	13,031
68,500	68,550	12,988	9,371	12,988	11,544	71,500	71,550	13,738	9,821	13,738	12,294	74,500	74,550	14,488	10,344	14,491	13,044
68,550	68,600	13,000	9,379	13,000	11,556	71,550	71,600	13,750	9,829	13,750	12,306	74,550	74,600	14,500	10,356	14,506	13,056
68,600	68,650	13,013	9,386	13,013	11,569	71,600	71,650	13,763	9,836	13,763	12,319	74,600	74,650	14,513	10,369	14,519	13,069
68,650	68,700	13,025	9,394	13,025	11,581	71,650	71,700	13,775	9,844	13,775	12,331	74,650	74,700	14,525	10,381	14,533	13,081
68,700	68,750	13,038	9,401	13,038	11,594	71,700	71,750	13,788	9,851	13,788	12,344	74,700	74,750	14,538	10,394	14,547	13,094
68,750	68,800	13,050	9,409	13,050	11,606	71,750	71,800	13,800	9,859	13,800	12,356	74,750	74,800	14,550</			

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
Your tax is—						Your tax is—						Your tax is—					
75,000						78,000						81,000					
75,000	75,050	14,613	10,469	14,631	13,169	78,000	78,050	15,363	11,219	15,471	13,919	81,000	81,050	16,113	11,969	16,311	14,669
75,050	75,100	14,625	10,481	14,645	13,181	78,050	78,100	15,375	11,231	15,485	13,931	81,050	81,100	16,125	11,981	16,325	14,681
75,100	75,150	14,638	10,494	14,659	13,194	78,100	78,150	15,388	11,244	15,499	13,944	81,100	81,150	16,138	11,994	16,339	14,694
75,150	75,200	14,650	10,506	14,673	13,206	78,150	78,200	15,400	11,256	15,513	13,956	81,150	81,200	16,150	12,006	16,353	14,706
75,200	75,250	14,663	10,519	14,687	13,219	78,200	78,250	15,413	11,269	15,527	13,969	81,200	81,250	16,163	12,019	16,367	14,719
75,250	75,300	14,675	10,531	14,701	13,231	78,250	78,300	15,425	11,281	15,541	13,981	81,250	81,300	16,175	12,031	16,381	14,731
75,300	75,350	14,688	10,544	14,715	13,244	78,300	78,350	15,438	11,294	15,555	13,994	81,300	81,350	16,188	12,044	16,395	14,744
75,350	75,400	14,700	10,556	14,729	13,256	78,350	78,400	15,450	11,306	15,569	14,006	81,350	81,400	16,200	12,056	16,409	14,756
75,400	75,450	14,713	10,569	14,743	13,269	78,400	78,450	15,463	11,319	15,583	14,019	81,400	81,450	16,213	12,069	16,423	14,769
75,450	75,500	14,725	10,581	14,757	13,281	78,450	78,500	15,475	11,331	15,597	14,031	81,450	81,500	16,225	12,081	16,437	14,781
75,500	75,550	14,738	10,594	14,771	13,294	78,500	78,550	15,488	11,344	15,611	14,044	81,500	81,550	16,238	12,094	16,451	14,794
75,550	75,600	14,750	10,606	14,785	13,306	78,550	78,600	15,500	11,356	15,625	14,056	81,550	81,600	16,250	12,106	16,465	14,806
75,600	75,650	14,763	10,619	14,799	13,319	78,600	78,650	15,513	11,369	15,639	14,069	81,600	81,650	16,263	12,119	16,479	14,819
75,650	75,700	14,775	10,631	14,813	13,331	78,650	78,700	15,525	11,381	15,653	14,081	81,650	81,700	16,275	12,131	16,493	14,831
75,700	75,750	14,788	10,644	14,827	13,344	78,700	78,750	15,538	11,394	15,667	14,094	81,700	81,750	16,288	12,144	16,507	14,844
75,750	75,800	14,800	10,656	14,841	13,356	78,750	78,800	15,550	11,406	15,681	14,106	81,750	81,800	16,300	12,156	16,521	14,856
75,800	75,850	14,813	10,669	14,855	13,369	78,800	78,850	15,563	11,419	15,695	14,119	81,800	81,850	16,313	12,169	16,535	14,869
75,850	75,900	14,825	10,681	14,869	13,381	78,850	78,900	15,575	11,431	15,709	14,131	81,850	81,900	16,325	12,181	16,549	14,881
75,900	75,950	14,838	10,694	14,883	13,394	78,900	78,950	15,588	11,444	15,723	14,144	81,900	81,950	16,338	12,194	16,563	14,894
75,950	76,000	14,850	10,706	14,897	13,406	78,950	79,000	15,600	11,456	15,737	14,156	81,950	82,000	16,350	12,206	16,577	14,906
76,000						79,000						82,000					
76,000	76,050	14,863	10,719	14,911	13,419	79,000	79,050	15,613	11,469	15,751	14,169	82,000	82,050	16,363	12,219	16,591	14,919
76,050	76,100	14,875	10,731	14,925	13,431	79,050	79,100	15,625	11,481	15,765	14,181	82,050	82,100	16,375	12,231	16,605	14,931
76,100	76,150	14,888	10,744	14,939	13,444	79,100	79,150	15,638	11,494	15,779	14,194	82,100	82,150	16,388	12,244	16,619	14,944
76,150	76,200	14,900	10,756	14,953	13,456	79,150	79,200	15,650	11,506	15,793	14,206	82,150	82,200	16,400	12,256	16,633	14,956
76,200	76,250	14,913	10,769	14,967	13,469	79,200	79,250	15,663	11,519	15,807	14,219	82,200	82,250	16,413	12,269	16,647	14,969
76,250	76,300	14,925	10,781	14,981	13,481	79,250	79,300	15,675	11,531	15,821	14,231	82,250	82,300	16,425	12,281	16,661	14,981
76,300	76,350	14,938	10,794	14,995	13,494	79,300	79,350	15,688	11,544	15,835	14,244	82,300	82,350	16,438	12,294	16,675	14,994
76,350	76,400	14,950	10,806	15,009	13,506	79,350	79,400	15,700	11,556	15,849	14,256	82,350	82,400	16,450	12,306	16,689	15,006
76,400	76,450	14,963	10,819	15,023	13,519	79,400	79,450	15,713	11,569	15,863	14,269	82,400	82,450	16,463	12,319	16,703	15,019
76,450	76,500	14,975	10,831	15,037	13,531	79,450	79,500	15,725	11,581	15,877	14,281	82,450	82,500	16,475	12,331	16,717	15,031
76,500	76,550	14,988	10,844	15,051	13,544	79,500	79,550	15,738	11,594	15,891	14,294	82,500	82,550	16,488	12,344	16,731	15,044
76,550	76,600	15,000	10,856	15,065	13,556	79,550	79,600	15,750	11,606	15,905	14,306	82,550	82,600	16,500	12,356	16,745	15,056
76,600	76,650	15,013	10,869	15,079	13,569	79,600	79,650	15,763	11,619	15,919	14,319	82,600	82,650	16,513	12,369	16,759	15,069
76,650	76,700	15,025	10,881	15,093	13,581	79,650	79,700	15,775	11,631	15,933	14,331	82,650	82,700	16,525	12,381	16,773	15,081
76,700	76,750	15,038	10,894	15,107	13,594	79,700	79,750	15,788	11,644	15,947	14,344	82,700	82,750	16,538	12,394	16,787	15,094
76,750	76,800	15,050	10,906	15,121	13,606	79,750	79,800	15,800	11,656	15,961	14,356	82,750	82,800	16,550	12,406	16,801	15,106
76,800	76,850	15,063	10,919	15,135	13,619	79,800	79,850	15,813	11,669	15,975	14,369	82,800	82,850	16,563	12,419	16,815	15,119
76,850	76,900	15,075	10,931	15,149	13,631	79,850	79,900	15,825	11,681	15,989	14,381	82,850	82,900	16,575	12,431	16,829	15,131
76,900	76,950	15,088	10,944	15,163	13,644	79,900	79,950	15,838	11,694	16,003	14,394	82,900	82,950	16,588	12,444	16,843	15,144
76,950	77,000	15,100	10,956	15,177	13,656	79,950	80,000	15,850	11,706	16,017	14,406	82,950	83,000	16,600	12,456	16,857	15,156
77,000						80,000						83,000					
77,000	77,050	15,113	10,969	15,191	13,669	80,000	80,050	15,863	11,719	16,031	14,419	83,000	83,050	16,613	12,469	16,871	15,169
77,050	77,100	15,125	10,981	15,205	13,681	80,050	80,100	15,875	11,731	16,045	14,431	83,050	83,100	16,625	12,481	16,885	15,181
77,100	77,150	15,138	10,994	15,219	13,694	80,100	80,150	15,888	11,744	16,059	14,444	83,100	83,150	16,638	12,494	16,899	15,194
77,150	77,200	15,150	11,006	15,233	13,706	80,150	80,200	15,900	11,756	16,073	14,456	83,150	83,200	16,650	12,506	16,913	15,206
77,200	77,250	15,163	11,019	15,247	13,719	80,200	80,250	15,913	11,769	16,087	14,469	83,200	83,250	16,663	12,519	16,927	15,219
77,250	77,300	15,175	11,031	15,261	13,731	80,250	80,300	15,925	11,781	16,101	14,481	83,250	83,300	16,675	12,531	16,941	15,231
77,300	77,350	15,188	11,044	15,275	13,744	80,300	80,350	15,938	11,794	16,115	14,494	83,300	83,350	16,688	12,544	16,955	15,244
77,350	77,400	15,200	11,056	15,289	13,756	80,350	80,400	15,950	11,806	16,129	14,506	83,350	83,400	16,700	12,556	16,969	15,256
77,400	77,450	15,213	11,069	15,303	13,769	80,400	80,450	15,963	11,819	16,143	14,519	83,400	83,450	16,713	12,569	16,983	15,269
77,450	77,500	15,225	11,081	15,317	13,781	80,450	80,500	15,975	11,831	16,157	14,531	83,450	83,500	16,725	12,581	16,997	15,281
77,500	77,550	15,238	11,094	15,331	13,794	80,500	80,550	15,988	11,844	16,171	14,544	83,500	83,550	16,738	12,594	17,011	15,294
77,550	77,600	15,250	11,106	15,345	13,806	80,550	80,600	16,000	11,856	16,185	14,556	83,550	83,600	16,750	12,606	17,025	15,306
77,600	77,650	15,263	11,119	15,359	13,819	80,600	80,650	16,013	11,869	16,199	14,569	83,600	83,650	16,763	12,619	17,039	15,319
77,650	77,700	15,275	11,131	15,373	13,831	80,650	80,700	16,025	11,881	16,213	14,581	83,650	83,700	16,775	12,631	17,053	15,331
77,700	77,750	15,288	11,144	15,387	13,844	80,700	80,750	16,038	11,894	16,227	14,594	83,700	83,750	16,788	12,644	17,067	15,344
77,750	77,800	15,300	11,156	15,401	13,856	80,750	80,800	16,050	11,906	16,241	14,606	83,750	83,800	16,800	12,656	17,081	15,356
77,800	77,850	15,313	11,169														

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
84,000						87,000						90,000					
84,000	84,050	16,863	12,719	17,151	15,419	87,000	87,050	17,613	13,469	17,991	16,169	90,000	90,050	18,383	14,219	18,831	16,919
84,050	84,100	16,875	12,731	17,165	15,431	87,050	87,100	17,625	13,481	18,005	16,181	90,050	90,100	18,397	14,231	18,845	16,931
84,100	84,150	16,888	12,744	17,179	15,444	87,100	87,150	17,638	13,494	18,019	16,194	90,100	90,150	18,411	14,244	18,859	16,944
84,150	84,200	16,900	12,756	17,193	15,456	87,150	87,200	17,650	13,506	18,033	16,206	90,150	90,200	18,425	14,256	18,873	16,956
84,200	84,250	16,913	12,769	17,207	15,469	87,200	87,250	17,663	13,519	18,047	16,219	90,200	90,250	18,439	14,269	18,887	16,969
84,250	84,300	16,925	12,781	17,221	15,481	87,250	87,300	17,675	13,531	18,061	16,231	90,250	90,300	18,453	14,281	18,901	16,981
84,300	84,350	16,938	12,794	17,235	15,494	87,300	87,350	17,688	13,544	18,075	16,244	90,300	90,350	18,467	14,294	18,915	16,994
84,350	84,400	16,950	12,806	17,249	15,506	87,350	87,400	17,700	13,556	18,089	16,256	90,350	90,400	18,481	14,306	18,929	17,006
84,400	84,450	16,963	12,819	17,263	15,519	87,400	87,450	17,713	13,569	18,103	16,269	90,400	90,450	18,495	14,319	18,943	17,019
84,450	84,500	16,975	12,831	17,277	15,531	87,450	87,500	17,725	13,581	18,117	16,281	90,450	90,500	18,509	14,331	18,957	17,031
84,500	84,550	16,988	12,844	17,291	15,544	87,500	87,550	17,738	13,594	18,131	16,294	90,500	90,550	18,523	14,344	18,971	17,044
84,550	84,600	17,000	12,856	17,305	15,556	87,550	87,600	17,750	13,606	18,145	16,306	90,550	90,600	18,537	14,356	18,985	17,056
84,600	84,650	17,013	12,869	17,319	15,569	87,600	87,650	17,763	13,619	18,159	16,319	90,600	90,650	18,551	14,369	18,999	17,069
84,650	84,700	17,025	12,881	17,333	15,581	87,650	87,700	17,775	13,631	18,173	16,331	90,650	90,700	18,565	14,381	19,013	17,081
84,700	84,750	17,038	12,894	17,347	15,594	87,700	87,750	17,788	13,644	18,187	16,344	90,700	90,750	18,579	14,394	19,027	17,094
84,750	84,800	17,050	12,906	17,361	15,606	87,750	87,800	17,800	13,656	18,201	16,356	90,750	90,800	18,593	14,406	19,041	17,106
84,800	84,850	17,063	12,919	17,375	15,619	87,800	87,850	17,813	13,669	18,215	16,369	90,800	90,850	18,607	14,419	19,055	17,119
84,850	84,900	17,075	12,931	17,389	15,631	87,850	87,900	17,825	13,681	18,229	16,381	90,850	90,900	18,621	14,431	19,069	17,131
84,900	84,950	17,088	12,944	17,403	15,644	87,900	87,950	17,838	13,694	18,243	16,394	90,900	90,950	18,635	14,444	19,083	17,144
84,950	85,000	17,100	12,956	17,417	15,656	87,950	88,000	17,850	13,706	18,257	16,406	90,950	91,000	18,649	14,456	19,097	17,156
85,000						88,000						91,000					
85,000	85,050	17,113	12,969	17,431	15,669	88,000	88,050	17,863	13,719	18,271	16,419	91,000	91,050	18,663	14,469	19,111	17,169
85,050	85,100	17,125	12,981	17,445	15,681	88,050	88,100	17,875	13,731	18,285	16,431	91,050	91,100	18,677	14,481	19,125	17,181
85,100	85,150	17,138	12,994	17,459	15,694	88,100	88,150	17,888	13,744	18,299	16,444	91,100	91,150	18,691	14,494	19,139	17,194
85,150	85,200	17,150	13,006	17,473	15,706	88,150	88,200	17,900	13,756	18,313	16,456	91,150	91,200	18,705	14,506	19,153	17,206
85,200	85,250	17,163	13,019	17,487	15,719	88,200	88,250	17,913	13,769	18,327	16,469	91,200	91,250	18,719	14,519	19,167	17,219
85,250	85,300	17,175	13,031	17,501	15,731	88,250	88,300	17,925	13,781	18,341	16,481	91,250	91,300	18,733	14,531	19,181	17,231
85,300	85,350	17,188	13,044	17,515	15,744	88,300	88,350	17,938	13,794	18,355	16,494	91,300	91,350	18,747	14,544	19,195	17,244
85,350	85,400	17,200	13,056	17,529	15,756	88,350	88,400	17,950	13,806	18,369	16,506	91,350	91,400	18,761	14,556	19,209	17,256
85,400	85,450	17,213	13,069	17,543	15,769	88,400	88,450	17,963	13,819	18,383	16,519	91,400	91,450	18,775	14,569	19,223	17,269
85,450	85,500	17,225	13,081	17,557	15,781	88,450	88,500	17,975	13,831	18,397	16,531	91,450	91,500	18,789	14,581	19,237	17,281
85,500	85,550	17,238	13,094	17,571	15,794	88,500	88,550	17,988	13,844	18,411	16,544	91,500	91,550	18,803	14,594	19,251	17,294
85,550	85,600	17,250	13,106	17,585	15,806	88,550	88,600	18,000	13,856	18,425	16,556	91,550	91,600	18,817	14,606	19,265	17,306
85,600	85,650	17,263	13,119	17,599	15,819	88,600	88,650	18,013	13,869	18,439	16,569	91,600	91,650	18,831	14,619	19,279	17,319
85,650	85,700	17,275	13,131	17,613	15,831	88,650	88,700	18,025	13,881	18,453	16,581	91,650	91,700	18,845	14,631	19,293	17,331
85,700	85,750	17,288	13,144	17,627	15,844	88,700	88,750	18,038	13,894	18,467	16,594	91,700	91,750	18,859	14,644	19,307	17,344
85,750	85,800	17,300	13,156	17,641	15,856	88,750	88,800	18,050	13,906	18,481	16,606	91,750	91,800	18,873	14,656	19,321	17,356
85,800	85,850	17,313	13,169	17,655	15,869	88,800	88,850	18,063	13,919	18,495	16,619	91,800	91,850	18,887	14,669	19,335	17,369
85,850	85,900	17,325	13,181	17,669	15,881	88,850	88,900	18,075	13,931	18,509	16,631	91,850	91,900	18,901	14,681	19,349	17,381
85,900	85,950	17,338	13,194	17,683	15,894	88,900	88,950	18,088	13,944	18,523	16,644	91,900	91,950	18,915	14,694	19,363	17,394
85,950	86,000	17,350	13,206	17,697	15,906	88,950	89,000	18,100	13,956	18,537	16,656	91,950	92,000	18,929	14,706	19,377	17,406
86,000						89,000						92,000					
86,000	86,050	17,363	13,219	17,711	15,919	89,000	89,050	18,113	13,969	18,551	16,669	92,000	92,050	18,943	14,719	19,391	17,419
86,050	86,100	17,375	13,231	17,725	15,931	89,050	89,100	18,125	13,981	18,565	16,681	92,050	92,100	18,957	14,731	19,405	17,431
86,100	86,150	17,388	13,244	17,739	15,944	89,100	89,150	18,138	13,994	18,579	16,694	92,100	92,150	18,971	14,744	19,419	17,444
86,150	86,200	17,400	13,256	17,753	15,956	89,150	89,200	18,150	14,006	18,593	16,706	92,150	92,200	18,985	14,756	19,433	17,456
86,200	86,250	17,413	13,269	17,767	15,969	89,200	89,250	18,163	14,019	18,607	16,719	92,200	92,250	18,999	14,769	19,447	17,469
86,250	86,300	17,425	13,281	17,781	15,981	89,250	89,300	18,175	14,031	18,621	16,731	92,250	92,300	19,013	14,781	19,461	17,481
86,300	86,350	17,438	13,294	17,795	15,994	89,300	89,350	18,188	14,044	18,635	16,744	92,300	92,350	19,027	14,794	19,475	17,494
86,350	86,400	17,450	13,306	17,809	16,006	89,350	89,400	18,201	14,056	18,649	16,756	92,350	92,400	19,041	14,806	19,489	17,506
86,400	86,450	17,463	13,319	17,823	16,019	89,400	89,450	18,215	14,069	18,663	16,769	92,400	92,450	19,055	14,819	19,503	17,519
86,450	86,500	17,475	13,331	17,837	16,031	89,450	89,500	18,229	14,081	18,677	16,781	92,450	92,500	19,069	14,831	19,517	17,531
86,500	86,550	17,488	13,344	17,851	16,044	89,500	89,550	18,243	14,094	18,691	16,794	92,500	92,550	19,083	14,844	19,531	17,544
86,550	86,600	17,500	13,356	17,865	16,056	89,550	89,600	18,257	14,106	18,705	16,806	92,550	92,600	19,097	14,856	19,545	17,556
86,600	86,650	17,513	13,369	17,879	16,069	89,600	89,650	18,271	14,119	18,719	16,819	92,600	92,650	19,111	14,869	19,559	17,569
86,650	86,700	17,525	13,381	17,893	16,081	89,650	89,700	18,285	14,131	18,733	16,831	92,650	92,700	19,125	14,881	19,573	17,581
86,700	86,750	17,538	13,394	17,907	16,094	89,700	89,750	18,299	14,144	18,747	16,844	92,700	92,750	19,139	14,894	19,587	17,594
86,750	86,800	17,550	13,406	17,921	16,106	89,750	89,800	18,313	14,156	18,7							

2014 Tax Table—Continued

If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—				If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household	At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—						Your tax is—						Your tax is—			
93,000						96,000						99,000					
93,000	93,050	19,223	14,969	19,671	17,669	96,000	96,050	20,063	15,719	20,511	18,419	99,000	99,050	20,903	16,469	21,351	19,169
93,050	93,100	19,237	14,981	19,685	17,681	96,050	96,100	20,077	15,731	20,525	18,431	99,050	99,100	20,917	16,481	21,365	19,181
93,100	93,150	19,251	14,994	19,699	17,694	96,100	96,150	20,091	15,744	20,539	18,444	99,100	99,150	20,931	16,494	21,379	19,194
93,150	93,200	19,265	15,006	19,713	17,706	96,150	96,200	20,105	15,756	20,553	18,456	99,150	99,200	20,945	16,506	21,393	19,206
93,200	93,250	19,279	15,019	19,727	17,719	96,200	96,250	20,119	15,769	20,567	18,469	99,200	99,250	20,959	16,519	21,407	19,219
93,250	93,300	19,293	15,031	19,741	17,731	96,250	96,300	20,133	15,781	20,581	18,481	99,250	99,300	20,973	16,531	21,421	19,231
93,300	93,350	19,307	15,044	19,755	17,744	96,300	96,350	20,147	15,794	20,595	18,494	99,300	99,350	20,987	16,544	21,435	19,244
93,350	93,400	19,321	15,056	19,769	17,756	96,350	96,400	20,161	15,806	20,609	18,506	99,350	99,400	21,001	16,556	21,449	19,256
93,400	93,450	19,335	15,069	19,783	17,769	96,400	96,450	20,175	15,819	20,623	18,519	99,400	99,450	21,015	16,569	21,463	19,269
93,450	93,500	19,349	15,081	19,797	17,781	96,450	96,500	20,189	15,831	20,637	18,531	99,450	99,500	21,029	16,581	21,477	19,281
93,500	93,550	19,363	15,094	19,811	17,794	96,500	96,550	20,203	15,844	20,651	18,544	99,500	99,550	21,043	16,594	21,491	19,294
93,550	93,600	19,377	15,106	19,825	17,806	96,550	96,600	20,217	15,856	20,665	18,556	99,550	99,600	21,057	16,606	21,505	19,306
93,600	93,650	19,391	15,119	19,839	17,819	96,600	96,650	20,231	15,869	20,679	18,569	99,600	99,650	21,071	16,619	21,519	19,319
93,650	93,700	19,405	15,131	19,853	17,831	96,650	96,700	20,245	15,881	20,693	18,581	99,650	99,700	21,085	16,631	21,533	19,331
93,700	93,750	19,419	15,144	19,867	17,844	96,700	96,750	20,259	15,894	20,707	18,594	99,700	99,750	21,099	16,644	21,547	19,344
93,750	93,800	19,433	15,156	19,881	17,856	96,750	96,800	20,273	15,906	20,721	18,606	99,750	99,800	21,113	16,656	21,561	19,356
93,800	93,850	19,447	15,169	19,895	17,869	96,800	96,850	20,287	15,919	20,735	18,619	99,800	99,850	21,127	16,669	21,575	19,369
93,850	93,900	19,461	15,181	19,909	17,881	96,850	96,900	20,301	15,931	20,749	18,631	99,850	99,900	21,141	16,681	21,589	19,381
93,900	93,950	19,475	15,194	19,923	17,894	96,900	96,950	20,315	15,944	20,763	18,644	99,900	99,950	21,155	16,694	21,603	19,394
93,950	94,000	19,489	15,206	19,937	17,906	96,950	97,000	20,329	15,956	20,777	18,656	99,950	100,000	21,169	16,706	21,617	19,406
94,000						97,000						<div style="border: 1px solid black; padding: 10px; width: fit-content; margin: 0 auto;"> <p>\$100,000 or over use the Tax Computation Worksheet</p> </div>					
94,000	94,050	19,503	15,219	19,951	17,919	97,000	97,050	20,343	15,969	20,791	18,669						
94,050	94,100	19,517	15,231	19,965	17,931	97,050	97,100	20,357	15,981	20,805	18,681						
94,100	94,150	19,531	15,244	19,979	17,944	97,100	97,150	20,371	15,994	20,819	18,694						
94,150	94,200	19,545	15,256	19,993	17,956	97,150	97,200	20,385	16,006	20,833	18,706						
94,200	94,250	19,559	15,269	20,007	17,969	97,200	97,250	20,399	16,019	20,847	18,719						
94,250	94,300	19,573	15,281	20,021	17,981	97,250	97,300	20,413	16,031	20,861	18,731						
94,300	94,350	19,587	15,294	20,035	17,994	97,300	97,350	20,427	16,044	20,875	18,744						
94,350	94,400	19,601	15,306	20,049	18,006	97,350	97,400	20,441	16,056	20,889	18,756						
94,400	94,450	19,615	15,319	20,063	18,019	97,400	97,450	20,455	16,069	20,903	18,769						
94,450	94,500	19,629	15,331	20,077	18,031	97,450	97,500	20,469	16,081	20,917	18,781						
94,500	94,550	19,643	15,344	20,091	18,044	97,500	97,550	20,483	16,094	20,931	18,794						
94,550	94,600	19,657	15,356	20,105	18,056	97,550	97,600	20,497	16,106	20,945	18,806						
94,600	94,650	19,671	15,369	20,119	18,069	97,600	97,650	20,511	16,119	20,959	18,819						
94,650	94,700	19,685	15,381	20,133	18,081	97,650	97,700	20,525	16,131	20,973	18,831						
94,700	94,750	19,699	15,394	20,147	18,094	97,700	97,750	20,539	16,144	20,987	18,844						
94,750	94,800	19,713	15,406	20,161	18,106	97,750	97,800	20,553	16,156	21,001	18,856						
94,800	94,850	19,727	15,419	20,175	18,119	97,800	97,850	20,567	16,169	21,015	18,869						
94,850	94,900	19,741	15,431	20,189	18,131	97,850	97,900	20,581	16,181	21,029	18,881						
94,900	94,950	19,755	15,444	20,203	18,144	97,900	97,950	20,595	16,194	21,043	18,894						
94,950	95,000	19,769	15,456	20,217	18,156	97,950	98,000	20,609	16,206	21,057	18,906						
95,000						98,000											
95,000	95,050	19,783	15,469	20,231	18,169	98,000	98,050	20,623	16,219	21,071	18,919						
95,050	95,100	19,797	15,481	20,245	18,181	98,050	98,100	20,637	16,231	21,085	18,931						
95,100	95,150	19,811	15,494	20,259	18,194	98,100	98,150	20,651	16,244	21,099	18,944						
95,150	95,200	19,825	15,506	20,273	18,206	98,150	98,200	20,665	16,256	21,113	18,956						
95,200	95,250	19,839	15,519	20,287	18,219	98,200	98,250	20,679	16,269	21,127	18,969						
95,250	95,300	19,853	15,531	20,301	18,231	98,250	98,300	20,693	16,281	21,141	18,981						
95,300	95,350	19,867	15,544	20,315	18,244	98,300	98,350	20,707	16,294	21,155	18,994						
95,350	95,400	19,881	15,556	20,329	18,256	98,350	98,400	20,721	16,306	21,169	19,006						
95,400	95,450	19,895	15,569	20,343	18,269	98,400	98,450	20,735	16,319	21,183	19,019						
95,450	95,500	19,909	15,581	20,357	18,281	98,450	98,500	20,749	16,331	21,197	19,031						
95,500	95,550	19,923	15,594	20,371	18,294	98,500	98,550	20,763	16,344	21,211	19,044						
95,550	95,600	19,937	15,606	20,385	18,306	98,550	98,600	20,777	16,356	21,225	19,056						
95,600	95,650	19,951	15,619	20,399	18,319	98,600	98,650	20,791	16,369	21,239	19,069						
95,650	95,700	19,965	15,631	20,413	18,331	98,650	98,700	20,805	16,381	21,253	19,081						
95,700	95,750	19,979	15,644	20,427	18,344	98,700	98,750	20,819	16,394	21,267	19,094						
95,750	95,800	19,993	15,656	20,441	18,356	98,750	98,800	20,833	16,406	21,281	19,106						
95,800	95,850	20,007	15,669	20,455	18,369	98,800	98,850	20,847	16,419	21,295	19,119						
95,850	95,900	20,021	15,681	20,469	18,381	98,850	98,900	20,861	16,431	21,309	19,131						
95,900	95,950	20,035	15,694	20,483	18,394	98,900	98,950	20,875	16,444	21,323	19,144						
95,950	96,000	20,049	15,706	20,497	18,406	98,950	99,000	20,889	16,456	21,337	19,156						

* This column must also be used by a qualifying widow(er).

2014 OPTIONAL SALES TAX TABLES

When Used

The election to deduct state and local general sales taxes requires that the taxpayer forgo any deduction for state and local income taxes. Whether this is advisable or not depends on a comparison of the amounts involved. In making the choice, however, the outcome could be influenced by the additional sales tax incurred due to certain “big ticket” purchases that were made. For example, a taxpayer who chose to deduct state and local income taxes for 2013 might well prefer the sales tax deduction in 2014 if a new boat was purchased or home improvements were made during the year. To make the sales tax election, the taxpayer must enter the amount on Schedule A, line 5, and check box b. Unless extended by Congress, the sales tax deduction will expire as to tax years after 2014.

If the sales tax election is made, the amount of the deduction can be determined by use of the *actual expense method* or the *optional sales tax tables* issued by the IRS. The actual expense method can be used only when the taxpayer has actual receipts to support the deduction claimed. In the absence of receipts, the usual case with most taxpayers, resorting to the optional sales tax tables is necessary. Under neither method, however, is the purchase of items used in a taxpayer’s trade or business to be considered.

Adjustments Necessary

The optional sales tax tables are based on a number of assumptions that require adjustments to be made. As the starting point for the use of the tables is AGI, nontaxable receipts have not been included. Examples of receipts that should be added include: tax-exempt interest, veterans’ benefits, nontaxable combat pay, public assistance payments, workers’ compensation, nontaxable Social Security, and other retirement benefits. They do not include any large nontaxable items that are not likely to be spent. For example, a \$100,000 inheritance should not be added if it was invested in a certificate of deposit.

The tables represent the sales tax on the average (and recurring) expenditures based on level of income by family size and do not include exceptional purchases. Therefore, add to the table amount any sales taxes on major purchases (such as motor vehicles, aircraft, boats, and home building materials, etc.).

When the optional sales tax tables are utilized, special adjustments may be needed when a taxpayer has lived in more than one taxing jurisdiction (e.g., state, county, city) during the year. The adjustments involve apportionment of taxes based on days involved and are illustrated in Instructions for Schedule A (Form 1040), pages A-3 to A-6.

Local Sales Taxes

Local sales taxes (i.e., those imposed by counties, cities, transit authorities) may or may not require a separate determination. In those states where they are not imposed, no further computations are necessary. This is also the case where the local taxes are uniform and are incorporated into the state sales tax table. In other situations, another step is necessary to arrive at the optional sales tax table deduction. Depending on where the taxpayer lives, one of two procedures needs to be used. In one procedure, the local sales tax is arrived at by using the **state table** amount—see the Example 1 worksheet. In the other procedure, special **local tables** issued by the IRS for enumerated state and local jurisdictions are modified (if necessary) and used—see the Example 2 worksheet.

Use Illustrated

EXAMPLE 1 The Archers file a joint return for 2014 reflecting AGI of \$88,000 and claiming three exemptions. They have tax-exempt interest of \$3,000, and during the year they incurred sales tax of \$1,650 on the purchase of an automobile for their dependent teenage son. They live in Bellaire, Texas, where the general sales tax rates are 6.25% for state and 2% for local. Since the IRS *has not issued* optional local sales tax tables for Texas, use the Worksheet below to arrive at the Archers' general sales tax deduction of \$3,086.

Sales Tax Deduction Worksheet

(To be used when *no* IRS Optional Local Sales Tax Table Available)

Adjusted Gross Income (AGI) as listed on line 38 of Form 1040	\$88,000
Add nontaxable items	<u>3,000</u>
Table income to be used for purposes of line 1 below	<u>\$91,000</u>
 1. Use table income to determine table amount—go to state of residence and find applicable range of table income and exemption column* for <i>state</i> sales tax	 \$ 1,088
2a. Enter local general sales tax rate	<u>2.0</u>
2b. Enter state general sales tax rate	<u>6.25</u>
2c. Divide 2a by 2b	<u>0.32</u>
2d. Multiply line 1 by line 2c for the local sales tax	348
3. Enter general sales tax on large purchases	<u>1,650</u>
4. Deduction for general sales tax (add lines 1 + 2d + 3) and report on line 5 of Schedule A of Form 1040	<u>\$ 3,086</u>

*Use total of personal and dependency exemptions as reported in item 6d of Form 1040.

EXAMPLE 2 The Hardys file a joint return for 2014, reporting AGI of \$40,000 and claiming four exemptions (two personal and two dependency). They received \$30,000 in nontaxable pension benefits. Although the Hardys do not keep sales tax receipts, they can prove that they paid \$4,800 in sales tax on the purchase of a new boat in 2014. The Hardys are residents of Georgia and live in a jurisdiction that imposes a 2% local sales tax. Since the IRS *has issued* optional local sales tax tables for Georgia, use the Worksheet below to arrive at the Hardys' general sales tax deduction of \$5,666.

Sales Tax Deduction Worksheet

(To be used for Alaska, Arizona, Arkansas, Colorado, Georgia, Illinois, Louisiana, Missouri, New York, North Carolina, South Carolina, Tennessee, Utah, Virginia, and West Virginia)

Adjusted Gross Income (AGI) as listed on line 38 of Form 1040	\$40,000
Add nontaxable income	<u>30,000</u>
Table income to be used for purposes of line 1 below	<u>\$70,000</u>
 1. Use the table income to determine <i>state</i> sales tax amount—go to table for state of residence and find applicable income range and exemption column*	 \$ 540
2a. Enter local general sales tax rate	<u>2.0</u>
2b. Enter IRS <i>local</i> sales tax table amount (based on 1%)	<u>\$163</u>
2c. Multiply line 2b by 2a for the local sales tax	326
3. Enter general sales tax on large purchases	<u>4,800</u>
4. Deduction for general sales tax (add lines 1 + 2c + 3) and report on line 5 of Schedule A of Form 1040	<u>\$ 5,666</u>

*Use total of personal and dependency exemptions as reported in item 6d of Form 1040.

2014 Optional State Sales Tax Tables (State Sales Tax Rate Shown Next to State Name)

Income	Exemptions					Exemptions					Exemptions					Exemptions										
	At	But less than	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5
			Alabama 1 4.000%					Arizona 2 5.600%					Arkansas 2 6.500%					California 3 7.500%								
\$0	\$20,000	223	263	290	310	328	352		214	237	251	262	271	283	283	315	335	350	363	380	267	292	308	321	330	344
\$20,000	\$30,000	329	387	426	456	481	517		364	403	428	446	462	482	460	513	546	572	592	620	446	488	515	536	552	574
\$30,000	\$40,000	384	451	496	531	560	601		448	496	527	550	569	595	558	621	662	693	718	753	546	598	631	656	676	703
\$40,000	\$50,000	431	505	556	595	628	673		524	580	616	644	666	696	644	718	765	801	830	869	635	695	734	763	787	818
\$50,000	\$60,000	473	554	609	652	687	737		594	658	699	730	755	789	722	805	859	899	931	976	716	785	829	861	888	924
\$60,000	\$70,000	510	598	657	703	741	795		658	729	775	809	837	875	794	886	945	989	1025	1074	792	867	916	952	981	1021
\$70,000	\$80,000	545	638	701	750	790	847		719	797	847	884	915	956	862	961	1025	1073	1112	1165	862	945	998	1037	1069	1112
\$80,000	\$90,000	577	675	742	793	836	896		777	861	915	955	988	1033	925	1032	1100	1152	1194	1251	929	1018	1075	1117	1152	1198
\$90,000	\$100,000	607	710	780	834	879	942		832	922	979	1023	1058	1106	985	1099	1172	1227	1272	1333	992	1088	1148	1194	1230	1280
\$100,000	\$120,000	647	757	831	888	936	1003		906	1004	1067	1115	1153	1206	1066	1189	1269	1328	1377	1443	1078	1182	1248	1297	1337	1391
\$120,000	\$140,000	699	817	896	958	1010	1082		1005	1114	1184	1237	1279	1338	1173	1309	1396	1462	1515	1588	1192	1306	1379	1434	1478	1538
\$140,000	\$160,000	747	873	957	1023	1078	1155		1099	1218	1295	1353	1399	1464	1274	1421	1516	1588	1646	1726	1299	1424	1504	1564	1612	1677
\$160,000	\$180,000	792	924	1013	1083	1142	1222		1187	1316	1399	1462	1512	1582	1368	1526	1628	1705	1768	1853	1400	1535	1621	1685	1737	1808
\$180,000	\$200,000	833	972	1066	1139	1200	1285		1272	1411	1499	1566	1621	1695	1457	1627	1736	1818	1884	1976	1497	1641	1733	1802	1857	1933
\$200,000	\$225,000	877	1023	1121	1198	1261	1351		1362	1510	1605	1677	1735	1815	1552	1732	1848	1936	2007	2104	1599	1753	1851	1924	1984	2064
\$225,000	\$250,000	924	1077	1180	1260	1327	1421		1460	1618	1721	1798	1860	1945	1654	1847	1970	2064	2144	2244	1709	1874	1979	2058	2121	2207
\$250,000	\$275,000	968	1127	1235	1319	1389	1487		1553	1722	1831	1913	1979	2070	1751	1955	2087	2186	2266	2376	1815	1990	2101	2185	2252	2344
\$275,000	\$300,000	1009	1176	1288	1375	1448	1550		1643	1822	1937	2024	2094	2191	1845	2060	2198	2303	2387	2504	1917	2102	2219	2307	2379	2476
\$300,000	or more	1256	1461	1598	1705	1794	1919		2199	2439	2594	2711	2805	2935	2413	2696	2878	3015	3126	3279	2540	2785	2942	3059	3153	3282
		Colorado 2 2.900%					Connecticut 4 6.350%					District of Columbia 4 5.750%					Florida 1 6.000%									
\$0	\$20,000	111	124	133	139	144	151		263	289	305	317	327	340	168	181	189	195	200	207	238	261	276	287	296	308
\$20,000	\$30,000	174	194	207	217	225	236		432	475	502	522	539	561	284	307	322	332	341	353	396	434	459	478	493	513
\$30,000	\$40,000	208	232	247	259	268	281		526	578	611	636	656	683	350	379	397	410	421	436	483	531	561	584	602	627
\$40,000	\$50,000	237	264	282	295	306	320		609	670	708	737	760	792	409	443	464	480	493	510	561	616	651	678	699	729
\$50,000	\$60,000	264	294	313	328	339	356		685	753	797	829	856	891	464	502	526	544	559	579	632	695	734	764	789	822
\$60,000	\$70,000	288	320	341	357	370	388		755	830	878	914	943	983	514	556	583	604	620	642	698	767	811	844	871	907
\$70,000	\$80,000	310	345	368	385	399	418		820	902	955	994	1025	1068	561	608	638	660	678	702	759	834	882	918	948	988
\$80,000	\$90,000	331	368	392	410	425	446		882	970	1027	1069	1103	1149	606	657	689	713	732	759	817	898	950	989	1020	1063
\$90,000	\$100,000	350	390	415	435	450	472		940	1035	1095	1140	1176	1226	649	704	738	764	784	813	873	959	1014	1056	1090	1136
\$100,000	\$120,000	377	419	447	467	484	507		1019	1122	1187	1236	1276	1329	708	767	804	833	855	886	947	1041	1101	1147	1183	1233
\$120,000	\$140,000	411	457	487	510	528	553		1124	1237	1309	1363	1407	1466	785	851	893	924	949	984	1046	1150	1216	1266	1307	1362
\$140,000	\$160,000	444	493	525	550	569	596		1222	1346	1425	1484	1531	1596	858	931	977	1011	1039	1077	1139	1253	1325	1380	1424	1484
\$160,000	\$180,000	474	526	561	586	607	636		1315	1448	1533	1596	1647	1717	928	1006	1056	1093	1123	1164	1227	1349	1427	1486	1533	1599
\$180,000	\$200,000	502	558	594	621	644	674		1403	1545	1636	1704	1758	1833	994	1078	1132	1172	1204	1248	1310	1441	1525	1588	1639	1708
\$200,000	\$225,000	532	591	629	658	682	714		1496	1648	1745	1817	1875	1955	1064	1155	1212	1252	1290	1337	1399	1538	1628	1695	1749	1824
\$225,000	\$250,000	564	626	667	698	722	757		1597	1759	1863	1940	2002	2087	1141	1238	1300	1346	1383	1434	1494	1644	1739	1811	1869	1949
\$250,000	\$275,000	594	660	703	735	761	797		1693	1865	1975	2057	2123	2213	1214	1318	1384	1433	1473	1527	1586	1744	1846	1922	1984	2068
\$275,000	\$300,000	623	692	737	771	798	836		1785	1967	2083	2170	2240	2335	1285	1395	1465	1517	1559	1617	1674	1841	1949	2029	2094	2184
\$300,000	or more	798	885	942	985	1020	1068		2350	2591	2744	2859	2951	3078	1721	1870	1965	2036	2093	2171	2211	2434	2576	2683	2770	2889
		Georgia 2 4.000%					Hawaii 1.7 4.000%					Idaho 1 6.000%					Illinois 2 6.250%									
\$0	\$20,000	151	168	179	187	194	203		220	255	279	297	312	333	337	396	436	467	493	529	251	281	301	316	329	346
\$20,000	\$30,000	241	267	284	297	308	322		356	414	452	482	507	542	501	588	647	692	730	783	389	434	465	488	507	533
\$30,000	\$40,000	289	321	341	357	369	387		430	501	548	584	614	656	586	687	756	809	852	914	462	516	551	578	601	632
\$40,000	\$50,000	332	368	391	409	423	443		496	578	632	674	708	757	660	773	849	908	957	1026	525	586	626	657	682	718
\$50,000	\$60,000	370	411	437	456	472	494		556	647	708	755	794	849	725	849	932	997	1051	1126	582	649	694	728	756	795
\$60,000	\$70,000	405	449	478	499	517	541		611	711	779	830	873	933	784	917	1007	1077	1135	1216	634	707	755	792	822	864
\$70,000	\$80,000	438	486	516	540	558	584		662	771																

2014 Optional State Sales Tax Tables (Continued)

Income	Louisiana 2 4.0000%					Maine 4 5.5000%					Maryland 4 6.0000%					Massachusetts 4 6.2500%								
\$0 \$20,000	161	175	184	191	196	204	146	159	167	173	178	184	208	229	244	255	264	276	201	219	230	239	246	255
\$20,000 \$30,000	267	291	306	318	327	339	246	267	281	291	299	310	343	380	404	422	437	458	317	345	363	376	387	402
\$30,000 \$40,000	326	356	374	388	399	415	302	328	345	358	368	381	419	464	493	515	533	559	379	413	434	450	463	481
\$40,000 \$50,000	379	413	435	451	464	482	352	383	402	417	429	445	486	538	572	598	619	648	434	472	496	514	529	549
\$50,000 \$60,000	427	466	490	509	523	544	398	433	455	472	485	503	547	606	642	673	697	731	483	525	552	573	589	611
\$60,000 \$70,000	471	514	541	562	578	600	441	479	504	522	537	557	604	668	711	743	770	806	528	574	603	626	643	668
\$70,000 \$80,000	513	560	589	612	629	654	480	523	550	570	586	608	656	727	773	808	837	877	569	619	651	675	694	720
\$80,000 \$90,000	552	603	635	659	678	704	518	564	593	615	632	656	706	782	832	870	901	944	608	661	695	721	741	769
\$90,000 \$100,000	590	644	678	703	724	752	554	603	634	657	676	701	754	835	888	929	962	1008	645	701	737	764	786	815
\$100,000 \$120,000	640	699	736	764	786	817	603	656	690	715	736	763	818	906	964	1008	1044	1093	694	755	793	822	846	877
\$120,000 \$140,000	707	772	813	844	868	902	668	727	764	792	815	845	902	1000	1064	1112	1152	1207	759	825	867	899	924	959
\$140,000 \$160,000	771	841	886	919	946	983	729	793	834	865	889	923	982	1088	1158	1211	1254	1314	819	891	936	970	997	1035
\$160,000 \$180,000	830	906	954	990	1020	1059	786	856	900	933	960	996	1057	1171	1247	1304	1350	1415	875	952	1000	1036	1066	1106
\$180,000 \$200,000	887	968	1020	1058	1090	1132	842	916	963	999	1027	1066	1129	1251	1331	1392	1442	1511	929	1009	1061	1099	1130	1173
\$200,000 \$225,000	946	1033	1089	1130	1163	1209	900	980	1030	1068	1099	1140	1204	1335	1420	1486	1539	1613	985	1070	1125	1165	1198	1243
\$225,000 \$250,000	1011	1104	1164	1208	1243	1292	963	1049	1103	1143	1176	1220	1286	1426	1517	1587	1644	1723	1045	1136	1193	1236	1271	1319
\$250,000 \$275,000	1073	1172	1235	1282	1320	1371	1024	1114	1172	1215	1250	1297	1364	1512	1609	1683	1744	1828	1102	1197	1258	1304	1341	1391
\$275,000 \$300,000	1133	1237	1304	1353	1393	1448	1082	1178	1239	1285	1321	1371	1439	1596	1698	1776	1840	1929	1157	1257	1321	1368	1407	1460
\$300,000 or more	1498	1637	1725	1791	1844	1917	1440	1569	1650	1711	1760	1827	1898	2105	2241	2345	2429	2546	1485	1613	1695	1756	1805	1872

