2017 REG Book Update

Page numbers refer to 2017 REG textbook pages. When new/edited text is shown along with old text, the new/edited text is highlighted in gray, unless noted otherwise. For those who prefer to purchase a new textbook due to the significant amount of changes, please visit https://www.rogercpareview.com/cpa-courses/textbooks.

Page 1-1

“For AGI” adjustments (on Face of 1040)

Interest on Student Loans - $2,500
Employment Tax-50%, Med. Premiums-100%
Moving Expenses
Business Expense (Sch. C)
Rent/Royalty & Flow-Through Entities (Sch. E)
Alimony (CANNOT)
Contributions to Retirement (KEOGH/IRA)
Early Withdrawal Penalty
Jury Duty pay
Education - $4,000/$2,000 depending on AGI
Health savings accounts (HSA)
Farm Income (Sch. F)
Qualified dividends are taxed at special 0%, 15% or 20%, similar to long-term capital gains.
  o 0% tax rate if in the 10% or 15% tax brackets
  o 15% tax rate if in the 25%, 28%, 33%, 35% tax bracket
  o 20% tax rate if in the 39.6% tax bracket (“high income” taxpayers with AGI over $450,000 (MFJ), $400,000 (Single)—$470,700, $418,400 for 2017)
  o Applies to qualified dividends from a domestic corporation and certain qualified foreign corporations. Must hold 60+ days during 121-day period beginning 60 days prior to ex-dividend date.
  o **Note:** Special rate doesn't apply to dividends from nontaxable entities such as REITs or dividends that are deductible by the payer organization. Treatment of mutual fund distributions is based on source of income being distributed (e.g., dividends representing distribution of interest earned by bond-oriented mutual fund doesn't qualify).
Tax Refunds

- Federal
  - Refund – Not taxable (a return of YOUR money)
  - Interest – YES, taxable
- State
  - Interest – YES, taxable
  - Refund – Generally, if itemized in the prior year, got deduction on Schedule A, taxable in current year (Form 1099G). If didn’t itemize in prior year, not taxable in current year. **Note:** A refund is taxable to the extent the taxpayer received a tax benefit in the prior year. For example, if the taxpayer itemizes their deductions because $500 in state taxes allowed their deductions to exceed the standard deduction by $100, then only the $100 tax benefit is taxable in the current year since the taxpayer would have otherwise claimed the standard deduction.
Personal assets, such as the family home or automobile, are also considered capital assets.

- Gains from the sales of personal assets are taxed as capital gains.
- Gain on personal residence excludable up to $250,000, or $500,000 if MFJ
- Losses on the sale or abandonment of personal use assets are not deductible.
  - **Note:** IRC §165(c) generally limits the deduction of losses by an individual to (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit; and (3) losses of property arising by casualty or theft.
- Discussed in more detail in the Property Tax section
Rental, Royalty, & Flow-through entities (Schedule E)

In general, rents and royalties are taxable when earned by an accrual basis taxpayer and in the period received by a taxpayer on the cash basis. When rents or royalties are received in advance, however, even an accrual basis taxpayer will include them in taxable income in the period received.

- Passive activity?
  - Any business venture in which the taxpayer doesn't materially participate (see 7 tests below)
    - All limited partnership interests
    - All rental activity (unless taxpayer is real estate professional, Schedule C)
  - 7 Tests for Material Participation determined on annual basis:
    - More than 500 hours of participation by individual.
    - Individual's participation is substantially all of participation by all owners/nonowners.
    - More than 100 hours and not less than any other's participation.
    - Activity is a “significant participation activity” (i.e., >100 hours) and all significant participation activities > 500 hours.
    - Material participation for 5 of last 10 years.
    - Material participation for any 3 prior years for personal service activities.
    - Depending on facts and circumstances, participation occurs on a regular, continuous, and substantial basis.
  - Losses deductible only to extent of passive gains
    - Unused losses carried forward until disposal of activity
    - Active rental losses partially deductible up to $25,000
      - Reduced by 50% of AGI over $100,000
      - No deduction if AGI over $150,000
  - Allocation required when various passive activities involve both gains and losses.
  - Excess loss allocated among activities involving losses
  - Allocation in proportion of activity's loss to total of losses
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 from a traditional IRA are still included in gross income) when the withdrawal is the result of:

- Payment of **medical expenses** exceeding 10% of AGI
- 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)

<table>
<thead>
<tr>
<th></th>
<th>Traditional IRA</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Age Limit?</strong></td>
<td>&lt; 70 ½ years old</td>
<td>No</td>
</tr>
<tr>
<td><strong>Income Limit?</strong></td>
<td>No</td>
<td>&lt; $133,000 ($196,000 MFJ) - 2017</td>
</tr>
<tr>
<td><strong>Contributions Deductible?</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Contribution Limit?</strong></td>
<td>$5,500 (+$1,000 catch-up contribution for &gt; age 50)</td>
<td>(limited to taxable compensation)</td>
</tr>
<tr>
<td><strong>Contribution Deadline?</strong></td>
<td>Filing deadline (no extensions) – e.g., April 15</td>
<td></td>
</tr>
<tr>
<td><strong>Required Minimum Distributions (RMDs)?</strong></td>
<td>Yes, after age 70 ½</td>
<td>No</td>
</tr>
<tr>
<td><strong>Withdrawals Generally Taxable?</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>10% penalty for distributions prior to age 59 ½</td>
<td></td>
</tr>
</tbody>
</table>
Jury Duty fee if remitted to employer

- Fee received always included in gross income.
- If remit fee to employer, deduct in arriving at AGI

Qualified Higher Education Expense

- Up to $4,000 of tuition and fees for enrollment at an eligible institution of higher education may be deducted by taxpayers with AGI up to $65,000 ($130,000 MFJ).
- Up to $2,000 for taxpayers with AGI between $65,000 and $80,000 ($130,000 and $160,000 for MFJ).
- $0 for taxpayers with AGI above $80,000 ($160,000 MFJ).
- Renewed for 2015 and 2016 tax years by December 2015 PATH Act.
- Requires Form 1098-T from eligible institution.
The Adjustments are income or expense items computed differently for AMT and regular tax. They can increase or decrease AMTI. The adjustments made by an individual include: (SIMPLE-PIE)

- The Standard deduction may not be claimed.
- Interest on My home equity loans is not deducted (unless to buy, build or improve main or second home. Interest on acquisition indebtedness and investments may still be claimed).
- Personal and dependency exemptions are not allowed (there is a much larger exemption available against AMTI).
- Local and state income taxes, all property taxes, and sales taxes are not deductible.
- Employee business expenses, tax preparation expenses, and investment expenses subject to the 2% (BIT) threshold are not deductible. Other miscellaneous deductions not subject to the 2% of AGI rule are still allowed.
Review the documents Alima has provided. Complete the Adjusted Gross Income section, Lines 23 through 37, on Form 1040 and Schedule A for Alima Xanders. Round to the nearest dollar.

**Note:** Line 38 of Form 1040 (not shown) is AGI, which is carried over from Line 37 of Form 1040.

---

**A Note from Alima**

In addition to the documents enclosed, here is a list of other items that you may need for my tax return.

I started a new job in January at North Cityview Hospital. It is an administrative position, similar to my old position but with more responsibilities. I moved in February to be closer to work and bought a house. The costs are listed below.

I took some self-improvement classes at State Community College and included the form State sent me.

Let me know if you need anything else.

Thanks!

<table>
<thead>
<tr>
<th>Item Description</th>
<th>Amount</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alimony paid to Jim Johnson</td>
<td>$26,000</td>
<td>SSN# 123-XX-XXXX</td>
</tr>
<tr>
<td>Safe deposit box fee</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Union dues</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Bank charges (for checking account)</td>
<td>125</td>
<td></td>
</tr>
<tr>
<td>Nursing Journal subscriptions</td>
<td>165</td>
<td></td>
</tr>
<tr>
<td>Cityview Daily Press (local newspaper)</td>
<td>105</td>
<td></td>
</tr>
<tr>
<td>Work Clothes</td>
<td>525</td>
<td>Required to wear a jacket and nice slacks.</td>
</tr>
<tr>
<td>Job hunting for current position</td>
<td>1,350</td>
<td></td>
</tr>
<tr>
<td>Moving costs</td>
<td>965</td>
<td>Cross-town move (30 miles).</td>
</tr>
<tr>
<td><strong>Charity gifts:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local Church cash donations</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Humane Society</td>
<td>75</td>
<td></td>
</tr>
<tr>
<td>Independent Political Party</td>
<td>150</td>
<td></td>
</tr>
</tbody>
</table>

Interest & Taxes are reported on forms:

- Commerce Mortgage is my home mortgage.
- GMC Mortgage is for a loan on a vacant lot I own for recreational purposes.
- State Mortgage is on a vacation home I have in Colorado.
## Resources

![W-2 Form](image)

**W-2 Wage and Tax Statement**

<table>
<thead>
<tr>
<th>Form</th>
<th>Wage and Tax Statement</th>
<th>20XX</th>
</tr>
</thead>
</table>

**Employer Information**
- **Employer's name**: NORTH CITIVIEW HOSPITAL
- **Address**: 8899 VISTA LANE, CITYVIEW, VA

**Employee Information**
- **Employee's name**: ALIMA XANDERS
- **Address**: 8899 VISTA LANE, CITYVIEW, VA

**Employer's Social Security Number**: XXX-XX-3698

**Federal Income Tax Withheld**: 15,750

**Social Security Tax Withheld**: 6,510

**Medicare Tax Withheld**: 1,522.50

**Total Wages and Tips**: 105,000

**Total Social Security Tips**: 105,000

**Total Medicare and Tips**: 105,000

**Total Wages**: 105,000

**Total Income Tax**: 5,985
### SAFEGUARD INVESTMENTS

<table>
<thead>
<tr>
<th>IRA contributions (other than amounts in box 2-4, 8-10, 13a, and 14a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rollover contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Roth IRA conversion amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fair market value of account</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Life insurance cost included in box 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
</tr>
</tbody>
</table>

#### Copy B

**FOR PARTICIPANT**

<table>
<thead>
<tr>
<th>IRA</th>
<th>SEP</th>
<th>SIMPLE</th>
<th>Roth IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Roe 12a</th>
<th>Roe 12b</th>
</tr>
</thead>
<tbody>
<tr>
<td>RMD date</td>
<td>RMD amount</td>
</tr>
<tr>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Roe 13a</th>
<th>Roe 13b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Postponed contribution</td>
<td>Year</td>
</tr>
<tr>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Roe 14a</th>
<th>Roe 14b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repayments</td>
<td>Code</td>
</tr>
<tr>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Roe 15a</th>
<th>Roe 15b</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of certain specified assets</td>
<td>Code(s)</td>
</tr>
<tr>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

---

### INVOICE

ACE CPAS, LLP
123 4TH STREET
CITYVIEW, VA

CLIENT:
Alima Xanders
8899 Vista Lane
Cityview, VA

<table>
<thead>
<tr>
<th>Service</th>
<th>1040</th>
<th>$365</th>
</tr>
</thead>
<tbody>
<tr>
<td>TAX RETURN PREPARATION</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Nairobi National Museum  
PO Box 40658  
723 Museum Hill  
Nairobi, City, Kenya  

July 2, 20XX  

Alima Xanders  
8899 Vista Lane  
Cityview, VA  

Dear Alima Xanders:  

Thank you for your generous gift of $500 to the Nairobi National Museum. Generous support from people like you make it possible for us to collect and preserve Kenya's past and present. If you should be in Kenya and want to visit the museum, a free pass will be made available for you.  

