Cash Basis and Accrual Basis of Accounting

Most individuals use the cash basis of accounting; however, the accrual method is generally required if purchases and sales of inventory are necessary for the determination of income.

- Service-type businesses whose gross receipts do not exceed $10M may use the cash basis. This generally includes:
  - Most individuals, S corps, Partnerships owned by individuals, personal service corporations (PSCs). Note: $10M limit does not apply to qualified PSCs where 95% of stock is owned by owner-employees (i.e., ownership test) and 95% of activities are in certain fields, such as health, law, accounting, etc. (i.e., function test).
Page 1-10

- Net capital loss up to $3,000 against ordinary income ($1,500 MFS)
  - Unused amount carried forward indefinitely
  - Corporations get $0 net capital loss. Can carry back 3 years and forward 5 years. No special tax rate.
Self-Employment tax – pays both employer and employee’s share (15.3%)

- 50% of FICA tax (7.65%) is deductible on return
  - 6.2% Social Security - on wages up to $118,500 for 2016 ($127,200 – 2017)
  - 1.45% Medicare – unlimited
- 100% of medical insurance premiums paid by a self-employed taxpayer for self and family are deductible (no member of the family may have coverage through an employer).

Moving expenses

- New work must be at least 50 miles further from old home, each way (i.e., 100-mile round trip).
- Includes direct costs of moving you and your stuff
- Does not include meals, house hunting costs or temporary living expenses
- Must work full-time at least 39 weeks (9 months) during 1st year following move (or 78 weeks during first 2 years if self-employed).
Withdrawals from either type of IRA prior to the age of 59½ may result in a tax penalty of 10% of the amount withdrawn (in addition to the inclusion in gross income). The penalty does not apply, but amounts withdrawn are still included in gross income, when the withdrawal is the result of:

- Payment of medical expenses exceeding 10% of AGI (7.5% if spouse > 65 through 2016)
- Payment of qualified higher education costs
- Death or disability of the participant
- First time purchase of a home (up to $10,000 may be withdrawn)
  - The penalty is taxed at your marginal tax rate, which is the rate at which your last and your next dollar of taxable income are taxed. Your effective rate is the average rate of taxation for all your dollars (total tax / total taxable income).
Page 1-23

- **Relationship**, or unrelated and a **Household member** for entire year
  - Lineal descendant
    - Parent, grandparent, brother, sister, step-brother, uncle, aunt, in-laws, brother-in-law
  - Doesn’t include cousins
  - Test met if dependent lives the entire year with taxpayer.
    - Note: A "qualifying child" (e.g., child, stepchild, grandchild) must live with taxpayer for more than \( \frac{1}{2} \) of year.
OTHER TAXES AND TAX PROCEDURES

Self-Employment Taxes (Schedule SE)

- Tax rate double social security tax rate
  - 6.2% OASDI (i.e., Social Security) - on amounts up to $118,500 - 2016 ($127,200 - 17)
  - 1.45% Medicare tax - no maximum
    - Total 7.65% x 2 = 15.3%
  - 50% claimed as deduction for AGI.
Medical expenses under 10% of AGI cannot reduce AMTI. As a result, the taxpayer must make an adjustment equal to the difference between computing medical expenses with a 10% threshold and computing it with the 7.5% threshold used for regular tax purposes for people 65 and older (through 2016). People under 65 are already using 10%.
Page 1-76

Line 16: $275
The church and Humane Society charitable contributions are deductible without receipts as they are less than $250. The Independent political party contribution is not deductible because it is political, and the Nairobi National Museum contribution is not deductible because it is a foreign charity.

Lines 17 and 18: null
These lines do not apply to Alima.

Line 19: $275
Line 19 is the total amount of deductible charitable contributions, Lines 16 through 18.
Personal Holding Company (PHC) Tax

To discourage the sheltering of certain types of passive income in corporations.

- **If Both**:
  - 5 or fewer individuals own **more** than **50% of stock**
  - 60% or more of revenue from passive sources (taxable interest, dividends, rental & royalty income)
    - Tax on undistributed personal holding company income (**UPHCI**) only (**20% rate**)
    - Self-assessed by filing form (Sch. PH) with return (Form 1120)
      - Can avoid if pay:
        - Actual dividend
        - Consent dividend – Hypothetical dividend
  - This tax was created to prevent individuals in high individual tax brackets from establishing corporations to hold their personal investments and benefit from lower corporate tax rates on income. As a result, the tax only applies to **undistributed income** of the corporation, after deducting corporate taxes and net long-term capital gains to arrive at UPHCI, and the tax can be reduced or eliminated by sufficient dividend distributions (of course, this results in the individual shareholders paying taxes on the dividends received).