Income	Michigan 2 6.0000%					Minnesota 1 6.8750%					Mississippi 1 7.0000%					Missouri 2 4.2250%								
\$0 \$20,000	226	251	266	278	288	301	235	254	265	274	281	291	414	476	518	550	576	613	172	195	211	223	233	247
\$20,000 \$30,000	357	395	419	437	452	473	394	426	446	461	473	489	642	739	803	853	893	950	272	309	334	353	368	390
\$30,000 \$40,000	427	472	501	523	541	565	483	522	547	566	581	601	763	878	955	1014	1062	1129	325	370	400	422	441	466
\$40,000 \$50,000	488	540	573	598	618	646	562	609	638	660	677	701	868	1000	1087	1154	1209	1285	373	424	457	483	504	534
\$50,000 \$60,000	543	601	638	665	688	719	636	688	722	746	766	793	963	1109	1205	1279	1340	1425	415	472	509	538	562	594
\$60,000 \$70,000	594	656	697	727	751	785	703	762	799	826	848	878	1048	1207	1313	1393	1460	1552	454	516	557	588	614	650
\$70,000 \$80,000	641	708	751	784	810	847	767	831	871	901	925	958	1128	1299	1412	1499	1570	1670	490	557	601	635	663	701
\$80,000 \$90,000	685	757	803	837	866	904	827	896	940	972	998	1034	1202	1384	1505	1598	1674	1780	524	595	643	679	708	749
\$90,000 \$100,000	726	802	851	888	918	959	885	959	1005	1040	1068	1106	1272	1465	1593	1690	1771	1883	556	632	682	720	751	794
\$100,000 \$120,000	782	863	916	956	988	1032	962	1043	1094	1132	1162	1204	1366	1573	1710	1815	1901	2021	599	680	734	775	809	855
\$120,000 \$140,000	854	944	1001	1044	1079	1127	1065	1155	1212	1254	1288	1333	1488	1713	1862	1977	2071	2202	655	744	803	847	884	935
\$140,000 \$160,000	923	1019	1081	1127	1165	1217	1163	1262	1324	1370	1407	1457	1602	1845	2005	2129	2230	2371	708	804	867	915	955	1010
\$160,000 \$180,000	986	1089	1155	1204	1245	1300	1255	1361	1428	1478	1518	1572	1708	1966	2138	2269	2377	2527	757	859	927	979	1021	1080
\$180,000 \$200,000	1047	1155	1225	1278	1320	1379	1343	1457	1529	1583	1625	1684	1808	2082	2263	2402	2517	2676	804	912	984	1039	1083	1146
\$200,000 \$225,000	1110	1225	1299	1355	1400	1462	1436	1559	1636	1693	1739	1801	1913	2202	2394	2541	2662	2831	853	968	1043	1101	1149	1215
\$225,000 \$250,000	1178	1300	1378	1437	1485	1551	1537	1669	1751	1813	1862	1929	2025	2332	2535	2691	2819	2997	905	1027	1108	1169	1220	1290
\$250,000 \$275,000	1242	1371	1453	1516	1566	1635	1634	1774	1862	1927	1980	2051	2132	2454	2668	2832	2967	3155	955	1084	1169	1233	1287	1360
\$275,000 \$300,000	1304	1439	1526	1591	1644	1716	1728	1876	1969	2038	2094	2169	2234	2572	2796	2968	3109	3305	1003	1138	1227	1295	1351	1428
\$300,000 or more	1676	1848	1959	2042	2109	2202	2303	2502	2627	2720	2795	2896	2842	3272	3557	3775	3955	4205	1292	1464	1578	1665	1737	1836

Income	Nebraska 1 5.5000%					Nevada 5 6.8500%					New Jersey 4.6 7.0000%					New Mexico 1 5.1250%								
\$0 \$20,000	223	247	262	273	282	294	265	293	311	324	335	350	248	266	278	286	293	302	195	217	231	241	250	262
\$20,000 \$30,000	371	410	436	455	470	491	412	455	482	503	520	543	413	443	463	477	489	505	337	375	400	419	434	455
\$30,000 \$40,000	453	502	533	556	575	601	490	541	574	598	618	646	504	542	566	584	599	618	419	467	498	522	541	567
\$40,000 \$50,000	527	583	619	647	669	699	558	616	653	681	704	735	586	631	659	680	696	719	492	550	587	614	637	668
\$50,000 \$60,000	594	658	699	730	755	789	619	683	725	755	780	815	661	712	743	767	786	812	561	626	669	701	727	762
\$60,000 \$70,000	656	727	772	806	834	872	675	745	789	823	850	888	730	786	822	848	869	898	625	698	745	781	810	850
\$70,000 \$80,000	714	792	841	878	908	949	727	802	850	886	915	955	795	856	895	924	947	978	685	766	818	857	889	933
\$80,000 \$90,000	769	853	906	946	979	1023	775	855	906	944	975	1018	857	923	964	995	1020	1054	743	831	887	930	965	1013
\$90,000 \$100,000	822	911	968	1011	1046	1093	821	905	959	999	1032	1077	915	986	1030	1063	1090	1126	798	892	954	1000	1037	1089
\$100,000 \$120,000	892	990	1052	1098	1136	1188	881	972	1030	1073	1108	1157	994	1071	1119	1155	1184	1224	873	977	1044	1094	1136	1192
\$120,000 \$140,000	966	1074	1138	1184	1226	1284	961	1059	1122	1170	1208	1260	1098	1184	1238	1278	1310	1353	973	1089	1165	1221	1267	1331
\$140,000 \$160,000	1035	1153	1218	1264	1306	1364	1036	1141	1209	1260	1301	1357	1197	1291	1349	1393	1428	1476	1069	1197	1280	1343	1393	1463
\$160,000 \$180,000	1108	1235	1300	1346	1388	1446	1105	1217	1289	1343	1387	1447	1290	1391	1454	1502	1540	1591	1159	1299	1389	1457	1512	1588
\$180,000 \$200,000	1178	1314	1380																					

2014 Optional State Sales Tax Tables

Income	Oklahoma	1	4.5000%	Pennsylvania	1	6.0000%	Rhode Island	4	7.0000%	South Carolina	2	6.0000%												
\$0 \$20,000	243	279	303	322	338	359	194	210	220	228	234	243	255	278	293	304	313	325	234	257	272	284	293	305
\$20,000 \$30,000	379	435	473	502	526	560	319	346	363	376	386	400	397	433	455	472	486	504	386	425	450	469	484	505
\$30,000 \$40,000	452	519	564	598	627	667	388	421	442	458	471	488	472	515	541	562	578	600	470	519	549	572	591	616
\$40,000 \$50,000	515	591	642	682	714	760	449	488	512	530	545	566	537	586	616	639	658	683	545	601	637	664	685	715
\$50,000 \$60,000	572	657	713	757	793	844	505	548	576	597	614	637	596	650	684	709	730	758	614	677	718	748	772	805
\$60,000 \$70,000	624	716	778	826	865	920	557	605	635	658	677	702	650	708	745	773	795	825	677	747	792	825	852	888
\$70,000 \$80,000	672	771	838	889	931	990	605	657	690	715	736	763	699	762	802	832	855	888	736	812	861	897	926	966
\$80,000 \$90,000	717	823	894	948	993	1056	650	707	743	770	791	821	745	812	855	886	912	947	792	874	926	965	997	1040
\$90,000 \$100,000	760	871	946	1004	1052	1119	693	754	792	821	844	876	789	860	905	938	965	1002	845	933	988	1030	1064	1110
\$100,000 \$120,000	817	936	1017	1079	1130	1202	752	817	859	890	916	950	847	923	971	1007	1036	1076	917	1012	1072	1118	1154	1204
\$120,000 \$140,000	891	1022	1109	1177	1233	1311	829	901	947	982	1010	1048	923	1006	1059	1098	1130	1173	1011	1117	1183	1233	1274	1329
\$140,000 \$160,000	960	1101	1195	1268	1328	1412	901	980	1031	1068	1099	1141	994	1086	1140	1182	1216	1263	1101	1216	1288	1343	1387	1447
\$160,000 \$180,000	1025	1175	1275	1353	1417	1507	969	1054	1109	1150	1182	1228	1060	1155	1216	1261	1297	1346	1185	1308	1387	1445	1493	1557
\$180,000 \$200,000	1086	1245	1351	1433	1501	1596	1034	1125	1183	1227	1262	1311	1123	1224	1287	1335	1374	1426	1265	1397	1481	1544	1594	1663
\$200,000 \$225,000	1150	1318	1431	1518	1589	1690	1103	1200	1262	1309	1346	1398	1188	1295	1362	1413	1453	1509	1350	1490	1580	1647	1701	1775
\$225,000 \$250,000	1219	1397	1516	1608	1684	1790	1177	1281	1347	1397	1438	1493	1258	1371	1443	1496	1539	1598	1441	1592	1687	1759	1817	1896
\$250,000 \$275,000	1284	1471	1597	1694	1774	1886	1248	1358	1429	1482	1524	1583	1325	1444	1519	1575	1620	1682	1528	1688	1790	1866	1927	2011
\$275,000 \$300,000	1347	1543	1674	1776	1860	1977	1316	1432	1507	1563	1608	1670	1388	1513	1592	1651	1698	1763	1613	1781	1889	1969	2024	2122
\$300,000 or more	1721	1970	2137	2266	2373	2522	1731	1886	1985	2059	2119	2201	1768	1926	2027	2102	2162	2245	2127	2350	2492	2599	2684	2801

Income	South Dakota	1	4.0000%	Tennessee	2	7.0000%	Texas	1	6.2500%	Utah	2	4.7000%												
\$0 \$20,000	235	271	296	314	330	351	366	416	450	475	496	525	254	283	301	315	326	342	236	267	288	304	317	335
\$20,000 \$30,000	366	423	461	490	514	548	579	658	711	751	784	830	419	466	497	520	539	565	376	426	459	484	504	533
\$30,000 \$40,000	437	505	550	584	613	653	693	789	852	900	940	995	510	568	606	634	657	688	452	512	551	581	606	640
\$40,000 \$50,000	498	575	627	666	699	744	793	903	975	1030	1075	1138	591	658	702	735	762	799	518	587	632	666	695	734
\$50,000 \$60,000	553	639	696	740	776	827	884	1006	1086	1147	1198	1268	664	741	790	828	858	899	578	655	705	743	775	819
\$60,000 \$70,000	603	697	759	807	846	901	967	1099	1187	1254	1309	1386	732	817	872	913	946	992	633	717	772	814	848	896
\$70,000 \$80,000	649	750	817	869	911	971	1043	1187	1281	1354	1413	1495	796	888	948	993	1029	1079	684	774	834	879	917	968
\$80,000 \$90,000	693	800	872	927	972	1035	1115	1268	1369	1447	1510	1598	856	956	1020	1068	1107	1161	732	829	892	941	981	1036
\$90,000 \$100,000	733	848	923	982	1030	1097	1183	1345	1453	1535	1602	1695	913	1020	1088	1140	1181	1239	777	880	947	999	1041	1100
\$100,000 \$120,000	788	911	992	1055	1106	1178	1274	1449	1564	1652	1725	1825	991	1105	1180	1236	1282	1344	838	948	1021	1077	1123	1186
\$120,000 \$140,000	860	993	1082	1151	1207	1285	1393	1584	1710	1807	1886	1996	1092	1220	1302	1364	1414	1483	917	1039	1118	1179	1229	1299
\$140,000 \$160,000	927	1071	1167	1240	1301	1385	1505	1712	1848	1952	2037	2156	1189	1328	1417	1485	1540	1615	992	1123	1210	1276	1330	1404
\$160,000 \$180,000	989	1143	1245	1323	1388	1478	1609	1830	1975	2086	2178	2305	1279	1429	1525	1598	1657	1739	1062	1202	1294	1365	1423	1503
\$180,000 \$200,000	1048	1211	1319	1402	1471	1566	1708	1942	2096	2214	2311	2446	1365	1525	1629	1707	1770	1857	1128	1277	1375	1450	1511	1596
\$200,000 \$225,000	1109	1282	1396	1485	1557	1658	1812	2060	2223	2348	2451	2594	1456	1627	1738	1821	1888	1981	1197	1356	1460	1539	1604	1695
\$225,000 \$250,000	1175	1358	1480	1573	1650	1757	1923	2186	2360	2493	2602	2753	1555	1738	1856	1945	2017	2116	1272	1440	1551	1635	1705	1800
\$250,000 \$275,000	1238	1431	1559	1657	1738	1851	2029	2307	2490	2630	2745	2904	1649	1843	1968	2063	2139	2245	1343	1521	1638	1727	1800	1901
\$275,000 \$300,000	1298	1500	1634	1737	1822	1941	2131	2422	2614	2761	2882	3049	1739	1944	2077	2177	2258	2369	1412	1598	1721	1814	1891	1997
\$300,000 or more	1657	1915	2086	2218	2326	2478	2740	3114	3361	3550	3705	3920	2292	2564	2740	2872	2979	3127	1822	2063	2221	2342	2441	2578

Income	Vermont	1	6.0000%	Virginia	2	4.3000%	Washington	1	6.5000%	West Virginia	2	6.0000%												
\$0 \$20,000	163	174	181	186	190	195	178	203	218	230	240	254	260	287	304	316	327	341	250	279	297	311	323	338
\$20,000 \$30,000	253	270	281	288	294	303	274	310	334	352	367	388	431	476	504	526	543	567	413	461	492	516	535	561
\$30,000 \$40,000	301	321	334	343	350	360	324	367	395	417	434	459	526	581	616	642	663	693	503	563	601	630	653	686
\$40,000 \$50,000	343	366	380	390	399	410	368	416	448	472	492	520	611	674	715	746	770	804	584	653	697	731	758	796
\$50,000 \$60,000	380	406	422	433	442	455	407	460	495	522	544	574	688	760	806	840	868	907	657	735	786	824	855	897
\$60,000 \$70,000	415	442	459	472	482	496	442	500	538	567	591	624	760	839	889	928	959	1001	725	811	867	909	943	991
\$70,000 \$80,000	446	476	494	508	519	533	475	537	578	609	634	670	826	912	968	1009	1043	1090	789	883	943	989	1027	1078
\$80,000 \$90,000	476	507	527	541	553	569	506	572	615	648	675	712	890	982	1042	1087	1123	1173	849	950	1016	1065	1105	1161
\$90,000 \$100,000	503	537	558	573	585	602	534	604	650	685	713	75												

Which Optional Local Sales Tax Table Should I Use?

IF you live in the state of...	AND you live in...	THEN use Local Table...
Alaska	Any locality	C
Arizona	Chandler, Glendale, Gilbert, Mesa, Peoria, Phoenix, Scottsdale, Tempe, Tucson, Yuma, or any other locality	B
Arkansas	Any locality	B
Colorado	Adams County, Arapahoe County, Boulder County, Centennial, Colorado Springs, Denver City/Denver County, El Paso County, Larimer County, Pueblo County, or any other locality	A
	Greeley, Jefferson County, Lakewood, Longmont or Pueblo City	B
	Arvada, Boulder, Fort Collins, Thornton, or Westminster	C
Georgia	Any locality	B
Illinois	City of Aurora	B
	Any other locality	A
Louisiana	Ascension Parish, Bossier Parish, Caddo Parish, Calcasieu Parish, East Baton Rouge Parish, Iberia Parish, Jefferson Parish, Lafayette Parish, Lafourche Parish, Livingston Parish, Orleans Parish, Ouachita Parish, Rapides Parish, St. Bernard Parish, St. Landry Parish, St. Tammany Parish, Tangipahoa Parish, or Terrebonne Parish	C
	Any other locality	B
Missouri	Any locality	B
New York	Counties: Albany, Allegany, Broome, Cattaraugus, Cayuga, Chautauqua, Chemung, Chenango, Clinton, Columbia, Cortland, Delaware, Dutchess, Erie, Essex, Franklin, Fulton, Genesee, Greene, Hamilton, Herkimer, Jefferson, Lewis, Livingston, Madison, Monroe, Montgomery, Nassau, Niagara, Oneida, Onondaga, Ontario, Orange, Orleans, Oswego, Otsego, Putnam, Rensselaer, Rockland, St. Lawrence, Saratoga, Schenectady, Schoharie, Schuyler, Seneca, Steuben, Suffolk, Sullivan, Tioga, Tompkins, Ulster, Warren, Washington, Wayne, Westchester, Wyoming, or Yates New York City or Norwich City	B
	Any other locality	D*
North Carolina	Any locality	A
South Carolina	Aiken County, Horry County, Lexington County, Newberry County, Orangeburg County, York County, or Myrtle Beach	A
	Bamberg County, Charleston County, Cherokee County, Chesterfield County, Darlington County, Dillon County, Florence County, Hampton County, Jasper County, Lee County, Marion County, Marlboro County, or any other locality	B
Tennessee	Any locality	B
Utah	Any locality	A
Virginia	Any locality	B
West Virginia	Any locality	B

2014 Optional Local Sales Tax Tables for Certain Local Jurisdictions

Income		Exemptions							Exemptions						
At least	But less than	1	2	3	4	5	Over 5	1	2	3	4	5	Over 5		
		Local Table A							Local Table B						
\$0	\$20,000	38	43	46	48	50	52	47	53	58	62	64	68		
20,000	30,000	60	66	71	74	77	81	71	82	89	94	99	105		
30,000	40,000	71	79	84	88	91	96	84	97	105	111	117	124		
40,000	50,000	81	90	96	100	104	109	96	110	119	126	132	140		
50,000	60,000	89	99	106	111	115	121	106	122	132	140	146	155		
60,000	70,000	97	108	115	121	125	131	115	132	143	152	159	169		
70,000	80,000	105	117	124	130	135	141	124	142	154	163	170	181		
80,000	90,000	112	124	132	139	144	150	132	151	164	173	181	192		
90,000	100,000	118	131	140	147	152	159	139	159	173	183	192	203		
100,000	120,000	127	141	150	157	163	171	149	171	185	196	205	218		
120,000	140,000	138	154	164	171	178	186	162	186	201	213	223	237		
140,000	160,000	149	166	176	184	191	200	175	200	216	229	240	254		
160,000	180,000	159	176	188	197	204	213	186	212	230	244	255	271		
180,000	200,000	168	187	199	208	216	226	196	225	243	258	270	286		
200,000	225,000	178	198	210	220	228	239	208	237	257	272	285	302		
225,000	250,000	189	209	223	233	241	253	220	251	272	288	301	319		
250,000	275,000	199	220	234	245	254	266	231	264	286	303	316	336		
275,000	300,000	208	231	246	257	266	279	242	276	299	317	331	351		
300,000	or more	265	294	313	327	338	354	306	349	378	400	418	444		
		Local Table C							Local Table D						
\$0	\$20,000	56	64	69	73	77	81	36	39	40	42	43	44		
20,000	30,000	87	100	108	114	120	127	60	64	67	69	71	73		
30,000	40,000	104	119	129	136	143	151	73	78	82	85	87	89		
40,000	50,000	119	136	147	156	163	173	85	91	95	98	101	104		
50,000	60,000	132	151	163	173	181	192	96	103	107	111	114	117		
60,000	70,000	144	164	178	189	197	209	105	113	119	122	125	130		
70,000	80,000	155	177	192	203	212	225	115	124	129	133	137	141		
80,000	90,000	165	189	205	217	227	240	124	133	139	143	147	152		
90,000	100,000	175	200	217	230	240	255	132	142	148	153	157	162		
100,000	120,000	188	215	233	247	258	274	143	154	161	166	171	176		
120,000	140,000	205	235	254	269	282	299	158	170	178	184	189	195		
140,000	160,000	221	253	274	290	304	322	172	186	194	201	206	212		
160,000	180,000	236	270	293	310	324	344	186	200	209	216	222	229		
180,000	200,000	250	286	310	328	343	364	198	214	224	231	237	245		
200,000	225,000	265	303	329	348	364	386	212	228	239	247	253	261		
225,000	250,000	281	322	348	369	385	409	226	244	255	264	270	279		
250,000	275,000	296	339	367	388	406	431	240	259	271	280	287	297		
275,000	300,000	311	355	385	407	426	452	254	274	286	296	303	313		
300,000	or more	397	454	492	520	544	577	336	362	379	392	402	415		

Income Tax Rates—Estates and Trusts

Tax Year 2014

Taxable Income		The Tax Is:	
Over—	But not Over—		Of the Amount Over—
\$ 0	\$ 2,500	15%	\$ 0
2,500	5,800	\$ 375.00 + 25%	2,500
5,800	8,900	1,200.00 + 28%	5,800
8,900	12,150	2,068.00 + 33%	8,900
12,150	.....	3,140.50 + 39.6%	12,150

Tax Year 2015

Taxable Income		The Tax Is:	
Over—	But not Over—		Of the Amount Over—
\$ 0	\$ 2,500	15%	\$ 0
2,500	5,900	\$ 375.00 + 25%	2,500
5,900	9,050	1,225.00 + 28%	5,900
9,050	12,300	2,107.00 + 33%	9,050
12,300	.....	3,179.50 + 39.6%	12,300

Income Tax Rates—Corporations

Taxable Income		The Tax Is:	
Over—	But not Over—		Of the Amount Over—
\$ 0	\$ 50,000	15%	\$ 0
50,000	75,000	\$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	.....	35%	0

Unified Transfer Tax Rates

For Gifts Made and for Deaths in 2007–2009

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over \$10,000	18 percent of such amount.
Over \$10,000 but not over \$20,000	\$1,800, plus 20 percent of the excess of such amount over \$10,000.
Over \$20,000 but not over \$40,000	\$3,800, plus 22 percent of the excess of such amount over \$20,000.
Over \$40,000 but not over \$60,000	\$8,200, plus 24 percent of the excess of such amount over \$40,000.
Over \$60,000 but not over \$80,000	\$13,000, plus 26 percent of the excess of such amount over \$60,000.
Over \$80,000 but not over \$100,000	\$18,200, plus 28 percent of the excess of such amount over \$80,000.
Over \$100,000 but not over \$150,000	\$23,800, plus 30 percent of the excess of such amount over \$100,000.
Over \$150,000 but not over \$250,000	\$38,800, plus 32 percent of the excess of such amount over \$150,000.
Over \$250,000 but not over \$500,000	\$70,800, plus 34 percent of the excess of such amount over \$250,000.
Over \$500,000 but not over \$750,000	\$155,800, plus 37 percent of the excess of such amount over \$500,000.
Over \$750,000 but not over \$1,000,000	\$248,300, plus 39 percent of the excess of such amount over \$750,000.
Over \$1,000,000 but not over \$1,250,000	\$345,800, plus 41 percent of the excess of such amount over \$1,000,000.
Over \$1,250,000 but not over \$1,500,000	\$448,300, plus 43 percent of the excess of such amount over \$1,250,000.
Over \$1,500,000	\$555,800, plus 45 percent of the excess of such amount over \$1,500,000.

Gift Tax Rates

For Gifts Made Only in 2010

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over \$10,000	18 percent of such amount.
Over \$10,000 but not over \$20,000	\$1,800, plus 20 percent of the excess of such amount over \$10,000.
Over \$20,000 but not over \$40,000	\$3,800, plus 22 percent of the excess of such amount over \$20,000.
Over \$40,000 but not over \$60,000	\$8,200, plus 24 percent of the excess of such amount over \$40,000.
Over \$60,000 but not over \$80,000	\$13,000, plus 26 percent of the excess of such amount over \$60,000.
Over \$80,000 but not over \$100,000	\$18,200, plus 28 percent of the excess of such amount over \$80,000.
Over \$100,000 but not over \$150,000	\$23,800, plus 30 percent of the excess of such amount over \$100,000.
Over \$150,000 but not over \$250,000	\$38,800, plus 32 percent of the excess of such amount over \$150,000.
Over \$250,000 but not over \$500,000	\$70,800, plus 34 percent of the excess of such amount over \$250,000.
Over \$500,000	\$155,800, plus 35 percent of the excess of such amount over \$500,000.

Unified Transfer Tax Rates

For Gifts Made and for Deaths in 2011–2012

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over \$10,000	18 percent of such amount.
Over \$10,000 but not over \$20,000	\$1,800, plus 20 percent of the excess of such amount over \$10,000.
Over \$20,000 but not over \$40,000	\$3,800, plus 22 percent of the excess of such amount over \$20,000.
Over \$40,000 but not over \$60,000	\$8,200, plus 24 percent of the excess of such amount over \$40,000.
Over \$60,000 but not over \$80,000	\$13,000, plus 26 percent of the excess of such amount over \$60,000.
Over \$80,000 but not over \$100,000	\$18,200, plus 28 percent of the excess of such amount over \$80,000.
Over \$100,000 but not over \$150,000	\$23,800, plus 30 percent of the excess of such amount over \$100,000.
Over \$150,000 but not over \$250,000	\$38,800, plus 32 percent of the excess of such amount over \$150,000.
Over \$250,000 but not over \$500,000	\$70,800, plus 34 percent of the excess of such amount over \$250,000.
Over \$500,000	\$155,800, plus 35 percent of the excess of such amount over \$500,000.

Unified Transfer Tax Rates

For Gifts Made and for Deaths after 2012

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over \$10,000	18 percent of such amount.
Over \$10,000 but not over \$20,000	\$1,800, plus 20 percent of the excess of such amount over \$10,000.
Over \$20,000 but not over \$40,000	\$3,800, plus 22 percent of the excess of such amount over \$20,000.
Over \$40,000 but not over \$60,000	\$8,200, plus 24 percent of the excess of such amount over \$40,000.
Over \$60,000 but not over \$80,000	\$13,000, plus 26 percent of the excess of such amount over \$60,000.
Over \$80,000 but not over \$100,000	\$18,200, plus 28 percent of the excess of such amount over \$80,000.
Over \$100,000 but not over \$150,000	\$23,800, plus 30 percent of the excess of such amount over \$100,000.
Over \$150,000 but not over \$250,000	\$38,800, plus 32 percent of the excess of such amount over \$150,000.
Over \$250,000 but not over \$500,000	\$70,800, plus 34 percent of the excess of such amount over \$250,000.
Over \$500,000 but not over \$750,000	\$155,800, plus 37 percent of the excess of such amount over \$500,000.
Over \$750,000 but not over \$1,000,000	\$248,300, plus 39 percent of the excess of such amount over \$750,000.
Over \$1,000,000	\$345,800, plus 40 percent of the excess of such amount over \$1,000,000.



Appendix B

Tax Forms

(Tax forms can be obtained from the IRS website: www.irs.gov)

Form 709	United States Gift (and Generation-Skipping Transfer) Tax Return	B-3
Form 1040	U.S. Individual Income Tax Return	B-7
Schedule A	Itemized Deductions	B-9
Schedule B	Interest and Ordinary Dividends	B-10
Schedule C	Profit or Loss From Business	B-11
Schedule D	Capital Gains and Losses	B-13
Schedule E	Supplemental Income and Loss	B-15
Schedule F	Profit or Loss From Farming	B-17
Schedule SE	Self-Employment Tax	B-19
Form 1041	U.S. Income Tax Return for Estates and Trusts	B-21
Schedule K-1	Beneficiary's Share of Income, Deductions, Credits, etc.	B-23
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Schedule M-3	Net Income (Loss) Reconciliation for Certain Partnerships	B-30

Form 1120	U.S. Corporation Income Tax Return	B-33
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Form 1120S	U.S. Income Tax Return for an S Corporation	B-41
Schedule K-1	Shareholder's Share of Income, Deductions, Credits, etc.	B-46
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Form 8949	Sales and Other Dispositions of Capital Assets	B-50
Form 8958	Allocation of Tax Amounts Between Certain Individuals in Community Property States	B-52
Form 8959	Additional Medicare Tax	B-54
Form 8960	Net Investment Income Tax—Individuals, Estates, and Trusts	B-55
Form 8962	Premium Tax Credit (PTC)	B-56

Form **709**
Department of the Treasury
Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return

OMB No. 1545-0020

► Information about Form 709 and its separate instructions is at www.irs.gov/form709.

(For gifts made during calendar year 2014)

► See instructions.

2014

Part 1—General Information

1 Donor's first name and middle initial	2 Donor's last name	3 Donor's social security number
4 Address (number, street, and apartment number)		5 Legal residence (domicile)
6 City or town, state or province, country, and ZIP or foreign postal code		7 Citizenship (see instructions)
8 If the donor died during the year, check here <input type="checkbox"/> and enter date of death _____, _____		Yes No
9 If you extended the time to file this Form 709, check here <input type="checkbox"/>		
10 Enter the total number of donees listed on Schedule A. Count each person only once ►		
11a Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b		
b Has your address changed since you last filed Form 709 (or 709-A)?		
12 Gifts by husband or wife to third parties. Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (see instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. If the answer is "No," skip lines 13–18.)		
13 Name of consenting spouse	14 SSN	
15 Were you married to one another during the entire calendar year? (see instructions)		
16 If 15 is "No," check whether <input type="checkbox"/> married <input type="checkbox"/> divorced or <input type="checkbox"/> widowed/deceased, and give date (see instructions) ►		
17 Will a gift tax return for this year be filed by your spouse? (If "Yes," mail both returns in the same envelope.)		
18 Consent of Spouse. I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.		
Consenting spouse's signature ►		Date ►
19 Have you applied a DSUE amount received from a predeceased spouse to a gift or gifts reported on this or a previous Form 709? If "Yes," complete Schedule C		

Part 2—Tax Computation

1 Enter the amount from Schedule A, Part 4, line 11	1
2 Enter the amount from Schedule B, line 3	2
3 Total taxable gifts. Add lines 1 and 2	3
4 Tax computed on amount on line 3 (see <i>Table for Computing Gift Tax</i> in instructions)	4
5 Tax computed on amount on line 2 (see <i>Table for Computing Gift Tax</i> in instructions)	5
6 Balance. Subtract line 5 from line 4	6
7 Applicable credit amount. If donor has DSUE amount from predeceased spouse(s), enter amount from Schedule C, line 4; otherwise, see instructions	7
8 Enter the applicable credit against tax allowable for all prior periods (from Sch. B, line 1, col. C)	8
9 Balance. Subtract line 8 from line 7. Do not enter less than zero	9
10 Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions)	10
11 Balance. Subtract line 10 from line 9. Do not enter less than zero	11
12 Applicable credit. Enter the smaller of line 6 or line 11	12
13 Credit for foreign gift taxes (see instructions)	13
14 Total credits. Add lines 12 and 13	14
15 Balance. Subtract line 14 from line 6. Do not enter less than zero	15
16 Generation-skipping transfer taxes (from Schedule D, Part 3, col. H, Total)	16
17 Total tax. Add lines 15 and 16	17
18 Gift and generation-skipping transfer taxes prepaid with extension of time to file	18
19 If line 18 is less than line 17, enter balance due (see instructions)	19
20 If line 18 is greater than line 17, enter amount to be refunded	20

Attach check or money order here.

Sign Here	Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.		May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No	
		Date		
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed PTIN
	Firm's name ►	Firm's EIN ►		
	Firm's address ►	Phone no.		

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SCHEDULE A Computation of Taxable Gifts (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation Yes No

B Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. (see instructions)

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse — complete **only** if you are splitting gifts with your spouse and he/she also made gifts.

Total of Part 1. Add amounts from Part 1, column H ▶

Part 2—Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse — complete **only** if you are splitting gifts with your spouse and he/she also made gifts.

Total of Part 2. Add amounts from Part 2, column H ▶

Part 3—Indirect Skips. Gifts to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse — complete **only** if you are splitting gifts with your spouse and he/she also made gifts.

Total of Part 3. Add amounts from Part 3, column H ▶

(If more space is needed, attach additional statements.)

Part 4—Taxable Gift Reconciliation

1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3	1		
2	Total annual exclusions for gifts listed on line 1 (see instructions)	2		
3	Total included amount of gifts. Subtract line 2 from line 1	3		
Deductions (see instructions)				
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers _____ of Schedule A	4		
5	Exclusions attributable to gifts on line 4	5		
6	Marital deduction. Subtract line 5 from line 4	6		
7	Charitable deduction, based on item nos. _____ less exclusions	7		
8	Total deductions. Add lines 6 and 7	8		
9	Subtract line 8 from line 3	9		
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule D, Part 3, col. H, Total)	10		
11	Taxable gifts. Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1	11		

Terminable Interest (QTIP) Marital Deduction. (see instructions for Schedule A, Part 4, line 4)

If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and:

- a. The trust (or other property) is listed on Schedule A, and
- b. The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule A, Part 4, line 4, then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Parts 1 and 3 of Schedule A is entered as a deduction on line 4, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule A, Part 4, line 6. The denominator is equal to the total value of the trust (or other property) listed in Parts 1 and 3 of Schedule A.

If you make the QTIP election, the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). See instructions for line 4 of Schedule A. If your spouse disposes (by gift or otherwise) of all or part of the qualifying life income interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax. See *Transfer of Certain Life Estates Received From Spouse* in the instructions.

12 Election Out of QTIP Treatment of Annuities

◀ Check here if you elect under section 2523(f)(6) **not** to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). See instructions. Enter the item numbers from Schedule A for the annuities for which you are making this election ▶ _____

SCHEDULE B Gifts From Prior Periods

If you answered "Yes," on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedules C or D, if applicable). Complete Schedule A before beginning Schedule B. See instructions for recalculation of the column C amounts. Attach calculations.

A Calendar year or calendar quarter (see instructions)	B Internal Revenue office where prior return was filed	C Amount of applicable credit (unified credit) against gift tax for periods after December 31, 1976	D Amount of specific exemption for prior periods ending before January 1, 1977	E Amount of taxable gifts
1	Totals for prior periods	1		
2	Amount, if any, by which total specific exemption, line 1, column D is more than \$30,000		2	
3	Total amount of taxable gifts for prior periods. Add amount on line 1, column E and amount, if any, on line 2. Enter here and on page 1, Part 2—Tax Computation, line 2.		3	

(If more space is needed, attach additional statements.)

Form **1040**

Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return**

2014

OMB No. 1545-0074

IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2014, or other tax year beginning _____, 2014, ending _____, 20

Your first name and initial _____ Last name _____ **Your social security number** _____

If a joint return, spouse's first name and initial _____ Last name _____ **Spouse's social security number** _____

Home address (number and street). If you have a P.O. box, see instructions. _____ Apt. no. _____ **▲ Make sure the SSN(s) above and on line 6c are correct.**

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Foreign country name _____ Foreign province/state/county _____ Foreign postal code _____ **Presidential Election Campaign**
Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. You Spouse

Filing Status

1 Single

2 Married filing jointly (even if only one had income)

3 Married filing separately. Enter spouse's SSN above and full name here. ▶ _____

4 Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ _____

5 Qualifying widow(er) with dependent child

Check only one box.

Exemptions

6a **Yourself.** If someone can claim you as a dependent, **do not** check box 6a

b **Spouse**

c Dependents:		(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)
(1) First name	Last name			
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>
				<input type="checkbox"/>

If more than four dependents, see instructions and check here ▶

d Total number of exemptions claimed **Add numbers on lines above ▶**

Boxes checked on 6a and 6b

No. of children on 6c who:

- lived with you
- did not live with you due to divorce or separation (see instructions)

Dependents on 6c not entered above

Income

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
8a	Taxable interest. Attach Schedule B if required	8a	
b	Tax-exempt interest. Do not include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ <input type="checkbox"/>	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions	15a	
b	Taxable amount	15b	
16a	Pensions and annuities	16a	
b	Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits	20a	
b	Taxable amount	20b	
21	Other income. List type and amount _____	21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶ _____	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35	36	
37	Subtract line 36 from line 22. This is your adjusted gross income ▶	37	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2014)

	38	Amount from line 37 (adjusted gross income)	38		
Tax and Credits	39a	Check <input type="checkbox"/> You were born before January 2, 1950, <input type="checkbox"/> Blind. } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1950, <input type="checkbox"/> Blind. } checked ▶ 39a <input type="checkbox"/>			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>			
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$6,200 Married filing jointly or Qualifying widow(er), \$12,400 Head of household, \$9,100	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40		
	41	Subtract line 40 from line 38	41		
	42	Exemptions. If line 38 is \$152,525 or less, multiply \$3,950 by the number on line 6d. Otherwise, see instructions	42		
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43		
	44	Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/>	44		
	45	Alternative minimum tax (see instructions). Attach Form 6251	45		
	46	Excess advance premium tax credit repayment. Attach Form 8962	46		
	47	Add lines 44, 45, and 46 ▶	47		
	48	Foreign tax credit. Attach Form 1116 if required	48		
	49	Credit for child and dependent care expenses. Attach Form 2441	49		
	50	Education credits from Form 8863, line 19	50		
	51	Retirement savings contributions credit. Attach Form 8880	51		
	52	Child tax credit. Attach Schedule 8812, if required	52		
53	Residential energy credits. Attach Form 5695	53			
54	Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	54			
55	Add lines 48 through 54. These are your total credits	55			
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- ▶	56			
Other Taxes	57	Self-employment tax. Attach Schedule SE	57		
	58	Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	58		
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59		
	60a	Household employment taxes from Schedule H	60a		
	b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b		
	61	Health care: individual responsibility (see instructions) Full-year coverage <input type="checkbox"/>	61		
	62	Taxes from: a <input type="checkbox"/> Form 8959 b <input type="checkbox"/> Form 8960 c <input type="checkbox"/> Instructions; enter code(s) <input type="text"/>	62		
63	Add lines 56 through 62. This is your total tax ▶	63			
Payments If you have a qualifying child, attach Schedule EIC.	64	Federal income tax withheld from Forms W-2 and 1099	64		
	65	2014 estimated tax payments and amount applied from 2013 return	65		
	66a	Earned income credit (EIC)	66a		
	b	Nontaxable combat pay election <input type="checkbox"/> 66b <input type="text"/>			
	67	Additional child tax credit. Attach Schedule 8812	67		
	68	American opportunity credit from Form 8863, line 8	68		
	69	Net premium tax credit. Attach Form 8962	69		
	70	Amount paid with request for extension to file	70		
	71	Excess social security and tier 1 RRTA tax withheld	71		
	72	Credit for federal tax on fuels. Attach Form 4136	72		
73	Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> Reserved c <input type="checkbox"/> Reserved d <input type="checkbox"/>	73			
74	Add lines 64, 65, 66a, and 67 through 73. These are your total payments ▶	74			
Refund Direct deposit? See instructions.	75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75		
	76a	Amount of line 75 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/> ▶	76a		
	b	Routing number <input type="text"/> ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings			
d	Account number <input type="text"/>				
77	Amount of line 75 you want applied to your 2015 estimated tax ▶	77			
Amount You Owe	78	Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions ▶	78		
	79	Estimated tax penalty (see instructions)	79		
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes. Complete below. <input type="checkbox"/> No				
	Designee's name ▶ <input type="text"/>	Phone no. ▶ <input type="text"/>	Personal identification number (PIN) ▶ <input type="text"/>		
Sign Here Joint return? See instructions. Keep a copy for your records.	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.				
	Your signature <input type="text"/>	Date <input type="text"/>	Your occupation <input type="text"/>	Daytime phone number <input type="text"/>	
	Spouse's signature. If a joint return, both must sign. <input type="text"/>		Date <input type="text"/>	Spouse's occupation <input type="text"/>	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input type="text"/>
	Print/Type preparer's name <input type="text"/>	Preparer's signature <input type="text"/>	Date <input type="text"/>	Check <input type="checkbox"/> if self-employed PTIN <input type="text"/>	
Paid Preparer Use Only			Firm's name ▶ <input type="text"/>	Firm's EIN ▶ <input type="text"/>	
			Firm's address ▶ <input type="text"/>	Phone no. <input type="text"/>	

**SCHEDULE A
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

► Information about Schedule A and its separate instructions is at www.irs.gov/schedulea.

► Attach to Form 1040.

OMB No. 1545-0074

2014

Attachment
Sequence No. **07**

Name(s) shown on Form 1040

Your social security number

Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see instructions)			
	2	Enter amount from Form 1040, line 38 2			
	3	Multiply line 2 by 10% (.10). But if either you or your spouse was born before January 2, 1950, multiply line 2 by 7.5% (.075) instead			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid	5 State and local (check only one box):				
	a	<input type="checkbox"/> Income taxes, or	}	5	
	b	<input type="checkbox"/> General sales taxes			
	6	Real estate taxes (see instructions)		6	
	7	Personal property taxes		7	
8	Other taxes. List type and amount ►		8		
	9	Add lines 5 through 8			9
Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098			
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ►			

	12	Points not reported to you on Form 1098. See instructions for special rules		12	
	13	Mortgage insurance premiums (see instructions)		13	
	14	Investment interest. Attach Form 4952 if required. (See instructions.)		14	
15	Add lines 10 through 14			15	
Gifts to Charity	16	Gifts by cash or check. If you made any gift of \$250 or more, see instructions		16	
	17	Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500		17	
	18	Carryover from prior year		18	
	19	Add lines 16 through 18			19
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ►		21	
	22	Tax preparation fees		22	
	23	Other expenses—investment, safe deposit box, etc. List type and amount ►		23	
	24	Add lines 21 through 23		24	
	25	Enter amount from Form 1040, line 38 25			
26	Multiply line 25 by 2% (.02)		26		
27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27	
Other Miscellaneous Deductions	28	Other—from list in instructions. List type and amount ►			28
Total Itemized Deductions	29	Is Form 1040, line 38, over \$152,525?			
		<input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40.	}		29
		<input type="checkbox"/> Yes. Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.			
30	If you elect to itemize deductions even though they are less than your standard deduction, check here			<input type="checkbox"/>	

SCHEDULE B
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Interest and Ordinary Dividends

▶ Attach to Form 1040A or 1040.
▶ Information about Schedule B and its instructions is at www.irs.gov/scheduleb.

OMB No. 1545-0074

2014
Attachment
Sequence No. **08**

Name(s) shown on return Your social security number

Part I
Interest

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ▶

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

2 Add the amounts on line 1
3 Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815
4 Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ▶

Note. If line 4 is over \$1,500, you must complete Part III.

Amount	
1	
2	
3	
4	

Part II
Ordinary Dividends

5 List name of payer ▶

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

6 Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ▶

Note. If line 6 is over \$1,500, you must complete Part III.

Amount	
5	
6	

Part III
Foreign Accounts and Trusts

(See instructions on back.)

You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

7a At any time during 2014, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions
If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements
b If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ▶
8 During 2014, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back

Yes	No

**SCHEDULE C
(Form 1040)**

**Profit or Loss From Business
(Sole Proprietorship)**

OMB No. 1545-0074

2014
Attachment
Sequence No. **09**

Department of the Treasury
Internal Revenue Service (99)

▶ **Information about Schedule C and its separate instructions is at www.irs.gov/schedulec.**
▶ **Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.**

Name of proprietor	Social security number (SSN)
A Principal business or profession, including product or service (see instructions)	B Enter code from instructions ▶ | | | | | | | |
C Business name. If no separate business name, leave blank.	D Employer ID number (EIN), (see instr.) | | | | | | | |
E Business address (including suite or room no.) ▶ City, town or post office, state, and ZIP code	
F Accounting method: (1) <input type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶	
G Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on losses . . . <input type="checkbox"/> Yes <input type="checkbox"/> No	
H If you started or acquired this business during 2014, check here . . . <input type="checkbox"/>	
I Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) . . . <input type="checkbox"/> Yes <input type="checkbox"/> No	
J If "Yes," did you or will you file required Forms 1099? . . . <input type="checkbox"/> Yes <input type="checkbox"/> No	

Part I Income

1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . <input type="checkbox"/>	1		
2 Returns and allowances	2		
3 Subtract line 2 from line 1	3		
4 Cost of goods sold (from line 42)	4		
5 Gross profit. Subtract line 4 from line 3	5		
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6		
7 Gross income. Add lines 5 and 6	7		

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8			18 Office expense (see instructions)	18		
9 Car and truck expenses (see instructions).	9			19 Pension and profit-sharing plans	19		
10 Commissions and fees	10			20 Rent or lease (see instructions):			
11 Contract labor (see instructions)	11			a Vehicles, machinery, and equipment	20a		
12 Depletion	12			b Other business property	20b		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions).	13			21 Repairs and maintenance	21		
14 Employee benefit programs (other than on line 19)	14			22 Supplies (not included in Part III)	22		
15 Insurance (other than health)	15			23 Taxes and licenses	23		
16 Interest:				24 Travel, meals, and entertainment:			
a Mortgage (paid to banks, etc.)	16a			a Travel	24a		
b Other	16b			b Deductible meals and entertainment (see instructions)	24b		
17 Legal and professional services	17			25 Utilities	25		
28 Total expenses before expenses for business use of home. Add lines 8 through 27a				26 Wages (less employment credits)	26		
29 Tentative profit or (loss). Subtract line 28 from line 7				27a Other expenses (from line 48)	27a		
30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30				27b Reserved for future use	27b		
31 Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32.							
32 If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Form 1040, line 12 , (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.							

32a All investment is at risk.
32b Some investment is not at risk.

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Part III Cost of Goods Sold (see instructions)

33 Method(s) used to value closing inventory: a Cost b Lower of cost or market c Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation Yes No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35		
36 Purchases less cost of items withdrawn for personal use	36		
37 Cost of labor. Do not include any amounts paid to yourself	37		
38 Materials and supplies	38		
39 Other costs	39		
40 Add lines 35 through 39	40		
41 Inventory at end of year	41		
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4	42		

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ► / /

44 Of the total number of miles you drove your vehicle during 2014, enter the number of miles you used your vehicle for:

 a Business _____ b Commuting (see instructions) _____ c Other _____

45 Was your vehicle available for personal use during off-duty hours? Yes No

46 Do you (or your spouse) have another vehicle available for personal use?. Yes No

47a Do you have evidence to support your deduction? Yes No

 b If "Yes," is the evidence written? Yes No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

48 Total other expenses. Enter here and on line 27a	48		

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**SCHEDULE D
(Form 1040)**

Capital Gains and Losses

OMB No. 1545-0074

Department of the Treasury
Internal Revenue Service (99)

▶ **Attach to Form 1040 or Form 1040NR.**
▶ **Information about Schedule D and its separate instructions is at www.irs.gov/scheduled.**
▶ **Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.**

2014
Attachment
Sequence No. **12**

Name(s) shown on return

Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 .				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in column (h). Then go to Part III on the back				15

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2014

Part III Summary

<p>16 Combine lines 7 and 15 and enter the result</p> <ul style="list-style-type: none"> • If line 16 is a gain, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. • If line 16 is a loss, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. • If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22. 	16	
<p>17 Are lines 15 and 16 both gains?</p> <p><input type="checkbox"/> Yes. Go to line 18.</p> <p><input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.</p>		
<p>18 Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet in the instructions . . . ▶</p>	18	
<p>19 Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet in the instructions ▶</p>	19	
<p>20 Are lines 18 and 19 both zero or blank?</p> <p><input type="checkbox"/> Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). Do not complete lines 21 and 22 below.</p> <p><input type="checkbox"/> No. Complete the Schedule D Tax Worksheet in the instructions. Do not complete lines 21 and 22 below.</p>		
<p>21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of:</p> <ul style="list-style-type: none"> • The loss on line 16 or • (\$3,000), or if married filing separately, (\$1,500) } <p>Note. When figuring which amount is smaller, treat both amounts as positive numbers.</p>	21 ()	
<p>22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?</p> <p><input type="checkbox"/> Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42).</p> <p><input type="checkbox"/> No. Complete the rest of Form 1040 or Form 1040NR.</p>		

**SCHEDULE E
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)
Name(s) shown on return

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040, 1040NR, or Form 1041.
▶ Information about Schedule E and its separate instructions is at www.irs.gov/schedulee.

OMB No. 1545-0074

2014
Attachment
Sequence No. **13**

Your social security number

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C or C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions) Yes No
B If "Yes," did you or will you file required Forms 1099? Yes No

1a Physical address of each property (street, city, state, ZIP code)

A _____

B _____

C _____

1b	Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A	-----	A			<input type="checkbox"/>
B	-----	B			<input type="checkbox"/>
C	-----	C			<input type="checkbox"/>

Type of Property:

- 1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
- 2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe)

Income:	Properties:	A	B	C
3 Rents received	3			
4 Royalties received	4			
Expenses:				
5 Advertising	5			
6 Auto and travel (see instructions)	6			
7 Cleaning and maintenance	7			
8 Commissions.	8			
9 Insurance	9			
10 Legal and other professional fees	10			
11 Management fees	11			
12 Mortgage interest paid to banks, etc. (see instructions)	12			
13 Other interest.	13			
14 Repairs.	14			
15 Supplies	15			
16 Taxes	16			
17 Utilities	17			
18 Depreciation expense or depletion	18			
19 Other (list) ▶ _____	19			
20 Total expenses. Add lines 5 through 19	20			
21 Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21			
22 Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22 () () ()			
23a Total of all amounts reported on line 3 for all rental properties	23a			
b Total of all amounts reported on line 4 for all royalty properties	23b			
c Total of all amounts reported on line 12 for all properties	23c			
d Total of all amounts reported on line 18 for all properties	23d			
e Total of all amounts reported on line 20 for all properties	23e			
24 Income. Add positive amounts shown on line 21. Do not include any losses	24			
25 Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25 () ()			
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26			

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Name(s) shown on return. Do not enter name and social security number if shown on other side.	Your social security number
---	-----------------------------

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations **Note.** If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (e) on line 28 and attach Form 6198. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section. Yes No

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
A			<input type="checkbox"/>		<input type="checkbox"/>
B			<input type="checkbox"/>		<input type="checkbox"/>
C			<input type="checkbox"/>		<input type="checkbox"/>
D			<input type="checkbox"/>		<input type="checkbox"/>

Passive Income and Loss			Nonpassive Income and Loss		
(f) Passive loss allowed (attach Form 8582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4562	(j) Nonpassive income from Schedule K-1	
A					
B					
C					
D					
29a	Totals				
b	Totals				
30	Add columns (g) and (j) of line 29a				30
31	Add columns (f), (h), and (i) of line 29b				31 ()
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below				32

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

Passive Income and Loss			Nonpassive Income and Loss		
(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1		
A					
B					
34a	Totals				
b	Totals				
35	Add columns (d) and (f) of line 34a				35
36	Add columns (c) and (e) of line 34b				36 ()
37	Total estate and trust income or (loss). Combine lines 35 and 36. Enter the result here and include in the total on line 41 below				37

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs) – Residual Holder

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b
39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below				39

Part V Summary

40	Net farm rental income or (loss) from Form 4835. Also, complete line 42 below	40	
41	Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18 ▶	41	
42	Reconciliation of farming and fishing income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code V; and Schedule K-1 (Form 1041), box 14, code F (see instructions) . . .	42	
43	Reconciliation for real estate professionals. If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules . . .	43	

**SCHEDULE F
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Farming

▶ Attach to Form 1040, Form 1040NR, Form 1041, Form 1065, or Form 1065-B.
▶ Information about Schedule F and its separate instructions is at www.irs.gov/schedulef.