Sincerely,  

Betty Karanja,  
Chair, Patrons Association  
Nairobi National Museum
**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$3,850**

2. Points paid on purchase of principal residence 
   - **$800**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$569.04**

5. Loan balance: **$35,487**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$6,850**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$1,153**

5. Loan balance: **$155,874**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement

---

**For Payee/Borrower**

1. Mortgage interest received from payee(s)/borrower(s) 
   - **$0**

2. Points paid on purchase of principal residence 
   - **$0**

3. Refund of overpaid interest 
   - **$0**

4. Land property tax: **$0**

5. Loan balance: **$0**

---

**Copy B**

1. Mortgage Interest Statement
### Excerpt from Page 1 of Form 1040

#### Income

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Wages, salaries, tips, etc. Attach Form(s) W-2</td>
<td>105,000</td>
</tr>
<tr>
<td>8a</td>
<td>Taxable interest. Attach Schedule B if required</td>
<td>90,000</td>
</tr>
<tr>
<td>8b</td>
<td>Tax-exempt interest. Do not include on line 8a</td>
<td></td>
</tr>
<tr>
<td>9a</td>
<td>Ordinary dividends. Attach Schedule B if required</td>
<td></td>
</tr>
<tr>
<td>9b</td>
<td>Qualified dividends</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Taxable refunds, credits, or offsets of state and local income taxes</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Alimony received</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Business income or (loss). Attach Schedule C or C-EZ</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Capital gain or (loss). Attach Schedule D if required. If not required, check here</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Other gains or (losses). Attach Form 4797</td>
<td></td>
</tr>
<tr>
<td>15a</td>
<td>IRA distributions</td>
<td>15b</td>
</tr>
<tr>
<td>16a</td>
<td>Pensions and annuities</td>
<td>16b</td>
</tr>
<tr>
<td>17</td>
<td>Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E</td>
<td>17</td>
</tr>
<tr>
<td>18</td>
<td>Farm income or (loss). Attach Schedule F</td>
<td>18</td>
</tr>
<tr>
<td>19</td>
<td>Unemployment compensation</td>
<td>19</td>
</tr>
<tr>
<td>20a</td>
<td>Social security benefits</td>
<td>20b</td>
</tr>
<tr>
<td>21</td>
<td>Other income. List type and amount</td>
<td>21</td>
</tr>
<tr>
<td>22</td>
<td>Combine the amounts in the far right column for lines 7 through 21. This is your total income</td>
<td>105,000</td>
</tr>
</tbody>
</table>

#### Adjusted Gross Income

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td>Educator expenses</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Car and business expenses of nonresidents, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Health savings account deduction. Attach Form 8889</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Moving expenses. Attach Form 3903</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Deductible part of self-employment tax. Attach Schedule SE</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Self-employed SEP, SIMPLE, and qualified plans</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Self-employed health insurance deduction</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Penalty on early withdrawal of savings</td>
<td></td>
</tr>
<tr>
<td>31a</td>
<td>Alimony paid</td>
<td>31a</td>
</tr>
<tr>
<td>32</td>
<td>IRA deduction</td>
<td>32</td>
</tr>
<tr>
<td>33</td>
<td>Student loan interest deduction</td>
<td>33</td>
</tr>
<tr>
<td>34</td>
<td>Tuition and fees. Attach Form 8917</td>
<td>34</td>
</tr>
<tr>
<td>35</td>
<td>Domestic production activities deduction. Attach Form 8933</td>
<td>35</td>
</tr>
<tr>
<td>36</td>
<td>Add lines 23 through 35</td>
<td>36</td>
</tr>
<tr>
<td>37</td>
<td>Subtract line 36 from line 22. This is your adjusted gross income</td>
<td>37</td>
</tr>
</tbody>
</table>
### Excerpt from Schedule A

**Medical and Dental Expenses**
1. Medical and dental expenses (see instructions) ........ 1
2. Enter amount from Form 1040, line 38 ........................... 2
3. Multiply line 2 by 10% (0.10). But if either you or your spouse was born before January 2, 1952, multiply line 2 by 7.5% (0.075) instead ........ 3
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. Income taxes, or ........................................... 5
   - b. General sales taxes ......................................... 
6. Real estate taxes (see instructions) ............................... 8
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 .... 10
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 1099. 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% (0.02) ..................................................... 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 35, over $15,650? □ No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 26. Also, enter this amount on Form 1040, line 40. □ Yes. Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter. .......................................................... 29
30. If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ .......................................................... 30
### Task-Based Simulation Solution 3

#### Excerpt from Page 1 of Form 1040

<table>
<thead>
<tr>
<th>Income</th>
<th>Amount</th>
<th>Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>7. Wages, salaries, tips, etc. Attach Form(s) W-2</td>
<td></td>
<td>23. Educator expenses</td>
</tr>
<tr>
<td>8a. Taxable interest. Attach Schedule B if required</td>
<td></td>
<td>24. Certain business expenses of reservists, performing artists, and fee-basis</td>
</tr>
<tr>
<td>b. Tax-exempt interest. Do not include on line 8a</td>
<td></td>
<td>government officials. Attach Form 2106 or 2106-EZ</td>
</tr>
<tr>
<td>9a. Ordinary dividends. Attach Schedule B if required</td>
<td>8a</td>
<td>25. Health savings account deduction. Attach Form 8889</td>
</tr>
<tr>
<td>b. Qualified dividends</td>
<td>8b</td>
<td>26. Moving expenses. Attach Form 3600</td>
</tr>
<tr>
<td>10. Taxable refunds, credits, or offsets of state and local income taxes</td>
<td></td>
<td>27. Deductible part of self-employment tax. Attach Schedule SE</td>
</tr>
<tr>
<td>11. Alimony received</td>
<td></td>
<td>28. Self-employed SEP, SIMPLE, and qualified plans</td>
</tr>
<tr>
<td>12. Business income or (loss). Attach Schedule C or C-EZ</td>
<td></td>
<td>29. Self-employed health insurance deduction</td>
</tr>
<tr>
<td>13. Capital gain or (loss). Attach Schedule D if required, if not required, check here □</td>
<td>13</td>
<td>30. Penalty on early withdrawal of savings</td>
</tr>
<tr>
<td>14. Other gains or (losses). Attach Form 4797</td>
<td></td>
<td>31a. Alimony paid. Recipient’s SSN</td>
</tr>
<tr>
<td>15a. IRA distributions</td>
<td>15b</td>
<td>32. IRA deduction</td>
</tr>
<tr>
<td>16a. Pensions and annuities</td>
<td></td>
<td>33. Student loan interest deduction</td>
</tr>
<tr>
<td>17. Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E</td>
<td></td>
<td>34. Tuition and fees. Attach Form 8917</td>
</tr>
<tr>
<td>18. Farm income or (loss). Attach Schedule F</td>
<td></td>
<td>35. Domestic production activities deduction. Attach Form 8903</td>
</tr>
<tr>
<td>19. Unemployment compensation</td>
<td></td>
<td>36. Add lines 23 through 35</td>
</tr>
<tr>
<td>20a. Social security benefits</td>
<td>20b</td>
<td>37. Subtract line 36 from line 22. This is your adjusted gross income</td>
</tr>
<tr>
<td>21. Other income. List type and amount</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Excerpt from Schedule A

<table>
<thead>
<tr>
<th>Medical and Dental Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Medical and dental expenses (see instructions)</td>
<td>1</td>
</tr>
<tr>
<td>2. Enter amount from Form 1040, line 38</td>
<td>2</td>
</tr>
<tr>
<td>3. Multiply line 2 by 10% (0.10). But if either you or your spouse was born before January 1, 1952, multiply line 2 by 7.6% (0.076) instead</td>
<td>3</td>
</tr>
<tr>
<td>4. Subtract line 3 from line 1. If line 3 is more than line 1, enter 0</td>
<td>4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxes You Paid</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>5. State and local (check only one box):</td>
<td></td>
</tr>
<tr>
<td>a. Income taxes, or</td>
<td>5</td>
</tr>
<tr>
<td>b. General sales taxes</td>
<td>5.985</td>
</tr>
<tr>
<td>6. Real estate taxes (see instructions)</td>
<td>6</td>
</tr>
<tr>
<td>7. Personal property taxes</td>
<td>7</td>
</tr>
<tr>
<td>8. Other taxes. List type and amount</td>
<td>8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest You Paid</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>9. Add lines 5 through 8</td>
<td>9</td>
</tr>
<tr>
<td>10. Home mortgage interest and points reported to you on Form 1098</td>
<td>10</td>
</tr>
<tr>
<td>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</td>
<td>11</td>
</tr>
<tr>
<td>12. Points not reported to you on Form 1098. See instructions for special rules</td>
<td>12</td>
</tr>
<tr>
<td>13. Mortgage insurance premiums (see instructions)</td>
<td>13</td>
</tr>
<tr>
<td>14. Investment interest. Attach Form 4952 if required. (See instructions.)</td>
<td>14</td>
</tr>
<tr>
<td>15. Add lines 10 through 14</td>
<td>15</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gifts to Charity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>16. Gifts by cash or check. If you made any gift of $250 or more, see instructions</td>
<td>16</td>
</tr>
<tr>
<td>17. Other than by cash or check. If any gift of $250 or more, see instructions. You must attach Form 8283 if over $500</td>
<td>17</td>
</tr>
<tr>
<td>18. Carryover from prior year</td>
<td>18</td>
</tr>
<tr>
<td>19. Add lines 16 through 18</td>
<td>19</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Casualty and Theft Losses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>20. Casualty or theft loss(es). Attach Form 4694. (See instructions.)</td>
<td>20</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Job Expenses and Certain Miscellaneous Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>21. Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.)</td>
<td>21</td>
</tr>
<tr>
<td>22. Tax preparation fees</td>
<td>21.115</td>
</tr>
<tr>
<td>23. Other expenses—investment, safe deposit box, etc. List type and amount</td>
<td>23</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Miscellaneous Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>24. Add lines 21 through 23</td>
<td>24</td>
</tr>
<tr>
<td>25. Enter amount from Form 1040, line 38</td>
<td>25</td>
</tr>
<tr>
<td>26. Multiply line 25 by 2% (0.02)</td>
<td>26</td>
</tr>
<tr>
<td>27. Subtract line 26 from line 24. If line 26 is more than line 24, enter 0</td>
<td>27</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Itemized Deductions</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>28. Other—from list in instructions. List type and amount</td>
<td>28</td>
</tr>
<tr>
<td>29. Is Form 1040, line 38, over $165,550?</td>
<td>29</td>
</tr>
<tr>
<td>30. If you elect to itemize deductions even though they are less than your standard deduction, check here</td>
<td>30</td>
</tr>
</tbody>
</table>
Explanation of solutions

Form 1040

Lines 23 through 30: null
These lines do not apply to Alima. She cannot deduct the $965 of moving expenses on Line 26 because the distance she moved was less than 50 miles.