  - In computing income subject to the PHC tax, payments made to owner-employees may be deducted by a PHC only in the period in which they are taxable to the owner-employees, regardless of when they are accrued on the books and records of the corporation.

Personal Service Corporations (PSC)

A PSC is one that performs professional services and is predominantly owned by the parties providing those services. Qualified PSCs are taxed at a flat rate of 35%. To qualify as a PSC, two criteria must be met:

- Substantially all activities involve the performance of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting services; and

- 95% or more of the stock is owned by employees performing those services. Includes:
  - Retired employees who had performed such services;
  - Estates of employees or retirees who performed such services; and
  - Persons who acquired stock as a result of the death of such an employee or retiree for the 2-year period beginning on the date of the employee’s or retiree’s death.

- **Note**: Owner-employees of a PSC are considered related parties for purposes of IRC §267(a)(2), which requires a deduction to be matched with the related payee’s recognition of income; thus, payments made to owner-employees may be deducted by a PSC only in the period in which they are taxable to the owner-employees.
Section 1202 Stock

A similar provision, which was made permanent by the 2015 PATH Act, is Section 1202 Qualified Small Business Stock (QSBS). If certain requirements are met, gain on the sale of Section 1202 stock acquired after September 27, 2010, and held for more than 5 years, is 100% excludable from income, up to $10 million ($5 million if MFS) or, if greater, 10 times the total basis of such stock sold during the year. This exclusion also applies for purposes of AMT, and the gain is not subject to the 3.8% surtax on unearned income either.

- If acquired prior to February 18, 2009 – 50% exclusion
- If acquired after February 17, 2009, and before September 28, 2010 – 75% exclusion
9. To determine whether a shareholder’s basis increases or decreases, one must determine the taxability of the distributions. Remember that, to the extent dividends paid are from current and accumulated earnings and profits ($165,000 + $23,000 = $188,000), they are considered taxable dividends; amounts paid in excess of E&P are a return of capital, which is not taxable and reduces the bases of the shareholders. So, of the $250,000 distributed, only $188,000 are dividends, and the other $62,000 ($250,000 – $188,000) is return of capital, which reduces the shareholders’ bases; thus, Iris’s basis decreases by $24,800 ($62,000 × 40%).

10. Iris’s ending basis in her stock is $355,200 ($380,000 beginning basis – $24,800 return of capital).

11. To the extent dividends paid are from current and accumulated earnings and profits ($165,000 + $23,000 = $188,000), they are considered taxable dividends; amounts paid in excess of E&P are a return of capital, which is not taxable. So, of the $250,000 distributed, only $188,000 are dividends, and the other $62,000 ($250,000 – $188,000) is return of capital; thus, Iris receives $100,000 ($250,000 × 40%), but only $75,200 ($188,000 × 40%) of the distribution is considered a taxable dividend.

12. Iris does not recognize a capital gain as a result of the distributions. Iris receives $100,000 ($250,000 × 40%), but only $75,200 ($188,000 × 40%) of the distribution is considered a taxable dividend; the rest ($100,000 total distribution – $75,200 dividend = $24,800) is a return of capital, which reduces her basis.

13. Nolan receives 250 shares of the total 1,000 shares of common stock in exchange for his contribution of equipment and $150,000; thus, his ownership percentage is 25% (250/1,000).

14. Nolan contributed land and a building with an adjusted basis of $375,000, for which the corporation assumed the mortgage of $400,000. Because the $400,000 amount of the mortgage exceeds his basis of $375,000 by $25,000, Nolan will have to recognize a capital gain of $25,000. Thus, Nolan’s beginning basis in his stock is $0 ($375,000 basis in property – $400,000 loan + $25,000 capital gain).

15. To determine whether a shareholder’s basis increases or decreases, one must determine the taxability of the distributions. Remember that, to the extent dividends paid are from current and accumulated earnings and profits ($165,000 + $23,000 = $188,000), they are considered taxable dividends; amounts paid in excess of E&P are a return of capital, which is not taxable and reduces the bases of the shareholders. So, of the $250,000 distributed, only $188,000 are dividends, and the other $62,000 ($250,000 – $188,000) is return of capital, which reduces the shareholders’ bases; however, in Nolan’s case, his basis is already $0, so he must recognize a capital gain for the amount received in excess of dividends, or $15,500 ($62,000 × 25%). The change in his basis is a net $0 ($0 basis – $15,500 return of capital + $15,500 capital gain recognized). Note: The loan made to the corporation by Nolan does not increase his basis in his stock. Loans only increase basis in flow-through entities.