OMB No. 1545-0074

2014

Attachment
Sequence No. **14**

Name of proprietor _____ Social security number (SSN) _____

A Principal crop or activity _____ **B** Enter code from Part IV

--	--	--	--	--	--

C Accounting method: Cash Accrual **D** Employer ID number (EIN), (see instr) _____

E Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on passive losses Yes No

F Did you make any payments in 2014 that would require you to file Form(s) 1099 (see instructions)? Yes No

G If "Yes," did you or will you file required Forms 1099? Yes No

Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method. Complete Parts II and III, and Part I, line 9.)

1a Sales of livestock and other resale items (see instructions)	1a			
b Cost or other basis of livestock or other items reported on line 1a	1b			
c Subtract line 1b from line 1a			1c	
2 Sales of livestock, produce, grains, and other products you raised			2	
3a Cooperative distributions (Form(s) 1099-PATR)	3a		3b Taxable amount	3b
4a Agricultural program payments (see instructions)	4a		4b Taxable amount	4b
5a Commodity Credit Corporation (CCC) loans reported under election			5a	
b CCC loans forfeited	5b		5c Taxable amount	5c
6 Crop insurance proceeds and federal crop disaster payments (see instructions)				
a Amount received in 2014	6a		6b Taxable amount	6b
c If election to defer to 2015 is attached, check here <input type="checkbox"/> d Amount deferred from 2013			6d	
7 Custom hire (machine work) income			7	
8 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)			8	
9 Gross income. Add amounts in the right column (lines 1c, 2, 3b, 4b, 5a, 5c, 6b, 6d, 7, and 8). If you use the accrual method, enter the amount from Part III, line 50 (see instructions)			9	

Part II Farm Expenses—Cash and Accrual Method. Do not include personal or living expenses (see instructions).

10 Car and truck expenses (see instructions). Also attach Form 4562	10				
11 Chemicals	11				
12 Conservation expenses (see instructions)	12				
13 Custom hire (machine work)	13				
14 Depreciation and section 179 expense (see instructions)	14				
15 Employee benefit programs other than on line 23	15				
16 Feed	16				
17 Fertilizers and lime	17				
18 Freight and trucking	18				
19 Gasoline, fuel, and oil	19				
20 Insurance (other than health)	20				
21 Interest:					
a Mortgage (paid to banks, etc.)	21a				
b Other	21b				
22 Labor hired (less employment credits)	22				
23 Pension and profit-sharing plans	23				
24 Rent or lease (see instructions):					
a Vehicles, machinery, equipment	24a				
b Other (land, animals, etc.)	24b				
25 Repairs and maintenance	25				
26 Seeds and plants	26				
27 Storage and warehousing	27				
28 Supplies	28				
29 Taxes	29				
30 Utilities	30				
31 Veterinary, breeding, and medicine	31				
32 Other expenses (specify):					
a _____	32a				
b _____	32b				
c _____	32c				
d _____	32d				
e _____	32e				
f _____	32f				
33 Total expenses. Add lines 10 through 32f. If line 32f is negative, see instructions	33				
34 Net farm profit or (loss). Subtract line 33 from line 9	34				

If a profit, stop here and see instructions for where to report. If a loss, complete lines 35 and 36.

35 Did you receive an applicable subsidy in 2014? (see instructions) Yes No

36 Check the box that describes your investment in this activity and see instructions for where to report your loss.
a All investment is at risk. **b** Some investment is not at risk.

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Part III Farm Income—Accrual Method (see instructions).

37	Sales of livestock, produce, grains, and other products (see instructions)			37		
38a	Cooperative distributions (Form(s) 1099-PATR)	38a		38b	Taxable amount	38b
39a	Agricultural program payments	39a		39b	Taxable amount	39b
40	Commodity Credit Corporation (CCC) loans:					
a	CCC loans reported under election			40a		
b	CCC loans forfeited	40b		40c	Taxable amount	40c
41	Crop insurance proceeds			41		
42	Custom hire (machine work) income			42		
43	Other income (see instructions)			43		
44	Add amounts in the right column for lines 37 through 43 (lines 37, 38b, 39b, 40a, 40c, 41, 42, and 43)			44		
45	Inventory of livestock, produce, grains, and other products at beginning of the year. Do not include sales reported on Form 4797	45				
46	Cost of livestock, produce, grains, and other products purchased during the year	46				
47	Add lines 45 and 46	47				
48	Inventory of livestock, produce, grains, and other products at end of year	48				
49	Cost of livestock, produce, grains, and other products sold. Subtract line 48 from line 47*			49		
50	Gross income. Subtract line 49 from line 44. Enter the result here and on Part I, line 9			50		

*If you use the unit-livestock-price method or the farm-price method of valuing inventory and the amount on line 48 is larger than the amount on line 47, subtract line 47 from line 48. Enter the result on line 49. Add lines 44 and 49. Enter the total on line 50 and on Part I, line 9.

Part IV Principal Agricultural Activity Codes



Do not file Schedule F (Form 1040) to report the following.

- Income from providing agricultural services such as soil preparation, veterinary, farm labor, horticultural, or management for a fee or on a contract basis. Instead file Schedule C (Form 1040) or Schedule C-EZ (Form 1040).
- Income from breeding, raising, or caring for dogs, cats, or other pet animals. Instead file Schedule C (Form 1040) or Schedule C-EZ (Form 1040).
- Sales of livestock held for draft, breeding, sport, or dairy purposes. Instead file Form 4797.

These codes for the Principal Agricultural Activity classify farms by their primary activity to facilitate the administration of the Internal Revenue Code. These six-digit codes are based on the North American Industry Classification System (NAICS).

Select the code that best identifies your primary farming activity and enter the six-digit number on line B.

Crop Production

- 111100 Oilseed and grain farming
- 111210 Vegetable and melon farming

- 111300 Fruit and tree nut farming
- 111400 Greenhouse, nursery, and floriculture production
- 111900 Other crop farming

Animal Production

- 112111 Beef cattle ranching and farming
- 112112 Cattle feedlots
- 112120 Dairy cattle and milk production
- 112210 Hog and pig farming
- 112300 Poultry and egg production
- 112400 Sheep and goat farming
- 112510 Aquaculture
- 112900 Other animal production

Forestry and Logging

- 113000 Forestry and logging (including forest nurseries and timber tracts)

**SCHEDULE SE
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

► Information about Schedule SE and its separate instructions is at www.irs.gov/schedulese.
► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2014
Attachment
Sequence No. **17**

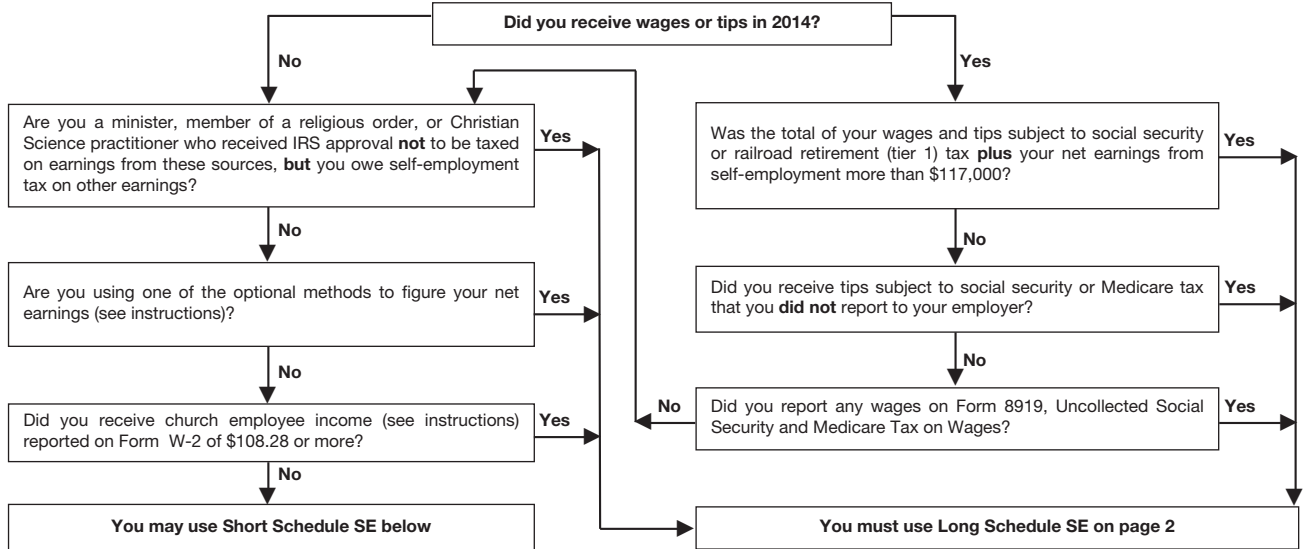
Name of person with self-employment income (as shown on Form 1040 or Form 1040NR)

Social security number of person with self-employment income ►

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Z	1b	()
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2		
3 Combine lines 1a, 1b, and 2	3		
4 Multiply line 3 by 92.35% (.9235). If less than \$400, you do not owe self-employment tax; do not file this schedule unless you have an amount on line 1b ► Note. If line 4 is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.	4		
5 Self-employment tax. If the amount on line 4 is: • \$117,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 57, or Form 1040NR, line 55 • More than \$117,000, multiply line 4 by 2.9% (.029). Then, add \$14,508 to the result. Enter the total here and on Form 1040, line 57, or Form 1040NR, line 55	5		
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.50). Enter the result here and on Form 1040, line 27, or Form 1040NR, line 27	6		

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2014

Name of person with self-employment income (as shown on Form 1040 or Form 1040NR)	Social security number of person with self-employment income ▶
--	---

Section B—Long Schedule SE

Part I Self-Employment Tax

Note. If your only income subject to self-employment tax is **church employee income**, see instructions. Also see instructions for the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361, but you had \$400 or more of other net earnings from self-employment, check here and continue with Part I ▶ <input type="checkbox"/>				
1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. Note. Skip lines 1a and 1b if you use the farm optional method (see instructions)	1a			
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Z	1b	()
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report. Note. Skip this line if you use the nonfarm optional method (see instructions)	2			
3 Combine lines 1a, 1b, and 2	3			
4a If line 3 is more than zero, multiply line 3 by 92.35% (.9235). Otherwise, enter amount from line 3 Note. If line 4a is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.	4a			
b If you elect one or both of the optional methods, enter the total of lines 15 and 17 here	4b			
c Combine lines 4a and 4b. If less than \$400, stop ; you do not owe self-employment tax. Exception. If less than \$400 and you had church employee income , enter -0- and continue ▶	4c			
5a Enter your church employee income from Form W-2. See instructions for definition of church employee income	5a			
b Multiply line 5a by 92.35% (.9235). If less than \$100, enter -0-	5b			
6 Add lines 4c and 5b	6			
7 Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2014	7	117,000		00
8a Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If \$117,000 or more, skip lines 8b through 10, and go to line 11	8a			
b Unreported tips subject to social security tax (from Form 4137, line 10)	8b			
c Wages subject to social security tax (from Form 8919, line 10)	8c			
d Add lines 8a, 8b, and 8c	8d			
9 Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 . ▶	9			
10 Multiply the smaller of line 6 or line 9 by 12.4% (.124)	10			
11 Multiply line 6 by 2.9% (.029)	11			
12 Self-employment tax. Add lines 10 and 11. Enter here and on Form 1040, line 57, or Form 1040NR, line 55	12			
13 Deduction for one-half of self-employment tax. Multiply line 12 by 50% (.50). Enter the result here and on Form 1040, line 27, or Form 1040NR, line 27	13			

Part II Optional Methods To Figure Net Earnings (see instructions)

Farm Optional Method. You may use this method only if (a) your gross farm income ¹ was not more than \$7,200, or (b) your net farm profits ² were less than \$5,198.				
14 Maximum income for optional methods	14	4,800		00
15 Enter the smaller of: two-thirds (² / ₃) of gross farm income ¹ (not less than zero) or \$4,800. Also include this amount on line 4b above	15			
Nonfarm Optional Method. You may use this method only if (a) your net nonfarm profits ³ were less than \$5,198 and also less than 72.189% of your gross nonfarm income, ⁴ and (b) you had net earnings from self-employment of at least \$400 in 2 of the prior 3 years. Caution. You may use this method no more than five times.				
16 Subtract line 15 from line 14	16			
17 Enter the smaller of: two-thirds (² / ₃) of gross nonfarm income ⁴ (not less than zero) or the amount on line 16. Also include this amount on line 4b above	17			

¹ From Sch. F, line 9, and Sch. K-1 (Form 1065), box 14, code B.
² From Sch. F, line 34, and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.
³ From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1.
⁴ From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2.

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts

2014

OMB No. 1545-0092

► Information about Form 1041 and its separate instructions is at www.irs.gov/form1041.

A Check all that apply:		For calendar year 2014 or fiscal year beginning _____, 2014, and ending _____, 20	
<input type="checkbox"/> Decedent's estate <input type="checkbox"/> Simple trust <input type="checkbox"/> Complex trust <input type="checkbox"/> Qualified disability trust <input type="checkbox"/> ESBT (S portion only) <input type="checkbox"/> Grantor type trust <input type="checkbox"/> Bankruptcy estate-Ch. 7 <input type="checkbox"/> Bankruptcy estate-Ch. 11 <input type="checkbox"/> Pooled income fund	Name of estate or trust (If a grantor type trust, see the instructions.)		C Employer identification number
	Name and title of fiduciary		D Date entity created
	Number, street, and room or suite no. (If a P.O. box, see the instructions.)		E Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions. <input type="checkbox"/> Described in sec. 4947(a)(1). Check here if not a private foundation . . . ► <input type="checkbox"/> <input type="checkbox"/> Described in sec. 4947(a)(2)
	City or town, state or province, country, and ZIP or foreign postal code		
B Number of Schedules K-1 attached (see instructions) ►	F Check applicable boxes:	<input type="checkbox"/> Initial return <input type="checkbox"/> Final return <input type="checkbox"/> Amended return	<input type="checkbox"/> Net operating loss carryback
	<input type="checkbox"/> Change in trust's name <input type="checkbox"/> Change in fiduciary <input type="checkbox"/> Change in fiduciary's name	<input type="checkbox"/> Change in fiduciary's address	
G Check here if the estate or filing trust made a section 645 election <input type="checkbox"/> Trust TIN ►			

Income	1 Interest income	1	
	2a Total ordinary dividends	2a	
	b Qualified dividends allocable to: (1) Beneficiaries _____ (2) Estate or trust _____		
	3 Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
	4 Capital gain or (loss). Attach Schedule D (Form 1041)	4	
	5 Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
	6 Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7 Ordinary gain or (loss). Attach Form 4797	7	
	8 Other income. List type and amount _____	8	
9 Total income. Combine lines 1, 2a, and 3 through 8 ►	9		
Deductions	10 Interest. Check if Form 4952 is attached ► <input type="checkbox"/>	10	
	11 Taxes	11	
	12 Fiduciary fees	12	
	13 Charitable deduction (from Schedule A, line 7)	13	
	14 Attorney, accountant, and return preparer fees	14	
	15a Other deductions not subject to the 2% floor (attach schedule)	15a	
	b Net operating loss deduction (see instructions)	15b	
	c Allowable miscellaneous itemized deductions subject to the 2% floor	15c	
	16 Add lines 10 through 15c ►	16	
	17 Adjusted total income or (loss). Subtract line 16 from line 9 17	17	
	18 Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
19 Estate tax deduction including certain generation-skipping taxes (attach computation)	19		
20 Exemption	20		
21 Add lines 18 through 20 ►	21		
Tax and Payments	22 Taxable income. Subtract line 21 from line 17. If a loss, see instructions	22	
	23 Total tax (from Schedule G, line 7)	23	
	24 Payments: a 2014 estimated tax payments and amount applied from 2013 return	24a	
	b Estimated tax payments allocated to beneficiaries (from Form 1041-T)	24b	
	c Subtract line 24b from line 24a	24c	
	d Tax paid with Form 7004 (see instructions)	24d	
	e Federal income tax withheld. If any is from Form(s) 1099, check ► <input type="checkbox"/>	24e	
	Other payments: f Form 2439 _____ ; g Form 4136 _____ ; Total ►	24h	
	25 Total payments. Add lines 24c through 24e, and 24h ►	25	
26 Estimated tax penalty (see instructions)	26		
27 Tax due. If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27		
28 Overpayment. If line 25 is larger than the total of lines 23 and 26, enter amount overpaid	28		
29 Amount of line 28 to be: a Credited to 2015 estimated tax ► _____ ; b Refunded ► _____	29		

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of fiduciary or officer representing fiduciary	Date	EIN of fiduciary if a financial institution	
			May the IRS discuss this return with the preparer shown below (see instr.)? <input type="checkbox"/> Yes <input type="checkbox"/> No

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ►				Firm's EIN ►
	Firm's address ►				Phone no.

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Schedule A Charitable Deduction. Do not complete for a simple trust or a pooled income fund.		
1	Amounts paid or permanently set aside for charitable purposes from gross income (see instructions)	1
2	Tax-exempt income allocable to charitable contributions (see instructions)	2
3	Subtract line 2 from line 1	3
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4
5	Add lines 3 and 4	5
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes (see instructions)	6
7	Charitable deduction. Subtract line 6 from line 5. Enter here and on page 1, line 13	7

Schedule B Income Distribution Deduction		
1	Adjusted total income (see instructions)	1
2	Adjusted tax-exempt interest	2
3	Total net gain from Schedule D (Form 1041), line 19, column (1) (see instructions)	3
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	4
5	Capital gains for the tax year included on Schedule A, line 1 (see instructions)	5
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6
7	Distributable net income. Combine lines 1 through 6. If zero or less, enter -0-	7
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8
9	Income required to be distributed currently	9
10	Other amounts paid, credited, or otherwise required to be distributed	10
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	11
12	Enter the amount of tax-exempt income included on line 11	12
13	Tentative income distribution deduction. Subtract line 12 from line 11	13
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14
15	Income distribution deduction. Enter the smaller of line 13 or line 14 here and on page 1, line 18	15

Schedule G Tax Computation (see instructions)		
1	Tax: a Tax on taxable income (see instructions)	1a
	b Tax on lump-sum distributions. Attach Form 4972	1b
	c Alternative minimum tax (from Schedule I (Form 1041), line 56)	1c
	d Total. Add lines 1a through 1c	1d
2a	Foreign tax credit. Attach Form 1116	2a
b	General business credit. Attach Form 3800	2b
c	Credit for prior year minimum tax. Attach Form 8801	2c
d	Bond credits. Attach Form 8912	2d
e	Total credits. Add lines 2a through 2d	2e
3	Subtract line 2e from line 1d. If zero or less, enter -0-	3
4	Net investment income tax from Form 8960, line 21	4
5	Recapture taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611	5
6	Household employment taxes. Attach Schedule H (Form 1040)	6
7	Total tax. Add lines 3 through 6. Enter here and on page 1, line 23	7

Other Information		Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends ► \$ _____		
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		
3	At any time during calendar year 2014, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See the instructions for exceptions and filing requirements for FinCEN Form 114. If "Yes," enter the name of the foreign country ► _____		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here (see instructions) ► <input type="checkbox"/>		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see instructions) ► <input type="checkbox"/>		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here ► <input type="checkbox"/>		
9	Are any present or future trust beneficiaries skip persons? See instructions		

**Schedule K-1
(Form 1041)**

Department of the Treasury
Internal Revenue Service

2014

For calendar year 2014,
or tax year beginning _____, 2014,
and ending _____, 20 _____

Final K-1

Amended K-1

661113
OMB No. 1545-0092

Beneficiary's Share of Income, Deductions, Credits, etc.
▶ See back of form and instructions.

Part I Information About the Estate or Trust	
A Estate's or trust's employer identification number	
B Estate's or trust's name	
C Fiduciary's name, address, city, state, and ZIP code	
D <input type="checkbox"/> Check if Form 1041-T was filed and enter the date it was filed _____	
E <input type="checkbox"/> Check if this is the final Form 1041 for the estate or trust	
Part II Information About the Beneficiary	
F Beneficiary's identifying number	
G Beneficiary's name, address, city, state, and ZIP code	
H <input type="checkbox"/> Domestic beneficiary <input type="checkbox"/> Foreign beneficiary	

Part III Beneficiary's Share of Current Year Income, Deductions, Credits, and Other Items			
1	Interest income	11	Final year deductions
2a	Ordinary dividends		
2b	Qualified dividends		
3	Net short-term capital gain		
4a	Net long-term capital gain		
4b	28% rate gain	12	Alternative minimum tax adjustment
4c	Unrecaptured section 1250 gain		
5	Other portfolio and nonbusiness income		
6	Ordinary business income		
7	Net rental real estate income		
8	Other rental income	13	Credits and credit recapture
9	Directly apportioned deductions		
		14	Other information
10	Estate tax deduction		
*See attached statement for additional information. Note. A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.			
For IRS Use Only			

For Paperwork Reduction Act Notice, see the Instructions for Form 1041.

IRS.gov/form1041

Cat. No. 11380D

Schedule K-1 (Form 1041) 2014

Form 1065 U.S. Return of Partnership Income
 Department of the Treasury Internal Revenue Service
 For calendar year 2014, or tax year beginning _____, 2014, ending _____, 20____
 ▶ Information about Form 1065 and its separate instructions is at www.irs.gov/form1065.
 OMB No. 1545-0123
2014

A Principal business activity	Type or Print	Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see the instructions.	E Date business started
C Business code number		City or town, state or province, country, and ZIP or foreign postal code	F Total assets (see the instructions) \$ _____

- G** Check applicable boxes: (1) Initial return (2) Final return (3) Name change (4) Address change (5) Amended return
 (6) Technical termination - also check (1) or (2)
- H** Check accounting method: (1) Cash (2) Accrual (3) Other (specify) ▶ _____
- I** Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ _____
- J** Check if Schedules C and M-3 are attached

Caution. Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a	Gross receipts or sales	1a		
	b	Returns and allowances	1b		
	c	Balance. Subtract line 1b from line 1a	1c		
	2	Cost of goods sold (attach Form 1125-A)	2		
	3	Gross profit. Subtract line 2 from line 1c	3		
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)	4		
	5	Net farm profit (loss) (attach Schedule F (Form 1040))	5		
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)	6		
7	Other income (loss) (attach statement)	7			
8	Total income (loss). Combine lines 3 through 7	8			
Deductions <small>(see the instructions for limitations)</small>	9	Salaries and wages (other than to partners) (less employment credits)	9		
	10	Guaranteed payments to partners	10		
	11	Repairs and maintenance	11		
	12	Bad debts	12		
	13	Rent	13		
	14	Taxes and licenses	14		
	15	Interest	15		
	16a	Depreciation (if required, attach Form 4562)	16a		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b		
	17	Depletion (Do not deduct oil and gas depletion.)	17		
	18	Retirement plans, etc.	18		
	19	Employee benefit programs	19		
	20	Other deductions (attach statement)	20		
	21	Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21		
22	Ordinary business income (loss). Subtract line 21 from line 8	22			

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ _____ ▶ _____
 Signature of general partner or limited liability company member manager Date

May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ▶	Firm's EIN ▶			
	Firm's address ▶	Phone no. _____			

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Schedule B Other Information																												
1	What type of entity is filing this return? Check the applicable box:	Yes	No																									
a	<input type="checkbox"/> Domestic general partnership																											
b	<input type="checkbox"/> Domestic limited partnership																											
c	<input type="checkbox"/> Domestic limited liability company																											
d	<input type="checkbox"/> Domestic limited liability partnership																											
e	<input type="checkbox"/> Foreign partnership																											
f	<input type="checkbox"/> Other ▶																											
2	At any time during the tax year, was any partner in the partnership a disregarded entity, a partnership (including an entity treated as a partnership), a trust, an S corporation, an estate (other than an estate of a deceased partner), or a nominee or similar person?																											
3	At the end of the tax year:																											
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization, or any foreign government own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership																											
b	Did any individual or estate own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership																											
4	At the end of the tax year, did the partnership:																											
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below																											
<table border="1" style="width:100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 50%;">(i) Name of Corporation</th> <th style="width: 15%;">(ii) Employer Identification Number (if any)</th> <th style="width: 15%;">(iii) Country of Incorporation</th> <th style="width: 20%;">(iv) Percentage Owned in Voting Stock</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td></tr> </tbody> </table>		(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock																							
(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock																									
b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below																											
<table border="1" style="width:100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 40%;">(i) Name of Entity</th> <th style="width: 10%;">(ii) Employer Identification Number (if any)</th> <th style="width: 10%;">(iii) Type of Entity</th> <th style="width: 15%;">(iv) Country of Organization</th> <th style="width: 25%;">(v) Maximum Percentage Owned in Profit, Loss, or Capital</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> </tbody> </table>		(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital																						
(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital																								
5	Did the partnership file Form 8893, Election of Partnership Level Tax Treatment, or an election statement under section 6231(a)(1)(B)(ii) for partnership-level tax treatment, that is in effect for this tax year? See Form 8893 for more details																											
6	Does the partnership satisfy all four of the following conditions?																											
a	The partnership's total receipts for the tax year were less than \$250,000.																											
b	The partnership's total assets at the end of the tax year were less than \$1 million.																											
c	Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return.																											
d	The partnership is not filing and is not required to file Schedule M-3 If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item L on Schedule K-1.																											
7	Is this partnership a publicly traded partnership as defined in section 469(k)(2)?																											
8	During the tax year, did the partnership have any debt that was cancelled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?																											
9	Has this partnership filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?																											
10	At any time during calendar year 2014, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See the instructions for exceptions and filing requirements for FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). If "Yes," enter the name of the foreign country. ▶																											

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Schedule B Other Information (continued)		Yes	No
11	At any time during the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions		
12a	Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election.		
b	Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions		
c	Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions		
13	Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly owned by the partnership throughout the tax year) <input type="checkbox"/>		
14	At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?		
15	If the partnership is required to file Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, enter the number of Forms 8858 attached. See instructions ▶		
16	Does the partnership have any foreign partners? If "Yes," enter the number of Forms 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, filed for this partnership. ▶		
17	Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return. ▶		
18a	Did you make any payments in 2014 that would require you to file Form(s) 1099? See instructions		
b	If "Yes," did you or will you file required Form(s) 1099?		
19	Enter the number of Form(s) 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, attached to this return. ▶		
20	Enter the number of partners that are foreign governments under section 892. ▶		

Designation of Tax Matters Partner (see instructions)

Enter below the general partner or member-manager designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶	Identifying number of TMP ▶
If the TMP is an entity, name of TMP representative ▶	Phone number of TMP ▶
Address of designated TMP ▶	

Schedule K		Partners' Distributive Share Items	Total amount	
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)	1	
	2	Net rental real estate income (loss) (attach Form 8825)	2	
	3a	Other gross rental income (loss)	3a	
	b	Expenses from other rental activities (attach statement)	3b	
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4	Guaranteed payments	4	
	5	Interest income	5	
	6	Dividends: a Ordinary dividends	6a	
	b	Qualified dividends	6b	
	7	Royalties	7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	8	
9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))	9a		
	b Collectibles (28%) gain (loss)	9b		
	c Unrecaptured section 1250 gain (attach statement)	9c		
10	Net section 1231 gain (loss) (attach Form 4797)	10		
11	Other income (loss) (see instructions) Type ▶	11		
Deductions	12	Section 179 deduction (attach Form 4562)	12	
	13a	Contributions	13a	
	b	Investment interest expense	13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶	13c(2)	
d	Other deductions (see instructions) Type ▶	13d		
Self-Employment	14a	Net earnings (loss) from self-employment	14a	
	b	Gross farming or fishing income	14b	
	c	Gross nonfarm income	14c	
Credits	15a	Low-income housing credit (section 42(j)(5))	15a	
	b	Low-income housing credit (other)	15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	15c	
	d	Other rental real estate credits (see instructions) Type ▶	15d	
	e	Other rental credits (see instructions) Type ▶	15e	
	f	Other credits (see instructions) Type ▶	15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	16b	
	c	Gross income sourced at partner level	16c	
		Foreign gross income sourced at partnership level		
	d	Passive category ▶ e General category ▶ f Other ▶	16f	
		Deductions allocated and apportioned at partner level		
	g	Interest expense ▶ h Other ▶	16h	
		Deductions allocated and apportioned at partnership level to foreign source income		
	i	Passive category ▶ j General category ▶ k Other ▶	16k	
	l	Total foreign taxes (check one): ▶ Paid <input type="checkbox"/> Accrued <input type="checkbox"/>	16l	
m	Reduction in taxes available for credit (attach statement)	16m		
n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment	17a	
	b	Adjusted gain or loss	17b	
	c	Depletion (other than oil and gas)	17c	
	d	Oil, gas, and geothermal properties—gross income	17d	
	e	Oil, gas, and geothermal properties—deductions	17e	
	f	Other AMT items (attach statement)	17f	
Other Information	18a	Tax-exempt interest income	18a	
	b	Other tax-exempt income	18b	
	c	Nondeductible expenses	18c	
	19a	Distributions of cash and marketable securities	19a	
	b	Distributions of other property	19b	
	20a	Investment income	20a	
b	Investment expenses	20b		
c	Other items and amounts (attach statement)			

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l					1	
2	Analysis by partner type:	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt Organization	(vi) Nominee/Other
a	General partners						
b	Limited partners						

Schedule L	Balance Sheets per Books	Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
	Assets				
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts				
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities				
6	Other current assets (attach statement)				
7a	Loans to partners (or persons related to partners)				
b	Mortgage and real estate loans				
8	Other investments (attach statement)				
9a	Buildings and other depreciable assets				
b	Less accumulated depreciation				
10a	Depletable assets				
b	Less accumulated depletion				
11	Land (net of any amortization)				
12a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
13	Other assets (attach statement)				
14	Total assets				
	Liabilities and Capital				
15	Accounts payable				
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (attach statement)				
18	All nonrecourse loans				
19a	Loans from partners (or persons related to partners)				
b	Mortgages, notes, bonds payable in 1 year or more				
20	Other liabilities (attach statement)				
21	Partners' capital accounts				
22	Total liabilities and capital				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note. The partnership may be required to file Schedule M-3 (see instructions).

1	Net income (loss) per books		6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):		a	Tax-exempt interest \$	
3	Guaranteed payments (other than health insurance)		7	Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):		a	Depreciation \$	
a	Depreciation \$		8	Add lines 6 and 7	
b	Travel and entertainment \$		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5 .	
5	Add lines 1 through 4				

Schedule M-2 Analysis of Partners' Capital Accounts

1	Balance at beginning of year		6	Distributions: a Cash	
2	Capital contributed: a Cash		b Property		
	b Property		7	Other decreases (itemize):	
3	Net income (loss) per books				
4	Other increases (itemize):		8	Add lines 6 and 7	
5	Add lines 1 through 4		9	Balance at end of year. Subtract line 8 from line 5	

651113

OMB No. 1545-0123

**Schedule K-1
(Form 1065)**

Department of the Treasury
Internal Revenue Service

2014

For calendar year 2014, or tax
year beginning _____, 2014
ending _____, 20____

Final K-1 Amended K-1

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership	
A	Partnership's employer identification number
B	Partnership's name, address, city, state, and ZIP code
C	IRS Center where partnership filed return
D	<input type="checkbox"/> Check if this is a publicly traded partnership (PTP)
Part II Information About the Partner	
E	Partner's identifying number
F	Partner's name, address, city, state, and ZIP code
G	<input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member
H	<input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner
I1	What type of entity is this partner? _____
I2	If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here <input type="checkbox"/>
J	Partner's share of profit, loss, and capital (see instructions):
	Beginning Ending
Profit	% | %
Loss	% | %
Capital	% | %
K	Partner's share of liabilities at year end:
Nonrecourse	\$ _____
Qualified nonrecourse financing	\$ _____
Recourse	\$ _____
L	Partner's capital account analysis:
Beginning capital account	\$ _____
Capital contributed during the year	\$ _____
Current year increase (decrease)	\$ _____
Withdrawals & distributions	\$ (_____)
Ending capital account	\$ _____
	<input type="checkbox"/> Tax basis <input type="checkbox"/> GAAP <input type="checkbox"/> Section 704(b) book
	<input type="checkbox"/> Other (explain)
M	Did the partner contribute property with a built-in gain or loss?
	<input type="checkbox"/> Yes <input type="checkbox"/> No
	If "Yes," attach statement (see instructions)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items		
1	Ordinary business income (loss)	15 Credits
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	16 Foreign transactions
4	Guaranteed payments	
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
7	Royalties	
8	Net short-term capital gain (loss)	
9a	Net long-term capital gain (loss)	17 Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)	
9c	Unrecaptured section 1250 gain	
10	Net section 1231 gain (loss)	18 Tax-exempt income and nondeductible expenses
11	Other income (loss)	
12	Section 179 deduction	19 Distributions
13	Other deductions	20 Other information
14	Self-employment earnings (loss)	
*See attached statement for additional information.		
For IRS Use Only		

**SCHEDULE M-3
(Form 1065)**

**Net Income (Loss) Reconciliation
for Certain Partnerships**

OMB No. 1545-0123

2014

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1065 or Form 1065-B.

▶ Information about Schedule M-3 (Form 1065) and its instructions is at www.irs.gov/form1065.

Name of partnership	Employer identification number
---------------------	--------------------------------

This Schedule M-3 is being filed because (check all that apply):

- A** The amount of the partnership's total assets at the end of the tax year is equal to \$10 million or more.
- B** The amount of the partnership's adjusted total assets for the tax year is equal to \$10 million or more. If box B is checked, enter the amount of adjusted total assets for the tax year _____.
- C** The amount of total receipts for the tax year is equal to \$35 million or more. If box C is checked, enter the total receipts for the tax year _____.
- D** An entity that is a reportable entity partner with respect to the partnership owns or is deemed to own an interest of 50 percent or more in the partnership's capital, profit, or loss, on any day during the tax year of the partnership.

Name of Reportable Entity Partner	Identifying Number	Maximum Percentage Owned or Deemed Owned

E Voluntary Filer.

Part I Financial Information and Net Income (Loss) Reconciliation

- 1a** Did the partnership file SEC Form 10-K for its income statement period ending with or within this tax year?
 - Yes.** Skip lines 1b and 1c and complete lines 2 through 11 with respect to that SEC Form 10-K.
 - No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.
- b** Did the partnership prepare a certified audited non-tax-basis income statement for that period?
 - Yes.** Skip line 1c and complete lines 2 through 11 with respect to that income statement.
 - No.** Go to line 1c.
- c** Did the partnership prepare a non-tax-basis income statement for that period?
 - Yes.** Complete lines 2 through 11 with respect to that income statement.
 - No.** Skip lines 2 through 3b and enter the partnership's net income (loss) per its books and records on line 4a.
- 2** Enter the income statement period: Beginning ____ / ____ / ____ Ending ____ / ____ / ____
- 3a** Has the partnership's income statement been restated for the income statement period on line 2?
 - Yes.** (If "Yes," attach a statement and the amount of each item restated.)
 - No.**
- b** Has the partnership's income statement been restated for any of the five income statement periods immediately preceding the period on line 2?
 - Yes.** (If "Yes," attach a statement and the amount of each item restated.)
 - No.**

4a Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	
b Indicate accounting standard used for line 4a (see instructions):		
1 <input type="checkbox"/> GAAP 2 <input type="checkbox"/> IFRS 3 <input type="checkbox"/> 704(b)		
4 <input type="checkbox"/> Tax-basis 5 <input type="checkbox"/> Other: (Specify) ▶ _____		
5a Net income from nonincludible foreign entities (attach statement)	5a	(_____)
b Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	_____
6a Net income from nonincludible U.S. entities (attach statement)	6a	(_____)
b Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	_____
7a Net income (loss) of other foreign disregarded entities (attach statement)	7a	_____
b Net income (loss) of other U.S. disregarded entities (attach statement)	7b	_____
8 Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	_____
9 Adjustment to reconcile income statement period to tax year (attach statement)	9	_____
10 Other adjustments to reconcile to amount on line 11 (attach statement)	10	_____
11 Net income (loss) per income statement of the partnership. Combine lines 4a through 10	11	_____

12 Enter the total amount (not just the partnership's share) of the assets and liabilities of all entities included or removed on the following lines:

	Total Assets	Total Liabilities
a Included on Part I, line 4	_____	_____
b Removed on Part I, line 5	_____	_____
c Removed on Part I, line 6	_____	_____
d Included on Part I, line 7	_____	_____

Name of partnership

Employer identification number

Part II Reconciliation of Net Income (Loss) per Income Statement of Partnership With Income (Loss) per Return

Income (Loss) Items	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
(Attach statements for lines 1 through 10)				
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Gross foreign distributions previously taxed				
5 Income (loss) from equity method U.S. corporations				
6 U.S. dividends				
7 Income (loss) from U.S. partnerships				
8 Income (loss) from foreign partnerships				
9 Income (loss) from other pass-through entities				
10 Items relating to reportable transactions				
11 Interest income (see instructions)				
12 Total accrual to cash adjustment				
13 Hedging transactions				
14 Mark-to-market income (loss)				
15 Cost of goods sold (see instructions)	()			()
16 Sale versus lease (for sellers and/or lessors)				
17 Section 481(a) adjustments				
18 Unearned/deferred revenue				
19 Income recognition from long-term contracts				
20 Original issue discount and other imputed interest				
21a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
22 Other income (loss) items with differences (attach statement)				
23 Total income (loss) items. Combine lines 1 through 22				
24 Total expense/deduction items. (from Part III, line 31) (see instructions)				
25 Other items with no differences				
26 Reconciliation totals. Combine lines 23 through 25				

Note. Line 26, column (a), must equal Part I, line 11, and column (d) must equal Form 1065, Analysis of Net Income (Loss), line 1.

Name of partnership	Employer identification number
---------------------	--------------------------------

Part III Reconciliation of Net Income (Loss) per Income Statement of Partnership With Income (Loss) per Return—Expense/Deduction Items

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 State and local current income tax expense				
2 State and local deferred income tax expense				
3 Foreign current income tax expense (other than foreign withholding taxes)				
4 Foreign deferred income tax expense				
5 Equity-based compensation				
6 Meals and entertainment				
7 Fines and penalties				
8 Judgments, damages, awards, and similar costs				
9 Guaranteed payments				
10 Pension and profit-sharing				
11 Other post-retirement benefits				
12 Deferred compensation				
13 Charitable contribution of cash and tangible property				
14 Charitable contribution of intangible property				
15 Organizational expenses as per Regulations section 1.709-2(a)				
16 Syndication expenses as per Regulations section 1.709-2(b)				
17 Current year acquisition/reorganization investment banking fees				
18 Current year acquisition/reorganization legal and accounting fees				
19 Amortization/impairment of goodwill				
20 Amortization of acquisition, reorganization, and start-up costs				
21 Other amortization or impairment write-offs				
22 Reserved				
23a Depletion—Oil & Gas				
b Depletion—Other than Oil & Gas				
24 Intangible drilling & development costs				
25 Depreciation				
26 Bad debt expense				
27 Interest expense (see instructions)				
28 Purchase versus lease (for purchasers and/ or lessees)				
29 Research and development costs				
30 Other expense/deduction items with differences (attach statement)				
31 Total expense/deduction items. Combine lines 1 through 30. Enter here and on Part II, line 24, reporting positive amounts as negative and negative amounts as positive				

Form 1120
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return
For calendar year 2014 or tax year beginning _____, 2014, ending _____, 20 _____

OMB No. 1545-0123
2014

▶ Information about Form 1120 and its separate instructions is at www.irs.gov/form1120.

<p>A Check if: 1a Consolidated return (attach Form 851) <input type="checkbox"/> b Life/nonlife consolidated return <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (see instructions) <input type="checkbox"/> 4 Schedule M-3 attached <input type="checkbox"/></p>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr> <td style="width:10%; text-align: center;">TYPE OR PRINT</td> <td style="width:45%;">Name</td> <td style="width:45%;">B Employer identification number</td> </tr> <tr> <td></td> <td>Number, street, and room or suite no. If a P.O. box, see instructions.</td> <td>C Date incorporated</td> </tr> <tr> <td></td> <td>City or town, state, or province, country and ZIP or foreign postal code</td> <td>D Total assets (see instructions) \$</td> </tr> </table>	TYPE OR PRINT	Name	B Employer identification number		Number, street, and room or suite no. If a P.O. box, see instructions.	C Date incorporated		City or town, state, or province, country and ZIP or foreign postal code	D Total assets (see instructions) \$
TYPE OR PRINT	Name	B Employer identification number								
	Number, street, and room or suite no. If a P.O. box, see instructions.	C Date incorporated								
	City or town, state, or province, country and ZIP or foreign postal code	D Total assets (see instructions) \$								
<p>E Check if: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change</p>										

Income	1a	Gross receipts or sales			
	b	Returns and allowances			
	c	Balance. Subtract line 1b from line 1a			
	2	Cost of goods sold (attach Form 1125-A)			
	3	Gross profit. Subtract line 2 from line 1c			
	4	Dividends (Schedule C, line 19)			
	5	Interest			
	6	Gross rents			
	7	Gross royalties			
	8	Capital gain net income (attach Schedule D (Form 1120))			
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			
10	Other income (see instructions—attach statement)				
11	Total income. Add lines 3 through 10				
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (see instructions—attach Form 1125-E)			
	13	Salaries and wages (less employment credits)			
	14	Repairs and maintenance			
	15	Bad debts			
	16	Rents			
	17	Taxes and licenses			
	18	Interest			
	19	Charitable contributions			
	20	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			
	21	Depletion			
	22	Advertising			
	23	Pension, profit-sharing, etc., plans			
	24	Employee benefit programs			
	25	Domestic production activities deduction (attach Form 8903)			
	26	Other deductions (attach statement)			
	27	Total deductions. Add lines 12 through 26			
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			
29a	29a	Net operating loss deduction (see instructions)			
	29b	b	Special deductions (Schedule C, line 20)		
		c	Add lines 29a and 29b		
Tax, Refundable Credits, and Payments	30	Taxable income. Subtract line 29c from line 28 (see instructions)			
	31	Total tax (Schedule J, Part I, line 11)			
	32	Total payments and refundable credits (Schedule J, Part II, line 21)			
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>			
	34	Amount owed. If line 32 is smaller than the total of lines 31 and 33, enter amount owed			
	35	Overpayment. If line 32 is larger than the total of lines 31 and 33, enter amount overpaid			
36	Enter amount from line 35 you want: Credited to 2015 estimated tax ▶ Refunded ▶				

Sign Here ▶ Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer	Date	Title
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May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ▶	Firm's EIN ▶			
	Firm's address ▶	Phone no.			

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Schedule C Dividends and Special Deductions (see instructions)		(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	Total. Add lines 1 through 8. See instructions for limitation			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	Total dividends. Add lines 1 through 17. Enter here and on page 1, line 4			
20	Total special deductions. Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b			

Schedule J Tax Computation and Payment (see instructions)

Part I—Tax Computation

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120))	<input type="checkbox"/>		
2	Income tax. Check if a qualified personal service corporation (see instructions)	<input type="checkbox"/>	2	
3	Alternative minimum tax (attach Form 4626)		3	
4	Add lines 2 and 3		4	
5a	Foreign tax credit (attach Form 1118)			
b	Credit from Form 8834 (see instructions)			
c	General business credit (attach Form 3800)			
d	Credit for prior year minimum tax (attach Form 8827)			
e	Bond credits from Form 8912			
6	Total credits. Add lines 5a through 5e		6	
7	Subtract line 6 from line 4		7	
8	Personal holding company tax (attach Schedule PH (Form 1120))		8	
9a	Recapture of investment credit (attach Form 4255)			
b	Recapture of low-income housing credit (attach Form 8611)			
c	Interest due under the look-back method—completed long-term contracts (attach Form 8697)			
d	Interest due under the look-back method—income forecast method (attach Form 8866)			
e	Alternative tax on qualifying shipping activities (attach Form 8902)			
f	Other (see instructions—attach statement)			
10	Total. Add lines 9a through 9f		10	
11	Total tax. Add lines 7, 8, and 10. Enter here and on page 1, line 31		11	

Part II—Payments and Refundable Credits

12	2013 overpayment credited to 2014		12	
13	2014 estimated tax payments		13	
14	2014 refund applied for on Form 4466		14	()
15	Combine lines 12, 13, and 14		15	
16	Tax deposited with Form 7004		16	
17	Withholding (see instructions)		17	
18	Total payments. Add lines 15, 16, and 17		18	
19	Refundable credits from:			
a	Form 2439		19a	
b	Form 4136		19b	
c	Form 8827, line 8c		19c	
d	Other (attach statement—see instructions).		19d	
20	Total credits. Add lines 19a through 19d		20	
21	Total payments and credits. Add lines 18 and 20. Enter here and on page 1, line 32		21	

Schedule K Other Information (see instructions)

1	Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶ _____	Yes	No
2	See the instructions and enter the:		
a	Business activity code no. ▶ _____		
b	Business activity ▶ _____		
c	Product or service ▶ _____		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ▶ _____		
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)		

Schedule K Other Information *continued* (see instructions)

		Yes	No
5 At the end of the tax year, did the corporation:			
a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851 , Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.			
(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock
b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below.			
(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital
6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) If "Yes," file Form 5452 , Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.			
7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of (a) the total voting power of all classes of the corporation's stock entitled to vote or (b) the total value of all classes of the corporation's stock? For rules of attribution, see section 318. If "Yes," enter: (i) Percentage owned ▶ _____ and (ii) Owner's country ▶ _____ (c) The corporation may have to file Form 5472 , Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶ _____			
8 Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ <input type="checkbox"/> If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.			
9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$ _____			
10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ _____			
11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ▶ <input type="checkbox"/> If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.			
12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ \$ _____			
13 Are the corporation's total receipts (page 1, line 1a, plus lines 4 through 10) for the tax year and its total assets at the end of the tax year less than \$250,000? If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year ▶ \$ _____			
14 Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)? If "Yes," complete and attach Schedule UTP.			
15a Did the corporation make any payments in 2014 that would require it to file Form(s) 1099?			
b If "Yes," did or will the corporation file required Forms 1099?			
16 During this tax year, did the corporation have an 80% or more change in ownership, including a change due to redemption of its own stock?			
17 During or subsequent to this tax year, but before the filing of this return, did the corporation dispose of more than 65% (by value) of its assets in a taxable, non-taxable, or tax deferred transaction?			
18 Did the corporation receive assets in a section 351 transfer in which any of the transferred assets had a fair market basis or fair market value of more than \$1 million?			

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach statement)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock: a Preferred stock				
	b Common stock				
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach statement)				
25	Retained earnings—Unappropriated				
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		()		()
28	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: The corporation may be required to file Schedule M-3 (see instructions).