Line 31a/31b: $26,000/123-XX-XXXX
Alima paid $26,000 in alimony to Jim Johnson. So long as she provides his Social Security number, she may deduct that amount in arriving at her adjusted gross income, and Jim must include it in his income on his return.

Line 32: $5,000
Alima contributed $5,000 to her traditional IRA. It is fully deductible in arriving at AGI because she did not actively participate in another pension or profit-sharing plan and it does not exceed the annual limit of $5,500.

Lines 33 through 35: null
These lines do not apply to Alima.

Line 36: $31,000
Line 36 is the total of all deductions in arriving at AGI—$31,000 ($26,000 alimony + $5,000 IRA).

Line 37: $74,000
Line 37 calculates AGI by subtracting Line 36 (total deductions for AGI—$31,000) from the total income on Line 22 ($105,000).

Schedule A

Lines 1 through 4: null
These lines do not apply to Alima.

Line 5: $5,985
Box 17 on Alima’s W-2 shows that $5,985 in state income tax was withheld from her pay. She can deduct this amount from her AGI as an itemized deduction on her Schedule A, Line 5.

Line 6: $4,575
All of the real estate taxes Alima paid (shown in Box 4 on her three Forms 1098) are deductible from AGI as an itemized deduction on her Schedule A, Line 6. There is no limit on the number of properties for real estate taxes ($2,852.48 + $569.04 + $1,153 = $4,575 rounded to the nearest dollar).

Lines 7 and 8: null
These lines do not apply to Alima.

Line 9: $10,560
Line 9 is the total of all taxes paid by Alima—$10,560 ($5,985 + $4,575).
Line 10: **$18,484**
Home mortgage interest is deductible for a primary and secondary residence; therefore, Alima may deduct the $11,634 mortgage interest for her home (Commerce Mortgage) and the $6,850 interest on the Colorado vacation home (State Mortgage), for a total of $18,484. The GMC Mortgage interest on the vacant lot is not deductible.

Lines 11 through 14: **null**
These lines do not apply to Alima.

Line 15: **$18,484**
Line 15 is the total of deductible interest paid, which includes only $18,484 in mortgage interest.

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.

Line 20: **null**
This line does not apply to Alima.

Line 21: **$2,115**
Line 21 includes the following unreimbursed, job-related expenses: $600 union dues + $165 Nursing Journal subscriptions + $1,350 job-hunting expenses. The $105 for the local newspaper and the $525 for work clothes are not deductible. The newspaper is not specific to her career, and the clothes can be worn for other occasions. If she had to wear hospital scrubs, then they would be deductible.

Line 22: **$365**
According to the Invoice provided, Alima paid $365 to have her Form 1040 prepared. It is deductible on Line 22 as a miscellaneous itemized deduction, subject to a 2% of AGI floor.

Line 23: **Safe deposit box/$100**
The $100 safe deposit box fee is deductible on Line 23. The type of expense and the amount must be listed on the blank line.
Line 24: $2,580
Line 24 is the total of the deductible miscellaneous expenses, subject to a 2% of AGI floor:
Safe deposit box 100
Union dues 600
Nursing journals 165
Tax return prep 365
Job hunting 1,350
Total $2,580

Note: The bank charges and the Cityview Daily Press are not deductible because they are not employee or investment expenses. The work clothes are not deductible because they are not uniforms and can be worn outside of work.

Line 25: $74,000
Line 25 is asking for Alima's AGI from Line 38 (not shown, but Line 37 is the same amount) of Form 1040, which is $74,000.

Line 26: $1,480
Line 26 calculates the 2% of AGI floor ($74,000 × 2% = $1,480).

Line 27: $1,100
Line 27 is the amount of miscellaneous expenses in excess of the 2% of AGI floor ($1,480) that may be deducted ($2,580 − $1,480 = $1,100).

Line 28: null
This line does not apply to Alima.

Line 29: $30,419
Line 29 calculates the total itemized deductions that may be carried to Form 1040 and deducted from AGI ($10,560 + $18,484 + $275 + $1,100 = $30,419).
TASK-BASED SIMULATION SOLUTIONS

Task-Based Simulation Solution 1

For items 1 and 2, candidates were asked to determine the filing status and number of exemptions for Mrs. Vick.

1. (M, 4) A taxpayer may file as married, filing jointly, which provides the most favorable rates if they are married as of the last day of the year, or at the time of death if the spouse died during the year. Mrs. Vick would qualify for MFJ. A joint return entitles Mrs. Vick to 2 exemptions, one for her and one for Mr. Vick. She is also entitled to an exemption for each qualifying child and qualifying relation. To be a qualifying child or qualifying relation, the individual must be a citizen; have income, excluding social security, below a certain amount; be a direct relative, such as the daughter, or, if not, have lived with the taxpayer for the entire year; have over one-half of their annual support provided by the taxpayer; and not be filing a joint tax return with a spouse. Both Mrs. Vick's daughter and cousin qualify and, as a result, Mrs. Vick will be entitled to 4 exemptions.

2. (Q, 3) While Mrs. Vick will not qualify to file as married filing jointly, which provides the most favorable rates and exemptions for both husband and wife, she will qualify for the next most favorable, which is qualifying widow or surviving spouse. This provides her with the same rates as MFJ, but only one exemption for herself. She qualifies because her spouse died within the last 2 years, she is providing over 50% of the cost of maintaining a household that is the principal residence of a child or stepchild, she was eligible to file a joint return in the year of death, and she has not remarried. In addition to one exemption for herself, she will be entitled to an exemption for each qualifying child and qualifying relation. To be a qualifying child or qualifying relation, the individual must be a citizen; have income, excluding social security, below a certain amount; be a direct relative, such as the daughter, or, if not, have lived with the taxpayer for the entire year; have over one-half of their annual support provided by the taxpayer; and not be filing a joint tax return with a spouse. Both Mrs. Vick's daughter and cousin qualify and, as a result, Mrs. Vick will be entitled to 3 exemptions.

3. ($0) State disability benefits received as a result of an injury on the job are excluded from gross income under IRC §104(a)(3), which applies to “amounts received through accident or health insurance.” IRC §105(e)(2) provides that “amounts received from a sickness and disability fund for employees maintained under the law of a State or the District of Columbia, shall be treated as amounts received through accident or health insurance” for purposes of IRC §104.

4. ($400) Interest on tax refunds is fully taxable, as is interest on savings accounts and certificates of deposit. Interest on municipal bonds is tax exempt. As a result, Mrs. Vick will be taxed on $400 ($50 + $350) in interest income.

5. ($900) Pension benefits are taxable except to the extent that they are considered a return of capital. Since the entire cost of the pension plan was incurred by the employer, the Vicks had no cost and the $900 in benefits would be entirely taxable.

6. ($0) Gifts received are generally excluded from gross income under IRC §102(a). Note: Gifts from employers are generally included.
7. ($0) Life insurance proceeds are generally excluded from gross income under IRC §101, unless purchased from a person other than the insurance company (e.g., as an investment). Note: If the proceeds are paid out in installments, then part of the receipts will be taxable as interest.

8. ($200) Jury duty pay is considered earned compensation and is fully taxable. Note: Even if jury duty pay is remitted to the taxpayer's employer, the amount is still included in gross income, but the taxpayer may deduct the amount remitted to their employer as an adjustment to income.

9. ($450) Winnings from gambling activities are fully taxable. Gambling losses are not netted against winnings but may be deducted (to the extent of gambling winnings) as a miscellaneous itemized deduction not subject to the 2% of AGI limitation.
Deductions (all reasonable operating expenses)

In general, deductions on a corporate tax return are claimed in accordance with the same matching principle used for GAAP purposes. As a result, expenses can be deducted in the period that they are accrued for financial reporting purposes. An accrual basis taxpayer can accrue an expense if the transaction meets both an all-events test and an economic performance test. The all-events test is met when the existence of a liability is established and the amount of liability can be determined with reasonable accuracy. In the event that another person is to provide the taxpayer with property or services, the economic performance test is satisfied when the property or services are actually provided. Certain accrued items are expected to be paid within a short period of time after accrual, however. These may only be deducted when accrued if they are paid within \(2 \frac{1}{2}\) months of the tax year-end. The items subject to this requirement include:

- Wages
- Bonuses
- Vacation pay
- Charitable contributions
• **Casualty losses**
  
  o Business property—*Lesser of adjusted basis immediately before the casualty, or decline in value.*
  
  o Note that “$100 floor” and “10% of adjusted gross income” limitations do not apply.
Lecture 2.05

Deductions (Continued)

- Charitable Contributions
  - Claimed after all others, except “special deductions.”
  - Limited to 10% of income before claiming deduction (10% ATI).
  - Adjusted Taxable Income (ATI) is Net Income adjusted for:
    - Charity
    - DRD
    - NOL carryback
    - Capital loss carryback
    - Domestic production activities deduction
  - Unused amount carried forward 5 years.
  - Pledge may be accrued if paid within 3 ½ months of year-end.
  - Individuals
    - Max per year is 50% of AGI.
    - Unused portion carried forward 5 years.
Lecture 2.09

Supplementary Schedules M-1, M-2, M-3

- M-1 Reconciliation of book income to taxable income
  - The corporation must prepare a reconciliation of book income to taxable income (before special deductions – DRD, Charity & NOL Deduction) on the Schedule M-1. The purpose of this schedule is to identify to the IRS amounts that are reported differently for GAAP and tax purposes. The calculation begins with book income.
3. (d) The requirement is to determine the **maximum** charitable contribution deduction that Tapper Corp. may take on its 20X3 return. Since Tapper is an accrual method calendar-year corporation, it can deduct contributions actually made during 20X3, plus Tapper can elect to deduct any contribution authorized by its board of directors during 20X3, so long as the contribution is subsequently made no later than 3 1/2 months after the end of the tax year. Thus, to maximize its deduction for 20X3, Tapper can deduct both the $10,000 contribution made during 20X3 as well as the $30,000 contribution authorized during 20X3 and paid on February 1, 20X4. The total ($40,000) is deductible for 20X3, since it is less than the limitation amount ($500,000 × 10% = $50,000).
8. **(F)** While the 80% and 100% DRD deductions are available to determine adjusted current earnings (ACE), the 70% DRD deduction must be added back to alternative minimum taxable income to determine adjusted current earnings (ACE).

9. **(T)** Although only interest on private activity bonds is added back to taxable income as a tax preference in computing alternative minimum taxable income (AMTI) before the ACE adjustment, interest on any remaining municipal bonds is added to AMTI to determine adjusted current earnings (ACE).

10. **(F)** Depreciation on personal property is calculated using the 150% declining balance method for AMT purposes; there is no difference when calculating adjusted current earnings (ACE). To compute ACE, the corporation begins with AMTI and adds certain items (SLIM): Seventy (70%) DRD, Life Insurance proceeds, and Municipal bond interest.
8. Iris's beginning basis in her stock is equal to the $380,000 basis she had in the contributed inventory. Since Iris received something other than stock in exchange for the inventory, she would have decreased her basis by the $100,000 in bonds received, but she would have also had to recognize a gain on the $100,000 in the year of formation; thus, her beginning basis is still $380,000 (i.e., $380,000 basis in inventory – $100,000 bonds + $100,000 gain recognized).