16. Nolan’s ending basis in his stock is $0 ($0 beginning basis – $15,500 return of capital + $15,500 capital gain recognized).
17. To the extent dividends paid are from current and accumulated earnings and profits ($165,000 + $23,000 = $188,000), they are considered taxable dividends; amounts paid in excess of E&P are a return of capital, which is not taxable. So, of the $250,000 distributed, only $188,000 are dividends, and the other $62,000 ($250,000 – $188,000) is return of capital; thus, Nolan receives $62,500 ($250,000 × 25%), but only $47,000 ($188,000 × 25%) of the distribution is considered a taxable dividend.

18. Nolan must recognize a capital gain of $15,500 as a result of the distribution. Nolan receives $62,500 ($250,000 × 25%), but only $47,000 ($188,000 × 25%) of the distribution is considered a taxable dividend; the rest ($62,500 total distribution – $47,000 dividend = $15,500) is a return of capital, which normally reduces the shareholder’s basis, but in Nolan’s case, his basis is already $0, so he must recognize a capital gain for the amount received in excess of dividends, or $15,500 ($62,000 × 25%).
Page 4-1

A partnership (P/S) is an association between two or more persons to operate a business as co-owners for profit.

- File an Information tax return, since a P/S is a flow-through entity (Form 1065)
  - For tax years beginning after 2015, the due date is 3/15 for calendar-year partnerships (2 ½ months after year-end), and the extension period is six months.
  - Tax year must be the same as the partners, or a majority of partners.
  - Note: Beginning April 1, 2017, with the Q2 2017 testing window, tax return due dates and extensions will no longer be tested on the CPA Exam.
A liquidating distribution is in some ways simpler, since the partner’s basis in the partnership must be reduced to $0 in all cases. The difference between cash and property distributions is as follows:

- **Cash, inventory and unrealized receivable distributions** – The total of cash, unrealized receivables, and appreciation on inventory distributed to a partner is compared to the partner’s basis in the partnership before the distribution and any excess basis is reported as a loss on the partner’s individual tax return. Only cash is used to determine gain.

- **Property distributions** – The basis of the distributed asset is always equal to the partner’s basis in the partnership before the distribution.
Limited Liability Partnership (LLP)
Another form of entity is the Limited Liability Partnership (LLP), in which some or all partners, depending on the state of jurisdiction, have limited liability. It is like a general partnership in that all partners have the right to participate in management of the partnership. Unlike general partnerships, partners in an LLP are not liable for the misconduct or negligence of other partners. In addition, an obligation of a partnership that is incurred while it is an LLP is generally the sole obligation of the partnership and the partners are not personally liable. [RUPA §306(c); adopted by a majority of states]
Page 7-12

**The basis in the new asset** will be: the basis of the old (200) + liability assumed (80) + gain recognized (100) – Liability on old (150) – cash/boot received (30) = 200 New basis. **Note:** This formula would include “+ cash/boot given” if cash/boot was given rather than received.
4. **Choose an option below:**

- [Original text] Office building—$22,821 Section 1245 recapture gain taxed as ordinary income
- Office building—$22,821 Section 1231 gain taxed at a maximum rate of 20%
- Office building—$22,821 unrecaptured Section 1250 gain taxed at 25%
- Office building—$12,821 Section 1250 recapture gain taxed as ordinary income, and $10,000 short-term capital gain
- Office building—$4,564 Section 291 recapture, $12,821 Section 1250 recapture gain, and $5,436 Section 1231 gain
Page 7-46

- 4.) Office building—$12,821 Section 1250 recapture gain taxed as ordinary income, and $10,000 short-term capital gain
- 5.) Computers—$176 Section 1231 ordinary loss
- 6.) Light trucks—$62,800 Section 1245 recapture gain and $3,000 Section 1231 gain taxed as long-term capital gain
4. **Office building—$12,821 Section 1250 recapture gain taxed as ordinary income, and $10,000 short-term capital gain**