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest \$ _____	
3	Excess of capital losses over capital gains			_____	
4	Income subject to tax not recorded on books this year (itemize): _____			_____	
	_____		8	Deductions on this return not charged against book income this year (itemize):	
5	Expenses recorded on books this year not deducted on this return (itemize):			a Depreciation . . . \$ _____	
a	Depreciation \$ _____			b Charitable contributions \$ _____	
b	Charitable contributions . . . \$ _____			_____	
c	Travel and entertainment . . . \$ _____			_____	
	_____		9	Add lines 7 and 8	
6	Add lines 1 through 5		10	Income (page 1, line 28)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year		5	Distributions: a Cash	
2	Net income (loss) per books			b Stock	
3	Other increases (itemize): _____			c Property	
	_____		6	Other decreases (itemize): _____	
	_____		7	Add lines 5 and 6	
4	Add lines 1, 2, and 3		8	Balance at end of year (line 4 less line 7)	

**SCHEDULE M-3
(Form 1120)**

**Net Income (Loss) Reconciliation for Corporations
With Total Assets of \$10 Million or More**

OMB No. 1545-0123

2014

Department of the Treasury
Internal Revenue Service

▶ **Attach to Form 1120 or 1120-C.** ▶ **Information about Schedule M-3 (Form 1120) and its separate instructions is available at www.irs.gov/form1120.**

Name of corporation (common parent, if consolidated return)

Employer identification number

- Check applicable box(es): (1) Non-consolidated return (2) Consolidated return (Form 1120 only)
(3) Mixed 1120/L/PC group (4) Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

- 1a** Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
 Yes. Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
 No. Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.
- b** Did the corporation prepare a certified audited non-tax-basis income statement for that period?
 Yes. Skip line 1c and complete lines 2a through 11 with respect to that income statement.
 No. Go to line 1c.
- c** Did the corporation prepare a non-tax-basis income statement for that period?
 Yes. Complete lines 2a through 11 with respect to that income statement.
 No. Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.
- 2a** Enter the income statement period: Beginning MM/DD/YYYY Ending MM/DD/YYYY
- b** Has the corporation's income statement been restated for the income statement period on line 2a?
 Yes. (If "Yes," attach an explanation and the amount of each item restated.)
 No.
- c** Has the corporation's income statement been restated for any of the five income statement periods immediately preceding the period on line 2a?
 Yes. (If "Yes," attach an explanation and the amount of each item restated.)
 No.
- 3a** Is any of the corporation's voting common stock publicly traded?
 Yes.
 No. If "No," go to line 4a.
- b** Enter the symbol of the corporation's primary U.S. publicly traded voting common stock
- c** Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock

4a Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	
b Indicate accounting standard used for line 4a (see instructions): (1) <input type="checkbox"/> GAAP (2) <input type="checkbox"/> IFRS (3) <input type="checkbox"/> Statutory (4) <input type="checkbox"/> Tax-basis (5) <input type="checkbox"/> Other (specify) _____		
5a Net income from nonincludible foreign entities (attach statement)	5a	()
b Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	
6a Net income from nonincludible U.S. entities (attach statement)	6a	()
b Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	
7a Net income (loss) of other includible foreign disregarded entities (attach statement)	7a	
b Net income (loss) of other includible U.S. disregarded entities (attach statement)	7b	
c Net income (loss) of other includible entities (attach statement)	7c	
8 Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	
9 Adjustment to reconcile income statement period to tax year (attach statement)	9	
10a Intercompany dividend adjustments to reconcile to line 11 (attach statement)	10a	
b Other statutory accounting adjustments to reconcile to line 11 (attach statement)	10b	
c Other adjustments to reconcile to amount on line 11 (attach statement)	10c	
11 Net income (loss) per income statement of includible corporations. Combine lines 4 through 10. Note. Part I, line 11, must equal Part II, line 30, column (a) or Schedule M-1, line 1 (see instructions).	11	

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

	Total Assets	Total Liabilities
a Included on Part I, line 4		
b Removed on Part I, line 5		
c Removed on Part I, line 6		
d Included on Part I, line 7		

Name of corporation (common parent, if consolidated return)	Employer identification number
Check applicable box(es): (1) <input type="checkbox"/> Consolidated group (2) <input type="checkbox"/> Parent corp (3) <input type="checkbox"/> Consolidated eliminations (4) <input type="checkbox"/> Subsidiary corp (5) <input type="checkbox"/> Mixed 1120/L/PC group	
Check if a sub-consolidated: (6) <input type="checkbox"/> 1120 group (7) <input type="checkbox"/> 1120 eliminations	
Name of subsidiary (if consolidated return)	Employer identification number

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return (see instructions)

	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
Income (Loss) Items (Attach statements for lines 1 through 12)				
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation				
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions				
13 Interest income (see instructions)				
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (see instructions)	()			()
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach statement)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach statement)				
26 Total income (loss) items. Combine lines 1 through 25				
27 Total expense/deduction items (from Part III, line 38)				
28 Other items with no differences				
29a Mixed groups, see instructions. All others, combine lines 26 through 28				
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 Reconciliation totals. Combine lines 29a through 29c				

Note. Line 30, column (a), must equal Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Name of corporation (common parent, if consolidated return)	Employer identification number
Check applicable box(es): (1) <input type="checkbox"/> Consolidated group (2) <input type="checkbox"/> Parent corp (3) <input type="checkbox"/> Consolidated eliminations (4) <input type="checkbox"/> Subsidiary corp (5) <input type="checkbox"/> Mixed 1120/L/PC group	
Check if a sub-consolidated: (6) <input type="checkbox"/> 1120 group (7) <input type="checkbox"/> 1120 eliminations	
Name of subsidiary (if consolidated return)	Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (see instructions)				
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property				
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Reserved				
30 Depletion				
31 Depreciation				
32 Bad debt expense				
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs				
36 Section 118 exclusion (attach statement)				
37 Other expense/deduction items with differences (attach statement)				
38 Total expense/deduction items. Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive				

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Form **1120S**
 Department of the Treasury
 Internal Revenue Service

U.S. Income Tax Return for an S Corporation

OMB No. 1545-0123

2014

Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
Information about Form 1120S and its separate instructions is at www.irs.gov/form1120s.

For calendar year 2014 or tax year beginning _____, 2014, ending _____, 20

A S election effective date	TYPE OR PRINT	Name	D Employer identification number
B Business activity code number (see instructions)		Number, street, and room or suite no. If a P.O. box, see instructions.	E Date incorporated
C Check if Sch. M-3 attached <input type="checkbox"/>		City or town, state or province, country, and ZIP or foreign postal code	F Total assets (see instructions) \$ _____

G Is the corporation electing to be an S corporation beginning with this tax year? Yes No If "Yes," attach Form 2553 if not already filed
H Check if: (1) Final return (2) Name change (3) Address change (4) Amended return (5) S election termination or revocation
I Enter the number of shareholders who were shareholders during any part of the tax year _____ ▶

Caution. Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1a	Gross receipts or sales			
	b	Returns and allowances	1b		
	c	Balance. Subtract line 1b from line 1a		1c	
	2	Cost of goods sold (attach Form 1125-A)		2	
	3	Gross profit. Subtract line 2 from line 1c		3	
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)		4	
	5	Other income (loss) (see instructions—attach statement)		5	
	6	Total income (loss). Add lines 3 through 5 ▶		6	
Deductions <small>(see instructions for limitations)</small>	7	Compensation of officers (see instructions—attach Form 1125-E)		7	
	8	Salaries and wages (less employment credits)		8	
	9	Repairs and maintenance		9	
	10	Bad debts		10	
	11	Rents		11	
	12	Taxes and licenses		12	
	13	Interest		13	
	14	Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)		14	
	15	Depletion (Do not deduct oil and gas depletion.)		15	
	16	Advertising		16	
	17	Pension, profit-sharing, etc., plans		17	
	18	Employee benefit programs		18	
	19	Other deductions (attach statement)		19	
	20	Total deductions. Add lines 7 through 19 ▶		20	
		21	Ordinary business income (loss). Subtract line 20 from line 6		21
Tax and Payments	22a	Excess net passive income or LIFO recapture tax (see instructions)	22a		
	b	Tax from Schedule D (Form 1120S)	22b		
	c	Add lines 22a and 22b (see instructions for additional taxes)		22c	
	23a	2014 estimated tax payments and 2013 overpayment credited to 2014	23a		
	b	Tax deposited with Form 7004	23b		
	c	Credit for federal tax paid on fuels (attach Form 4136)	23c		
		Add lines 23a through 23c		23d	
	24	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ <input type="checkbox"/>		24	
	25	Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed		25	
	26	Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid		26	
27	Enter amount from line 26 Credited to 2015 estimated tax ▶		27		
		Refunded ▶			

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here	Signature of officer _____	Date _____	Title _____	May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No
	Print/Type preparer's name _____	Preparer's signature _____	Date _____		PTIN _____
Paid Preparer Use Only	Firm's name ▶ _____	Firm's EIN ▶ _____	Check <input type="checkbox"/> if self-employed	
	Firm's address ▶ _____	Phone no. _____		

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Schedule B Other Information (see instructions)

- | | Yes | No |
|---|-----|----|
| 1 Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual
c <input type="checkbox"/> Other (specify) ▶ _____ | | |
| 2 See the instructions and enter the:
a Business activity ▶ _____ b Product or service ▶ _____ | | |
| 3 At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If "Yes," attach Schedule B-1, Information on Certain Shareholders of an S Corporation . . . | | |
| 4 At the end of the tax year, did the corporation:
a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total stock issued and outstanding of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below | | |

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage of Stock Owned	(v) If Percentage in (iv) is 100%, Enter the Date (if any) a Qualified Subchapter S Subsidiary Election Was Made

- | | Yes | No |
|---|-----|----|
| b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below | | |

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital

- | | | |
|---|--|--|
| 5 a At the end of the tax year, did the corporation have any outstanding shares of restricted stock?
If "Yes," complete lines (i) and (ii) below.
(i) Total shares of restricted stock ▶ _____
(ii) Total shares of non-restricted stock ▶ _____ | | |
|---|--|--|

- | | | |
|--|--|--|
| b At the end of the tax year, did the corporation have any outstanding stock options, warrants, or similar instruments?
If "Yes," complete lines (i) and (ii) below.
(i) Total shares of stock outstanding at the end of the tax year ▶ _____
(ii) Total shares of stock outstanding if all instruments were executed ▶ _____ | | |
|--|--|--|

6 Has this corporation filed, or is it required to file, **Form 8918**, Material Advisor Disclosure Statement, to provide information on any reportable transaction?

7 Check this box if the corporation issued publicly offered debt instruments with original issue discount
If checked, the corporation may have to file **Form 8281**, Information Return for Publicly Offered Original Issue Discount Instruments.

8 If the corporation: (a) was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation **and** (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ \$ _____

9 Enter the accumulated earnings and profits of the corporation at the end of the tax year. \$ _____

- 10 Does the corporation satisfy **both** of the following conditions?
- | | | |
|---|--|--|
| a The corporation's total receipts (see instructions) for the tax year were less than \$250,000 | | |
| b The corporation's total assets at the end of the tax year were less than \$250,000 | | |
- If "Yes," the corporation is not required to complete Schedules L and M-1.

11 During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?
If "Yes," enter the amount of principal reduction \$ _____

12 During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions

- | | | |
|--|--|--|
| 13 a Did the corporation make any payments in 2014 that would require it to file Form(s) 1099? | | |
| b If "Yes," did the corporation file or will it file required Forms 1099? | | |

Schedule K Shareholders' Pro Rata Share Items		Total amount	
Income (Loss)	1 Ordinary business income (loss) (page 1, line 21)	1	
	2 Net rental real estate income (loss) (attach Form 8825)	2	
	3a Other gross rental income (loss)	3a	
	b Expenses from other rental activities (attach statement)	3b	
	c Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4 Interest income	4	
	5 Dividends: a Ordinary dividends	5a	
	b Qualified dividends	5b	
	6 Royalties	6	
	7 Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7	
Income (Loss)	8a Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	8a	
	b Collectibles (28%) gain (loss)	8b	
	c Unrecaptured section 1250 gain (attach statement)	8c	
	9 Net section 1231 gain (loss) (attach Form 4797)	9	
	10 Other income (loss) (see instructions) . . . Type ▶	10	
Deductions	11 Section 179 deduction (attach Form 4562)	11	
	12a Charitable contributions	12a	
	b Investment interest expense	12b	
	c Section 59(e)(2) expenditures (1) Type ▶ ----- (2) Amount ▶	12c(2)	
d Other deductions (see instructions) . . . Type ▶	12d		
Credits	13a Low-income housing credit (section 42(j)(5))	13a	
	b Low-income housing credit (other)	13b	
	c Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	13c	
	d Other rental real estate credits (see instructions) Type ▶	13d	
	e Other rental credits (see instructions) . . . Type ▶	13e	
	f Biofuel producer credit (attach Form 6478)	13f	
	g Other credits (see instructions) Type ▶	13g	
Foreign Transactions	14a Name of country or U.S. possession ▶ -----		
	b Gross income from all sources	14b	
	c Gross income sourced at shareholder level	14c	
	Foreign gross income sourced at corporate level		
	d Passive category	14d	
	e General category	14e	
	f Other (attach statement)	14f	
	Deductions allocated and apportioned at shareholder level		
	g Interest expense	14g	
	h Other	14h	
	Deductions allocated and apportioned at corporate level to foreign source income		
	i Passive category	14i	
	j General category	14j	
	k Other (attach statement)	14k	
Other information			
l Total foreign taxes (check one): ▶ <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	14l		
m Reduction in taxes available for credit (attach statement)	14m		
n Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	15a Post-1986 depreciation adjustment	15a	
	b Adjusted gain or loss	15b	
	c Depletion (other than oil and gas)	15c	
	d Oil, gas, and geothermal properties—gross income	15d	
	e Oil, gas, and geothermal properties—deductions	15e	
	f Other AMT items (attach statement)	15f	
Items Affecting Shareholder Basis	16a Tax-exempt interest income	16a	
	b Other tax-exempt income	16b	
	c Nondeductible expenses	16c	
	d Distributions (attach statement if required) (see instructions)	16d	
	e Repayment of loans from shareholders	16e	

Schedule K Shareholders' Pro Rata Share Items (continued)		Total amount	
Other Information	17a Investment income	17a	
	b Investment expenses	17b	
	c Dividend distributions paid from accumulated earnings and profits	17c	
	d Other items and amounts (attach statement)		
Reconciliation	18 Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
Assets		(a)	(b)	(c)	(d)
1 Cash					
2a Trade notes and accounts receivable					
b Less allowance for bad debts	()	()			
3 Inventories					
4 U.S. government obligations					
5 Tax-exempt securities (see instructions)					
6 Other current assets (attach statement)					
7 Loans to shareholders					
8 Mortgage and real estate loans					
9 Other investments (attach statement)					
10a Buildings and other depreciable assets					
b Less accumulated depreciation	()	()			
11a Depletable assets					
b Less accumulated depletion	()	()			
12 Land (net of any amortization)					
13a Intangible assets (amortizable only)					
b Less accumulated amortization	()	()			
14 Other assets (attach statement)					
15 Total assets					
Liabilities and Shareholders' Equity					
16 Accounts payable					
17 Mortgages, notes, bonds payable in less than 1 year					
18 Other current liabilities (attach statement)					
19 Loans from shareholders					
20 Mortgages, notes, bonds payable in 1 year or more					
21 Other liabilities (attach statement)					
22 Capital stock					
23 Additional paid-in capital					
24 Retained earnings					
25 Adjustments to shareholders' equity (attach statement)					
26 Less cost of treasury stock	()	()			
27 Total liabilities and shareholders' equity					

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note. The corporation may be required to file Schedule M-3 (see instructions)

<p>1 Net income (loss) per books</p> <p>2 Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize) _____</p> <p>3 Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):</p> <p style="padding-left: 20px;">a Depreciation \$ _____</p> <p style="padding-left: 20px;">b Travel and entertainment \$ _____</p> <p>_____</p> <p>4 Add lines 1 through 3</p>	<p>5 Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):</p> <p style="padding-left: 20px;">a Tax-exempt interest \$ _____</p> <p>_____</p> <p>6 Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):</p> <p style="padding-left: 20px;">a Depreciation \$ _____</p> <p>_____</p> <p>7 Add lines 5 and 6</p> <p>8 Income (loss) (Schedule K, line 18). Line 4 less line 7</p>
--	---

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year			
2 Ordinary income from page 1, line 21			
3 Other additions			
4 Loss from page 1, line 21	()		
5 Other reductions	()	()	
6 Combine lines 1 through 5			
7 Distributions other than dividend distributions			
8 Balance at end of tax year. Subtract line 7 from line 6			

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**Schedule K-1
(Form 1120S)**

Department of the Treasury
Internal Revenue Service

2014

For calendar year 2014, or tax
year beginning _____, 2014
ending _____, 20_____

Final K-1 Amended K-1 OMB No. 1545-0123

**Shareholder's Share of Income, Deductions,
Credits, etc.**

▶ See back of form and separate instructions.

Part I Information About the Corporation		Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items	
A Corporation's employer identification number		1 Ordinary business income (loss)	13 Credits
B Corporation's name, address, city, state, and ZIP code		2 Net rental real estate income (loss)	
		3 Other net rental income (loss)	
		4 Interest income	
C IRS Center where corporation filed return		5a Ordinary dividends	
		5b Qualified dividends	14 Foreign transactions
		6 Royalties	
Part II Information About the Shareholder		7 Net short-term capital gain (loss)	
		8a Net long-term capital gain (loss)	
		8b Collectibles (28%) gain (loss)	
D Shareholder's identifying number		8c Unrecaptured section 1250 gain	
E Shareholder's name, address, city, state, and ZIP code		9 Net section 1231 gain (loss)	
		10 Other income (loss)	15 Alternative minimum tax (AMT) items
F Shareholder's percentage of stock ownership for tax year _____ %			
		11 Section 179 deduction	16 Items affecting shareholder basis
		12 Other deductions	
			17 Other information
		* See attached statement for additional information.	

For IRS Use Only

**SCHEDULE M-3
(Form 1120S)**

**Net Income (Loss) Reconciliation for S Corporations
With Total Assets of \$10 Million or More**

OMB No. 1545-0123

2014

Department of the Treasury
Internal Revenue Service

▶ Attach to Form 1120S.

▶ Information about Sch. M-3 (Form 1120S) and its separate instructions is at www.irs.gov/form1120s.

Name of corporation _____

Employer identification number _____

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1 a Did the corporation prepare a certified audited non-tax-basis income statement for the period ending with or within this tax year? (See instructions if multiple non-tax-basis income statements are prepared.)

- Yes.** Skip line 1b and complete lines 2 through 11 with respect to that income statement.
- No.** Go to line 1b.

b Did the corporation prepare a non-tax-basis income statement for that period?

- Yes.** Complete lines 2 through 11 with respect to that income statement.
- No.** Skip lines 2 through 3b and enter the corporation's net income (loss) per its books and records on line 4a.

2 Enter the income statement period: Beginning _____ / _____ / _____ Ending _____ / _____ / _____

3 a Has the corporation's income statement been restated for the income statement period on line 2?

- Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
- No.**

b Has the corporation's income statement been restated for any of the five income statement periods immediately preceding the period on line 2?

- Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
- No.**

4 a Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	
b Indicate accounting standard used for line 4a (see instructions):		
(1) <input type="checkbox"/> GAAP (2) <input type="checkbox"/> IFRS		
(3) <input type="checkbox"/> Tax-basis (4) <input type="checkbox"/> Other (specify) _____		
5 a Net income from nonincludible foreign entities (attach statement)	5a	(_____)
b Net loss from nonincludible foreign entities (attach statement and enter as a positive amount)	5b	
6 a Net income from nonincludible U.S. entities (attach statement)	6a	(_____)
b Net loss from nonincludible U.S. entities (attach statement and enter as a positive amount)	6b	
7 a Net income (loss) of other foreign disregarded entities (attach statement)	7a	
b Net income (loss) of other U.S. disregarded entities (except qualified subchapter S subsidiaries) (attach statement)	7b	
c Net income (loss) of other qualified subchapter S subsidiaries (QSubs) (attach statement)	7c	
8 Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach statement)	8	
9 Adjustment to reconcile income statement period to tax year (attach statement)	9	
10 Other adjustments to reconcile to amount on line 11 (attach statement)	10	
11 Net income (loss) per income statement of the corporation. Combine lines 4 through 10	11	
Note. Part I, line 11, must equal Part II, line 26, column (a) or Schedule M-1, line 1 (see instructions).		

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines:

	Total Assets	Total Liabilities
a Included on Part I, line 4		
b Removed on Part I, line 5		
c Removed on Part I, line 6		
d Included on Part I, line 7		

Name of corporation	Employer identification number
---------------------	--------------------------------

Part II Reconciliation of Net Income (Loss) per Income Statement of the Corporation With Total Income (Loss) per Return (see instructions)

	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
Income (Loss) Items (Attach statements for lines 1 through 10)				
1 Income (loss) from equity method foreign corporations . . .				
2 Gross foreign dividends not previously taxed . . .				
3 Subpart F, QEF, and similar income inclusions . . .				
4 Gross foreign distributions previously taxed . . .				
5 Income (loss) from equity method U.S. corporations . . .				
6 U.S. dividends not eliminated in tax consolidation . . .				
7 Income (loss) from U.S. partnerships . . .				
8 Income (loss) from foreign partnerships . . .				
9 Income (loss) from other pass-through entities . . .				
10 Items relating to reportable transactions . . .				
11 Interest income (see instructions) . . .				
12 Total accrual to cash adjustment . . .				
13 Hedging transactions . . .				
14 Mark-to-market income (loss) . . .				
15 Cost of goods sold (see instructions) . . .	()			()
16 Sale versus lease (for sellers and/or lessors) . . .				
17 Section 481(a) adjustments . . .				
18 Unearned/deferred revenue . . .				
19 Income recognition from long-term contracts . . .				
20 Original issue discount and other imputed interest . . .				
21a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities . . .				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses . . .				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses . . .				
e Abandonment losses . . .				
f Worthless stock losses (attach statement) . . .				
g Other gain/loss on disposition of assets other than inventory . . .				
22 Other income (loss) items with differences (attach statement) . . .				
23 Total income (loss) items. Combine lines 1 through 22 . . .				
24 Total expense/deduction items (from Part III, line 32) . . .				
25 Other items with no differences . . .				
26 Reconciliation totals. Combine lines 23 through 25				

Note. Line 26, column (a), must equal Part I, line 11, and column (d) must equal Form 1120S, Schedule K, line 18.

Name of corporation

Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of the Corporation With Total Income (Loss) per Return—Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Equity-based compensation				
8 Meals and entertainment				
9 Fines and penalties				
10 Judgments, damages, awards, and similar costs				
11 Pension and profit-sharing				
12 Other post-retirement benefits				
13 Deferred compensation				
14 Charitable contribution of cash and tangible property				
15 Charitable contribution of intangible property				
16 Current year acquisition or reorganization investment banking fees				
17 Current year acquisition or reorganization legal and accounting fees				
18 Current year acquisition/reorganization other costs				
19 Amortization/impairment of goodwill				
20 Amortization of acquisition, reorganization, and start-up costs				
21 Other amortization or impairment write-offs				
22 Reserved				
23a Depletion—Oil & Gas				
b Depletion—Other than Oil & Gas				
24 Depreciation				
25 Bad debt expense				
26 Interest expense (see instructions)				
27 Corporate owned life insurance premiums				
28 Purchase versus lease (for purchasers and/or lessees)				
29 Research and development costs				
30 Section 118 exclusion (attach statement)				
31 Other expense/deduction items with differences (attach statement)				
32 Total expense/deduction items. Combine lines 1 through 31. Enter here and on Part II, line 24, reporting positive amounts as negative and negative amounts as positive				

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side

Social security number or taxpayer identification number

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either may show your basis (usually your cost) even if your broker did not report it to the IRS. Brokers must report basis to the IRS for most stock you bought in 2011 or later (and for certain debt instruments you bought in 2014 or later).

Part II Long-Term. Transactions involving capital assets you held more than 1 year are long term. For short-term transactions, see page 1.

Note. You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the total directly on Schedule D, line 8a; you are not required to report these transactions on Form 8949 (see instructions).

You must check Box D, E, or F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- (D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- (E)** Long-term transactions reported on Form(s) 1099-B showing basis was **not** reported to the IRS
- (F)** Long-term transactions not reported to you on Form 1099-B

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the Note below and see <i>Column (e)</i> in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
						(f) Code(s) from instructions	(g) Amount of adjustment	
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 8b (if Box D above is checked), line 9 (if Box E above is checked), or line 10 (if Box F above is checked) ▶								

Note. If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8958**
 (Rev. November 2014)
 Department of the Treasury
 Internal Revenue Service (99)

**Allocation of Tax Amounts Between
 Certain Individuals in Community Property States**
 ▶ Attach to Form 1040.

▶ Information about Form 8958 and its instructions is at www.irs.gov/form8958.

OMB No. 1545-0074

Attachment
 Sequence No. **63**

Your first name and initial		Your last name		Your social security number
Spouse's or partner's first name and initial		Spouse's or partner's last name		Spouse's or partner's social security number
	A Total Amount	B Allocated to Spouse or RDP SSN ____ - ____ - ____	C Allocated to Spouse or RDP SSN ____ - ____ - ____	
1 Wages (each employer)				
2 Interest Income (each payer)				
3 Dividends (each payer)				
4 State Income Tax Refund				
5 Self-Employment Income (See instructions)				
6 Capital Gains and Losses				
7 Pension Income				
8 Rents, Royalties, Partnerships, Estates, Trusts				

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 37779G

Form **8958** (Rev. 11-2014)

	A Total Amount	B Allocated to Spouse or RDP SSN ____ - ____ - ____	C Allocated to Spouse or RDP SSN ____ - ____ - ____
9 Deductible part of Self-Employment Tax (See instructions)			
10 Self-Employment Tax (See instructions)			
11 Taxes Withheld			
12 Other items such as: Social Security Benefits, Unemployment Compensation, Deductions, Credits, etc.			

Form **8959**

Department of the Treasury
Internal Revenue Service
Name(s) shown on return

Additional Medicare Tax

▶ If any line does not apply to you, leave it blank. See separate instructions.
▶ Attach to Form 1040, 1040NR, 1040-PR, or 1040-SS.
▶ Information about Form 8959 and its instructions is at www.irs.gov/form8959.

OMB No. 1545-0074

2014

Attachment
Sequence No. **71**

Your social security number

Part I Additional Medicare Tax on Medicare Wages

1	Medicare wages and tips from Form W-2, box 5. If you have more than one Form W-2, enter the total of the amounts from box 5	1		
2	Unreported tips from Form 4137, line 6	2		
3	Wages from Form 8919, line 6	3		
4	Add lines 1 through 3	4		
5	Enter the following amount for your filing status: Married filing jointly \$250,000 Married filing separately \$125,000 Single, Head of household, or Qualifying widow(er) \$200,000	5		
6	Subtract line 5 from line 4. If zero or less, enter -0-	6		
7	Additional Medicare Tax on Medicare wages. Multiply line 6 by 0.9% (.009). Enter here and go to Part II	7		

Part II Additional Medicare Tax on Self-Employment Income

8	Self-employment income from Schedule SE (Form 1040), Section A, line 4, or Section B, line 6. If you had a loss, enter -0- (Form 1040-PR and Form 1040-SS filers, see instructions.)	8		
9	Enter the following amount for your filing status: Married filing jointly \$250,000 Married filing separately \$125,000 Single, Head of household, or Qualifying widow(er) \$200,000	9		
10	Enter the amount from line 4	10		
11	Subtract line 10 from line 9. If zero or less, enter -0-	11		
12	Subtract line 11 from line 8. If zero or less, enter -0-	12		
13	Additional Medicare Tax on self-employment income. Multiply line 12 by 0.9% (.009). Enter here and go to Part III	13		

Part III Additional Medicare Tax on Railroad Retirement Tax Act (RRTA) Compensation

14	Railroad retirement (RRTA) compensation and tips from Form(s) W-2, box 14 (see instructions)	14		
15	Enter the following amount for your filing status: Married filing jointly \$250,000 Married filing separately \$125,000 Single, Head of household, or Qualifying widow(er) \$200,000	15		
16	Subtract line 15 from line 14. If zero or less, enter -0-	16		
17	Additional Medicare Tax on railroad retirement (RRTA) compensation. Multiply line 16 by 0.9% (.009). Enter here and go to Part IV	17		

Part IV Total Additional Medicare Tax

18	Add lines 7, 13, and 17. Also include this amount on Form 1040, line 62, (Form 1040NR, 1040-PR, and 1040-SS filers, see instructions) and go to Part V	18		
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Part V Withholding Reconciliation

19	Medicare tax withheld from Form W-2, box 6. If you have more than one Form W-2, enter the total of the amounts from box 6	19		
20	Enter the amount from line 1	20		
21	Multiply line 20 by 1.45% (.0145). This is your regular Medicare tax withholding on Medicare wages	21		
22	Subtract line 21 from line 19. If zero or less, enter -0-. This is your Additional Medicare Tax withholding on Medicare wages	22		
23	Additional Medicare Tax withholding on railroad retirement (RRTA) compensation from Form W-2, box 14 (see instructions)	23		
24	Total Additional Medicare Tax withholding. Add lines 22 and 23. Also include this amount with federal income tax withholding on Form 1040, line 64 (Form 1040NR, 1040-PR, and 1040-SS filers, see instructions)	24		

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 59475X

Form **8959** (2014)

Form **8960**
 Department of the Treasury
 Internal Revenue Service (99)

**Net Investment Income Tax—
 Individuals, Estates, and Trusts**

▶ Attach to your tax return.

▶ Information about Form 8960 and its separate instructions is at www.irs.gov/form8960.

OMB No. 1545-2227

2014
 Attachment
 Sequence No. **72**

Name(s) shown on your tax return

Your social security number or EIN

Part I Investment Income		<input type="checkbox"/> Section 6013(g) election (see instructions) <input type="checkbox"/> Section 6013(h) election (see instructions) <input type="checkbox"/> Regulations section 1.1411-10(g) election (see instructions)	
1	Taxable interest (see instructions)	1	
2	Ordinary dividends (see instructions)	2	
3	Annuities (see instructions)	3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	
c	Combine lines 4a and 4b	4c	
5a	Net gain or loss from disposition of property (see instructions)	5a	
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b	
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c	
d	Combine lines 5a through 5c	5d	
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)	6	
7	Other modifications to investment income (see instructions)	7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7	8	
Part II Investment Expenses Allocable to Investment Income and Modifications			
9a	Investment interest expenses (see instructions)	9a	
b	State, local, and foreign income tax (see instructions)	9b	
c	Miscellaneous investment expenses (see instructions)	9c	
d	Add lines 9a, 9b, and 9c	9d	
10	Additional modifications (see instructions)	10	
11	Total deductions and modifications. Add lines 9d and 10	11	
Part III Tax Computation			
12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-	12	
Individuals:			
13	Modified adjusted gross income (see instructions)	13	
14	Threshold based on filing status (see instructions)	14	
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	
16	Enter the smaller of line 12 or line 15	16	
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). Enter here and include on your tax return (see instructions)	17	
Estates and Trusts:			
18a	Net investment income (line 12 above)	18a	
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b	
c	Undistributed net investment income. Subtract line 18b from 18a (see instructions). If zero or less, enter -0-	18c	
19a	Adjusted gross income (see instructions)	19a	
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b	
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c	
20	Enter the smaller of line 18c or line 19c	20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (.038). Enter here and include on your tax return (see instructions)	21	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 59474M

Form **8960** (2014)

Form **8962**
 Department of the Treasury
 Internal Revenue Service

Premium Tax Credit (PTC)

OMB No. 1545-0074

2014
 Attachment
 Sequence No. **73**

▶ Attach to Form 1040, 1040A, or 1040NR.

▶ Information about Form 8962 and its separate instructions is at www.irs.gov/form8962.

Name shown on your return	Your social security number	Relief (see instructions) <input type="checkbox"/>
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Part 1: Annual and Monthly Contribution Amount

1 Family Size: Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d	1	
2a Modified AGI: Enter your modified AGI (see instructions) 2a		b Enter total of your dependents' modified AGI (see instructions)
3 Household Income: Add the amounts on lines 2a and 2b	3	
4 Federal Poverty Line: Enter the federal poverty amount as determined by the family size on line 1 and the federal poverty table for your state of residence during the tax year (see instructions). Check the appropriate box for the federal poverty table used. a <input type="checkbox"/> Alaska b <input type="checkbox"/> Hawaii c <input type="checkbox"/> Other 48 states and DC	4	
5 Household Income as a Percentage of Federal Poverty Line: Divide line 3 by line 4. Enter the result rounded to a whole percentage. (For example, for 1.542 enter the result as 154, for 1.549 enter as 155.) (See instructions for special rules.)	5	%
6 Is the result entered on line 5 less than or equal to 400%? (See instructions if the result is less than 100%) <input type="checkbox"/> Yes. Continue to line 7. <input type="checkbox"/> No. You are not eligible to receive PTC. If you received advance payment of PTC, see the instructions for how to report your Excess Advance PTC Repayment amount.		
7 Applicable Figure: Using your line 5 percentage, locate your "applicable figure" on the table in the instructions	7	
8a Annual Contribution for Health Care: Multiply line 3 by line 7 8a		b Monthly Contribution for Health Care: Divide line 8a by 12. Round to whole dollar amount
	8b	

Part 2: Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Did you share a policy with another taxpayer or get married during the year and want to use the alternative calculation? (see instructions)
 Yes. Skip to Part 4, Shared Policy Allocation, or Part 5, Alternative Calculation for Year of Marriage. **No. Continue to line 10.**

10 Do all Forms 1095-A for your tax household include coverage for January through December with no changes in monthly amounts shown on lines 21–32, columns A and B?
 Yes. Continue to line 11. Compute your annual PTC. Skip lines 12–23
 No. Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

Annual Calculation	A. Premium Amount (Form(s) 1095-A, line 33A)	B. Annual Premium Amount of SLCSP (Form(s) 1095-A, line 33B)	C. Annual Contribution Amount (Line 8a)	D. Annual Maximum Premium Assistance (Subtract C from B)	E. Annual Premium Tax Credit Allowed (Smaller of A or D)	F. Annual Advance Payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals						
Monthly Calculation	A. Monthly Premium Amount (Form(s) 1095-A, lines 21–32, column A)	B. Monthly Premium Amount of SLCSP (Form(s) 1095-A, lines 21–32, column B)	C. Monthly Contribution Amount (Amount from line 8b or alternative marriage monthly contribution)	D. Monthly Maximum Premium Assistance (Subtract C from B)	E. Monthly Premium Tax Credit Allowed (Smaller of A or D)	F. Monthly Advance Payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						

24 Total Premium Tax Credit: Enter the amount from line 11E or add lines 12E through 23E and enter the total here	24	
25 Advance Payment of PTC: Enter the amount from line 11F or add lines 12F through 23F and enter the total here	25	
26 Net Premium Tax Credit: If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If you elected the alternative calculation for marriage, enter zero. If line 24 equals line 25, enter zero. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27	26	

Part 3: Repayment of Excess Advance Payment of the Premium Tax Credit

27 Excess Advance Payment of PTC: If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here	27	
28 Repayment Limitation: Using the percentage on line 5 and your filing status, locate the repayment limitation amount in the instructions. Enter the amount here	28	
29 Excess Advance Premium Tax Credit Repayment: Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44	29	

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Appendix C

Glossary

The key terms in this glossary have been defined to reflect their conventional use in the field of taxation. The definitions may therefore be incomplete for other purposes.

A

- AAA bypass election.** In the context of a distribution by an S corporation, an election made by the entity to designate that the distribution is first from accumulated earnings and profits (AEP) and only then from the accumulated adjustments account (AAA).
- Abandoned spouse.** The abandoned spouse provision enables a married taxpayer with a dependent child whose spouse did not live in the taxpayer's home during the last six months of the tax year to file as a head of household rather than as married filing separately.
- Accelerated cost recovery system (ACRS).** A method in which the cost of tangible property is recovered (depreciated) over a prescribed period of time. This depreciation approach disregards salvage value, imposes a period of cost recovery that depends upon the classification of the asset into one of various recovery periods, and prescribes the applicable percentage of cost that can be deducted each year. A modified system is currently the default cost recovery method; it is referred to as MACRS. § 168.
- Accelerated death benefits.** The amount received from a life insurance policy by the insured who is terminally ill or chronically ill. Any realized gain may be excluded from the gross income of the insured if the policy is surrendered to the insurer or is sold to a licensed viatical settlement provider. § 101(g).
- Acceleration rule.** Treatment of an intercompany transaction on a consolidated return, when a sold asset leaves the group.
- Accident and health benefits.** Employee fringe benefits provided by employers through the payment of health and accident insurance premiums or the establishment of employer-funded medical reimbursement plans. Employers generally are entitled to a deduction for such payments, whereas employees generally exclude such fringe benefits from gross income. §§ 105 and 106.
- Accident and health insurance benefits.** See *accident and health benefits*.
- Accountable plan.** A type of expense reimbursement plan that requires an employee to render an adequate accounting to the employer and return any excess reimbursement or allowance. If the expense qualifies, it will be treated as a deduction *for* AGI.
- Accounting income.** The accountant's concept of income is generally based upon the realization principle. Financial accounting income may differ from taxable income (e.g., accelerated depreciation might be used for Federal income tax and straight-line depreciation for financial accounting purposes). Differences are included in a reconciliation of taxable and accounting income on Schedule M-1 or Schedule M-3 of Form 1120 for corporations.
- Accounting method.** The method under which income and expenses are determined for tax purposes. Important accounting methods include the cash basis and the accrual basis. Special methods are available for the reporting of gain on installment sales, recognition of income on construction projects (the completed contract and percentage of completion methods), and the valuation of inventories (last-in, first-out and first-in, first-out). §§ 446-474.
- Accounting period.** The period of time, usually a year, used by a taxpayer for the determination of tax liability. Unless a fiscal year is chosen, taxpayers must determine and pay their income tax liability by using the calendar year (January 1 through December 31) as the period of measurement. An example of a fiscal year is July 1 through June 30. A change in accounting period (e.g., from a calendar year to a fiscal year) generally requires the consent of the IRS. Usually, taxpayers are free to select either an initial calendar or a fiscal year without the consent of the IRS. §§ 441-444.
- Accrual method.** A method of accounting that reflects expenses incurred and income earned for any one tax year. In contrast to the cash basis of accounting, expenses need not be paid to be deductible, nor need income be received to be taxable. Unearned income (e.g., prepaid interest and rent) generally is taxed in the year of receipt regardless of the method of accounting used by the taxpayer. § 446(c)(2).

Accumulated adjustments account (AAA). An account that aggregates an S corporation's post-1982 income, loss, and deductions for the tax year (including nontaxable income and nondeductible losses and expenses). After the year-end income and expense adjustments are made, the account is reduced by distributions made during the tax year.

Accumulated E & P. See *accumulated earnings and profits*.

Accumulated earnings and profits. Net undistributed tax-basis earnings of a corporation aggregated from March 1, 1913, to the end of the prior tax year. Used to determine the amount of dividend income associated with a distribution to shareholders. § 316 and Reg. § 1.316-2.

Accumulated earnings credit. A reduction allowed in arriving at accumulated taxable income, in determining the accumulated earnings tax.

Accumulated earnings tax. A special tax imposed on C corporations that accumulate (rather than distribute) their earnings beyond the reasonable needs of the business. The accumulated earnings tax and related interest are imposed on accumulated taxable income in addition to the corporate income tax. §§ 531-537.

Accumulated taxable income (ATI). The base upon which the accumulated earnings tax is imposed. Generally, it is the taxable income of the corporation as adjusted for certain items (e.g., the Federal income tax, excess charitable contributions, the dividends received deduction) less the dividends paid deduction and the accumulated earnings credit. § 535.

Accuracy-related penalty. Major civil taxpayer penalties relating to the accuracy of tax return data, including misstatements stemming from taxpayer negligence and improper valuation of income and deductions, are coordinated under this umbrella term. The penalty usually equals 20 percent of the understated tax liability.

ACE adjustment. An adjustment in computing corporate alternative minimum taxable income (AMTI), computed at 75 percent of the excess of adjusted current earnings (ACE) over unadjusted AMTI. ACE computations reflect longer and slower cost recovery deductions and other restrictions on the timing of certain recognition events. Exempt interest, life insurance proceeds, and other receipts that are included in earnings and profits but not in taxable income also increase the ACE adjustment. If unadjusted AMTI exceeds ACE, the ACE adjustment is negative. The negative adjustment is limited to the aggregate of the positive adjustments under ACE for prior years, reduced by any previously claimed negative adjustments.

Acquiescence. Agreement by the IRS on the results reached in certain judicial decisions; sometimes abbreviated *Acq.* or *A.*

Acquisition indebtedness. Debt incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer. The interest on such loans is deductible as qualified residence interest. However, interest on such debt is deductible only on the portion of the indebtedness that does not exceed \$1,000,000 (\$500,000 for married persons filing separate returns). § 163(h)(3).

Acquisitive reorganization. A "Type D" reorganization where substantially all of the acquiring corporation's property is transferred to the target and the acquiring corporation's shareholders own at least 50 percent of the

target after the restructuring. The acquiring liquidates after the restructuring.

Active income. Wages, salary, commissions, bonuses, profits from a trade or business in which the taxpayer is a material participant, gain on the sale or other disposition of assets used in an active trade or business, and income from intangible property if the taxpayer's personal efforts significantly contributed to the creation of the property. The passive activity loss rules require classification of income and losses into three categories with active income being one of them.

Ad valorem tax. A tax imposed on the value of property. The most common ad valorem tax is that imposed by states, counties, and cities on real estate. Ad valorem taxes can be imposed on personal property as well.

Additional first-year depreciation. See *fifty percent additional first-year depreciation and one hundred percent additional first-year depreciation*.

Additional Medicare Tax. A tax created as part of the Affordable Care Act that went into effect starting in 2013. This tax is imposed at 0.9% on an individual's wage and self-employment income in excess of a threshold amount. For married individuals, the threshold is \$250,000 (\$125,000 if married filing separately). For other individuals the threshold is \$200,000. These dollar amounts are not adjusted annually for inflation. If an employer pays an employee more than \$200,000 during the year, then regardless of filing status, the employer is required to withhold the Additional Medicare Tax on the excess paid over \$200,000 and reports the tax on the employee's Form W-2. The tax is reported on Form 8959 (Additional Medicare Tax), filed with the individual's Form 1040. § 3101(b) and § 1401(b).

Adjusted basis. The cost or other basis of property reduced by depreciation allowed or allowable and increased by capital improvements. Other special adjustments are provided in § 1016 and the related Regulations.

Adjusted current earnings (ACE). Used to determine an adjustment in computing corporate alternative minimum taxable income (AMTI). ACE reflects restrictions on the timing of certain recognition events. Exempt interest, life insurance proceeds, and other receipts that are included in earnings and profits but not in taxable income also increase ACE.

Adjustments. See *AMT adjustments*.

Adoption expenses credit. A provision intended to assist taxpayers who incur nonrecurring costs directly associated with the adoption process, such as legal costs, social service review costs, and transportation costs. Up to \$13,400 (\$13,400 for a child with special needs regardless of the actual adoption expenses) of costs incurred to adopt an eligible child qualify for the credit. A taxpayer may claim the credit in the year qualifying expenses are paid or incurred if the expenses are paid during or after the year in which the adoption is finalized. For qualifying expenses paid or incurred in a tax year prior to the year the adoption is finalized, the credit must be claimed in the tax year following the tax year during which the expenses are paid or incurred. § 23.

Affiliated group. A parent-subsidiary group of corporations that is eligible to elect to file on a consolidated basis. Eighty

percent ownership of the voting power and value of all of the corporations must be achieved every day of the tax year, and an identifiable parent corporation must exist (i.e., it must own at least 80 percent of another group member without applying attribution rules).

Aggregate (conduit) concept. The theory of partnership taxation under which, in certain cases, a partnership is treated as a mere collection of the activities of each partner. See also *entity concept*.

Alimony and separate maintenance payments. Alimony deductions result from the payment of a legal obligation arising from the termination of a marital relationship. Payments designated as alimony generally are included in the gross income of the recipient and are deductible for AGI by the payor.

Alimony recapture. The amount of alimony that previously has been included in the gross income of the recipient and deducted by the payor that now is deducted by the recipient and included in the gross income of the payor as the result of front-loading. § 71(f).

All events test. For accrual method taxpayers, income is earned when (1) all of the events have occurred that fix the right to receive the income and (2) the amount can be determined with reasonable accuracy. Accrual of income cannot be postponed simply because a portion of the income may have to be returned in a subsequent period. The all events test also is utilized to determine when expenses can be deducted by an accrual basis taxpayer. The application of the test could cause a variation between the treatment of an item for accounting and for tax purposes. For example, a reserve for warranty expense may be properly accruable under generally accepted accounting principles but not be deductible under the Federal income tax law. Because of the application of the all events test, the deduction becomes available in the year the warranty obligation becomes fixed and the amount is determinable with reasonable certainty. Reg. §§ 1.446-1(c)(1)(ii) and 1.461-1(a)(2).

Allocate. The assignment of income for various tax purposes. A multistate corporation's nonbusiness income usually is allocated to the state where the nonbusiness assets are located; it is not apportioned with the rest of the entity's income. The income and expense items of an estate or a trust are allocated between income and corpus components. Specific items of income, expense, gain, loss, and credit can be allocated to specific partners if a substantial economic nontax purpose for the allocation is established.

Alternate valuation date. Property passing from a decedent by death may be valued for estate tax purposes as of the date of death or the alternate valuation date. The alternate valuation date is six months after the date of death or the date the property is disposed of by the estate, whichever comes first. To use the alternate valuation date, the executor or administrator of the estate must make an affirmative election. Election of the alternate valuation date is not available unless it decreases the amount of the gross estate and reduces the estate tax liability.

Alternative depreciation system (ADS). A cost recovery system that produces a smaller deduction than would be calculated under ACRS or MACRS. The alternative system

must be used in certain instances and can be elected in other instances. § 168(g).

Alternative minimum tax (AMT). The AMT is a fixed percentage of alternative minimum taxable income (AMTI). AMTI generally starts with the taxpayer's adjusted gross income (for individuals) or taxable income (for other taxpayers). To this amount, the taxpayer (1) adds designated preference items (e.g., tax-exempt interest income on private activity bonds), (2) makes other specified adjustments (e.g., to reflect a longer, straight-line cost recovery deduction), (3) adjusts certain AMT itemized deductions for individuals (e.g., interest incurred on housing but not taxes paid), and (4) subtracts an exemption amount. The taxpayer must pay the greater of the resulting AMT (reduced for larger corporations by only the foreign tax credit) or the regular income tax (reduced by all allowable tax credits). The AMT does not apply at all to certain small C corporations. AMT preferences and adjustments are assigned to partners, LLC members, and S corporation shareholders.

Alternative minimum tax credit. The AMT can result from timing differences that give rise to positive adjustments in calculating the AMT base. To provide equity for the taxpayer when these timing differences reverse, the regular tax liability may be reduced by a tax credit for a prior year's minimum tax liability attributable to timing differences. § 53.

Alternative minimum taxable income (AMTI). The base (prior to deducting the exemption amount) for computing a taxpayer's alternative minimum tax. This consists of the taxable income for the year modified for AMT adjustments and AMT preferences. § 55(b)(2).

Alternative tax. An option that is allowed in computing the tax on net capital gain. For the corporate taxpayer, the rate is 35 percent (the same as the highest regular corporate tax rate). Thus, for corporate taxpayers, the alternative tax does not produce a beneficial result. For noncorporate taxpayers, the rate is usually 15 percent (but is 25 percent for unrecaptured § 1250 gain and 28 percent for collectibles and § 1202 gain). However, if the noncorporate taxpayer is in either the 10 percent or the 15 percent tax bracket, the alternative tax rate is 0 percent (rather than 15 percent). Certain high-income taxpayers (i.e., in the 39.6 percent tax bracket) have an alternative tax rate of 20 percent. §§ 1(h) and 1201.