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 CEP + $23,000 AEP = $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 CEP + $23,000 AEP = $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 exceeded his basis of $375,000 by $25,000, Nolan would have had to recognize a gain of $25,000 in the year of formation. Thus, Nolan's beginning basis in his stock is $0 ($375,000 basis in property – $400,000 loan + $25,000 gain recognized).

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 CEP + $23,000 AEP = $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 CEP + $23,000 AEP = $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%).
*Note: The following order applies in calculating stock basis to determine whether a distribution is taxable or whether a loss is deductible:

- + Income items, including gains
  - Distributions (does not include dividend distributions from C corp years)
  - Nondeductible, noncapital expenses (e.g., nondeductible portion of meals and entertainment expense) and depletion
  - Items of loss and deduction (if amounts are greater than remaining basis, allocate them proportionally until basis is reduced to 0, and reminder is suspended until enough basis exists to absorb it)

For example, Roger, the sole shareholder of an S corporation, has $10,000 of stock basis (and no debt basis) on January 1, year 1. Roger received a Schedule K-1 for year 1 with the following items:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary business income (loss)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Net §1231 gain</td>
<td>5,000</td>
</tr>
<tr>
<td>Nondeductible expenses</td>
<td>2,000</td>
</tr>
<tr>
<td>Charitable contribution</td>
<td>1,000</td>
</tr>
<tr>
<td>Distributions</td>
<td>9,000</td>
</tr>
</tbody>
</table>

(1) Using the ordering rule, stock basis is first increased by items of income, so our initial stock basis of $10,000 is increased by the $5,000 net §1231 gain, for a stock basis before distributions of $15,000.

(2) Then we reduce the $15,000 stock basis by distributions of $9,000, for a remaining basis amount of $6,000. Since the shareholder has adequate stock basis before distributions, the $9,000 distribution is not taxable.

(3) Next, Roger's $6,000 stock basis is reduced by the $2,000 of nondeductible expenses, bringing stock basis to $4,000.

(4) Finally, Roger has an ordinary loss of $15,000 and a $1,000 charitable deduction. Since Roger's loss and deduction items exceed his stock basis, we would look to see if he had any debt basis (money loaned to company). Since there is no debt basis, the loss and deduction items must be pro-rated to determine the amount currently allowable:

- $15,000 loss/$16,000 total loss and deduction items × $4,000 remaining basis = $3,750 loss allowable in year 1
- $1,000 deduction/$16,000 total loss and deduction items × $4,000 remaining basis = $250 allowable charitable deduction in year 1

Roger's remaining $11,250 ordinary loss and $750 charitable deduction are suspended until Roger has enough basis to absorb it.

**Types of Income**

**Net Business Income (Ordinary Business Income)**

- **Income** = Ordinary income/Loss + Muni-bond interest + Separately stated income items
  - Income computed on an *Average daily basis.*
For example, Assume an S corporation with 100 shares outstanding reported $365,000 of income in 20X1 (a 365-day year). One particular shareholder purchased 5 shares on 11/30/X1, and held them through the end of the year. The income averages $365,000 / 365 days = $1,000 per day. With 100 shares outstanding, this comes to $1,000 / 100 shares = $10 per share per day. The individual shareholder making the purchase on 11/30/X1 held the shares for the last 31 days of the year, and is allocated $10 x 5 shares x 31 days = $1,550.

Losses

- **Basis Limitation**—Losses are limited to amount invested (i.e., stock basis) + amount loaned to company (i.e., debt basis). Basis cannot go below zero; losses are suspended until the shareholder has sufficient basis to absorb the loss. Note: For S corporations, basis is often equal to the amount “at-risk.”

- **At-Risk Rules**—Losses are further limited by the investor's amount “at risk” under IRC Sec. 465 (similar to basis rules but amounts at-risk do not include amounts for which the investor bears no economic risk of loss—e.g., certain nonrecourse loans and loans from certain related parties).

- **Passive Activity Loss Limitation**—IRC §469 provides that passive losses are limited to passive income.
  - Note: For CPA exam purposes, you should be aware of the impact of the at-risk and passive activity loss limitations, but you are unlikely to be asked to calculate anything beyond the basis limitation.

Municipal bond interest

- Increases basis
- Not taxable
Lecture 3.03

DISTRIBUTIONS TO SHAREHOLDERS

Distributions to Shareholders are nontaxable to the extent of the Accumulated Adjustment Account (AAA) and are applied to reduce the AAA and shareholder's stock basis.

- AAA represents the cumulative total of undistributed net income items for S corporation taxable years beginning after 1982. (Pre-1983, Previously Taxed Income (PTI)—beyond scope of exam.)
- Accumulated Earnings and Profits (AEP) represent earnings and profits that were accumulated (and never taxed to shareholders) during C corporation taxable years.
  1. Distributions to the extent of the AAA are not taxable.
  2. Distributions in excess of the AAA are treated as Ordinary Dividends to the extent of the corporation's AEP.
  3. Distributions are next nontaxable to the extent of remaining stock basis, as a tax-free return of capital.
  4. Distributions in excess of stock basis are treated as gain from the sale of stock.

Note: The tax treatment for liquidating distributions is the same for S corporations as it is for C corporations (i.e., recognize gain/loss on the distribution of property to a shareholder as if the property were sold at its FMV in exchange for the shareholder's stock), except that gains/losses recognized by an S corporation are ultimately passed through to the shareholders.

Accumulated Adjustment Account (AAA)

The AAA generally represents the cumulative balance of all items of the undistributed net income and deductions for S corporations. The AAA is generally increased by all income items and is decreased by distributions and all loss and deduction items; however, adjustments for tax-exempt income and related expenses, as well as adjustments for federal income taxes attributable to a taxable year in which the corporation was a C corporation are made to the Other Adjustments Account (OAA), rather than the AAA.

Note that the amounts represented in the AAA differ from AEP. A positive AEP balance represents earnings and profits accumulated in C corporation years that have never been taxed to shareholders. A positive AAA balance represents income from S corporation years that has already been taxed to shareholders but not yet distributed.

Distributions from an S corporation are generally treated as first coming from its accumulated adjustment account (AAA), and then are treated as coming from its accumulated earnings and profits (AEP); however, note that an S corporation may elect to distribute AEP before AAA. A positive balance in an S corporation's AAA is generally nontaxable when distributed because it represents amounts that have already been taxed to shareholders during S years. In contrast, an S corporation's AEP represents earnings accumulated during C years that have never been taxed to shareholders, and must be reported as dividend income when received.
Basis

The most important concept in partnership tax law is that of a partner’s basis, which generally equals the amount the partner has “at risk” in the partnership. A partner’s basis is not identical to the partner’s Equity/Capital in the business, since a partner’s basis includes the partner’s share of partnership liabilities to creditors and the partner’s capital account does not. Note: Basis is generally equal the amount at-risk unless a particular reason is given as to why the partner is not at-risk for such amount (e.g., a partner is not personally liable for repayment of a liability).
Recourse Vs. Nonrecourse Liabilities

Recourse Liabilities – Debtor bears an economic risk of loss.
- Partners generally share in recourse liabilities to the extent they are personally liable for repayment.
- Since limited partners in a limited partnership are not generally liable for the repayment of debt, *recourse liabilities are allocated only to general partners*, unless otherwise specified.

Nonrecourse liabilities – Debtor does NOT bear an economic risk of loss.
- Partners (general and limited) generally share in nonrecourse liabilities in relation to their profits interest in the partnership. If a profits interest is not stated, it is the same as the capital interest.
  - Profits interest – Partner’s share of future profits/losses.
  - Capital interest – Partner’s share of net assets if partnership liquidates.

Capital (Equity) accounts represent the partners’ shares of partnership equity (partnership assets minus liabilities). A separate capital account for each partner is maintained. The partnership keeps track of each partner’s capital account and presents an analysis of the capital account on Schedule K-1. **Note**, the capital account is different than the partner’s adjusted basis. **For example**, the capital account does not include a partner’s share of partnership liabilities, whereas basis does.
**Partnership Tax Year**
Per IRC Sec. 706(a), generally a partnership is required to adopt the same tax year as that of the partners (or a *majority* of partnership interests). Thus, if the partners are all individuals that report income using calendar years, the partnership itself should have a December 31 year-end. If there is no majority interest tax year, the tax year of the principal partners (i.e., those owning 5%+) is used. If there are no principal partners or their tax years are not the same, the year with the *least aggregate deferral* is used. Least aggregate deferral means the year that defers the least amount of the partners' income for the least amount of time, which is determined by adding together for each year: deferral period per partner × partner's % ownership.

**For example,** Partner A (50% interest) reports income on the fiscal year ending 6/30 and Partner B (50% interest) reports income on the fiscal year ending 7/31.

<table>
<thead>
<tr>
<th>Year-end 6/30</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner</td>
<td>Year-end</td>
<td>% Interest in partnership</td>
<td>Months of deferral</td>
<td>Interest × deferral</td>
</tr>
<tr>
<td>A</td>
<td>6/30</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>7/31</td>
<td>.5</td>
<td>1</td>
<td>.5</td>
</tr>
<tr>
<td>Aggregate</td>
<td></td>
<td></td>
<td></td>
<td>.5*</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year-end 7/31</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner</td>
<td>Year-end</td>
<td>% Interest in partnership</td>
<td>Months of deferral</td>
<td>Interest × deferral</td>
</tr>
<tr>
<td>A</td>
<td>6/30</td>
<td>.5</td>
<td>11</td>
<td>5.5</td>
</tr>
<tr>
<td>B</td>
<td>7/31</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Aggregate</td>
<td></td>
<td></td>
<td></td>
<td>5.5</td>
</tr>
</tbody>
</table>

*A 6/30 year-end must be used since it results in the least aggregate deferral of income.*
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 (and marketable securities) is used to determine a **gain**.

- **Property distributions** – The basis of the distributed asset is always equal to the partner's basis in the partnership before the distribution, so no gain or loss is recognized.
Partnership Elections
A partnership may elect to change its tax status to that of a Large Partnership by filing Form 1065-B. To qualify as a large partnership, the partnership must have had 100 or more partners in the preceding tax year. A large partnership may be required to pay certain taxes, such as a recapture of investment tax credit, but generally all other items of profit and loss pass through to the partners.

A partnership may file a Sec. 754 election to adjust the basis of partnership property whenever there is a transfer of a partnership interest (i.e., sale/exchange or when a partner dies). When this election is in effect, the partnership must increase/decrease its inside basis in partnership assets to make the new partner’s outside basis equal to their share of inside basis in partnership property. The election applies to all such transfers until the election is revoked by the partnership with IRS consent. (Note that the Sec. 754 election also covers basis adjustments in the event of a distribution of property, but this is likely beyond the scope of the exam).

SIMILARITIES AND DIFFERENCES BETWEEN LLPs AND LLCs
Limited Liability Company (LLC)
Some states allow for a type of business entity referred to as a Limited Liability Company (LLC). Owners of LLCs, which generally can be individuals, corporations, other LLCs, or foreign entities, are referred to as members. In most cases, all members have the right to participate in the management of the LLC and are treated as agents. Certain types of companies, such as banks and insurance companies, may not be structured as LLCs.