Section 1250 property includes depreciable real property, such as buildings and structural components. Section 1250 recaptures gain on the sale of real property as ordinary income to the extent of “additional depreciation” taken on the property. Any depreciation taken in excess of the straight-line method is considered to be additional depreciation. Any depreciation taken on a property held for less than one year is considered to be additional depreciation for purposes of Section 1250 as well. Any Section 1231 gain in excess of the amount recaptured as ordinary income is treated as unrecaptured Section 1250 gain and is taxed at a special capital gain rate of 25%. However, because the building was held for less than one year (1/20/X8 to 12/18/X8), the building is not considered Section 1231 property, so none of the gain qualifies for special tax rates. Note: Section 291 does not apply to individuals, only C corporations.
Page 9-1

For calendar year corporations, an **automatic extension** of the due date for **5 months** is available. Fiscal year corporations get a **6-month** automatic extension, except corporations with a fiscal year ending June 30, which only get a **7-month** automatic extension. **An extension does not extend the time to pay, only the time to file.** If the entire tax liability is not paid by the original due date of the return, interest will be owed to the IRS on the unpaid balance. In addition, if the amount paid by the original due date is less than **90%** of the total tax liability, a monthly delinquency penalty will be owed in addition to the interest charges.
Regulation D Exemption – Private Placement (504, 505, 506)

- Rule 504 - Offerings up to $1 million ($5 million as of Jan. ’17—testable Oct. ’17) to be completed within 12 months (Seed Capital exemption).
  - SEC must be notified within 15 days of first sale.
    - No advertising to nonaccredited investors.
    - Resale to nonaccredited investors is permitted.
    - No special info given to investors.
    - Unlimited number of investors.
    - Cannot use if required to report under 1934 act.
Page 12-5

- **Note:** Rule 505 is repealed as of May ’17 due to the increase in the limit under Rule 504.

- **Rule 505** - Offerings up to $5 million to be completed within 12 months.
  - SEC must be notified within **15 days** of first sale.
  - All general solicitation (advertising) of the offer prohibited.
  - No resale for 2 years (investment purpose only - restricted security)
    - *The issuer needs to take reasonable steps to assure that the purchaser is buying for investment purposes and not for underwriting purposes.*
  - Unlimited number of accredited investors
  - Limited to 35 or fewer non-accredited investors.
  - Audited balance sheet must be provided to non-accredited investors.
  - Can use if required to report under 1934 act

***

**Regulation D – Private Placement**

<table>
<thead>
<tr>
<th>Rule 504</th>
<th>Rule 505</th>
<th>Rule 506</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Notify SEC within 15 days of first sale</strong></td>
<td>No advertising</td>
<td>Advertising allowed if purchasers are all accredited investors</td>
</tr>
<tr>
<td>No advertising to nonaccredited investors</td>
<td>No advertising</td>
<td></td>
</tr>
<tr>
<td>Resale to nonaccredited investors permitted</td>
<td>Investment purpose only (2 years) – Cannot resell for 2 years</td>
<td></td>
</tr>
<tr>
<td>Offerings ≤ $1,000,000 (≤ $5,000,000 as of 1/17—testable 10/17)</td>
<td>≤ $5,000,000 (Repealed as of 5/17)</td>
<td>Unlimited dollar amount</td>
</tr>
<tr>
<td>Offerings must occur within 12-month period</td>
<td>Within 12-month period</td>
<td>Unlimited amount of time for issuance</td>
</tr>
<tr>
<td>Unlimited number of investors</td>
<td>Unlimited Accredited Investors</td>
<td>Unlimited Accredited Investors</td>
</tr>
<tr>
<td>Financial information given: Nothing</td>
<td>Accredited = Nothing</td>
<td>Accredited = Nothing</td>
</tr>
<tr>
<td></td>
<td>Non-accredited = Audited B/S</td>
<td>Non-accredited = Audited B/S and represented by accredited</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Under <strong>JOBS act</strong>, general solicitation allowed if all purchasers Accredited</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Title III – Crowdfunding

Allows entities to issue securities through “crowdfunding,” which is the obtaining of small investments from a large number of investors. This is an additional exemption that makes it possible for privately owned companies to sell securities to investors over the internet through an SEC-registered intermediary—i.e., either a broker-dealer or a “funding portal.”

- Up to $1 million may be raised in a 12-month period.
- Limits are set on amounts individual investors may invest per 12-month period:
  - The greater of $2,000 or 5% of annual income or net worth (if less), for those with annual income or net worth less than $100,000.
  - Up to 10% of annual income or net worth (if less), up to a maximum of $100,000, if both annual income and net worth equal or exceed $100,000.
- Securities generally cannot be resold for 1 year.
- Among other disclosure requirements, the following is required depending on the total amount of offerings within a 12-month period:
  - Up to $100,000
    - Federal income tax return information
    - Financial statements certified by principal executive officer
  - $100,000 – $500,000
    - Reviewed financial statements
  - $500,000 – $1,000,000
    - Audited financial statements—however, if issuing for first time under Regulation Crowdfunding, then reviewed financial statements

Title IV – Small Company Capital Formation

Expands Regulation A (referred to as “Regulation A+”), exempting offerings to the public up to $50 million. Provides an exemption for a new class of securities; securities must be unrestricted equity securities, debt securities, and debt securities that are convertible into equity securities.