Alternative tax NOL deduction (ATNOLD). In calculating the AMT, the taxpayer is allowed to deduct NOL carryovers and carrybacks. However, for this purpose, a special calculation is required that is referred to as the ATNOLD. The regular income tax is modified for AMT adjustments and preferences to produce the ATNOLD. § 56(d).

American Opportunity credit. This credit replaces the HOPE scholarship credit for 2009 through 2017 and applies for qualifying expenses for the first four years of postsecondary education. Qualified expenses include tuition and related expenses and books and other course materials. Room and board are ineligible for the credit. The maximum credit available per student is \$2,500 (100 percent of the first \$2,000 of qualified expenses and 25 percent of the next \$2,000 of qualified expenses). Eligible students include the taxpayer, taxpayer's spouse, and taxpayer's dependents. To qualify for the credit, a student must take

at least one-half of the full-time course load for at least one academic term at a qualifying educational institution. The credit is phased out for higher-income taxpayers. § 25A.

Amortization. The tax deduction for the cost or other basis of an intangible asset over the asset's estimated useful life. Examples of amortizable intangibles include patents, copyrights, and leasehold interests. Most purchased intangible assets (e.g., goodwill) can be amortized for income tax purposes over a 15-year period.

Amount realized. The amount received by a taxpayer upon the sale or exchange of property. Amount realized is the sum of the cash and the fair market value of any property or services received by the taxpayer plus any related debt assumed by the buyer. Determining the amount realized is the starting point for arriving at realized gain or loss. § 1001(b).

AMT adjustments. In calculating AMTI, certain adjustments are added to or deducted from taxable income. These adjustments generally reflect timing differences. § 56.

AMT exemption. An amount deducted from alternative minimum taxable income in deriving alternative minimum tax base. The exemption amount is phased out when AMTI exceeds specified threshold amounts.

AMT preferences. In calculating alternative minimum taxable income (AMTI), certain preference items are added to taxable income. AMT preferences generally reflect differences between the regular tax and the alternative minimum tax (AMT) computational bases. For instance, interest income from certain state and local bonds may be an AMT preference item.

Annual exclusion. In computing the taxable gifts for the year, each donor excludes the first \$14,000 (for 2015) of a gift to each donee. Usually, the annual exclusion is not available for gifts of future interests. § 2503(b).

Annuity. A fixed sum of money payable to a person at specified times for a specified period of time or for life. If the party making the payment (i.e., the obligor) is regularly engaged in this type of business (e.g., an insurance company), the arrangement is classified as a commercial annuity. A so-called private annuity involves an obligor that is not regularly engaged in selling annuities (e.g., a charity or family member).

Apportionment. The assignment of the business income of a multi-state corporation to specific states for income taxation. Usually, the apportionment procedure accounts for the property, payroll, and sales activity levels of the various states, and a proportionate assignment of the entity's total income is made using a three-factor apportionment formula. These activities indicate the commercial domicile of the corporation relative to that income. Some states exclude nonbusiness income from the apportionment procedure; they allocate nonbusiness income to the states where the nonbusiness assets are located.

Appreciated inventory. In partnership taxation, appreciated inventory is a hot asset, and a partner's share of its ordinary income potential must be allocated. If a partner sells an interest in the partnership, ordinary income is recognized to the extent of the partner's share in the partnership's inventory and unrealized receivables. The definition of "inventory" here is broad enough to include any accounts receivable, including unrealized receivables.

Arm's length. See *arm's length transaction*.

Arm's length price. See *arm's length transaction*.

Arm's length transaction. The standard under which unrelated parties would determine an exchange price for a transaction. Suppose, for example, Cardinal Corporation sells property to its sole shareholder for \$10,000. In testing whether the \$10,000 is an "arm's length" price, one would ascertain the price that would have been negotiated between the corporation and an unrelated party in a bargained exchange.

ASC 740 (SFAS 109). Under Generally Accepted Accounting Principles, the rules for the financial reporting of the tax expense of an enterprise. Permanent differences affect the enterprise's effective tax rate. Temporary differences create a deferred tax asset or a deferred tax liability on the balance sheet.

ASC 740-10 (FIN 48). An interpretation by the Financial Accounting Standards Board. When an uncertain tax return position exists, this interpretation is used to determine the financial reporting treatment, if any, for the taxpayer. If it is more likely than not (i.e., a greater than 50 percent probability) that the uncertain return position will be sustained (e.g., by the courts) on its technical merits, it must be reported on the financial statements. The amount to be reported then is computed based on the probabilities of the outcome of the technical review, and the amounts at which the dispute would be resolved. If the more-likely-than-not test is failed, no current financial disclosure of the results of the return position is required.

ASC 740-30 (APB 23). Under Generally Accepted Accounting Principles, the rules for the financial reporting of the tax expense relative to a U.S. corporation's non-U.S. subsidiary. If the parent documents that it is permanently reinvesting the non-U.S. earnings of a non-U.S. subsidiary, the parent does not record as an expense any U.S. income tax the parent might pay on such earnings (i.e., the book tax expense is deferred until such earnings are, if ever, repatriated to the United States).

Asset use test. In the context of a corporate reorganization, a means by which to determine if the continuity of business enterprise requirement is met. The acquiring corporation must continue to use the target entity's assets in the acquirer's business going forward; if this is not the case, the requirement is failed.

Assignment of income. A taxpayer attempts to avoid the recognition of income by assigning to another the property that generates the income. Such a procedure will not avoid income recognition by the taxpayer making the assignment if the income was earned at the point of the transfer. In this case, the income is taxed to the person who earns it.

At-risk limitation. Generally, a taxpayer can deduct losses related to a trade or business, S corporation, partnership, or investment asset only to the extent of the at-risk amount. The taxpayer has an amount at risk in a business or investment venture to the extent that personal assets have been subjected to the risks of the business. Typically, the taxpayer's at-risk amount includes (1) the amount of money or other property that the investor contributed to the venture for the investment, (2) the amount of any of the entity's liabilities for which the taxpayer personally is liable and that

relate to the investment, and (3) an allocable share of nonrecourse debts incurred by the venture from third parties in arm's length transactions for real estate investments.

Attribution. Under certain circumstances, the tax law applies attribution (constructive ownership) rules to assign to one taxpayer the ownership interest of another taxpayer. If, for example, the stock of Gold Corporation is held 60 percent by Marsha and 40 percent by Sidney, Marsha may be deemed to own 100 percent of Gold Corporation if Marsha and Sidney are mother and child. In that case, the stock owned by Sidney is attributed to Marsha. Stated differently, Marsha has a 60 percent direct and a 40 percent indirect interest in Gold Corporation. It can also be said that Marsha is the constructive owner of Sidney's interest.

Automatic mileage method. Automobile expenses are generally deductible only to the extent the automobile is used in business or for the production of income. Personal commuting expenses are not deductible. The taxpayer may deduct actual expenses (including depreciation and insurance), or the standard (automatic) mileage rate may be used (57.5 cents per mile for 2015 and 56 cents per mile for 2014). Automobile expenses incurred for medical purposes or in connection with job-related moving expenses are deductible to the extent of actual out-of-pocket expenses or at the rate of 23 cents per mile for 2015 and 23.5 cents per mile for 2014. For charitable activities, the rate is 14 cents per mile.

B

Bad debts. A deduction is permitted if a business account receivable subsequently becomes partially or completely worthless, providing the income arising from the debt previously was included in income. Available methods are the specific charge-off method and the reserve method. However, except for certain financial institutions, TRA of 1986 repealed the use of the reserve method for 1987 and thereafter. If the reserve method is used, partially or totally worthless accounts are charged to the reserve. A nonbusiness bad debt deduction is allowed as a short-term capital loss if the loan did not arise in connection with the creditor's trade or business activities. Loans between related parties (family members) generally are classified as nonbusiness. § 166.

Balance sheet approach. The process under ASC 740 (SFAS 109) by which an entity's deferred tax expense or deferred tax benefit is determined as a result of the reporting period's changes in the balance sheet's deferred tax asset and deferred tax liability accounts.

Basis in partnership interest. The acquisition cost of the partner's ownership interest in the partnership. Includes purchase price and associated debt acquired from other partners and in the course of the entity's trade or business.

Benchmarking. The tax professional's use of two or more entities' effective tax rates and deferred tax balance sheet accounts. Used chiefly to compare the effectiveness of the entities' tax planning techniques, and to suggest future tax-motivated courses of action.

Blockage rule. A factor to be considered in valuing a large block of corporate stock. Application of this rule generally justifies a discount in the asset's fair market value, because

the disposition of a large amount of stock at any one time may depress the value of the shares in the marketplace.

Boot. Cash or property of a type not included in the definition of a tax-deferred exchange. The receipt of boot causes an otherwise tax-deferred transfer to become immediately taxable to the extent of the lesser of the fair market value of the boot or the realized gain on the transfer. For example, see transfers to controlled corporations under § 351(b) and like-kind exchanges under § 1031(b).

Branch profits tax. A tax on the effectively connected earnings and profits of the U.S. branch of a foreign corporation. The tax is levied in addition to the usual § 11 tax in an amount equal to 30 percent of the dividend equivalent amount. Treaties can override the tax or reduce the withholding percentage. Earnings reinvested in the U.S. operations of the entity are not subject to the tax until repatriation.

Built-in gains tax. A penalty tax designed to discourage a shift of the incidence of taxation on unrealized gains from a C corporation to its shareholders, via an S election. Under this provision, any recognized gain during the first 10 (or 7 or 5) years of S status generates a corporate-level tax on a base not to exceed the aggregate untaxed built-in gains brought into the S corporation upon its election from C corporation taxable years.

Built-in loss property. Property contributed to a corporation under § 351 or as a contribution to capital that has a basis in excess of its fair market value. An adjustment is necessary to step down the basis of the property to its fair market value. The adjustment prevents the corporation and the contributing shareholder from obtaining a double tax benefit. The corporation allocates the adjustment proportionately among the assets with the built-in loss. As an alternative to the corporate adjustment, the shareholder may elect to reduce the basis in the stock.

Business bad debt. A tax deduction allowed for obligations obtained in connection with a trade or business that have become either partially or completely worthless. In contrast to nonbusiness bad debts, business bad debts are deductible as business expenses. § 166.

Business purpose. A justifiable business reason for carrying out a transaction. Mere tax avoidance is not an acceptable business purpose. The presence of a business purpose is crucial in the area of corporate reorganizations and certain liquidations.

Buy-sell agreement. An arrangement, particularly appropriate in the case of a closely held corporation or a partnership, whereby the surviving owners (shareholders or partners) or the entity agrees to purchase the interest of a withdrawing owner. The buy-sell agreement provides for an orderly disposition of an interest in a business and may aid in setting the value of the interest for estate tax purposes.

Bypass amount. The amount that can be transferred by gift or at death free of any unified transfer tax. For 2015, the bypass amount is \$5.43 million for estate tax and \$5.43 million for gift tax.

Bypass election. In the context of a distribution by an S corporation, an election made by the entity to designate that the distribution is first from accumulated earnings and profits and only then from the accumulated adjustments account (AAA).

C

- C corporation.** A separate taxable entity subject to the rules of Subchapter C of the Code. This business form may create a double taxation effect relative to its shareholders. The entity is subject to the regular corporate tax and a number of penalty taxes at the Federal level.
- Cafeteria plan.** An employee benefit plan under which an employee is allowed to select from among a variety of employer-provided fringe benefits. Some of the benefits may be taxable, and some may be statutory nontaxable benefits (e.g., health and accident insurance and group term life insurance). The employee is taxed only on the taxable benefits selected. A cafeteria benefit plan is also referred to as a flexible benefit plan. § 125.
- Capital account.** The financial accounting analog of a partner's tax basis in the entity.
- Capital asset.** Broadly speaking, all assets are capital except those specifically excluded from that definition by the Code. Major categories of noncapital assets include property held for resale in the normal course of business (inventory), trade accounts and notes receivable, and depreciable property and real estate used in a trade or business (§ 1231 assets). § 1221.
- Capital contribution.** Various means by which a shareholder makes additional funds available to the corporation (placed at the risk of the business), sometimes without the receipt of additional stock. If no stock is received, the contributions are added to the basis of the shareholder's existing stock investment and do not generate gross income to the corporation. § 118.
- Capital gain.** The gain from the sale or exchange of a capital asset.
- Capital gain property.** Property contributed to a charitable organization that if sold rather than contributed, would have resulted in long-term capital gain to the donor.
- Capital interest.** Usually, the percentage of the entity's net assets that a partner would receive on liquidation. Typically determined by the partner's capital sharing ratio.
- Capital loss.** The loss from the sale or exchange of a capital asset.
- Capital sharing ratio.** A partner's percentage ownership of the entity's capital.
- Cash balance plan.** A hybrid form of pension plan similar in some aspects to a defined benefit plan. Such a plan is funded by the employer, and the employer bears the investment risks and rewards. But like defined contribution plans, a cash balance plan establishes allocations to individual employee accounts, and the payout for an employee depends on investment performance.
- Cash equivalent doctrine.** Generally, a cash basis taxpayer does not report income until cash is constructively or actually received. Under the cash equivalent doctrine, cash basis taxpayers are required to report income if they receive the equivalent of cash (e.g., property is received) in a taxable transaction.
- Cash method.** See *cash receipts method*.
- Cash receipts method.** A method of accounting that reflects deductions as paid and income as received in any one tax year. However, deductions for prepaid expenses that benefit more than one tax year (e.g., prepaid rent and prepaid interest) usually are spread over the period benefited rather than deducted in the year paid. § 446(c)(1).
- Casualty loss.** A casualty is defined as "the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature" (e.g., floods, storms, fires, auto accidents). Individuals may deduct a casualty loss only if the loss is incurred in a trade or business or in a transaction entered into for profit or arises from fire, storm, shipwreck, or other casualty or from theft. Individuals usually deduct personal casualty losses as itemized deductions subject to a \$100 nondeductible amount and to an annual floor equal to 10 percent of adjusted gross income that applies after the \$100 per casualty floor has been applied. Special rules are provided for the netting of certain casualty gains and losses.
- Certiorari.** Appeal from a U.S. Court of Appeals to the U.S. Supreme Court is by Writ of Certiorari. The Supreme Court does not have to accept the appeal and usually does not (cert. den.) unless there is a conflict among the lower courts that needs to be resolved or a constitutional issue is involved.
- Charitable contributions.** Contributions are deductible (subject to various restrictions and ceiling limitations) if made to qualified nonprofit charitable organizations. A cash basis taxpayer is entitled to a deduction solely in the year of payment. Accrual basis corporations may accrue contributions at year-end if payment is properly authorized before the end of the year and payment is made within two and one-half months after the end of the year. § 170.
- Check-the-box Regulations.** By using the check-the-box rules prudently, an entity can select the most attractive tax results offered by the Code, without being bound by legal forms. By default, an unincorporated entity with more than one owner is taxed as a partnership; an unincorporated entity with one owner is a disregarded entity, taxed as a sole proprietorship or corporate division. No action is necessary by the taxpayer if the legal form or default status is desired. Form 8832 is used to "check a box" and change the tax status. Not available if the entity is incorporated under state law.
- Child tax credit.** A tax credit based solely on the number of qualifying children under age 17. The maximum credit available is \$1,000 per child through 2017. A qualifying child must be claimed as a dependent on a parent's tax return to qualify for the credit. Taxpayers who qualify for the child tax credit may also qualify for a supplemental credit. The supplemental credit is treated as a component of the earned income credit and is therefore refundable. The credit is phased out for higher-income taxpayers. § 24.
- Circuit Court of Appeals.** Any of 13 Federal courts that consider tax matters appealed from the U.S. Tax Court, a U.S. District Court, or the U.S. Court of Federal Claims. Appeal from a U.S. Court of Appeals is to the U.S. Supreme Court by Certiorari.
- Circular 230.** A portion of the Federal tax Regulations that describes the levels of conduct at which a tax preparer must operate. Circular 230 dictates, for instance, that a tax preparer may not charge an unconscionable fee or delay the execution of a tax audit with inappropriate delays. Circular

230 requires that there be a reasonable basis for a tax return position and that no frivolous returns be filed.

Citor. A tax research resource that presents the judicial history of a court case and traces the subsequent references to the case. When these references include the citing cases' evaluations of the cited case's precedents, the research can obtain some measure of the efficacy and reliability of the original holding.

Claim of right doctrine. A judicially imposed doctrine applicable to both cash and accrual basis taxpayers that holds that an amount is includible in income upon actual or constructive receipt if the taxpayer has an unrestricted claim to the payment. For the tax treatment of amounts repaid when previously included in income under the claim of right doctrine, see § 1341.

Closely held C corporation. A regular corporation (i.e., the S election is not in effect) for which more than 50 percent of the value of its outstanding stock is owned, directly or indirectly, by five or fewer individuals at any time during the tax year. The term is relevant in identifying C corporations that are subject to the passive activity loss provisions. § 469.

Closely held corporation. A corporation where stock ownership is not widely dispersed. Rather, a few shareholders are in control of corporate policy and are in a position to benefit personally from that policy.

Closing agreement. In a tax dispute, the parties sign a closing agreement to spell out the terms under which the matters are settled. The agreement is binding on both the Service and the taxpayer.

Collectibles. A special type of capital asset, the gain from which is taxed at a maximum rate of 28 percent if the holding period is more than one year. Examples include art, rugs, antiques, gems, metals, stamps, some coins and bullion, and alcoholic beverages held for investment.

Combined return. In multistate taxation, a group of unitary corporations may elect or be required to file an income tax return that includes operating results for all of the affiliates, not just those with nexus in the state. Thus, apportionment data is reported for the group's worldwide or water's edge operations.

Community property. Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, and Wisconsin have community property systems. Alaska residents can elect community property status for assets. The rest of the states are common law property jurisdictions. The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse. Assume, for example, that Jeff and Alice are husband and wife and that their only income is the \$50,000 annual salary Jeff receives. If they live in New York (a common law state), the \$50,000 salary belongs to Jeff. If, however, they live in Texas (a community property state), the \$50,000 salary is owned one-half each by Jeff and Alice.

Compensatory damages. Damages received or paid by the taxpayer can be classified as compensatory damages or as

punitive damages. Compensatory damages are paid to compensate one for harm caused by another. Compensatory damages are excludible from the recipient's gross income.

Complete termination redemption. Sale or exchange treatment is available relative to this type of redemption. The shareholder must retire all of his or her outstanding shares in the corporation (ignoring family attribution rules) and cannot hold an interest, other than that of a creditor, for the 10 years following the redemption. § 302(b)(3).

Completed contract method. A method of reporting gain or loss on certain long-term contracts. Under this method of accounting, all gross income and expenses are recognized in the tax year in which the contract is completed. Reg. § 1.451-3.

Complex trust. Not a simple trust. Such trusts may have charitable beneficiaries, accumulate income, and distribute corpus. §§ 661-663.

Composite return. In multistate taxation, an S corporation may be allowed to file a single income tax return that assigns pass-through items to resident and nonresident shareholders. The composite or "block" return allows the entity to remit any tax that is attributable to the nonresident shareholders.

Conduit concept. An approach assumed by the tax law in the treatment of certain entities and their owners. Specific tax characteristics pass through the entity without losing their identity. For example, items of income and expense, capital gains and losses, tax credits, etc., realized by a partnership pass through the partnership (a conduit) and are subject to taxation at the partner level. Also, in an S corporation, certain items pass through and are reported on the returns of the shareholders.

Conservation easement. An interest in real property that maintains its natural or pristine condition. Most often it restricts the development of the property. Properly structured, the grant of such an easement can generate an income tax deduction for the donor. If the grant takes place after the owner's death, a § 2055 charitable contribution deduction results, and a portion of the property's value is excluded from the gross estate. § 2031(c).

Conservatism principle. The theory behind much of Generally Accepted Accounting Principles, under which assurance is provided that an entity's balance sheet assets are not overstated, nor liabilities understated. For instance, under ASC 740 (SFAS 109), a deferred tax asset is not recorded until it is more likely than not that the future tax benefit will be realized.

Consolidated return. A procedure whereby certain affiliated corporations may file a single return, combine the tax transactions of each corporation, and arrive at a single income tax liability for the group. The election to file a consolidated return usually is binding on future years. §§ 1501-1505 and related Regulations.

Consolidation. The combination of two or more corporations into a newly created corporation. Thus, Apt Corporation and Bye Corporation combine to form Cart Corporation. A consolidation may qualify as a nontaxable reorganization if certain conditions are satisfied. §§ 354 and 368(a)(1)(A).

Constructive dividend. A taxable benefit derived by a shareholder from his or her corporation that is not actually

initiated by the board of directors as a dividend. Examples include unreasonable compensation, excessive rent payments, bargain purchases of corporate property, and shareholder use of corporate property. Constructive dividends generally are found in closely held corporations.

Constructive liquidation scenario. The means by which recourse debt is shared among partners in basis determination.

Constructive receipt. If income is unqualifiedly available although not physically in the taxpayer's possession, it still is subject to the income tax. An example is accrued interest on a savings account. Under the constructive receipt concept, the interest is taxed to a depositor in the year available, rather than the year actually withdrawn. The fact that the depositor uses the cash basis of accounting for tax purposes is irrelevant. See Reg. § 1.451-2.

Continuity of business enterprise. In a tax-favored reorganization, a shareholder or corporation that has substantially the same investment after an exchange as before should not be taxed on the transaction. Specifically, the transferee corporation must continue the historic business of the transferor or use a significant portion of the transferor's assets in the new business.

Continuity of interest. In a tax-favored reorganization, a shareholder or corporation that has substantially the same investment after an exchange as before should not be taxed on the transaction. Specifically, the seller must acquire an equity interest in the acquiring corporation equal in value to at least 50 percent of all formerly outstanding stock of the acquired entity.

Control. Holding a specified level of stock ownership in a corporation. For § 351, the new shareholder(s) must hold at least 80 percent of the total combined voting power of all voting classes of stock and at least 80 percent of the shares of all nonvoting classes. Other tax provisions require different levels of control to bring about desired effects, such as 50 or 100 percent.

Controlled foreign corporation (CFC). A non-U.S. corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned by U.S. shareholders on any day during the taxable year of the foreign corporation. For purposes of this definition, a U.S. shareholder is any U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of the foreign corporation. Stock owned directly, indirectly, and constructively is used in this measure. See *U.S. shareholder*.

Controlled group. A controlled group of corporations is required to share the lower corporate tax rates and various other tax benefits among the members of the group. A controlled group may be either a brother-sister or a parent-subsidiary group.

Corporate liquidation. Occurs when a corporation distributes its net assets to its shareholders and ceases to be a going concern. Generally, a shareholder recognizes capital gain or loss upon the liquidation of the entity, regardless of the corporation's balance in its earnings and profits account. The liquidating corporation recognizes gain and loss on assets that it sells during the liquidation period and on assets that it distributes to shareholders in kind.

Corpus. The body or principal of a trust. Suppose, for example, Grant transfers an apartment building into a trust, income payable to Ruth for life, remainder to Shawn upon Ruth's death. Corpus of the trust is the apartment building.

Correspondence audit. An audit conducted by the IRS by the U.S. mail. Typically, the IRS writes to the taxpayer requesting the verification of a particular deduction or exemption. The remittance of copies of records or other support is requested of the taxpayer.

Cost depletion. Depletion that is calculated based on the adjusted basis of the asset. The adjusted basis is divided by the expected recoverable units to determine the depletion per unit. The depletion per unit is multiplied by the units sold during the tax year to calculate cost depletion.

Cost recovery. The portion of the cost of an asset written off under ACRS (or MACRS), which replaced the depreciation system as a method for writing off the cost of an asset for most assets placed in service after 1980 (after 1986 for MACRS). § 168.

Court of Federal Claims. A trial court (court of original jurisdiction) that decides litigation involving Federal tax matters. Appeal from this court is to the Court of Appeals for the Federal Circuit.

Court of original jurisdiction. The Federal courts are divided into courts of original jurisdiction and appellate courts. A dispute between a taxpayer and the IRS is first considered by a court of original jurisdiction (i.e., a trial court). The four Federal courts of original jurisdiction are the U.S. Tax Court, the U.S. District Court, the Court of Federal Claims, and the Small Cases Division of the U.S. Tax Court.

Credit for certain retirement plan contributions. A nonrefundable credit is available based on eligible contributions of up to \$2,000 to certain qualified retirement plans, such as traditional and Roth IRAs and § 401(k) plans. The benefit provided by this credit is in addition to any deduction or exclusion that otherwise is available resulting from the qualifying contribution. The amount of the credit depends on the taxpayer's AGI and filing status. § 25B.

Credit for child and dependent care expenses. A tax credit ranging from 20 percent to 35 percent of employment-related expenses (child and dependent care expenses) for amounts of up to \$6,000 is available to individuals who are employed (or deemed to be employed) and maintain a household for a dependent child under age 13, disabled spouse, or disabled dependent. § 21.

Credit for employer-provided child care. A nonrefundable credit is available to employers who provide child care facilities to their employees during normal working hours. The credit, limited to \$150,000, is comprised of two components. The portion of the credit for qualified child care expenses is equal to 25 percent of these expenses, while the portion of the credit for qualified child care resource and referral services is equal to 10 percent of these expenses. Any qualifying expenses otherwise deductible by the taxpayer must be reduced by the amount of the credit. In addition, the taxpayer's basis for any property used for qualifying purposes is reduced by the amount of the credit. § 45F.

Credit for small employer pension plan startup costs. A nonrefundable credit available to small businesses based on administrative costs associated with establishing and

maintaining certain qualified plans. While such qualifying costs generally are deductible as ordinary and necessary business expenses, the availability of the credit is intended to lower the costs of starting a qualified retirement program and therefore encourage qualifying businesses to establish retirement plans for their employees. The credit is available for eligible employers at the rate of 50 percent of qualified startup costs. The maximum credit is \$500 (based on a maximum \$1,000 of qualifying expenses). § 45E.

Crop insurance proceeds. The proceeds received when an insured crop is destroyed. Section 451(d) permits the farmer to defer reporting the income from the insurance proceeds until the tax year following the taxable year of the destruction.

Crop method. A method of accounting for agricultural crops that are planted in one year but harvested in a subsequent year. Under this method, the costs of raising the crop are accumulated as inventory and are deducted when the income from the crop is realized.

Cross-purchase buy-sell agreement. Under this arrangement, the surviving owners of the business agree to buy out the withdrawing owner. Assume, for example, Ron and Sara are equal shareholders in Tip Corporation. Under a cross-purchase buy-sell agreement, Ron and Sara would contract to purchase the other's interest, should that person decide to withdraw from the business.

Current E & P. See *current earnings and profits*.

Current earnings and profits. Net tax-basis earnings of a corporation aggregated during the current tax year. A corporate distribution is deemed to be first from the entity's current earnings and profits and then from accumulated earnings and profits. Shareholders recognize dividend income to the extent of the earnings and profits of the corporation. A dividend results to the extent of current earnings and profits, even if there is a larger negative balance in accumulated earnings and profits.

Current tax expense. Under ASC 740 (SFAS 109), the book tax expense that relates to the current reporting period's net income and is actually payable (or creditable) to the appropriate governmental agencies for the current period. Also known as "cash tax" or "tax payable."

D

De minimis fringe. Benefits provided to employees that are too insignificant to warrant the time and effort required to account for the benefits received by each employee and the value of those benefits. Such amounts are excludible from the employee's gross income. § 132.

De minimis fringe benefit. See *de minimis fringe*.

Death benefit. A payment made by an employer to the beneficiary or beneficiaries of a deceased employee on account of the death of the employee.

Debt-financed income. Included in computations of the unrelated business income of an exempt organization, the gross income generated from debt-financed property.

Deceased spouse's unused exclusion (DSUE). In computing the Federal estate tax, the decedent uses the exclusion amount to shelter an amount of the gross estate from tax-

ation. When the first spouse to die fails to use a portion of his/her exclusion amount, the unused portion is "portable," and becomes available to the surviving spouse. The surviving spouse can use the DSUE only of his/her last spouse to predecease.

Deduction for qualified tuition and related expenses.

Taxpayers are allowed a deduction of up to \$4,000 for higher education expenses. Certain taxpayers are not eligible for the deduction: those whose gross AGI exceeds a specified amount and those who can be claimed as a dependent by another taxpayer. These expenses are classified as a deduction *for* AGI, and they need not be employment-related. § 222.

Deductions for adjusted gross income. The Federal income tax is not imposed upon gross income. Rather, it is imposed upon taxable income. Congressionally identified deductions for individual taxpayers are subtracted either from gross income to arrive at adjusted gross income or from adjusted gross income to arrive at the tax base, taxable income.

Deductions from adjusted gross income. See *deductions for adjusted gross income*.

Deductions in respect of a decedent. Deductions accrued at the moment of death but not recognizable on the final income tax return of a decedent because of the method of accounting used. Such items are allowed as deductions on the estate tax return and on the income tax return of the estate (Form 1041) or the heir (Form 1040). An example of a deduction in respect of a decedent is interest expense accrued to the date of death by a cash basis debtor.

Deemed-paid credit. A foreign tax credit allowed to a U.S. taxpayer that has received an actual or constructive dividend from a non-U.S. corporation that has paid foreign income taxes. The credit is computed using the proportion of foreign income taxes paid by the payor corporation to its post-1986 undistributed earnings. Under § 78, the U.S. taxpayer claiming a deemed-paid credit includes the same amount in gross income for the tax year.

Deferred compensation. Compensation that will be taxed when received or upon the removal of certain restrictions on receipt and not when earned. Contributions by an employer to a qualified pension or profit sharing plan on behalf of an employee are an example. The contributions will not be taxed to the employee until the funds are made available or distributed to the employee (e.g., upon retirement).

Deferred tax asset. Under ASC 740 (SFAS 109), an item created on an enterprise's balance sheet by a temporary book-tax difference, such that a tax benefit is not recognized until a later date, although it already has been reported in the financial statements (e.g., the carryforward of a disallowed deduction).

Deferred tax benefit. Under ASC 740 (SFAS 109), a reduction in the book tax expense that relates to the current reporting period's net income but will not be realized until a future reporting period. Creates or adds to the entity's deferred tax asset balance sheet account. For instance, the carryforward of a net operating loss is a deferred tax benefit.

Deferred tax expense. Under ASC 740 (SFAS 109), a book tax expense that relates to the current reporting period's

net income but will not be realized until a future reporting period. Creates or adds to the entity's deferred tax liability balance sheet account. For instance, a deferred tax expense is created when tax depreciation deductions for the period are "accelerated" and exceed the corresponding book depreciation expense.

Deferred tax liability. As determined under the rules of ASC 740 (SFAS 109), an item created on an enterprise's balance sheet by a temporary book-tax difference, such that a tax benefit is recognized earlier for tax purposes than it is in the financial accounting records (e.g., the use of an accelerated cost recovery deduction).

Defined benefit plan. Qualified plans can be dichotomized into defined benefit plans and defined contribution plans. Under a defined benefit plan, a formula defines the benefits employees are to receive. The formula usually includes years of service, employee compensation, and some stated percentage. The employer must make annual contributions based on actuarial computations that will be sufficient to pay the vested retirement benefits.

Defined contribution pension plan. Qualified plans can be dichotomized into defined benefit plans and defined contribution plans. Under a defined contribution plan, a separate account is maintained for each covered employee. The employee's benefits under the plan are based solely on (1) the amount contributed and (2) income from the fund that accrues to the employee's account. The plan defines the amount the employer is required to contribute (e.g., a flat dollar amount, an amount based on a special formula, or an amount equal to a certain percentage of compensation).

Dependency exemption. See *personal and dependency exemptions*.

Depletion. The process by which the cost or other basis of a natural resource (e.g., an oil or gas interest) is recovered upon extraction and sale of the resource. The two ways to determine the depletion allowance are the cost and percentage (or statutory) methods. Under cost depletion, each unit of production sold is assigned a portion of the cost or other basis of the interest. This is determined by dividing the cost or other basis by the total units expected to be recovered. Under percentage (or statutory) depletion, the tax law provides a special percentage factor for different types of minerals and other natural resources. This percentage is multiplied by the gross income from the interest to arrive at the depletion allowance. §§ 613 and 613A.

Depreciation. The deduction for the cost or other basis of a tangible asset over the asset's estimated useful life.

Determination letter. Upon the request of a taxpayer, the IRS will comment on the tax status of a completed transaction. Determination letters frequently are used to determine whether a retirement or profit sharing plan qualifies under the Code, and to determine the tax-exempt status of certain nonprofit organizations.

Disabled access credit. A tax credit designed to encourage small businesses to make their facilities more accessible to disabled individuals. The credit is equal to 50 percent of the eligible expenditures that exceed \$250 but do not exceed \$10,250. Thus, the maximum amount for the credit is \$5,000. The adjusted basis for depreciation is reduced by the

amount of the credit. To qualify, the facility must have been placed in service before November 6, 1990. § 44.

Disaster area loss. A casualty sustained in an area designated as a disaster area by the President of the United States. In such an event, the disaster loss may be treated as having occurred in the taxable year immediately preceding the year in which the disaster actually occurred. Thus, immediate tax benefits are provided to victims of a disaster. § 165(i).

Disclaimers. Rejections, refusals, or renunciations of claims, powers, or property. Section 2518 sets forth the conditions required to avoid gift tax consequences as the result of a disclaimer.

Disguised sale. When a partner contributes property to the entity and soon thereafter receives a distribution from the partnership, the transactions are collapsed and the distribution is seen as a purchase of the asset by the partnership. § 707(a)(2)(B).

Disproportionate distribution. A distribution from a partnership to one or more of its partners in which at least one partner's interest in partnership hot assets is increased or decreased. For example, a distribution of cash to one partner and hot assets to another changes both partners' interest in hot assets and is disproportionate. The intent of rules for taxation of disproportionate distributions is to ensure that each partner eventually recognizes his or her proportionate share of partnership ordinary income.

Disproportionate redemption. Sale or exchange treatment is available relative to this type of redemption. After the exchange, the shareholder owns less than 80 percent of his or her pre-redemption interest in the corporation and only a minority interest in the entity. § 302(b)(2).

Disregarded entity. The Federal income tax treatment of business income usually follows the legal form of the taxpayer (i.e., an individual's sole proprietorship is reported on the Form 1040); a C corporation's taxable income is computed on Form 1120. The check-the-box Regulations are used if the unincorporated taxpayer wants to use a different tax regime. Under these rules, a disregarded entity is taxed as an individual or a corporate division; other tax regimes are not available. For instance, a one-member limited liability company is a disregarded entity.

Distributable net income (DNI). The measure that determines the nature and amount of the distributions from estates and trusts that the beneficiaries must include in income. DNI also limits the amount that estates and trusts can claim as a deduction for such distributions. § 643(a).

District Court. See *Federal District Court*.

Dividend. A nondeductible distribution to the shareholders of a corporation. A dividend constitutes gross income to the recipient if it is paid from the current or accumulated earnings and profits of the corporation.

Dividend equivalent amount (DEA). The amount subject to the branch profits tax, it is equal to the effectively connected E & P of the U.S. branch of a foreign corporation, reduced/(increased) by an increase/(reduction) in U.S. net equity.

Dividends received deduction. A deduction allowed a shareholder that is a corporation for dividends received from a domestic corporation. The deduction usually is 70 percent of the dividends received, but it could be 80 or 100

percent depending upon the ownership percentage held by the recipient corporation. §§ 243–246.

Divisive reorganization. A “Type D” spin-off, split-off or split-up reorganization in which the original corporation divides its active business (in existence for at least five years) assets among two or more corporations. The stock received by the original corporation shareholders must be at least 80 percent of the other corporations.

Dock sale. A purchaser uses its owned or rented vehicles to take possession of the product at the seller’s shipping dock. In most states, the sale is apportioned to the operating state of the purchaser, rather than the seller. See also *apportion* and *sales factor*.

Dollar-value LIFO. An inventory technique that focuses on the dollars invested in the inventory rather than the particular items on hand each period. Each inventory item is assigned to a pool. A pool is a collection of similar items and is treated as a separate inventory. At the end of the period, each pool is valued in terms of prices at the time LIFO was adopted (base period prices), whether or not the particular items were actually on hand in the year LIFO was adopted, to compare with current prices to determine if there has been an increase or decrease in inventories.

Domestic production activities deduction (DPAD). A deduction based on 9 percent of the lesser of qualified production activities income (QPAI) or modified adjusted gross income but not to exceed 50 percent of the W–2 production wages paid. In the case of a corporate taxpayer, taxable income is substituted for modified AGI. § 199.

Domestic production gross receipts (DPGR). A key component in computing the domestic production activities deduction (DPAD). Includes receipts from the sale and other disposition of qualified production property produced in significant part within the United States. DPGR is defined in § 199(c)(4).

E

Earned income credit. A tax credit designed to provide assistance to certain low-income individuals who generally have a qualifying child. This is a refundable credit. To receive the most beneficial treatment, the taxpayer must have qualifying children. However, it is possible to qualify for the credit without having a child. See Chapter 12 for the computation procedure required in order to determine the amount of the credit allowed.

Earnings and profits (E & P). Measures the economic capacity of a corporation to make a distribution to shareholders that is not a return of capital. Such a distribution results in dividend income to the shareholders to the extent of the corporation’s current and accumulated earnings and profits.

Economic effect test. Requirements that must be met before a special allocation may be used by a partnership. The premise behind the test is that each partner who receives an allocation of income or loss from a partnership bears the economic benefit or burden of the allocation.

Economic income. The change in the taxpayer’s net worth, as measured in terms of market values, plus the value of the assets the taxpayer consumed during the year. Because

of the impracticality of this income model, it is not used for tax purposes.

Economic performance test. One of the requirements that must be satisfied for an accrual basis taxpayer to deduct an expense. The accrual basis taxpayer first must satisfy the all events test. That test is not deemed satisfied until economic performance occurs. This occurs when property or services are provided to the taxpayer, or in the case in which the taxpayer is required to provide property or services, whenever the property or services are actually provided by the taxpayer.

Education expenses. Employees may deduct education expenses that are incurred either (1) to maintain or improve existing job-related skills or (2) to meet the express requirements of the employer or the requirements imposed by law to retain employment status. The expenses are not deductible if the education is required to meet the minimum educational standards for the taxpayer’s job or if the education qualifies the individual for a new trade or business. Reg. § 1.162–5.

Educational savings bonds. U.S. Series EE bonds whose proceeds are used for qualified higher educational expenses for the taxpayer, the taxpayer’s spouse, or a dependent. The interest may be excluded from gross income, provided the taxpayer’s adjusted gross income does not exceed certain amounts. § 135.

Effective tax rate. The financial statements for an entity include several footnotes, one of which reconciles the expected (statutory) income tax rate (e.g., 35 percent for a C corporation) with the effective tax rate (i.e., total tax expense as a percentage of book income). The reconciliation often is done in dollar and/or percentage terms.

Effectively connected income. Income of a nonresident alien or foreign corporation that is attributable to the operation of a U.S. trade or business under either the asset-use or the business-activities test.

E-file. The electronic filing of a tax return. The filing is either direct or indirect. As to direct, the taxpayer goes online using a computer and tax return preparation software. Indirect filing occurs when a taxpayer utilizes an authorized IRS e-file provider. The provider often is the tax return preparer.

E-filing. See *E-file*.

Employment taxes. Taxes that an employer must pay on account of its employees. Employment taxes include FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) taxes. Employment taxes are paid to the IRS in addition to income tax withholdings at specified intervals. Such taxes can be levied on the employees, the employer, or both.

Energy credits. See *energy tax credits*.

Energy tax credits. Various tax credits are available to those who invest in certain energy property. The purpose of the credit is to create incentives for conservation and to develop alternative energy sources.

Enrolled agent (EA). A tax practitioner who has gained admission to practice before the IRS by passing an IRS examination and maintaining a required level of continuing professional education.

Entertainment expenses. Expenses that are deductible only if they are directly related to or associated with a trade or

business. Various restrictions and documentation requirements have been imposed upon the deductibility of entertainment expenses to prevent abuses by taxpayers. See, for example, the provision contained in § 274(n) that disallows 50 percent (20 percent prior to 1994) of entertainment expenses. § 274.

Entity accounting income. Entity accounting income is not identical to the taxable income of a trust or estate, nor is it determined in the same manner as the entity's financial accounting income would be. The trust document or will determines whether certain income, expenses, gains, or losses are allocated to the corpus of the entity or to the entity's income beneficiaries. Only the items that are allocated to the income beneficiaries are included in entity accounting income.

Entity buy-sell agreement. An arrangement whereby the entity is to purchase a withdrawing owner's interest. When the entity is a corporation, the agreement generally involves a stock redemption on the part of the withdrawing shareholder. See also *buy-sell agreement* and *cross-purchase buy-sell agreement*.

Entity concept. The theory of partnership taxation under which a partnership is treated as a separate and distinct entity from the partners and has its own tax attributes.

Equity method. Under Generally Accepted Accounting Principles, the method of financial reporting for the operations of a subsidiary when the parent corporation owns between 20 and 50 percent of the subsidiary's stock. Creates a book-tax difference, as the two entities' operating results are combined for book purposes, but a Federal income tax consolidated return cannot be filed.

Estate freeze. Procedures directed toward fixing and stabilizing the value of an interest retained in a business, while transferring the growth portion to family members. In the case of a closely held corporation, the estate freeze usually involves keeping the preferred stock and giving away the common stock. The ultimate objective is to reduce estate value when the original owner-donor dies.

Estate tax. A tax imposed on the right to transfer property by death. Thus, an estate tax is levied on the decedent's estate and not on the heir receiving the property.

Estimated tax. The amount of tax (including alternative minimum tax and self-employment tax) a taxpayer expects to owe for the year after subtracting tax credits and income tax withheld. The estimated tax must be paid in installments at designated intervals (e.g., for the individual taxpayer, by April 15, June 15, September 15, and January 15 of the following year).

Excess lobbying expenditure. An excise tax is applied on otherwise tax-exempt organizations with respect to the excess of total lobbying expenditures over grass roots lobbying expenditures for the year.

Excess loss account. When a subsidiary has generated more historical losses than its parent has invested in the entity, the parent's basis in the subsidiary is zero, and the parent records additional losses in an excess loss account. This treatment allows the parent to continue to deduct losses of the subsidiary, even where no basis reduction is possible, while avoiding the need to show a negative stock basis on various financial records. If the subsidiary stock is sold while

an excess loss account exists, capital gain income usually is recognized to the extent of the balance in the account.

Excise tax. A tax on the manufacture, sale, or use of goods; on the carrying on of an occupation or activity; or on the transfer of property. Thus, the Federal estate and gift taxes are, theoretically, excise taxes.

Exclusion amount. The value of assets that is exempt from transfer tax due to the credit allowed for gifts or transfers by death. For gifts and deaths in 2015, the exclusion amount is \$5.43 million. An exclusion amount unused by a deceased spouse may be used by the surviving spouse. See also *exemption equivalent amount*.

Exempt organization. An organization that is either partially or completely exempt from Federal income taxation. § 501.

Exemption amount. See *AMT exemption*.

Exemption equivalent. The maximum value of assets that can be transferred to another party without incurring any Federal gift or estate tax because of the application of the unified tax credit. See also *exemption equivalent amount*.

Exemption equivalent amount. The nontaxable amount (in 2015, \$5.43 million for gift tax and estate tax) that is the equivalent of the unified transfer tax credit allowed.

Expanded affiliated group (EAG). For purposes of the domestic production activities deduction (DPAD), all members of an expanded affiliated group (EAG) are treated as a single corporation. Thus, the activities of any member of the group are attributed to the other members. An EAG must meet the requirements for filing a consolidated return with ownership levels lowered to 50 percent. § 199(d)(4)(B).

F

Fair market value. The amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. Reg. §§ 1.1001-1(a) and 20.2031-1(b).

Farm price method. A method of accounting for agricultural crops. The inventory of crops is valued at its market price less the estimated cost of disposition (e.g., freight and selling expense).

FDAP. Income of a nonresident alien or non-U.S. corporation that is received in the form of dividends, interest, rents, royalties, certain compensation, premiums, annuities, and other "fixed, determinable, annual, or periodic" forms. FDAP income usually is subject to U.S. income taxation at a flat 30 percent tax rate.

Federal District Court. A trial court for purposes of litigating Federal tax matters. It is the only trial court in which a jury trial can be obtained.

Feeder organization. An entity that carries on a trade or business for the benefit of an exempt organization. However, such a relationship does not result in the feeder organization itself being tax-exempt. § 502.

FICA tax. An abbreviation that stands for Federal Insurance Contributions Act, commonly referred to as the Social Security tax. The FICA tax is comprised of the Social Security tax (old age, survivors, and disability insurance) and the Medicare tax (hospital insurance) and is imposed on both employers and employees. The employer is responsible for withholding from

the employee's wages the Social Security tax at a rate of 6.2 percent on a maximum wage base and the Medicare tax at a rate of 1.45 percent (no maximum wage base). The maximum Social Security wage base for 2015 is \$118,500 and for 2014 is \$117,000.

Field audit. An audit conducted by the IRS on the business premises of the taxpayer or in the office of the tax practitioner representing the taxpayer.

Fifty percent additional first-year depreciation. This provision, which was effective for property acquired after December 31, 2007, and placed in service before January 1, 2015, provided for an additional cost recovery deduction of 50 percent in the tax year the qualified property is placed in service. Qualified property included most types of new property other than buildings. The taxpayer can elect to forgo this bonus depreciation. See also *one hundred percent additional first-year depreciation*.

Final Regulation. See *finalized Regulation*.

Finalized Regulation. The U.S. Treasury Department Regulations (abbreviated Reg.) represent the position of the IRS as to how the Internal Revenue Code is to be interpreted. Their purpose is to provide taxpayers and IRS personnel with rules of general and specific application to the various provisions of the tax law. Regulations are published in the *Federal Register* and in all tax services.

Financial Accounting Standards Board (FASB). See *Generally Accepted Accounting Principles (GAAP)*.

Fiscal year. A 12-month period ending on the last day of a month other than December. In certain circumstances, a taxpayer is permitted to elect a fiscal year instead of being required to use a calendar year.

Flat tax. In its pure form, a flat tax would eliminate all exclusions, deductions, and credits and impose a one-rate tax on gross income.

Flexible spending plan. An employee benefit plan that allows the employee to take a reduction in salary in exchange for the employer paying benefits that can be provided by the employer without the employee being required to recognize income (e.g., medical and child care benefits).

Flow-through entity. The entity is a tax reporter rather than a taxpayer. The owners are subject to tax. Examples are partnerships, S corporations, and limited liability companies.

Foreign earned income exclusion. The Code allows exclusions for earned income generated outside the United States to alleviate any tax base and rate disparities among countries. In addition, the exclusion is allowed for housing expenditures incurred by the taxpayer's employer with respect to the non-U.S. assignment, and self-employed individuals can deduct foreign housing expenses incurred in a trade or business. The exclusion is limited to \$100,800 per year for 2015 (\$99,200 in 2014). § 911.

Foreign Investment in Real Property Tax Act (FIRPTA). Under the Foreign Investment in Real Property Tax Act, gains or losses realized by nonresident aliens and non-U.S. corporations on the disposition of U.S. real estate creates U.S. source income and are subject to U.S. income tax.

Foreign tax credit (FTC). A U.S. citizen or resident who incurs or pays income taxes to a foreign country on income subject to U.S. tax may be able to claim some of these taxes as a credit against the U.S. income tax. §§ 27 and 901–905.

Franchise. An agreement that gives the transferee the right to distribute, sell, or provide goods, services, or facilities within a specified area. The cost of obtaining a franchise may be amortized over a statutory period of 15 years. In general, the franchisor's gain on the sale of franchise rights is an ordinary gain because the franchisor retains a significant power, right, or continuing interest in the subject of the franchise. §§ 197 and 1253.

Franchise tax. A tax levied on the right to do business in a state as a corporation. Although income considerations may come into play, the tax usually is based on the capitalization of the corporation.