***
• Specified life – A trust must have an identifiable termination point, expressed in years or in the length of a life in being at the time the trust is created, plus a maximum of 21 years.
  o Private Trust = cannot live forever – lives until purpose is satisfied (e.g., if established for college, after graduation → trust ends)
  o Charitable Trust = lives forever (perpetuity)
FIDUCIARY INCOME TAX RETURN (1041)

Estates and trusts are required to file an annual fiduciary income tax return, Form 1041.

- Filed annually by estates and trusts to report the income earned by the entity.
  - Estates – Required when gross income is $600 or more, or there is a nonresident alien beneficiary
  - Trusts – Required for any taxable income, gross income of $600 or more, or there is a nonresident alien beneficiary
  - Similar to Form 1040, but no standard deduction is given and different exemptions exist.
Income Taxation of Trusts and Estates (1041)

<table>
<thead>
<tr>
<th>Trusts/Estates</th>
<th>DNI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Return</td>
<td>= Max amount that can be taxed to beneficiaries as income. Rest considered a distribution of principal. (Payoutable profits)</td>
</tr>
</tbody>
</table>

**Gross Income (same as Indiv.)**

- Interest
- Dividends
- Rental income
- Capital Gains

**Gross Income**

- + Municipal Bond Interest (no Capital Gains)
- - Everything else the same as Trust/Estate

**Deductions** = Same, except 3 rules (in addition to no standard deduction)

1. **Trustee Management Fees (Fiduciary Fees)** – Accountants, attorneys, income tax preparation (only deduct % based on taxable income)

2. **Charity** – Can give 100% away; individuals only up to 50% of AGI

3. **Income Distribution Deduction** – Taxed once and only once! No double taxation. Either stays or gets distributed to K-1 → Sch. E → 1040

**Exemptions**

- Simple = $300
- Complex = $100
- Estates = $600

= Taxable Income = DNI (Maximum amount that’s taxable)

---

**Income Taxation of Trusts and Estates**

Calculate **distributable net income (DNI)** – Maximum amount that can be taxed to the beneficiary; the rest is a tax-free distribution of principal (Payoutable Profits).

- Different from taxable income in certain ways:
  - Includes tax-exempt income (Municipal bond interest).
  - Excludes net capital gains (unless they are to be distributed to the beneficiary).
  - Actual distributions of DNI reduce taxable income (100% deductible, except for any tax-exempt income included).
    - Such distributions reported on recipients’ returns.
  - No income distributions deduction.
  - No personal exemption allowed.
Distributable net income identifies the income that is available to distribute to the income beneficiaries of the trust each year. It is based on the income and expenses reported on the income tax return of the trust, with two adjustments:

- **Tax-exempt income** (e.g., municipal bond interest) is included in DNI since it is available to distribute, even though it is not subject to taxation.
- **Net capital gains** are **not** included in DNI since, under trust law, they are treated as adjustments to the corpus (unless they are to be distributed to the beneficiary).

The calculation of income on a **fiduciary income tax return** is almost identical to the determination of income on an individual return. The most significant differences that apply are:

- There is no limit on **charitable deductions** (they must be authorized in the trust instrument or will of the decedent). Can give an unlimited amount to charity.
- Income paid to an estate that was earned by the decedent prior to death (such as the final paycheck of the taxpayer from their employer or installment payments paid to a decedent's estate) must be included in the fiduciary income tax return (Form 1041) and also reported as a receivable on the estate tax return of the decedent (Form 706). This is known as **income in respect of a decedent (IRD)**. Note: Estate taxes paid on IRD are deductible on the Form 1041.
- Fees paid to the **trustee** (fiduciary fees) and other costs of administering the trust are generally deductible. Fees paid to administer an estate can be deducted on the fiduciary income tax return if the executor waives the right to deduct these costs on the estate tax return.
- A deduction is claimed for all **distributions of DNI** to beneficiaries of the trust or estate. The beneficiaries report the income on their personal tax returns. The amounts flow through on a 1041 Schedule K-1, then to the Schedule E on their individual 1040 tax returns. Distributions of corpus are not deductible and not taxable to the beneficiaries.
Lecture 5.07

GIFT TAX

Taxes may be owed by those who transfer large amounts of their wealth to others during their lifetime and upon their death, based on the unified transfer tax. Transfers made during their lifetime are reported on gift tax returns (Form 709), and the estate tax return (Form 706) combines all reported gifts and the value of the estate at death to determine if any additional taxes are due. The estate tax is discussed later.

<table>
<thead>
<tr>
<th>Gross Gifts – Form 709</th>
<th>Gross Estate – Like a personal B/S (706)</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Cash</td>
<td>+ All Assets (+IRD → Money coming in later)</td>
</tr>
<tr>
<td>+ Property</td>
<td>+ Life Insurance Proceeds</td>
</tr>
<tr>
<td>+ Loan interest</td>
<td>+ Revocable Trust</td>
</tr>
<tr>
<td>+ Bargain sale</td>
<td>+ ½ of property with spouse</td>
</tr>
<tr>
<td>+ Irrevocable Trust (P.V)</td>
<td>= Gross Estate (Value @ Death or AVD-6 mo's)</td>
</tr>
<tr>
<td>= Gross Gifts</td>
<td></td>
</tr>
</tbody>
</table>

EXCLUSIONS

- Support Minors
- Marital Deduction
- Education & Medical Bills → (Paid directly to school/hospital)
- $14,000 Gift Exclusion
  (start enjoyment now)

= Taxable Gifts (709)
+ T.G.s over the years
+ Taxable Estate

= Total Taxable Transfer
× tax rate
= tentative tax liability
- Unified credit
- Other credits
- Prepayments

= Tax due (706 due 9 mo's after death)

There are three types of transfers that may take place during a person's lifetime:

Gift of a present interest – An immediate transfer of wealth that can be accessed by the recipient immediately.

Gift of a future interest – An irrevocable transfer of the right to access wealth at a future time.

Uncompleted gift (no interest) – A revocable transfer of the right to access wealth at a future time.

A gift of a present interest ("start enjoyment NOW") normally must be reported in years in which the taxpayer transfers more than $14,000 in wealth to a single individual ($28,000 for MFJ with gift-splitting election).

- Right to immediately use and enjoy the property. A present interest exists if:
  - Annuity starting now

©Roger CPA Review
o Outright ownership of the property
o The guaranteed right to immediately receive the periodic dividends, rents or other income stream the property generates.

- A delayed right to property does not qualify.
- Depositing cash into a joint bank account with an intended beneficiary (noncontributing tenant) only becomes a gift when the beneficiary withdraws funds from that account for his own benefit.

- Exclusions:
  o Gifts to spouses. Gifts given in contemplation of marriage (engagement rings) are not exempt.
  o Support minors
  o Payments directly to schools for tuition for another.
  o Payments directly to health care providers for another.
  o $14,000 annual exclusion

A gift of a future interest must be reported, regardless of size, at the present value of the future interest.

- Any gift in which amount is not immediately available to gift beneficiary (cannot enjoy now).
- Does not qualify for the $14,000 annual exclusion.

An uncompleted gift (no interest) is not reported, and the wealth is still considered a part of the taxpayer's estate as long as they retain their right to revoke the transfer.

- When donor retains right to revoke gift (e.g., revocable trust)

Gifts may involve:

- Transfers of cash or property
- Sales of property at a bargain price to another family member
- Loans to family members on which a fair rate of interest is not charged (i.e., imputed interest)
- Trusts established for others in which income and/or corpus will eventually go to someone other than the taxpayer.

It is possible for the interests in a trust to be split. If the income of the trust each year goes immediately to one beneficiary, and the corpus will go to another at the time the trust terminates, then the grantor of the trust is making a gift of a present interest to the income beneficiary each year and a gift of a future interest (assuming it is irrevocable) to the remainder beneficiary.

The following are automatically excluded from the definition of taxable gifts:
- Transfers to spouses (must be married at the time of transfer)
- Transfers to qualified charitable organizations
- Political contributions to organizations
- Payment of medical expenses or tuition of another (must be made directly to the health care or education provider)

Gift tax returns (Form 709) are due by April 15 of the year following the calendar year in which the reportable gifts occur. The fact that a gift must be reported on a gift tax return does not, however, automatically mean that any tax liability will be owed. Each individual is permitted to make taxable gifts up to their lifetime limit before owing any tax. The lifetime exclusion amount is $5,490,000 for 2017.
Effective for estate tax returns filed after July 31, 2015, there are new requirements for reporting the basis of estate assets. In a nutshell, **basis must be consistently reported between the estate and the heirs**; more specifically, IRC Sec. 1014(f)(1) provides that the basis of any property to which this provision applies cannot exceed the final valuation of the property determined for estate tax purposes.

- Only applies to property that increased the tax liability of the estate.
- An information statement (Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent*, and Schedules A) must be filed with the IRS and furnished to each beneficiary stating such valuation/basis within 30 days of the earlier of the due date of the estate tax return or the date the return was filed.

**Portability** allows spouses to combine their estate tax exemptions, so they can give away or leave more than $10,980,000 (2017) without owing taxes. So, if the first spouse to die doesn't use up their individual gift/estate tax exemption, the surviving spouse gets to use what is left. It does require the living spouse to file an estate tax return, even though no tax is due at that time. When the second spouse dies, their heirs can use some of the first spouse's unused exemption plus the current spouse's exemption, so no estate tax may be due, even though the estate is over the exemption amount.
Once the taxable estate is determined, the **tentative tax** is computed based on the appropriate tax tables. This tentative tax is then reduced by various credits:

- **Foreign tax credit** – Taxes paid on property in other countries to the extent the property has been taxed twice.

- **Unified credit** (a.k.a., applicable credit) – A credit that is large enough to eliminate the tax on an estate equal to the lifetime exclusion (i.e., about 40% × $5,490,000 lifetime exclusion for 2017).

- The former *State Death Tax credit* has been replaced by the **State Death Tax deduction**.
The amount of the DPAD is generally calculated at 9% of the lesser of (1) QPAI or (2) taxable income computed before this deduction; however, the second part of this calculation changes depending on the nature of the entity:

- For C corporations, the deduction is limited to taxable income (i.e., DPAD is 9% of the lesser of QPAI or taxable income).
- For sole proprietors, partnerships, S corporations, or LLCs, the deduction is limited to AGI (i.e., DPAD is 9% of the lesser of QPAI or AGI).
- For all entities, the deduction cannot exceed 50% of W-2 wages.

Depreciation Recapture is discussed in another section.
The tax treatment of sales of **ordinary income assets** is extremely straightforward: all gains and losses are fully included in the determination of taxable income with no special treatment or limitations (assuming an arm's-length transaction, i.e., no related parties are involved).
Section 1250 Depreciation Recapture for Real Property

When depreciable real property, consisting of buildings and structural components, is sold at a gain, it is subject to Section 1250 depreciation recapture. As a result, the amount of the gain, up to additional depreciation, is treated as an ordinary gain. Any gain in excess is Unrecaptured 1250 gain, which is treated as Section 1231 gain, and taxed as a LTCG at 25% (i.e., on an individual tax return—does not apply to corporations).