- Among other disclosure requirements, the following is required depending on the total amount of offerings within a 12-month period:
  - Tier 1—Up to $20 million, with up to $6 million in offers by affiliates of the issuer.
    - Unaudited financial statements required.
  - Tier 2—Up to $50 million, with up to $15 million in offers by affiliates of the issuer.
    - Audited financial statements required.
    - Non-accredited investors are limited to 10% of annual income or net worth, if greater.
5. (b) Regulation D provides 3 exemptions for private placements of securities. Although there are restrictions, all three exemptions allow for the sale of exempt securities to both accredited and nonaccredited investors. Answer (a) is incorrect because the exemption under Rule 505 does limit nonaccredited investors to a maximum of 35, but not all investors. Answer (c) is incorrect because the exemptions under Rules 505 and 506 allow for offerings of up to $5 million and an unlimited amount, respectively. Answer (d) is incorrect because the exemptions are not limited to small business corporations. Note: Rule 505 is repealed as of 5/17, but a $5 million limit now applies under Rule 504 as of 1/17—testable 10/17.

6. (d) Rule 506 of Regulation D allows an exemption for offerings that are unlimited as to amount and the length of time, provided certain requirements are met. Rule 504 is limited to offerings of up to $1 million ($5 million as of 1/17—testable 10/17) and Rule 505 (repealed as of 5/17) is limited to offerings of up to $5 million. Exemption under Regulation A is also limited to offerings of up to $5 million.
1. (Y) The dollar limitation for an offering under Rule 504 of Regulation D is $1 million ($5 million as of 1/17—testable 10/17). Since the offering was for $450,000, it complies.

2. (Y) Under Rule 504 of Regulation D, general solicitation is not allowed to nonaccredited investors, but it is allowed to accredited investors.

3. (Y) Rule 504 of Regulation D applies to offerings of up to $1 million ($5 million as of 1/17—testable 10/17) that are completed within 12 months.
Page 12-21

15. (Y) This offering violated several of the requirements of Rule 505 of Regulation D, including being over the $5 million limit by $1 million, selling to 40 nonaccredited investors in excess of the limit of 35, and not notifying the SEC until 18 days after the first sale instead of the required 15 days.

**Note:** Rule 505 is repealed as of 5/17, but a $5 million limit now applies under Rule 504 as of 1/17—testable 10/17.
Required:

On May 1, 20X1, Able Corp. was petitioned involuntarily into bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code.

When the petition was filed, Able had the following unsecured creditors:

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Amount owed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cole</td>
<td>$18,000</td>
</tr>
<tr>
<td>Lake</td>
<td>2,000</td>
</tr>
<tr>
<td>Young</td>
<td>1,500</td>
</tr>
<tr>
<td>Thorn</td>
<td>1,000</td>
</tr>
</tbody>
</table>

The following transactions occurred before the bankruptcy petition was filed:

- On February 15, 20X1, Able paid Vista Bank the $1,000 balance due on an unsecured business loan.
- On February 28, 20X1, Able paid $1,000 to Owen, an officer of Able, who had lent Able money.
- On March 1, 20X1, Able bought a computer for use in its business from Core Computer Co. for $2,000 cash.

***
Explanation of solutions

1. (T) A debtor may file a voluntary petition in bankruptcy, provided it is not considered an abuse. There is no requirement that the debtor be insolvent, although there are income limitations that may prevent the voluntary petition.

2. (F) When there are fewer than 12 creditors, it only requires 1 creditor to involuntarily petition a debtor into bankruptcy. The debt represented by those filing the petition, however, must equal at least $15,775 of unsecured debt at the time of the petition. Since the amount owed to Lake, Young, and Thorn totals only $4,500, it is not sufficient.

3. (T) When there are fewer than 12 creditors, it only requires 1 creditor to involuntarily petition a debtor into bankruptcy. The debt represented by those filing the petition, however, must equal at least $15,775 of unsecured debt at the time of the petition. Since the amount owed to Cole is $18,000, it is sufficient.