Fraud. Tax fraud falls into two categories: civil and criminal. Under civil fraud, the IRS may impose as a penalty an amount equal to as much as 75 percent of the underpayment [§ 6651(f)]. Fines and/or imprisonment are prescribed for conviction of various types of criminal tax fraud (§§ 7201–7207). Both civil and criminal fraud involve a specific intent on the part of the taxpayer to evade the tax; mere negligence is not enough. Criminal fraud requires the additional element of willfulness (i.e., done deliberately and with evil purpose). In practice, it becomes difficult to distinguish between the degree of intent necessary to support criminal, rather than civil, fraud. In either situation, the IRS has the burden of proof to show the taxpayer committed fraud.

Fringe benefit. Compensation or other benefit received by an employee that is not in the form of cash. Some fringe benefits (e.g., accident and health plans, group term life insurance) may be excluded from the employee's gross income and therefore are not subject to the Federal income tax.

Frivolous return. A tax return that included a position that has no more than a 5 percent chance of being sustained upon review. Taxpayer and tax preparer penalties are assessed if a frivolous position is included in a filed tax return.

Fruit and tree metaphor. The courts have held that an individual who earns income from property or services cannot assign that income to another. For example, a father cannot assign his earnings from commissions to his child and escape income tax on those amounts.

Functional currency. The currency of the economic environment in which the taxpayer carries on most of its activities and in which the taxpayer transacts most of its business.

FUTA tax. An employment tax levied on employers. Jointly administered by the Federal and state governments, the tax provides funding for unemployment benefits. FUTA applies at a rate of 6.0 percent on the first \$7,000 of covered wages paid during the year for each employee in 2015. The Federal government allows a credit for FUTA paid (or allowed under a merit rating system) to the state. The credit cannot exceed 5.4 percent of the covered wages.

Future interest. An interest that will come into being at some future time. It is distinguished from a present interest, which already exists. Assume that Dan transfers securities to a newly created trust. Under the terms of the trust instrument, income from the securities is to be paid each year to Wilma for her life, with the securities passing to Sam upon Wilma's death. Wilma has a present interest in the trust because she is entitled to current income distributions. Sam has a future interest because he must wait for Wilma's

death to benefit from the trust. The annual exclusion of \$14,000 (in 2015) is not allowed for a gift of a future interest. § 2503(b).

G

General business credit. The summation of various nonrefundable business credits, including the tax credit for rehabilitation expenditures, business energy credit, work opportunity credit, research activities credit, low-income housing credit, and disabled access credit. The amount of general business credit that can be used to reduce the tax liability is limited to the taxpayer's net income tax reduced by the greater of (1) the tentative minimum tax or (2) 25 percent of the net regular tax liability that exceeds \$25,000. Unused general business credits can be carried back 1 year and forward 20 years. § 38.

General partner. A partner who is fully liable in an individual capacity for the debts of the partnership to third parties. A general partner's liability is not limited to the investment in the partnership. See also *limited partner*.

General partnership (GP). A partnership that is owned by one or more general partners. Creditors of a general partnership can collect amounts owed them from both the partnership assets and the assets of the partners individually.

Generally Accepted Accounting Principles (GAAP). Guidelines relating to how to construct the financial statements of enterprises doing business in the United States. Promulgated chiefly by the Financial Accounting Standards Board (FASB).

Gift tax. A tax imposed on the transfer of property by gift. The tax is imposed upon the donor of a gift and is based on the fair market value of the property on the date of the gift.

Golden parachute payment. A severance payment to employees that meets the following requirements: (1) the payment is contingent on a change of ownership of a corporation through a stock or asset acquisition and (2) the aggregate present value of the payment equals or exceeds three times the employee's average annual compensation. To the extent the severance payment meets these conditions, a deduction is disallowed to the employer for the excess of the payment over a statutory base amount (a five-year average of compensation if the taxpayer was an employee for the entire five-year period). In addition, a 20 percent excise tax is imposed on the employee who receives the excess severance pay. §§ 280G and 4999.

Goodwill. The reputation and built-up business of a company. For accounting purposes, goodwill has no basis unless it is purchased. In the purchase of a business, goodwill generally is the difference between the purchase price and the fair market value of the assets acquired. The intangible asset goodwill can be amortized for tax purposes over a 15-year period. Reg. § 1.167(a)-3.

Grantor. A transferor of property. The creator of a trust is usually referred to as the grantor of the entity.

Grantor trust. A trust under which the grantor retains control over the income or corpus (or both) to such an extent that he or she is treated as the owner of the property and its income for income tax purposes. Income from a grantor

trust is taxable to the grantor and not to the beneficiary who receives it. §§ 671-679.

Gross roots expenditures. Exempt organizations are prohibited from engaging in political activities, but spending incurred to influence the opinions of the general public relative to specific legislation is permitted by the law.

Gross estate. The property owned or previously transferred by a decedent that is subject to the Federal estate tax. The gross estate can be distinguished from the probate estate, which is property actually subject to administration by the administrator or executor of an estate. §§ 2031-2046.

Gross income. Income subject to the Federal income tax. Gross income does not include all economic income. That is, certain exclusions are allowed (e.g., interest on municipal bonds). For a manufacturing or merchandising business, gross income usually means gross profit (gross sales or gross receipts less cost of goods sold). § 61 and Reg. § 1.61-3(a).

Group term life insurance. Life insurance coverage provided by an employer for a group of employees. Such insurance is renewable on a year-to-year basis, and typically no cash surrender value is built up. The premiums paid by the employer on the insurance are not taxed to the employees on coverage of up to \$50,000 per person. § 79 and Reg. § 1.79-1(b).

Guaranteed payments. Payments made by a partnership to a partner for services rendered or for the use of capital to the extent the payments are determined without regard to the income of the partnership. The payments are treated as though they were made to a nonpartner and thus are deducted by the entity.

H

Half-year convention. A cost recovery convention that assumes that all property is placed in service at mid-year and thus provides for a half-year's cost recovery for that year.

Head of household. An unmarried individual who maintains a household for another and satisfies certain conditions set forth in § 2(b). This status enables the taxpayer to use a set of income tax rates that are lower than those applicable to other unmarried individuals but higher than those applicable to surviving spouses and married persons filing a joint return.

Health Savings Account (HSA). A medical savings account created in legislation enacted in December 2003 that is designed to replace and expand Archer Medical Savings Accounts.

Highly compensated employee. The employee group is generally divided into two categories for fringe benefit (including pension and profit sharing plans) purposes. These are (1) highly compensated employees and (2) non-highly compensated employees. For most fringe benefits, if the fringe benefit plan discriminates in favor of highly compensated employees, it will not be a qualified plan with respect, at a minimum, to the highly compensated employees.

Historic business test. In a corporate reorganization, a means by which to determine if the continuity of business enterprise requirement is met. The acquiring corporation must continue to operate the target entity's existing

business(es) going forward; if this is not the case, the requirement is failed.

Hobby loss. Losses from an activity not engaged in for profit. The Code restricts the amount of losses that an individual can deduct for hobby activities so that these transactions cannot be used to offset income from other sources. § 183.

Holding period. The period of time during which property has been held for income tax purposes. The holding period is significant in determining whether gain or loss from the sale or exchange of a capital asset is long-term or short-term. § 1223.

Home equity loans. Loans that utilize the personal residence of the taxpayer as security. The interest on such loans is deductible as qualified residence interest. However, interest is deductible only on the portion of the loan that does not exceed the lesser of (1) the fair market value of the residence, reduced by the acquisition indebtedness, or (2) \$100,000 (\$50,000 for married persons filing separate returns). A major benefit of a home equity loan is that there are no tracing rules regarding the use of the loan proceeds. § 163(h)(3).

Hot assets. Unrealized receivables and substantially appreciated inventory under § 751. When hot assets are present, the sale of a partnership interest or the disproportionate distribution of the assets can cause ordinary income to be recognized.

H.R. 10 plans. See *Keogh plans*.

Hybrid method. A combination of the accrual and cash methods of accounting. That is, the taxpayer may account for some items of income on the accrual method (e.g., sales and cost of goods sold) and other items (e.g., interest income) on the cash method.

I

Imputed interest. For certain long-term sales of property, the IRS can convert some of the gain from the sale into interest income if the contract does not provide for a minimum rate of interest to be paid by the purchaser. The seller recognizes less long-term capital gain and more ordinary income (interest income). § 483 and the related Regulations.

Inbound taxation. U.S. tax effects when a non-U.S. person begins an investment or business activity in the United States.

Incentive stock option (ISO). A type of stock option that receives favorable tax treatment. If various qualification requirements can be satisfied, there are no recognition tax consequences when the stock option is granted. However, the spread (the excess of the fair market value at the date of exercise over the option price) is a tax preference item for purposes of the alternative minimum tax. The gain on disposition of the stock resulting from the exercise of the stock option will be classified as long-term capital gain if certain holding period requirements are met (the employee must not dispose of the stock within two years after the option is granted or within one year after acquiring the stock). § 422.

Income. For tax purposes, an increase in wealth that has been realized.

Income in respect of a decedent (IRD). Income earned by a decedent at the time of death but not reportable on the final income tax return because of the method of accounting that appropriately is utilized. Such income is included in the gross estate and is taxed to the eventual recipient (either the estate or heirs). The recipient is, however, allowed an income tax deduction for the estate tax attributable to the income. § 691.

Income tax provision. Under ASC 740 (SFAS 109), a synonym for the book tax expense of an entity for the financial reporting period. Following the “matching principle,” all book tax expense that relates to the net income for the reporting period is reported on that period’s financial statements, including not only the current tax expense, but also any deferred tax expense and deferred tax benefit.

Income tax treaties. See *tax treaty*.

Independent contractor. A self-employed person as distinguished from one who is employed as an employee.

Indexation. A procedure whereby adjustments are made by the IRS to key tax components (e.g., standard deduction, tax brackets, personal and dependency exemptions) to reflect inflation. The adjustments usually are made annually and are based on the change in the consumer price index.

Individual Retirement Account (IRA). A type of retirement plan to which an individual with earned income can contribute a statutory maximum of \$5,500 in 2015. IRAs can be classified as traditional IRAs or Roth IRAs. With a traditional IRA, an individual can contribute and deduct a maximum of \$5,500 per tax year in 2015. The deduction is a deduction for AGI. However, if the individual is an active participant in another qualified retirement plan, the deduction is phased out proportionally between certain AGI ranges (note that the phaseout limits the amount of the deduction and not the amount of the contribution). With a Roth IRA, an individual can contribute a maximum of \$5,500 per tax year in 2015. No deduction is permitted. However, if a five-year holding period requirement is satisfied and if the distribution is a qualified distribution, the taxpayer can make tax-free withdrawals from a Roth IRA. The maximum annual contribution is phased out proportionally between certain AGI ranges. §§ 219 and 408A.

Individual Shared Responsibility Payment (ISRP). A mandate or penalty tax that individuals owe starting in 2014 for any month in which they do not have health coverage and do not qualify for an exemption. This mandate was created as part of the Affordable Care Act to encourage individuals to obtain health care coverage. If owed, the penalty is the greater of a “flat dollar amount” or a percentage of household income less the filing threshold. When fully in effect in 2016, the flat dollar amount is \$695 and the percent applied to household income is 2.5%. For a family, the flat dollar amount cannot exceed three times the flat dollar amount. After 2016, the \$695 amount is adjusted annually. The overall cap on the penalty is the national average cost of a bronze level plan (this amount is published by the IRS). Worksheets for computing the penalty are included in the instructions to Form 8965 (Health Coverage Exemptions). § 5000A.

Inheritance tax. A tax imposed on the right to receive property from a decedent. Thus, theoretically, an inheritance

tax is imposed on the heir. The Federal estate tax is imposed on the estate.

Inside basis. A partnership's basis in the assets it owns.

Installment method. A method of accounting enabling certain taxpayers to spread the recognition of gain on the sale of property over the collection period. Under this procedure, the seller arrives at the gain to be recognized by computing the gross profit percentage from the sale (the gain divided by the contract price) and applying it to each payment received. § 453.

Intangible drilling and development costs (IDC). Taxpayers may elect to expense or capitalize (subject to amortization) intangible drilling and development costs. However, ordinary income recapture provisions apply to oil and gas properties on a sale or other disposition if the expense method is elected. §§ 263(c) and 1254(a).

Intermediate sanctions. The IRS can assess excise taxes on disqualified persons and organization management associated with so-called public charities engaging in excess benefit transactions. An excess benefit transaction is one in which a disqualified person engages in a non-fair market value transaction with the exempt organization or receives unreasonable compensation. Prior to the idea of intermediate sanctions, the only option available to the IRS was to revoke the organization's exempt status.

International Accounting Standards Board (IASB). The body that promulgates International Financial Reporting Standards (IFRS). Based in London, representing accounting standard setting bodies in over 100 countries, the IASB develops accounting standards that can serve as the basis for harmonizing conflicting reporting standards among nations.

International Financial Reporting Standards (IFRS). Produced by the International Accounting Standards Board (IASB), guidelines developed since 2001 as to revenue recognition, accounting for business combinations, and a conceptual framework for financial reporting. IFRS provisions are designed so that they can be used by all entities, regardless of where they are based or conduct business. IFRS have gained widespread acceptance throughout the world, and the SEC is considering how to require U.S. entities to use IFRS in addition to, or in lieu of, the accounting rules of the Financial Accounting Standards Board.

Interpretive Regulation. A Regulation issued by the Treasury Department that purports to explain the meaning of a particular Code Section. An interpretive Regulation is given less deference than a legislative Regulation.

Investment income. Consisting of virtually the same elements as portfolio income, a measure by which to justify a deduction for interest on investment indebtedness.

Investment interest. Payment for the use of funds used to acquire assets that produce investment income. The deduction for investment interest is limited to net investment income for the tax year.

Investor losses. Losses on stock and securities. If stocks and bonds are capital assets in the hands of the holder, a capital loss materializes as of the last day of the taxable year in which the stocks or bonds become worthless. Under certain circumstances involving stocks and bonds of affiliated corporations, an ordinary loss is permitted upon worthlessness.

Involuntary conversion. The loss or destruction of property through theft, casualty, or condemnation. Gain realized on an involuntary conversion can, at the taxpayer's election, be deferred for Federal income tax purposes if the owner reinvests the proceeds within a prescribed period of time in property that is similar or related in service or use. § 1033.

Itemized deductions. Personal and employee expenditures allowed by the Code as deductions from adjusted gross income. Examples include certain medical expenses, interest on home mortgages, state income taxes, and charitable contributions. Itemized deductions are reported on Schedule A of Form 1040. Certain miscellaneous itemized deductions are reduced by 2 percent of the taxpayer's adjusted gross income. In addition, a taxpayer whose adjusted gross income exceeds a certain level (indexed annually) must reduce the itemized deductions by 3 percent of the excess of adjusted gross income over that level. Medical, casualty and theft, and investment interest deductions are not subject to the 3 percent reduction. The 3 percent reduction may not reduce itemized deductions that are subject to the reduction to below 20 percent of their initial amount.

J

Joint tenants. Two or more persons having undivided ownership of property with the right of survivorship. Right of survivorship gives the surviving owner full ownership of the property. Suppose Bob and Tami are joint tenants of a tract of land. Upon Bob's death, Tami becomes the sole owner of the property. For the estate tax consequences upon the death of a joint tenant, see § 2040.

K

Keogh plans. Retirement plans available to self-employed taxpayers. They are also referred to as H.R. 10 plans. Under such plans, a taxpayer may deduct each year up to 100 percent of net earnings from self-employment or \$53,000 for 2015, whichever is less. If the plan is a profit sharing plan, the percentage is 25 percent.

Kiddie tax. Passive income, such as interest and dividends, that is recognized by a child under age 19 (or under age 24 if a full-time student) is taxed to him or her at the rates that would have applied had the income been incurred by the child's parents, generally to the extent the income exceeds \$2,100 for 2015. The additional tax is assessed regardless of the source of the income or the income's underlying property. If the child's parents are divorced, the custodial parent's rates are used. The parents' rates reflect any applicable alternative minimum tax and the phaseouts of lower tax brackets and other deductions. § 1(g).

L

Least aggregate deferral method. An algorithm set forth in the Regulations to determine the tax year for a partnership or an S corporation with owners whose tax years differ.

The tax year selected is the one that produces the least aggregate deferral of income for the owners.

Least aggregate deferral rule. See *least aggregate deferral method*.

Legislative Regulation. Some Code Sections give the Secretary of the Treasury or his delegate the authority to prescribe Regulations to carry out the details of administration or to otherwise complete the operating rules. Regulations issued pursuant to this type of authority truly possess the force and effect of law. In effect, Congress is almost delegating its legislative powers to the Treasury Department.

Lessee. One who rents property from another. In the case of real estate, the lessee is also known as the tenant.

Lessor. One who rents property to another. In the case of real estate, the lessor is also known as the landlord.

Letter ruling. The written response of the IRS to a taxpayer's request for interpretation of the revenue laws with respect to a proposed transaction (e.g., concerning the tax-free status of a reorganization). Not to be relied on as precedent by other than the party who requested the ruling.

Liabilities in excess of basis. On the contribution of capital to a corporation, an investor recognizes gain on the exchange to the extent contributed assets carry liabilities with a face amount in excess of the tax basis of the contributed assets. This rule keeps the investor from holding the investment asset received with a negative basis. § 357(c).

Life insurance proceeds. A specified sum (the face value or maturity value of the policy) paid to the designated beneficiary of the policy by the life insurance company upon the death of the insured.

Lifetime learning credit. A tax credit for qualifying expenses for taxpayers pursuing education beyond the first two years of postsecondary education. Individuals who are completing their last two years of undergraduate studies, pursuing graduate or professional degrees, or otherwise seeking new job skills or maintaining existing job skills are all eligible for the credit. Eligible individuals include the taxpayer, taxpayer's spouse, and taxpayer's dependents. The maximum credit is 20 percent of the first \$10,000 of qualifying expenses and is computed per taxpayer. The credit is phased out for higher-income taxpayers. § 25A.

Like-kind exchange. An exchange of property held for productive use in a trade or business or for investment (except inventory and stocks and bonds) for other investment or trade or business property. Unless non-like-kind property (boot) is received, the exchange is fully tax-deferred. § 1031.

Limited liability company (LLC). A legal entity allowed by all of the states. The entity is subject to Federal income tax treatment as though it were a partnership in which all members or owners of the LLC are treated much like limited partners. There are no restrictions on ownership, all members may participate in management, and none has personal liability for the entity's debts.

Limited liability limited partnership (LLLP). A limited partnership for which the general partners are also protected from entity liabilities. An LLLP—or "triple LP"—can be formed in about 20 states. In those states, a limited partnership files with the state to adopt LLLP status.

Limited liability partnership (LLP). A legal entity allowed by many of the states, where a general partnership registers with

the state as an LLP. Owners are general partners, but a partner is not liable for any malpractice committed by other partners. The personal assets of the partners are at risk for the entity's contractual liabilities, such as accounts payable. The personal assets of a specific partner are at risk for his or her own professional malpractice and tort liability and for malpractice and torts committed by those whom he or she supervises.

Limited partner. A partner whose liability to third-party creditors of the partnership is limited to the amounts invested in the partnership. See also *general partner* and *limited partnership*.

Limited partnership (LP). A partnership in which some of the partners are limited partners. At least one of the partners in a limited partnership must be a general partner.

Liquidating distribution. A distribution by a partnership or corporation that is in complete liquidation of the entity's trade or business activities. Typically, such distributions generate capital gain or loss to the investors without regard, for instance, to the earnings and profits of the corporation or to the partnership's basis in the distributed property. They can, however, lead to recognized gain or loss at the corporate level.

Listed property. Property that includes (1) any passenger automobile; (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment (with an exception for exclusive business use); (5) any cellular telephone (or other similar telecommunications equipment); and (6) any other property of a type specified in the Regulations. If listed property is predominantly used for business, the taxpayer is allowed to use the statutory percentage method of cost recovery. Otherwise, the straight-line cost recovery method must be used. § 280F.

Living trust. A revocable trust. Often touted as a means of avoiding some probate costs.

Lobbying expenditure. An expenditure made for the purpose of influencing legislation. Such payments can result in the loss of the exempt status of, and the imposition of Federal income tax on, an exempt organization.

Long-term care insurance. Insurance that helps pay the cost of care when the insured is unable to care for himself or herself. Such insurance is generally thought of as insurance against the cost of an aged person entering a nursing home. The employer can provide the insurance, and the premiums may be excluded from the employee's gross income. § 7702B.

Long-term contract. A building, installation, construction, or manufacturing contract that is entered into but not completed within the same tax year. A manufacturing contract is a long-term contract only if the contract is to manufacture (1) a unique item not normally carried in finished goods inventory or (2) items that normally require more than 12 calendar months to complete. The two available methods to account for long-term contracts are the percentage of completion method and the completed contract method. The completed contract method can be used only in limited circumstances. § 460.

Long-term nonpersonal use capital assets. Includes investment property with a long-term holding period. Such

property disposed of by casualty or theft may receive § 1231 treatment.

Long-term tax-exempt rate. Used in deriving net operating loss limitations in the context of an equity structure shift. The highest of the Federal long-term interest rates in effect for any of the last three months. § 382.

Lower of cost or market (replacement cost). An elective inventory method, whereby the taxpayer may value inventories at the lower of the taxpayer's actual cost or the current replacement cost of the goods. This method cannot be used in conjunction with the LIFO inventory method.

Low-income housing credit. Beneficial treatment to owners of low-income housing is provided in the form of a tax credit. The calculated credit is claimed in the year the building is placed in service and in the following nine years. § 42.

Lump-sum distribution. Payment of the entire amount due at one time rather than in installments. Such distributions often occur from qualified pension or profit sharing plans upon the retirement or death of a covered employee. The recipient of a lump-sum distribution may recognize both long-term capital gain and ordinary income upon the receipt of the distribution. The ordinary income portion may be subject to a special 10-year income averaging provision. § 402(e).

M

Majority interest partners. Partners who have more than a 50 percent interest in partnership profits and capital, counting only those partners who have the same taxable year. The term is of significance in determining the appropriate taxable year of a partnership. § 706(b).

Marital deduction. A deduction allowed against the taxable estate or taxable gifts upon the transfer of property from one spouse to another.

Marriage penalty. The additional tax liability that results for a married couple when compared with what their tax liability would be if they were not married and filed separate returns.

Matching rule. Treatment of an intercompany transaction on a consolidated return, when a sold asset remains within the group.

Material participation. If an individual taxpayer materially participates in a nonrental trade or business activity, any loss from that activity is treated as an active loss that can be offset against active income. Material participation is achieved by meeting any one of seven tests provided in the Regulations. § 469(h).

Meaningful reduction test. A decrease in the shareholder's voting control. Used to determine whether a stock redemption qualifies for sale or exchange treatment.

Medical expenses. Medical expenses of an individual, a spouse, and dependents are allowed as an itemized deduction to the extent such amounts (less insurance reimbursements) exceed 10 percent (or 7.5 percent if at least age 65) of adjusted gross income. § 213.

Merger. The absorption of one corporation by another with the corporation being absorbed losing its legal identity. Flow Corporation is merged into Jobs Corporation, and the shareholders of Flow receive stock in Jobs in exchange for their stock in Flow. After the merger, Flow ceases to exist as

a separate legal entity. If a merger meets certain conditions, it is not currently taxable to the parties involved. § 368(a)(1)

Mid-month convention. A cost recovery convention that assumes that property is placed in service in the middle of the month that it is actually placed in service.

Mid-quarter convention. A cost recovery convention that assumes that property placed in service during the year is placed in service at the middle of the quarter in which it is actually placed in service. The mid-quarter convention applies if more than 40 percent of the value of property (other than eligible real estate) is placed in service during the last quarter of the year.

Minimum tax credit (AMT). See *alternative minimum tax credit*.

Miscellaneous itemized deductions. A special category of itemized deductions that includes expenses such as professional dues, tax return preparation fees, job-hunting costs, unreimbursed employee business expenses, and certain investment expenses. Such expenses are deductible only to the extent they exceed 2 percent of adjusted gross income. § 67.

Modified accelerated cost recovery system (MACRS). A method in which the cost of tangible property is recovered over a prescribed period of time. Enacted by the Economic Recovery Tax Act (ERTA) of 1981 and substantially modified by the Tax Reform Act (TRA) of 1986 (the modified system is referred to as MACRS), the approach disregards salvage value, imposes a period of cost recovery that depends upon the classification of the asset into one of various recovery periods, and prescribes the applicable percentage of cost that can be deducted each year. § 168.

Modified adjusted gross income. A key determinant in computing the domestic production activities deduction (DPAD) and certain other tax provisions (e.g., deduction for higher education tuition, exclusion of interest on education savings bonds). §§ 135, 144, and 199.

Moving expenses. A deduction for AGI is permitted to employees and self-employed individuals provided certain tests are met. The taxpayer's new job must be at least 50 miles farther from the old residence than the old residence was from the former place of work. In addition, an employee must be employed on a full-time basis at the new location for 39 weeks in the 12-month period following the move. Deductible moving expenses include the cost of moving the household and personal effects, transportation, and lodging expenses during the move. The cost of meals during the move is not deductible. Qualified moving expenses that are paid (or reimbursed) by the employer can be excluded from the employee's gross income. In this case, the related deduction by the employee is not permitted. §§ 62(a)(15), 132(a)(6), and 217.

Multiple support agreement. To qualify for a dependency exemption, the support test must be satisfied. This requires that over 50 percent of the support of the potential dependent be provided by the taxpayer. Where no one person provides more than 50 percent of the support, a multiple support agreement enables a taxpayer to still qualify for the dependency exemption. Any person who contributed more than 10 percent of the support is entitled to claim the exemption if each person in the group who contributed

more than 10 percent files a written consent (Form 2120). Each person who is a party to the multiple support agreement must meet all of the other requirements for claiming the dependency exemption. § 152(c).

Multistate Tax Commission (MTC). A regulatory body of the states that develops operating rules and regulations for the implementation of the UDITPA and other provisions that assign the total taxable income of a multistate corporation to specific states.

N

National sales tax. Intended as a replacement for the current Federal income tax. Unlike a value added tax (VAT), which is levied on the manufacturer, it would be imposed on the consumer upon the final sale of goods and services. To keep the tax from being regressive, low-income taxpayers would be granted some kind of credit or exemption.

Negligence. Failure to exercise the reasonable or ordinary degree of care of a prudent person in a situation that results in harm or damage to another. A penalty is assessed on taxpayers who exhibit negligence or intentional disregard of rules and Regulations with respect to the underpayment of certain taxes.

Net capital gain (NCG). The excess of the net long-term capital gain for the tax year over the net short-term capital loss. The net capital gain of an individual taxpayer is eligible for the alternative tax. § 1222(11).

Net capital loss (NCL). The excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of such assets. Up to \$3,000 per year of the net capital loss may be deductible by noncorporate taxpayers against ordinary income. The excess net capital loss carries over to future tax years. For corporate taxpayers, the net capital loss cannot be offset against ordinary income, but it can be carried back three years and forward five years to offset net capital gains. §§ 1211, 1212, and 1221(10).

Net investment income. The excess of investment income over investment expenses. Investment expenses are those deductible expenses directly connected with the production of investment income. Investment expenses do not include investment interest. The deduction for investment interest for the tax year is limited to net investment income. § 163(d).

Net Investment Income Tax (NIIT). A tax created as part of the Affordable Care Act that went into effect starting in 2013. This tax is imposed on individuals, estates, and trusts at a rate of 3.8% of the lesser of (i) net investment income, or (ii) modified AGI less a threshold amount. For married individuals, the threshold is \$250,000 (\$125,000 if married filing separately). For other individuals the threshold is \$200,000. For estates and trusts, the threshold amount is equal to the amount where the 39.6% tax bracket begins for that year. For individuals, the dollar amounts are not adjusted for inflation. The tax is reported on Form 8960 (Net Investment Income Tax—Individuals, Estates, and Trusts), filed with the individual's Form 1040. § 1411.

Net operating loss (NOL). To mitigate the effect of the annual accounting period concept, § 172 allows taxpayers to use an excess loss of one year as a deduction for certain

past or future years. In this regard, a carryback period of 2 (or more) years and a carryforward period of 20 years currently are allowed.

Nexus. A multistate corporation's taxable income can be apportioned to a specific state only if the entity has established a sufficient presence, or nexus, with that state. State law, which often follows the Uniform Division of Income for Tax Purposes Act (UDITPA), specifies various activities that lead to nexus in various states.

Ninety-day letter. This notice is sent to a taxpayer upon request, upon the expiration of the 30-day letter, or upon exhaustion by the taxpayer of his or her administrative remedies before the IRS. The notice gives the taxpayer 90 days in which to file a petition with the U.S. Tax Court. If a petition is not filed, the IRS will demand payment of the assessed deficiency. §§ 6211–6216.

Non-additional-cost services. Services the employer may provide the employee at no additional cost to the employer. Generally, the benefit is the ability to utilize the employer's excess capacity (e.g., vacant seats on an airliner). Such amounts are excludible from the recipient's gross income.

Nonaccountable plan. An expense reimbursement plan that does not have an accountability feature. The result is that employee expenses must be claimed as deductions from AGI. An exception is moving expenses that are deductions for AGI.

Nonacquiescence. Disagreement by the IRS on the result reached in certain judicial decisions. *Nonacq.* or *NA*.

Nonbusiness bad debt. A bad debt loss that is not incurred in connection with a creditor's trade or business. The loss is classified as a short-term capital loss and is allowed only in the year the debt becomes entirely worthless. In addition to family loans, many investor losses are nonbusiness bad debts. § 166(d).

Nonliquidating distribution. A payment made by a partnership or corporation to the entity's owner when the entity's legal existence does not cease thereafter. If the payor is a corporation, such a distribution can result in dividend income to the shareholders. If the payor is a partnership, the partner usually assigns a basis in the distributed property that is equal to the lesser of the partner's basis in the partnership interest or the basis of the distributed asset to the partnership. In this regard, the partner first assigns basis to any cash that he or she receives in the distribution. The partner's remaining basis, if any, is assigned to the noncash assets according to their relative bases to the partnership.

Nonqualified deferred compensation (NQDC). Compensation arrangements that are frequently offered to executives. Such plans may include stock options, restricted stock, etc. Often, an executive may defer the recognition of taxable income. The employer, however, does not receive a tax deduction until the employee is required to include the compensation in income.

Nonqualified stock option (NQSO). A type of stock option that does not satisfy the statutory requirements of an incentive stock option. If the NQSO has a readily ascertainable fair market value (e.g., the option is traded on an established exchange), the value of the option must be included in the employee's gross income at the date of the grant. Otherwise, the employee does not recognize income at the

grant date. Instead, ordinary income is recognized in the year of exercise of the option.

Nonrecourse debt. Debt secured by the property that it is used to purchase. The purchaser of the property is not personally liable for the debt upon default. Rather, the creditor's recourse is to repossess the related property. Nonrecourse debt generally does not increase the purchaser's at-risk amount.

Nonrefundable credit. A credit that is not paid if it exceeds the taxpayer's tax liability. Some nonrefundable credits qualify for carryback and carryover treatment.

Nonresident alien (NRA). An individual who is neither a citizen nor a resident of the United States. Citizenship is determined under the immigration and naturalization laws of the United States. Residency is determined under § 7701(b) of the Internal Revenue Code.

Nontaxable exchange. A transaction in which realized gains or losses are not recognized. The recognition of gain or loss is postponed (deferred) until the property received in the nontaxable exchange is subsequently disposed of in a taxable transaction. Examples are § 1031 like-kind exchanges and § 1033 involuntary conversions.

Not essentially equivalent redemption. Sale or exchange treatment is given to this type of redemption. Although various safe-harbor tests are failed, the nature of the redemption is such that dividend treatment is avoided, because it represents a meaningful reduction in the shareholder's interest in the corporation. § 302(b)(1).

O

Occupational fee. A tax imposed on various trades or businesses. A license fee that enables a taxpayer to engage in a particular occupation.

Occupational taxes. See *occupational fee*.

Offer in compromise. A settlement agreement offered by the IRS in a tax dispute, especially where there is doubt as to the collectibility of the full deficiency. Offers in compromise can include installment payment schedules, as well as reductions in the tax and penalties owed by the taxpayer.

Office audit. An audit conducted by the IRS in the agent's office.

Office in the home expenses. Employment and business-related expenses attributable to the use of a residence (e.g., den or office) are allowed only if the portion of the residence is exclusively used on a regular basis as a principal place of business of the taxpayer or as a place of business that is used by patients, clients, or customers. If the expenses are incurred by an employee, the use must be for the convenience of the employer as opposed to being merely appropriate and helpful. In computing the office-in-the-home expenses, a taxpayer can use either the regular method or simplified method. As a general rule, the regular method requires more effort and recordkeeping but results in a larger deduction. § 280A.

One hundred percent additional first-year depreciation. The Tax Relief Act of 2010 provides for a cost recovery deduction of 100 percent in the tax year qualified property is placed in service. Qualified property includes most types

of new property other than buildings. This provision is effective for property acquired after December 31, 2010, and placed in service before January 1, 2012. See also *fifty percent additional first-year depreciation*.

One-year rule for prepaid expenses. Taxpayers who use the cash method are required to use the accrual method for deducting certain prepaid expenses (i.e., must capitalize the item and can deduct only when used). If a prepayment will not be consumed or expire by the end of the tax year following the year of payment, the prepayment must be capitalized and prorated over the benefit period. Conversely, if the prepayment will be consumed by the end of the tax year following the year of payment, it can be expensed when paid. To obtain the current deduction under the one-year rule, the payment must be a required payment rather than a voluntary payment.

Operating agreement. The governing document of a limited liability company. This document is similar in structure, function, and purpose to a partnership agreement.

Optional adjustment election. See *Section 754 election*.

Options. The sale or exchange of an option to buy or sell property results in capital gain or loss if the property is a capital asset. Generally, the closing of an option transaction results in short-term capital gain or loss to the writer of the call and the purchaser of the call option. § 1234.

Ordinary and necessary. An ordinary expense is common and accepted in the general industry or type of activity in which the taxpayer is engaged. It comprises one of the tests for the deductibility of expenses incurred or paid in connection with a trade or business; for the production or collection of income; for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax. §§ 162(a) and 212. A necessary expense is appropriate and helpful in furthering the taxpayer's business or income-producing activity. §§ 162(a) and 212.

Ordinary income property. Property contributed to a charitable organization that, if sold rather than contributed, would have resulted in other than long-term capital gain to the donor (i.e., ordinary income property and short-term capital gain property). Examples are inventory and capital assets held for less than the long-term holding period.

Organizational costs. See *organizational expenditures*.

Organizational expenditures. Items incurred early in the life of a corporate entity that are eligible for a \$5,000 limited expensing (subject to phaseout) and an amortization of the balance over 180 months. Organizational expenditures exclude those incurred to obtain capital (underwriting fees) or assets (subject to cost recovery). Typically, eligible expenditures include legal and accounting fees and state incorporation payments. Such items must be incurred by the end of the entity's first tax year. § 248.

Original issue discount (OID). The difference between the issue price of a debt obligation (e.g., a corporate bond) and the maturity value of the obligation when the issue price is less than the maturity value. OID represents interest and must be amortized over the life of the debt obligation using the effective interest method. The difference is not considered to be original issue discount for tax

purposes when it is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of years to maturity. §§ 1272 and 1273(a)(3).

Other adjustments account (OAA). Used in the context of a distribution from an S corporation. The net accumulation of the entity's exempt income (e.g., municipal bond interest).

Other property. In a corporate reorganization, any property in the exchange that is not stock or securities, such as cash or inventory. This amount usually constitutes boot. This result is similar to that in a like-kind exchange.

Outbound taxation. U.S. tax effects when a U.S. person begins an investment or business activity outside the United States.

Outside basis. A partner's basis in his or her partnership interest.

Ownership change. An event that triggers a § 382 limitation for the acquiring corporation.

P

Parent-subsidiary controlled group. A controlled or affiliated group of corporations where at least one corporation is at least 80 percent owned by one or more of the others. The affiliated group definition is more difficult to meet.

Partial liquidation. A stock redemption where noncorporate shareholders are permitted sale or exchange treatment. In certain cases, an active business must have existed for at least five years. Only a portion of the outstanding stock in the entity is retired.

Partnership. For income tax purposes, a partnership includes a syndicate, group, pool, or joint venture, as well as ordinary partnerships. In an ordinary partnership, two or more parties combine capital and/or services to carry on a business for profit as co-owners. § 7701(a)(2).

Partnership agreement. The governing document of a partnership. A partnership agreement should describe the rights and obligations of the partners; the allocation of entity income, deductions, and cash flows; initial and future capital contribution requirements; conditions for terminating the partnership; and other matters.

Passive investment company. A means by which a multistate corporation can reduce the overall effective tax rate by isolating investment income in a low- or no-tax state.

Passive investment income (PII). Gross receipts from royalties, certain rents, dividends, interest, annuities, and gains from the sale or exchange of stock and securities. When earnings and profits (E & P) also exists, if the passive investment income of an S corporation exceeds 25 percent of the corporation's gross receipts for three consecutive years, S status is lost.

Passive loss. Any loss from (1) activities in which the taxpayer does not materially participate or (2) rental activities (subject to certain exceptions). Net passive losses cannot be used to offset income from nonpassive sources. Rather, they are suspended until the taxpayer either generates net passive income (and a deduction of such losses is allowed) or disposes of the underlying property (at which time the loss deductions are allowed in full). One relief provision allows landlords who actively participate in the rental activ-

ities to deduct up to \$25,000 of passive losses annually. However, a phaseout of the \$25,000 amount commences when the landlord's AGI exceeds \$100,000. Another relief provision applies for material participation in a real estate trade or business.

Patent. An intangible asset that may be amortized over a statutory 15-year period as a § 197 intangible. The sale of a patent usually results in favorable long-term capital gain treatment. §§ 197 and 1235.

Payroll factor. The proportion of a multistate corporation's total payroll that is traceable to a specific state. Used in determining the taxable income that is to be apportioned to that state.

Pension plan. A type of deferred compensation arrangement that provides for systematic payments of definitely determinable retirement benefits to employees who meet the requirements set forth in the plan.

Percentage depletion. Depletion based on a statutory percentage applied to the gross income from the property. The taxpayer deducts the greater of cost depletion or percentage depletion. § 613.

Percentage of completion method. A method of reporting gain or loss on certain long-term contracts. Under this method of accounting, the gross contract price is included in income as the contract is completed. Reg. § 1.451-3.

Permanent and total disability. A person is considered permanently and totally disabled if he or she is unable to engage in any substantial gainful activity due to a physical or mental impairment. In addition, this impairment must be one that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months. The taxpayer generally must provide the IRS a physician's statement documenting this condition.

Permanent differences. Under ASC 740 (SFAS 109), tax-related items that appear in the entity's financial statements or its tax return but not both. For instance, interest income from a municipal bond is a permanent book-tax difference.

Permanent establishment (PE). A level of business activity, as defined under an income tax treaty, that subjects the taxpayer to taxation in a country other than that in which the taxpayer is based. Often evidenced by the presence of a plant, an office, or other fixed place of business. Inventory storage and temporary activities do not rise to the level of a PE. PE is the treaty's equivalent to nexus.

Permanently reinvesting. Under ASC 740-30 (APB 23) of Generally Accepted Accounting Principles, a special rule that relates to the book tax expense of non-U.S. subsidiaries. If a parent corporation documents that it is permanently reinvesting the non-U.S. earning of a non-U.S. subsidiary, the parent does not record as an expense any U.S. income tax that the parent might pay on such earnings, i.e., the book tax expense is deferred until such earnings are (if ever) repatriated to the United States.

Personal and dependency exemptions. The tax law provides an exemption for each individual taxpayer and an additional exemption for the taxpayer's spouse if a joint return is filed. An individual may also claim a dependency exemption for each dependent, provided certain tests are met. The amount of the personal and dependency exemptions is \$4,000 in 2015 (\$3,950 in 2014). The exemption is

subject to phaseout once adjusted gross income exceeds certain statutory threshold amounts.

Personal casualty gain. The recognized gain from any involuntary conversion of personal use property arising from fire, storm, shipwreck, or other casualty, or from theft.

Personal casualty loss. The recognized loss from any involuntary conversion of personal use property arising from fire, storm, shipwreck, or other casualty, or from theft.

Personal exemption. See *personal and dependency exemptions*.

Personal holding company tax. A penalty tax imposed on certain closely held corporations with excessive investment income. Assessed at the top individual tax rate on personal holding company income, reduced by dividends paid and other adjustments. § 541.

Personal residence. If a residence has been owned and used by the taxpayer as the principal residence for at least two years during the five-year period ending on the date of sale, up to \$250,000 of realized gain is excluded from gross income. For a married couple filing a joint return, the \$250,000 is increased to \$500,000 if either spouse satisfies the ownership requirement and both spouses satisfy the use requirement. § 121.

Personal service corporation (PSC). A corporation whose principal activity is the performance of personal services (e.g., health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) and where such services are substantially performed by the employee-owners. The 35 percent statutory income tax rate applies to PSCs.

Personalty. All property that is not attached to real estate (realty) and is movable. Examples of personalty are machinery, automobiles, clothing, household furnishings, and personal effects.

Points. Loan origination fees that may be deductible as interest by a buyer of property. A seller of property who pays points reduces the selling price by the amount of the points paid for the buyer. While the seller is not permitted to deduct this amount as interest, the buyer may do so.

Portfolio income. Income from interest, dividends, rentals, royalties, capital gains, or other investment sources. Net passive losses cannot be used to offset net portfolio income.

Power of appointment. A legal right granted to someone by a will or other document that gives the holder the power to dispose of property or the income from property. When the holder may appoint the property to his or her own benefit, the power usually is called a general power of appointment. If the holder cannot benefit himself or herself but may only appoint to certain other persons, the power is a special power of appointment. Assume Gary places \$500,000 worth of securities in trust granting Donna the right to determine each year how the trustee is to divide the income between Ann and Babs. Under these circumstances, Donna has a special power of appointment. If Donna had the further right to appoint the income to herself, she probably possesses a general power of appointment. For the estate tax and gift tax effects of powers of appointment, see §§ 2041 and 2514.

Precedent. A previously decided court decision that is recognized as authority for the disposition of future decisions.

Precontribution gain or loss. Partnerships allow for a variety of special allocations of gain or loss among the partners, but gain or loss that is “built in” on an asset contributed to the partnership is assigned specifically to the contributing partner. § 704(c)(1)(A).

Preferences. See *AMT preferences*.

Preferred stock bailout. A process where a shareholder used the issuance and sale, or later redemption, of a preferred stock dividend to obtain long-term capital gains, without any loss of voting control over the corporation. In effect, the shareholder received corporate profits without suffering the consequences of dividend income treatment. This procedure led Congress to enact § 306, which, if applicable, converts the prior long-term capital gain on the sale or redemption of the tainted stock to dividend income.

Premium Tax Credit (PTC). A tax credit that is refundable and available in advance of filing a return for the year. The PTC serves to reduce the cost of health coverage obtained on the Marketplace (Exchange). A PTC is available to individuals who purchase coverage on the Exchange and have household income equal to or greater than 100% of the Federal poverty line (FPL) and no greater than 400% of the FPL. Also, an individual must not have been able to obtain affordable coverage from his or her employer. If obtained in advance, the PTC is given to the insurance provider to lower the monthly premium cost to the individual. The PTC is reconciled on Form 8962 (Premium Tax Credit) filed with Form 1040 or 1040-A (not Form 1040-EZ). Individuals who obtain insurance through the Marketplace receive Form 1095-A (Health Insurance Marketplace Statement) by January 31 of the following year. This form provides information necessary to claim or reconcile the PTC, including the monthly cost of premiums and the amount of PTC received in advance each month. § 36B.

Previously taxed income (PTI). Under prior law, the undistributed taxable income of an S corporation was taxed to the shareholders as of the last day of the corporation’s tax year and usually could be withdrawn by the shareholders without tax consequences at some later point in time. The role of PTI has been taken over by the accumulated adjustments account. See also *accumulated adjustments account (AAA)*.

Principal partner. A partner with a 5 percent or greater interest in partnership capital or profits. § 706(b)(3).

Private activity bond. Interest on state and local bonds is excludible from gross income. § 103. Certain such bonds are labeled private activity bonds. Although the interest on such bonds is excludible for regular income tax purposes, it is treated as a tax preference in calculating the AMT.

Private foundation. An exempt organization that is subject to additional statutory restrictions on its activities and on contributions made to it. Excise taxes may be levied on certain prohibited transactions, and the Code places more stringent restrictions on the deductibility of contributions to private foundations. § 509.

Probate costs. The costs incurred in administering a decedent’s estate.

Probate estate. The property of a decedent that is subject to administration by the executor or administrator of an estate.

Procedural Regulation. A Regulation issued by the Treasury Department that is a housekeeping-type instruction indicating information that taxpayers should provide the IRS as well as information about the internal management and conduct of the IRS itself.

Profit and loss sharing ratios. Specified in the partnership agreement and used to determine each partner's allocation of ordinary taxable income and separately stated items. Profits and losses can be shared in different ratios. The ratios can be changed by amending the partnership agreement or by using a special allocation. § 704(a).

Profit sharing plan. A deferred compensation plan established and maintained by an employer to provide for employee participation in the company's profits. Contributions are paid from the employer's current or accumulated profits to a trustee. Separate accounts are maintained for each participating employee. The plan must provide a definite, predetermined formula for allocating the contributions among the participants. It also must include a definite, predetermined formula for distributing the accumulated funds after a fixed number of years, on the attainment of a stated age, or on the occurrence of certain events such as illness, layoff, or retirement.

Profits (loss) interest. A partner's percentage allocation of partnership operating results, determined by the profit and loss sharing ratios.

Property. Assets defined in the broadest legal sense. Property includes the unrealized receivables of a cash basis taxpayer, but not services rendered. § 351.

Property dividend. Generally treated in the same manner as a cash distribution, measured by the fair market value of the property on the date of distribution. Distribution of appreciated property causes the distributing C or S corporation to recognize gain. The distributing corporation does not recognize loss on property that has depreciated in value.

Property factor. The proportion of a multistate corporation's total property that is traceable to a specific state. Used in determining the taxable income that is to be apportioned to that state.

Proportionate distribution. A distribution in which each partner in a partnership receives a pro rata share of hot assets being distributed. For example, a distribution of \$10,000 of hot assets equally to two 50 percent partners is a proportionate distribution.

Proposed Regulation. A Regulation issued by the Treasury Department in proposed, rather than final, form. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal.

Proprietorship. A business entity for which there is a single owner. The net profit of the entity is reported on the owner's Federal income tax return (Schedule C of Form 1040).

Public Law 86-272. A congressional limit on the ability of the state to force a multistate corporation to assign taxable income to that state. Under P.L. 86-272, where orders for tangible personal property are both filled and delivered outside the state, the entity must establish more than the mere solicitation of such orders before any income can be apportioned to the state.

Punitive damages. Damages received or paid by the taxpayer can be classified as compensatory damages or as punitive damages. Punitive damages are those awarded to punish the defendant for gross negligence or the intentional infliction of harm. Such damages are includible in gross income. § 104.

Q

Qualified ABLE program. A state program that allows funds to be set aside for the benefit of an individual who became disabled or blind before age 26. Cash may be put into the fund annually up to the annual gift tax exclusion amount. Distributions to the designated beneficiary are not taxable provided they do not exceed qualified disability expenses for the year. § 529A.

Qualified business unit (QBU). A subsidiary, branch, or other business entity that conducts business using a currency other than the U.S. dollar.

Qualified dividend income. See *qualified dividends*.

Qualified dividends. Distributions made by domestic (and certain non-U.S.) corporations to noncorporate shareholders that are subject to tax at the same rates as those applicable to net long-term capital gains (i.e., 0 percent, 15 percent, or 20 percent). The 20 percent rate applies to certain high-income taxpayers (i.e., whose tax bracket is 39.6 percent). The dividend must be paid out of earnings and profits, and the shareholders must meet certain holding period requirements as to the stock. §§ 1(h)(1) and (11).