The amount of additional depreciation, if any, is affected by the holding period of the asset.
- If the asset was held for 1 year or less, additional depreciation is all depreciation.
- If the asset was held for more than 1 year, additional depreciation is depreciation in excess of the amount that would have been taken under straight-line. Note: Since straight-line is the depreciation method required for real property, this applies in limited circumstances.
Gifts are excluded from gross income. Although the donor of a gift may have to report and pay gift taxes in some cases, the recipient (donee) of the gift generally does not report any taxable income on the receipt of the gift. If the gift is in the form of appreciated property, the cost basis and acquisition date of the property to the donee is the same as for the donor (Carryover basis & Carryover Holding Period).

For example: If Greta Giver purchased stock in 20X1 for $10,000, and gave it to her son Ron Recipient in 20X8 at a time the stock was worth $30,000, Ron would report no income from the receipt of the stock. If Ron sold the stock for $29,000 later in 20X8, he would have to report a long-term capital gain on the sale of $19,000. Both the gain and the long-term status result from carrying over Greta's purchase price of $10,000 in 20X1.

If the donor pays gift taxes on a gift, the portion of the tax paid attributable to the appreciation in the property’s value at the date of the gift over the donor’s basis, is added to the donee’s basis.

For example: Assume Tara gives Sam land worth $200,000 and pays $27,000 in gift taxes. Tara bought the land for $150,000. Sam’s basis in the gift from Tara includes Tara’s $150,000 basis in the property plus the portion of the gift taxes paid that is attributable to the increase in value at the date of the gift, calculated as follows: $200,000 FMV on date of gift – $150,000 basis = $50,000 increase in value. $50,000 increase/$200,000 FMV = 25% × $27,000 gift tax paid = $6,750 applicable portion of gift tax + Tara’s $150,000 basis = $156,750 for Sam’s basis.

When the value of the property on the date of the gift is lower than the donor basis (dropped in value), the donee must keep track of both amounts (Dual-Basis Rules). The higher donor basis is used to calculate a subsequent gain on sale, and the lower FMV on the gift date is used to calculate a subsequent loss on sale. If the selling price is between the two amounts, the selling price is also used as the basis, so that no gain or loss results. The effect is to not tax the donee on gains to the extent the donor suffered a non-deductible loss. The acquisition date for the donee is the date from which the amount used as basis was derived.
What is Cost or Tax Basis?
1) Inherited → FMV at date of death or AVD → L/T
2) Gift → Carryover basis → Carryover holding period
   • Add portion of gift taxes paid to basis for appreciation in property value,
   • If dropped in value (dual-basis rules) – What do you eventually sell it for?

Between =
No G/L

$ 12 Selling Price
$ 10 Carryover basis

$ 6 FMV
$ 3 Selling Price

$ 2 GAIN
$ (3) LOSS

TYPES OF PROPERTY — SUMMARY

<table>
<thead>
<tr>
<th>Property Category</th>
<th>Included in Category</th>
<th>Tax Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Assets</td>
<td>All assets except:</td>
<td>INDIVIDUALS:</td>
</tr>
<tr>
<td></td>
<td>• Inventory</td>
<td>LTCG: Special rates</td>
</tr>
<tr>
<td></td>
<td>• Business receivables</td>
<td>STCG: Regular rates</td>
</tr>
<tr>
<td></td>
<td>• Self-created artistic works</td>
<td>• Net loss: Maximum of $3,000</td>
</tr>
<tr>
<td></td>
<td>• Depreciable or amortizable business assets, and land used in a business (1231)</td>
<td>during the current year.</td>
</tr>
<tr>
<td></td>
<td>• Treasury stock</td>
<td>• Carryforward indefinite.</td>
</tr>
<tr>
<td>Ordinary Assets</td>
<td>• Inventory</td>
<td>CORPORATIONS:</td>
</tr>
<tr>
<td></td>
<td>• Business Receivables</td>
<td>• Net loss: Not deductible</td>
</tr>
<tr>
<td></td>
<td>• Self-created artistic works</td>
<td>• Carryback 3 years</td>
</tr>
<tr>
<td>Section 1231 Assets</td>
<td>• Depreciable or amortizable business assets</td>
<td>• Carryforward 5 years</td>
</tr>
<tr>
<td></td>
<td>• Land used in a business (parking lot and shed)</td>
<td>• Considered S/T</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net gains are generally</td>
</tr>
<tr>
<td></td>
<td></td>
<td>considered to be LTCG.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net losses are generally</td>
</tr>
<tr>
<td></td>
<td></td>
<td>considered to be ordinary losses.</td>
</tr>
</tbody>
</table>

©Roger CPA Review
6. **Sale of Personal Residence**
   
   There is also special treatment for individuals for a **gain on sale of personal residences**. Under IRC Section 121, if a taxpayer sells a home that served as the taxpayer's principal residence for at least 2 of the previous 5 years, the first **$250,000** of the gain on sale is not recognized (**$500,000** for a married couple filing a joint return). Can do every 2 years.
   
   - If don't meet 2-year requirement but forced to sell due to change in place of employment (50+ miles), health or other unforeseen circumstances (war, divorce, death), a pro rata amount of the exclusion applies.
   - The exclusion of gain does not apply to periods of **nonqualified use** after 2008. Nonqualified use generally includes any use other than as a principal residence, except any use during (1) the 5 years between the sale and when the taxpayer last used the property as a personal residence, (2) a military service absence for up to 10 years, and (3) a temporary absence up to 2 years for certain unforeseen circumstances. When there is nonqualified use, the exclusion is reduced by a pro rata amount based on the ratio of the length of nonqualified use to the total time of ownership. **For example**, if Jim owned a home for the last 5 years and used it as a personal residence for the first year, rented it out for the next 3 years, and then moved back in for the last year, the exclusion would be reduced by 3/5 for the period of nonqualified use. Thus, if Jim has a gain of $100,000 on the sale, he can exclude only 2/5 of it from his gross income, or $40,000, and must recognize the other $60,000.
Explanation of solutions

1. (C) Capital assets that are held for one year or less are considered short-term. As a result, the gain from the sale of stock held for 10 months would be a short-term capital gain.

2. (E) Assets used in a trade or business, such as land, buildings, and equipment, are considered Section 1231 assets if they are not inventory. If they are held for one year or less, gains and losses are ordinary. If they are held for longer than one year, net gains on Section 1231 assets that exceed depreciation recaptured are taxed as long-term capital gains, and net losses on Section 1231 assets are deductible as ordinary.

3. (F) Depreciable personal property that is used in a trade or business is subject to depreciation recapture under Section 1245 to the extent of depreciation allowed on the property. The portion of the gain recaptured under Section 1245 is taxed as ordinary income. Any remaining gain on such assets held longer than one year is Section 1231 gain (i.e., treated as long-term capital gain).

4. (G) Depreciable real property that is used in a trade or business is subject to depreciation recapture under Section 1250 if accelerated depreciation methods were applied, or the property was held less than one year. For property held longer than one year, gain is recaptured as ordinary income to the extent of depreciation taken in excess of the straight-line method. For property held less than one year, gain is recaptured as ordinary income to the extent of all depreciation claimed. Any remaining gain (referred to as unrecaptured Section 1250 gain) is Section 1231 gain and is considered a long-term capital gain.

5. (E) Assets used in a trade or business, such as land, buildings, and equipment, are considered Section 1231 assets if they are not inventory. Net gains on Section 1231 assets that exceed depreciation recaptured are taxed as long-term capital gains, and net losses on Section 1231 assets are deductible as ordinary. If assets used in a trade or business are held for one year or less, gains and losses are ordinary.

6. (A) Personal assets, including personal jewelry, automobiles, and personal residences, are considered capital assets; thus, gains on the sale of personal assets are capital gains, taxed as short-term or long-term capital gains, depending on the holding period. Inherited assets, however, are always treated as long-term. In certain circumstances, some or all of the gains on personal residences are not taxable. Losses from the sale of personal assets are not deductible.

7. (I) Personal assets, including personal jewelry, automobiles, and personal residences, are considered capital assets. Gains on the sale of personal assets are capital gains, taxed as short-term or long-term capital gains, depending on the holding period. In certain circumstances, however, some or all of the gains on personal residences are not taxable. Losses from the sale of personal assets are not deductible.

8. (F) Depreciable personal property that is used in a trade or business is subject to depreciation recapture under Section 1245 to the extent of depreciation allowed on the property. The portion of the gain recaptured under Section 1245 is taxed as ordinary income. Any remaining gain on such assets held longer than one year is Section 1231 gain (i.e., treated as long-term capital gain).
9. (I) Gambling losses are deductible only to the extent of winnings from gambling. In a period in which there were no gambling winnings, gambling losses would not be deductible.

10. (H) Business assets that are held for sale in the ordinary course of business, such as inventory and receivables that result from the sale of inventory or providing services, are considered ordinary assets. Sales of ordinary business assets result in ordinary income or losses.

11. (E) Assets used in a trade or business, such as land, buildings, and equipment, are considered Section 1231 assets if they are not inventory. If they are held for one year or less, gains and losses are ordinary. If they are held for longer than one year, net gains on Section 1231 assets that exceed depreciation recaptured are taxed as long-term capital gains, and net losses on Section 1231 assets are deductible as ordinary.

12. (A) Personal assets, including personal jewelry, automobiles, and personal residences, are considered capital assets; thus, gains on the sale of personal assets are capital gains, taxed as short-term or long-term capital gains, depending on the holding period. Inherited assets, however, are always treated as long-term; therefore, this would be considered a long-term capital gain. In certain circumstances, some or all of the gains on personal residences are not taxable. Losses from the sale of personal assets are not deductible.
Generally, exempt status is not automatic; a written application (Form 1023) must be filed with the IRS requesting approval as an exempt organization within 27 months from the end of the month in which they were organized. The organization generally must operate in the form of a:

- Corporation or
- Trust.

Note: Public charities with no more than $5,000 of gross receipts and religious organizations are automatically exempt if they meet the Section 501(c)(3) requirements; i.e., they need not file Form 1023.
## Tax-Exempt Organizations

<table>
<thead>
<tr>
<th>Form It</th>
<th>Filings</th>
<th>UBI (Unrelated Business Income)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Must fall under specific categories</td>
<td>5/15 – Information Return Due- Form 990</td>
<td>Tattoo parlor @ church or school</td>
</tr>
<tr>
<td>Corporation OR Trust</td>
<td>Identify contributors</td>
<td>Taxed as either a corporation or trust</td>
</tr>
</tbody>
</table>
| **27 months** to file paperwork when comes into existence | Identify amount contributed | **UBI (Expenses)**
| | | ($1,000)
| | | = **UBTI**

### Public/Private

1. **Private** = Most of funding comes from private foundation or group of people,
   2. Rest are **Public**

<table>
<thead>
<tr>
<th>Public/Private</th>
<th>Identify gross receipts/distributions</th>
<th>Either goods (Goodwill) or services (hospital gift shop) have to be free in order to not be taxed on UBI.</th>
</tr>
</thead>
</table>
| UNLESS → No return | 1) You are a CHURCH  
2) Gross receipts < **$50,000** | • **Exceptions** = Campus Bookstore and Cafeteria  
• Related → for the benefit of the members (students) |

### Notes
- **Corp Rate**
- **Trust Rate**
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 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.

If part of a tax underpayment is the result of fraud (i.e., the actual, deliberate or intentional misreporting of taxable income with the specific purpose of evading a tax believed to be owing), there is an additional penalty equal to 75% of the portion of the underpayment attributable to the fraud.
PREPARER RESPONSIBILITIES

The AICPA’s Statements on Standards for Tax Services (SSTSs) are enforceable tax practice standards with which all AICPA members providing tax services must abide. Note, however, the SSTSs are no longer tested on the CPA exam.

There are several special obligations imposed on paid tax return preparers. Penalties for failure to comply with such obligations apply under IRC Sec. 6695. A “tax return preparer” for these purposes includes anyone who prepares for compensation, or who employs one or more persons to prepare, all or a substantial portion of any tax return or claim for refund. Does not include those who provide typing, reproduction, or other mechanical assistance. Also, a person who prepares a personal return for their employer (i.e., the return of an officer, partner, member, shareholder, etc.) is not considered a “tax return preparer.”

- The preparer must sign the preparer’s declaration on the tax return and provide their preparer tax identification number (i.e., PTIN).
- The return must be timely filed and a copy of the completed return must be provided to the taxpayer.
- The preparer must retain either documentation of the taxpayer’s name and tax identification number or a copy of the prepared return for 3 years.
- The preparer need not obtain from the taxpayer documentation of information provided to prepare the return, but must make reasonable inquiries about the existence of such support where appropriate. For example, the preparer should ask the client if travel and entertainment costs are supported by a log and if charitable contributions exceeding $250 are supported by receipts from the charities.
Information that is obtained from a client in connection with the preparation of their tax return is confidential, and the preparer is not permitted to use it for personal benefit or reveal this information to third parties without the consent of the taxpayer except in limited circumstances. The most important exceptions are:

- To respond to a valid government order (while discussions between CPAs and clients on federal tax matters are privileged, this does not apply to criminal matters and tax shelters).
- As part of a quality control peer review program.
- To permit the electronic preparation or submission of the taxpayer's return.
- To secure legal advice from an attorney.
Who can sue?

- Anyone, including unforeseen parties

A plaintiff must prove all of the following in order to succeed in a case based on fraud (RIMS or MILE):

- **Reliance** – The plaintiff must have justifiably relied on the financial statements.
- **Intent to deceive** – The auditor must have had actual or constructive knowledge that their opinion was inappropriate.
- **Material misstatement** – The financial statements must have contained material misstatements or omissions.
- **Suffered loss** – The plaintiff must have suffered a financial loss as a result of the above.

**Defenses** by accountant:

- Not gross negligent; followed GAAS (showing due professional care)
- Not material
- Good faith and no knowledge of falsity
TAX RETURN PREPARERS

A “tax return preparer” includes anyone who prepares *for compensation*, or who employs one or more persons to prepare, all or a substantial portion of any tax return or claim for refund.

- Need not be enrolled to practice before the IRS.
- Considered a preparer only if compensation is received, which can be either explicit or implicit.
- Performing the following acts does NOT classify a person as a tax preparer:
  - Preparing a return for family or a friend free of charge
  - Simply typing, reproducing, or providing other mechanical assistance in preparing a return

Tax return preparers are required to register for a Preparer Tax Identification Number (PTIN). This nine-digit number must be used by paid tax return preparers on all returns or claims for refunds. Paid preparers must renew their PTINs annually to legally prepare tax returns.

Information that is obtained from a client in connection with the preparation of their tax return is *confidential*, and the preparer is not permitted to use it for personal benefit or reveal this information to third parties without the consent of the taxpayer, except in limited circumstance. The most important *exceptions* are:

- To respond to a valid government order (while discussions between CPAs and clients on federal tax matters are privileged, this does not apply to criminal matters and tax shelters).
- As part of a quality control peer review program.
- To permit the electronic preparation or submission of the taxpayer's return.
- To secure legal advice from an attorney.
2. With respect to any given tax return, which of the following statements is correct?
   a. More than one person may be deemed to be a preparer of a tax return.
   b. The final reviewer of a tax return is automatically considered the preparer of the return.
   c. Only one person may be deemed to be a preparer of a tax return.
   d. The two individuals who have done the most work in preparing the return will be deemed to be the only preparers.
2. (a) Multiple individuals may be held responsible as the preparer for any one tax return. Under Regulation §301.7701-15(a), a tax return preparer is defined as “any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code (Code).” This can include a signing preparer and any number of nonsigning preparers since Regulation §301.7701-15(b)(3) provides that a single entry on a tax return could constitute a “substantial portion” of a return depending on the size and complexity of the entry. While a final reviewer, or “signing tax return preparer,” has the primary responsibility for the overall substantive accuracy of the preparation of a return or claim for refund, other nonsigning preparers may also be held responsible for the same return as a preparer.
Exemptions (ACID-BRAINS)

Section 3 of the Securities Act of 1933 describes certain securities that are exempt, while Section 4 describes certain transactions that are exempt.

- **Regulation A** – small public offerings (< $50M over 12 months; 20-day notice/waiting period; offering circular; can advertise/resell)
- **Commercial paper** (notes, bonds) mature ≤ 9mo's and used for Commercial (not investing) purposes
  - Casual sales by other than issuer, underwriter, dealer
  - Crowdfunding (< $1M over 12 months sold through online intermediary)
- **Intrastate offerings**
  - At least 80% of co sales are exclusive to state of incorporation and principal place of business, but buyers cannot resell outside the state for 9 months.
- **Regulation D** – Private placement offerings (Rule 504 < $5M; Rule 506 = unlimited)
- **Brokerage transactions**
- **Regulated industries** (Savings and loans – e.g., cd’s)
- **Agencies of the Gov.** (Railroads, Municipal bonds)
- **Insurance contracts/Policies**
  - But stock issued by insurance companies is not exempt.
- **Not for profit** (charity/church)
- **Stock dividends / Splits** (i.e., exchanges with existing holders) as long as no commission is paid.

Regulation A – Small Public Offerings of Privately Held Corporations

Regulation A applies to offerings that raise up to **$50 million** over a period not exceeding **12 months**. Securities must be unrestricted equity securities, debt securities, and debt securities that are convertible into equity securities. The requirements are:

- The SEC must be notified within **20 days** of the first sale.
- An **offering circular** (mini-registration statement) containing key information about the company must be prepared and provided to all prospective investors (an offering circular is far less extensive than a prospectus).
- The following disclosure requirements apply 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.
- Secondary sales are limited to 30% of the original offering or any other offering in the first year.
Casual sales are exempt. These refer to sales by persons not connected with the issuing company, and are available to all sellers except:

- Issuers
- Underwriters
- Dealers
- Directors
- Officers
- Owners of at least 10% of any class of shares

**Regulation Crowdfunding**

Allows entities to issue securities through "crowdfunding," which is the obtaining of small investments from a large number of investors. This exemption 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 ($1,070,000 as adjusted for inflation).
- Limits are set on amounts individual investors may invest per 12-month period:
  - The greater of $2,000 ($2,200 as adjusted for inflation) or 5% of annual income or net worth (if less), for those with annual income or net worth less than $100,000 ($107,000 as adjusted for inflation).
  - Up to 10% of annual income or net worth (if less) up to a maximum of $100,000 ($107,000 as adjusted for inflation), if both annual income and net worth equal or exceed $100,000 ($107,000 as adjusted for inflation).
- 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
    - F/S certified by principal executive officer
  - $100,000 – $500,000
    - Reviewed F/S
  - $500,000 – $1,000,000
    - Audited F/S—however, if issuing for first time under Regulation Crowdfunding, then reviewed F/S

**Intrastate offers** are exempt as long as:

The company does at least 80% of its business operations in a single state.

Securities are offered exclusively to residents of that state.

The investors agree not to resell their securities to non-residents for at least 9 months.

In addition to the exemptions already mentioned (Regulation D, Regulation A, intrastate offers, casual sales), there are several other minor exemptions that are occasionally mentioned on the exam, though not in any detail:

- Sales of government securities
- Issuances by companies that are already being regulated by a federal agency (such as banks regulated by the Federal Reserve System and railroads regulated by the Interstate Commerce Commission)
- Insurance policies
- Fund-raising by non-profit organizations
• Short-term loans to be repaid within 9 months (also known as commercial paper)
• Exchanges of securities with existing shareholders at no charge, such as stock splits and dividends

The Securities Act of 1933 imposes substantial obligations on the auditors involved in the preparation of the prospectuses. These liability issues are discussed as part of the accountant liability section.

Lecture 12.04
Regulation D Exemption – Private Placement (504, 506)

The general purpose of Regulation D is to simplify the sale of securities to sophisticated and “accredited investors.”

• Accredited investors include:
  o Banks, savings and loans, credit unions, insurance companies, broker dealers, certain trusts, partnerships, corporations, etc.
  o Wealthy individuals
    ▪ Net worth exceeding $1,000,000 (excluding primary residence) or
    ▪ Net income of $200,000 ($300,000 MFJ) for the two most recent years

• Rule 504 – Offerings up to $5 million to be completed within 12 months (Seed Capital exemption).
  o SEC must be notified (Form D) within 15 days of first sale.
    ▪ No general advertising or solicitation is generally allowed.*
    ▪ Generally, restricted securities – Resale is permitted after one year.*
    ▪ No special info given to investors.
    ▪ Unlimited number of investors, accredited or nonaccredited.
    ▪ Companies cannot use this exemption if they are already required to report under the 1934 act or if they are an investment company.
    ▪ *Note: Solicitation and resale restrictions may not apply if securities are exempt under certain state laws (i.e., blue sky laws).

• Rule 506 – Unlimited as to dollar value and time.
  o SEC must be notified (Form D) within 15 days of first sale.
  o General solicitation and advertising of the offer is allowed as long as sales are made only to accredited investors.
  o No resale for one year (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.
  o Unlimited number of accredited investors allowed.
  o Limited to 35 or fewer nonaccredited investors. Such nonaccredited investors must be sophisticated investors or be represented in their purchase by a sophisticated investor (i.e., an investor with the knowledge and experience in financial and business matters that enables them to evaluate the merits and risks of the investment).
  o Audited balance sheet (at a minimum) must be provided to nonaccredited investors.
Can use if required to report under 1934 act.

### Regulation D – Private Placement

<table>
<thead>
<tr>
<th>Rule 504</th>
<th>Rule 506</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Notify SEC within <strong>15 days</strong> of first sale (Form D)</strong></td>
<td><em><em>General solicitation and advertising</em> allowed if purchasers are all accredited investors</em>*</td>
</tr>
<tr>
<td><em><em>No general solicitaton or advertising</em> (generally)</em>*</td>
<td><strong>Investment purpose only – Cannot resell for 1 year</strong></td>
</tr>
<tr>
<td><strong>Resale generally restricted up to 1 year</strong></td>
<td><strong>Offerings ≤ $5,000,000</strong></td>
</tr>
<tr>
<td><strong>Offerings must occur within 12-month period</strong></td>
<td><strong>Unlimited dollar amount</strong></td>
</tr>
<tr>
<td><strong>Unlimited number of investors</strong></td>
<td><strong>Unlimited amount of time for issuance</strong></td>
</tr>
<tr>
<td><strong>Financial information given: Nothing</strong></td>
<td><strong>Unlimited Accredited Investors</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Non-accredited ≤ 35 (0 if general solicitation)</strong></td>
</tr>
</tbody>
</table>

* General solicitation/advertising includes newspaper, magazine, TV, and radio ads, ads on public websites, as well as any seminars where participants are invited by such advertising.