Qualified employee discounts. Discounts offered employees on merchandise or services that the employer ordinarily sells or provides to customers. The discounts must be generally available to all employees. In the case of property, the discount cannot exceed the employer's gross profit (the sales price cannot be less than the employer's cost). In the case of services, the discounts cannot exceed 20 percent of the normal sales price. § 132.

Qualified nonrecourse debt. Debt issued on realty by a bank, retirement plan, or governmental agency. Included in the at-risk amount by the investor. § 465(b)(6).

Qualified production activities income (QPAI). A key determinant in computing the domestic production activities deduction (DPAD). It consists of domestic production gross receipts (DPGR) reduced by cost of goods sold and other assignable expenses. Thus, QPAI represents the profit derived from domestic production activities. § 199.

Qualified real property business indebtedness. Indebtedness that was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property. The taxpayer must not be a C corporation. For qualified real property business indebtedness, the taxpayer may elect to exclude some or all of the income realized from cancellation of debt on qualified real property. If the election is made, the basis of the property must be reduced by the amount excluded. The amount excluded cannot be greater than the excess of the principal amount of the outstanding debt over the fair market value (net of any other debt outstanding on the property) of the property securing the debt. § 108(c).

Qualified residence interest. A term relevant in determining the amount of interest expense the individual taxpayer may deduct as an itemized deduction for what otherwise would be disallowed as a component of personal interest (consumer interest). Qualified residence interest consists of interest paid on qualified residences (principal residence and one other residence) of the taxpayer. Debt that qualifies as qualified residence interest is limited to \$1 million of debt to acquire, construct, or substantially improve qualified residences (acquisition indebtedness) plus \$100,000 of other debt secured by qualified residences (home equity indebtedness). The home equity indebtedness may not exceed the fair market value of a qualified residence reduced by the acquisition indebtedness for that residence. § 163(h)(3).

Qualified small business corporation. For purposes of computing an exclusion upon the sale of qualified small business stock, a C corporation that has aggregate gross assets not exceeding \$50 million and that is conducting an active trade or business. § 1202.

Qualified small business stock. Stock in a qualified small business corporation, purchased as part of an original issue after August 10, 1993. The shareholder may exclude from gross income 50 (or 75 or 100) percent of the realized gain on the sale of the stock if he or she held the stock for more than five years. § 1202.

Qualified terminable interest property (QTIP). Generally, the marital deduction (for gift and estate tax purposes) is not available if the interest transferred will terminate upon the death of the transferee spouse and pass to someone else. Thus, if Jim (the husband) places property in trust, life estate to Mary (the wife), and remainder to their children upon Mary's death, this is a terminable interest that will not provide Jim (or Jim's estate) with a marital deduction. If, however, the transfer in trust is treated as qualified terminable interest property (the QTIP election is made), the terminable interest restriction is waived and the marital deduction becomes available. In exchange for this deduction, the surviving spouse's gross estate must include the value of the QTIP election assets, even though he or she has no control over the ultimate disposition of the asset. Terminable interest property qualifies for this election if the donee (or heir) is the only beneficiary of the asset during his or her lifetime and receives income distributions relative to the property at least annually. For gifts, the donor spouse is the one who makes the QTIP election. For property transferred by death, the executor of the estate of the deceased spouse makes the election. §§ 2056(b)(7) and 2523(f).

Qualified transportation fringes. Transportation benefits provided by the employer to the employee. Such benefits include (1) transportation in a commuter highway vehicle between the employee's residence and the place of employment, (2) a transit pass, and (3) qualified parking. Qualified transportation fringes are excludible from the employee's gross income to the extent categories (1) and (2) above do not exceed \$130 per month in 2015 and category (3) does not exceed \$250 per month in 2015. These amounts are indexed annually for inflation. § 132.

Qualified tuition program. A program that allows college tuition to be prepaid for a beneficiary. When amounts in the plan are used, nothing is included in gross income pro-

vided they are used for qualified higher education expenses. § 529.

Qualified tuition reduction plan. A type of fringe benefit plan that is available to employees of nonprofit educational institutions. Such employees (and the spouse and dependent children) are allowed to exclude from gross income a tuition waiver pursuant to a qualified tuition reduction plan. The exclusion applies to undergraduate tuition. In limited circumstances, the exclusion also applies to the graduate tuition of teaching and research assistants. § 117(d).

Qualifying child. An individual who, as to the taxpayer, satisfies the relationship, abode, and age tests. To be claimed as a dependent, such individual must also meet the citizenship and joint return tests and not be self-supporting. §§ 152(a)(1) and (c).

Qualifying relative. An individual who, as to the taxpayer, satisfies the relationship, gross income, support, citizenship, and joint return tests. Such an individual can be claimed as a dependent of the taxpayer. §§ 152(a)(2) and (d).

R

Rate reconciliation. Under Generally Accepted Accounting Principles, a footnote to the financial statements often includes a table that accounts for differences in the statutory income tax rate that applies to the entity (say, 35 percent) and the higher or lower effective tax rate that the entity realized for the reporting period. The rate reconciliation includes only permanent differences between the book tax expense and the entity's income tax provision. The rate reconciliation table often is expressed in dollar and/or percentage terms.

Realized gain. See *realized gain or loss*.

Realized gain or loss. The difference between the amount realized upon the sale or other disposition of property and the adjusted basis of the property. § 1001.

Realized loss. See *realized gain or loss*.

Realty. Real estate.

Reasonable cause. Relief from taxpayer and preparer penalties often is allowed where reasonable cause is found for the taxpayer's actions. For example, reasonable cause for the late filing of a tax return might be a flood that damaged the taxpayer's record-keeping systems and made a timely completion of the return difficult.

Reasonable needs of the business. A means of avoiding the penalty tax on an unreasonable accumulation of earnings. In determining the base for this tax (accumulated taxable income), § 535 allows a deduction for "such part of earnings and profits for the taxable year as are retained for the reasonable needs of the business." § 537.

Reasonableness. See *reasonableness requirement*.

Reasonableness requirement. The Code includes a reasonableness requirement with respect to the deduction of salaries and other compensation for services. What constitutes reasonableness is a question of fact. If an expense is unreasonable, the amount that is classified as unreasonable is not allowed as a deduction. The question of reasonableness generally arises with respect to closely held corporations where there is no separation of ownership and management. § 162(a)(1).

Recapitalization. An “E” reorganization, constituting a major change in the character and amount of outstanding equity of a corporation. For instance, common stock exchanged for preferred stock can qualify for tax-free “E” reorganization treatment.

Recognized gain. See *recognized gain or loss*.

Recognized gain or loss. The portion of realized gain or loss subject to income taxation.

Recognized loss. See *recognized gain or loss*.

Recourse debt. Debt for which the lender may both foreclose on the property and assess a guarantor for any payments due under the loan. A lender also may make a claim against the assets of any general partner in a partnership to which debt is issued, without regard to whether the partner has guaranteed the debt.

Recovery of capital doctrine. When a taxable sale or exchange occurs, the seller may be permitted to recover his or her investment (or other adjusted basis) in the property before gain or loss is recognized.

Redemption to pay death taxes. Sale or exchange treatment is available relative to this type of stock redemption, to the extent of the proceeds up to the total amount paid by the estate or heir for estate/inheritance taxes and administration expenses. The stock value must exceed 35 percent of the value of the decedent’s adjusted gross estate. In meeting this test, shareholdings in corporations where the decedent held at least 20 percent of the outstanding shares are combined.

Refundable credit. A credit that is paid to the taxpayer even if the amount of the credit (or credits) exceeds the taxpayer’s tax liability.

Regular corporation. See *C corporation*.

Rehabilitation expenditures credit. A credit that is based on expenditures incurred to rehabilitate industrial and commercial buildings and certified historic structures. The credit is intended to discourage businesses from moving from older, economically distressed areas to newer locations and to encourage the preservation of historic structures. § 47.

Rehabilitation expenditures credit recapture. When property that qualifies for the rehabilitation expenditures credit is disposed of or ceases to be used in the trade or business of the taxpayer, some or all of the tax credit claimed on the property may be recaptured as additional tax liability. The amount of the recapture is the difference between the amount of the credit claimed originally and what should have been claimed in light of the length of time the property was actually held or used for qualifying purposes. § 50.

Related corporation. See *controlled group*.

Related party. Various Code Sections define related parties and often include a variety of persons within this (usually detrimental) category. Generally, related parties are accorded different tax treatment from that applicable to other taxpayers who enter into similar transactions. For instance, realized losses that are generated between related parties are not recognized in the year of the loss. However, these deferred losses can be used to offset recognized gains that occur upon the subsequent sale of the asset to a nonrelated party. Other uses of a related-party definition include the conversion of gain upon the sale of a depreci-

able asset into all ordinary income (§ 1239) and the identification of constructive ownership of stock relative to corporate distributions, redemptions, liquidations, reorganizations, and compensation.

Related-party transactions. The tax law places restrictions upon the recognition of gains and losses between related parties because of the potential for abuse. For example, restrictions are placed on the deduction of losses from the sale or exchange of property between related parties. In addition, under certain circumstances, related-party gains that would otherwise be classified as capital gain are classified as ordinary income. §§ 267, 707(b), and 1239.

Rental activity. Any activity where payments are received principally for the use of tangible property is a rental activity. Temporary Regulations provide that in certain circumstances, activities involving rentals of real and personal property are not to be treated as rental activities. The Temporary Regulations list six exceptions.

Reorganization. Occurs, among other instances, when one corporation acquires another in a merger or an acquisition, a single corporation divides into two or more entities, a corporation makes a substantial change in its capital structure, or a corporation undertakes a change in its legal name or domicile. The exchange of stock and other securities in a corporate reorganization can be effected favorably for tax purposes if certain statutory requirements are followed strictly. Tax consequences include the nonrecognition of any gain that is realized by the shareholders except to the extent of boot received.

Required taxable year. A partnership or limited liability company must use a required tax year as its tax accounting period, or one of three allowable alternative tax year ends. The required tax year is determined using the least aggregate deferral rule. But if there is a common tax year used by owners holding a majority of the entity’s capital or profits interests, or used by all of the owners who hold 5 percent or more of the capital or profits interests, then that tax year end is used by the entity.

Research activities credit. A tax credit whose purpose is to encourage research and development. It consists of three components: the incremental research activities credit, the basic research credit, and the energy credit. The incremental research activities credit is equal to 20 percent of the excess qualified research expenditures over the base amount. The basic research credit is equal to 20 percent of the excess of basic research payments over the base amount. § 41.

Research and experimental expenditures. The Code provides three alternatives for the tax treatment of research and experimentation expenditures. They may be expensed in the year paid or incurred, deferred subject to amortization, or capitalized. If the taxpayer does not elect to expense such costs or to defer them subject to amortization (over 60 months), the expenditures must be capitalized. § 174. Three types of research activities credits are available: the basic research credit, the incremental research activities credit, and the energy credit. The rate for each type is 20 percent. § 41.

Reserve method. A method of accounting whereby an allowance is permitted for estimated uncollectible accounts.

Actual write-offs are charged to the reserve, and recoveries of amounts previously written off are credited to the reserve. The Code permits only certain financial institutions to use the reserve method. § 166.

Residential rental real estate. Buildings for which at least 80 percent of the gross rents are from dwelling units (e.g., an apartment building). This type of building is distinguished from nonresidential (commercial or industrial) buildings in applying the recapture of depreciation provisions. The term also is relevant in distinguishing between buildings that are eligible for a 27.5-year life versus a 39-year life for MACRS purposes. Generally, residential buildings receive preferential treatment.

Restricted property plan. An arrangement whereby an employer transfers property (usually stock) to an employee at a bargain price (for less than the fair market value). If the transfer is accompanied by a substantial risk of forfeiture and the property is not transferable, no compensation results to the employee until the restrictions disappear. An example of a substantial risk of forfeiture would be a requirement that the employee return the property if his or her employment is terminated within a specified period of time. § 83.

Revenue Agent's Report (RAR). A Revenue Agent's Report (RAR) reflects any adjustments made by the agent as a result of an audit of the taxpayer. The RAR is mailed to the taxpayer along with the 30-day letter, which outlines the appellate procedures available to the taxpayer.

Revenue neutrality. A description that characterizes tax legislation when it neither increases nor decreases the total revenue collected by the taxing jurisdiction. Thus, any tax revenue losses are offset by tax revenue gains.

Revenue Procedure. A matter of procedural importance to both taxpayers and the IRS concerning the administration of the tax laws is issued as a Revenue Procedure (abbreviated Rev.Proc.). A Revenue Procedure is published in an *Internal Revenue Bulletin* (I.R.B.).

Revenue Ruling. A Revenue Ruling (abbreviated Rev.Rul.) is issued by the National Office of the IRS to express an official interpretation of the tax law as applied to specific transactions. It is more limited in application than a Regulation. A Revenue Ruling is published in an *Internal Revenue Bulletin* (I.R.B.).

Reversionary interest. The trust property that reverts to the grantor after the expiration of an intervening income interest. Assume that Phil places real estate in trust with income to Junior for 11 years, and upon the expiration of this term, the property returns to Phil. Under these circumstances, Phil holds a reversionary interest in the property. A reversionary interest is the same as a remainder interest, except that, in the latter case, the property passes to someone other than the original owner (e.g., the grantor of a trust) upon the expiration of the intervening interest.

Roth IRAs. See *Individual Retirement Account (IRA)*.

S

S corporation. The designation for a small business corporation. See also *Subchapter S*.

Sale or exchange. A requirement for the recognition of capital gain or loss. Generally, the seller of property must

receive money or relief from debt to have sold the property. An exchange involves the transfer of property for other property. Thus, collection of a debt is neither a sale nor an exchange. The term *sale or exchange* is not defined by the Code.

Sales factor. The proportion of a multistate corporation's total sales that is traceable to a specific state. Used in determining the taxable income that is to be apportioned to that state.

Sales tax. A state- or local-level tax on the retail sale of specified property. Generally, the purchaser pays the tax, but the seller collects it, as an agent for the government. Various taxing jurisdictions allow exemptions for purchases of specific items, including certain food, services, and manufacturing equipment. If the purchaser and seller are in different states, a use tax usually applies.

Schedule K-1. A tax information form prepared for each partner in a partnership, each shareholder of an S corporation, and some beneficiaries of certain trusts. The Schedule K-1 reports the owner's share of the entity's ordinary income or loss from operations, as well as the owner's share of separately stated items.

Schedule M-1. On the Form 1120, a reconciliation of book net income with Federal taxable income. Accounts for temporary and permanent differences in the two computations, such as depreciation differences, exempt income, and nondeductible items. On Forms 1120S and 1065, the Schedule M-1 reconciles book income with the owners' aggregate ordinary taxable income.

Schedule M-3. An *expanded* reconciliation of book net income with Federal taxable income (see *Schedule M-1*). Required of C and S corporations and partnerships/LLCs with total assets of \$10 million or more.

Scholarships. Scholarships are generally excluded from the gross income of the recipient unless the payments are a disguised form of compensation for services rendered. However, the Code imposes restrictions on the exclusion. The recipient must be a degree candidate. The excluded amount is limited to amounts used for tuition, fees, books, supplies, and equipment required for courses of instruction. Amounts received for room and board are not eligible for the exclusion. § 117.

Section 121 exclusion. If a residence has been owned and used by the taxpayer as the principal residence for at least two years during the five-year period ending on the date of sale, up to \$250,000 of realized gain is excluded from gross income. For a married couple filing a joint return, the \$250,000 is increased to \$500,000 if either spouse satisfies the ownership requirement and both spouses satisfy the use requirement.

Section 179 expensing. The ability to deduct a capital expenditure in the year an asset is placed in service rather than over the asset's useful life or cost recovery period. The annual ceiling on the deduction is \$25,000 for 2015 (\$500,000 for 2014). However, the deduction is reduced dollar for dollar when § 179 property placed in service during the taxable year exceeds \$200,000 in 2015 (\$2 million in 2014). In addition, the amount expensed under § 179 cannot exceed the aggregate amount of taxable income derived from the conduct of any trade or business by the taxpayer.

Section 179 expensing election. See *Section 179 expensing*.

Section 338 election. When a corporation acquires at least 80 percent of a subsidiary within a 12-month period, it can elect to treat the acquisition of such stock as an asset purchase. The acquiring corporation's basis in the subsidiary's assets then is the cost of the stock. The subsidiary is deemed to have sold its assets for an amount equal to the grossed-up basis in its stock.

Section 382 limitation. When one corporation acquires another, the acquiror's ability to use the loss and credit carryovers of the target may be limited, in an anti-abuse provision specified in the Code. Generally, for instance, the maximum NOL deduction available to the acquiror is the takeover-date value of the target times the tax-exempt interest rate on that date.

Section 401(k) plan. A cash or deferred arrangement plan that allows participants to elect to receive up to \$18,000 in 2015 in cash (taxed currently) or to have a contribution made on their behalf to a profit sharing or stock bonus plan (excludible from gross income). The plan may also be in the form of a salary reduction agreement between the participant and the employer.

Section 754 election. An election that may be made by a partnership to adjust the basis of partnership assets to reflect a purchasing partner's outside basis in interest or to reflect a gain, loss, or basis adjustment of a partner receiving a distribution from a partnership. The intent of the election is to maintain the equivalence between outside and inside basis for that partner. Once the election is made, the partnership must make basis adjustments for all future transactions, unless the IRS consents to revoke the election.

Section 1231 gains and losses. If the combined gains and losses from the taxable dispositions of § 1231 assets plus the net gain from business involuntary conversions (of both § 1231 assets and long-term capital assets) is a gain, the gains and losses are treated as long-term capital gains and losses. In arriving at § 1231 gains, however, the depreciation recapture provisions (e.g., § 1245) are applied first to produce ordinary income. If the net result of the combination is a loss, the gains and losses from § 1231 assets are treated as ordinary gains and losses. § 1231(a).

Section 1231 lookback. For gain to be classified as § 1231 gain, the gain must survive the § 1231 lookback. To the extent of nonrecaptured § 1231 losses for the five prior tax years, the gain is classified as ordinary income. § 1231(c).

Section 1231 property. Depreciable assets and real estate used in trade or business and held for the required long-term holding period. § 1231(b).

Section 1244 stock. Stock issued under § 1244 by qualifying small business corporations. If § 1244 stock becomes worthless, the shareholders may claim an ordinary loss rather than the usual capital loss, within statutory limitations.

Section 1245 property. Property that is subject to the recapture of depreciation under § 1245. For a definition of § 1245 property, see § 1245(a)(3).

Section 1245 recapture. Upon a taxable disposition of § 1245 property, all depreciation claimed on the property

is recaptured as ordinary income (but not to exceed any recognized gain from the disposition).

Section 1250 property. Real estate that is subject to the recapture of depreciation under § 1250. For a definition of § 1250 property, see § 1250(c).

Section 1250 recapture. Upon a taxable disposition of § 1250 property, accelerated depreciation or cost recovery claimed on the property may be recaptured as ordinary income.

Securities. Generally, stock, debt, and other financial assets. To the extent securities other than the stock of the transferee corporation are received in a § 351 exchange, the new shareholder realizes a gain.

Self-employment tax. A tax of 12.4 percent is levied on individuals with net earnings from self-employment (up to \$118,500 in 2015) to provide Social Security benefits (i.e., the old age, survivors, and disability insurance portion) for such individuals. In addition, a tax of 2.9 percent is levied on individuals with net earnings from self-employment (with no statutory ceiling) to provide Medicare benefits (i.e., the hospital insurance portion) for such individuals. If a self-employed individual also receives wages from an employer that are subject to FICA, the self-employment tax will be reduced. A partial deduction is allowed in calculating the self-employment tax. Individuals with net earnings of \$400 or more from self-employment are subject to this tax. §§ 1401 and 1402.

Separate foreign tax credit limitation category. The foreign tax credit of a taxpayer is computed for each of several types of income sources, as specified by the Code to limit the results of tax planning. FTC income "baskets" include general and passive. The FTC for the year is the sum of the credits as computed within all of the taxpayer's separate FTC baskets used for the tax year.

Separate return limitation year (SRLY). A series of rules limits the amount of an acquired corporation's net operating loss carryforwards that can be used by the acquiror. Generally, a consolidated return can include the acquiree's net operating loss carryforward only to the extent of the lesser of the subsidiary's (1) current-year or (2) cumulative positive contribution to consolidated taxable income.

Separately stated item. Any item of a partnership or an S corporation that might be taxed differently to any two owners of the entity. These amounts are not included in the ordinary income of the entity, but are instead reported separately to the owners; tax consequences are determined at the owner level.

Severance tax. A tax imposed upon the extraction of natural resources.

Short period. See *short taxable year*.

Short sale. A sale that occurs when a taxpayer sells borrowed property (usually stock) and repays the lender with substantially identical property either held on the date of the short sale or purchased after the sale. No gain or loss is recognized until the short sale is closed, and such gain or loss is generally short-term. § 1233.

Short taxable year. A tax year that is less than 12 months. A short taxable year may occur in the initial reporting period, in the final tax year, or when the taxpayer changes tax years.

Significant participation activity. Seven tests determine whether an individual has achieved material participation

in an activity, one of which is based on more than 500 hours of participation in significant participation activities. A significant participation activity is one in which the individual's participation exceeds 100 hours during the year. Temp.Reg. § 1.469-5T.

Simple trust. Trusts that are not complex trusts. Such trusts may not have a charitable beneficiary, accumulate income, or distribute corpus.

Simplified employee pension (SEP) plan. An employer may make contributions to an employee's IRA in amounts not exceeding the lesser of 15 percent of compensation or \$53,000 per individual in 2015. These employer sponsored simplified employee pensions are permitted only if the contributions are nondiscriminatory and are made on behalf of all employees who have attained age 21 and have worked for the employer during at least three of the five preceding calendar years. § 219(b).

Small business corporation. A corporation that satisfies the definition of § 1361(b), § 1244(c), or both. Satisfaction of § 1361(b) permits an S election, and satisfaction of § 1244 enables the shareholders of the corporation to claim an ordinary loss on the worthlessness of stock.

Small business stock. See *Section 1244 stock*.

Small Cases Division. A division within the U.S. Tax Court where jurisdiction is limited to claims of \$50,000 or less. There is no appeal from this court.

Sole proprietorship. An individual who operates a business activity reports the results of the business on Form 1040 for the year, usually on Schedule C or F. Federal income tax liabilities are computed using individual tax rates.

Solicitation. A level of activity brought about by the taxpayer within a specific state. Under Public Law 86-272, certain types of solicitation activities do not create nexus with the state. Exceeding mere solicitation, though, creates nexus.

Special allocation. Any amount for which an agreement exists among the partners of a partnership outlining the method used for spreading the item among the partners.

Special use value. Permits the executor of an estate to value, for estate tax purposes, real estate used in a farming activity or in connection with a closely held business at its current use value rather than at its most suitable or optimal use value. Under this option, a farm is valued for farming purposes even though, for example, the property might have a higher potential value as a shopping center. For the executor of an estate to elect special use valuation, the conditions of § 2032A must be satisfied.

Specific charge-off method. A method of accounting for bad debts in which a deduction is permitted only when an account becomes partially or completely worthless.

Spin-off. A type of reorganization where, for example, Ace Corporation transfers some assets to Bow Corporation in exchange for enough Bow stock to represent control. Ace then distributes the Bow stock to its shareholders.

Split-off. A type of reorganization where, for example, Arc Corporation transfers some assets to Bond Corporation in exchange for enough Bond stock to represent control. Arc then distributes the Bond stock to its shareholders in exchange for some of their Arc stock.

Split-up. A type of reorganization where, for example, Ally Corporation transfers some assets to Bar Corporation and

the remainder to Zip Corporation. In return, Ally receives enough Bar and Zip stock to represent control of each corporation. Ally then distributes the Bar and Zip stock to its shareholders in return for all of their Ally stock. The result of the split-up is that Ally is liquidated, and its shareholders now have control of Bar and Zip.

Sprinkling trust. When a trustee has the discretion to either distribute or accumulate the entity accounting income of the trust and to distribute it among the trust's income beneficiaries in varying magnitudes. The trustee can "sprinkle" the income of the trust.

Standard deduction. The individual taxpayer can either itemize deductions or take the standard deduction. The amount of the standard deduction depends on the taxpayer's filing status (single, head of household, married filing jointly, surviving spouse, or married filing separately). For 2015, the amount of the standard deduction ranges from \$6,300 (for single) to \$12,600 (for married, filing jointly). Additional standard deductions of either \$1,250 (for married taxpayers) or \$1,550 (for single taxpayers) are available if the taxpayer is blind or age 65 or over. Limitations exist on the amount of the standard deduction of a taxpayer who is another taxpayer's dependent. The standard deduction amounts are adjusted for inflation each year. § 63(c).

Startup expenditures. Expenditures paid or incurred prior to the beginning of the business that would have been deductible as an ordinary and necessary business expense if business operations had begun. Examples of such expenditures include advertising; salaries and wages; travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and salaries and fees to executives, consultants, and professional service providers. A taxpayer will immediately expense the first \$5,000 (subject to phaseout) of startup expenditures and amortize the balance over a period of 180 months, unless the taxpayer elects to not do so.

Statute of limitations. Provisions of the law that specify the maximum period of time in which action may be taken concerning a past event. Code §§ 6501-6504 contain the limitation periods applicable to the IRS for additional assessments, and §§ 6511-6515 relate to refund claims by taxpayers.

Statutory employee. Statutory employees are considered self-employed independent contractors for purposes of reporting income and expenses on their tax returns. Generally, a statutory employee must meet three tests:

- It is understood from a service contract that the services will be performed by the person.
- The person does not have a substantial investment in facilities (other than transportation used to perform the services).
- The services involve a continuing relationship with the person for whom they are performed.

For further information on statutory employees, see Circular E, *Employer's Tax Guide* (IRS Publication 15).

Step transaction. Disregarding one or more transactions to arrive at the final result. Assume, for example, that the shareholders of Clue Corporation liquidate the corporation and receive cash and operating assets. Immediately after

the liquidation, the shareholders transfer the operating assets to newly formed Blue Corporation. Under these circumstances, the IRS may contend that the liquidation of Clue should be disregarded (thereby depriving the shareholders of capital gain treatment). What may really have happened is a reorganization of Clue with a distribution of boot (ordinary income) to Clue's shareholders. If so, there will be a carryover of basis in the assets transferred from Clue to Blue.

Step-down in basis. A reduction in the tax basis of property.

Step-up in basis. An increase in the income tax basis of property. A step-up in basis occurs when a decedent dies owning appreciated property. Since the estate or heir acquires a basis in the property equal to the property's fair market value on the date of death (or alternate valuation date if available and elected), any appreciation is not subject to the income tax. Thus, a step-up in basis is the result, with no immediate income tax consequences.

Stock bonus plan. A type of deferred compensation plan in which the employer establishes and maintains the plan and contributes employer stock to the plan for the benefit of employees. The contributions need not be dependent on the employer's profits. Any benefits of the plan are distributable in the form of employer stock, except that distributable fractional shares may be paid in cash.

Stock dividend. Not taxable if pro rata distributions of stock or stock rights on common stock. Section 305 governs the taxability of stock dividends and sets out five exceptions to the general rule that stock dividends are nontaxable.

Stock option. The right to purchase a stated number of shares of stock from a corporation at a certain price within a specified period of time. §§ 421 and 422.

Stock redemption. A corporation buys back its own stock from a specified shareholder. Typically, the corporation recognizes any realized gain on the noncash assets that it uses to effect a redemption, and the shareholder obtains a capital gain or loss upon receipt of the purchase price.

Stock rights. Assets that convey to the holder the power to purchase corporate stock at a specified price, often for a limited period of time. Stock rights received may be taxed as a distribution of earnings and profits. After the right is exercised, the basis of the acquired share includes the investor's purchase price or gross income, if any, to obtain the right. Disposition of the right also can be taxable.

Subchapter S. Sections 1361–1379 of the Internal Revenue Code. An elective provision permitting certain small business corporations (§ 1361) and their shareholders (§ 1362) to elect to be treated for income tax purposes in accordance with the operating rules of §§ 1363–1379. However, some S corporations usually avoid the corporate income tax, and corporate losses can be claimed by the shareholders.

Subpart F. Identifies the current tax treatment of income earned by a controlled foreign corporation. Certain types of income are included in U.S. gross income by U.S. shareholders of such an entity as they are generated, not when they are repatriated.

Subpart F income. See *Subpart F*.

Substance over form. A standard used when one must ascertain the true reality of what has occurred. Suppose, for example, a father sells stock to his daughter for \$1,000. If the stock is really worth \$50,000 at the time of the transfer, the substance of the transaction is probably a gift to her of \$49,000.

Substantial authority. Taxpayer and tax preparer understatement penalties are waived where substantial authority existed for the disputed position taken on the return.

Substantial risk of forfeiture (SRF). A term that is associated with a restricted property plan. Generally, an employee who receives property (e.g., stock of the employer-corporation) from the employer at a bargain price or at no cost must include the bargain element in gross income. However, the employee currently does not have to do so if there is a substantial risk of forfeiture. A substantial risk of forfeiture exists if a person's rights to full enjoyment of property are conditioned upon the future performance, or the refraining from the performance, of substantial services by the individual. § 83.

Sunset provision. A provision attached to new tax legislation that will cause such legislation to expire at a specified date. Sunset provisions are attached to tax cut bills for long-term budgetary reasons to make their effect temporary. Once the sunset provision comes into play, the tax cut is rescinded and former law is reinstated. An example of a sunset provision is contained in the Tax Relief Reconciliation Act of 2001 that related to the estate tax. After the estate tax was phased out in 2010, a sunset provision called for the reinstatement of the estate tax as of January 1, 2011.

Supreme Court. See *U.S. Supreme Court*.

Surviving spouse. When a husband or wife predeceases the other spouse, the survivor is known as a surviving spouse. Under certain conditions, a surviving spouse may be entitled to use the income tax rates in § 1(a) (those applicable to married persons filing a joint return) for the two years after the year of death of his or her spouse. § 2. With respect to the Federal estate tax, this term describes the second spouse to die of a married couple, for the period between the two dates of death.

Syndication costs. Incurred in promoting and marketing partnership interests for sale to investors. Examples include legal and accounting fees, printing costs for prospectus and placement documents, and state registration fees. These items are capitalized by the partnership as incurred, with no amortization thereof allowed.

T

Tax avoidance. The minimization of one's tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance can be contrasted with tax evasion, which entails the reduction of tax liability by illegal means.

Tax benefit rule. A provision that limits the recognition of income from the recovery of an expense or a loss properly deducted in a prior tax year to the amount of the deduction that generated a tax saving. Assume that last year Gary had medical expenses of \$4,000 and adjusted gross income of \$30,000. Because of the AGI limitation, Gary could deduct

only \$1,000 of these expenses [$\$4,000 - (10\% \times \$30,000)$]. If this year Gary is reimbursed in full by his insurance company for the \$4,000 of expenses, the tax benefit rule limits the amount of income from the reimbursement to \$1,000 (the amount previously deducted with a tax saving).

Tax Court. See *U.S. Tax Court*.

Tax credit for the elderly or disabled. An elderly (age 65 and over) or disabled taxpayer may receive a tax credit amounting to 15 percent of \$5,000 (\$7,500 for qualified married individuals filing jointly). This amount is reduced by Social Security benefits, excluded pension benefits, and one-half of the taxpayer's adjusted gross income in excess of \$7,500 (\$10,000 for married taxpayers filing jointly). § 22.

Tax credits. Amounts that directly reduce a taxpayer's tax liability. The tax benefit received from a tax credit is not dependent on the taxpayer's marginal tax rate, whereas the benefit of a tax deduction or exclusion is dependent on the taxpayer's tax bracket.

Tax evasion. The reduction of taxes by the use of subterfuge or fraud or other nonlegal means. For example, a cash basis taxpayer tries to increase his or her charitable contribution deduction by prepaying next year's church pledge with a pre-dated check issued in the following year.

Tax haven. A country in which either locally sourced income or residents of the country are subject to a low rate of taxation.

Tax preferences items. See *AMT preferences*.

Tax preparer. One who prepares tax returns for compensation. A tax preparer must register with the IRS and receive a special ID number to practice before the IRS and represent taxpayers before the agency in tax audit actions. The conduct of a tax preparer is regulated under Circular 230. Tax preparers also are subject to penalties for inappropriate conduct when working in the tax profession.

Tax Rate Schedules. Rate schedules that are used by upper-income taxpayers and those not permitted to use the tax table. Separate rate schedules are provided for married individuals filing jointly, heads of households, single taxpayers, estates and trusts, and married individuals filing separate returns. § 1.

Tax research. The method used to determine the best available solution to a situation that possesses tax consequences. Both tax and nontax factors are considered.

Tax shelters. The typical tax shelter generated large losses in the early years of the activity. Investors would offset these losses against other types of income and therefore avoid paying income taxes on this income. These tax shelter investments could then be sold after a few years and produce capital gain income, which is taxed at a lower rate compared to ordinary income. The passive activity loss rules and the at-risk rules now limit tax shelter deductions.

Tax Table. A table that is provided for taxpayers with less than \$100,000 of taxable income. Separate columns are provided for single taxpayers, married taxpayers filing jointly, heads of households, and married taxpayers filing separately. § 3.

Tax treaty. An agreement between the U.S. Department of State and another country designed to alleviate double taxation of income and asset transfers and to share administra-

tive information useful to tax agencies in both countries. The United States has income tax treaties with almost 70 countries and transfer tax treaties with about 20.

Taxable estate. The taxable estate is the gross estate of a decedent reduced by the deductions allowed by §§ 2053–2057 (e.g., administration expenses, marital and charitable deductions). The taxable estate is subject to the unified transfer tax at death. § 2051.

Taxable gift. The amount of a gift that is subject to the unified transfer tax. Thus, a taxable gift has been adjusted by the annual exclusion and other appropriate deductions (e.g., marital and charitable). § 2053.

Taxable year. The annual period over which income is measured for income tax purposes. Most individuals use a calendar year, but many businesses use a fiscal year based on the natural business year.

Technical Advice Memoranda (TAM). TAMs are issued by the IRS in response to questions raised by IRS field personnel during audits. They deal with completed rather than proposed transactions and are often requested for questions related to exempt organizations and employee plans.

Technical termination of a partnership. The entity is treated for tax purposes as though it has terminated, even though it continues in its activities. When there has been a sale or exchange of more than 50 percent of the capital interests of the partnership within 12 months, the partnership is deemed to have terminated when the 50 percent threshold is crossed. A new partnership immediately is formed through asset contributions by the partners. These activities can affect the entity's tax year and its bases in the assets it holds.

Temporary differences. Under ASC 740 (SFAS 109), tax-related items that appear in the entity's financial statements and its tax return, but in different time periods. For instance, doubtful accounts receivable often create a temporary book-tax difference, as a bad debt reserve is used to compute an expense for financial reporting purposes, but a bad debt often is deductible only under the specific write-off rule for tax purposes, and the difference observed for the current period creates a temporary difference.

Temporary Regulation. A Regulation issued by the Treasury Department in temporary form. When speed is critical, the Treasury Department issues Temporary Regulations that take effect immediately. These Regulations have the same authoritative value as Final Regulations and may be cited as precedent for three years. Temporary Regulations are also issued as proposed Regulations.

Tenants by the entirety. Essentially, a joint tenancy between husband and wife.

Tenants in common. A form of ownership where each tenant (owner) holds an undivided interest in property. Unlike a joint tenancy or a tenancy by the entirety, the interest of a tenant in common does not terminate upon that individual's death (there is no right of survivorship). Assume that Tim and Cindy acquire real estate as equal tenants in common. Upon Tim's death, his one-half interest in the property passes to his estate or heirs, not automatically to Cindy.

Terminable interest. An interest in property that terminates upon the death of the holder or upon the occurrence of some other specified event. The transfer of a terminable

interest by one spouse to the other may not qualify for the marital deduction. §§ 2056(b) and 2523(b).

Theft loss. A loss from larceny, embezzlement, or robbery. It does not include misplacement of items.

Thin capitalization. When debt owed by a corporation to the shareholders becomes too large in relation to the corporation's capital structure (i.e., stock and shareholder equity), the IRS may contend that the corporation is thinly capitalized. In effect, some or all of the debt is reclassified as equity. The immediate result is to disallow any interest deduction to the corporation on the reclassified debt. To the extent of the corporation's earnings and profits, interest payments and loan repayments on the reclassified debt are treated as dividends to the shareholders.

Thirty-day letter. A letter that accompanies an RAR (Revenue Agent's Report) issued as a result of an IRS audit of a taxpayer (or the rejection of a taxpayer's claim for refund). The letter outlines the taxpayer's appeal procedure before the IRS. If the taxpayer does not request any such procedures within the 30-day period, the IRS issues a statutory notice of deficiency (the 90-day letter).

Throwback rule. If there is no income tax in the state to which a sale otherwise would be apportioned, the sale essentially is exempt from state income tax, even though the seller is domiciled in a state that levies an income tax. Nonetheless, if the seller's state has adopted a throwback rule, the sale is attributed to the seller's state and the transaction is subjected to a state-level tax.

Traditional IRA. See *Individual Retirement Account (IRA)*.

Transfer pricing. The process of setting internal prices for transfers of goods and services among related taxpayers. For example, what price should be used when Subsidiary purchases management services from Parent? The IRS can adjust transfer prices when it can show that the taxpayers were attempting to avoid tax by, say, shifting losses, deductions, or credits from low-tax to high-tax entities or jurisdictions.

Transportation expenses. Transportation expenses for an employee include only the cost of transportation (e.g., taxi fares and automobile expenses) in the course of employment when the employee is not away from home in travel status. Commuting expenses are not deductible.

Travel expenses. Expenses that include meals (generally subject to a 50 percent disallowance) and lodging and transportation expenses while away from home in the pursuit of a trade or business (including that of an employee).

Treaty shopping. An international investor attempts to use the favorable aspects of a tax treaty to his or her advantage, often elevating the form of the transaction over its substance (e.g., by establishing only a nominal presence in the country offering the favorable treaty terms).

U

UDITPA. The Uniform Division of Income for Tax Purposes Act has been adopted in some form by many of the states. The Act develops criteria by which the total taxable income of a multistate corporation can be assigned to specific states.

Unclaimed property. A U.S. state may have the right to acquire property that has been made available to an individual

or legal entity for a fixed period of time, where the claimant has not taken possession of the property after a notice period. Examples of such property that a state could acquire are an uncashed payroll check, or an unused gift card.

Undistributed personal holding company income. The tax base for the personal holding company tax. § 545.

Unearned income. Income received but not yet earned. Normally, such income is taxed when received, even for accrual basis taxpayers.

Unified transfer tax. Rates applicable to transfers by gift and death made after 1976. § 2001(c).

Unified transfer tax credit. A credit allowed against any unified transfer tax. §§ 2010 and 2505.

Uniform capitalization (UNICAP) rules. Under § 263A, the Regulations provide a set of rules that all taxpayers (regardless of the particular industry) can use to determine the items of cost (and means of allocating those costs) that must be capitalized with respect to the production of tangible property.

Unitary approach. See *unitary theory*.

Unitary theory. Sales, property, and payroll of related corporations are combined for nexus and apportionment purposes, and the worldwide income of the unitary entity is apportioned to the state. Subsidiaries and other affiliated corporations found to be part of the corporation's unitary business (because they are subject to overlapping ownership, operation, or management) are included in the apportionment procedure. This approach can be limited if a water's edge election is in effect.

Unit-livestock-price method. A method of accounting for the cost of livestock. The livestock are valued using a standard cost of raising an animal with the characteristics of the animals on hand to the same age as those animals.

Unrealized receivables. Amounts earned by a cash basis taxpayer but not yet received. Because of the method of accounting used by the taxpayer, these amounts have a zero income tax basis. When unrealized receivables are distributed to a partner, they generally convert a transaction from nontaxable to taxable or an otherwise capital gain to ordinary income (i.e., as a "hot asset").

Unreasonable compensation. A deduction is allowed for "reasonable" salaries or other compensation for personal services actually rendered. To the extent compensation is "excessive" ("unreasonable"), the distribution could be treated as a dividend, such that no deduction is allowed. The problem of unreasonable compensation usually is limited to closely held corporations, where the motivation is to pay out profits in some form that is deductible to the corporation.

Unreasonable position. A tax preparer penalty is assessed regarding the understatement of a client's tax liability due to a tax return position that is found to be too aggressive. The penalty is avoided if there is substantial authority for the position or if the position is disclosed adequately on the tax return. The penalty equals the greater of \$1,000 or one-half of the tax preparer's fee that is traceable to the aggressive position.

Unrecaptured § 1250 gain. Gain from the sale of depreciable real estate held more than one year. The gain is equal to or

less than the depreciation taken on such property and is reduced by § 1245 and § 1250 gain.

Unrelated business income (UBI). Income recognized by an exempt organization that is generated from activities not related to the exempt purpose of the entity. For instance, the gift shop located in a hospital may generate unrelated business income. § 511.

Unrelated business income tax (UBIT). Levied on the unrelated business income of an exempt organization.

U.S. Court of Federal Claims. A trial court (court of original jurisdiction) that decides litigation involving Federal tax matters. Appeal from this court is to the Court of Appeals for the Federal Circuit.

U.S. shareholder. For purposes of classification of an entity as a controlled foreign corporation, a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of a foreign corporation. Stock owned directly, indirectly, and constructively is counted for this purpose.

U.S. Supreme Court. The highest appellate court or the court of last resort in the Federal court system and in most states. Only a small number of tax decisions of the U.S. Courts of Appeal are reviewed by the U.S. Supreme Court under its certiorari procedure. The Supreme Court usually grants certiorari to resolve a conflict among the Courts of Appeal (e.g., two or more appellate courts have assumed opposing positions on a particular issue) or when the tax issue is extremely important (e.g., size of the revenue loss to the Federal government).

U.S. Tax Court. One of four trial courts of original jurisdiction that decides litigation involving Federal income, death, or gift taxes. It is the only trial court where the taxpayer must not first pay the deficiency assessed by the IRS. The Tax Court will not have jurisdiction over a case unless a statutory notice of deficiency (90-day letter) has been issued by the IRS and the taxpayer files the petition for hearing within the time prescribed.

U.S. trade or business. A set of activities that is carried on in a regular, continuous, and substantial manner. A non-U.S. taxpayer is subject to U.S. tax on the taxable income that is effectively connected with a U.S. trade or business.

Use tax. A sales tax that is collectible by the seller where the purchaser is domiciled in a different state.

V

Vacation home. The Code places restrictions upon taxpayers who rent their residences or vacation homes for part of the tax year. The restrictions may result in a scaling down of expense deductions for the taxpayers. § 280A.

Valuation allowance. Under ASC 740 (SFAS 109), a tax-related item is reported for book purposes only when it is more likely than not that the item actually will be realized. When the “more likely than not” test is failed, a contra-asset account is created to offset some or all of the related deferred tax asset. For instance, if the entity projects that it will not be able to use all of its net operating loss carryforward due to a lack of future taxable income, a valuation allowance is created to reduce the net deferred tax asset

that corresponds to the carryforward. If income projections later change and it appears that the carryforward will be used, the valuation allowance is reversed or “released.” Creation of a valuation allowance usually increases the current tax expense and thereby reduces current book income, and its release often increases book income in the later reporting period.

Value added tax (VAT). A national sales tax that taxes the increment in value as goods move through the production process. A VAT is much used in other countries but has not yet been incorporated as part of the U.S. Federal tax structure.

Vesting requirements. A qualified deferred compensation arrangement must satisfy a vesting requirement. Under this provision, an employee’s right to accrued plan benefits derived from employer contributions must be nonforfeitable in accordance with one of two vesting time period schedules (or two required alternate vesting schedules for certain employer matching contributions).

Voluntary revocation. The owners of a majority of shares in an S corporation elect to terminate the S status of the entity as of a specified date. The day on which the revocation is effective is the first day of the corporation’s C tax year.

W

W-2 wages. The domestic production activities deduction (DPAD) cannot exceed 50 percent of the W-2 wages paid for any particular year. Prop.Reg. § 199-2(f)(2) provides several methods for calculating the W-2 wages, but the payments must involve common law employees. To qualify, employees need to be involved in the production process. § 199.

Wash sale. A loss from the sale of stock or securities that is disallowed because the taxpayer, within 30 days before or after the sale, has acquired stock or securities substantially identical to those sold. § 1091.

Water’s edge. A limitation on the worldwide scope of the unitary theory. If a corporate water’s edge election is in effect, the state can consider in the apportionment procedure only the activities that occur within the boundaries of the United States.

Water’s-edge election. See *water’s edge*.

Wherewithal to pay. This concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax. Under it, there is a correlation between the imposition of the tax and the ability to pay the tax. It is particularly suited to situations in which the taxpayer’s economic position has not changed significantly as a result of the transaction.

Whistleblower Program. An IRS initiative that offers special rewards to informants who provide evidence regarding tax evasion activities of businesses or high-income individuals. More than \$2 million of tax, interest, and penalty must be at stake. The reward can reach 30 percent of the tax recovery that is attributable to the whistleblower’s information.

Withholding allowances. The number of withholding allowances serves as the basis for determining the amount of income taxes withheld from an employee’s salary or

wages. The more withholding allowances claimed, the less income tax withheld by an employer. An employee may claim withholding allowances for personal exemptions for self and spouse (unless claimed as a dependent of another person), dependency exemptions, and special withholding allowances.

Work opportunity tax credit. Employers are allowed a tax credit equal to 40 percent of the first \$6,000 of wages (per eligible employee) for the first year of employment. Eligible employees include certain hard-to-employ individuals (e.g., qualified ex-felons, high-risk youth, food stamp recipients, and veterans). The employer's deduction for wages is reduced by the amount of the credit taken. For qualified summer youth employees, the 40 percent rate is applied to the first \$3,000 of qualified wages.

Working condition fringe. A type of fringe benefit received by the employee that is excludible from the employee's gross income. It consists of property or services provided (paid or reimbursed) by the employer for which the employee could take a tax deduction if the employee had paid for them. § 132.

Worthless securities. A loss (usually capital) is allowed for a security that becomes worthless during the year. The loss is deemed to have occurred on the last day of the year. Special rules apply to securities of affiliated companies and small business stock. § 165.

Writ of Certiorari. Appeal from a U.S. Court of Appeals to the U.S. Supreme Court is by Writ of Certiorari. The Supreme Court need not accept the appeal, and it usually does not (*cert. den.*) unless a conflict exists among the lower courts that must be resolved or a constitutional issue is involved.

Appendix D-1

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Appendix E

Practice Set Assignments— Comprehensive Tax Return Problems

PROBLEM 1—INDIVIDUALS (FORM 1040)

John R. and Anne L. Miller are married and live at 13071 Sterling Drive, Aitkin, MN 56431. John is a self-employed insurance claims adjuster (business activity code 524290), and Anne is the dietitian for the local school district. They choose to file a joint tax return each year.



1. John represents several national casualty insurance companies on a contract basis. He operates this business on the cash basis. He is paid a retainer and receives additional compensation if the claims he processes for the year exceed a specified number. As an independent contractor, he is responsible for whatever expenses he incurs. John works out of an office near his home. The office is located at 1202 Motel Road. He shares Suite 326 with a financial consultant, and operating expenses are divided equally between them. The suite has a common waiting room with a receptionist furnished and paid by the landlord. John paid his one-half share of the 2014 expenses as detailed below:

Office rent	\$11,600
Utilities (includes telephone and fax)	4,300
Replacement of waiting room furniture on April 22	3,600
Renters' insurance (covers personal liability, casualty, theft)	1,400
Office expense (supplies, postage)	740
New Toshiba copier on February 7	300
Waiting room coffee service (catered)	280
Waiting room magazine subscriptions	90

For his own business use, John purchased a \$2,100 laptop computer on June 17 and a \$1,200 Nikon camera on February 5. Except for his vehicle (see item 2 below), John uses the § 179 write-off option whenever possible. John has no expenditures for which he is required to file Form 1099s.

2. On January 2, 2014, John paid \$31,000 (including sales tax) to purchase a gently used Toyota Camry that he uses 92% of the time for business. No trade-in was involved, and he did not claim any § 179 expensing. John uses the actual operating cost method to compute his tax deduction. He elects to use the 200%

declining-balance MACRS depreciation method with a half-year convention. His expenses relating to the Camry for 2014 are as follows:

Gasoline	\$3,500
Auto insurance	1,700
Interest on car loan	820
Auto club dues	325
Oil changes and lubrication	210
License and registration	190

In connection with his business use of the Camry, John paid \$510 for tolls and \$350 in fines for traffic violations. In 2014, John drove the Camry 14,352 miles for business and 1,248 miles for personal use (which includes his daily, round-trip commute to work).

3. John handles most claim applications locally, but on occasion he must travel out of town. Expenses in connection with these business trips during 2014 were \$930 for lodging and \$1,140 for meals. He also paid \$610 for business dinners he had with several visiting executives of insurance companies with whom he does business. John's other business-related expenses for 2014 are listed below:

Contribution to H.R. 10 (Keogh) retirement plan	\$8,000
Premiums on medical insurance covering self and family (spouse and children)	4,600
Premiums on disability insurance policy (pays for loss of income in the event John is disabled and cannot work)	2,400
State and local occupation fee	450
Birthday gift for receptionist (\$25 box of Godiva chocolates plus \$3 for gift wrap)	28

4. Anne earns \$32,000 working as a registered dietitian for the Aitkin Public School District. The job she holds, manager of the school lunch program, is not classified as full time. Consequently, she is not eligible to participate in the teacher retirement or health insurance programs. Anne's expenses for 2014 are summarized as follows:

Contribution to traditional IRA	\$5,500
Job hunting expense	720
Continuing education program	350
Membership dues to the National Association of Dietitians	120
Subscription to <i>Nutrition Today</i>	90

In order to work full time and earn a larger salary, Anne applied for a position as chief dietitian for a chain of nursing homes. According to the director of the recruiting service she hired, the position has not yet been filled and Anne is one of the leading candidates. The continuing education program was sponsored by the National Association of Dietitians and consisted of a one-day seminar on special diets for seniors. Anne drove the family Chevrolet Malibu 930 miles on job-related use, out of a total of 8,670 miles driven for the year. The Millers purchased the car on July 11, 2012, for \$23,400. Anne uses the automatic mileage method for computing any available deduction for business use of the car.

5. The Millers have supported Gary Simon (Anne's widowed father) for several years, appropriately claiming him as a dependent for tax purposes. On December 27, 2013, Gary suffered a massive stroke. The doctors did everything they could for Gary, but he died in the intensive care unit of Riverwood Hospital on January 8, 2014. In January and February of 2014, the Millers paid the following for Gary: medical expenses of \$11,800 not covered by Medicare (\$6,000 incurred in 2013 and \$5,800 in 2014) and funeral expenses of \$15,300. Gary's health insurance was limited to his Medicare coverage because the Millers' medical insurance (see item 3 above) only covered John, Anne, and their sons. Gary's will named Anne as executor and sole heir of his estate.

6. One of the assets that Anne inherited with the transfer of Gary's estate was his house. Upon the advice of the financial consultant who shares office space with John, the Millers decided to convert Gary's home into a furnished rental house. After several minor repairs (e.g., touching up the paint on the interior walls, replacing various window screens, pressure washing the brick exterior, etc.), the property was advertised for rent in the classified section of the local newspaper on March 1, 2014. The repairs cost \$720, and the newspaper ad was \$360. Based on reconstructed records and appraisal estimates, information about the property is as follows:

	Original Cost	FMV on 1/8/14
House	\$40,000	\$220,000
Land	10,000	50,000
Furniture and appliances	21,000	14,000

7. Gary's former residence was rented almost immediately with occupancy commencing April 1, 2014, under the following terms: one-year lease; \$2,400 per month due the first day of the month; first and last month's rent in advance; \$2,000 damage deposit; lawn care included but not utilities. The tenant complied with all terms, except the December rent payment was not made until January 1, 2015—the tenant took an extended holiday trip that started on Thanksgiving Day (November 27) through Christmas Day (December 25). Expenses in connection with the property were as follows: property taxes, \$2,600; repairs, \$320; lawn maintenance, \$540; insurance, \$1,800; and street paving assessment, \$2,100. The property is located at 12120 Lake Road, Aitkin, MN 56431. (Note: If you are using H&R Block software, input 365 in the "days owned" box and in the "days rented" box. Otherwise, the program will apportion the expenses inappropriately.)
8. In early December 2013, a friend advised John to buy stock in Pioneer Aviation, Inc. (PAI). At that time, PAI was in serious financial straits and was headed toward bankruptcy. Nevertheless, according to John's friend, the value of the corporation's underlying assets was such that the shareholders were bound to recover considerably more than the current market price of \$.50 per share. Excited at the chance for a "sure" profit, on December 15, 2013, John purchased 20,000 shares for \$10,000. In September 2014, the trustee in bankruptcy announced that the stock was worthless and that even some of PAI's preferred creditors would not be paid.
9. On June 14, 2014, the Millers sold 500 shares of Garnet Corporation for \$17,500 (\$35 per share). They owned 1,000 shares, acquired as follows: 500 shares on November 5, 2013, for \$25 a share and 700 shares on April 5, 2014, for \$30 a share. The Millers did not instruct their broker as to which shares to sell, so Form 1099-B for this sale reported \$12,500 basis for these shares.
10. One month before she died on April 14, 2005, Violet Simon (Anne's mother) gave Anne a coin collection. Based on careful records that Violet kept, the collection had a cost basis of \$9,000 and a fair market value of \$18,000 at the time Violet passed away. On February 12, 2014, the Miller residence was burglarized and the coin collection was stolen. The Millers filed a claim with the carrier of their homeowner's insurance policy for \$24,000 (the current value of the collection). Unfortunately, all they were able to collect was \$10,000, which was the maximum pay-out allowed for valuables (e.g., jewelry, antiques) without a special rider attached to the insurance policy.
11. In her will, Violet Simon (see item 10) left Anne a vacant lot on Mississippi Road. Violet had paid \$15,000 for the property, and it had a value of \$19,000 when she died. Violet had purchased the lot because it was adjacent to a school that she expected to expand. By 2014, it has become clear that the Mississippi Road area of Aitkin is not growing and that no school expansion will take place. Consequently, on July 1, 2014, Anne sold the lot for \$19,000. Not included in this price are unpaid property taxes (and interest on the unpaid taxes) of \$700 on the lot, which the purchaser assumed and later paid. Form 1099-B did not report the basis of this property.

12. Every year around Christmas, John receives cards from various car repair facilities (including dealerships) expressing thanks for the business referrals and enclosing cash. John has no arrangement, contractual or otherwise, that requires any compensation for the referrals he makes. Concerned about the legality of such “gifts,” John consulted an attorney about the matter a few years ago. Without passing judgment on the status of the payors, the attorney found that John’s acceptance of the payments does not violate state or local law. John sincerely believes that the payments he receives have no effect on the referrals he makes. During December 2014, John received cards containing \$7,200. One additional card containing \$900 was delayed in the mail and was not received by John until January 4, 2015.
13. In addition to those previously noted, the Millers’ receipts during 2014 are summarized below:

Payments to John for services rendered (as reported on Forms 1099–MISC issued by several payor insurance companies) pursuant to contractual arrangement	\$82,000
Income tax refunds for tax year 2013:	
Federal	210
State of Minnesota	90
Interest income (reported on separate Forms 1099–INT):	
State of Minnesota general-purpose bonds	1,400
General Electric corporate bonds	1,100
Certificate of deposit at Aitkin National Bank	900
Qualified dividends (Duke Energy, reported on Form 1099–DIV)	1,200
Proceeds from garage sale (see item 14 below)	9,200
Cash gifts from John’s parents	24,000
John’s net state lottery losses (\$1,000 of winnings reported on Form W2-G; \$2,300 of losses)	(1,300)

14. On June 7 and 8, 2014, the Millers held a garage sale to dispose of unwanted furniture, appliances, books, bicycles, clothes, and one boat (including trailer). The estimated basis of the items sold is \$25,500. All assets were used by the Millers for personal purposes.
15. Payments made for 2014 expenditures not mentioned elsewhere are as follows:

Medical:	
Copayment portion of medical expenses	\$1,300
Dental (orthodontist)	1,200
Taxes:	
State income tax (see item 17 below)	3,456
State sales taxes	1,120
Property taxes on personal residence	3,800
Interest on home mortgage reported on Form 1098	4,200
Charitable contributions	3,600

The Millers’ medical insurance does not cover dental services. The Millers pledge contributions of \$1,200 per year to their church. In 2014, they paid the pledges for 2013–2015. During 2014, the Millers drove the Malibu 270 miles for medical purposes (e.g., trips to the hospital, doctor and dentist offices) and 320 miles delivering meals to the poor for Meals-on-Wheels, a qualified charity.

16. The Millers have two sons who live with them: Trace and Trevor. Both are full-time students. Trace is an accomplished singer and earned \$4,200 during the year performing at special events (e.g., weddings, anniversaries, civic functions). Trace deposits his earnings in a savings account intended to help cover future college expenses. Trevor does not have a job.
17. The Form W–2 Anne receives from her employer reflects wages of \$32,000. Appropriate amounts for Social Security and Medicare taxes were deducted. Income tax

withholdings were \$1,320 for Federal and \$1,056 for state. The Millers made quarterly tax payments of \$2,000 for Federal and \$600 for state on each of the following dates: April 15, 2014, June 16, 2014, September 15, 2014, and December 29, 2014. None of the Millers hold any foreign financial accounts. Relevant Social Security numbers are noted below:

Name	Social Security Number	Birth Date
John R. Miller	111-11-1111	06/06/1972
Anne L. Miller	123-45-6781	08/14/1973
Gary Simon	123-45-6784	03/12/1934
Trace Miller	123-45-6788	09/13/1997
Trevor Miller	123-45-6789	07/20/1999

Requirements

Prepare an income tax return (with all appropriate forms and schedules) for the Millers for 2014 following these guidelines:

- Make necessary assumptions for information not given in the problem but needed to complete the return.
- The taxpayers are preparing their own return (i.e., no preparer is involved).
- The taxpayers have substantiation (e.g., records, receipts) to support all transactions for the year.
- If any refund is due, the Millers want a refund check sent to them by mail.
- The Millers had itemized deductions from AGI for 2013 of \$16,700, of which \$1,500 was for state and local income taxes.
- The Millers do not want to contribute to the Presidential Election Campaign Fund.

PROBLEM 2—INDIVIDUALS (FORM 1040)

David (Dave) S. and Karen H. Brown are husband and wife and live at 4112 Foxglove Drive, McKinney, TX 75070. Dave is a retired petroleum engineer, and Karen is a portrait artist. They choose to file a joint tax return each year.

1. When he retired at age 65, Dave was chief of offshore operations at Pelican Exploration Corporation. While employed, Dave participated in Pelican's contributory qualified pension plan, to which he had contributed \$250,000 (in after-tax dollars). Under one of the plan options, he chose a life-annuity payout of \$60,000 per year over his life. As part of his retirement package, Dave also received nontaxable health insurance coverage for him and Karen. Due to Dave's expertise in Gulf of Mexico offshore operations, Pelican continues to use his services on a consulting basis (see item 3 below).
2. Karen, an accomplished artist, is well known regionally for oil portraits (business activity code 711510). She paints in the Photorealism style, providing her clients with portraits that are often mistaken for photographs. Painting in this style is very time-consuming. Consequently, her output averages between 15 and 16 portraits a year. Her fee of \$3,200 per portrait was set several years ago and never varies. As this is quite reasonable for a Photorealistic oil portrait, she has a long waiting list of clients who have not yet been scheduled for sittings. She does all of her work in the studio the Browns maintain in their personal residence (see item 6 below). Karen is a cash-basis taxpayer with respect to her art business.
3. During 2014, Dave made seven trips on behalf of Pelican as an outside consultant (business activity code 541330). On a typical trip, Dave flies by commercial airline to New Orleans, Houston, or Corpus Christi, and then takes a company helicopter to the offshore platform. If necessary, he rents a room at a local motel. Sometimes



offsite consultations can solve the problem, and a trip to the rig is not necessary. His expenses for these trips are as follows:

Airfare	\$5,100
Lodging	3,100
Meals	2,200
Ground transportation (taxis, limos, rental cars)	750

After each trip, Dave recovers his expenses when he is paid by Pelican for the services rendered. Pelican does not require an accounting for the expenses and reimburses Dave based on his verbal report of how much he spent.

4. In early January 2014, Karen was paid for three portraits she painted and delivered in late 2013. During 2014, Karen completed 14 portraits. Payment was received for 11 portraits when they were delivered to the buyers. One portrait was delivered in mid-2014 to the CEO of a company who promised payment within 30 days. Payment was never received, and the company has since entered bankruptcy. Since the CEO has been indicted for securities fraud, Karen feels certain that she will never be paid for the portrait. The final two portraits were delivered in late 2014, and payments for both were received in early 2015. In December 2014, Karen accepted \$3,200 as payment for a portrait to be done in 2015. Although she did not like the arrangement, the customer said the prepayment was motivated by anticipated cash-flow considerations.
5. Karen keeps receipts for all her expenses. Her total cost for painting supplies in 2014 was \$3,010 (e.g., for canvases, brushes, oil paints, smocks, palettes, and other art supplies). The framing of the finished portrait is left to the customer since the most appropriate frame is a matter of personal taste and consideration for where the painting will be exhibited.
6. For convenience and security reasons, Karen prefers to work at home. One-fourth of the 4,000 square-foot living area is devoted to Karen's studio. The Browns built the home at a cost of \$350,000 on a lot previously acquired for \$100,000, and they moved in on June 15, 2011. As to business use, depreciation is based on MACRS (using the mid-month convention) applicable to 39-year nonresidential realty. Besides home mortgage interest and property taxes (see item 19 below), residence expenses for 2014 are summarized below:

Utilities	\$4,200
Molly Maid cleaning service	2,800
Service fee for home security system	1,600
Removal of stains from studio flooring	1,100
Homeowner's insurance	970
Repairs to studio skylight	340

7. At a mortgage foreclosure auction held on February 4, 2002, Dave acquired an abandoned sugarcane farm near Magnolia, known as LaBeaux Place, for \$30,000. In view of the expansion trend in nearby Houston, he regarded the purchase as a good investment. Early in 2014, Dave was contacted by a Houston real estate developer who offered \$250,000 for LaBeaux Place. Considering the prospect of a large taxable gain, Dave arranged for a property swap by written notice on May 10. In exchange for several vacant lots on Padre Island (TX) worth \$240,000 and cash of \$10,000, Dave transferred LaBeaux Place to the developer. The exchange took place on June 20, 2014.
8. Dave purchased unimproved land near Beaumont (TX) for \$18,200 at an auction held on April 17, 1989. Described as Block 46, the property was adjacent to a modest prison rice farm owned by the Texas Department of Corrections (TDC). Dave bought the property based on a hunch that the TDC might someday wish to expand its Beaumont prison facility. In late 2013, the TDC contacted Dave and offered him

- \$160,000 for Block 46. Dave countered with a selling price of \$225,000. After prolonged negotiations, Dave and the TDC could not come to a mutually agreeable selling price. The TDC then threatened to condemn Block 46. After repeated threats of condemnation, Dave transferred the property to the TDC on June 28, 2014, for \$180,000. On December 17, 2014, Dave reinvested \$175,000 in vacant land located near Texas State University in San Marcos. Dave spent the remaining \$5,000 on a vacation for him and Karen to Hawaii in early 2015.
9. The Browns had always thought that taking extended road trips in an RV would be fun. So in June 2014, they bought a new Winnebago Deluxe Coach RV for \$106,250 [\$100,000 (discounted list price) + \$6,250 (state sales tax)]. However, it only took Dave and Karen two weeks on the road to determine that this method of traveling the continental United States was not for them. In August 2014, they sold the RV to a neighbor for \$90,000. The neighbor paid \$20,000 down and paid the balance of \$70,000 in early December 2014. Dave did not charge his neighbor any interest.
 10. On May 9, 1997, Dave's father gave him 400 shares of Ragusa Corporation common stock as a birthday gift. The stock cost his father \$16,000 (\$40 a share) and was worth \$20,000 on the date of the gift. In 2009, when the stock was worth \$140 per share, Ragusa declared a 2-for-1 stock split. On July 27, 2014, Dave sold 400 shares for \$20,000 (\$50 a share). For sentimental reasons, Dave kept the remaining 400 shares. Form 1099-B did not report the basis of this property.
 11. On December 21, 2014, the Browns sold 500 shares of Cormorant Power common stock for \$40,000 (\$80 a share). They purchased the stock on February 1, 2014, for \$50,000 (\$100 a share), the basis reported on Form 1099-B. The Browns sold the stock to generate a loss to offset some of their capital gains. However, they considered Cormorant Power to be a good investment, so they repurchased 500 shares on February 19, 2015, for \$45,000 (\$90 a share).
 12. On March 2, 2013, Karen was contacted by Eva Baum, a former college roommate. Over lunch Eva asked Karen for a loan of \$6,000 to help finance a new venture. Karen made the loan because the venture, a summer art camp in Sedona, AZ, sounded interesting. Eva signed a note due in two years at 10% interest. In late 2014, Karen learned that Eva had disappeared after being charged by Arizona authorities with grand theft. She also learned that Eva is wanted in New Mexico for parole violation from a prior felony conviction. Eva made no payments to Karen on the note.
 13. The Browns have a long-term capital loss carryover of \$7,000 from 2013.
 14. On May 9, 2010, Maximilian Brown (Dave's favorite uncle) gifted him the family antique gun collection. Based on family records and qualified appraisals, the collection had an adjusted basis to Maximilian of \$4,200 and was worth \$13,000 on the date of the gift. Since Karen abhors guns, Dave has been under heavy pressure to get rid of the collection. After Maximilian died in early 2014, Dave donated the collection to the Alamo Siege Museum (a qualified charity). The transfer was made on December 5, 2014; at that time, several qualified appraisers valued the collection at \$16,000. The museum added the guns to its extensive collection of firearms.
 15. While walking the dog in late December 2013, Karen was hit by an out-of-control delivery truck. The mishap sent Karen to the hospital for several days of observation and medical evaluation. Aside from severe bruises, she suffered no permanent injury. Once apprehended, the driver of the truck was ticketed for DUI. The owner of the truck, a local distributor for a national brewery, was quite concerned about the adverse publicity that would result if Karen filed a lawsuit. Consequently, it paid all her medical expenses and offered Karen a settlement if she would sign a release. Under the terms of the settlement, Karen would receive \$134,000—\$126,000 for personal injury and \$8,000 for loss of income because her injuries prevented her from painting for a period of weeks. On January 31, 2014, Karen signed the release and was immediately paid \$134,000.

16. In August 2013, Dave was rear-ended while stopped at a red light. Thankfully, Dave was uninjured. However, his car was damaged. The driver who caused the accident left the scene immediately, so Dave was forced to use his insurance to repair the damage to his car. As a result, Dave was subject to the \$1,000 deductible provision in the policy which he paid with respect to his car repairs in 2013. The Browns claimed no deductions with respect to the accident on their 2013 income tax return. In 2014, the insurance company (Peregrine Casualty) located the driver at fault and recovered the amount paid for repairs by both Dave and Peregrine. Consequently, in April 2014, Dave received a check from Peregrine refunding the \$1,000 he paid for repairs according to his policy's deductible.
17. After an acrimonious divorce, the Browns' only daughter (Pamela Jansen) moved back home in December 2013. She brought her twins (Malone and Macie) with her. Under the divorce decree, Pamela was given custody of the children and awarded child support of \$2,100 a month. The decree does not indicate who is entitled to the dependency exemptions for the children. Pamela has no income for 2014 except the \$4,200 she received for two months of child support. She plans to initiate legal proceedings against her ex-husband for delinquent child support.
18. Besides the items already mentioned, the Browns have the following receipts for 2014:

Social Security benefits (Dave, \$12,000; Karen, \$6,000)	\$18,000
Consulting income paid by Pelican (including expense reimbursement of \$11,150—see item 3)	35,000
Life insurance proceeds (see below)	50,000
Qualified dividend income (reported on separate Forms 1099-DIV):	
Ragusa Corporation	1,200
Pelican Power	400
Interest income (reported on separate Forms 1099-INT):	
IBM bonds	600
CD at First National Bank of McKinney	400
Wells Fargo money market fund	300
City of Beaumont (TX) general purpose bonds	9,000

The life insurance proceeds relate to a policy owned by Maximilian Brown (see item 14), which named Dave as sole beneficiary. The receipt of the proceeds came as a complete surprise to Dave, as he never knew the policy existed.

19. Payments made for 2014 expenditures not already mentioned are as follows:

Payment of Pamela's legal fees and court costs incident to her divorce	\$9,000
Medical:	
Medicare B insurance premiums for Dave and Karen	2,244
Health care premiums for dependents	3,600
Dental implants for Karen	8,000
Taxes on personal residence	3,600
Interest on home mortgage	2,200
Church pledge	1,200
Professional journals:	
Oil and gas related (Dave)	160
Art related (Karen)	120
Dues to professional organizations (Dave)	140
State professional license fee (Dave)	250
2013 tax return preparation fee (\$200 for Dave's business; \$250 for Karen's business; and \$450 for personal income tax return)	900

Texas does not impose an income tax, so the Browns choose the state and local sales tax option. In addition to the state general sales tax, the local sales tax rate is 2% (1.5% city; 0.5% county). They do not keep track of sales tax expenditures for

routine purchases (e.g., clothes, prepared foods) but can verify the sales tax on exceptional items (i.e., big-ticket purchases like the RV).

20. The Browns made quarterly Federal income tax payments of \$2,400 on each of the following dates: April 15, 2014, June 16, 2014, September 15, 2014, and December 15, 2014. Last year's Federal income tax return reflected an overpayment of \$800 tax, which the Browns chose to apply to their 2014 income tax liability. The trustee of Dave's retirement plan also withheld \$6,500 of tax with respect to his retirement withdrawals for the year. Neither Dave nor Karen holds any foreign financial accounts. Relevant Social Security numbers are noted below:

Name	Social Security Number	Birth Date
David S. Brown	123-45-6785	09/15/1943
Karen K. Brown	123-45-6786	12/03/1948
Pamela Jansen	123-45-6784	10/19/1981
Malone Jansen	123-45-6787	06/25/2008
Macie Jansen	123-45-6788	06/25/2008

Requirements

Prepare an income tax return (with all appropriate forms and schedules) for the Browns for 2014 following these guidelines:

- Make necessary assumptions for information not given in the problem but needed to complete the return.
- The Browns are employing the same tax return preparer who completed their prior year tax return.
- The taxpayers have substantiation (e.g., records, receipts) to support all transactions for the year.
- If any refund is due, the Browns want it applied to next year's tax liability.
- The Browns do not want to contribute to the Presidential Election Campaign Fund.

PROBLEM 3—C CORPORATION (FORM 1120)

On November 1, 2005, Janet Morton and Kim Wong formed Pet Kingdom, Inc., to sell pets and pet supplies. Pertinent information regarding Pet Kingdom is summarized as follows:

- Pet Kingdom's business address is 1010 Northwest Parkway, Dallas, TX 75225; its telephone number is (214) 555-2211; and its e-mail address is petkingdom@pki.com.
- The employer identification number is 11-1111111, and the principal business activity code is 453910.
- Janet and Kim each own 50% of the common stock; Janet is president and Kim is vice president of the company. No other class of stock is authorized.
- Both Janet and Kim are full-time employees of Pet Kingdom. Janet's Social Security number is 123-45-6789, and Kim's Social Security number is 987-65-4321.
- Pet Kingdom is an accrual method, calendar year taxpayer. Inventories are determined using FIFO and the lower of cost or market method. Pet Kingdom uses the straight-line method of depreciation for book purposes and accelerated depreciation (MACRS) for tax purposes.
- During 2014, the corporation distributed cash dividends of \$250,000.



Pet Kingdom's financial statements for 2014 are shown below.

Income Statement		
Income		
Gross sales		\$ 5,750,000
Sales returns and allowances		<u>(200,000)</u>
Net sales		\$ 5,550,000
Cost of goods sold		<u>(2,300,000)</u>
Gross profit		\$ 3,250,000
Dividends received from stock investments in less-than-20%-owned U.S. corporations		43,750
Interest income:		
State bonds	\$ 15,000	
Certificates of deposit	<u>20,000</u>	<u>35,000</u>
Total income		\$ 3,328,750
Expenses		
Salaries—officers		
Janet Morton	\$262,500	
Kim Wong	<u>262,500</u>	\$525,000
Salaries—clerical and sales		725,000
Taxes (state, local, and payroll)		238,000
Repairs and maintenance		140,000
Interest expense:		
Loan to purchase state bonds	\$ 9,000	
Other business loans	<u>207,000</u>	216,000
Advertising		58,000
Rental expense		109,000
Depreciation*		106,000
Charitable contributions		38,000
Employee benefit programs		60,000
Premiums on term life insurance policies on lives of Janet Morton and Kim Wong; Pet Kingdom is the designated beneficiary		<u>40,000</u>
Total expenses		<u>(2,255,000)</u>
Net income before taxes		\$ 1,073,750
Federal income tax		<u>(356,023)</u>
Net income per books		<u><u>\$ 717,727</u></u>

*Depreciation for tax purposes is \$136,000. You are not provided enough detailed data to complete a Form 4562 (depreciation). If you solve this problem using H&R BLOCK Tax Software, enter the amount of depreciation on line 20 of Form 1120.

Balance Sheet

Assets	January 1, 2014	December 31, 2014
Cash	\$ 1,200,000	\$ 1,037,750
Trade notes and accounts receivable	2,062,500	2,147,000
Inventories	2,750,000	3,030,000
Stock investment	1,125,000	1,125,000
State bonds	375,000	375,000
Certificates of deposit	400,000	400,000
Prepaid Federal tax	–0–	3,977
Buildings and other depreciable assets	5,455,000	5,455,000
Accumulated depreciation	(606,000)	(712,000)
Land	812,500	812,500
Other assets	140,000	128,500
Total assets	\$13,714,000	\$13,802,727
Liabilities and Equity	January 1, 2014	December 31, 2014
Accounts payable	\$ 2,284,000	\$ 1,975,000
Other current liabilities	175,000	155,000
Mortgages	4,625,000	4,575,000
Capital stock	2,500,000	2,500,000
Retained earnings	4,130,000	4,597,727
Total liabilities and equity	\$13,714,000	\$13,802,727

During 2014, Pet Kingdom made estimated tax payments of \$90,000 each quarter to the IRS. Prepare a Form 1120 for Pet Kingdom for tax year 2014. Suggested software: H&R BLOCK Tax Software.

PROBLEM 4—C CORPORATION (FORM 1120)

On February 12, 2002, Nancy Trout and Delores Lake formed Kingfisher Corporation to sell fishing tackle. Pertinent information regarding Kingfisher is summarized as follows:

- Kingfisher's business address is 1717 Main Street, Ely, MN 55731; its telephone number is (218) 555-2211; and its e-mail address is kingfisher@kf.com.
- The employer identification number is 11-1111111, and the principal business activity code is 451110.
- Nancy owns 50% of the common stock and is president of the company, and Delores owns 50% of the common stock and is vice president of the company. No other class of stock is authorized.
- Both Nancy and Delores are full-time employees of Kingfisher. Nancy's Social Security number is 123-45-6789, and Delores's Social Security number is 987-65-4321.
- Kingfisher is an accrual method, calendar year taxpayer. Inventories are determined using FIFO and the lower of cost or market method. Kingfisher uses the straight-line method of depreciation for book purposes and accelerated depreciation (MACRS) for tax purposes.
- During 2014, the corporation distributed cash dividends of \$80,000.



Kingfisher's financial statements for 2014 are shown below.

Income Statement			
Income			
Gross sales			\$2,408,000
Sales returns and allowances			<u>(80,000)</u>
Net sales			\$2,328,000
Cost of goods sold			<u>(920,000)</u>
Gross profit			\$1,408,000
Dividends received from stock investments in less-than-20%-owned U.S. corporations			12,000
Interest income			
State bonds	\$ 14,000		
Certificates of deposit	<u>10,000</u>		<u>24,000</u>
Total income			\$1,444,000
Expenses			
Salaries—officers			
Nancy Trout	\$160,000		
Delores Lake	<u>160,000</u>	\$320,000	
Salaries—clerical and sales		290,000	
Taxes (state, local, and payroll)		85,000	
Repairs and maintenance		56,000	
Interest expense:			
Business loans	\$ 12,000		
Loan to purchase state bonds	<u>8,000</u>	20,000	
Advertising		6,000	
Rental expense		68,000	
Depreciation*		40,000	
Charitable contributions		15,000	
Employee benefit programs		24,000	
Premiums on term life insurance policies on lives of Nancy Trout and Delores Lake; Kingfisher is the designated beneficiary		<u>16,000</u>	
Total expenses			<u>(940,000)</u>
Net income before taxes			\$ 504,000
Federal income tax			<u>(171,904)</u>
Net income per books			<u>\$ 332,096</u>

*You are not provided enough detailed information to complete a Form 4562 (depreciation). If you solve this problem using H&R BLOCK Tax Software, enter the amount of depreciation on line 20 of Form 1120.

Balance Sheet

Assets	January 1, 2014	December 31, 2014
Cash	\$ 380,000	\$ 335,524
Trade notes and accounts receivable	308,400	480,280
Inventories	900,000	1,012,000
State bonds	160,000	160,000
Federal income tax refund	–0–	3,096
Certificates of deposit	140,000	140,000
Stock investments	300,000	300,000
Building and other depreciable assets	240,000	240,000
Accumulated depreciation	(88,800)	(128,800)
Land	20,000	20,000
Other assets	3,600	2,000
Total assets	<u>\$2,363,200</u>	<u>\$2,564,100</u>
Liabilities and Equity	January 1, 2014	December 31, 2014
Accounts payable	\$ 300,000	\$ 299,104
Other current liabilities	80,300	40,000
Mortgages	210,000	200,000
Capital stock	500,000	500,000
Retained earnings	<u>1,272,900</u>	<u>1,524,996</u>
Total liabilities and equity	<u>\$2,363,200</u>	<u>\$2,564,100</u>

During 2014, Kingfisher made estimated tax payments of \$43,750 each quarter to the IRS. Prepare a Form 1120 for Kingfisher for tax year 2014. Suggested software: H&R BLOCK Tax Software.

PROBLEM 5—PARTNERSHIP (FORM 1065)

On January 1, 2008, the Branson Company (EIN 22-2222222) and Porto Engineering, Inc. (EIN 33-3333333), formed Branto LLC (an equally owned joint venture). During its first four years, the LLC worked with the U.S. Department of Homeland Security and the National Transportation Safety Board to design and develop a specific device for airport passenger screening. Porto provides engineering expertise, and Branson provides high-tech manufacturing, selling, and distribution expertise. Early in 2013, the two governmental agencies recommended the product. In 2014, Branto's screening device was being successfully marketed, sold, delivered, and installed in airports around the United States.

The LLC uses the accrual method of accounting and the calendar year for reporting purposes. Its current address is 3750 Airport Boulevard, Seattle, WA, 98124. The following information was taken from the trial balance supporting the LLC's GAAP-basis (audited) financial statements for the 2014 calendar year:

Revenues:	
Sales revenues	\$40,000,000
Interest income	50,000
Total revenues	<u>\$40,050,000</u>
Amounts related to cost of goods sold:	
Beginning inventory	\$ 2,000,000
Materials purchases	8,000,000
Labor	9,000,000
Additional § 263A costs	–0–
Other costs: Various items	2,700,000
Book depreciation	1,275,000
Less: Ending inventory	<u>(3,000,000)</u>
Total amount of work in progress	<u>\$19,975,000</u>



Other costs <i>not</i> related to production:	
Salaries and wages	\$ 1,000,000
Taxes and licenses (no state income taxes)	300,000
Charitable contributions	100,000
Interest expense	1,200,000
Meals and entertainment (subject to 50% disallowance)	1,200,000
Travel expenses	800,000
Insurance (including key employee life insurance of \$100,000)	300,000
Legal and professional fees	900,000
Office expenses	2,000,000
Sales and promotion expenses	1,500,000
Utilities	800,000
Warranty expense (increase to reserves; not fixed and determinable)	300,000
Total other costs	<u>\$10,400,000</u>
Net income per books and GAAP-basis audited financial statements	<u>\$ 9,675,000</u>

The beginning and ending GAAP-basis balance sheets for the LLC were as follows at December 31, 2014:

	Beginning	Ending
Cash	\$ 975,000	\$ 825,000
Accounts receivable	620,000	2,600,000
Inventories	2,000,000	3,000,000
U.S. government obligations	1,000,000	1,000,000
Land	600,000	600,000
Buildings and equipment	12,000,000	19,500,000
Accumulated depreciation	<u>(6,375,000)</u>	<u>(7,650,000)</u>
Total assets	<u>\$10,820,000</u>	<u>\$19,875,000</u>
Accounts payable	\$ 420,000	\$ 800,000
Operating line of credit (guaranteed by members)	1,000,000	5,500,000
Warranty reserves (not guaranteed by members)	200,000	500,000
Mortgage notes on building	5,000,000	6,000,000
Capital, Branson Company	2,100,000	3,537,500
Capital, Porto Engineering, Inc.	<u>2,100,000</u>	<u>3,537,500</u>
Total liabilities and capital	<u>\$10,820,000</u>	<u>\$19,875,000</u>

The LLC uses the lower of cost or market method for valuing inventory. Branto is subject to § 263A; for simplicity, assume that § 263A costs are reflected in the same manner for book and tax purposes. Branto did not change its inventory accounting method during the year. There were no write-downs of inventory items, and Branto does not use the LIFO method.

The LLC claimed \$2,499,270 of depreciation expense for tax purposes (book depreciation is \$1,275,000). All tax depreciation expense should be reported on Form 1125-A. The LLC placed \$7.5 million of assets in service during the current year; this exceeds the threshold for eligibility for a § 179 deduction. Current asset additions are treated as 5-year MACRS assets. The LLC has a positive adjustment of \$98,100 for AMT purposes related to tax depreciation (tax depreciation exceeds that allowable for AMT purposes).

All borrowings were used exclusively for business operations; consequently, none of the interest expense is considered investment interest expense. The LLC members were required to guarantee the debt related to the operating line of credit. The accounts payable, accrued warranty claim liabilities, and mortgage were not guaranteed by the members. The mortgage relates to the real property and is considered qualified nonrecourse financing. The partners share equally in all LLC liabilities, because all initial contributions and all ongoing allocations and distributions are pro rata.

The LLC's activities are eligible for the domestic production activities deduction (DPAD). For simplicity, assume that the LLC's qualified production activities income

(QPAD) is \$9.5 million. Assume the LLC's production-related W-2 wages are \$10 million. Because of prior state losses and tax concessions, no current or deferred state income taxes are reported for financial purposes.

No guaranteed payments were paid to either of the LLC members. Instead, the members each withdrew \$3.4 million of cash during the year. None of the members contributed cash or other property to the LLC during the year.

Both LLC members are U.S. Subchapter C corporations. Both members are classified as domestic corporations and "LLC member-managers" on Schedule K-1.

The IRS's business code for "Other specialty trade contractors" is 238900. The LLC files its tax return in Ogden, Utah. Branson Company is located at 3750 Airport Boulevard, Seattle, WA 98124 (the same as the LLC's address).

The capital account reconciliation on the partners' Schedules K-1 is prepared on a GAAP basis, as are the LLC's Schedules L and M-2. On the Analysis of Income (Loss), the IRS's instructions indicate that the amounts for any LLC members should be reported on the line for limited partners. The LLC is required to file Schedule M-3, Form 8916-A (Supplemental Attachment to Schedule M-3), and Schedule C with its Form 1065. The instructions for Schedule M-3 state that, if a line description is provided on pages 2 or 3 of the form (or on Form 8916), an income or expense item should be reported on the M-3 regardless of whether there is a book-tax difference.

- Prepare pages 1, 4, and 5 of Form 1065 and Form 1125-A for Branto LLC. Do not prepare Form 4562. Leave any items blank where insufficient information has been provided. Prepare supporting schedules as necessary if adequate information is provided.
- Prepare Schedule M-3 and Form 8916-A (page 1 only). Do not prepare Schedule C or page 2 of Form 8916-A. There are four book-tax differences (two temporary differences and two permanent differences).
- Prepare Schedule K-1 for 50% LLC member Branson Company.

PROBLEM 6—S CORPORATION (FORM 1120S)

John Parsons (123-45-6781) and George Smith (123-45-6782) are 70% and 30% owners, respectively, of Premium, Inc. (11-1111111), a candy company located at 1005 16th Street, Cut and Shoot, TX 77303. Premium's S election was made on January 15, 2008, its date of incorporation. The following information was taken from the company's 2014 income statement.



Interest income	\$ 100,000
Gross sales receipts	2,410,000
Beginning inventory	9,607
Direct labor	(203,102)
Direct materials purchased	(278,143)
Direct other costs	(249,356)
Ending inventory	3,467
Salaries and wages	(442,103)
Officers' salaries	(150,000)
Repairs	(206,106)
Depreciation expense	(15,254)
Interest expense	(35,222)
Rent expense (operating)	(40,000)
Taxes	(65,101)
Charitable contributions (cash)	(20,000)
Advertising expenses	(20,000)
Payroll penalties	(15,000)
Other deductions	(59,899)
Book income	704,574

A comparative balance sheet appears below.

	January 1, 2014	December 31, 2014
Cash	\$ 47,840	\$?
Accounts receivable	93,100	123,104
Inventories	9,607	3,467
Prepaid expenses	8,333	17,582
Building and equipment	138,203	185,348
Accumulated depreciation	(84,235)	(?)
Land	<u>2,000</u>	<u>2,000</u>
Total assets	<u>\$214,848</u>	<u>\$844,422</u>
Accounts payable	\$ 42,500	\$ 72,300
Notes payable (less than 1 year)	4,500	2,100
Notes payable (more than 1 year)	26,700	24,300
Capital stock	30,000	30,000
Retained earnings	<u>111,148</u>	<u>?</u>
Total liabilities and capital	<u>\$214,848</u>	<u>\$844,422</u>

Premium's accounting firm provides the following additional information.

Distributions to shareholders	\$100,000
Beginning balance, Accumulated adjustments account	111,148

Using the preceding information, prepare a complete Form 1120S and Schedule K-1s for John Parsons and George Smith, 5607 20th Street, Cut and Shoot, TX 77303. Do not complete the Form 4562. If any information is missing, make realistic assumptions.

PROBLEM 7—GIFT TAX (FORM 709)

James A. and Ella R. Polk, ages 70 and 65, are retired physicians who live at 13319 Taylorcrest Street, Houston, Texas 77079. Their three adult children (Benjamin Polk, Michael Polk, and Olivia Turner) are mature and responsible persons. The Polks have heard that the Obama administration has proposed lowering the Federal gift tax exclusion from \$5.25 million to \$3 million. Although this change may not occur, the Polks feel they should take advantage of the more generous exclusion available under existing law. Thus, in 2014, the Polks make transfers of many of their high value investments. These and other gifts made during 2014 are summarized below.

Asset Transfer	Donor	
	James	Ella
Condominium located in Conroe (TX) acquired in 1999, cost \$1.2 million, to Benjamin, Michael, and Olivia as equal tenants in common.	\$1,900,000	\$1,900,000
Office building, located in Round Rock (TX) built in 2001, cost \$1.8 million, to Benjamin, Michael, and Olivia as equal tenants in common.	2,300,000	2,300,000
Vacation ranch in Bandera (TX) inherited by James from his father in 1996, value then \$900,000, to Benjamin, Michael, and Olivia as equal joint tenants with right of survivorship.	2,600,000	–0–
Ella used her separate property to reimburse her father (Alan Roberts) for his heart bypass operation.	–0–	82,000
Paid for daughter's (Olivia's) wedding to John Turner	20,000	20,000
James used his separate property to purchase a new automobile (BMW) as a graduation present (from medical school) for his favorite niece (Carol Polk)	42,000	–0–

Prepare 2014 gift tax returns (Form 709) for both of the Polks. A § 2513 election to split gifts is made. The Polks have made no taxable gifts in prior years. Relevant Social Security numbers are 123-45-6789 (James) and 123-45-6788 (Ella).

PROBLEM 8—ESTATE TAX (FORM 706)

Harriet C. Harper, age 74, died as a result of an automobile accident on June 6, 2014. At the time of her death, Harriet lived at 1520 Marlin Drive, Clearwater, FL 33758. She was predeceased by her husband, John W. Harper, who died in 2001. Harriet is survived by her two adult children, Travis Harper and Hannah Baker. Information regarding Harriet's estate is summarized below.

- John's will established a marital deduction trust with \$1 million of assets. Under the terms of the trust, Harriet received a life estate with the remainder passing to their children (i.e., Travis and Hannah). To obtain a marital deduction for John's estate, his executor made a QTIP election. On June 6, 2014, the trust had a value of \$2.1 million. During 2014, the trust assets are distributed to Travis and Hannah.
- Harriet owned three insurance policies with Falcon Assurance Company—one on her life and one on the life of each of her children. All policies have a maturity value of \$100,000; all name Harriet or her estate as the beneficiary. As of June 6, 2014, the policies on Travis and Hannah each had a value of \$40,000.
- A tract of undeveloped land in Pinellas County (FL) was purchased by Harriet as an investment in 2002 for \$300,000. To help finance the purchase, Harriet obtained mortgage funds from Tampa Savings and Loan. As of June 6, 2014, the land was worth \$1 million, and Harriet owed \$200,000 on the mortgage.
- Rental beach cottages in Destin (FL) were inherited from John and worth \$1.2 million on June 6, 2014. The cottages had a value of \$600,000 when John died; his original cost is unknown.
- A family vacation lodge in Union (SC) was held as joint tenants with right of survivorship in the names of Harriet Harper, Travis Harper, and Hannah Baker. The property was purchased in 2002 for \$400,000; \$200,000 was provided by Harriet and \$100,000 was furnished by each of her children. On June 6, 2014, the lodge was worth \$1.4 million.
- Harriet's Marlin Drive residence is owned by her. It had a value of \$800,000 on June 6, 2014.
- The accident that fatally injured Harriet was caused by the delivery truck of a national soft drink bottling company. Not only was the truck in disrepair, but the driver was charged with DUI. To avoid the adverse publicity of a lawsuit involving the obvious gross negligence, the corporate office offered to settle any claims. After careful deliberation, Harriet's co-executors (Travis and Hannah) signed a release. In return, the estate received \$700,000 in cash plus payment of all medical expenses. Of the medical expenses, the doctors and hospital were paid directly by the bottling company. The settlement was received by the estate before it was closed and the Form 706 filed.
- Other assets owned by Harriet as of June 6, 2014 included:

Checking account at Dunedin State Bank	\$ 18,000
State of Georgia bonds (interest accrued to date of death)	205,000
Personal and household effects	60,000
Federal income tax refund receivable (for tax year 2013)	4,000

- Liabilities and expenses in connection with the administration of the estate include:

Harriet's credit card debt and household bills (e.g., utilities, gardener)	\$21,000
Federal income tax (January 1, 2014, to June 6, 2014)	27,000
Funeral expenses	9,000
Attorney's fees	24,000
Accounting fees	10,000
Appraisal fees and court costs	6,000
Unpaid pledge to Clearwater First Methodist Church Building Fund (paid by the estate during its administration)	40,000

Because Travis and Hannah had experience in handling their father's estate, Harriet's will designated them as co-executors of her estate. The probate of the Estate of Harriet C. Harper is completed December 16, 2014. Travis and Hannah are the sole heirs.

Prepare an estate tax return (Form 706) for Harriet. In this regard, make the following assumptions.

- Disregard any request for information that is not available.
- Some deductions require a choice between the income and estate taxes (Form 706 or Form 1041) and cannot be deducted twice (see Chapters 27 and 28). Resolve all choices in favor of Form 706.
- Harriet had made no taxable gifts in prior years.
- Relevant Social Security numbers:

Name	Social Security Number
Harriet Harper	123-45-6781
Travis Harper	123-45-6782
Hannah Baker	123-45-6783

PROBLEM 9—TRUST (FORM 1041)



Prepare the 2014 fiduciary income tax return (Form 1041) for the Blue Trust. In addition, determine the amount and character of the income and expense items that each beneficiary must report for the year, and prepare a Schedule K-1 for Betty Blue. Omit all alternative minimum tax computations. The year's activities of the trust include the following.

Dividend income, all U.S. stocks	\$50,000
Taxable interest income	10,000
Tax-exempt interest income	15,000
Fiduciary's fees	4,000

The trust and Betty both use the calendar tax year. Under the terms of the trust instrument, fiduciary's fees are allocated to income. The trustee must distribute all of the entity's accounting income to Betty Blue by February 15 of the following year. The trustee followed this charge and made no other distributions during the year. Fiduciary's fees properly were assigned as an offset to taxable interest income.

The trust was created on July 8, 1990. There are no tax credits for the year, and none of the entity's income was derived from a personal services contract. The trust has no economic interest in any foreign trust. Its Federal identification number is 11-1111111.

The trustee, Hoover State Federal Bank, is located at 4959 Cold Harbor Boulevard, Mountain Brook, AL 35223. Its employer identification number is 98-7654321. Betty lives at 67671 Crestline Road, Birmingham, AL 35212. Her Social Security number is 123-45-6789.



Appendix F

Tax Formulas

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Tax Formula for Individuals

Income (broadly defined)	\$xx,xxx
Less: Exclusions.....	(x,xxx)
Gross income.....	\$xx,xxx
Less: Deductions for adjusted gross income.....	(x,xxx)
Adjusted gross income.....	\$xx,xxx
Less: The greater of—	
Total itemized deductions	
or standard deduction.....	(x,xxx)
Less: Personal and dependency exemptions.....	(x,xxx)
Taxable income.....	\$xx,xxx
Tax on taxable income.....	\$ x,xxx
Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes).....	(xxx)
Tax due (or refund).....	\$ xxx

Basic Standard Deduction Amounts

Filing Status	2014	2015
Single	\$ 6,200	\$ 6,300
Married, filing jointly	12,400	12,600
Surviving spouse	12,400	12,600
Head of household	9,100	9,250
Married, filing separately	6,200	6,300

Amount of Each Additional Standard Deduction

Filing Status	2014	2015
Single	\$1,550	\$1,550
Married, filing jointly	1,200	1,250
Surviving spouse	1,200	1,250
Head of household	1,550	1,550
Married, filing separately	1,200	1,250

Personal and Dependency Exemption

2014	2015
\$3,950	\$4,000

AMT Formula for Individuals

Taxable income (increased by any standard deduction and personal or dependency exemptions)

Plus or minus: Adjustments

Plus: Preferences

Equals: Alternative minimum taxable income (AMTI)

Minus: Exemption

Equals: Alternative minimum tax (AMT) base

Multiplied by: 26% or 28% rate

Equals: Tentative minimum tax before foreign tax credit

Minus: AMT foreign tax credit

Equals: Tentative minimum tax (TMT)

Minus: Regular tax liability (less any foreign tax credit)

Equals: AMT (if TMT > regular tax liability)

AMT Formula for Corporations

Taxable income prior to any regular tax NOL deduction

Plus or minus: Adjustments

Plus: Preferences

Equals: Pre-ACE alternative minimum taxable income (AMTI)

Plus or minus: ACE adjustment

Equals: AMTI before ATNOLD

Minus: ATNOLD (limited to 90% of AMTI before ATNOLD)

Equals: AMTI

Minus: Exemption

Equals: Alternative minimum tax (AMT) base

Multiplied by: 20%

Equals: Tentative minimum tax before AMT foreign tax credit

Minus: AMT foreign tax credit

Equals: Tentative minimum tax (TMT)

Minus: Regular tax liability (less any foreign tax credit)

Equals: AMT (if TMT > regular tax liability)

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