### Exemption under Rule 144

A purchaser of restricted securities in a private offering (REG D), who purchased them for investment purposes rather than resale, may resell the securities subject to certain restrictions, without being subject to the registration provisions. The securities must have been held for at least 1 year; only limited amounts of stock may be sold (i.e., they may not all be “dumped” on the market, but rather “trickled” (no more than 1% of all outstanding shares sold every 3 months); and the SEC must be notified of the intention to sell the restricted securities. Note: The holding period is 6 months for a company subject to the reporting requirements under the 1934 Act.
Under the Liability provisions of Section 10, Rule 10b-5, it is unlawful to make any untrue statement of a material fact or to omit a material fact (e.g., writing off a material bribe as a consulting fee in a 10Q). Under Section 18, it is unlawful to make false or misleading statements with respect to a material statement unless done in “good faith” (e.g., Intentionally filing an incorrect quarterly report with the SEC).

- Registration and reporting requirements (S-1) apply if either:
  - Listed or Traded on a national exchange, or
  - At least $10 million in assets and 2,000 shareholders (500 if nonaccredited shareholders). Note: Shares held by employees who received their shares under an employee stock compensation plan are not included in nonaccredited shareholder count.

  - Required disclosures:
    - Names of officers and directors
    - Nature of business
    - Financial structure of firm
    - Any bonus and profit-sharing provisions

- Forms S-2 and S-3 that require less detailed information may be filed by issuers under certain circumstances.
Questions 6 and 7 are based on the following:
Pix Corp. is making a $56,000,000 stock offering. Pix wants the offering exempt from registration under the Securities Act of 1933.

6. Which of the following provisions of the Act would Pix have to comply with for the offering to be exempt?
   a. Regulation A.
   b. Regulation D, Rule 504.
   c. Regulation Crowdfunding.
   d. Regulation D, Rule 506.

7. Which of the following requirements would Pix have to comply with when selling the securities?
   a. No more than 35 investors.
   b. No more than 35 Nonaccredited investors.
   c. Accredited investors only.
   d. Nonaccredited investors only.
5. **(b)** Regulation D provides 2 exemptions for private placements of securities. Although there are restrictions, both exemptions allow for the sale of exempt securities to both accredited and nonaccredited investors. Answer (a) is incorrect because the exemption under Rule 506 does limit nonaccredited investors to a maximum of 35, but not all investors. Answer (c) is incorrect because the exemptions under Rules 504 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 has been repealed.

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. Exemption under Regulation A is limited to offerings of up to $50 million. Rule 504 of Regulation D is limited to offerings of up to $5 million. Regulation Crowdfunding is limited to offerings up to $1,000,000, as adjusted for inflation.

7. **(b)** Under Rule 506 of Regulation D, there is no limit on sales to accredited investors but sales to nonaccredited investors is limited to a maximum of 35.

8. **(a)** The Securities Act of 1933 applies to issuances of securities in interstate commerce. An offering that is exclusively intrastate by an issuer that resides and does business in that state would be exempt and would not be regulated by the SEC. Such shares are to be held for at least 9 months before being sold to investors outside the state.
Butler raised an additional $16,450,000 through the following stock offerings, which were sold completely:

- **June 20X2**—Butler made a $450,000 unregistered offering of Class B nonvoting common stock under Rule 504 of Regulation D of the Securities Act of 1933. This offering was sold over one year to 20 accredited investors with no general solicitation. The SEC was notified eight days after the first sale of this offering.

- **September 20X2**—Butler made a $10,000,000 unregistered offering of Class A voting common stock under Rule 506 of Regulation D of the Securities Act of 1933. This offering was sold over one year to 200 accredited investors and 30 non-accredited investors through a private placement. The SEC was notified 14 days after the first sale of this offering.

- **November 20X2**—Butler made a $6,000,000 unregistered offering of preferred stock under Rule 504 of Regulation D of the Securities Act of 1933. This offering was sold during a one-year period to 40 non-accredited investors by private placement. The SEC was notified 18 days after the first sale of this offering.
Items to be answered:

**Items 1 through 5** are questions related to the June 20X2 offering made under Rule 504 of Regulation D of the Securities Act of 1933. For each item, indicate your answer by choosing either Yes or No.

1. Did the offering comply with the dollar limitation of Rule 504? ○ ○
2. Did the offering comply with the method of sale restrictions? ○ ○
3. Was the offering sold during the applicable time limit? ○ ○
4. Was the SEC notified timely of the first sale of the securities? ○ ○
5. Was the SEC correct in claiming that this offering was not exempt from registration? ○ ○

**Items 6 through 10** are questions related to the September 20X2 offering made under Rule 506 of Regulation D of the Securities Act of 1933. For each item, indicate your answer by choosing either Yes or No.

6. Did the offering comply with the dollar limitation of Rule 506? ○ ○
7. Did the offering comply with the method of sale restrictions? ○ ○
8. Was the offering sold to the correct number of investors? ○ ○
9. Was the SEC notified timely of the first sale of the securities? ○ ○
10. Was the SEC correct in claiming that this offering was not exempt from registration? ○ ○

**Items 11 through 15** are questions related to the November 20X2 offering made under Rule 504 of Regulation D of the Securities Act of 1933. For each item, indicate your answer by choosing either Yes or No.

11. Did the offering comply with the dollar limitation of Rule 504? ○ ○
12. Was the offering sold during the applicable time limit? ○ ○
13. Was the offering sold to the correct number of investors? ○ ○
14. Was the SEC notified timely of the first sale of the securities? ○ ○
15. Was the SEC correct in claiming that this offering was not exempt from registration? ○ ○
Explanations

1. (Y) The dollar limitation for an offering under Rule 504 of Regulation D is $5 million. Since the offering was for $450,000, it complies.

2. (Y) Under Rule 504 of Regulation D, general solicitation is generally not allowed (unless exempt under state law).

3. (Y) Rule 504 of Regulation D applies to offerings of up to $5 million that are completed within 12 months.

4. (Y) Under Rule 504 of Regulation D, an issuer is required to notify the SEC within 15 days of the first sale.

5. (N) It appears that the offering in June 20X2 met all of the requirements for exemption under Rule 504 of Regulation D, and the SEC is not correct in its assertion.
Explanations

11. (N) Rule 504 of Regulation D allows for an exemption from registration for offerings of up to $5 million.

12. (Y) Rule 504 of Regulation D requires offerings to be completed within 12 months.

13. (Y) Rule 504 of Regulation D allows sales to an unlimited number of investors of any type.

14. (N) Rule 504 of Regulation D requires notification of the SEC within 15 days of the first sale.

15. (Y) This offering violated a couple of the requirements of Rule 504 of Regulation D, including being over the $5 million limit by $1 million and not notifying the SEC until 18 days after the first sale, instead of the required 15 days.
3 Basic Partner Rights

A partnership is an association between two or more persons to operate a business as co-owners for profit. **Informally created** since the partners have **Unlimited Liability**. The Partners are **agents** of the partnership. In such an arrangement, partners have **three basic rights**:

- **Profits (Interest)** – Each partner generally has a right to a proportionate share of (1) the profits generated by the business and (2) a return of the net assets in the partnership in the event the partnership terminates. This is known as the **partnership interest**. The right is personal and **transferable/assignable** without the need for approval by the other partners. As a result, a partner can transfer their interest in the partnership to a personal creditor, or the courts may permit a personal creditor to seize that interest to satisfy an unpaid personal debt of the partner. When that occurs, the creditor is entitled to receive that partner’s share of profits and distributions.

- **Property** – All property acquired by a partnership becomes partnership property and belongs to the partnership as an entity, rather than to the individual partners. Each partner has a right to use partnership property for partnership purposes. Under RUPA, partnership property not only includes property purchased in the partnership name but also includes property purchased by a partner, who is an agent of the partnership, with partnership funds. This right is **not transferable/assignable**, so a personal creditor of a partner cannot obtain a right to any specific partnership property as a result of an assignment of interest by that partner.

- **Participation (Management Right – vote/make contracts/debts)** – Each partner has a right to participate in the management of the business, including a right to inspect the books and records of the business at any time, make contracts, and vote on partnership actions. This right is also **not transferable/assignable**.
Taxation

• Both are pass-through entities.
• Both may report their operations by filing Form 1065 and distributing K-1s to its members or partners.
  o An LLP is always treated as a partnership.
  o An LLC with more than one member is treated as a partnership, and those with one member are treated as sole proprietorships (Schedule C). **Note:** These are the default tax classifications; an LLC can also elect to be treated as a corporation by filing Form 8832, *Entity Classification Election*. 
A tort is an action that causes injury to another person or their property, whether intentional or caused by negligence, which may result in a civil trial. Generally, when there is criminal intent and a criminal act, the action may also constitute a crime, which would result in a criminal trial; however, not all crimes require criminal intent (e.g., selling alcohol to a minor without knowing he or she is, in fact, a minor). An individual is always responsible for their own torts and crimes. A principal is responsible for torts committed by an agent when committed in the course and scope of the agency relationship. A principal, however, is not responsible for crimes committed by an agent, although some states are expanding a principal's liability for actions of their agents.
Items to be answered:

c. Items 11 through 15 also represent creditor claims against the bankruptcy estate. For each of the creditors listed in Items 11 through 15, select from List II the amount that creditor will receive.

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>11.</td>
<td>TVN Computers, Inc.</td>
<td>A.</td>
<td>$0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12.</td>
<td>Hart Manufacturing Corp.</td>
<td>B.</td>
<td>$300</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13.</td>
<td>Ted Smith</td>
<td>C.</td>
<td>$600</td>
<td>D.</td>
<td>$1,000</td>
</tr>
<tr>
<td>14.</td>
<td>Power Electric Co.</td>
<td>E.</td>
<td>$1,200</td>
<td>F.</td>
<td>$2,400</td>
</tr>
<tr>
<td>15.</td>
<td>Soft Office Supplies</td>
<td>G.</td>
<td>$4,925</td>
<td>H.</td>
<td>$12,850</td>
</tr>
<tr>
<td></td>
<td></td>
<td>I.</td>
<td>$12,925</td>
<td>J.</td>
<td>$13,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td>K.</td>
<td>$15,000</td>
<td>L.</td>
<td>$25,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>M.</td>
<td>$27,500</td>
<td>N.</td>
<td>$30,000</td>
</tr>
</tbody>
</table>
13. Ted Smith is an employee and his claim is a priority claim. There is a limit of $12,850, however, resulting in an unsecured claim of the difference of $150. Smith will receive the priority amount of $12,850 plus 50 cents on the dollar for the remainder, or $75, for a total of $12,925.